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I.R.C. Conformity

Challenges by state taxing authorities to corporate structures involving real estate investment trusts are on the rise. In this article, authors Josie Lowman and Charolette Noel trace the development of REITs and discuss the associated state tax issues and challenges made by some states. Also discussed are recent legislative developments in various states affecting REITs.

State Taxation of REITs: Understanding the Issues Faced by Taxpayers and State Tax Administrators

BY JOSIE LOWMAN AND CHAROLETTE NOEL

Federal income tax laws generally provide certain beneficial treatment to real estate investment trusts (REITs). State legislatures, by conforming to the federal provisions, generally intended to afford REITs the same beneficial treatment.

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In some states, such as Louisiana, the challenge faced by tax administrators is that state income tax legislation conforms to the federal income tax treatment for REITs, but state and federal laws limit the states' ability to tax certain out-of-state REIT shareholders. More particularly, most state legislatures plainly intended, by incorporating a dividends-paid deduction, that REITs not pay an entity level tax on their earnings. States have constitutional and sometimes statutory limitations, beyond those faced by the federal government, on their ability to tax out-of-state shareholders. Because of the specific provisions enacted, it can hardly be said that these state laws reach an ''unintended'' result.

In other states, such as Massachusetts, the challenge of tax administrators is that state legislatures intentionally provided a state-specific dividends-received deduction for all corporate shareholders. As discussed below, for federal income tax purposes, a corporate shareholder of a REIT is not allowed a deduction for divi-

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dends received from a REIT. Several states, however, elected not to conform to the specific federal provision. These states adopted their own provisions regarding deductibility of dividends and do not provide an exception for dividends received from a REIT.

Following is a general discussion of the taxation of REITs, challenges in Massachusetts and Louisiana to REIT structures, and legislative developments in the area of taxation of REITs.

State Conformity to Federal Law

Many states base their state income tax laws on federal law; *i.e.*, they utilize federal taxable income or federal tax concepts to compute state taxable income. There are significant benefits to states for doing so, including ease of administration of tax laws by drawing upon a developed body of federal law and utilizing determinations of the Internal Revenue Service.

The taxation of REITs and REIT shareholders is being challenged in several states.

The extent to which states utilize federal law provisions varies by state. Said another way, states that conform to specific provisions of federal income tax law (*e.g.*, the definition of ''gross income'') also intentionally do not conform to other specific provisions of federal income tax law (*e.g.*, deductions for net operating losses and dividends received).

The ultimate legal result of choices by state legislatures to conform to federal law, or not to conform, has consequences that may be *perceived* as beneficial or detrimental, intentional or unintentional. The consequences, however, apply to both taxpayers and the states alike in accordance with the relevant rules of statutory construction.

Disputes Related to Conformity

As discussed above, one area where state-federal tax conformity issues have fueled a heated debate is state income taxation of REITs. Some tax administrators who are dissatisfied with the tax consequences of taxation of REITs and REIT shareholders are appealing to the courts, rather than to legislatures, to change the law. The taxation of REITs and, more particularly, REIT shareholders, is being challenged in several states, including Kentucky, Louisiana, Massachusetts, New Mexico, and North Carolina.

Generally, the authority to enact state tax laws is within the exclusive purview and jurisdiction of the state legislature. If the intent of the legislature or the enacted taxing statute is vague or ambiguous, rules of statutory construction typically require the taxing statute to be interpreted in favor of the taxpayer. Conversely, if a statutory credit or deduction is vague or ambiguous, rules of statutory construction typically require the deduction or credit to be interpreted against the taxpayer.

State legislatures have broad authority to determine the types of businesses subject to tax. States similarly have discretion to deviate from the federal tax treatment. When they do, states must abide by the duly enacted statutes until the legislature revises the law. If the state desires to tax a REIT, its shareholder, or other type of business not currently subject to tax, the state may enact any such tax as long as it meets the constitutional standards of:

- substantial nexus,
- nondiscrimination,
- fair apportionment, and
- a fair relationship to services provided by the state.[1]

One common dispute is whether states have substantial nexus with nonresident shareholders of a REIT based solely on the shareholder's stock ownership.

What Are REITs And How Do They Work?

REITs came into being in the 1960s when several real estate industry groups requested Congress to provide a tax favorable structure around investments based in real estate. The real estate groups wanted a single layer of tax, the same beneficial tax treatment that mutual funds and other more traditional investments received. In light of this request, Congress passed legislation that added Subchapter M to the Internal Revenue Code (I.R.C.), providing for the formation and taxation of REITs.

When the REIT I.R.C. provisions were first put into place, REITs were formed as—and considered—partnerships or trusts for federal income tax purposes. The I.R.C. sections were amended at a later date to provide that REITs could be formed as corporations and could be considered as such under federal income tax law. REITs are now permitted to be formed as trusts, partnerships, or corporations.

In simplified terms, a REIT must have at least 100 shareholders and can hold only certain types of real estate or real-estate-type investments. Federal income tax laws also require a REIT to distribute at least 90 percent of its earnings as a dividend each year. The REIT may hold realty (sometimes referred to as a ''dirt REIT'') or mortgages (referred to as a ''finance REIT'').

If the REIT holds actual realty, the REIT typically leases the property and collects rent from lessees. If mortgages were contributed to the REIT, the REIT collects the interest and principal payments on such mortgages.

Current I.R.C. provisions provide that REITs are taxed as corporations but are allowed a dividends-paid deduction (DPD). This provision affords the REIT the ability to avoid corporate level tax on its earnings, consistent with the intent of Congress. According to I.R.C. §243(d)(3), dividends issued by a REIT to its shareholders are not considered dividends for federal income tax purposes; thus, the shareholders do not get a dividends-received deduction (DRD) for dividends received from a REIT. The typical net result is that the income earned by a REIT is taxed only once—at the shareholder level—for federal income tax purposes.

[1] *See Complete Auto Transit Inc. v. Brady*, 430 U.S. 274, 279 (1977).

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State Income Tax Provisions

The calculation of corporate taxable income in many states starts with federal taxable income. Even states that do not explicitly begin the calculation of corporate taxable income with reportable federal taxable income generally incorporate the federal taxing scheme into their state tax codes. For example, most states follow the federal income tax treatment for REITs by allowing a DPD. Many states, however, incorporate only certain specific provisions of the I.R.C. or modify the federal provisions.

One area where states often depart from the I.R.C. is the treatment of dividends. Many states do not incorporate the federal DRD provisions. Instead these states modify the federal DRD provisions by either denying the DRD, providing a lesser DRD or allowing DRDs only from certain entities. Several states have elected not to incorporate the federal DRD exclusion for dividends issued by REITs. The net result of decoupling from federal treatment is that some state statutes grant the shareholder of a REIT a DRD and grant the REIT a DPD.

State Challenges to REIT Structures

State tax authorities have challenged REIT structures on various grounds. One is that the particular state's DRD should be read to deny the deduction for dividends received from REITs. Another is that the REIT shareholder has nexus with the state and, thus, is subject to tax on the REIT dividend. Yet another is that certain transactions are shams. This characterization is particularly troubling where the state's own statutes provide for both the DPD at the REIT level and a DRD at the shareholder level. Such challenges by the states have, in some cases, arguably led to a degree of ''judicial activism'' as courts seek to right a perceived wrong in a manner not supported by statutes. Recent REIT cases in Massachusetts and Louisiana illustrate the dangers of tax authorities attempting to accomplish through the courts what should be left to the legislature.

BostonBank Corp. v. Massachusetts

In *BankBoston Corp. v. Massachusetts Comr. of Rev.*,[2] the Massachusetts Commissioner of Revenue (commissioner) audited BankBoston's 1996 and 1997 corporation excise tax returns. BankBoston owned an interest in a REIT and had taken the Massachusetts DRD on the dividends received from the REIT. The commissioner determined that the dividends issued by BankBoston's REIT were not eligible for the state's DRD. During the years at issue, Massachusetts did not follow the federal DRD exclusion for REIT dividends. Rather, Massachusetts' own DRD allowed corporations a 95 percent DRD for dividends received from subsidiaries. Massachusetts law also allowed REITs a DPD.

Recent REIT cases in Massachusetts and Louisiana illustrate the dangers of tax authorities attempting to accomplish through the courts what should be left to the legislature.

Upon audit, the commissioner disallowed BankBoston's deduction for dividends from the REIT. The commissioner argued, and the Massachusetts Appeals Court agreed, that the Massachusetts tax code was intended to follow the federal taxation of REITs to provide one level of tax on income generated by a REIT. Thus, even though the Massachusetts DRD provisions provided for a 95 percent DRD for dividends from a subsidiary, with no distinction for dividends from a REIT, BankBoston was not allowed the DRD for dividends from the REIT.

The Massachusetts Court of Appeals went to great length to justify its holding that the Massachusetts tax provision could be read to deny a DRD for dividends received from the REIT. The court found that prior case law provides strong support for the conclusion that the state and federal tax code provisions should be interpreted uniformly. It is difficult, to say the least, to reconcile this holding with the clear difference between the language of the Massachusetts DRD and the federal DRD, particularly considering that the percentage deduction allowed, *i.e.*, 95 percent, is not uniform with federal law. The holding calls into question every income tax statute that differs on its face from federal law. As an indication of the court's conviction in its decision, the court did ''note with approval that the commissioner did not assess penalties here, and that counsel for the commissioner conceded at oral argument that penalties would not be appropriate in this case.''[3]

Bridges v. Autozone Properties Inc.

In *Bridges v. Autozone Properties Inc.*,[4] Autozone Inc. created a Nevada holding company named Autozone Properties Inc. (Autozone Properties). Autozone Properties in turn formed Autozone Development Corp. (Autozone Development), a REIT that owned property within and without Louisiana. Autozone Properties itself had no property, payroll, or sales in Louisiana. Its only connection to Louisiana was holding shares in Autozone Development. Autozone Development filed in-

[2] *BankBoston Corp. v. Massachusetts Comr. of Rev.*, 68 Mass. App. Ct. 156 (2007).

[3] *Id.* at 164.

[4] *Bridges v. Autozone Properties Inc.*, 900 So.2d 784 (La. 2005), *opinion concurring in denial of rehearing* (May 13, 2005).

come tax returns in Louisiana, while Autozone Properties (a shareholder) did not.

For income tax purposes, Louisiana adopts the I.R.C., including provisions relating to REITs. As a consequence, Autozone Development was allowed a DPD in computing Louisiana taxable income. However, the Louisiana Department of Revenue claimed that Autozone Properties was doing business in the state and, thus, that Louisiana had jurisdiction to tax the dividend income received from the REIT. The state also claimed that the REIT was a trust, and that, under Louisiana law regarding trust taxation, the shareholders were subject to tax as if they were doing business in the state. This argument was based on provisions of Louisiana law requiring that Louisiana REITs be established as trusts.

The Louisiana Supreme Court found that the REIT was organized as a corporation and could be taxed as a REIT. The court disagreed with the department's argument that the REIT was a trust subject to Louisiana's trust tax provisions. However, in a very troubling aspect of its decision, the court held that Louisiana had jurisdiction over Autozone Properties and could tax the REIT dividends it received.

The taxpayer requested a rehearing, but the request was not timely filed. Thus, it was denied. Nevertheless, because of the ''serious federal constitutional issue,'' the chief justice of the Supreme Court took the time in a concurrence to the denial of a rehearing to tell the legal world that the Louisiana Supreme Court had confused the issues of ''authority to tax'' with ''personal jurisdiction,'' noting the latter appeared to be lacking. The chief justice admitted that he concurred in the initial opinion ''because the corporate restructuring undertaken by the various Autozone entities in 1995 seemed to me essentially to be a 'scheme' designed to deprive the State of Louisiana of corporate income and franchise taxes it would otherwise have been entitled to receive.''[5]

Legislative Developments

Some states are amending their statutes to either deny the DPD at the REIT level or to require that the shareholder pay tax on the REIT dividends. In the current 2007 legislative session, Kentucky, New York, and Maryland have passed, or are very close to passing, legislation that would tax the dividends received from a REIT, as discussed below.

Kentucky H.B. 258, signed by the governor on March 21, 2007, disallows the DPD at the REIT level for a captive real estate trust.[6] This legislation was enacted in response to the taxing authority's unsuccessful attempt to tax Autozone Development, the REIT, under the prior Kentucky statutes. The Kentucky Board of Tax Appeals found that the DPD was allowed because Kentucky taxable income starts with federal taxable income.[7] Kentucky did not have any further modifications in its law that would require the disallowance of the DPD; thus, Autozone Development was entitled to the DPD under prior law.

New York Gov. Eliot Spitzer's 2007 budget bill was passed on April 1, 2007, and signed on April 9, 2007.[8] New York law now provides that where substantially all the capital stock of a REIT is directly or indirectly controlled or owned by a corporation, the REIT is required to be included in the combined return and is not allowed the DPD.[9]

Both the Maryland House and Senate have passed separate bills that would require REITs to add back the DPD if the REIT is a captive REIT.[10] Unfortunately, the Maryland Comptroller of the Treasury has announced that Maryland will begin auditing REITs and requiring an addback of the DPD even under Maryland's current add-back provisions.[11] The Maryland comptroller has concluded that captive REITs are transactions among related entities and have no purpose other than state tax avoidance. What makes this position even more interesting is that, in a Feb. 7, 2007, *Baltimore Sun* article, a spokesman for the comptroller was quoted as saying that Maryland had studied the REIT situation and determined that under its current laws, the state could do nothing to capture the income.[12]

Conclusion

The heated debate on state tax treatment of REITs stems from specific state tax provisions that either conform or fail to conform to federal income tax concepts relating to the income tax treatment of REITs and REIT shareholders. Several states have attempted to ''fix'' this perceived problem by conveniently avoiding a strict reading of their taxing statutes. Where state tax laws vary from federal provisions, the consequences of decoupling should apply equally to taxpayers and taxing authorities in accordance with the relevant rules of statutory construction. Case law to the contrary can and will be raised in future disputes to support unexpected results. Taxing authorities and taxpayers beware.

[5] *Id.*

[6] The Kentucky bill defines a captive REIT as ''real estate investment trust as defined in Section 856 of the Internal Revenue Code that meets the following requirements: (a) 1. The shares or other ownership interests of the real estate investment trust are not regularly traded on an established securities market; or 2. the real estate investment trust does not have enough shareholders or owners to be required to register with the Securities and Exchange Commission; and (b) 1. The maximum amount of stock or other ownership interest that is owned or constructively owned by a corporation equals or exceeds: a. Twenty-five percent (25%) if the corporation does not occupy property owned, constructively owned, or controlled by the real estate investment trust; or b. Ten percent (10%) if the corporation occupies property owned, constructively owned, or controlled by the real estate investment trust; The total ownership interest of a corporation shall be determined by aggregating all interests owned or constructively owned by a corporation.''

[7] *Autozone Development Corp. v. Finance and Administration Cabinet Department of Revenue*, File No. K04-R-16, Order No. K-19382 (Ky. Bd. Tax App. Oct. 10, 2005).

[8] New York S.B. 02110, enacted April 9, 2007.

[9] Id.

[10] Maryland H.B. 1257 (Passed by the House March 24, 2007) and Maryland S.B. 945 (Passed by the Senate March 27, 2007). Both bills define ''captive REIT'' as a REIT that is not being regularly traded on an established securities market and that has more than 50 percent of its shares owned by a single entity that is a ''C'' corporation.

[11] 2007 Taxday Item 12 (March 8, 2007).

[12] *See* http://www.baltimoresun.com/business/bal-bz.hancock07feb07,0,1772927.column.

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