State Law & State Taxation Corner

*By John A. Biek**

States Push Back Against State Tax Planning With Captive REITs

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Introduction

When people think of state tax planning with passthrough entities, they usually think of S corporations, limited liability companies and limited partnerships. In the states that follow the federal S corporation[1] and "check-the-box" rules,[2] operating a business in S corporation, LLC or limited partnership form generally eliminates the entity-level state tax on the net income of the business, leaving it up to the resident and nonresident shareholders or partners in the business to pay taxes to the state on the net income of the business.

Within the past 10 to 15 years, some retailers and financial institutions with a substantial amount of real property assets saw an opportunity to reduce their tax in separate return states significantly where they were doing business by transferring the real property assets to a subsidiary[3] that was qualified as a real estate investment trust (a "REIT") under the Internal Revenue Code of 1986, as amended (the "Code"). This captive REIT would then lease its real property assets back to its parent corporation, thereby creating rental expenses for the parent corporation and rental income for the captive REIT. State income tax liability on the captive REIT's rental income could be eliminated (or at least significantly reduced) to the extent that the separate return states allowed the captive REIT to deduct the dividends that it paid to its parent corporation and other shareholders, which is generally the case, *and* the separate return states also allowed the parent corporation to claim the dividends received deduction for the dividends that it received from the captive REIT. If this state tax planning worked, the captive REIT would not be taxable at all in the separate return states, while the parent corporation of the captive REIT would be able to deduct rental expenses on its state tax returns without having to pay any state taxes on its dividend income from the captive REIT. Because the parent corporation is a C corporation, its net income would not pass through to, and have to be reported on, nonresident shareholder returns filed with the separate return states.

This captive REIT tax planning would not work at the federal level because of Code provisions that disallow the dividends received deduction for REIT dividends in order to ensure that the REIT's income is taxed federally at the shareholder level, just as it would be in the case of any other passthrough entity. However, many separate return state income tax laws do not expressly make the dividends received deduction inapplicable to REIT dividends, and captive REIT tax planning has sought to exploit this gap in the separate return income tax laws.

State income tax auditors have not taken a kind view of these captive REIT structures. One of the axioms of state tax planning is that something that looks too good to be true stands a good chance of being challenged by the states. The separate return states have had time to audit these captive REIT structures, and we are now beginning to see the outcome of the state tax litigation that ensued.

The *BankBoston Corp.*[4] and *UNB Investment Co.*[5] cases discussed in this article upheld the state department of revenue's policy of disallowing the dividends received deduction for REIT dividends, thereby taxing the captive REIT's net income in the parent corporation's hands. The *Autozone Properties*[6] case took a more questionable track, affirming a Louisiana income tax assessment against the out-of-state holding company on its captive REIT dividends even though the Louisiana Department of Revenue had not demonstrated that the Commerce Clause allowed the state to tax dividend income of a corporation that did not have physical presence in Louisiana. In the two *New Plan Realty Trust cases,*[7] the Ohio Supreme Court and the Ohio Court of Appeals concluded that the municipal tax codes in Columbus and Cincinnati did not allow the captive REIT to deduct the dividends that it paid to its shareholders, thereby subjecting the captive REIT's net income to municipal taxation.

In addition to these cases, states have been amending their income tax statutes to discourage captive REIT planning by, for example, expressly providing that REIT dividends do *not* qualify for the dividends received deductions, by denying the captive REIT the dividends paid deduction, or by requiring that the parent corporation include the net income of its captive REIT in a combined return.

These state litigation and legislative developments are discussed in this column, following a brief summary of the federal income tax rules for REITs.

Federal Income Tax Treatment of REITs and their Shareholders

Congress created REITs in 1960 in order to extend the favorable federal income tax treatment of regulated investment companies ("RICs"), popularly referred to as mutual funds, to investments in real estate.[8] The RIC provisions of Code Secs. 851-855 established a tax-favored vehicle through which average persons could invest in a professionally managed and diversified portfolio of corporate stocks and other securities. If the RIC satisfied the highly technical organizational, asset holding, income and distribution requirements of the Code, the RIC would be allowed to eliminate its own federal income tax liability by taking a deduction on its federal income tax return for the dividends that it paid out to its shareholders, thereby condensing federal income taxation of the RIC's investment profits to a single level of federal taxation on the RIC's shareholders.[9] In 1960, legislation described as "An Act to amend Section 5701 of the Internal Revenue Code of 1954 with respect to the excise tax on cigars and for other purposes,"[10] Congress set about creating similar rules for REITs, which would provide average investors the opportunity to invest in a professionally managed and diversified portfolio of commercial real estate (such as shopping malls and shopping centers, apartment properties, office buildings and health care facilities) and mortgages on real estate.[11]

To accomplish this objective, Code Secs. 856-860 provide detailed organizational, income, asset and distribution requirements that the REIT must satisfy in order to qualify for the dividends paid deduction that confers the coveted passthrough entity status on the REIT. The organizational requirements, which are found in Code Secs. 856(a) and (c) require that the REIT (a) be organized as a corporation, trust or association; (b) be managed by one or more trustees or directors; (c) be taxable as a domestic corporation but for the application of Code Secs. 856-859; (d) not be a financial institution or insurance company; (e) have beneficial ownership interests evidenced by transferable shares or certificates of beneficial

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interests; (f) have 100 or more "persons" owning the REIT's shares or beneficial interests; (g) subject to the provisions of Code Sec. 857(k), not be closely held (as determined by Code Sec. 857(h)); and (h) make the necessary election to be taxed as a REIT (or have such an election in place for the previous taxable year).

The requirements described in (a) through (e) in the previous paragraph must be satisfied throughout the taxable year of the REIT. The 100 or more person ownership requirement of (f) must be met on at least 335 days of a 12-month taxable year, except for the initial taxable year for which the REIT election is made.[12] The closely held prohibition of (g) must be satisfied during the last half of each taxable year of the REIT, except for the initial tax year for which the REIT election is made.[13]

The definition of a "person" in the ownership requirement for the REIT is determined by reference to the definitions in the Investment Company Act of 1940, as amended.[14] Because the Investment Company Act defines a "person" to mean a "natural person or a company,"[15] and the term "company" in turn is defined to include a corporation, partnership, association, joint stock company, trust, fund or any organized group of persons,[16] it is clear that a REIT may have corporations and other business entities as shareholders.

The "not closely held" requirement for the REIT is determined by reference to the stock ownership rules of Code Sec. 542(a)(2).[17] Under these rules, a REIT generally will be considered to be closely held (and lose its REIT status) if at any time during the last half of the taxable year more than 50 percent of the value of the REIT's outstanding shares of stock is owned, directly or indirectly, by or for five or fewer individuals.[18] In applying the Code Sec. 542(a)(2) stock ownership rules to the REIT, the attribution rules of Code Sec. 544 are applied without regard to the partner attribution rules of Code Sec. 544(a)(2).[19] What all of this means is that the REIT shares owed by a corporation, partnership, estate or trust generally will be considered to be owed proportionally by its shareholders, partners or beneficiaries, thereby helping the REIT to show that more than 50 percent of the value of the REIT's shares of stock is *not* owned by five or fewer shareholders.

One of the axioms of state tax planning is that something that looks too good to be true stands a good chance of being challenged by the states.

In addition to this multi-part ownership test, Code Sec. 856(c) provides two income tests and an asset test that the REIT must satisfy in order to ensure that the REIT is deriving passive income from a diversified portfolio of real estate investments for its shareholders.

Under the first income test, which is found in Code Sec. 857(c)(3), the REIT must derive *at least 75 percent of its gross income* from (a) dividends, or other distributions on, and gain from sales or other dispositions of shares in other REITs; (b) interest on obligations secured by mortgages on real property or interests in real property; (c) rents from real property; (d) gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) that is not property described in Code Sec. 1221(a)(1); (e) abatements and refunds of taxes on real property; (f) income and gain derived from foreclosure property, as defined in Code Sec. 856(e)(1); (g) noncontingent amounts received or accrued as consideration for entering into agreements to make loans secured by mortgages on real property, or interests in real property, or to purchase or lease real property; (h) gain from the sale or other disposition of a real estate asset that is not a prohibited transaction solely by reason of Code Sec. 857(b)(6)(C); and (i) qualified temporary investment income, as defined in Code Sec. 856(c)(5)(D).

The second income test, which is found in Code Sec. 856(c)(2), requires that *at least 95 percent of the REIT's gross income*, excluding gross income from prohibited transactions, be derived from (a) the categories that qualified for the 75 percent gross income test discussed in the previous paragraph; (b) dividends, (c) interest and (d) gain from the sale or other disposition of stocks or securities. This broader 95-percent gross income test addresses how the REIT deals with funds that are not yet invested in the categories of real estate assets eligible for the narrower 75 percent gross income test.

The multi-part asset test of Code Sec. 856(c)(4) requires that, at the close of each quarter of the REIT's taxable year, (a) *at least 75 percent* of the value of the REIT's total assets be comprised of real estate assets, cash and cash items (including receivables), and government securities; (b) *not more than 25 per-*

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cent of the value of the REIT's total assets consist of corporate securities; (c) *not more than 20 percent* of the value of the REIT's total assets consist of securities of one or more taxable REIT subsidiaries; (d) *not more than 5 percent* of the value of the REIT's total assets be represented by securities of any one issuer, other than securities of a taxable REIT subsidiary and securities includable under the 75 percent asset test described in (a); and (e) the REIT hold *not more than 10 percent* of the total voting power and value of the outstanding securities of any one issuer (other than a taxable REIT subsidiary and those securities includable under the 75 percent asset test of (a)).

These ownership, income and asset tests for qualifying a domestic corporation, trust or association as a REIT are highly technical, and the reader should be aware that Code Sec. 856 is replete with definitions, exceptions and safe harbors that are beyond the scope of this article. Readers who are managing or advising REITs would be well advised to study Sec. 856 carefully because the failure to satisfy each of these tests could have dire federal (and state) tax consequences for the REIT and its shareholders or beneficiaries.

Code Sec. 857 provides the federal income tax treatment of a REIT and its shareholders or beneficiaries. The key provision is Code Sec. 857(b)(2)(B), which, if the REIT distributes dividends to its shareholders generally equal to (a) at least 90 percent of its "real estate investment trust taxable income" during the taxable year (determined without regard to the deduction for dividends paid) *and* (b) at least 90 percent of the excess of the REIT's net income from foreclosure property over the tax imposed on such income by Code Sec. 857(b)(4)(A), allows the REIT to deduct the amount of dividends that it paid to its shareholders or beneficiaries in determining its REIT taxable income.[20] This REIT taxable income distribution test is also one of the requirements that the REIT must meet each year in order to retain its status as a REIT.[21] Any undistributed REIT taxable income is subject to the regular Code Sec. 11 tax rates,[22] but the REIT can zero out its REIT taxable income by distributing a sufficient amount of its profits to its shareholders during the taxable year. The effect of this dividend paid deduction can be to turn the REIT into a passthrough entity.

Congress intended, however, that the shareholders of the REIT pay federal income tax, at ordinary income rates, on the dividends that they receive from the REIT (except for REIT dividends designated as a capital gain dividend, which are taxable to the shareholders as long-term capital gain).[23] Recognizing that corporate shareholders would be able to avoid this federal tax liability if they could claim the dividends received deduction for their REIT dividends, Code Sec. 857(c)(1) provides that "[f]or purposes of Section 243 (relating to deductions for dividends received by corporations) *a dividend received from a real estate investment trust* which meets the requirements of this part *shall not be considered a dividend.*"[24] A similar disallowance rule appears in Code Sec. 243(d)(3).[25] In addition, Code Sec. 1501 excludes REITs from the definition of term "affiliated group," thereby preventing corporations from including a REIT subsidiary in the corporation's federal consolidated tax return and eliminating the intercompany REIT dividends from the affiliated group's consolidated federal taxable income.

State Income Tax Treatment of REITs

A few states, including Delaware, Ohio and Pennsylvania, exempt REITs altogether from having to file state income/franchise tax returns.[26] The other states usually arrive at the same result by allowing the REIT to use its federal taxable income as the starting point for computing the REIT's corporation's or trust's state taxable income.[27] If the REIT has zero REIT taxable income because it has distributed all of its net income to its shareholders, the REIT generally will have no taxable income at the state level.[28]

State Cases Involving Captive REITs

As noted earlier, state tax planning with captive REITs has sought to take advantage of the failure of many state income/franchise tax laws explicitly to state that the state's dividends received deduction does not apply to REIT dividends. A couple of state court decisions have now held that, notwithstanding this drafting oversight, captive REIT dividends were *not* eligible for the dividends received deduction provided in the state's corporate income tax statutes. As a result, the dividends paid by the captive REIT were subject to the state's corporate income tax in the hands of the REIT's parent corporation.

In *BankBoston Corp. v. Commissioner of Revenue,*[29] Matthews Street Real Estate Investment Trust, Inc. (the "REIT") distributed $5,952,766 and $116,806,719 of dividends to its parent corporation, Multibank Leas-

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ing Corp. ("MLC"), in the 1996 and 1997 tax years, respectively. MLC was a wholly owned subsidiary of BankBoston Corporation.[30] The REIT was not subject to either the federal income tax or the Massachusetts corporate excise tax on its net income.[31] When MLC, the parent corporation of the REIT, deducted most of the dividends that it had received from the REIT on its Massachusetts corporation excise tax return pursuant to Section 38(a)(1) of the Massachusetts corporate excise tax laws,[32] the Massachusetts Commissioner of Revenue disallowed this deduction, and the Massachusetts Appellate Tax Board upheld the Commissioner's decision.[33]

The Massachusetts corporate excise tax provisions in Chapter 63 of the Massachusetts General laws did not include any explicit references to REITs during the 1996 and 1997 tax years, and the Massachusetts Court of Appeals described the dispute between BankBoston and the Commissioner as being "a disagreement [over] whether Massachusetts law treated REIT distributions to a corporate shareholder in the same way as the Code during the years in question, despite the lack of explicit language providing for such treatment within the confines of G.L. c. 63."[34] Although the Massachusetts *corporate excise tax* provisions in Chapter 63 did not provide a definition of the term "dividend," the Massachusetts *personal income tax* provisions in Chapter 62 did define a "dividend" to mean "any item of Federal gross income which is treated as a dividend under the provisions of the Code."[35]

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The Commissioner argued in the *BankBoston* case that the Massachusetts dividends received deduction in Chapter 63 had to be administered consistently with this personal income tax definition of the term "dividend" in Chapter 62, as well as with the Code provisions applicable to REITs and their shareholders.[36] Accordingly, the Commissioner contended, the Code Sec. 243(a) disallowance of the federal dividends received deduction for REIT dividends had to be read into Chapter 63 of the Massachusetts General Laws. The Court of Appeals sustained the Commissioner's argument because the court concluded that:

> The thrust of the dividends received deduction in the Massachusetts corporate excise has been to impose a unified tax on a corporate enterprise, recognizing that affiliates and subsidiaries should not create additional liabilities by transferring revenues within the family. *However, the elimination of all corporate excise by importing the dividends-received deduction to REIT ownership distorts the careful balancing by which corporations are intended to be taxed no more than once, but certainly once, within the corporate family. An interpretation which at one stroke eliminates all tax to a corporation and its affiliates misapplies the leveling purpose of REITs, defeats uniformity between Massachusetts and Federal law, and creates inconsistency between Chapters 62 and 63 of the General Laws.*[37]

Three years earlier, the New Jersey Tax Court had provided a similar analysis of this REIT dividend received deduction issue in *UNB Investment Co. v. Director, Division of Taxation*.[38] UNB Investment Company ("UNB") owned all of the shares of stock of Bridgewater Mortgage Company, Inc. ("Bridgewater"), which had been qualified as a REIT under the relevant provisions of the Code and Section 54:10A-4(l) of the New Jersey Corporation Business Tax Act (the "CBT Act").[39] In Bridgewater's initial tax year, Bridgewater distributed an $11,730,709 dividend to its parent corporation, UNB, and Bridgewater deducted this dividend payment on its New Jersey corporation business tax return pursuant to New Jersey Revised Statutes Section 54:10A-4(k), which presumes that a corporation's "entire net income" for New Jersey CBT purposes is the same as its federal taxable income before the net operating loss deduction, and the holding of the New Jersey courts in the *Corporate Property Investors* case.[40]

UNB, meanwhile, deducted its $11,730,709 of REIT dividend income on its own New Jersey corporation business tax return pursuant to New Jersey Revised Statues Section 54:10A-4(k)(5), which provides corporations a deduction for 100 percent of dividends received from a subsidiary that is at least 80 percent owned by the taxpayer corporation.[41] UNB contended that because Section 54:10A-4(k)(5) did not explicitly make the dividends received deduction inapplicable to REIT dividends, as Code Sec. 243(a) does, UNB was entitled to deduct the dividends that it had received from Bridgewater for purposes of the New Jersey corporation business tax.[42]

The New Jersey Division of Taxation auditor disallowed UNB's dividends received deduction, arguing that this audit adjustment was a logical consequence of the holding in *Corporate Property Investors*, which had allowed REITs to avoid liability for the New Jersey CBT through the dividends paid deduction. If UNB were also allowed to deduct the dividend income that it received from Bridgewater, the REIT's New Jersey source income would escape New Jersey tax altogether, which, the Division argued, was not the intended purpose of the dividends received deduction in the CBT Act.[43]

The New Jersey Tax Court engaged in a detailed review of the legislative history of both the 1960 federal legislation creating REITs and the 1972 New Jersey legislation recognizing REITs as tax-favored entities. Although the New Jersey legislative history was a bit opaque, the Tax Court concluded in *UNB Investments* that:

> The Director's disallowance of the exclusion from UNB's entire net income of the dividends paid by Bridgewater was consistent with the legislative intent to promote REITs as a vehicle for small investors and to make New Jersey competitive with other states in attracting REITs to do business here. The Director's application of the CBT Act in this case harmonizes Section 4(k)(5) and 4(l), and is consistent with the statutory scheme read as a whole.[44]

The Tax Court then went on to invalidate the tax assessment that had been issued to UNB, however, because the Director had not issued a regulation making the dividends received deduction of Section 54:10A-4(k)(5) inapplicable to REIT dividends.[45] The Tax Court declared that the "determination by the Director, disallowing the exclusion for dividends received by UNB from Bridgewater, has virtually all the indicia of a rule." [46] As a result, UNB lost the substantive issue of whether the New Jersey CBT Act allows a dividend received deduction for REIT dividends, but UNB ultimately prevailed in the case.

Subsequent to the *UNB Investments* case, the New Jersey Division of Taxation amended its regulations to provide that "[d]ividends received from an entity qualified as a real estate investment trust (REIT) as defined under IRC Section 856, and N.J.S.A. 54:10A-4(a), are ineligible for inclusion in the dividends received deduction for corporations . . . . For those taxpayers that are subject to New Jersey corporation business tax, REIT distributions in conformity with Federal law are subject to taxation."[47]

Bridges v. Autozone Properties, Inc.,[48] a captive REIT case arising out of Louisiana, did not address the dividends received deduction issue, perhaps because the REIT's parent corporation did not file any Louisiana corporate income tax return on which the dividends received deduction would have been taken. Autozone, Inc. ("Autozone"), a Nevada corporation engaged in a nationwide automobile parts sales business, restructured its operations in 1995 to transfer all of its retail stores, including 68 stores in Louisiana, to Autozone Development Corporation ("Development"), an indirect subsidiary of Autozone.[49] Under the new corporate structure, the retail sales of automobile parts were made by Autozone Stores, Inc. ("Stores"), another newly created Autozone subsidiary that paid eight percent of its gross sales to Development as rental payments for the use of the leased stores.[50] A third subsidiary, Autozone Properties, Inc. ("Properties"), was formed to own 100 percent of the common stock and 90 percent of the preferred stock of Development, which was then qualified as a REIT for federal and Louisiana corporate income tax purposes.[51]

During the tax years 1996-1998, Stores paid Development approximately $20 million of rent for its use of the Louisiana retail stores, and Stores deducted these rent expenses on its Louisiana corporate income tax returns.[52] Development, the REIT, distributed all of its profits, including the rental income received from Stores, to Properties as dividends. Development filed Louisiana corporate income tax returns that reported no taxable income after deducting the dividends that it had paid to its shareholders.[53] Properties did not file any tax returns in Louisiana because it took the position that it was not maintaining any physical presence in Louisiana that could give it taxable nexus in the state under the Commerce Clause and the Due Process Clause of the United States Constitution.

The Louisiana Department of Revenue filed suit against Properties, the parent corporation of Development, the REIT, alleging that Properties owed more than $1.9 million of Louisiana corporate income tax, franchise tax, penalties and interest on the dividend income that Properties had received from Development in the 1997 and 1998 tax years.[54] (The Department did not dispute Development's right to

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deduct its dividends payments on its Louisiana tax returns.) Properties raised the affirmative defense that it did not have personal jurisdiction in Louisiana because it lacked the required "substantial nexus" or "significant contacts" with Louisiana.[55] To support its personal jurisdiction defense, Properties argued that (1) a nonresident shareholder of a corporation doing business in Louisiana does not become subject to the jurisdiction of the Louisiana courts solely as a result of its ownership interest in the corporation; (2) the situs of Properties' shares of stock of Development was in Nevada, where Properties was commercially domiciled; and (3) the Due Process and Commerce Clauses of the United States Constitution prevented Louisiana from asserting jurisdiction over Properties.[56]

The Louisiana Supreme Court issued a lengthy opinion that upheld the Department's authority to tax Properties on its REIT dividends, after plenty of anguished discussion of how corporate taxpayers like Autozone were using REITs and other passthrough entities to deprive Louisiana of tax revenue. On the first issue in the case, the Department failed to convince the Louisiana Supreme Court that it should treat Development as a "trust," based on Development's REIT tax status, in order to allow the Department to apply the Louisiana tax statutes subjecting out-of-state beneficiaries to tax on their shares of the trust's Louisiana income.[57] The Louisiana Supreme Court explained that "[a]s noted above, 26 U.S.C. § 856(a), as amended, provides REITs with the option of organizing as a trust, corporation or association. Development chose to organize as a corporation domiciled in Nevada. Development's status as a corporation remains intact and is not converted to a trust simply by its business operations in Louisiana."[58]

The Louisiana Supreme Court's disposition of the taxable nexus issue in the *Autozone Properties* case was more questionable both because the court resolved it solely on Due Process grounds, without deciding whether the physical presence Commerce Clause nexus standard of *Quill Corp. v. North Dakota*[59] applies to the Louisiana corporate income tax, and because the Louisiana Supreme Court concluded that the state could tax the out-of-state Properties on its dividend income consistently with due process principles even though Properties did not maintain any physical presence in Louisiana, and even though Louisiana did not impose a tax withholding obligation on payors of dividends to out-of-state shareholders like Properties.[60]

Some states have been amending their income/franchise tax statutes to ensure that the net income that a REIT derives from sources in the state is subject to taxation by the state at either the REIT level or the shareholder level.

The U.S. Supreme Court had explained in its *Quill* decision that, at least for state sales and use tax purposes, the taxpayer must have physical presence in the taxing state in order for the taxpayer to have nexus under the Commerce Clause. However, the Louisiana Supreme Court sidestepped this Commerce Clause nexus issue in *Autozone Properties* because the court found that:

> The Commerce Clause issue has not been raised on appeal in this case. *Bridges v. Autozone Properties*, 2003-0492 (La. App. 1st Cir. 1/5/04), 873 So. 2d 25, 28 n.2. Since the parties did not argue this issue in brief, we will treat the issue as abandoned. *Boudreaux v. State of Louisiana, DOTD*, 2001-1329 (La. 2/26/02), 815 So. 2d 7. *Thus, our singular focus is the Due Process Clause of the 14th Amendment.*[61]

It appears, however, that the Commerce Clause issue was not yet properly before the Louisiana courts in the *Autozone Properties* case. The courts were dealing with Autozone Properties' personal jurisdiction defense, which was purely a Due Process Clause issue. The substantive issues related to Louisiana's right to tax Properties' dividend income were not yet before the courts. Therefore, it is puzzling, to say the least, that both the Louisiana Court of Appeals and the Louisiana Supreme Court concluded that Properties had "abandoned" its Commerce Clause nexus defense.

Even under Due Process Clause principles, it was highly questionable for the Louisiana Supreme Court to determine that Properties, an out-of-state corporation with no physical presence in Louisiana, was obligated to pay Louisiana corporation income tax on its dividend income from Development, the in-state REIT. Under the *International Harvester* case,[62] it ap-

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pears that a state may have due process jurisdiction (but not necessarily Commerce Clause authority) to impose a tax on income that an out-of-state taxpayer derives from sources in the taxing state, but the state must have the necessary personal jurisdiction over the out-of-state taxpayer to enforce the tax payment obligation. In the *International Harvester* case, Wisconsin imposed a tax withholding requirement on J.C. Penney, the in-state corporation that had paid the dividends that Wisconsin was attempting to tax. On the other hand, the Louisiana corporate income tax statutes did *not* impose such a tax collection obligation on Development, and there is a real question whether Properties acquired *personal jurisdiction* in Louisiana solely as a result of its receipt of dividends from another C corporation (Development) doing business in Louisiana. The Louisiana Supreme Court never really addressed this issue in its opinion in the *Autozone Properties* case.

While not captive REIT cases, the two Ohio *New Plan Realty Trust* cases[63] provide a useful reminder that corporations can be subject to *local* taxes on their business profits, and that these local income taxes are not necessarily imposed on the federal taxable income of the corporation. New Plan Realty Trust ("New Plan") was a REIT that owned rental property in the City of Columbus. In preparing its 1996 Columbus corporate income tax return (Form BR-25), New Trust subtracted the dividends that it had paid to its shareholders and reported zero tax liability to Columbus, following its federal income tax treatment for that tax year.[64] The City of Columbus Division of Income Tax assessed New Plan $5,376.16 of municipal income tax, plus penalties and interest, for the 1996 tax year, explaining that the Columbus municipal income tax applied to all types of business entities, including trusts, S corporation and C corporation, on their *net profit before distributions to shareholders or beneficiaries*.[65]

In February 2002, the Ohio Supreme Court upheld the Columbus tax assessment against New Plan. The applicable Columbus tax ordinance defined the "taxable income" that was subject to the city's 2.0 percent tax, as including "*net profits* from the operation of a business, profession or other enterprise or activity,"[66] while the term "net profits" was defined to mean "the *net gain* from the operation of a business, profession, or enterprise or other activity . . . after provision for all ordinary and necessary expenses either paid or accrued in accordance with the accounting system used by the taxpayer for federal income tax purposes."[67]

Based on these statutory definitions, the Ohio Supreme Court concluded that:

> It is crystal clear that the only reduction in taxable income allowed to the corporate taxpayer under Columbus City Code 361.09 is for "ordinary and necessary expenses." The quoted language that follows that phrase cannot under any reasonable syntactical construction modify the phrase "net gain." Unless the Columbus ordinance is rewritten, taxable net profit for purposes of city taxation is whatever gain remains after subtracting ordinary and necessary expenses.[68]

After concluding that "paid dividends are not ordinary and necessary expenses of a business,"[69] the Ohio Supreme Court held that New Plan Realty Trust was not entitled to the REIT dividends paid deduction on its Columbus tax return. Because Columbus did not tax a REIT's shareholders on their dividends, the city was only taxing New Plan's taxable income once.

Ten months later, the Ohio Court of Appeals followed the Ohio Supreme Court's decision in the Columbus *New Plan Realty Trust* case in affirming a Cincinnati business tax assessment against New Plan Realty Trust for tax years 1995-1998. The Cincinnati income tax ordinances used the same definitions of "taxable income" and "net profits" as the Columbus business income tax did.

State Legislative Responses to State Tax Planning with Captive REITs

Some states have been amending their income/franchise tax statutes to ensure that the net income that a REIT derives from sources in the state is subject to taxation by the state at either the REIT level or the shareholder level. This state legislation has taken several approaches.

For example, Massachusetts and Connecticut chose the path of amending their dividends received deduction provisions to make it clear that corporate taxpayers cannot deduct REIT dividends. In 2003, the Massachusetts corporate excise tax definition of "net income" was amended to provide that "[f]or purposes of this section, any dividend received directly or indirectly from a real estate investment trust, as provided in sections 856 to 859, inclusive of

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the Code, for the taxable year of the trust in which the dividend is paid, shall not be (i) treated as a dividend; and (ii) included as part of the dividends received deduction otherwise available to the taxpayer under paragraph (1) of subsection (a) of section 38."[70] This amendment was noted by the Massachusetts Court of Appeals in its *BankBoston Corp.* decision.

Similarly, Connecticut General Statutes Section 12-217(a)(3) has made it clear that a corporate shareholder of a REIT may not deduct the dividends it receives from the REIT by providing that:

> Notwithstanding any provision of this section to the contrary, no dividend received from a real estate investment trust shall be deductible under this section by the recipient of the dividend unless the dividend is: (A) deductible under Section 243 of the Internal Revenue Code; or (B) received by a qualified dividend recipient from a qualified real estate investment trust . . . .[71]

In the current economic climate, captive REITs employing the type of planning described in this article are easily labeled as a "corporate loophole" by state legislators searching for additional tax revenue.

These Connecticut and Massachusetts legislative changes kept those states' income tax treatments of REITs and their corporate shareholders in sync with the federal REIT tax rules.

The Illinois income tax treatment of REITs and their corporate shareholders has been left in a bit of disarray by 2007 legislation. For many years, the Illinois Department of Revenue followed the federal tax treatment of REITs and their shareholders. Section 203(e)(2)(D) of the Illinois Income Tax Act (the "IITA") provided that a REIT subject to the tax imposed by Code Sec. 857 was required to use its federal REIT taxable income (which already included the dividends paid deduction) as the starting point for computing the REIT's Illinois taxable income.[72] A corporate shareholder of a REIT also used its federal taxable income to compute its Illinois taxable income,[73] and there was no subtraction modification that could apply to dividends received from the REIT.[74] Accordingly, an individual or corporate shareholder of a REIT was subject to Illinois income tax on the REIT dividends.

The Illinois Department of Revenue reportedly became concerned that some Illinois corporate taxpayers might be attempting to avoid the disallowance of the dividends received deduction for REIT dividends by interposing an offshore holding company between a captive REIT and the corporate taxpayer. Even if the captive REIT earned income from real estate assets in Illinois, the captive REIT would not have to pay Illinois tax on that income as long as it had no REIT taxable income under Code Sec. 857(b)(2). Because the offshore holding company would not be subject to Illinois corporate income tax or includible in a unitary group due to the Illinois "80/20 rule,"[75] it would not matter that the offshore holding company could not claim an Illinois (or federal) income tax deduction for the dividends it received from the captive REIT. Meanwhile, the dividends that the corporate taxpayer received from the offshore holding company would not be considered to be REIT dividends, thereby entitling the corporate taxpayer to deduct those dividends from its federal taxable income and, by extension, its Illinois taxable income.

The Illinois Franchise Tax and License Fee Amnesty Act of 2007[76] sought to resolve this concern by disallowing the dividends paid deduction of the captive REIT, starting with tax years beginning in 2009. Specifically, new IITA Section 203(b)(2)(E-2) states that "[f]or taxable years beginning after December 31, 2008, any deduction for dividends paid to a corporation by a captive real estate investment trust that is allowed to a real estate investment trust under Section 857(b)(2)(B) of the Internal Revenue Code for dividends paid" shall be added back into the captive REIT's Illinois base income. A "captive REIT" is defined to mean a corporation, trust or association that (a) is considered to be a REIT for the taxable year under Code Sec. 856; (b) is not regularly traded on an established securities market; *and* (c) has more than 50 percent of the voting power or value of its beneficial interest or shares, at any time during the last half of the taxable year, owned or controlled, directly or indirectly, by a single C corporation.[77] The term "captive REIT" will *not* include a REIT that is owned more than 50 percent by a publicly traded REIT, a tax-exempt organization described in Code Sec. 501, a listed Australian property trust, or a REIT that, subject to the

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rules of the Illinois Secretary of State, is intended to become regularly traded on an established securities market and that satisfies the requirements of Code Sec. 856(a)(5) and (6) by reason of Sec. 856(h)(2).[78] The constructive ownership rules of Code Sec. 318(a) will be used to determine ownership test in the captive REIT definition.[79]

The 2007 Illinois legislation also created a new subtraction modification in IITA Section 203(b)(2)(O) for "dividends received from a real estate investment trust," which will apply to taxable years ending on or after December 31, 2008.[80] There are a couple of potential problems with this new dividends received deduction. First, this dividends received deduction in Section 203(b)(2)(O) will apply to dividends received from any type of REIT, whereas only captive REITs are required to add back their dividends paid deduction under Section 203(b)(2)(E-15). Second, the dividends received deduction takes effect a year earlier than the captive REIT dividends paid deduction addback provision. The Illinois Department of Revenue has introduced legislation to amend Section 203(b)(2)(O) to limit the dividends received deduction provision to dividends from the captive REITs that will be required to add back their dividends paid deduction under Section 203(b)(2)(E-15). [81]

New York has taken the route of requiring New York corporation franchise taxpayers to include their captive REITs in a combined report.[82] As amended, New York Tax Law Section 209(5) now provides that a REIT "substantially all of the capital stock of which is owned or controlled directly or indirectly by one or more other corporations which are not real estate investment trusts and are either (a) subject to tax under this article [9-A], or (b) included in a combined report with a corporation that is subject to tax under this article, shall be required to make a report on a combined basis covering any such other corporations." The dividends paid deduction for the REIT is disallowed. Including the captive REIT's net income in the New York combined report will offset the deduction that the parent corporation would otherwise receive for rent payments it made to its captive REIT.

Maryland enacted, and the Rhode Island legislature is considering, bills that address the tax treatment of REITs. Maryland S.B. 954 and H.B. 1257 disallow the dividends paid deduction, effective for tax years beginning after December 31, 2006, for a "captive REIT," which is defined as a REIT that is not regularly traded on an established securities exchange *and* that is more than 50 percent owned or controlled by a C corporation (other than a tax-exempt organization described in Code Sec. 501(a), a listed Australian Property Trust, or a publicly traded REIT). Rhode Island S. 974 has similar provisions.

This Maryland and Rhode Island legislation is based closely on model captive REIT legislation that the Multistate Tax Commission (the "MTC") has drafted. This model legislation was approved by the MTC Executive Committee on August 2, 2007 and referred for a public hearing. If the MTC model legislation is approved by its member states following the public hearing, more states may adopt the tack of subjecting captive REITs to the state's corporate income tax by disallowing the captive REIT's dividends paid deduction. While this is contrary to the federal income tax rules for REITs, it may give the states a better chance of taxing the captive REIT's income because the captive REIT may have taxable nexus in the state.

Conclusion

In light of the case law and legislative developments discussed in this article, businesses should think carefully before setting up captive REITs in an effort to minimize their state income/franchise tax liabilities in states where the business has significant offices, stores, factories or other real property assets. The captive REIT state tax planning structure was clever, but its success hinged on the captive REIT being able to deduct the dividends that it pays to its parent corporation, while the parent corporation is allowed to deduct both the rental payments that it makes to the captive REIT and the dividends that it receives from the captive REIT. The cumulative effect of these deductions, state tax auditors would contend, is to shift income from the parent corporation to the captive REIT, which does not have to pay federal or (it is hoped) state taxes on its net income.

The Achilles heel of the captive REIT state tax planning structure is that it seeks to exploit the failure of certain separate return states to make their dividends received deduction explicitly inapplicable to REIT dividends. Congress enacted Code Secs. 243(d)(3) and 857(c)(1) in order to ensure that a REIT's net income would be subject to federal income tax at the shareholder level, whether those shareholders are individuals, corporations or other types of entities. Congress recognized that if a corporate parent were allowed to deduct the dividends that it received from its REIT subsidiary, very little, if any, of a REIT subsidiary's net income might be taxed.

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States generally closely adhere to the federal income tax rules in administering their income or franchise taxes. This symbiotic relationship between the federal and state income tax rules was the linchpin of the *BankBoston* and *UNB Investments* decisions holding that the Massachusetts and New Jersey corporation income tax statutes did *not* allow the parent corporation of a captive REIT to deduct the dividends that the parent corporation received from the REIT, even though the state's dividends received deduction statute did not explicitly state that the deduction did not apply to REIT dividends. The taxpayers in *BankBoston* and *UNB Investments* were not able to make a persuasive argument that the Massachusetts and New Jersey legislatures meant to adopt only half of the federal scheme for taxing the income of REITs, thereby creating an opportunity for the captive REIT's Massachusetts or New Jersey source income to escape the state's income tax altogether.

If the Massachusetts and New Jersey courts were willing to import Code Secs. 243(d)(3) and 857(c)(1) into the state's income tax laws in order to fill the gap in the state's dividends received deduction statute—and to prevent what the court perceived to be abusive state tax planning—more state courts are likely to follow suit. If a court believes that a taxpayer corporation has created a captive REIT for the sole purpose of avoiding its tax liability in states where the corporation maintains stores or offices, the court is going to be inclined to adopt the state's argument that the rental income of the captive REIT has to be subject to the state's income tax at the shareholder level, if not the REIT level.

It also is likely that more states will enact legislation to combat state tax planning with captive REITs. In the current economic climate, captive REITs employing the type of planning described in this article are easily labeled as a "corporate loophole" by state legislators searching for additional tax revenue. A trend appears to be developing towards states amending their income tax statutes to disallow the dividends paid deduction of captive REITs. States may believe that it is easier for them to tax the captive REIT, which will have taxable nexus in any state where it owns real property, than the captive REIT's corporate shareholder, which may be a holding company that has limited taxable nexus, as was the case in the *Autozone Properties* case. However, it is hoped that states will not amend their laws to disallow the dividends paid deduction of publicly traded REITs and their REIT subsidiaries. Having the state diverge from the way that the federal government and many other states tax the income of publicly traded REITs would create confusion and the risk of double taxation at the state level.

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Endnotes

* The author would like to thank his partners Andrea M. Despotes and Avram I Feldman for their helpful comments on this issue.

1 Code Secs. 1361-1379.

2 Reg. §§301.7701-2 and 301.7701-3.

3 As discussed in this article, the REIT ownership requirements in the Code provide that the REIT must have 100 or more shareholders or beneficiaries. This requirement typically has been satisfied for captive REITs by having the REIT issue shares of preferred stock to enough persons to meet the ownership test.

4 *BankBoston Corp. v. Commissioner of Revenue*, Mass. AppCt, 68 Mass. App. Ct. 156, 861 NE 2d 450 (2007).

5 *UNB Investment Co. v. Director, Division of Taxation,* NJ Tax Ct., 21 N.J. Tax 354 (2004).

6 *Bridges v. Autozone Properties, Inc.,* SCt La., 900 So2d 784 (2005).

7 City of Columbus, Division of Income Tax v. New Plan Realty Trust, SCt Ohio, 94 Ohio St. 3d 193, 2002 Ohio 479, 761 NE2d 609; New Plan Realty Trust, Inc. v. Tax Commissioner of City of Cincinnati, Ohio CtApp, 2002 Ohio 5577 (2002).

8 *See* H. Rep. No. 2214, 86th Cong., 2d Sess., *reprinted in* 1960 U.S. Code Cong. & Admin. News 3765.

9 Code Sec. 852(b)(2)(D).

10 *See* Pub. L. 86-779, H.R. 10960, 86th Cong., 2d Sess., r*eprinted in* 1960 U.S. Code Cong. & Admin. News 1388.

11 For a detailed analysis of the federal income tax rules for REITs, *see* 742 Tax Mgt. Portfolio, *Real Estate Investment Trusts* (BNA 2002).

12 Code Secs. 856(b) and (h)(2); Reg. §1.856-1(c).

13 Code Secs. 856(h)(1)(A) and (h)(3); Code Sec. 542(a)(2).

14 Code Sec. 856(c)(5)(F).

15 Investment Company Act of 1940, 15 U.S.C. §80(a)-2(a)(28).

16 15 USC §80(a)-2(a)(8).

17 Code Sec. 856(h)(1)(A).

18 Code Sec. 542(a)(2).

19 Code Sec. 856(h)(1)(B).

20 Code Secs. §857(b)(2)(B) and 857(b)(3)(A)(ii); Reg. §1.857-2(a)(3).

21 Code Sec. 857(a)(1).

22 Code Sec. 857(b)(11).

23 Code Sec. 857(b)(3)(B).

24 Code Sec. 857(c)(1) (emphasis added).

25 Code §243(d)(3) provides that "[a]ny dividend received from a real estate investment trust which, for the taxable year of the trust in which the dividend is paid, qualifies under part II of subchapter M (Section 856 and following) shall not be treated as a dividend." *See also* Reg. §1.857-6(a) and (d).

26 Del. Code, tit. 30, §1901(b)(16); Ohio Rev. Code §5733.09(C); 72 Pa. Consol. Stat. §7401(1).

27 *See, e.g.,* Instructions to Illinois Form IL-1120 (providing that a REIT subject to federal income tax under Code Sec. 857 shall enter its federal "REIT taxable income" on line 1 of its Form IL-1120).

28 *See Department of Revenue v. Autozone Development Corp.*, Ky. Ct. App. (Oct 12, 2007) (the court allowed REIT to claim dividends paid deduction to compute its Kentucky corporate income tax liability).

29 *BankBoston Corp. v. Commissioner of Revenue,* Mass. CtApp, 68 Mass. App. Ct. 156, 861 NE2d 450 (2007).

30 *Id.* at 158.

31 Massachusetts Department of Revenue Directive 02-12 (Sept. 17, 2002), [Mass.] St.

ENDNOTES

Tax Rep. (CCH) ¶ 360-197 (REITs that file as corporations or financial institutions are eligible under the Massachusetts tax laws for the same dividends paid deduction that is available at the federal level).

32 Mass. Gen. Laws, ch. 63, §38(a)(1) (providing a Massachusetts dividends received deduction equal to 95 percent of the dividends received from a corporate subsidiary).

33 *BankBoston Corp., supra* note 4, at 156.

34 *Id.* at 159. In 2003, the Massachusetts legislature amended Chapter 63 to make it clear that REIT dividends are *not* eligible for the Massachusetts dividends received deduction. St. 2003, ch. 4, §14.

35 Mass. Gen. Laws, ch. 62, §1(e), as amended by St. 1989, ch. 287, §46.

36 *BankBoston Corp.*, *supra* note 4, at 159.

37 *Id.* at 165-66 (emphasis added). The Court of Appeals distinguished *Commissioner of Revenue v. Northeast Petroleum Corp.,* 401 Mass. 44, 514 N.E.2d 359 (1987), which had permitted a Massachusetts dividends received deduction for a liquidating distribution made to a corporate shareholder. In 1987, when the *Northeast Petroleum* case was decided, Section 1(e) of Chapter 62 of the Massachusetts General Laws defined the term "dividend" more broadly to mean "any item of federal gross income which is a dividend under [§316] of the Code or which is treated as a dividend under any other provision of the Code." Based on this definition of "dividend," the Massachusetts Supreme Judicial Court found in *Northeast Petroleum* that the liquidating distribution was a "dividend" for purposes of applying the Massachusetts dividends received deduction. However, the Massachusetts Supreme Judicial Court had clearly stated in *Northeast Petroleum* that any dividends received deduction provision in the Massachusetts corporate excise tax laws must be interpreted consistently with the Code. Moreover, Louisiana had already taxed the income that was the source of the liquidating distribution at issue in the *Northeast Petroleum* case. Neither of these factors was present in the *BankBoston* case.

38 *UNB Investment Co. v. Director, Division of Taxation, supra* note 5.

39 *Id.* at 358.

40 *Corporate Property Investors v. Director, Division of Taxation,* NJ Tax Ct., 15 N.J. Tax 14 (1994), *aff'd*, NJ App. Div., 15 N.J. Tax 205 (1995) (allowing a REIT to utilize the Code Sec. 857(b)(2)(B) dividends paid deduction to compute its entire net income under the New Jersey CBT Act).

41 *Id.* at 359.

42 *Id.* at 362.

43 *Id.* at 360.

44 *Id.* at 372.

45 *Id.* at 373.

46 *Id.*

47 N.J. Admin. Code tit. 18, §7-5.2(2)(i).

48 *Bridges v. Autozone Properties, Inc., supra* note 6.

49 *Id.* at 786.

50 *Id.* at 787.

51 *Id.* The other 10 percent of the preferred shares of Development stock presumably was issued to enough officers and executives of Autozone to allow Development to meet the ownership requirement of Code Sec. 857(a).

52 *Id.*

53 *Id.*

54 *Id.* at 787-88.

55 *Id.* at 788.

56 *Id.*

57 *Id.* at 798-800.

58 *Id.* at 800.

59 *Quill Corp. v. North Dakota,* SCt, 504 U.S. 298, 112 S. Ct. 1904 (1992).

60 For an insightful critique of the *Autozone Properties* case, *see* I.J. HELLERSTEIN & W. HELLERSTEIN, STATE TAXATION ¶ 6.04[1][a] (3d ed. 2007).

61 *Bridges v. Autozone Properties, Inc,.* supra note 4, at 801 (emphasis added).

62 *International Harvester Co. v. Wisconsin Department of Revenue,* SCt, 322 US 435, 64 SCt 1060 (1944).

63 *City of Columbus, Division of Income Tax v. New Plan Realty Trust, supra* note 7; *New Plan Realty Trust, Inc. v. Tax Commissioner of City of Cincinnati, supra* note 7.

64 *New Plan Realty Trust,* 94 Ohio St. 3d at 193.

65 *Id.* at 194.

66 Columbus City Code §361.16 (emphasis added).

67 Columbus City Code §361.09 (emphasis added).

68 *New Plan Trust,* 94 Ohio St. 3d at 195.

69 *Id.*

70 Mass. Gen. Laws ch. 63, §30(4), as amended by Mass. 2003 Stat., ch. 4, §14.

71 A "qualified dividend recipient" is defined in Connecticut General Statutes Section 12-217(a)(3) to mean a dividend recipient who has invested in a qualified real estate investment trust prior to April 1, 1997, while a "qualified real estate investment trust" is defined as an entity that was both incorporated and had contributed to it at least $500 million worth of real estate assets prior to April 1, 1997, and that made an election prior to April 1, 1998, to be treated as a REIT for federal tax purposes.

72 35 ILCS 5/203(e)(2)(D).

73 35 ILCS 5/203(e)(1).

74 35 ILCS 5/203(h).

75 35 ILCS 5/1501(a)(27) (defining the "unitary business group" to exclude "those members whose business activity outside the United States is 80% or more of any such member's total business activity," as measured by that member's Illinois property and payroll factors). *See also* 86 Ill. Admin. Code §100.9700(c).

76 Illinois P.A. 95-0233 (S.B. 1544) (2007).

77 35 ILCS 5/1501(a)(1.5)(A).

78 35 ILCS 5/1501(a)(1.5)(B).

79 35 ILCS 5/1501(a)(1.5)(C).

80 35 ILCS 5/203(b)(2)(O).

81 *See* Illinois S.B. 783.

82 New York S.B. 2110, as modified by S.B. 6335 and S.B. 6336.

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