State & Local Tax Policy

Bulletin

September 29, 2000

Next SALT Subcommittee Conference Call - ***Tuesday, October 10, 2000 at 3:00 p.m. EST.*** All interested parties are invited to attend. We will discuss the new Tennessee legislation and other recent developements.

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TRIUMPH IN TENNESSEE

As most of you may know, about a year ago, NAREIT initiated an advocacy effort in an attempt to reverse Tennessee's 1999 legislation that imposed franchise and excise taxes on limited partnerships ("LPs") and limited liability companies ("LLCs"). As a result of this lobbying effort, Tennessee enacted a modification to its excise and franchise tax provisions for REIT-owned pass-through entities. Many thanks are due to the forty-plus REITs that joined our "Tennessee Tax Coalition" and, in particular, to our Steering Committee members John Foy, Chris Price, Gus Stephas, and Jeff Curry, all on behalf of CBL Properties; Mike Harris from Highwoods Properties; Dean Jernigan and John McConomy from Storage USA, Inc.; Howard Silver from Equity Inns; Katheryn Surface from United Dominion; and Jim Windmiller from Duke-Weeks. The success of this effort once again demonstrates what the REIT industry can accomplish when it works together.

Background. The 1999 Tennessee legislation (the "1999 Act") subjected limited partnerships ("LPs") and limited liability companies ("LLCs") not only to Tennessee's excise tax of 6% of net income, but also to Tennessee's franchise tax of 25 cents per $100 on the greater of apportioned net worth or book value of Tennessee property. Thus, the 1999 Act imposed an additional level of tax on REITs that owned Tennessee property through LPs or LLCs. Although effective for most REIT-owned LPs and LLCs beginning in 2000, the 1999 Act was retroactive to January 1, 1999, for those LPs and LLCs that were 80% or more owned by corporate taxpayers subject to Tennessee tax under pre-1999 rules. Furthermore, the 1999 Act did not permit a REIT that owned non-Tennessee LP or LLC interests to deduct the net earnings or net worth of such entities for excise and franchise tax purposes or to include the apportionment factors of the non-Tennessee entities in the REIT's apportionment calculation. Finally, the 1999 Act also determined entity classification in accordance with Internal Revenue Code ("IRC") section 7701 and its regulations.

In This Issue

2000 Legislation. On June 28, 2000, Governor Sundquist signed into law Senate Bill No. 3082 ("SB 3082"). Please see http://www.state.tn.us/sos/acts/101pub/pc982.pdf to access the chaptered version of the legislation.

General. The provisions in sections 45 through 53 of SB 3082 specifically appy to REIT owned entities. The other sections of SB 3082 include provisions that limit "disregarded" status to LLCs owned by a "corporation" and provide for inclusion of non-Tennessee partnership and LLC apportionment values in the computation of the Tennessee apportionment factor.

Effective Date. Sections 45 through 53 of the law are effective for taxable years ending after June 28, 2000. Generally, the remaining portion of SB 3082 is effective for years ending after June 30, 1999 for those companies that were affected by the 1999 Law.

Excise Tax. Under SB 3082, REITs follow federal income tax and report income and losses allocated from "pass-through entities" ("PTEs"). The PTE does not report income and losses allocated directly or indirectly to a REIT. Note that the foregoing rule only applies if the REIT files a Tennessee tax return. Essentially, REITs that own and operate real property in Tennessee through pass-through entities will be treated for excise tax purposes as if they directly owned such property. Accordingly, both REITs that own property directly and REITs that own property through partnerships and LLCs will be entitled to the dividends paid deduction allowed for federal income tax and Tennessee excise tax purposes.

As relevant for a REIT's excise tax calculation, SB 3082 amends Section 67-4-2004 of the Tennessee Code Annotated ("T.C.A.") to define a PTE as "an entity treated as a partnership for federal income tax purposes or a business entity which has a single owner and which is disregarded as an entity separate from its owner for federal income tax purposes, but not for purposes of [Tennessee's excise and franchise tax provisions]." Although a QRS is a disregarded entity for federal purposes, Section 17 of SB 3082, amending Section 67-4-2007 of the T.C.A., makes clear that a QRS shall not be disregarded for Tennessee excise tax purposes. Therefore, Section 67-4-2004 treats a QRS as a PTE. Essentially, a QRS that is doing business in Tennessee must file a Tennessee excise tax return, but its income and losses pass to the REIT as they would under federal law. On the other hand, it appears that a single member LLC owned directly by a corporate REIT (or presumably a business trust REIT treated as a corporation for federal tax purposes) arguably would be disregarded under the revisions to Section 67-4-2007, and its income and losses are attributed to its parent REIT.

REITs that own Tennessee property through partnerships that are disregarded for federal tax purposes (because, for example, all but one of the partners are disregarded entities such as a QRS or single member LLC) should be careful. Such partnerships are still subject to Tennessee excise taxes. (See Section 17 of SB 3082, revising Section 67-4-2007: "Notwithstanding any provision of law to the contrary, entities that are disregarded for federal tax purposes, except for limited liability companies whose single member is a corporation, shall not be disregarded for Tennessee excise tax purposes."). However, these partnerships are not considered "pass-through entities" under revised Section 67-4-2004 because although they are business entities, disregarded for federal income tax purposes, and not disregarded for Tennessee excise tax purposes, they do not have a "single" owner. Therefore, consideration should be given to adding another partner (possibly a taxable REIT subsidiary after 2000) in order for the partnership to be respected for federal tax purposes and treated as a PTE in Tennessee.

Please note that the excise tax changes made by Sections 46 and 47 of the SB 3082 will only apply if the REIT files an excise tax return. Some REITs may not have any connection to Tennessee other than the ownership of an interest in a Tennessee limited partnership or LLC. SB 3082 does not legally require these REITs to file an excise tax return. Even though the provision as drafted is not expressly elective, it appears that it is effectively elective in these circumstances. (Note that the pass-through entity's income will remain subject to tax to the extent of the non-REIT owners' interest.)

If the REIT elects not to file, in which case the pass-through entity's income would be taxed at the entity level. Furthermore, it appears that although filing a tax return is a prerequisite for a REIT to obtain excise tax relief, the statute does not impose this requirement to obtain franchise tax relief. As described below, for franchise tax purposes, the pass-through entity still would be entitled to exclude from its franchise tax base the proportional amount of the base owned by the REIT.

Tip: REITs may wish to check their partnership agreements to determine if this excise tax burden can be specifically charged to the non-REIT partners.

A final area of caution involves partnership and LLC-owned single member LLCs. The 1999 Act included a provision that treated these entities in accordance with IRC section 7701. Therefore, they were generally disregarded under Tennessee law, as under federal law, and, therefore, not subject to Tennessee tax. Unfortunately, SB 3082 deleted that provision retroactive to the date of the 1999 Act. Although SB 3082 disregards corporate-owned single member LLCs, single member LLCs that are not corporate owned (e.g., those owned by partnerships) are not disregarded. Further, under current informal policy of the Tennessee Department of Revenue ("TDOR"), the term "corporation" does not include a REIT or QRS. Thus, under current TDOR policy, single member LLCs that are owned by a partnership, LLC, REIT or QRS are taxable entities for 1999 Tennessee excise and franchise tax purposes. It is noteworthy that such entities were classified as "disregarded entities" under the law in effect at the original due date of the Tennessee tax return, i.e., April 1, 2000, and did not have a filing obligation at that time. Presumably, there may be cases of single member LLCs that did not file 1999 tax returns and, thus, may be viewed by the TDOR as delinquent.

Franchise Tax

1999 Law. The 1999 law extended the Tennessee franchise tax to all limited partnerships and limited liability companies doing business (i.e., owning real property) in Tennessee. Furthermore, the franchise tax base was the greater of net worth or adjusted book value of Tennessee property. Because many REITs own real property in partnership form, and most of that ownership is leveraged (thus, the book value or fair market value of such property would be far in excess of the REIT's equity interest in the property), the application of the franchise tax to REIT-owned partnerships and LLCs created not only double taxation, but also resulted in a very high franchise tax base for these partnerships and LLCs. In addition, the 1999 law contained a potentially unconstitutional method of apportioning net worth. Although a Tennessee partnership was required to include the value of its investment in lower-level partnerships and LLCs in its franchise tax base, it was not permitted to include the apportionment factors of non-Tennessee partnerships and LLCs in its apportionment calculation. Accordingly, the franchise tax base of this Tennessee partnership could be quite skewed. Although for most REITs, the effective date of the 1999 law was January 1, 2000, for those partnerships that were more than 80% owned by a corporate entity subject to tax under pre-1999 law, the 1999 law applied as of January 1, 1999.

2000 Franchise Tax Legislation

Effective Date. Generally, the new law is effective, as in the case of the excise tax, for years beginning after date of enactment - therefore, for the entire 2000 calendar year. As noted under the excise tax section above, partnership-owned (or even REIT-owned) single member LLCs may be subject to the franchise tax in 1999.

The application of the new Tennessee franchise tax provisions will depend on what type of entity owns Tennessee real property as discussed in the matrices below.

REIT-Owned Partnerships or LLCs

Respected for Federal Tax Purposes. If the entity that owns Tennessee real property is treated as a partnership for federal income tax purposes, the entity is exempt from Tennessee franchise tax to the extent owned, directly or indirectly, by a REIT. Apparently, the entity (but not necessarily the REIT) still must file a Tennessee franchise tax return. Furthermore, the franchise tax base for such an entity that is owned more than 50% by a REIT is, rather than book value of real property, the net worth of the entity. Therefore, the entity's liabilities (which may be significant) can reduce its franchise tax base. Note that such an entity will not necessarily completely avoid paying Tennessee franchise taxes. The tax base attributable to non-REIT partners still will be taxed to the pass-through entity.

Disregarded for Federal Tax Purposes. If the REIT-owned partnership or LLC is disregarded for federal income tax purposes (e.g., because all but one of the partners or members are QRSs or REIT-owned single member LLCs), not only does the entity remain fully subject to Tennessee franchise tax, but its franchise tax base also is calculated based on book value of Tennessee property rather than net worth. In such case, consideration should be given to bringing in an additional partner or member (again, possibly a taxable REIT subsidiary) in order that the entity be respected for federal income tax purposes. A single member LLC that is owned by a corporation (or presumably a business trust treated as a corporation for federal tax purposes) is disregarded for Tennessee franchise tax purposes. However, as noted above, under current informal TDOR Policy, a REIT or QRS is not treated as a "corporation" for this purpose.

Under T.C.A. § 67-4-2107(b), a Tennessee taxpayer may deduct 100% of its investment in a lower level entity that pays franchise tax. Thus situations may exist in which a REIT and its subsidiary entities may not be taxed fully on their total Tennessee net worth. For example, if a REIT owns 90% of a limited partnership, 90% of the partnership's net worth is excluded from the franchise tax base, and the partnership would pay tax on the remaining 10% of its net worth. At the same time, if the REIT has no net worth other than its investment in these lower level entities, the REIT would pay only the minimum franchise tax of $100.00.

Thanks to William Fones of Baker, Donelson, Bearman and Caldwell for his assistance with the foregoing summary.

The following matrices are supplied by Steve Ryan of Deloitte & Touche LLP in Chicago, IL. These matrices summarize the applicable Tennessee tax status and treatment of various legal forms for 1999 and 2000. For this purpose, the terms detailed below apply. Please note that it is not completely clear whether the law treats business trust and corporate REITs equally.

Term	Definition
Captive LP/LLC	Limited partnership or LLC organized under state law that is treated as a disregarded entity for federal income tax purposes under Internal Revenue Code section 7701 and related regulations
Corp.	Corporation not owned by a REIT
Disregarded or Disr.	Disregarded status
LP	Entity classified as a limited partnership for federal income tax purposes
LLC	Limited liability company classified as a partnership for federal income tax purposes.
PTE	Pass-through entity status
QRS	Qualified REIT subsidiary that is treated as a disregarded entity for federal income tax purposes under Code section 856(i)
REIT	Real estate investment trust, inclusive of corporate and business trust REIT entities
SMLLC	Single member LLC
Taxable or Tax.	Taxable status
TDOR	Tennessee Department of Revenue
3d Pty.	Third party status

1999 Tax Year

Entity	Owners	Fed Status	TN Excise Status	TN Franchise Status
SMLLC	Corp.	Disregarded	Disregarded	Disregarded
	REIT	Disregarded	Taxable (1)	Taxable (1)
QRS	Disregarded	Taxable (1)	Taxable (1)	Taxable (1)
	LP/LLC	Disregarded	Taxable	Taxable
	Captive LP/LLC	Disregarded	Taxable	Taxable
Captive LP/LLC	SMLLC+ REIT	Disregarded	Taxable (2)	Taxable (2)
SMLLC+ QRS	Disregarded	Taxable (2)	Taxable (2)	(2)
	SMLLC+LP/LC	Disregarded	Taxable	Taxable
LP/LLC	REIT+3d Pty.	PTE	Taxable	Taxable
	QRS+3d Pty.	PTE	Taxable	Taxable
	LP/LC+3d Pty.	PTE	Taxable	Taxable
QRS	REIT	Disregarded	Taxable	Taxable

(1) Current informal TDOR policy is that REIT and QRS do not have “Corp” status
(2) See (1) above regarding disregarded “Corp” status, possible classification as Disr. on basis that SMLLC is first disregarded and then LLC is effectively treated as SMLLC.

2000 Tax Year

Entity	Owners	Fed Status	TN Excise Status	TN Franchise Status
SMLLC	Corp.	Disregarded	Disregarded	Disregarded
	REIT	Disregarded	PTE (1) and (2)	Taxable (1)
	QRS	Disregarded	PTE (1) and (2)	Taxable (1)
	LP/LLC	Disregarded	PTE (3)	Taxable
	Captive LP/LLC	Disregarded	PTE (3)	Taxable
Captive LP	SMLLC+ REIT	Disregarded	Taxable (4)	Taxable (4)
	SMLLC+QRS	Disregarded	Taxable (4)	Taxable
	SMLLC+LP/LC	Disregarded	Taxable	Taxable
Captive LLC	SMLLC+ REIT	Disregarded	Taxable (5) and (6)	Taxable (5)
	SMLLC+ QRS	Disregarded	Taxable (5) and (6)	Taxable (5)
	SMLLC+ LP/LLC	Disregarded	Taxable	Taxable
LP/LLC	REIT+3d Pty.	PTE	PTE (3)	Exempt (3)
	QRS+3d Pty.	PTE	PTE (3)	Exempt (3)
	LP/LLC+3d Pty.	PTE	PTE (3)	Exempt (3)
QRS	REIT	Disregarded	PTE (3)	Taxable

(1) Presuming that either the REIT or the QRS is not treated as a corporation.
(2) If not Disr. under (1) then PTE status and not taxable based on REIT ownership (direct or indirect).
(3) Not taxable based on REIT ownership (direct or indirect) because of exclusion (excise tax) or exemption (franchise tax).
(4) Possible classification as PTE on basis that SMLLC is first disregarded under (1) and then LP is effectively treated as having a “single owner.” As PTE, see (3) (although more likely taxable because not a “partnership” for federal purposes).
(5) Possible classification as Disr. on basis that SMLLCC is first disregarded under (1) and then LLC is effectively treated as SMLLC.
(6) Alternatively, could be classified as PTE under (4) above.

New York City License Tax Can Be Expensive When No Par Value Stock is Issued

NAREIT is aware that New York City is attempting to collect from REITs and mutual funds a "license tax" that can be significant in certain situations. Although the New York City license tax is generally 1/20 of 1% of par value, it is 5 cents per share for stock without par value. The tax is based on the amount of issued capital stock (each time stock is issued), and it is apportioned to New York City based on the standard three-factor test. The license tax can present a trap for the unwary non-New York corporation with substantial New York City assets or large New York City payroll and no par value stock. Each time such corporation issues stock, a tax of 5 cents per share is due to New York City.

California - Proposition 39

California's November ballot contains Proposition 39. Proposition 39 has two components. The first component would change the state constitution to lower the voting requirements for passage of local school bonds. If this provision passes, it could be adverse to large property owners, as the ability to exceed the Proposition 13 caps on tax rates will change. Taxes may go up as more special assessments could pass the lower hurdle rate. Commercial properties would bear the bulk of the increases. In addition, Proposition 39 would change existing statutory law regarding charter school facilities. This portion of Proposition 39 is politically popular. The co-chairs of NAREIT's Property Tax Task Force, Norm Quinn of Equity Office, and Martin Lutsky of The Rouse Company, suggest that REITs with California interests consider opposing Proposition 39 because of the former provision. The Howard Jarvis Taxpayers Association is sponsoring the "no vote" effort. If you have any questions about this proposed legislation or wish financially to support their work, please contact Jon Coupal at 916-444-9950 or visit www.saveourhomes.com or www.caltax.org.

Mississippi - Soliciting Comments to Limitation of DPD for Private REITs.

As we reported in the last SALT Bulletin, Mississippi recently enacted legislation that limits the allowance of the dividend paid deduction ("DPD") to a "publicly traded" REIT and limits the deductions of a holding company of a REIT. The legislation does not define a "publicly traded REIT" but authorizes the Mississippi Tax Commissioner to promulgate rules and regulations consistent with IRC section 269 "to prevent the evasion or avoidance of state income tax." NAREIT is considering forming a task force to submit comments regarding this issue. Thanks to Marye Helen Owen from Anderson-Tully Company who has agreed to lead this task force. If you are interested in participating in this task force, please contact Dara Freedman at dfreedman@nareit.com.

REIT Entitled to DPD in Ohio Municipality Case

In a recent Columbus, Ohio decision, a REIT successfully argued that it was entitled to a dividends paid deduction ("DPD") for Columbus tax purposes. We had reported in prior versions of the SALT Bulletin that several Ohio municipalities were asserting that their local ordinances did not permit REITs to claim a DPD. In City of Columbus v. New Plan Realty Trust, (Aug. 29, 2000), the Court of Appeals held that the statute's application of the local tax to the REIT's "net profits" meant "net profits" after application of the DPD. See the members' only Government Relations section of www.nareit.com for the full text of the case.

NAREIT Monitoring State Tax Conformity with RMA

NAREIT is currently monitoring state tax conformity with the provisions of the REIT Modernization Act ("RMA"). Although the RMA was enacted in 1999, it is not effective until January 1, 2001. As was the case in 1998 following REITSA's enactment in 1997, several states, including California, have not yet conformed their tax code to the Internal Revenue Code to reflect the RMA's changes.

We suggest that REITs with California property advocate for California conformity to the RMA as of January 1, 2001, and we will be contacting you shortly to assist you with this advocacy. In addition, NAREIT would like to form a State Tax Conformity Task Force that will actively monitor tax developments in all states for the purpose of advising NAREIT and its members when any advocacy or lobbying initiatives are needed. If you are interested in participating in this State Tax Conformity Task Force, please let us know. (contact: Dara Freedman at dfreedman@nareit.com).

Pennsylvania Legislative Update

Senate Bill 2, passed by the Pennsylvania General Assembly on May 16, 2000 and signed by Governor Tom Ridge on May 24, 2000, provides tax cuts in excess of $770 million. Significant changes impacting REITs include the reduction and eventual phase-out of the Capital Stock/Franchise tax as well as the elimination of the $200 minimum tax. The Capital Stock/Franchise tax is currently imposed on a separate entity basis on REITs, QRSs and LLCs doing business in Pennsylvania.

For tax years beginning in 2000, the Capital Stock/Franchise tax rate is reduced by 2 mills to 8.99 mills (0.00899). The tax rate is further reduced in 2001 by 1.5 mills to 7.49 mills (0.00749). Beginning in 2002, the tax rate will be reduced an additional 1 mill (0.001) per year until the tax rate is reduced to zero in 2009. Tax savings should be recognized immediately by adjusting your remaining safe harbor estimated payments for the year 2000 to reflect the new tax rate of 8.99 mills and the elimination of the $200 minimum tax.

Additionally, modifications to Pennsylvania's realty transfer tax previously proposed by Senate Bill 362 were not incorporated into Senate Bill 2. No further action has been taken to incorporate these changes, which would have adversely impacted REITs transferring Pennsylvania real property.

Thanks to Drew VandenBrul of Arthur Andersen LLP in Philadelphia, PA for this update.

Can New Jersey Municipalities Bypass Assessors to Increase Assessments?

By Raymond A. Koski, Esq., National Realty Counselors, Fort Lee, NJ

Taxes are often the biggest single line item cost in a REIT's operating budget. Taxes per square foot can make a lease or break a renewal. Many municipalities, rather than face revaluation and/or appeals, have whole classes of property reassessed annually to keep the ratio of assessed to true value as close to 100% as possible. As described below, a recent case in the New Jersey State Tax Court again sends a signal that there could be a tilting of the playing field in favor of the taxing authority to exact higher assessments and taxes from REITs and other owners of commercial and industrial properties.

A New Jersey tax assessor may not "spot assess," or increase an assessment based solely on a sale of a property. To avoid spot assessing, an assessor must review an entire property class (commercial, industrial, vacant land, residential) and increase the valuations of those properties which market data indicates are assessed below the lower limit (15% below the applicable ratio). This practice puts the onus on the assessor to conduct a comprehensive, thorough and impartial review of all properties within the class. Therefore, the assessed value of other property, in addition to that of the "sold" property, may be increased even though it the former has not been sold. Conversely, if the assessor finds that a property was assessed above the upper limit of the range, he or she should reduce the assessment. Fat chance!

But Can a Municipality Do What the Assessor Cannot? In Township of Wayne v. Pointview at French Hill, Inc., the Township of Wayne (not the assessor) appealed to increase the Defendant Taxpayer's assessment based solely on the property's combined purchase price of $1,300,000. The property's assessment was only $536,700. The ratio of the assessed value to the purchase price resulted in a ratio of 41.28%, well below the "safe harbor" corridor that would have prevented a reassessment in Wayne. Because the sale at issue showed an assessment below the tolerable range, the property was vulnerable to an increase so long as other proofs of value could be established by the assessor's diligence.

The court properly denied the motion for summary judgment because there were material issues of fact to be decided. Nevertheless, the court set a date for trial, thereby permitting the Township of Wayne to presumably conduct discovery - to review the taxpayer's own workpapers and due diligence among other indicia of value, extrinsic and intrinsic, to determine the market value of the property. By the case going to trial, the municipality can do what a tax assessor could not do, under same or similar circumstances - change a property's assessment based solely on one sale price.

The municipality and the assessor are far from being independent of each other. The town hires the assessor, pays the assessor's salary, evaluates the assessor's performance, and, if appropriate, terminates the assessor's employment or gives her a raise. Constructively, they are of the same entity. The town is <u>advised by the assessor</u> which property sales, occurring within the proper time frame, before October 1st (assessment day), make a property vulnerable for an increase. You, the taxpayer, potentially the defendant, own a property which the sale indicates is underassessed. The town sues for an increase. The municipality proceeds with discovery and obtains all of your recent due diligence, appraisals, mortgage data, internal DCF & IRR cash flow projections, etc. Essentially, the municipality takes you to task with your own information.

Can a property owner, particularly a REIT claim that it paid too much or that the property isn't worth that much now but down the road. . . . ? Hardly.

So, you can purchase a property and conduct meetings with the assessor who says there won't be a reassessment of the class, and this information is either technically or in fact correct. Then, on or about the end of March (April 1st is appeal day), the municipality decides to do what its EMPLOYEE, the assessor, cannot, and you get served with the appeal.

What's the downside?

Unanticipated Litigation Defense Costs
Increased Taxes
Tenant Problems (Intitial Term & Renewals)
Competitive Disadvantage of Tax PSF Because of Sale
Possible Base Year Disruption and Renegotiation
Loss of Value Due to Higher Owner Tax Contribution

What to do? Don't cross your fingers hoping it will go away. It won't! Hire competent, area legal and valuation professionals who can properly evaluate your position. If it appears you are vulnerable, and the town is looking for an increase, negotiating a workable increase may be in your best interest. There are a variety of remedies available if you find yourself in this position. Don't wait until the papers are served to have you into State Tax Court. Get this resolved in due diligence before you make commitments to tenants, budgets and shareholders. Consulting with competent tax counsel to determine what due diligence is protected by the attorney-client and work product privilege is essential.

NAREIT appreciates the assistance of those who contributed to this issue of the State and Local Tax Policy bulletin.