NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

July 25, 2011

Ms. Loretta King
Multistate Tax Commission
444 N. Capitol Street, N.W., Suite 425
Washington, D.C. 20001-1538
lking@mtc.gov

Re: Comments on *MTC Proposed Statute Regarding Pass-Through Entity Income That is Ultimately Realized By an Entity That Is Not Subject to Income Tax*

Dear Ms. King:

The National Association of Real Estate Investment Trusts (NAREIT)® thanks you for the opportunity to submit additional comments on the *MTC Proposed Statute Regarding Pass-Through Entity Income That is Ultimately Realized By an Entity That Is Not Subject to Income Tax* (the June 6 Proposed Draft) and the corresponding Hearing Officer's Report (Report), released on June 6, 2011, in connection with the MTC's Executive Committee meeting on July 28, 2011. These comments supplement our earlier submission in which we suggested revised statutory language, consistent with our May 12, 2011 comments. Again, we appreciate the opportunity to participate in the MTC's drafting process, and we particularly appreciate the changes made by the Hearing Officer in the June 6 Proposed Draft in response to NAREIT's earlier comments. Furthermore, as we indicated in our Oct. 24, 2007 comment letter to the MTC in connection with its "captive REIT" project, which ultimately produced a model captive REIT statute (the Model Captive REIT Statute), we recognize a state's interest in adopting legislation that would limit any inappropriate use of REITs, including "captive REIT" structures that had been widely publicized, by denying the REIT's dividends paid deduction (DPD) in certain cases involving non-public REITs. With that said, any such legislation should be narrowly tailored to prevent application to legitimate uses of business transactions.

NAREIT is the worldwide representative voice for REITs and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate, and finance income-producing real estate, as well as those firms and individuals who advise, study, and service those businesses.

EXECUTIVE SUMMARY

In sum, we believe that the MTC Captive REIT Statute, which denies a REIT's DPD if the REIT is more than 50% owned by a taxable corporation other than another non-"captive REIT," qualified REIT subsidiary (QRS) of a non-captive REIT, Australian REIT, or similar, foreign REIT-like entity, largely addresses the concerns surrounding the June 6 Proposed Draft with respect to REITs. Therefore, the June 6 Proposed Draft, at least with respect to REITs, is unnecessary. The Model Captive REIT Statute was adopted after a lengthy process in which NAREIT participated, and was intended to address a perceived abuse in a narrow manner so as not to interfere with legitimate business structures. Furthermore, at the July 2011 meeting, the MTC will consider an extension of the Model Captive REIT statute to require an add back of certain related party expenses paid to a captive REIT, which NAREIT supports.

NAREIT opposes the expansion of the Model Captive Statute reflected in the June 6 Proposed Draft because it would interfere with legitimate business structures, result in double taxation and, if interpreted broadly, would be impossible to administer. Furthermore, the June 6 Proposed Draft is ambiguous because it does not clearly define the types of entities whose ownership in a REIT could cause the REIT to lose its DPD. Additionally, the June 6 Proposed Draft is not clear regarding whether the ownership threshold of an entity "not subject to income tax" is to be applied on an entity or aggregate basis. Although application on an aggregate basis would be impractical to administer for listed REITs whose shareholders typically hold their shares in "street name," at the very least, an aggregate application should only consider those shareholders who own five percent or more of the REIT's shares.

Additionally, to the extent that the MTC does expand the Model Captive REIT Statute, at a minimum, the MTC should retain the "more than 50%" threshold for ownership in a REIT from the Model Captive REIT Statute. Furthermore, a REIT should not face loss of its DPD so long as the investment in the REIT is made "for a valid business purpose." Such a standard would be consistent with that set forth in the MTC's Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses adopted in 2006.

BACKGROUND

I. <u>REITs: Background</u>

For the benefit of the Executive Committee, set forth below is background concerning REITs updated from our May 2011 submission to the MTC.

A. REITs Are Not "Tax Shelters," But Were Designed to Benefit the "Small Investor"

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through companies modeled after mutual funds. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. REITs are required to distribute at least 90% of their taxable income to their shareholders. In addition, REITs must satisfy a number of income and asset tests to ensure that they are focused on owning and operating real estate assets. REITs cannot be "closely held" – five or fewer individuals cannot own more than 50% of the REIT's stock, and REITs must be held by at least 100 shareholders. In exchange for meeting these and a number of other requirements, federal law grants REITs (and mutual funds) a dividends paid deduction (DPD). In 2010, listed REITs distributed approximately $18 billion to shareholders.

B. REITs Benefit Investors and the Economy

The vision of Congress has come to fruition: the total equity market capitalization of REITs at the end of May 2011 was $461 billion (up from only $1.5 billion at the end of 1971). Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 35-year compound annual return for the period ending May 31, 2011 of the S&P 500 stock index was 11.04%, while that of equity (property-owning) REITs was 13.86%**.** The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are around 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Simply put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

C. Most States Tax REIT Income Only Once at the Shareholder Level

Virtually all states with income-based taxes follow the federal rules and do not levy direct income taxes on REIT income or REIT-owned partnerships except to the extent that the REIT retains income or capital gains. These states tax REIT dividends received by the residents of their state (regardless of whether the REITs, from which these residents received dividends, own properties in such state), and collect a great deal of state and local property taxes from the real estate investments that REITs must make to maintain their status.

Nearly every state with an income-based system follows the federal rules and allows the DPD. Only Mississippi limits its DPD to "publicly traded" REITs, a term that is not defined. In 2007, Maryland enacted a law that permits the DPD to reduce Maryland taxable income only for a REIT that is either: (i) publicly traded; or (ii) not more than 50% held by a taxable corporation that is not a REIT or a listed Australian property trust (LAPT or A-REIT, Australia's version of the REIT). Also in 2007, Kentucky and Indiana adopted statutes that are conceptually similar to the Maryland statute (although the triggering threshold in Kentucky is lower than in the other states). Louisiana adopted a similar statute in 2005. Since then, a number of additional states have adopted "captive REIT" statutes in which the state denies the DPD for a REIT generally more than 50% held by a taxable C corporation (other than a REIT, QRS, and, in some states, a foreign, REIT-like entity). In 2008, the MTC adopted its Model Captive REIT Statute, a similarly phrased captive REIT statute. More recently, the MTC has worked on using a similar definition of captive REIT but requiring a related party add-back, rather than a DPD disallowance (for cases in which the relevant state did not have nexus over the REIT), which the MTC is considering for adoption at its July 2011 meeting. More than ten states have adopted similarly phrased statutes.

The above-mentioned statutes prevent or would prevent a REIT from being used primarily to escape state income taxes, while not disturbing the economic activities of widely-held REITs.

D. Non-Publicly Traded REITs Are Used For Many Legitimate Transactions

Although there had been a great deal of press several years ago concerning the use of private REITs as a "state tax shelter," in addition to publicly traded REITs, REITs can include the following legitimate structures: SEC-registered, non-exchange traded REITs; "incubator" REITs that plan an eventual public offering; widely-held, non-publicly-traded REITs (often by tax-exempt institutions, or, in some cases, tax-exempt institutions and/or LAPTs, along with one or more publicly traded REITs); and subsidiaries of a publicly traded REIT purposes or to avoid the need to obtain lender consents.

E. REIT Ownership Structures

As mentioned in our May 2011 submission to the MTC, the following types of entities may own a significant interest in a REIT.

1. <u>Widely Held REITs</u>

As noted above, widely held and/or publicly traded REITs often own lower-tier REIT subsidiaries for legitimate investment purposes, including to retain goodwill or to avoid having to obtain lender consents. Because there was no abusive purpose to such ownership, the Model Captive REIT Statute allows such REITs to own lower-tier REITs without the lower-tier REITs' being considered captive REITs.

2. <u>Partnerships, Including Partnerships Owned by Widely Held REITs</u>

The limited partnership is and has been for decades the prevalent form for owning real estate in the U.S. – both for REITs and non-REITs. Of the more than 150 publicly traded REITs, about 50% own property through a limited partnership structure called an "umbrella partnership REIT" or "UPREIT." In an UPREIT, the REIT typically owns a majority interest in an operating partnership that owns and operates the group's properties. The REIT is publicly traded or widely held. Investors in the operating partnership own partnership units that are convertible after a period of time into REIT stock or cash. Many of such operating partnerships own lower-tier REITs, in some cases acquiring formerly publicly traded REITs, and in others, investing in joint ventures with other investors. Additionally, other investors, including individuals, tax exempt institutions, mutual funds, etc. may invest in REITs through partnerships.

3. Pension Plans and Other Tax Exempt Investors

Long standing federal and state policy does not impose tax liability on investment income of charities, pension plans and similar tax exempt entities. This policy contemplates that when a tax exempt entity's investments rise to the level of an unrelated trade or business, only then is such unrelated business taxable income (UBTI) subject to the unrelated business income tax. Although tax-exempt investors, including pension plans and universities, may invest in income-producing real estate directly, they may also choose to invest in REITs alongside other investors. Doing so enables them to realize the benefit of a professional management team with a proven track record.

The federal REIT rules contain their own limitation on large ownership by such entities in REITs, the "pension held REIT rules" of section 856(h)(2)(D) of the Code. Specifically, if one pension owns more than 25% (by value) of a REIT or one or more pensions that each own more than 10% (by value) of a REIT hold in the aggregate more than 50% (by value) of the interests in the REIT, the REIT will be considered pension-held, and any pension that owns more than 10% (by value) will be viewed as earning its proportionate interest in income earned by the REIT that would be UBTI if earned directly by such investor. In other words, to the extent the pension plan or plans essentially control the business of the REIT, they are viewed by federal tax law (and that of all conforming states) as though they are engaged in an unrelated trade or business to the extent that they would be if they invested directly. To the extent they could invest in the underlying portfolio of the REIT without being so treated as being engaged in an unrelated trade or business, they are not taxed, and should not be taxed as if they are engaged in such a business.

4. Australian REITs and Other Foreign REITs

Finally, similarly to U.S. listed REITs, LAPTs or A-REITs are Australia's version of the publicly traded REIT, and their ownership of more than the requisite percentage of a U.S. REIT should not be treated any differently than similar ownership by a widely held U.S. REIT. In fact, many of the states that adopted captive REIT statutes based on the MTC's model treated LAPTs and similar foreign REIT-like entities as U.S. REITs. Limiting the DPD of "captive REITs" treats the ownership by LAPTs and widely held U.S. REITs in a similar fashion.

As we have discussed during the Model Captive REIT development process, the U.S. REIT structure is becoming more popular, and has been adopted, with certain modifications, in a number of countries recently. Today there are REIT regimes in Canada, Europe (Belgium, Bulgaria, France, Germany, Italy, the Netherlands, and the United Kingdom), the Middle East (Israel), Asia (Hong Kong, Japan, Malaysia, Singapore, South Korea, Taiwan and Thailand), and the Pacific (Australia and New Zealand), and many other countries are considering adopting a REIT regime. As markets become more globalized, we would anticipate that U.S. investors may become more interested in owning the shares in such entities. Such entities may become more interested in owning shares of U.S. REITs, and U.S. shareholders may become more interests in owning shares of such entities.

5. <u>Widely-Held Corporations, Including Mutual Funds</u>

Widely held corporations, including mutual funds, also may invest in REITs, in most cases, as a means to diversify their investment portfolio. With that said, a number of years ago, there began to be many press reports of widely held corporations forming REITs as a means of achieving state tax savings independently of any business purpose. The MTC's Model Captive REIT Statute, and similar statutes adopted by many states was a meant to address this abusive use of the REIT structure.

Because of the many types of legitimate investment structures that can be utilized in investing in REITs, NAREIT urged the MTC to exercise caution in creating any limitations that could affect adversely these non-abusive uses of non-listed REITs, and we continue to urge caution.

II. <u>June 6 Proposed Draft</u>

Because we are not experts in the state taxation of insurance companies, our comments are focused on the June 6 Proposed Draft to the extent it would affect REITs directly.

The June 6 Proposed Draft provides as follows with respect to REITs:

"When 50 per cent or more of the capital interests or profits interest in a real estate investment trust (REIT) as defined in section 856 of the Internal Revenue Code, 26 U.S.C. 856 is owned directly or indirectly , by *[identify each entity type that is not subject to income tax and that state wants to cover under this provision, such as "an insurance company, ", with a citation to the state tax statute applicable to each such entity type]*, the dividends paid deduction to which the REIT is entitled under the Internal Revenue Code, to the extent attributable to dividends paid to such entity, shall not be recognized."

DISCUSSION

I. <u>Because the MTC's Adopted Captive REIT Statute Already Largely Addresses the Proposal's Main Concerns, the June 6 Proposed Draft is Unnecessary</u>

A. Model Captive REIT Statute

1. *Generally*

The MTC adopted a model captive REIT statute (the Model Captive REIT Statute) in July 2008 after a lengthy process in which NAREIT participated. The Model Captive REIT Statute generally provides that **the entire amount** of a REIT's DPD is disallowed if the REIT is a "captive REIT." A REIT is a captive REIT if more than 50% owned by a taxable entity treated as an association taxable as a corporation under the Internal Revenue Code of 1986, as amended (the Code) other than another non-captive REIT, qualified REIT subsidiary of a non-captive REIT (a disregarded entity), LAPT, or a similar foreign, REIT-like entity. At the July 2011 meeting, the MTC will consider a modification to this Model Statute that largely keeps the same "captive REIT" definition, but would require a related entity to "add back" certain expenses paid to a captive REIT. A number of states have adopted captive REIT statutes that are similar to the Model Captive REIT Statute. *See, e.g.*¸ Alabama, Georgia, Illinois, Indiana, Oklahoma, Maryland, North Carolina, North Dakota, Rhode Island, and Utah.

2. *Narrowly Drafted To Allow for Legitimate Business Structures*

Notably, the Model Captive REIT Statute focuses on more than 50% ownership of a REIT by a taxable, non-REIT corporation. As our July 2007 and October 2007 submissions to the MTC regarding the Model Captive REIT Statute mention, we were aware of no abusive situation in which a REIT was owned by an entity other than a non-REIT corporation. In fact, we noted the MTC's concern that taxable corporations other than those taxable under subchapter C of the Code (*e.g.*, an insurance company) might own more than 50% of a REIT, and, for that reason, we suggested a modification (which was adopted) to the captive REIT statute to address ownership by associations taxable as corporations under the Code. Presumably, therefore, an insurance company that owns more than 50% of a REIT would cause the REIT to be a captive REIT (notwithstanding that an insurance company is not taxable under Subchapter C of the Code) and the REIT's **entire** DPD, not just the DPD proportionally owned by the insurance company, would be denied. To the extent that the MTC believes that this is not the case, NAREIT would not oppose a clarification to the Model Captive REIT Statute on this point.

Thus, we encouraged the MTC to permit ownership of U.S. REITs by such entities without causing U.S. REITs to be viewed as "captive REITs," and the Model Captive REIT Statute adopted this recommendation.

B. June 6 Proposed Draft Largely Duplicates Model Captive REIT Statute

First, we believe that the June 6 Proposed Draft is unnecessary because in large part, it duplicates the MTC's adopted "captive REIT" statute, which disallows the **entire** amount (rather than just a proportionate amount) of a REIT's DPD to the extent that a non-listed REIT is more than 50% owned by a corporation not exempt from the tax under section 501(a) of the Internal Revenue Code (Adopted Captive REIT Statute).[1] We assume that this captive REIT statute would apply to a REIT more than 50% owned by an insurance company, which we understand was the original intent behind the June 6 Proposed Draft. Further, the June 6 Proposed Draft was adopted after a multiple-year process in which NAREIT participated and was meant to address abusive situations without affecting legitimate business structures.

Second, to the extent that the June 6 Proposed Draft provides that more than a 50% ownership interest in a REIT by a corporation causes a proportionate loss of the REIT's DPD, this rule already would be covered by the existing Model Captive REIT Statute (and the REIT's entire DPD would be disallowed). With that said, if the MTC believes it is necessary to modify the

[1] To the extent this adopted statute does not address all captive REIT situations in states that may not have jurisdiction over a REIT to deny a DPD, the MTC will vote later in July on adoption of an add back statute that would require certain entities related to a captive REIT to add back certain deductions claimed by the related entities.

Model Captive REIT Statute so that more than 50% ownership of a REIT by an insurance company results in loss of a REIT's DPD, NAREIT would not oppose this clarification. However, to the extent that the June 6 Proposed Draft would expand the Model Captive REIT Statute, it would be unworkable as further discussed below.

II. The June 6 Proposed Draft Inappropriately Expands the Model Captive REIT Statute: It is Too Ambiguous, Unworkable and Would Result In Double Taxation Contrary to the Policy Behind the Creation of REITs

For the reasons described in our 2007 submissions to the MTC concerning the Model Captive REIT Statute, NAREIT opposes expansion of that statute to treat a REIT as a captive REIT if more than 50% owned by entities other than by an association taxable as a corporation. To the extent that the June 6 Proposed Draft is broader than the Model Captive REIT Statute, the June 6 Proposed Draft is ambiguous and would result in double taxation of REIT income contrary to the policy behind the creation of REITs. Further, if interpreted broadly, the proposal is potentially unworkable. Specifically, the term “not subject to income tax” is not defined (although the Proposed Draft would defer to the states on the definition), and it is unclear whether the 50% threshold of ownership by an entity “not subject to income tax” is to be applied to a single entity not subject to income tax or to all investors not subject to income tax.

A. Ownership by Entity "Not Subject to Income Tax"

This section of our submission assumes that the 50% threshold of ownership by an entity “not subject to income tax” is to be applied to a single entity not subject to income tax. The June 6 Proposed Draft applies to an entity "not subject to income tax" as defined by the relevant state. It is unclear whether this provision would apply to: 1) entities subject to other types of taxes than income taxes (similarly to insurance companies); 2) entities not subject to income tax at all (like partnerships or limited liability companies); 3) entities subject to, but not normally liable for, income taxes like REITs, mutual funds,[2] and S corporations; 4) entities not subject to income tax in that particular state; and/or 5) entities specifically exempt from income taxes in most cases like tax exempt charities and pension funds. NAREIT believes that unless the June 6 Proposed Draft is clarified, it could affect many legitimate investment structures and thwart the policy goals behind the creation of REITs – enabling investors from all walks of life to invest in professionally-managed, income-producing real estate.

The June 6 Proposed Draft would disallow a REIT's DPD proportionately to the extent an entity not subject to income tax owns 50% or more of the REIT. While clearly this proposal contemplates such ownership of a REIT's shares by an insurance company, it it not clear what other types of entity types may be included. NAREIT opposes merely leaving the designation of such entities to the respective states as it could lead to disruption of legitimate REIT investments, would be unworkable, and could result in double taxation, contrary to the policy behind establishment of the REIT model.

[2] Although REITs and mutual funds do pay income tax on undistributed income, and REITs, in particular, pay income tax on foreclosure property income, and on certain built in gains of former C corporation assets.

As described above, there are many common structures used for investing in REITs, including ownership by REIT-owned operating partnerships; other investment partnerships; other U.S and foreign REITs and mutual funds; pension plans and universities, etc. As discussed in our 2007 submissions to the MTC in connection with its Model Captive REIT Statute, to the extent that the June 6 Proposed Draft would expand the Model Captive REIT Statute to disallow a REIT's DPD to the extent the REIT is owned by another REIT, mutual fund, partnership, etc., the proposal would disrupt legitimate investment structures for investing in both income producing real estate, and, with respect to listed REIT stock, publicly traded securities. Not only that, many of these entities are ultimately owned by taxable investors. Denying the REIT's DPD would result in double taxation- tax at the REIT level as well as at the ultimate investor level. Furthermore, it would disrupt the current model of taxation of REIT dividends among the states. Specifically, virtually every state with income-based tax system imposes an income tax on their residents' receipt of REIT dividends and allows a DPD for a non-captive REIT with respect to its distributions of dividends attributable to income earned in that state.

Finally, in connection with ownership by REITs by pension plans and other tax exempt investors, it is important to recognize that such investors are permitted to invest directly in real estate, and, subject to the UBTI rules, investment income from such direct real estate would not be subject to tax. Thus, imposing a second layer of tax merely because the tax exempt investor invested through a REIT rather than directly would be contrary to the policy of not taxing such investors on their investment income. [3]

B. Aggregate Application of the 50% Threshold Would Be Unworkable

The June 6 Proposed Draft contemplates 50% or more ownership of a REIT's stock by an entity not subject to income tax. While it appears that this threshold refers to 50% or more ownership by a single entity, the June 6 Proposed Draft is ambiguous and should be clarified. Importantly, like all public companies, the overwhelming majority of listed REIT shares are held in street name by brokers, who are not obligated to report shareholder identifying information to the REIT. Thus, these REITs have *no way of identifying* their shareholders (other than their shareholders who own more than 5% of their shares, who must report this ownership to the Securities and Exchange). This difficulty would be magnified if the June 6 Proposed Draft imposed some type of constructive ownership context. Accordingly, these REITs have *no way of substantially complying* with a statute that would require them first, to identify their shareholders not subject to tax, and then to identify the percentage of the REIT stock owned by such shareholders. While it would be impractical for REITs to be required to identify all of their shareholders, if aggregation were required, it should only apply to shareholders owning five percent or more of the REIT. *Cf.* Section 382(g)(4)(A)(considering changes in ownership by "five percent shareholders" separately for purposes of section 382's loss disallowance rules.).[4]

[3] Further, as discussed above, more than 50% ownership by a single pension plan or by multiple pension plans owning at least 10% would trigger the pension held REIT rules, causing the investor to be viewed as realizing UBTI (if direct ownership would trigger UBTI) to the extent of its proportionate interest in the REIT.
[4] Shareholders owning five percent or more of a company are required to register with the Securities and Exchange Commission and their registration information is publicly available.

C. No Loss of DPD if "Valid Business Purpose" Required At a Minimum and More than 50% Threshold Retained

NAREIT opposes the expansion of the Model Captive REIT Statute as contemplated by the June 6 Proposed Draft (other than clarifying its application to insurance company-owned REITs). To the extent that the MTC does expand this model statute, however, at a minimum, the MTC should retain the "more than 50%" threshold for ownership in a REIT from the Model Captive REIT Statute. Furthermore, a REIT should not face loss of its DPD so long as the investment in the REIT is made "for a valid business purpose."[5] Such a standard would be consistent with that set forth in the MTC's Model Statute Requiring the Add-back of Certain Intangible and Interest Expenses adopted in 2006.

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Thank you again for the opportunity to submit these comments. Please contact me at (202) 739-9446, or my colleague Tony Edwards, at (202) 739-9408 if you would like to discuss these comments in more detail. I plan to attend the Executive Committee meeting on July 28, 2011 to discuss these comments in more detail.

Sincerely,

Dara F. Bernstein

Dara F. Bernstein
Senior Tax Counsel

Cc: Sheldon H. Laskin, Esq. (slaskin@mtc.gov)

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[5] That statute defines "valid business purpose" as "one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the primary motivation for a business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer or the entry by the taxpayer into new business markets."