SB 945

Department of Legislative Services

Maryland General Assembly
2007 Session

FISCAL AND POLICY NOTE
Revised

Senate Bill 945 (Senator Madaleno, *et al.*)
Budget and Taxation Ways and Means

Income Tax - Captive Real Estate Investment Trusts

This bill limits a company's ability to avoid the Maryland corporate income tax by shifting income away from the State through the use of a captive Real Estate Investment Trust (REIT).

The bill takes effect July 1, 2007 and applies to tax year 2007 and beyond.

Fiscal Summary

State Effect: General fund revenues could increase by $7.6 million in FY 2008 and Transportation Trust Fund revenues could increase by $2.4 million. Revenues in future years are assumed to remain constant beginning in FY 2010. General fund expenditures would increase by $34,000 in FY 2008 due to one-time tax form changes and computer expenses.

($ in millions)	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012
GF Revenue	$7.60	$10.11	$7.60	$7.60	$7.60
SF Revenue	2.40	3.19	2.40	2.40	2.40
GF Expenditure	.03	0	0	0	0
Net Effect	$9.97	$13.30	$10.00	$10.00	$10.00

Note:() = decrease; GF = general funds; FF = federal funds; SF = special funds; - = indeterminate effect

Local Effect: Local highway user revenues would increase by $720,000 in FY 2008, $957,600 in FY 2009, and $720,000 annually beginning in FY 2010. Expenditures would not be affected.

Small Business Effect: None.

Analysis

Bill Summary: The bill would disallow for State income tax purposes the dividends paid deduction allowed under the Internal Revenue Code (IRC) for a captive REIT. The bill defines a captive REIT as a corporation, trust, or association:

- that is a REIT under Section 856 of the IRC;
- is not regularly traded on an established securities market;
- where more than 50% of the voting power or value of beneficial interests or shares are owned or controlled, indirectly or directly, at any time during the last half of the tax year by a single entity that is subject to the provisions of Subchapter C of Chapter 1 of the IRC.

However, entity (last item above) does not include ● a REIT that does not meet the three conditions specified above; ● a person exempt from taxation under Section 501 of the IRC; ● a listed Australian Property Trust; or ● subject to regulations adopted by the Comptroller, a REIT that is intended to become regularly traded on an established securities market and that meets the requirements of Section 856(A) (5) and (6) of the IRC by reason of Section 856(H)(2) of the code.

Current Law/Background:

Real Estate Investment Trusts (REITs)

REITs are organizations that act as investment agents for shareholders to invest in real estate and can qualify for special federal tax treatment if certain conditions specified in the IRC are met. If a REIT meets these conditions, including distributing at least 90% of its taxable income to its shareholders, it is entitled, unlike other corporations, to claim a deduction for the amount of dividends paid to shareholders. As a result, taxes are generally not imposed on the REIT but on the shareholders based on the amount of income that is passed through to them in the form of dividends paid. Not every REIT generates income from the direct ownership or operation of real estate. For example, a REIT can be utilized by a finance company to make loans secured by real estate not directly owned or operated by the company. Due to the federal tax treatment of REITs, shareholders are taxed on the dividends received by their state of residence, rather than taxation by the state where the real estate is located, as would be the case for a corporation or pass-through entity. According to the State Department of Assessments

and Taxation (SDAT), 322 REITs were registered to do business in the State in fiscal 2006.

"Captive REITs"

The intent of SB 945 is to limit a corporation's ability to use REITs to avoid State taxes. A REIT that is owned or controlled by a single person, despite federal ownership restrictions, is commonly referred to as a "captive REIT." In essence, corporations can form REITs and pay rent to themselves in order to avoid State taxes. Rental and mortgage REITs are two common types of captive REITs.

The rental REIT method can be utilized by large multistate retailers. A retailer would form a REIT that would own the real property associated with its retail stores. The parent company subject to State income taxes makes rental payments to the REIT that owns the property, which reduces State income tax liabilities by shifting income from the parent company to the REIT. The REIT files a State income tax return, but claims the dividends paid deduction that a REIT is entitled to claim. The parent company deducts for State income tax purposes the amount of rent paid to the REIT. The dividends are ultimately distributed back to the parent company through a holding company located in a state such as Delaware, since this type of income is not taxed there. When the parent company receives the dividends, it is not taxed by the State as it is able to deduct them since the dividends were received from a subsidiary.

It has been reported that large, multistate banks are also using mortgage REITs to avoid taxes in other states. The bank would create a REIT that holds the mortgages or mortgage-backed securities originated by the bank. Instead of the mortgage interest income accruing to the bank that files a state income tax return, the interest income accrues to the REIT. This REIT can avoid state taxes by claiming the dividends paid deduction and would pass the income through to the shareholders of the REIT, which would be an affiliated out-of-state company not subject to state taxation.

A recent *Wall Street Journal* article detailed how some retailers and banks are using these methods to exploit loopholes in state tax laws. The article described how one large multistate retailer was aggressively employing the technique and had, over a four-year period, used captive REITs to shield approximately $7.3 billion from taxation in 27 states thereby avoiding approximately $350 million in taxes. The article also noted how regulators in at least six states had initiated action against companies employing these methods. For example, Massachusetts tax officials are seeking $42 million from one bank for back taxes, interests, and penalties as a result of its use of captive REITs. Other states are responding as described below.

North Carolina tax authorities are currently in litigation with one of the large multistate retailers identified in the *Wall Street Journal* article. In April and August of 2005, the state assessed the company for approximately $30 million in State income taxes for tax years 1998 through 2001. This amount included interest and a 25% negligence charge. Without these charges, the assessment totaled approximately $25 million. North Carolina imposes a corporate income tax rate of 6.9%, close to the 7% rate assessed by Maryland. The retailer operates about 140 stores in North Carolina. The company paid the amount assessed, but in March 31, 2006 sued the state in superior court for a refund of the amount paid.

Earlier this year, the Kentucky State Legislature introduced captive REIT tax compliance legislation. Legislation passed both chambers unanimously and was delivered to the Governor on March 9. Governor Eliot Spitzer of New York also announced plans earlier this year to introduce captive REIT tax compliance legislation.

Other states have previously enacted captive REIT tax compliance legislation, including Pennsylvania and Louisiana. Pennsylvania enacted legislation in 2003 designed to limit the ability of corporations to use captive REITs to avoid state capital stock and franchise and corporate net income taxes.

The Comptroller recently announced that in the course of corporate audits, captive REIT-related deductions will be disallowed and corporations would be sent assessments for additional taxes based on the amount of deduction disallowed. The Comptroller's Office plans to use its authority under Sections 10-109 and 10-306.1 of Tax-General to disallow these deductions. Both of these sections were implemented by Chapter 556 of 2004, the intent of which was to limit a company's ability to avoid State taxes by the use of intangible transfers or "Delaware holding companies." So called "Delaware holding companies" (DHCs) are out-of-state subsidiaries established in Delaware (or in other states providing similar tax advantages) by companies operating in Maryland to hold and manage intangible assets. DHCs had been used by Maryland operating companies to avoid State income taxes by shifting income away from Maryland to DHCs that were not subject to State taxation.

Some corporations with captive REITs have asserted that they are in compliance with State law. The State could be involved in lengthy litigation if the Comptroller proceeds to challenge corporations that claim captive REIT-related deductions given the State's litigation involving Delaware holding companies and litigation in other states that have challenged the use of captive REITs. Section 10-109 and 10-306.1 provide authority to the Comptroller as discussed below.

Section 10-109

The Comptroller can distribute, apportion, or allocate gross income, deductions, credits, or allowances between and among two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in the United States, and whether or not affiliated, if: (1) the organizations, trades, or businesses are owned or controlled directly or indirectly by the same interests; and (2) the Comptroller determines that the distribution, apportionment, or allocation is necessary in order to reflect an arm's length standard, within the meaning of § 1.482-1 of the regulations of the Internal Revenue Service and to clearly reflect the income of those organizations, trades, or businesses (known as "Section 482 authority"). The Comptroller is required to apply the administrative and judicial interpretations of § 482 of the Internal Revenue Code in administering the provision.

Section 10-306.1

A corporation, for purposes of determining Maryland taxable income, is required to add back to its taxable income any otherwise deductible interest expense or intangible expense paid directly or indirectly to one or more related members, unless certain conditions are met, including that the transaction did not have as a principal purpose the avoidance of tax. Intangible property is defined as patents, patent applications, trade names, trademarks, service marks, copyrights, and similar types of intangible assets.

State Revenues: It is not known how many corporations are utilizing the tax avoidance techniques that would be disallowed under the bill. Since Legislative Services lacks the authority to examine individual tax returns, the impact on State revenues cannot be precisely estimated. However, based on the experience of other states, examination of property records in the State, and adjusting for differences in population and the retail presence of companies likely to be engaged in captive REIT tax avoidance, Legislative Services estimates that the bill would increase corporate income tax revenues by $5 to $15 million annually when fully implemented.

Legislative Services examined the property records of all of the Maryland stores of a large multistate retailer identified in newspaper articles as utilizing captive REITs in order to avoid income taxes in other states. This retailer operates about 50 stores in Maryland under two trading names. Some of these stores were located at the same property site, resulting in 44 unique properties. Property records could not be located for 9 sites. Of the remaining 35 sites, Legislative Services determined that at least 18 of the locations are currently owned by a REIT that would likely qualify as a captive REIT under the bill. The Maryland Court of Appeals ruled on June 9, 2003 that corporations could not use DHCs to avoid the State corporate income tax. The majority of REIT

transfers executed by this company, which had been utilizing Delaware holding companies, were conducted in 2003 and 2004.

The Comptroller's Office advises that based on limited data so far, the legislation that disallowed the use of DHCs to avoid State income taxes increased State revenues by about $45 million in tax year 2005. Since DHCs provided an easier method to avoid State taxes and could be employed by a broader range of corporations compared with the use of captive REITs, it is expected that SB 945 would increase State revenues significantly less than the $40 million generated by the DHC legislation.

State Expenditures: The Comptroller's Office reports that it would incur a one-time expenditure increase of $34,000 in fiscal 2008 to add an additional line to the corporate income tax form. This amount includes data processing changes to the SMART income tax return processing and imaging systems and systems testing.

Additional Information

Prior Introductions: None.

Cross File: HB 1257 (Delegate Hixson, *et al.*) – Ways and Means.

Information Source(s): Department of Legislative Services

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