DEPARTMENT OF TAXATION
2008 Fiscal Impact Statement

1. Patron Stephen C. Shannon

2. Bill Number HB 975

House of Origin:
X **Introduced**
___ **Substitute**
___ **Engrossed**

Second House:
___ **In Committee**
___ **Substitute**
___ **Enrolled**

3. Committee House Finance

4. Title Corporate Income Tax: Captive Real Estate Investment Trusts

5. Summary/Purpose:

This bill would require Real Estate Investment Trusts ("REIT") that are more than 50% owned by a corporation (a "captive REIT") to add back any federal deduction for dividends paid by the REIT to its shareholders. Currently, the income of a captive REIT avoids all Virginia tax because a corporate shareholder can exclude REIT dividends from its Virginia taxable income, although the REIT income is included in federal taxable income.

This bill would be effective for taxable years beginning on and after January 1, 2008.

This is a Department of Taxation bill.

6. Fiscal Impact Estimates are: Preliminary. (See Line 8.)

7. Budget amendment necessary: No.

8. Fiscal implications:

<u>Administrative Cost</u>

TAX has not assigned any administrative costs to this bill because the changes required by a single bill such as this can be implemented as part of the annual changes to our systems and forms. As stand-alone legislation, TAX considers implementation of this bill as "routine," and does not require additional funding.

TAX will provide specific administrative costs on any legislation that is not "routine." Additionally, TAX will review all state tax legislation likely to be enacted prior to the passage by each house. If the aggregate number of routine bills likely to pass either house is unusually large, it is possible that additional resources will be required. If so, TAX will identify the costs at that time.

Revenue Impact

This bill would increase General Fund revenue from corporate income tax by a minimum of $6.3 million annually. This additional tax revenue is assumed in the Executive Budget. If this bill is not enacted, General Fund revenues would need to be reduced by $6.3 million in Fiscal Year 2009 and Fiscal Year 2010. This estimate was derived from examination of the tax returns of taxpayers identified as using captive REITs from public information.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

Background

Congress authorized the use of REITs in 1960 to allow citizens from all walks of life to participate in businesses that own and operate commercial real estate. Patterned after mutual funds, REITs must distribute substantially all of their income, and can deduct dividends paid to their shareholders. As with mutual funds, the dividends paid deduction ("DPD") and the distribution requirement places the tax burden from a REIT's real estate business onto the REIT's shareholders.

Congress recognized that REIT income might escape any taxation when shareholders are corporations. Therefore Congress created a REIT exception to a dividend deduction intended to prevent multiple taxation of dividends within affiliated groups of corporations. Virginia and many other states, however, do not conform to the various federal exceptions to deductible dividends. Therefore, many corporate shareholders of REITs are deducting REIT dividends on their Virginia returns. Corporations that are not deducting REIT dividends are allocating dividend income to the state of their commercial domicile.

As states moved to prevent tax avoidance by corporations using intangible holding companies (Virginia enacted such a provision in 2004), many corporations have implemented the captive REIT strategy. A number of states have challenged the captive REIT strategy in administrative or judicial actions. Legislation similar to this bill has been enacted in Maryland, New York, Rhode Island, Indiana, Kentucky, and North Carolina. A similar proposal is pending in Illinois. The Multistate Tax Commission has a draft proposal for a uniform Captive REIT statute. This proposal incorporates virtually all of the provisions of the Multistate Tax Commission proposal and also incorporates provisions suggested by the National Association of Real Estate Investment Trusts.

REIT Tax Avoidance Strategy

The "captive REIT" strategy can be used to reduce tax liability in certain states, such as Virginia, that allow corporations to file separate returns when the taxpayer owns certain types of assets, specifically, commercial real estate or mortgages. When those assets are placed in a REIT, the REIT itself pays no federal or state income tax on its real estate rental or mortgage interest income.

Although the shareholder must pay federal income tax on its REIT dividends, the strategy typically employs an intangible holding company as the shareholder, which is located in a state other than Virginia. Therefore, no Virginia income tax will be paid with respect to commercial Virginia real estate or mortgage assets owned by a captive REIT.

During the spring of 2007, this strategy gained a great deal of attention in the media, particularly in the Wall Street Journal. Many of these reports used Wal-Mart's captive REIT as an example.

Proposal

This bill would require the captive REIT to pay income tax on the business it does in Virginia. It would not affect publicly traded REITs, or other widely held REITs in which a single corporate entity does not own 50% or more of the REIT's shares. Captive REITs would be required to add back any federal deduction for dividends paid to its shareholders. It would then allocate and apportion income, and pay Virginia income tax, in the same manner as other corporations.

A Captive REIT would be defined as a REIT whose shares are not publicly traded and 50% or more of the shares are owned by a corporate entity. Exceptions are provided to ensure that an affiliated group of REITs would not be considered captive REITs unless the ultimate ownership of the group is by a single corporate entity. Entities organized under the laws of Australia and other foreign countries that are similar to REITs will also not be considered a captive REIT, if they are widely held.

This bill would be effective for taxable years beginning on and after January 1, 2008.

cc : Secretary of Finance

Date: 1/18/2008 AMS
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