DEPARTMENT OF TAXATION
2016 Fiscal Impact Statement

1. Patron Glen H. Sturtevant

2. Bill Number SB 508

House of Origin:
_____ **Introduced**
_____ **Substitute**
_____ **Engrossed**

Second House:
__X__ **In Committee**
_____ **Substitute**
_____ **Enrolled**

3. Committee House Finance

4. Title Captive REIT Addition; Exception for REITs Held in a Segregated Asset Account of a Life Insurance Corporation

5. Summary/Purpose:

For purposes of determining whether a real estate investment trust ("REIT") is a captive REIT subject to the Virginia income tax addition, this bill would exclude any voting power or value of the beneficial interests or shares in a REIT that is held in a segregated asset account of a life insurance corporation.

This bill would be effective for taxable years beginning on or after January 1, 2016.

6. Budget amendment necessary: No.

7. Fiscal Impact Estimates are: Not available. (See Line 8.)

8. Fiscal implications:

Administrative Costs

The Department of Taxation ("the Department") considers implementation of this bill as routine, and does not require additional funding.

Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2017. Because only a very limited number of taxpayers would qualify for the exception, the Department anticipates that the negative General Fund revenue impact would be minimal. The Virginia income tax addition for dividends paid by captive REITs was enacted in 2009 to curtail a tax planning strategy. REITs held by life insurance companies in segregated asset accounts are not being used as a tax planning strategy to reduce income taxes. The only taxpayers that are known to qualify for the exemption provide services to certain Virginia political subdivisions. If this bill is enacted, the taxpayers that would qualify for the exception may lower the amounts that they charge for such services or avoid passing on costs attributable to Virginia's addition for captive REITs. Therefore, this bill may result in costs savings for certain Virginia political subdivisions to the extent that the service costs are reduced or avoided.

9. Specific agency or political subdivisions affected:

Department of Taxation

10. Technical amendment necessary: No.

11. Other comments:

REITs

In 1960, Congress enacted legislation that authorized certain real estate companies to elect to be treated as REITs for federal income tax purposes. Congress created REITs to allow small investors the opportunity to pool capital and invest in larger-scale commercial properties. To encourage the formation of REITs, Congress allows a REIT to deduct dividends distributed to investors when determining its taxable income. Therefore, REITs are effectively exempt from taxation to the extent that such companies distribute their taxable income to investors. An investor that receives a dividend from a REIT may be subject to taxation on such income.

To qualify as a REIT for federal income tax purposes, a real estate company:

- Must be structured as a corporation, trust, or association;
- Must have transferable shares or transferable certificates of interest;
- Would otherwise be taxable as a domestic corporation;
- May not be a financial institution or an insurance company;
- Must have a minimum of 100 shareholders;
- May have no more than 50 percent of its shares held by 5 or fewer individuals;
- Must pay dividends of at least 90 percent of the REIT's taxable income annually; and
- Must meet certain income and investment requirements.

Captive REITs and State Tax Avoidance

For federal income tax purposes, a corporation may receive a dividends received deduction for dividends paid to it by another corporation. Congress recognized that corporations could utilize the dividends received deduction in conjunction with the tax benefits provided by REITs to structure transactions for tax avoidance purposes. Therefore, it disallowed the dividends received deduction for dividends received from a REIT for federal income tax purposes.

In contrast, many states that allow corporations to file separate returns, including Virginia, have a separate dividends received subtraction or deduction that includes no exception for dividends received from a REIT. Therefore, in such states, many corporations began utilizing a tax planning technique that used REITs and the state dividends received subtraction or deduction to avoid taxation. In such planning technique, a REIT is created by a parent corporation that is owned or controlled by such corporation (a "captive REIT"). The parent corporation transfers real property assets to the captive REIT. The captive REIT then leases such real property assets back to the parent corporation in exchange for rent. Therefore, the parent corporation utilizes rent payments to shift income to the captive REIT.

The captive REIT may claim a deduction from taxable income, which consists of rental income received from the parent corporation, to the extent that it distributes dividends to the parent corporation. The parent corporation may then claim the state dividends received deduction for the dividends it received from the captive REIT. The parent corporation may also deduct the rent it pays to the captive REIT as a business expense. This planning technique may allow a parent corporation to significantly reduce its state income tax liability.

Virginia's Captive REIT Addition

To prevent the captive REIT structure from being utilized for tax avoidance purposes in Virginia, the General Assembly enacted legislation during the 2009 Session (House Bill 2504 and Senate Bill 1147 (2009 *Acts of Assembly*, Chapters 426 and 558)) which require an addition to Virginia taxable income for captive REITs to the extent that such entities claimed a deduction for federal income tax purposes for distributing dividends. For purposes of Virginia's corporate income tax addition for dividends deducted by a captive REIT, a REIT is a captive REIT if:

- It is not regularly traded on an established securities market;
- More than 50 percent of the voting power or value of beneficial interests or shares of which, at any time during the last half of the taxable year, is owned or controlled, directly or indirectly, by a single entity that is a corporation or an association that is taxable as a corporation for federal income tax purposes, and not a tax exempt entity for federal income tax purposes; and
- More than 25 percent of its income consists of rents from real property.

Variable Contracts

Holders of certain life insurance contracts, annuity contracts, or contracts that provide for the funding of insurance on retired lives may receive certain federal tax benefits including, but not limited to, deferred taxation on the cash value associated with such contracts until certain distributions occur. For the holder of life insurance contract, annuity contract, or contract that provides for the funding of insurance on retired lives to benefit from the federal tax preferences, such contract must qualify as a variable contract.

For federal tax purposes, a "variable contract" is a contract that:

- Provides for the allocation of all or part of the amounts received under the contract to an account which, pursuant to state law or regulation, is segregated from the general asset accounts of the company;
- Provides for the payment of annuities, is a life insurance contract, or provides for the funding of insurance on retired lives; and
- Provides for variable benefits.

The provision of "variable benefits" means:

- In the case of an annuity contract, that the amounts paid for the contract, or the benefits paid out, must reflect the investment return and market value of the segregated asset account;
- In the case of a life insurance contract, that the amount of the death benefit (or the period of coverage) must be adjusted on the basis of the segregated asset account's investment return and market value; and
- In the case of contracts that provide for the funding of insurance on retired lives, that the premiums paid in, or the benefits paid out, must reflect the segregated asset account's investment return and market value.

In certain cases, to ensure that a life insurance contract, annuity contract, or a contract that provides for funding of insurance on retired lives qualifies as a variable contract, a life insurance company may place the voting power, value of the beneficial interests, or shares related to a REIT into a segregated asset account. Segregated asset accounts are not generally used by life insurance companies to facilitate state tax avoidance.

Proposed Legislation

For purposes of determining whether a real estate investment trust ("REIT") is a captive REIT subject to the Virginia income tax addition, this bill would exclude any voting power or value of the beneficial interests or shares in a REIT that is held in a segregated asset account of a life insurance corporation.

This bill would be effective for taxable years beginning on or after January 1, 2016.

Similar Bills

House Bill 95 is identical to this bill.

cc : Secretary of Finance

Date: 2/17/2016 MTH
SB508FE161