# DEPARTMENT OF TAXATION
# 2018 Fiscal Impact Statement

**1. Patron** Nick Rush

**2. Bill Number** HB 365

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

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

**3. Committee** House Finance

**4. Title** Individual and Corporate Income Tax; subtraction for Virginia real estate investment trust income

**5. Summary/Purpose:**

This bill would allow an individual and corporate income tax subtraction for certain income attributable to an investment in a Virginia real estate investment trust ("REIT") made on or after January 1, 2019, but before December 31, 2024. To qualify, the REIT would be required to be certified by the Department of Taxation ("the Department") as a Virginia REIT for the year in which the investment is made.

This bill would be effective for taxable years beginning on and after on or after January 1, 2019.

**6. Budget amendment necessary:** No.

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

**8. Fiscal implications:**

Administrative Costs

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

The Department will provide specific administrative costs on any legislation that is not "routine." Additionally, the Department 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, the Department will identify the costs at that time.

Revenue Impact

This bill would have an unknown negative General Fund revenue impact beginning in Fiscal Year 2019. It is unknown how many investments in Virginia REITs would be made on or after January 1, 2019, but before December 31, 2024, and the amount of income attributable to such investments that would qualify for the subtraction proposed by this bill.

Additionally, the effect of federal tax reform on the number of REITs utilized as an investment vehicle is unknown. The REIT structure is advantageous because it effectively exempts eligible companies from corporate income taxation to the extent that such companies distribute their taxable income to investors. Because federal tax reform reduces the federal corporate income tax rate from a top marginal rate of 35 percent to a flat rate of 21 percent, an unknown number of companies may forgo REIT status to avoid many of the restrictions placed on them.

**9. Specific agency or political subdivisions affected:**

Department of Taxation

**10. Technical amendment necessary:** Yes.

Page 9, Line 550, after “Department of Taxation shall”
Strike: promulgate regulations in accordance with the Administrative Process Act (§ 2.2-4000 et seq. of the Code of Virginia)
Insert: develop guidelines

Page 10, Line 553, end of line
Insert: Such guidelines shall be exempt from the provisions of the Administrative Process Act (§ 2.2-4000 et seq.).

**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 who receives a dividend from a REIT may be subject to taxation on such income. For individual investors, REIT dividends are generally taxed at ordinary income rates, up to the maximum rate of 37 percent, rather than at lower long-term capital gain rates applicable to other forms of investment income. For corporate investors, REIT dividends are not eligible a dividends-received deduction 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.

Proposed Legislation

This bill would allow an individual and corporate income tax subtraction for certain income attributable to an investment in a Virginia REIT made on or after January 1, 2019, but before December 31, 2024. To qualify, the REIT would be required to be certified by the Department as a Virginia REIT for the year in which the investment is made.

In order to be certified as a Virginia REIT, the REIT trustee would be required to register the trust with the Department prior to December 31, 2024, indicating that it intends to invest:

- At least 90 percent of trust funds in Virginia; and
- At least 40 percent of trust funds in real estate in localities that are distressed or double distressed.

If the Department determines that the REIT satisfies the preceding criteria, the Department would be required to certify the REIT as a Virginia REIT at such time as the REIT actually invests at least 90 percent of trust funds in Virginia and at least 40 percent of trust funds in real estate in localities that are distressed or double distressed.

A locality would be considered "distressed" if it meets any of the following criteria:

- The locality has an annual unemployment rate for the most recent calendar year for which such data is available that is greater than the final statewide average unemployment rate for that calendar year; or
- The locality has a poverty rate for the most recent calendar year for which such data is available that exceeds the statewide average poverty rate for that year.

A locality would be considered "double distressed" if the locality meets both of the criteria above.

No subtraction would be allowed to an individual taxpayer:

- For an investment in a trust that is managed by a family member or an affiliate of the taxpayer;
- Who claimed the subtraction for certain long-term capital gains for the same investment;
- Who claimed the subtraction for investments in Virginia venture capital accounts for the same investment; or
- Who claimed the Qualified Equity and Subordinated Debt Investments Tax Credit for the same investment.

No subtraction would be allowed to a corporate taxpayer for an investment in a trust that is managed by an affiliate of the taxpayer. No subtraction would be allowed to a corporate taxpayer who claimed either the subtraction for certain long-term capital gains for the same investment or the subtraction for investments in Virginia venture capital accounts for the same investment.

This bill would require the Department to promulgate regulations in accordance with the Administrative Process Act before December 31, 2018. Such regulations would be required to establish procedures implementing the subtraction relating to the registration and certification of a REIT as a Virginia REIT.

This bill would require the Department to report annually by November 1 of each year to the Chairperson of the House Committee on Appropriations and the Senate Committee on Finance regarding the number of registrations and certifications of Virginia REITs.

This bill would be effective for taxable years beginning on and after on or after January 1, 2019.

cc : Secretary of Finance

Date: 1/24/2018 JJS
HB365F161