Real estate investment trusts have historically been an attractive investment because they provide regular cash distributions. REITs, like most other investment vehicles, struggled as the economy declined. In the past year, however, REITs have begun to renew their place as an attractive investment vehicle. In comparison with U.S. treasuries and bonds, the performance of REITs has been solid. According to Barron’s, in 2010 the MSCI Global Equity Indices, the U.S. REIT Index, was up 23.5 percent, while the S&P 500 was up only 12.8 percent.1 Moody’s Investor Service likewise reported that REIT dividends have begun to rebound, although dividends won’t return to what they were before the economic crisis, at least not this year.2

REIT dividends sharply declined during the height of the financial crisis, but many firms have now taken positive steps to deleverage their balance sheets and better manage their liquidity. The result is that many REITs are in a better financial position today than they were in 2009. On the tax front, a 2009 IRS ruling has helped to improve REITs’ liquidity. That ruling provided that REITs could pay up to 90 percent of their dividends through 2011 in common stock.3 Many REITs took advantage of the ruling, though some have now returned to all-cash dividends.

But from a tax perspective and more narrowly, from a state tax perspective, what does all this mean? First, it means that the news for REITs is generally positive, though the road ahead will likely have some bumps. It also means that investors will remain interested in REITs as an investment vehicle. So state tax practitioners must stay on top of developments and issues that might affect the taxation of REITs and their shareholders. This article will start with the basics of REIT taxation and then will turn to other state tax considerations and recent state developments affecting REITs.

REIT Basics

A REIT is a company that uses the pooled capital of many investors to purchase and generally to operate income-producing property or finance real estate. REITs can either be private or offered as a publicly traded security. Individual investors purchase a unit of the investment trust. Each unit represents a proportionate fraction of ownership in each of the underlying properties in the REIT. REITs are popular for small investors because a REIT allows them the opportunity to invest in real estate without needing to have the necessary capital for direct ownership of those same properties.4

REITs must adhere to a variety of requirements to maintain their status.5 REITs may be formed as partnerships, trusts, or corporations, though they are taxed for federal income tax purposes as corporations regardless of how they are organized. REITs are passive entities that must derive at least 95 percent of their income from passive activities, noted Joseph Gulant, partner and Business Tax Practice Group leader at Blank Rome LLP. REITs must, in general, have at least 100 shareholders.6 To ensure diversification of ownership, 50 percent of any REIT

4 This article is generally addressing REITs as a legitimate investment vehicle and does not specifically address the captive REIT structure that has been used for tax avoidance purposes.
5 IRC section 856(a) provides numerous organizational requirements.
6 IRC section 865(h).
cannot be owned by fewer than five persons. There are also income requirements for REITs, under which 75 percent of a REIT's gross income must come from rents from real property, interest from loans secured by real property, gain from the sale of real property, REIT dividends, income from foreclosed property, qualified temporary investment property, or other specified sources.

There are three categories of REITs, which are based on their source of income: equity REITs, mortgage REITs, and hybrid REITs. As the name implies, equity REITs own and rent properties. These REITs can make solid long-term investments because they earn dividends from rental income as well as capital gains from the sale of properties. Mortgage REITs actually make loans. These REITs are more speculative because their income is tied to interest rates. When interest rates rise, the value of a mortgage REIT will drop. Conversely, if interest rates are expected to drop, a mortgage REIT could be an attractive investment. Hybrid REITs do a combination of owning and renting properties and making loans.

REITs may be created for a single development project or they may be set up for a specific number of years. In either case, when the project is over or the number of years has expired, the REIT is liquidated and proceeds are distributed to shareholders. If a REIT is publicly traded, it may be either closed-ended, meaning it can issue shares to the public just once unless approval is obtained from current shareholders, or open-ended, meaning it may issue shares and redeem shares at fair market value at any time.

Federal Taxation of REITs

For federal tax purposes, REITs are taxed as corporations, said Jennifer Weiss, a partner with Alston & Bird LLP. That technically means that REITs are taxed first at the entity level and then at the shareholder level. However, said Weiss, REITs function as hybrid entities in that they are taxed as pass-through entities as long as they comply with the requirements to maintain their REIT status. To enable them to avoid corporate-level taxation, REITs are permitted to deduct dividends paid to shareholders from their corporate taxable income. And because REITs are required by law to distribute at least 90 percent of their taxable income to their shareholders each year, with most REITs distributing 100 percent of their taxable income, this means that REITs effectively avoid federal income tax. REITs will, however, be subject to corporate-level tax on what is left after their annual distributions, Weiss noted. That is, if a REIT chooses to distribute 90 percent of its taxable income, it will become subject to corporate-level tax only on the remaining 10 percent.

A determination of a REIT's tax liability at the entity level begins with the REIT's taxable income, which will include capital gain and loss distributions to shareholders with adjustments for net income from foreclosure property. Net income from foreclosure property is generally computed at the highest corporate level. REITs must also factor in a tax on prohibited transactions and on any income attributable to gross income that caused the REIT to fail one of the income tests, both of which are imposed at a 100 percent penalty rate. REITs also may be subject to the alternative minimum tax based on tax preference items.

REIT dividend payments are taxable to the shareholder as ordinary income. Under IRC section 243(d)(3), dividends issued by a REIT to shareholders are not considered a dividend for federal income tax purposes. That means shareholders are not permitted to take a dividends-received deduction for dividends received from a REIT. If, however, the dividends qualify as capital gains, they are taxed at the capital gains rate. If a dividend qualifies as a capital gain dividend, it is long-term capital gain to the shareholder regardless of whether the sale of that shareholder's unit shares would result in long-term capital gain or loss.

A portion of the dividends paid to a shareholder also may constitute a nontaxable return of capital, which is not considered income. What portion of a distribution is taxable as a dividend and what portion is nontaxable as a return of invested capital is determined based on the REIT's earnings and profits, not on its taxable income. A nontaxable return of capital occurs when some or all of the money a shareholder has in an investment is returned to that shareholder. That generally happens when the REIT's distribution to the shareholder exceeds the REIT's earnings and profits. A return of capital does reduce the shareholder's adjusted basis in the REIT, and while that return is generally nontaxable, it is taxable as a capital gain if the return exceeds the shareholder's adjusted basis.

Taxation at the State Level

Because many states conform to the federal tax code, REITs are generally afforded similar treatment at the state level. However, state conformity to the Internal Revenue Code is anything but simple, particularly regarding the tax treatment of REITs.

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1[IRC section 856(h)(3).]
2[IRC section 856(c)(3).]
3[IRC section 857(a)(1)(A).]
For those states that impose an income tax, most begin the calculation of state taxable income with federal taxable income, or they incorporate federal taxable income in some manner in the state tax code. Also, most states follow the federal treatment of REITs by allowing for a dividends-paid deduction (DPD). In some cases that is because the definition of state taxable income is federal taxable income after the DPD or, if the definition of state taxable income is federal taxable income before the DPD, the state will provide for a state-level DPD.

However, some states deviate from the federal rules. Jeff Glickman, a partner with Alston & Bird LLP, explained that some states have chosen to limit or modify the DPD. For example, New Hampshire imposes an entity-level tax on REITs, without subtracting the dividends paid. It is also important to note that even if the DPD is allowed, some states require that the REIT and any qualified REIT subsidiaries (QRS) file income tax returns. There also are states, such as Mississippi, where the DPD is allowed only if the REIT is publicly traded.

**Even though REITs may not pay federal or state income tax at the entity level because of the DPD, states may impose franchise, gross receipts, or net worth taxes on the REIT and the QRS.**

Another concern for REITs is the variety of alternative taxes being imposed by states. Even though REITs may not pay federal or state income tax at the entity level because of the DPD, states may impose franchise, gross receipts, or net worth taxes on the REIT and the QRS. Glickman explained that more and more states are using alternative taxes, such as gross receipts taxes. In these states, REITs will be a part of the taxing structure like any other corporation. For example, Glickman said, the commercial activity tax in Ohio does not provide a DPD for REITs.

REITs and their shareholders also may be liable for sales and use taxes depending on the types of transactions in which the REIT engages. States may or may not have special rules or exceptions for REITs. If there are no exceptions, states can hold shareholders personally liable for any unpaid tax.

**Other State Tax Considerations for REITs**

**Choice of Entity**

Another tax consideration for REITs is choice of entity. As noted above, a REIT can be formed as a corporation, trust, or partnership. States generally do not limit the type of entity that can qualify as a REIT, though most are formed as a corporation or trust. That said, there may be specific state tax planning reasons to form a REIT as a partnership rather than a corporation. Typically, for federal and state income tax purposes, REITs are taxed as corporations regardless of how they were organized. For purposes of state alternative or non-income taxes, however, how a REIT is organized matters greatly. For example, said Steven Wlodychak, a principal in the Transaction Advisory Services/State and Local Tax Practice with Ernst & Young LLP, a REIT in Illinois would be subject to the franchise tax if it was formed as a corporation, but not if it was formed as a business trust, limited liability company, or partnership, because the franchise tax is assessed only against corporations. “Business structure is critical when considering alternative taxes,” Wlodychak said.

**Nexus**

One problem state officials frequently face is that a state may conform to the federal code regarding the income tax treatment of REITs at the entity level, but federal and state laws limit the state’s ability to collect income tax from nonresident shareholders. Wlodychak used the following example: Assume a REIT operates entirely in California, but all of its shareholders are located in Florida. If the REIT earned $100 in any given year and distributed the $100 to its shareholders, the REIT will pay nothing in federal and state income tax because of the DPD. However, the Florida residents will not pay tax on the REIT dividends either because Florida does not impose an income tax. Dividends are treated for individual income tax purposes as income received from a corporation. Case law has long held that only an individual’s state of residence can tax dividend income received from a corporation. In this scenario, the REIT’s income that was earned in one state may escape tax in another state at both the entity and the shareholder levels.

**Net Operating Losses**

Given the continued strain on state budgets, several states are still suspending the use of net operating losses. For example, Illinois implemented a three-year suspension of the NOL carryover deduction for C corporations for tax years ending after December 31, 2010, and before December 31, 2014. In Massachusetts, losses sustained in tax years before January 1, 2010, may be carried forward five years but may not be carried back. Losses sustained in any tax year beginning on or after January 1, 2010, may be carried forward for 20 years but may not be carried back.

State conformity to federal rules, NOL suspensions, and their relationship to the cancellation of

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11SB 2505.
indebtedness income (CODI) rules of IRC section 108(i) present another issue for REITs. Section 108(i) was enacted as part of the American Recovery and Reinvestment Act of 2009 and permits operating businesses (including REITs) to elect to defer federal income tax on CODI recognized from some types of reacquisitions of applicable debt instruments during 2009 and 2010. If an election is made, the CODI may be recognized ratably over a five-year period beginning in 2014.

Many REITs had CODI events in 2009 and 2010 and took advantage of the one-time deferral provision. For federal income tax purposes, CODI deferred under section 108(i) is not taken into account in computing a REIT’s taxable income until the income is includible (presumably beginning in 2014). However, explained Wlodychak, if a state decouples from section 108(i), the CODI deferred for federal income tax purposes is immediately recognized for state income tax purposes. Because the DPD that the REIT would have received at the federal level would not have included the CODI, the REIT is left with taxable income at the state level. However, when CODI is recognized at the federal level, if the state provides for a tax base modification in that year, the REIT will be left with a state-level NOL. Although having an NOL may not be a bad thing for regular corporations, REITs are not regular corporations. They distribute all their taxable income each year. Because most states do not allow NOL carrybacks, the REIT would be unable to recognize the loss associated with the section 108(i) event at a later date.

The end result, Wlodychak said, is that the REIT would have a stranded loss it is unable to use. In essence, the impact of these complex rules is that what should have been a temporary difference turned into a permanent tax item on the REIT’s books. Unfortunately, there is no quick solution to that problem. Wlodychak noted that those states that decoupled from section 108(i) could choose to conform only for REITs, but that solution seems unlikely and could further complicate compliance with section 108(i).

**Transfer Taxes**

In California, REITs should be on the lookout for separate city and county controlling interest transfer taxes not only when they transfer properties by deed but when they sell the equity of their subsidiaries that own real property regardless of the legal form of the subsidiaries that are sold. Transfer taxes are, in essence, a transaction fee imposed on the transfer of title to property. California delegates by state law the authority to impose documentary transfer taxes to counties and local governments, provided these jurisdictions impose their taxes in conformity with the state provisions.12

In most jurisdictions, California’s documentary transfer tax is imposed at a relatively low rate of $1.10 per $1,000 of value. However, several “char- ter” jurisdictions that assert they are not limited by state law also impose their transfer taxes at higher rates and as if they operated as a controlling interest tax. These jurisdictions include the city of Oakland, the city and county of San Francisco, and Santa Clara County. Wlodychak questioned the legal authority for local jurisdictions to deviate from the state statute’s prescribed method of imposing documentary transfer tax, but the amount of tax collected from a REIT by a local jurisdiction is low enough that owners or real property, including REITs, appear reluctant to challenge the tax.

**In California, REITs should be on the lookout for separate city and county controlling interest transfer taxes.**

Also, Los Angeles County has adopted a very broad reading of the state’s documentary transfer tax. The county’s website states:

The Los Angeles County Registrar-Recorder/County Clerk (“RRCC”) began enforcing collection of Documentary Transfer Tax (“DTT”) on legal entity transfers where no document is recorded, but which resulted in a greater than 50 percent interest in control of the legal entity being transferred. The collection is made pursuant to Chapter 4.60 of the Los Angeles County Code, and California Revenue and Taxation Code (“RTC”) sections 11911 and 11925, and is consistent with case law which defines “realty sold” as having the same meaning as changes in ownership for property tax purposes in RTC section 64(c)(1). In addition, effective January 1, 2010, RTC section 408 was amended to allow recorders to obtain information pertaining to these transfers from the Assessor. As a result, in an effort to collect the tax, the RRCC will continue to identify, and send notices for, properties where a change of ownership occurred which transferred a greater than 50 percent controlling interest in the legal entity thereby creating a liability for the DTT.

**Property Tax**

In terms of fixed costs for REITs (and in particular, equity REITs), property taxes rank close to the

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12 Cal. Rev. and Tax Code section 11911.
top. But REITs may be paying excessive property tax bills. Michael Allen, a partner with Ryan LLC, explained that the nature of a REIT’s business is that it raises money on Wall Street, not Main Street, to purchase commercial property. Accordingly, investor yield expectations are different. Wall Street’s expectations are typically aligned with stock returns and are generally much lower than what typical real estate investors require. When the REIT raises money, it cannot hold that money in cash. The REIT is expected by its investors — and required by the IRS in order to maintain its preferential tax treatment — to invest that money by purchasing real estate. However, the expected return on an investment in a REIT is typically only 2 to 3 percent, based on Wall Street equity returns. That is relatively low when compared with the 6 to 9 percent return a traditional commercial real estate investor will expect from a real estate investment. Because of their lower investor expectations, REITs are able to purchase property at a higher cost while still achieving their expected returns. Therefore they can overpay the market for a property and still meet investor requirements regarding the return on that investment.

Allen mentioned an important point regarding REITs that purchase hotels. To maintain their tax status, all REITs are required to have no more than 15 percent of their revenue in non-realty assets. That poses a problem for hotel REITs because a significant portion of the assets purchased with a hotel may include both tangible and intangible personal property. For example, a hotel sale includes not only the real property itself, but the beds, furniture, linens, and other items in the hotel. An operating hotel will also typically include significant intangible assets, such as the hotel’s flag name, the staff in place, and the reservation system. Because a hotel is so much more than just the real property housing it, and because the REIT cannot have more than 15 percent of its revenue in non-realty assets, REITs are allocating a disproportionate amount of the purchase price to the real property itself, Allen explained. That causes the assessed value to be set artificially high, which results in inflated property tax assessments not only for the purchased hotel but also for all others in that market.

Other Recent State Developments Affecting REITs

Numerous states have moved to combined reporting, and that now includes the District of Columbia. Although that may not affect all REITs, it does affect those structured as captive REITs. Because REITs generally do not pay corporate income tax, they have been used by a parent corporation as a means of tax avoidance. The parent corporation could shift profits to a REIT subsidiary or stash income-earning assets with a REIT subsidiary. Combined reporting eliminates the ability of corporations to benefit from that structure. The change is effective for tax years beginning on or after December 31, 2010.

Many states are now requiring passthrough entities to withhold an amount equal to a partner’s share of income multiplied by the state’s highest individual tax rate.

In a recent trend, many states are now requiring passthrough entities to withhold an amount equal to a partner’s share of income multiplied by the state’s highest individual tax rate. For example, Kentucky enacted legislation that required, for tax years beginning on or after December 31, 2011, any passthrough entity doing business in the state, with the exception of a publicly traded partnership, to withhold income tax on nonresident individuals and

13IRC section 856(c)(4)(A).
14Fiscal Year 2012 Budget Support Act of 2011.
corporate partners if the estimated tax liability is reasonably expected to exceed a specific threshold.\(^{15}\)

Last year, when the New York State Legislature finished its 2010-2011 budget law year, the bill extended indefinitely the combined reporting rules adopted in 2008 for captive REITs and regulated investment companies. The 2008 budget legislation required that for tax years beginning in 2008, 2009, and 2010, all captive REITs and RICs that were more than 50 percent owned by a New York bank or other corporation were required to file a combined return with the closest corporation that directly or indirectly owned or controlled them. The 2010 legislation also amends the definition of a captive REIT to mean a REIT that is not traded on an established securities market and of which more than 50 percent of the REIT’s voting stock is owned or controlled by a single entity traded as an association but taxable as a corporation under the IRC that is not exempt from federal income tax and is not a REIT.

Finally, in March 2011 the Multistate Tax Commission issued a draft model statute “regarding partnership or pass-through entity income that is ultimately realized by an entity that is not subject to income tax.” The model statute was designed to address a perceived tax inequity in which insurance companies, which pay a premium tax as opposed to an income tax, could receive income from a passthrough entity that would avoid income taxation. The model statute would impose an entity-level state income tax on a passthrough entity that is more than 50 percent owned by an insurance company or other entity that is not “subject to income tax.” The definition of passthrough entity would include a REIT.

**Conclusion**

REITs, like most other investment vehicles, are in a transitioning state. The outlook is generally positive; however, the feasibility of forming and operating a REIT may be influenced by a variety of factors, including state taxes. Understanding the state tax issues facing REITs, including how choice of entity or a section 108(i) election could affect a REIT’s tax liability, could be vital to the success of the entity.