State and local tax update

► Michele J. Randall, Partner, State and Local Tax Real Estate Leader, Ernst & Young LLP

► Steven N. J. Wlodychak, Principal, State and Local Leader, EY Center for Tax Policy, Ernst & Young LLP

► Christopher B. Kramer, Senior Manager, Ernst & Young LLP
Agenda

► State income tax considerations
► State franchise tax considerations
► State real estate transfer tax considerations
► Other state tax reform, developments and legislation
► Question and answer
State income tax considerations
State income tax considerations

- Income taxes: Limitations on dividend paid deduction (DPD)
  - Most states allow DPD for a REIT
  - Local jurisdictions such as Ohio municipalities specifically disallow DPD. Other jurisdictions have challenged the allowance of DPD.
  - Certain states disallow DPD for non-publicly traded REITs
  - If REIT is considered “captive,” DPD may be disallowed. Generally, a REIT may be captive if more than 50% of ownership is held by single corporation or corporation subject to subchapter C provisions. Captive REIT definition varies by state.
Captive REIT considerations

► What is a Captive REIT?
  ► Precise definition varies by state
  ► IL example:
    ► a corporation, trust, or association:
      ► that is considered a real estate investment trust for the taxable year under §856 of the Internal Revenue Code;
      ► the certificates of beneficial interest or shares of which are not regularly traded on an established securities market; and
      ► of which more than 50% of the voting power or value of the beneficial interest or shares, at any time during the last half of the taxable year, is owned or controlled, directly, indirectly, or constructively, by a single corporation
  
► In general, states that have enacted Captive REIT legislation disallow the DPD for a Captive REIT

► Recent trend in foreign investors using REITs to acquire US property
  ► Transactions running afoul of Captive REIT legislation, even though these entities do not partake in any of the perceived abuses captive REIT legislation designed to mitigate
Captive REIT considerations (cont.)

Key
States with “captive REIT” law
(NOTE: Technically, NH and MS don’t have captive REIT law but either deny DPD entirely (NH) or have special limitations on dividends to other corporations (MS)).

As of 9/21/2015
State income tax considerations (cont.)

- Income taxes: combined return considerations
  - Is a REIT considered a “corporation” for purposes of the combined return rules
  - Determination of TRS (taxable REIT subsidiary) and REIT combined income
    - Treatment of excess DPD
    - Intercompany transactions
  - 80/20 rules that can impact inclusion of legal entity with foreign activity in combined group
  - Consider water’s edge versus worldwide elections
  - Available consolidated/combined elections
State income tax considerations (cont.)

- Income taxes: combined return considerations
  - Certain states have special rules regarding the inclusion of a REIT in a combined group

- Illustration: California versus Wisconsin
  - Both states require combined filing for members of a unitary group
    - California: REIT and TRSs would file in same combined return
    - Wisconsin: REITs prohibited from being included in a combined return
      - REIT would file on stand alone basis
      - TRS group may be required to file a combined return
State franchise tax considerations
Franchise tax considerations

- Franchise (net worth) taxes can be significant in REIT or real estate fund structure
  - Several states impose significant franchise taxes based on capital or in-state property values
  - Unincorporated and pass-through entities may be subject to franchise taxes in certain states
  - Franchise taxes can be impacted by choice of legal entity. States may not follow federal check the box rules for franchise tax classification.
  - Special provisions may apply in determining a REIT’s franchise taxes. QRS (qualified REIT subsidiary) may be subject to franchise taxes and other types of fees or minimum taxes.
Franchise tax considerations (cont.)

► Choice of entity is critical for franchise tax purposes
  ► A REIT or QRS legally organized as a business trust may qualify for exemption from franchise taxes in several states
  ► A QRS may be entitled to the same special provisions as a REIT and may act as a blocker to minimize the REIT’s tax base
  ► LLCs may be beneficial in isolating the franchise tax base in certain states (e.g., LLCs are subject to franchise tax while LPs are not subject to franchise tax in PA)
  ► LP/LLC structure may result in different in beneficial sourcing rules in a state that does not follow check the box for franchise tax purposes
Franchise tax considerations (cont.)

Example: SC QRS Business Trust

► A QRS is a regarded entity for purposes of SC franchise tax
► Position exists that a QRS Business Trust is not subject to SC franchise tax
Special REIT franchise tax rules

Massachusetts: Special apportionment formula for SEC registrant REITs

- Tax is based on “net worth” (Net Worth = Total Assets - Total Liabilities)
- Under special REIT apportionment formula, only Massachusetts real and tangible property not subject to property tax and intangible assets are included in the numerator of a REIT’s franchise tax apportionment factor
- REIT Apportionment Percentage = Taxable Massachusetts assets ÷ Total assets
- Taxable net worth = Net worth × REIT apportionment percentage
North Carolina:

- North Carolina franchise tax is determined based on the higher of three tax bases, either:
  1. issued and outstanding capital stock, surplus, and undivided profits;
  2. actual investment in tangible property in North Carolina;

- In determining their “capital stock, surplus and undivided profits base,” a REIT is allowed to deduct the aggregate market value of investments in the stocks, bonds, debentures, other securities or evidences of debt of other corporations, partnerships, individuals, municipalities governmental agencies or governments.

Oklahoma: REITs exempt from franchise tax
Franchise tax considerations

Example: NC LP Structure

► Holding property in LP limits the flow up from the NC property
► REIT is allowed a deduction for investment in stock, bonds and partnerships
State real estate transfer tax considerations
The taxability of real estate transactions is dependent on both the type of the transaction and the jurisdiction in which the property is located as states have taken different approaches.

Two types of real estate transfer tax transactions:
- Direct asset transfer
- Controlling interest transfer

For example, both Texas and Arizona have opted to not impose any tax on the transfer of real property whether it is done directly or indirectly.

Alternatively, 17 states have elected to impose a tax on the indirect transfer of a controlling interest in real property.

Opportunity: proposed transactions may be able to be structured in a way to be exempt from taxation by taking into account these considerations.
State real estate transfer tax considerations (cont.)

► As states have added controlling interest transfer tax and other new transfer tax provisions to existing real estate transfer tax regimes, the change has not always been accompanied by sufficient guidance or interpretation to account for the unique facts of a controlling interest transfer.

► There remains significant variation and constant changes in state laws regarding real estate transfer taxes.
  ► The form and timing of transactions play a large role in influencing the ultimate tax liability of any real estate transfers.
  ► Complex and varied state statutes in this area of state tax.
Key

- **States with real estate transfer taxes imposed upon a change of ownership of a business entity doing business in the state. (Controlling Interests Tax) (California only certain cities)**
- **In addition, New York imposes real estate transfer tax upon bargain leases.**
- **Illinois, Maryland Pennsylvania, Rhode Island (eff. 7/1/15) and the District of Columbia require that the Target be a “real estate company” or “entity” (measured by significant percentage of income or assets of the entity derived from or constituting real property).**
- **States with real estate transfer tax only upon document recording.**

Certain large cities (e.g., San Francisco and Oakland) and counties have enacted a controlling interests tax. Taxes administered by local county assessor.

ALSO -- 926 N. Ardmore Ave. LLC (case before Cal. Sup. Ct.)

Key

- **States without a real estate transfer or recording tax.**

Washington County, OR imposes a deed tax.

As of 09/21/2015
MD Controlling Interest Transfer tax example

- MD Controlling Interest Transfer tax only imposed on greater than 80% transfer of “real property entity”
  - MD property constitutes 80% value of assets
  - Aggregate value of property of at least $1M
- Example: Buyer purchases ownership interest of TX, LLC; MD LLC; IN LLC
  - MD controlling interest transfer tax imposed since MD LLC qualifies as a “real property entity”
MD Controlling Interest Transfer tax example (cont.)

- MD Controlling Interest Transfer tax only imposed on greater than 80% transfer of “real property entity”
  - MD property constitutes 80% value of assets
  - Aggregate value of property of at least $1m

- Example: Buyer purchases ownership interest of Holdco SMLLC (single member limited liability company)
  - No MD controlling interest transfer tax imposed since MD LLC does not qualify as a “real property entity”
Other state tax reform, developments and legislation
State tax trends impacting real estate industry

- Significant state trends
  - Enactment of combined reporting
    - Connecticut (tax years commencing on or after 1 January 2016)
    - Rhode Island (tax years after 2014)
  - Move to single sales factor apportionment
  - Move to economic nexus standards and market sourcing
  - Phase out of franchise (net worth) base taxes
  - NOL suspensions or changes in calculations
  - Increased audit activity
    - Pass through entity withholding tax
    - Sales and use tax
    - Transfer taxes
  - Enactment of gross receipt taxes that are imposed on real estate rental income
### 2015 legislative scorecard

**Key:** **Green** – enacted; **Red** – dead; **Purple** – vetoed; **Black** – proposed

| Repeal/phase-out tax | • Corporate income/franchise: HI, MS, NY (all manufacturers), TX  
|                      | • Personal income: GA, MS, TN  
|                      | • Business surcharges or entity level tax/fee: CT (business entity fee), ME (AMT)  
| Rates                | • Increase: Corporate income: CA, CT (extend corporate surcharge), SD (new franchise tax); Personal income: AK (new tax), CT, KS, PA, UT; Sales/use: Chicago, DC, GA, ID, KS, LA, ME, MI, NE, OH, OR (new tax), PA, PR, SD (local); Other business tax: NV (new Commerce Tax, increase business license fee)  
|                      | • Decrease: Corporate income: CT, GA, ID, IL, ME, NE, NH, NM, NYC, NC, ND, PA, RI, TX; Personal income: AR, GA, ID, IL, ME, MS, MT, NM, NC, ND, OH, OR, SC; Sales/use: CT, NM, TN, TX  
| Nexus                | • Affiliate/remote retailers: FL, LA, MD, MI, NV, OH, SC, TN, WA  
|                      | • Economic: AL, MS, NYC, TN, WA  
| Income tax           | • Market sourcing: IN, KY, MO, NM, NYC, NC, TN, VA (study commission)  
|                      | • Single sales factor: NYC, NM (limited), NC, ND (electable), TN (but did adopt triple weighted sales factor), VA (certain data centers)  
|                      | • Combined reporting: AL, CT, FL, KY, LA, MD, MO, NJ, PA; Consolidated returns: MN, MT  
|                      | • Tax havens: AL, CO, CT, DC, FL, KY, ME, MA, MT, NH, OR, PA, VT  
|                      | • Miscellaneous: Limit NOLs: CT, LA, MN, PR; Expand related party add-back: IN, TN; Limit deductions and credits: CT, LA, PR  
| Sales tax            | • Tax services: CA, IL, ME, NV, NC, OH, PA, PR, VT  
|                      | • Expand base/eliminate exemptions: GA, TN (software); Exempt cloud computing: VT  
|                      | • Close loopholes: NY, WA  
| Property tax         | • Property tax relief: ID, IL, ME, MD, NE, NV, ND, PA, TX, WI  
| Controversy          | • Amnesty program: AL, AZ, IN, KS, KY (property taxes), MD, MA, MA (2nd program), MO, NH, NM, OH, OK, PR, SC  
|                      | • Independent tax court: NM, WA  
| Other                | • Limit tax credits: AK (film), LA (film, refundable credits, investment, R&D, etc.); MA (film), KS, LA, ME, NJ, NV, ND, OK, TX (study effectiveness)  
|                      | • Create/expand credits: AL, AR, GA, KY, NM, NY, NC, ND, OH, OR, PA, RI, TN, UT, VA  
|                      | • Adopt a VAT: PR  
|                      | • Inversions: MO, NJ, VA  
|                      | • Payroll tax: VT  

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Recent California Transfer Tax developments

  
  ► The California Court of Appeals for the Second District held that the California Documentary Transfer Tax (DTT) may be applied to transfers of interests in legal entities if the transfer results in a ‘change of ownership’ under the real estate property tax.
  
  ► The court’s interpretation may impact businesses that transfer interests in legal entities that hold California real property. Business activities, such as acquiring or disposing of legal entities, restructuring legal entity ownership, or other transactions modifying legal entity interests could have the unintended consequence of triggering the DTT.
  
  ► It remains unclear whether the decision applies solely to the local application of the DTT, or to all jurisdictions that have incorporated the language used in the model statute.
  
  ► If applicable beyond the limits of Los Angeles County, municipalities and counties may attempt to collect DTT retroactively on prior transactions.
  
  ► 926 N. Ardmore Ave, LLC has filed an appeal to the Supreme Court of California.
California tax developments

► 1031 reporting requirements
  ► A.B. 92 (enacted 18 June 2013) (introduced 16 June 2013)
    ► Requires annual information return with respect to certain IRC §1031 tax-deferred exchanges after 1 January 2014 where California property is exchanged for non-California property
    ► Information return due for the year of exchange and each subsequent tax year until the deferred gain is recognized
    ► Allows the Franchise Tax Board (FTB) to accelerate deferred tax with taxpayer’s failure to file both information return and income/franchise tax return
    ► Provides taxpayers the right to protest and appeal from proposed tax
    ► Allows FTB to determine the content of the information return without any public input by exempting this determination from California’s administrative procedures
California property tax developments

► Ocean Avenue LLC v. County of Los Angeles, Court of Appeals of California, Second District, B249722, (July 1, 2015)
  ► The California Court of Appeals for the Second District held that even though 100% percent of an entity owning CA real property was sold, a re-assessable change in ownership of the entity’s real property did not occur since no one person obtained more than 50% of the entity
  ► AB 2372 (introduced 21 February 2014) provided that a re-assessable change in ownership would occur when cumulatively 90% or more of the ownership interest in an entity are transferred in a three year period (even if no owner obtains more than 50%)
    ► Transfer similar to that in Ocean Avenue would be taxable under this legislation
    ► AB 2372 failed to make it out of the Senate Appropriations Committee
    ► Could see similar legislation introduced in the future as California continues to seek revenue
California mandatory e-filing

- For taxable years beginning on or after 1 January 2014, California requires all business entities (e.g., corporations, S corporations, partnerships and LLCs) that prepare an original or amended return using tax preparation software to electronically file (e-file) their return with the Franchise Tax Board (FTB).

- Note that an amended return filed after 1 January 2015 for a tax year beginning prior to 1 January 2014 is not required to be e-filed.

- Failing to e-file will result in a noncompliance penalty, but the penalty will not take effect until tax years beginning on or after 1 January 2017.

- In limited circumstances, taxpayers may request a waiver of this requirement.

- Consider impact of DRE’s filing under this rule.
Kansas tax developments

► S.B. 265, Laws 2014, effective 1 July 2014
► Legislation repealed nonresident withholding requirements for S corporations, partnerships and LLCs
► These flow-through entities were previously required to deduct and withhold tax from a nonresident’s share of the flow-through entity’s Kansas taxable income, whether distributed or undistributed, and pay the withheld amount to the Kansas Department of Revenue
Nevada Commerce Tax

- SB 483, signed on 10 June 2015
- Tax is imposed on “business entities” which is broadly defined. REITs are exempt if they do not own property directly but their subsidiary entities appear to be taxable (similar language to the Texas margins tax)
- It appears to apply to real estate rental and amounts realized from the sale of real estate.
  - Exemption provided for disposition of IRC §1231 assets
- Tax rate is determined based on industry designation under NAICS. The tax rate for real estate is .25%.
- The Commerce Tax can be taken as a 50% credit against the Modified Business Tax (based on wages)
- The effective date of the legislation is 1 July 2015
- Tax is imposed annually on a 30 June year end with a return and payment due date of 15 August
  - First report due 15 August 2016
Hawaii state tax reform legislation: proposed legislation would remove DPD

▶ On 22 January 2015, S.B. 118 was introduced in the Hawaii Senate to remove the dividends paid deduction for REITs in the state. S.B. 118 was referred to the Senate Ways and means Committee, and has been scheduled for a public hearing on 18 February 2015.

▶ S.B. 118 was revised to require “the department of business, economic development, and tourism, with the assistance of the department of taxation, shall study the impact of real estate investment trusts in Hawaii and the possible effect of repealing the dividends paid deduction for real estate investment trusts.” Passed second reading as amended (S.B. 118 SD1) on 5 March 2015.

▶ A similar bill, H.B. 82, was also introduced in the Hawaii House of Representatives, however, on 4 February 2015, this bill was deferred by the Committee on Consumer Protection & Commerce/Committee on Judiciary. No further action is expected.
New York State tax reform legislation

► A. 8559D and S.6359D (enacted 31 March 2014)
► Corporate franchise tax rate changes
  ► Entire net income rate reduced to 6.5% beginning in 2016
  ► Business capital tax rate reduced to zero by 2021 tax year
  ► Fixed minimum dollar tax cap increased to $200,000 (determined by NY sales)
  ► Makes MTA surcharge permanent and increase rate to 1.82%
  ► Eliminates subcapital tax and significantly modifies investment capital rules
► Net operating loss changes
  ► Convert from pre- apportionment to post apportionment NOL for 2015 tax year
  ► 3-year carryback added but limited carryback to 2015 and forward
Merges bank tax with general corporation tax
Adoption of economic nexus and market based sourcing
Modified combined reporting rules for 2015 tax year
  Substantial intercorporate transactions no longer required for combination
  Combined report does not include a non-captive REIT
  Captive REITs continue to be subject to combined reporting rules.
Effective on or after 1 January 2015 with some exceptions
New York City substantially conforms to New York State tax reform changes (S4610). The changes would be retroactive to 1 January 2015.
New York City did not modify its unincorporated business tax provisions
North Carolina 2015 legislation

► On 18 September 2015, House Bill 97 was signed by the North Carolina Governor
► Corporate and personal income tax rates reduced
► Corporate tax base expanded
  ► Net interest expense paid to related member added back. Certain “qualified interest” is allowed as deduction.
  ► Single sales factor phase in enacted
  ► Market based sourcing
► Franchise tax base simplification
  ► For taxes due on or after 1 January 2017, the capital stock, surplus and undivided profits base is replaced with a more simplified “net worth” base and certain adjustments are removed
► Expansion of sales tax base by including revenues from repair, maintenance and installation services for tangible personal properties. Installation by real property contractors pursuant to real property contracts are exempt.
Rhode Island Controlling Interest Transfer Tax

Effective 1 July 2015, new legislation requires “acquired real estate companies” to:
(i) file notice of a potential acquisition of a real estate company at least five (5) days prior to the grant, transfer, assignment;
(ii) pay tax for the acquisition of the real estate company

“Real estate company” means a corporation, limited liability company, partnership, or other legal entity which:
1. Is primarily engaged in the business of holding, selling or leasing real estate, where 90% or more of the ownership of said real estate is held by 35 or fewer persons and which company either:
   (a) derives 60% or more of its annual gross receipts from the ownership or disposition of real estate; or,
   (b) owns real estate the value of which comprises 90% or more of the value of the entity’s entire tangible asset holdings exclusive of tangible assets which are fairly transferrable and actively traded on an established market.

OR

2. 90% or more of the ownership interest in such entity is held by 35 or fewer persons and the entity owns as 90% or more of the fair market value of its assets a direct or indirect interest in a real estate company. An indirect ownership interest is an interest in an entity 90% or more of which is held by 35 or fewer persons and the purpose of the entity is the ownership of a real estate company.

“acquired real estate company” means a real estate company that has undergone a change in ownership interest if:
(i) such change does not affect the continuity of the operations of the company; and
(ii) the change, whether alone or together with prior changes has the effect of granting, transferring, assigning or conveying or vesting, transferring directly or indirectly, 50% or more of the total ownership in the company within a period of three (3) years.

Tax rate = .46%
Recent Tennessee tax developments

► Tennessee Notice 14-12
► Tennessee Department of Revenue (TDOR) clarifies that an SMLLC owned by a REIT is a disregarded entity for franchise and excise tax purposes
► TDOR removed its frequently answered questions with respect to an SMLLC owned by a REIT because it was no longer applicable to open tax periods

► Tennessee Revenue Ruling 13-22 (December 2013)
► Ruling was published in June of 2014
► Addresses the excise tax consequences of several public REIT fact patterns including QRS and disregarded limited partnership
► The ruling is unfavorable and conflicts with historical policy regarding treatment of entities owned by public REITs
The better the question. The better the answer.
The better the world works.