F I S C A L   I M P A C T   R E P O R T

SPONSOR Wirth **ORIGINAL DATE** 02/15/17 **LAST UPDATED** **HB**

SHORT TITLE Captive Real Estate Investment Trust Income **SB** 391

ANALYST Graeser

REVENUE (dollars in thousands)

Estimated Revenue					Recurring or Nonrecurring	Fund Affected
FY17	**FY18**	**FY19**	**FY20**	**FY21**		
	500.0	1,000.0	1,000.0	1,000.0	Recurring	General Fund

Parenthesis ( ) indicate expenditure decreases. ** R = recurring; NR = non-recurring

SOURCES OF INFORMATION
LFC Files

Responses Received From
Taxation and Revenue Department (TRD)

SUMMARY

Synopsis of Bill

Senate Bill 391 amends the definition of "net income" to add back any deduction claimed in calculating federal taxable income of a corporation for expenses and costs paid to a "captive real estate trust". A captive real estate trust is a limited subset of all real estate trusts (REITs) that are not regularly traded on an established securities market and the shares of which are more than 50% owned by the reporting corporation.

There is no effective date of this bill. It is assumed that the new effective date is 90 days after this session ends (June 16, 2017). The provisions of the bill are applicable for tax years beginning January 1, 2017.

FISCAL IMPLICATIONS

This bill may partially limit the loss of state revenue from corporations that have set up a captive real estate investment trust to avoid paying state taxes. Deductions claimed for payments to listed REITs or to REITs less than 50% owned by the reporting corporation will not be affected by the addback of this bill.

It is difficult to score the fiscal impact of this bill, since the data are obscure. Reitsacrossamerica.com[1] indicates that total REIT activity in New Mexico is about $5 billion. The National Association of REITs[2] indicates that the median earnings of listed and unlisted REITs are about 4.25%. Assuming that none of the REITs are owned by New Mexican individuals, then the total state revenue loss from the REIT tax shelter industry would total about $12.5 million. The growth nationwide in REITs has been driven primarily by the tax shelter features. However, some multi-state/multi-national corporations have adopted the REIT device and formed "captive real estate investment trusts." The nature of these captive REITs is that they are used for state tax avoidance purposes. These captive trusts are generally not listed on any public market and are owned by a holding company that probably also owns the New Mexico corporate entity that is currently deducting rental payments to the captive REIT. It is these captive REITs deductions that would be added back to net income of the NM corporation.

For the purpose of scoring this bill, LFC staff has assumed that 1/8th of the tax shelter activity is captive and subject to the addback of this bill. The provisions of the bill come into play on January 1, 2017, but there will be no FY 17 activity. Some of the revenue would be received in March 2018, but the bulk of the new revenue will be paid with final corporate returns filed in September 2018.

SIGNIFICANT ISSUES

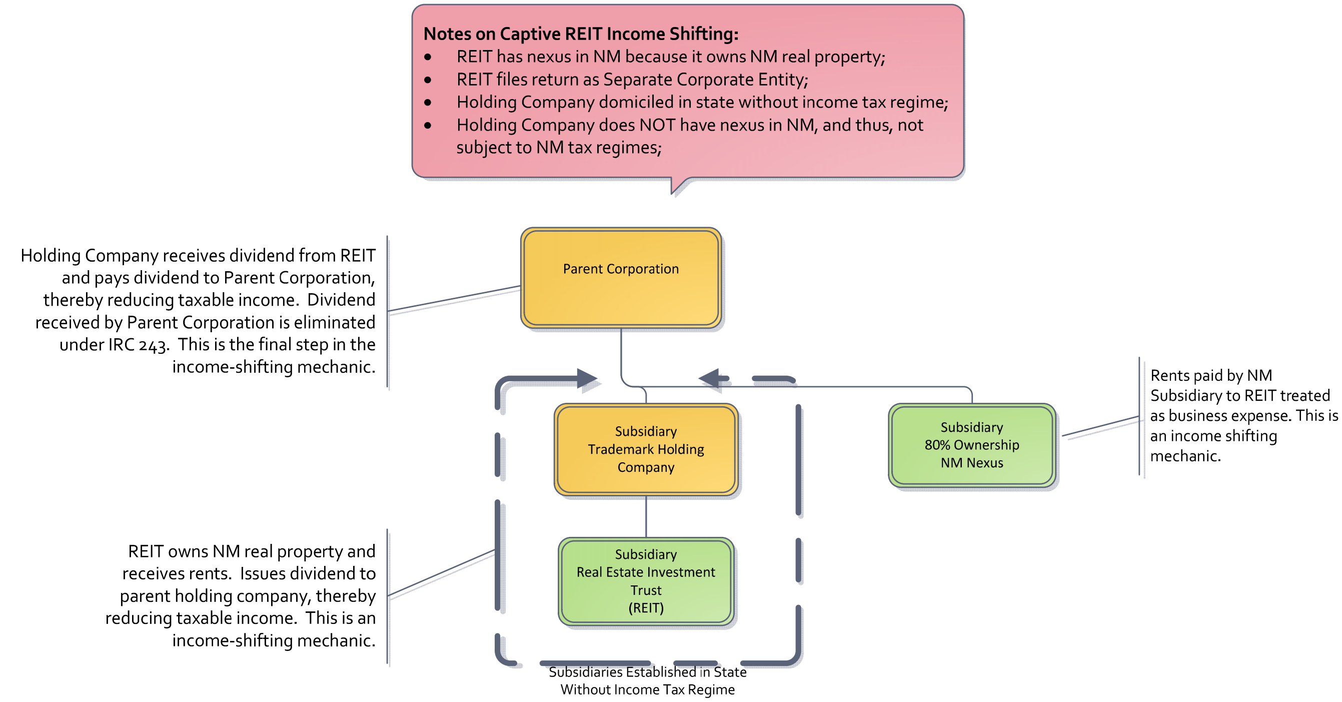
TRD has provided the following:

Under the separate corporate entity filing option, captive REITs are a corporate entity structural tool CIT filers can use to shift income on real property rental income earned in New Mexico to other states, thereby reducing New Mexico CIT liabilities. This bill is commonly referred to as an "addback" statute and is intended to curtail tax escapement through use of a REIT.

A simplified example of the Captive REIT issue is provided herein. The illustration below depicts the simplified example.

The Corporate Parent owns an operating subsidiary having nexus with New Mexico. The New Mexico subsidiary pays rent to the REIT, and reduces its taxable income because the rent payments are a business expense. The REIT owns New Mexico real property, has nexus with New Mexico, and files a return as a separate entity. Any entity that files a federal 1120-REIT is required to file an S-Corporation return in New Mexico. The REIT receives rent payments from the New Mexico subsidiary, and issues dividends to a Holding Company. The REIT's tax liability is reduced because taxable income is reduced thru dividends paid. The Holding Company, typically domiciled in a state without an income tax regime, is a subsidiary of the Parent Corporation. While the Holding Company owns the REIT, it does not have nexus with New Mexico, and thus is not subject to New Mexico CIT. Consequently, the dividends paid to the Holding Company represent the income that is avoiding taxation. The Holding Company then passes the dividend to the Parent Corporation; the dividend income is eliminated from federal taxable income under IRC 243.

[1] Reitsacrossamerica.com
[2] https://www.reit.com/data-research



New Mexico has experienced income-shifting efforts by corporate taxpayers and examined these efforts through the audit and compliance process. Income shifting risks are higher in states, like New Mexico, that allow groups of corporations that are commonly owned to file as independent separate entities. Under current law, tools to curtail these income-shifting efforts are limited. Several states, including Georgia, Alabama, Illinois, and Utah have revised their laws to reduce income-shifting through the use of REITs. In 2015 Utah further revised their law to require combined reporting; one advantage of combined reporting is reduction of income-shifting. Other separate entity filing states have enacted a broader range of addback statutes.

PERFORMANCE IMPLICATIONS

The LFC tax policy of accountability is <u>not</u> met since TRD is <u>not</u> required in the bill to report annually to an interim legislative committee regarding the data compiled from the reports from taxpayers taking the REIT deduction and particularly, the number of taxpayers and the amount of deductions added back to net income by the provisions of this bill. However, the larger REIT deduction from net income is not separately reported to New Mexico, so TRD would have no means of extracting either the basic REIT deduction or any change in the REIT deduction attributed to the provisions of this bill.

ADMINISTRATIVE IMPLICATIONS

TRD has requested this bill to aid in reducing the use of this tactic by some large corporations.

OTHER SUBSTANTIVE ISSUES

This bill is not proposing to eliminate the entire passive REIT tax expenditure, but only the smaller tax expenditure attributed to deductions paid to captive REITs. However, to understand the scope of this bill, LFC is including an extract from a Forbes magazine story entitled, “Are

REITs Paying Their Fair Share To States?"[3]

Cara Griffith, Contributor

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A REIT is a company that uses the pooled capital of many investors to purchase and operate income-producing property or to 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 REITs allow them to invest in real estate without needing to have the necessary capital for direct ownership of those same properties.

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 requisite number of years has passed, 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.

For federal tax purposes, REITs are taxed as corporations, which means that they are taxed first at the entity level and then at the shareholder level. However, 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 the trusts 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. 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.

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.

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. 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 dividend-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.

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[3] http://www.forbes.com/sites/taxanalysts/2015/06/12/are-reits-paying-their-fair-share-to-states/#69219e1f120c

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