2009 SENATE FINANCE AND TAXATION

SB 2089

2009 SENATE STANDING COMMITTEE MINUTES

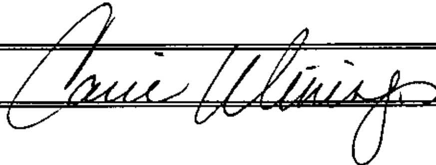
Bill/Resolution No. 2089

Senate Finance and Taxation Committee

☐ Check here for Conference Committee

Hearing Date: 01/26/2009

Recorder Job Number: 7681

Committee Clerk Signature	

Minutes:

Chairman Cook: Opened hearing on SB 2089.

Mary Loftsgard, Associate Director of the Tax Administration Division, and Office of State Tax Commissioner: See attachment #1 in support of the bill. See also attachment #2 and #3 for additional information.

Chairman Cook: In looking at attachment #3, I see this Wal-Mart heading just touched on the question I was thinking. It is possible than for a corporation to take all of their assets/real estate and put them into a REIT and then be able to deduct their expenses that they pay rent for this property from their own individual corporate income tax. It showed up as income over here and that actually becomes non-taxable. Is that how they made this work?

Mary Loftsgard: Yes, and that can happen in a variety of ways. I want to make a point that these types of entities are used to move or shelter income or avoid state taxes whether they are a separate entity or not.

Chairman Cook: Is it possible for a corporation and put them into a REIT?

Mary Loftsgard: Yes and can happen under a variety of ways.....problems with income escaping.

Senator Oehlke: I am guessing that the state should show a fiscal note with some income on it, but this fiscal note doesn't show any change. Is that because we don't know, or we are guessing?

Mary Loftsgard: We are not able to determine that.

Senator Triplett: That was my question also. We have so many bills in front of us this session that are going to reduce taxes if passed, and it would be nice to have a rough estimate to be able to look at the combined effect to the community. When you say that the tax department is required to do this double deduction the way the laws work together (federal and state) it seems to me that there must be something in your records to give you a clue. Why is there nothing?

Mary Loftsgard: We have nothing right now on the corporate income tax form that would require a corporation that it is a REIT, and many of these groups may not be North Dakota tax payers. They are included in the combined group because they are unitary, but the REIT itself doesn't have a presence here so it is not a filer here in North Dakota.

Senator Triplett: Can you give us a clue in terms of our record how often that you have come across those in audits, and what was the dollar impact.

Mary Loftsgard: Off the top of my head I can't. We will see if we can pull that together.

Senator Triplett: Do you think it is significant?

Mary Loftsgard: It has the potential to be.

Chairman Cook: Compare this relationship of what multi-state tax commission is doing here to income tax to what the streamline governing board does to sales tax laws in North Dakota. We understand that by simplifying sales tax laws that we will start capturing a lot of sales that is owed right now and not being collected. The fiscal note for any streamline bill as it gets introduced always shows 0. But yet we know that there could be projected revenue. I

understand why it does not show up on a fiscal note, but there are studies out there that speculate on exactly how much that income is for North Dakota. Has the multi-state tax commission done any studies as to what type of income is being lost by state because of rates, and is that in this Wall Street Journal study.

Mary Loftsgard: Refers to attachment #2 for answer (Bottom of page 5 - that is just for the company)

Senator Dotzenrod: Is that figure for all of the states, or is that for just one?

Mary Loftsgard: To the best of my recollection, for all states.

Denita Wald, General Council, and State Tax Department: At the back of that article it refers to some figures. Our main purpose in this is that 1. We think that we have a problem, and if we don't let's plug the hole now.

26.05

Chairman Cook: We don't know if in North Dakota if Wal-Mart has the property zoned in a REIT do we?

Denita Wald: Check Wal-Mart for sale sign and it says contact REIT on sign.

Senator Triplett: Do you think this could be in the millions of dollars?

Mary Loftsgard: Could be.

Chairman Cook: In two years from now would you know? Could it be tracked?

Mary Loftsgard: We could certainly do something to try to identify those entities, and have follow up numbers in two years. There were 11 states that have legislation regarding REITs.

Chairman Cook: You mention the multi-state tax commission during the hearing, have you worked with representatives of REITs? There is part of me that is wondering why there are not a lot of people in here. We are not getting testimony on both sides to get a feel for what it will do. Do I understand that in that hearing that the feeling was what they felt should be done?

Mary Loftsgard: I think the entities that were involved, it was a national conference, their primary concern was with staying on the captive REITs again that are not widely?. Almost just a separate vehicle.

Chairman Cook: My friend that has stock in a publicly traded REIT, if he does his personal income tax, he is not affected?

Mary Loftsgard: It will not.

Chairman Cook: Further testimony in support? (No) Opposed? (No) Neutral? (No)

Closed hearing on the SB 2089.

2009 SENATE STANDING COMMITTEE MINUTES

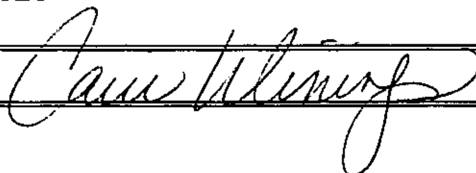
Bill/Resolution No. 2089

Senate Finance and Taxation Committee

☐ Check here for Conference Committee

Hearing Date: 01/27/2009

Recorder Job Number: 7820

Committee Clerk Signature 

Minutes:

Chairman Cook: Reopened hearing on SB 2089.

Senator Hogue moved a Do Pass.

Senator Oehlke Seconded the motion.

Chairman Cook: Any discussion? (No)

A Roll Call vote was taken: 7 Yea, 0 Nay, 0 Absent.

Senator Hogue will carry the bill.

FISCAL NOTE
Requested by Legislative Council
03/04/2009

Amendment to: SB 2089

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2007-2009 Biennium		2009-2011 Biennium		2011-2013 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues						
Expenditures						
Appropriations						

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

2007-2009 Biennium			2009-2011 Biennium			2011-2013 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts

2A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

SB 2089 with House Amendments deals with add-back provisions for unitary groups of corporations that contain a member corporation that is a certain type of real estate investment trust. It also repeals obsolete code provisions relating to severed coal and mineral intersts.

B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

Section 1 of SB 2089 with House Amendments addresses a specific situation which arises when a unitary group of corporations includes a corporation that is a "captive" Real Estate Investment Trust (REIT). Under current law both REIT income and all dividends paid by the REIT to its parent company are excluded from ND taxable income. This is inconsistent with the treatment of other corporations in a unitary group. This bill addresses the issue with add-back provisions.

The fiscal impact of this section of the bill cannot be determined.

Section 2 of the bill repeals obsolete sections of code relating to severed coal and other mineral interests. There is no fiscal impact to this section.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*

A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation is also included in the executive budget or relates to a continuing appropriation.*

Name:	Kathryn L. Strombeck	Agency:	Office of Tax Commissioner
Phone Number:	328-3402	Date Prepared:	03/05/2009

FISCAL NOTE

Requested by Legislative Council
12/22/2008

Bill/Resolution No.: SB 2089

1A. **State fiscal effect:** *Identify the state fiscal effect and the fiscal effect on agency appropriations compared to funding levels and appropriations anticipated under current law.*

	2007-2009 Biennium		2009-2011 Biennium		2011-2013 Biennium	
	General Fund	Other Funds	General Fund	Other Funds	General Fund	Other Funds
Revenues						
Expenditures						
Appropriations						

1B. **County, city, and school district fiscal effect:** *Identify the fiscal effect on the appropriate political subdivision.*

2007-2009 Biennium			2009-2011 Biennium			2011-2013 Biennium		
Counties	Cities	School Districts	Counties	Cities	School Districts	Counties	Cities	School Districts

2A. **Bill and fiscal impact summary:** *Provide a brief summary of the measure, including description of the provisions having fiscal impact (limited to 300 characters).*

SB 2089 deals with add-back provisions for unitary groups of corporations that contain a member corporation that is a certain type of real estate investment trust.

B. **Fiscal impact sections:** *Identify and provide a brief description of the sections of the measure which have fiscal impact. Include any assumptions and comments relevant to the analysis.*

SB 2089 addresses a specific situation which arises when a unitary group of corporations includes a corporation that is a "captive" Real Estate Investment Trust (REIT). Under current law both REIT income and all dividends paid by the REIT to its parent company are excluded from ND taxable income. This is inconsistent with the treatment of other corporations in a unitary group. This bill addresses the issue with add-back provisions.

The fiscal impact of this bill cannot be determined.

3. **State fiscal effect detail:** *For information shown under state fiscal effect in 1A, please:*

A. **Revenues:** *Explain the revenue amounts. Provide detail, when appropriate, for each revenue type and fund affected and any amounts included in the executive budget.*

B. **Expenditures:** *Explain the expenditure amounts. Provide detail, when appropriate, for each agency, line item, and fund affected and the number of FTE positions affected.*

C. **Appropriations:** *Explain the appropriation amounts. Provide detail, when appropriate, for each agency and fund affected. Explain the relationship between the amounts shown for expenditures and appropriations. Indicate whether the appropriation is also included in the executive budget or relates to a continuing appropriation.*

Name:	Kathryn L. Strombeck	Agency:	Office of Tax Commissioner
Phone Number:	328-3402	Date Prepared:	01/23/2009

Date: 01/27/09

Roll Call Vote #: 1

2009 SENATE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. : 2089

Senate Finance and Taxation Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken ☑ Do Pass ☐ Do Not Pass ☐ Amended

Motion Made By Sen. Hogue Seconded By Sen. Oehlke

Senators	Yes	No	Senators	Yes	No
Sen. Dwight Cook - Chairman	✓		Sen. Arden Anderson	✓	
Sen. Joe Miller – Vice Chairman	✓		Sen. Jim Dotzenrod	✓	
Sen. David Hogue	✓		Sen. Constance Triplett	✓	
Sen. Dave Oehlke	✓				

Total: Yes 7 No 0

Absent 0

Floor Assignment Senator Hogue

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

SB 2089: Finance and Taxation Committee (Sen. Cook, Chairman) recommends **DO PASS** (7 YEAS, 0 NAYS, 0 ABSENT AND NOT VOTING). SB 2089 was placed on the Eleventh order on the calendar.

2009 HOUSE FINANCE AND TAXATION

SB 2089

2009 HOUSE STANDING COMMITTEE MINUTES

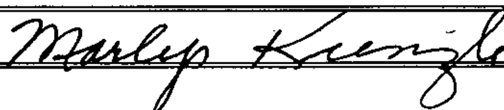
Bill/Resolution No. SB 2089 A

House Finance and Taxation Committee

☐ Check here for Conference Committee

Hearing Date: March 2, 2009

Recorder Job Number: #9926

Committee Clerk Signature 

Minutes:

Chairman Belter: Opened the hearing for SB 2089.

Matt Peyerl: Supervisor for Corporate Income Tax for the Office of State Tax commissioner. Testimony attachment #1 which included a walkthrough of the bill.

Attachment # 2

Chairman Belter: My questions is, why would you not come with a FN as the Commissioner must want this and they must feel this is not working?

Matt Peyerl: That is a good question, in that it is a specific circumstance and the information is not apparent in their return. It would probably come out if there was an audit.

Rep Pinkerton: Page 3, item 2, 3, and 4 (inaudible).

Matt Peyerl: That would be correct. It allows for some of type of time period when they are on their way to becoming traded. The intent is very specific that it is only targeting those that are wholly owned by parent companies and have no intentions to becoming anything else but that.

Rep Pinkerton: (Inaudible)

Matt Peyerl: That is my interpretation as well.

Rep Froseth: Even though this does not have a FN, wouldn't the effect be that more corporate taxes would be collected?

Matt Peyerl: That is correct. It would only increase it would not decrease. We do not know the extent of the increase would be and that is the problem.

Chairman Belter: This attachment from Walmart is that from you?

Matt Peyerl: Yes that was a supplement to the testimony. The main article in that testimony is the tax shelter, which we do not have that tax issue.

Attachment # 3

Chairman Belter: Closed the hearing on 2089.

2009 HOUSE STANDING COMMITTEE MINUTES

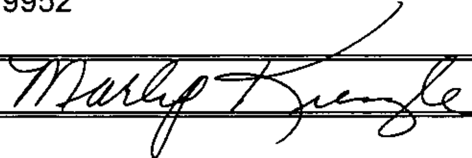
Bill/Resolution No. SB 2089 B

House Finance and Taxation Committee

☐ Check here for Conference Committee

Hearing Date: March 2, 2009

Recorder Job Number: # 9952

Committee Clerk Signature 

Minutes:

Chairman Belter: Opened the hearing for SB 2089.

Rep Headland: I apologize for missing that hearing. Just a question, we are trying to move from the elimination of tax, (inaudible) why would we add a tax that is double counted?

Rep Winrich: It is double counted now. Remember the IC Disc Bill. It is a deal where one company or entity sets up a wholly owned company just because of the tax laws. This Captive Reet turns out to be one of these corporations. The taxes get juggled by the different parts of the corporation. Under the present law the corporate tax in North Dakota does not parallel the Federal regulations so the dividends are counted twice so we are eliminating one of those.

Rep Headland: So you are deducting on your Federal return and then hold the deduction on the state return?

Rep Winrich: As I understood the testimony, the combination entity on paper involves two corporations filed, one of those corporations under Federal Law cannot claim the dividend as a business expense under Federal law but the other one can. So it gets deducted once. Under the North Dakota state law both of them can be deducted. What it ends up is that North Dakota taxable law income is different than Federal taxable law income.

There is an example to assist you.

Chairman Belter: We won't act on it as Rep Drovdal wants to talk a little bit about the possibility of an amendment on this bill so we won't act on it.

Hearing is closed.

2009 HOUSE STANDING COMMITTEE MINUTES

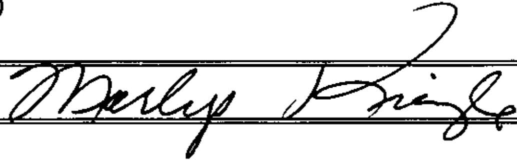
Bill/Resolution No. SB 2089

House Finance and Taxation Committee

☐ Check here for Conference Committee

Hearing Date: March 3, 2009

Recorder Job Number: #10020

Committee Clerk Signature	

Minutes:

Chairman Belter: Opened the hearing for SB 2089.

Rep Drovdal:

See attachment # 1 the proposed amendment.

If you recall we had a bill with a two dollar severance tax for mineral acres. There was some discussion by the common recorder that there is language in our Century Code that has been obsolete and has not been used since the Supreme Court ruled in 3 separate occasions that the severance tax is illegal. They have asked if it would be possible for us to take that language out.

This amendment would remove those two sections from the Century Code that does not apply to today's world.

In talking with Attorney Walstad he agreed that there is no use for this language.

We have been looking for a bill to attach it to and this bill happens to deal with 57 the same part of the Century code.

Chairman Belter: We have a motion for the amendment do we have a second?

Rep Weiler: 2nd the motion.

Rep Winrich: The effective date would not matter? Oh I guess it would be okay.

Voice vote on amendment was **Passed**.

Do pass from **Rep Drovdal**.

Seconded by **Rep Winrich**.

Vote was 12 yes, 0 no, and 1 absent

Carrier is **Rep Pinkerton**.

98122.0101
Title.0200

Prepared by the Legislative Council staff for
Representative Drovdal
March 2, 2009

VR
3/3/09

PROPOSED AMENDMENTS TO SENATE BILL NO. 2089

Page 1, line 3, after "purposes" insert "; to repeal sections 57-02-24 and 57-02-25 of the North Dakota Century Code, relating to elimination of obsolete provisions relating to listing and assessment of severed coal and mineral interests"

Page 4, after line 3, insert:

"**SECTION 2. REPEAL.** Sections 57-02-24 and 57-02-25 of the North Dakota Century Code are repealed."

Renumber accordingly

Date: March 3, 2009

Roll Call Vote #: 1

2009 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2089

House FINANCE AND TAXATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number 101

Action Taken ☐ Do Pass ☐ Do Not Pass ☐ Amended

Motion Made By Drovdal Seconded By Weiler

Representatives	Yes	No	Representatives	Yes	No
Chairman Wesley R. Belter			Representative Froelich		
Vice Chairman David Drovdal			Representative Kelsh		
Representative Brandenburg			Representative Pinkerton		
Representative Froseth			Representative Schmidt		
Representative Grande			Representative Winrich		
Representative Headland					
Representative Weiler					
Representative Wrangham					

Voice

Total (Yes) ______ No ______

Absent ______

Floor Assignment ______

If the vote is on an amendment, briefly indicate intent: Motion carries

Date: March 3 2009

Roll Call Vote #: 2

2009 HOUSE STANDING COMMITTEE ROLL CALL VOTES
BILL/RESOLUTION NO. 2089

House FINANCE AND TAXATION Committee

☐ Check here for Conference Committee

Legislative Council Amendment Number

Action Taken ☒ Do Pass ☐ Do Not Pass ☐ Amended

Motion Made By Drovdal Seconded By Winrich

Representatives	Yes	No	Representatives	Yes	No
Chairman Wesley R. Belter	✓		Representative Froelich	✓	
Vice Chairman David Drovdal	✓		Representative Kelsh	✓	
Representative Brandenburg	✓		Representative Pinkerton	✓	
Representative Froseth	✓		Representative Schmidt	✓	
Representative Grande			Representative Winrich	✓	
Representative Headland	✓				
Representative Weiler	✓				
Representative Wrangham	✓				

Total (Yes) 12 No 0

Absent 1 (Grande)

Floor Assignment Rep Pinkerton

If the vote is on an amendment, briefly indicate intent:

REPORT OF STANDING COMMITTEE

SB 2089: Finance and Taxation Committee (Rep. Belter, Chairman) recommends **AMENDMENTS AS FOLLOWS** and when so amended, recommends **DO PASS** (12 YEAS, 0 NAYS, 1 ABSENT AND NOT VOTING). SB 2089 was placed on the Sixth order on the calendar.

Page 1, line 3, after "purposes" insert "; to repeal sections 57-02-24 and 57-02-25 of the North Dakota Century Code, relating to elimination of obsolete provisions relating to listing and assessment of severed coal and mineral interests"

Page 4, after line 3, insert:

"**SECTION 2. REPEAL.** Sections 57-02-24 and 57-02-25 of the North Dakota Century Code are repealed."

Renumber accordingly

2009 TESTIMONY

SB 2089

#\

Testimony Of the Office of State Tax Commissioner
Before The
Senate Finance And Taxation Committee

Senate Bill 2089

January 26, 2009

Chairman Cook, members of the Senate Finance and Taxation Committee, I am Mary Loftsgard, Associate Director of the Tax Administration Division, of the Office of State Tax Commissioner. I am here today on behalf of the Commissioner to testify in support of Senate Bill 2089.

Reasons for Proposed Changes

This bill was introduced by the Tax Commissioner to address a specific situation which arises when a unitary group of corporations includes a corporation that is a "captive" Real Estate Investment Trust (REIT). As I will explain further, the bill does not affect all REITS, such as those that are publicly held and widely traded. The bill is specific to captive REITS.

For a unitary group of corporations we begin calculating North Dakota taxable income by adding together the federal taxable income/loss of all companies in the unitary group. From that aggregate amount, we subtract dividends paid by any corporation in the unitary group to another corporation in the unitary group. This principle of unitary combination avoids double representation of a corporation's income.

Unitary groups can include REITS. Because REITs are treated differently from regular corporations for federal tax purposes, as North Dakota law is now structured, it allows an exclusion from North Dakota taxable income for both REIT income and all dividends paid by the REIT to its parent company. This is inconsistent with the treatment of other corporations in a unitary group, where each corporation's income is included but intercompany dividends are excluded from the combined report.

This bill is based, in large part, on a model statute developed by the Multistate Tax Commission (MTC). North Dakota adopted the Multistate Compact (N.D.C.C. Chapter 57-59) in 1969 and has been a member the MTC since that time.

Background

Some background on REITs may be helpful in explaining this bill. REITs were enabled by Congress to encourage the pooling of investments in income-producing real estate. In an investment sense, they serve much the same investment purpose as a mutual fund.

REITs have some of the same characteristics as a simple trust, and for income tax purposes REITs operate much like a pass-through entity. REITs are required by federal law to annually distribute at least 90% of the REIT earnings as a dividend. For federal purposes, REITS are allowed to deduct these dividend payments in determining their federal taxable income. Most often, the REIT will "dividend out" all its income and will report zero federal taxable income. The owners of the REIT report the dividend income on their income tax returns and pay any associated federal tax. In contrast, a regular corporation is not allowed to deduct the dividends it pays out. The following illustrates the resulting difference in federal taxable income.

	Regular corporation	REIT
Income	$1,000,000	$1,000,000
Deductions	-310,000	-310,000
Dividends paid	NA	-690,000
Taxable Income	$ 690,000	-0-

Since the establishment of REITs, there has been an increasing propensity of corporations, particularly in the retail and mortgage industries, to use this form of entity to shelter income for tax purposes. In this scenario, corporations form a "captive" REIT subsidiary where the corporation itself, and perhaps some corporate officers, are the only owners in the captive REIT. These captive REITS are not operating companies, but essentially function as holding companies for assets transferred to them by the corporation. States encountered, with increasing frequency, instances where regular corporations transferred assets to a captive REIT. The income associated with those assets was also transferred to the captive REIT and, due to federal tax treatment and existing combined reporting principles, that income was effectively shielded from state taxation.

As an outgrowth of member states' concerns, in 2004 the MTC formed a task force to study tax sheltering activity and to make recommendations to prevent use of abusive tax shelters. One of the areas studied extensively by the task force was the misuse of passthrough entities, such as captive REITS, to shelter income from state taxation. In early 2006 the MTC income tax uniformity subcommittee voted to specifically study tax sheltering practices of REITs. A drafting group of 8 MTC member states worked with

MTC staff to develop a model statute. As part of the process, drafts were reviewed in 2006 through 2008 at MTC uniformity committee meetings. These were public meetings and were attended by members of the REIT investment community. Input from that group was incorporated in the model statute to clarify what constituted a captive REIT. In October, 2007, a public hearing was held on the model statute and, based on testimony at the hearing, some modifications to further clarify the rule were recommended. The recommendations were adopted as the final model statute by the MTC Executive Committee in January 2008.

I've attached an example to illustrate the effect a captive REIT has on the North Dakota tax base under existing law. The first scenario assumes a corporation and a non-REIT subsidiary are unitary. To determine the tax base for the unitary group, the federal taxable incomes of the two corporations are added together. To avoid double taxation of the subsidiary income, dividends paid by the subsidiary to the parent are then eliminated. The second scenario illustrates the situation for a corporation and a captive REIT subsidiary. The tax base is determined in exactly the same manner, but because of the federal deduction for dividends paid by the captive REIT, the North Dakota tax base is less than in the first scenario. Essentially, in a unitary combined report, the captive REIT is allowed to exclude any income from taxation and then exclude the income again by virtue of the intercompany dividend elimination.

EXPLANATION OF THE BILL

Section 1 – Amends N.D.C.C. 57-38-01.3 to provide for an addition to federal taxable income. Senate Bill 2089 addresses this situation by requiring captive REITS to add back the amount of the dividends paid deduction. The third scenario on the attached illustration shows the result. Senate Bill 2089 acts to counter the double elimination of captive REIT income that occurs under present law.

I want to stress again that this bill affects only captive REITS. Subdivision (2) of the bill, identifies entities which are not affected. These include:

- publicly traded REITS, i.e. those that, similar to a mutual fund, are publicly traded and whose owners are typically large groups of unrelated parties,
- REITs owned by other non-captive REITS
- listed Australian property trusts, and

- qualified foreign entities.

Australian property trusts and qualified foreign entities are, like non-captive REITS, widely held. They are used to encourage investment in United States real estate and are not viewed as vehicles for tax sheltering.

Section 2 – Effective date. This section specifies that the bill is effective for taxable years beginning after December 31, 2008.

CONCLUSION

The Tax Commissioner respectfully requests that you give favorable consideration to Senate Bill 2089.

Scenario with Non- REIT Subsidiary:

Parent corporation has $2,000,000 in federal taxable income (FTI).
Subsidiary corporation has $500,000 in FTI.
Subsidiary corporation pays $500,000 in dividends to the parent corporation.

Parent Corporation FTI	$2,000,000	(Includes dividends paid by subsidiary)
Subsidiary Corporation FTI	$500,000	
Dividends Paid to Parent by Subsidiary	-$500,000	
Unitary Group ND FTI Base	$2,000,000	

Scenario with Captive REIT Subsidiary:

Parent corporation has $2,000,000 in federal taxable income (FTI).
Captive REIT has $500,000 in FTI before the deduction for dividends paid.
Captive REIT pays $500,000 in dividends to the parent corporation.
After the deduction for dividends paid, the REIT has 0 FTI.

Parent Corporation FTI	$2,000,000	(Includes dividends paid by captive REIT)
Captive REIT FTI	$0	
Dividends Paid to Parent by Captive REIT	-$500,000	
Unitary Group ND FTI Base	$1,500,000	

Scenario with REIT Subsidiary Under SB 2089:

Parent corporation has $2,000,000 in federal taxable income (FTI).
Captive REIT has $500,000 in FTI before the deduction for dividends paid.
Captive REIT pays $500,000 in dividends to the parent corporation.
After the deduction for dividends paid, the captive REIT has 0 FTI.
The $500,000 captive REIT dividend deduction is added back.

Parent Corporation FTI	$2,000,000	(Includes dividends paid by captive REIT)
Captive REIT FTI	$0	
Dividends Paid to Parent by Captive REIT	-$500,000	
Add Back Captive REIT Dividends Paid	$500,000	
Unitary Group ND FTI Base	$2,000,000	

Same handout given to House.

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Essex Property Trust, Inc.
William P. Hankowsky
Liberty Property Trust
Ronald L. Havner, Jr.
Public Storage, Inc.
Mitchell E. Hersh
Mack-Cali Realty Corporation
Rick R. Holley
Plum Creek Timber Company, Inc.
vid H. Hoster II
Group Properties, Inc.
s B. Lebovitz
Associates Properties, Inc.
Leventhal
apital Partners, LLC
d H. Linde
Boston Properties, Inc.
Peter S. Lowy
The Westfield Group
Hamid R. Moghadam
AMB Property Corporation
Constance B. Moore
BRE Properties, Inc.
David J. Neithercut
Equity Residential
Dennis D. Oklak
Duke Realty Corporation
Edward J. Pettinella
Home Properties, Inc.
Charles A. Ratner
Forest City Enterprises, Inc.
Steven G. Rogers
Parkway Properties, Inc.
R. Scot Sellers
Archstone-Smith
David E. Simon
Simon Property Group
Jay Sugarman
iStar Financial Inc.
Gerard H. Sweeney
Brandywine Realty Trust
Robert S. Taubman
Taubman Centers, Inc.
C. Reynolds Thompson, III
Colonial Properties Trust
Garrett Thornburg
Thornburg Mortgage, Inc.
Thomas W. Toomey
United Dominion Realty Trust
Scott A. Wolstein
Developers Diversified Realty Corporation
Donald C. Wood
Federal Realty Investment Trust

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

October 24, 2007

Bruce Fort, Esq.
Counsel
Multistate Tax Commission
444 North Capitol Street, NW, Suite 425
Washington D.C. 20001-1538
bfort@mtc.gov

Re: Comments on Multistate Tax Commission's Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts

Dear Bruce:

The National Association of Real Estate Investment Trusts (NAREIT)® thanks you for the opportunity to submit comments on the Multistate Tax Commission's (MTC) draft Proposed Model Statute for Taxation of Captive Real Estate Investment Trusts, which is posted on www.mtc.gov (Final Draft). Furthermore, NAREIT would like to thank you for the opportunity to have participated over the last year in the MTC's process of preparing this draft.

NAREIT is the representative voice for U.S. real estate investment trusts (REITs) and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

EXECUTIVE SUMMARY

The Final Draft first provides that it is meant to address captive REITs only and should not be interpreted as precluding the right of a state to tax the income earned by any type of REIT as source income. The Final Draft then provides that a dividends paid deduction (DPD) should be added back for state corporate income tax purposes by a REIT that is a captive REIT.

A "captive REIT" is defined as a REIT, that is not: a) a publicly traded REIT and of which b) more than 50% of the voting power or value of beneficial interests or shares are directly or indirectly owned or controlled by a single taxable entity that is treated as an association taxable as a corporation under the Internal Revenue

1875 I Street, NW, Suite 600, Washington, D.C. 20006-5413
Phone 202-739-9400 Fax 202-739-9401 www.nareit.com

Code of 1986, as amended (the Code). The Final Draft then excludes from the definition of entities treated as associations taxable as corporations: REITs, qualified REIT subsidiaries (QRSs); "listed Australian property trusts," as specifically defined (LAPTs) (Australia's version of the U.S. REIT) and/or trusts 75% or more held by an LAPT; and certain non-listed and listed foreign REIT-like entities.

NAREIT supports the Final Draft because it specifically addresses the DPD of "captive REITs" without affecting the DPD of widely held and/or publicly traded REITs. With that said, NAREIT continues to believe that the most appropriate model for state taxation of REITs and their shareholders is conformity with federal principles (as is the case for publicly traded REITs in all states but one that have an income-based tax system). Under this model, a state permits a (non-captive) REIT a DPD while taxing its residents on REIT dividends regardless of where the income giving rise to those dividends was generated.

Set forth below is background concerning the REIT structure and more details concerning our comments.

DISCUSSION

I. Background

A. REITs Are Not "Tax Shelters," But Were Designed to Benefit the "Small Investor."

Congress created REITs in 1960 to enable investors from all walks of life to own professionally managed, income-producing real estate through professionally managed companies. REITs combine the capital of many shareholders to invest in a diversified portfolio of income-producing real estate, such as apartments, hotels, shopping centers, offices, timberlands, and warehouses. REITs are required to distribute at least 90% of their taxable income to their shareholders. In exchange for doing so (and for satisfying a number of other requirements), federal law grants REITs (and mutual funds) a DPD. In 2006, publicly traded REITs distributed more than $15 billion to their shareholders.

B. REITs Benefit Investors and the Economy.

Congress' vision has been realized: as of September 2007, more than 150 publicly traded REITs had a total equity market capitalization of more than $370 billion. Throughout the U.S., real estate owned by REITs generates millions of dollars in property taxes on top of the individual income taxes currently generated by REIT dividends paid to state residents. Investors have benefited from owning REITs: the 15-year compound annual return for the period ending Aug. 31, 2007 of the S&P 500 stock index was 10.92%, **while that of REITs was 13.42%.**

The economy benefits from REITs as well – because REITs cannot pass through losses to investors (unlike partnerships), their focus must be on creating value for shareholders. Furthermore, unlike other real estate owners that use high levels of debt, average debt levels for public REITs are less than 50%, leading to less volatility in the real estate market and fewer bankruptcies and workouts. Simply put, REITs are the most practical method for investors to add commercial real estate in their investment portfolios to obtain the asset diversification recommended by most financial advisors.

C. Most States Tax REIT Income Only Once at the Shareholder Level.

All but one state with an income-based tax system allow the DPD for public REITs. As a result of the DPD, most, if not all, of a REIT's income is taxed at one level – the shareholder level. Only Mississippi limits its DPD to "publicly traded" REITs, a term which is not defined. In 2007, Maryland enacted legislation (identical bills, H.B. 1257 and S. 945) that permits the DPD to reduce Maryland taxable income only for a REIT that is either: (i) publicly traded; or (ii) not more than 50% held by a taxable corporation that is not a REIT or an LAPT. Also in 2007, Kentucky (H.B. 258) and Indiana (S. 500) adopted statutes that are conceptually similar to the Maryland statute (although the triggering threshold in Kentucky is lower than in the other states). Louisiana adopted a similar statute in 2005, H.B. 888. Other states adopting similar statutes this year include Illinois (S.B. 1544) and Rhode Island (H.B. 5300).

The above-mentioned statutes prevent or would prevent a REIT from being used primarily to escape state income taxes, while not disturbing the economic activities of widely held REITs.

D. Non-Publicly Traded REITs Are Used For Many Legitimate Transactions.

Although there has been a great deal of press recently concerning the use of private REITs as a "state tax shelter," the following legitimate structures are representative of REITs that are not publicly traded:

- SEC-registered, non-exchange traded REITs. There are a number of REITs that are required to register with the SEC due to the size of their shareholder and asset base, but are not traded on any exchange. Recently, several of these have become publicly traded.

- "Incubator" REITs that plan an eventual public offering. Several publicly-traded REITs began as privately-held REITs in order to establish a track record for management. Thereafter, they engaged in a public stock offering. Limiting the DPD to publicly traded REITs would negatively affect the business plans of these companies.

- Widely held, non-publicly traded REITs. There are also a number of REITs with sizeable property portfolios and shareholder bases that are privately held, often by tax-exempt institutions.

- Non-public subsidiaries of publicly traded REITs and LAPTs. In certain cases, a publicly traded REIT that acquires another publicly traded or widely held REIT will keep the acquired company as a private REIT subsidiary for goodwill purposes or to avoid the need to obtain lender consents. Similarly, LAPTs, Australia's version of the U.S. REIT, often own U.S. REIT shares directly to facilitate compliance with the U.S.-Australian Tax Treaty by their small unitholders. Additionally, tax-exempt institutions and/or LAPTs may invest, along with one or more publicly traded REITs, in a joint venture entity formed as a privately held REIT.

II. Comments

NAREIT appreciates the careful thought undertaken by the MTC in preparing the Final Draft and appreciates the opportunity over the past year to provide comments to the MTC in connection with its preparation of the Final Draft.

We believe that the most appropriate method of taxation for REITs and their shareholders in states with income tax regimes is to conform to the federal model of taxation. As noted above, virtually every state with an income-based tax structure allows publicly traded REITs the DPD. Additionally, these states then tax all REIT dividend income received by resident shareholders, regardless of where the REIT's real estate is located.

For example, State A imposes an income tax on all of the REIT dividends earned by a State A resident shareholder of a REIT with only State B properties, while State B imposes its income tax on all of the REIT dividends earned by a State B resident of a REIT with only State A properties. In that example, neither state imposes income taxes on the REIT based on the location of in-state property. If State A were to seek to impose an additional REIT-level tax on a REIT with State A properties, that would result in double taxation of that REIT's income and inappropriate revenues to State A, making State A's tax policy out of sync with the rest of the nation.

With that said, we recognize a state's interest in adopting legislation that would limit any inappropriate use of REITs, including "captive REIT" structures that have been publicized recently, by denying the DPD in certain cases involving certain non public REITs. However, any

such legislation should be narrowly tailored to prevent application to legitimate uses of business transactions such as those described in the prior section. We support the Final Draft. To the extent that the MTC may wish to explore other types of limitations on the uses of captive REITs, including in those states that follow the "separate entity" method of reporting, again, we would welcome the opportunity to work with you further.

****

Thank you again for the opportunity to submit these comments. Please contact me at (202) 739-9446, or my colleague Tony Edwards, at (202) 739-9408 if you would like to discuss these comments in more detail. I plan to attend the Nov. 6, 2007 MTC Uniformity Committee meeting via teleconference. I also plan to attend in person the Nov. 8, 2007 MTC Executive Committee meeting. I will be available to discuss these comments in more detail there as well.

Sincerely,

Dara F. Bernstein
REIT Counsel

#7

If to the Landlord:

Wal-Mart Real Estate Business Trust
[illegible] SW 8th Street
Bentonville, Arkansas 72716
Attn: Tony Fuller

If to the Tenant:

Wal-Mart Stores East, Inc.
702 SW 8th Street
Bentonville, Arkansas 72716
Attn: Tony Fuller

SJ REIT Article w/ Pictures

Same landlord to given House.

FRIENDLY LANDLORD

Wal-Mart Cuts Taxes By Paying Rent to Itself

Other Retailers, Banks Use Loophole in Rules To Lower States' Levies

By JESSE DRUCKER
February 1, 2007; Page A1

As the world's biggest retailer, **Wal-Mart Stores** Inc. pays billions of dollars a year in rent for its stores. Luckily for Wal-Mart, in about 25 states it has been paying most of that rent to itself -- and then deducting that amount from its state taxes.

The strategy is complex, but the bottom line is simple: It has saved Wal-Mart from paying several hundred million dollars in taxes, according to court records and a person familiar with the matter. And Wal-Mart is far from alone.

IT'S A DEAL

Below, an excerpt from the lease agreement signed between a Wal-Mart-owned REIT and another Wal-Mart unit.

The arrangement takes advantage of a tax loophole that the federal government plugged decades ago, but which many states have been slower to catch. Here's how it works: One Wal-Mart subsidiary pays the rent to a real-estate investment trust, or REIT, which is entitled to a tax break if it pays its profits out in dividends. The REIT is 99%-owned by another Wal-Mart subsidiary, which receives the REIT's dividends tax-free. And Wal-Mart gets to deduct the rent from state taxes as a business expense, even though the money has stayed within the company.

Partly thanks to sophisticated financial strategies like these, states' tax collections from companies have been plummeting. On average, Wal-Mart has paid only about half of the statutory state tax rates for the past decade, according to Standard & Poor's Compustat, which collects data from SEC filings. The so-called "captive REIT" strategy alone cut Wal-Mart's state taxes by about 20% over one four-year period. Now several state regulators are trying to crack down on the strategy, used largely by retailers and banks, and some other states have changed their laws to try to end the practice. Yesterday, New York Gov. Eliot Spitzer included elimination of the loophole as part of his proposed budget, a fix he said would bring the state $83 million a year.

RELATED DOCUMENTS

Lee Scott

In a June 2002 affidavit,[1] a Wal-Mart executive laid out the relationship between the REIT and its owner, another Wal-Mart subsidiary. H. Lee Scott Jr., now Wal-Mart's CEO, served as the REIT's "managing trustee," according to **a property deed from 1996**[2].

North Carolina tax authorities are challenging Wal-Mart, saying its REIT strategy was intended to "distort [the company's] true net income," according to its filings in the case in Superior Court in Raleigh, N.C. The state calls captive REITs a "high priority corporate tax sheltering issue" and in 2005 ordered Wal-Mart to pay $33 million for back taxes, interest and penalties stemming from the REIT. The company paid it and last year sued the state for a refund.

The structure Wal-Mart is using features some unusual elements. Because REITs must have at least 100 shareholders to gain tax benefits, roughly 100 Wal-Mart executives were enlisted to own a combined total of around 1% of the REIT's shares, without any voting rights. H. Lee Scott Jr., now Wal-Mart's CEO, was listed as the REIT's "managing trustee" from 1996 to 2004.

A single Wal-Mart real-estate official, Tony Fuller, represented the company both as tenant and landlord in its lease with itself. Ernst & Young LLP, the accounting firm that sold the strategy to Wal-Mart, also is the company's outside auditor. In its internal sales training materials, the accounting firm explicitly labeled the strategy as a method to reduce taxes -- a red flag to tax authorities, who often demand that tax shelters have other business purposes.

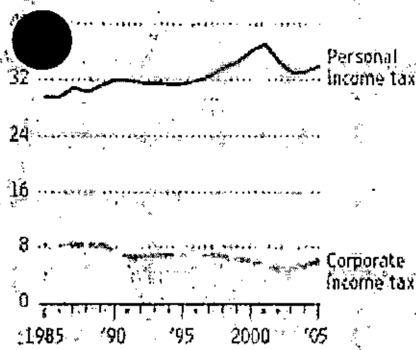
Wal-Mart attorneys say in court filings that the strategy is perfectly legal and that North Carolina is exceeding its authority. A spokesman for the Bentonville, Ark., company, John Simley, said Wal-Mart "is comfortable with its current structure and is in compliance with federal and state tax laws." He added that the REIT structure was adopted to "more effectively and efficiently manage the company's real-estate portfolio, including the impact on the company's overall state tax planning."

Regulators in at least a half-dozen states are going after companies that have trimmed their taxes through similar arrangements, including **Regions Financial** Corp.'s AmSouth Bancorp. unit; **AutoZone** Inc. of Memphis, Tenn.; and two units of **Bank of America** Corp. In a Massachusetts case against Bank of America unit Fleet Funding Inc., authorities call Fleet's REIT arrangement a "sham" in court filings. They note that Fleet increased the salaries of the roughly 100 employees whom it made REIT shareholders to compensate them for personal income taxes stemming from ownership. The Multistate Tax Commission, an association of state revenue authorities, says it has started examining the use of captive REITs to avoid taxes, alerting states to the issue and proposing legislative fixes to close the loophole.

States collected more than $44 billion last year in corporate income taxes, out of $607 billion in total state tax receipts, according to the Nelson A. Rockefeller Institute of Government, a nonpartisan think tank associated with the State University of New York. But the average effective corporate state and local tax rate has dropped from 6.7% during the 1980s to about 5% during the first half of this decade, according to a recent report by the Congressional Research Service. This is in part because of the proliferation of state and local tax breaks, as well as tax shelters, according to several academic and government studies.

Shifting Burden

As tax-saving strategies such as Wal-Mart's have helped lower the share of state taxes paid by companies, the percentage paid by individuals has risen:



Source: Rockefeller Institute of Government

Some corporate state tax planners say arrangements like these are merely smart business, and that the loopholes exploited by companies should be fixed by state legislatures rather than litigated by state lawyers. Critics of the shelters complain they let companies use public services provided by local governments -- such as police and fire protection or new highways -- without having to shoulder their fair share of the costs. Meanwhile, the portion of state taxes borne by individuals is steadily rising.

Congress created REITs in 1960 as a way to allow smaller investors to put money in a wide portfolio of commercial real estate, spreading their risk. Congress also gave them a tax benefit: REITs aren't subject to corporate income tax on the profits they pay to shareholders as long as they pay out at least 90% of the profits. The shareholders still usually get federally taxed on the dividends, which still count as income for them.

After a boom in REITs in the early 1990s, big accounting firms including Ernst & Young and KPMG LLP figured out that on the state level, they could pair the tax break on REIT dividends with a separate tax rule that allows companies to receive dividends tax-free from their subsidiaries. With the REIT as a subsidiary itself, two rules aimed at avoiding double taxation could be combined to effectively avoid any taxation at all.

The strategy worked especially well if the REIT was owned by a company incorporated, and claiming to do all its business, in a state such as Delaware or Nevada that often wouldn't tax the corporate income anyway. That created an extra hurdle for other states to challenge the practice if they caught onto it.

Ernst & Young early on targeted the banking industry as a possible beneficiary of the captive REIT strategy. Like retailers, banks have branches in many states and often are liable for lots of state-level corporate tax. Ernst & Young targeted at least 30 banks, some of them its audit clients. The SEC generally permits that dual role as long as the firm's fee isn't contingent on the tax savings.

According to documents from a 1995 internal Ernst & Young sales training meeting reviewed by The Wall Street Journal, the accounting firm suggested banks put some of their income-producing assets, such as a portfolio of mortgages, into a REIT subsidiary, then use the double-tax break to "shelter" the income from state taxes. The REIT would issue a tiny number of non-voting shares to bank "officers and directors" to meet the 100-shareholder rule that REIT law requires.

U.S. banks "pay millions of dollars each year in state and local taxes," read the Ernst & Young presentation to its sales force. "The FSI State Tax Financial Product we have developed can significantly reduce or eliminate this heavy tax obligation..." One section of the Ernst & Young sales package featured hypothetical questions from clients about the REIT shelter, and the proposed answers. To pass legal muster, many corporate tax shelters purport to have additional business purposes behind merely saving taxes. Ernst & Young, however, was blunt about the reason for its proposed strategy:

"Q: What's the business purpose?

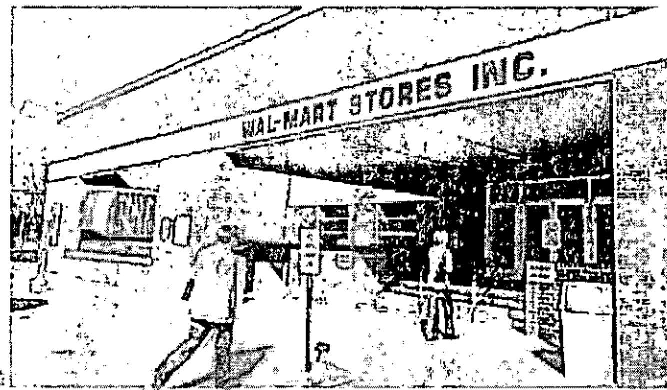
"A: Reduction in state and local taxes.

"Q: What if the press gets wind of this and portrays us as a 'tax cheat'?

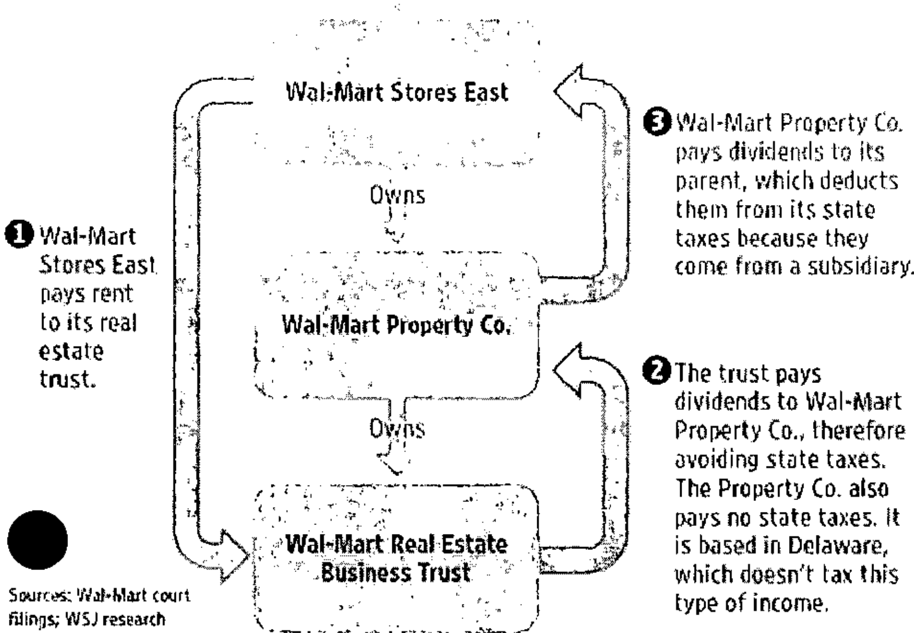
"A: That's a possibility....If you are concerned about possible negative publicity, you can counter it by reinvesting the savings in the community."

Tax Relief

Wal-Mart has cut its tax bills in about 25 states using a ...sticated ...estate strategy:



Company headquarters in Bentonville, Ark.



Sources: Wal-Mart court filings; WSJ research

An Ernst & Young spokesman declined to comment on its REIT work, saying the firm was "prohibited from commenting on client matters." The spokesman said he could not verify the authenticity of the internal sales training documents based on quotes provided by the Journal. However, he said the "limited language communicated in the internal memo does not reflect the quality and nature of the advice we provide to our clients."

State authorities have had mixed records so far in pursuing back taxes and penalties in captive-REIT cases. AutoZone, the big auto-parts chain, won the right to deduct the dividends from its taxes in Kentucky but lost a preliminary round in Louisiana. The Hawaii Department of Taxation won a case involving a REIT used by Central Pacific Financial Corp., a bank holding company. AmSouth is in litigation with Alabama over tax benefits from its REIT.

Fleet Funding's REIT, on which the company was advised by KPMG, has led Massachusetts to seek more than $42 million in back taxes, interest and penalties. BankBoston Corp. is in similar litigation with Massachusetts. Both banks have been acquired by Bank of America, which declined to comment on the litigation.

Fleet's attorneys have said in court papers that its REITs were legitimate, and the fact that they were partly motivated by tax considerations does not legally undermine their valid business purpose -- to raise capital, they say. A KPMG spokeswoman declined to comment on the Fleet case, but said it had stopped any involvement with "prepackaged tax products" before a 2005 agreement it made with the U.S. Justice Department over improper tax strategies that also led to the indictment of 17 former KPMG officials.

It's unknown how many disputes have been raised over the strategy used by Wal-Mart and others, because such tax disputes are generally not disclosed unless lawsuits are publicly filed or the company reveals them in SEC filings.

Wal-Mart adopted its captive-REIT structure just as it was unwinding a previous strategy to reduce taxes that states had begun to challenge. For the first half of the 1990s, the retailer used a so-called intangible holdings company structure also used by many other corporations. Wal-Mart transferred its trademarks to a subsidiary called WMR Inc. in Delaware, which does not tax many forms of corporate income. Then it paid the subsidiary for the use of the brands. That allowed Wal-Mart to deduct those payments from its local income taxes in some states, while WMR's income wasn't taxed by Delaware.

Several states won challenges to the strategy, used by various retailers. Wal-Mart settled a dispute over its use of WMR in Louisiana -- the details of the settlement are sealed -- and lost on the main points of a case in New Mexico. Wal-Mart merged with WMR in February of 1997 and its use as a state tax avoidance vehicle was apparently discontinued, according to New Mexico court records.

In the meantime, Wal-Mart set up a new vehicle to control its state tax bill: captive REITs. In the summer and fall of 1996, Delaware corporate records show, Wal-Mart created a new hierarchy of subsidiaries: a REIT called the Wal-Mart Real Estate Business Trust; a Delaware-based parent company for the REIT, called the Wal-Mart Property Co.; and Wal-Mart Stores East Inc., parent of the Delaware firm. Wal-Mart Property owned 99% of the REIT's shares, and 100% of the voting shares, according to Wal-Mart court filings in North Carolina and West Virginia. The company also set up a similar arrangement for its Sam's Club stores.

To meet the 100-shareholder threshold required for REITs, Wal-Mart distributed a minimal amount of nonvoting stock, to approximately 114 Wal-Mart employees, according to a person familiar with the arrangement. The dividend payouts were nominal. The structure involved Wal-Mart's top executive tier. The shareholders were generally executive vice presidents and above. David Glass, then Wal-Mart's president and CEO, was listed as president of Wal-Mart Stores East on the lease agreement, and Paul Carter, then a Wal-Mart executive vice president, was listed as the president of the REIT.

Wal-Mart began transferring to the REIT ownership of the properties -- the land and buildings -- for hundreds of its stores in 27 states, real-estate records show. Then Wal-Mart Stores East signed a 10-year lease agreement with its REIT that took effect on Jan. 31, 1997, agreeing to pay a fixed percentage of the stores'"gross sales" as rent, according to a copy of the arrangement filed in the North Carolina case. Mr. Fuller, the Wal-Mart real-estate official, is listed as the contact for both the tenant and the landlord. The original lease was due to be renewed this week.

Wal-Mart could deduct from its state-taxable income the rent paid by Wal-Mart Stores East to the REIT. The REIT paid the majority of its rental earnings to its 99% owner, Wal-Mart Property Co., in the form of dividends. That company's base in Delaware gave it another way to avoid liability for state taxes, since some states do require that dividends a REIT pays to its corporate owner be taxed, as the federal government does.

The Delaware subsidiary then paid the money back to Wal-Mart Stores East, the same subsidiary that made the payments to the REIT to begin with. Those payments to Wal-Mart Stores East weren't taxed either, because dividends paid to a corporation by a subsidiary normally aren't counted as taxable income for the parent company.

The result of the circuitous transaction: Wal-Mart could effectively turn rental payments to itself into state level tax-deductions in most of the states where the payments have been made. Under typical circumstances, rent paid to a third-party landlord also would reduce taxable income. But that would ordinarily be cash out the door, like most other tax-deductible expenses. Here, the majority of the tax-deductible rental payments came straight back to Wal-Mart.

The national tax savings have been significant. Over a four-year period, from 1998 to 2001, Wal-Mart and Sam's Club paid company-controlled REITs a total of $7.27 billion that eventually came back to Wal-Mart in states across the country, according to a North Carolina Department of Revenue auditor's report filed in court by Wal-Mart. Based on an average state corporate income tax rate of 6.5%, three accounting experts consulted by The Wall Street Journal estimated the REIT payments led to a state tax savings for Wal-Mart of roughly $350 million over just those four years. SEC filings show the company paid $1.18 billion in state taxes during that period. The loss of federal deductions that bigger state tax

payments would have triggered brought the company's effective tax savings overall down to about $230 million. Wal-Mart declined to comment on the figures.

It is not clear how much Wal-Mart has paid to its own REITs in the most recent five years. The yearly rental payments -- on which the tax savings are based -- are pegged to the "gross sales" of the stores, according to the lease agreement.

Underscoring that the rental payments were cashless Wal-Mart accounting moves, an affidavit filed in North Carolina by the company's former controller, James A. Walker Jr., states that the payments were made by simply debiting the account of one subsidiary and then crediting the account of the other. "Wal-Mart Stores, Inc. served, in effect, as a bank for" both sides, the affidavit stated.

In 2005, after an audit, the North Carolina Department of Revenue issued a notice to Wal-Mart challenging the REIT structure. The state is site of about 140 of the company's roughly 3,900 U.S. stores, including Sam's Clubs. Wal-Mart paid the $33 million the state sought, and in March 2006 sued for a refund.

The company argues that the state does not have the authority to essentially combine the results of the subsidiary that did business in North Carolina with those of the Delaware-based unit and the REIT. The Delaware-based subsidiary, the company says, did no business in North Carolina and therefore was not taxable there. The company says in court filings that the REIT was qualified under federal law, that all the deductions were properly taken and that its North Carolina tax returns reflect its "true income."

Drovdal, David O. SB 2089 testimony

From: Walstad, John M.
[Se]nt: Friday, February 20, 2009 10:58 AM
[To]: Drovdal, David O.
[C]c: Nelson, Jeffrey N.
Subject: Severed mineral issues

Skip- I wonder if this is the culprit. These sections require assessment of severed minerals but those interests are exempt from taxation, so I thought these sections are just ignored by counties.

57-02-24. Assessors to list coal and minerals. The assessor shall list for taxation all coal and other minerals underlying any lands the ownership of which has been severed from the ownership of the overlying strata and shall assess such coal and other minerals to the owner in the county in which the same actually lie.

57-02-25. Procedure in assessment of coal and mineral reserves. The county auditor, at the time of furnishing the assessors with books and blanks for their assessments, shall give each assessor an accurate description of any lands the title to the coal or minerals in which is not in the person holding the title or fee to the overlying strata or land. Such list must describe accurately the land in which such coal or mineral reservations lie, giving the name of the holder of the title to such land and of the holder of the reserved mineral rights thereunder. The list also must describe accurately, when known and when possible, the location of the coal or minerals lying in such land and must disclose the name of the person in whom the title to such minerals is reserved as provided herein. The recorder shall furnish the county auditor with such information as is contained in the office of the recorder and as will enable the auditor to prepare the lists described in this section.

John Walstad
[Co]de Revisor
[Nor]th Dakota Legislative Council
600 E. Boulevard Avenue
Bismarck, ND 58505

Testimony 1

Testimony Of The Office of State Tax Commissioner Before The House Finance And Taxation Committee

Senate Bill 2089

March 2, 2009

Chairman Belter, members of the House Finance and Taxation Committee, I am Matt Peyerl, Supervisor, Corporate Income Tax, for the Office of State Tax Commissioner. I am here today on behalf of the Commissioner to testify in support of Senate Bill 2089.

Reasons for Proposed Changes

This bill was introduced by the Tax Commissioner to address a specific situation which arises when a unitary group of corporations includes a corporation that is a "captive" Real Estate Investment Trust (REIT). As I will explain further, the bill does not affect all REITS, such as those that are publicly held and widely traded. The bill is specific to captive REITS.

For a unitary group of corporations we begin calculating North Dakota taxable income by adding together the federal taxable income/loss of all companies in the unitary group. From that aggregate amount, we subtract dividends paid by any corporation in the unitary group to another corporation in the unitary group. This principle of unitary combination avoids double representation of a corporation's income.

Unitary groups can include REITS. Because REITs are treated differently from regular corporations for federal tax purposes, as North Dakota law is now structured, it allows an exclusion from North Dakota taxable income for both REIT income and all dividends paid by the REIT to its parent company. This is inconsistent with the treatment of other corporations in a unitary group, where each corporation's income is included but intercompany dividends are excluded from the combined report.

This bill is based, in large part, on a model statute developed by the Multistate Tax Commission (MTC). North Dakota adopted the Multistate Compact (N.D.C.C. Chapter 57-59) in 1969 and has been a member the MTC since that time.

Background

Some background on REITs may be helpful in explaining this bill. REITs were enabled by Congress to encourage the pooling of investments in income-producing real estate. In an investment sense, they serve much the same investment purpose as a mutual fund.

REITs have some of the same characteristics as a simple trust, and for income tax purposes REITs operate much like a pass-through entity. REITs are required by federal

law to annually distribute at least 90% of the REIT earnings as a dividend. For federal purposes, REITS are allowed to deduct these dividend payments in determining their federal taxable income. Most often, the REIT will "dividend out" all its income and will report zero federal taxable income. The owners of the REIT report the dividend income on their income tax returns and pay any associated federal tax. In contrast, a regular corporation is not allowed to deduct the dividends it pays out. The following illustrates the resulting difference in federal taxable income.

	Regular corporation	REIT
Income	$1,000,000	$1,000,000
Deductions	-310,000	-310,000
Dividends paid	NA	-690,000
Taxable Income	$ 690,000	-0-

Since the establishment of REITs, there has been an increasing propensity of corporations, particularly in the retail and mortgage industries, to use this form of entity to shelter income for tax purposes. In this scenario, corporations form a "captive" REIT subsidiary where the corporation itself, and perhaps some corporate officers, are the only owners in the captive REIT. These captive REITS are not operating companies, but essentially function as holding companies for assets transferred to them by the corporation. States encountered, with increasing frequency, instances where regular corporations transferred assets to a captive REIT. The income associated with those assets was also transferred to the captive REIT and, due to federal tax treatment and existing combined reporting principles, that income was effectively shielded from state taxation.

As an outgrowth of member states' concerns, in 2004 the MTC formed a task force to study tax sheltering activity and to make recommendations to prevent use of abusive tax shelters. One of the areas studied extensively by the task force was the misuse of passthrough entities, such as captive REITS, to shelter income from state taxation. In early 2006 the MTC income tax uniformity subcommittee voted to specifically study tax sheltering practices of REITs. A drafting group of 8 MTC member states worked with MTC staff to develop a model statute. As part of the process, drafts were reviewed in 2006 through 2008 at MTC uniformity committee meetings. These were public meetings

and were attended by members of the REIT investment community. Input from that group was incorporated in the model statute to clarify what constituted a captive REIT. In October, 2007, a public hearing was held on the model statute and, based on testimony at the hearing, some modifications to further clarify the rule were recommended. The recommendations were adopted as the final model statute by the MTC Executive Committee in January 2008.

I've attached an example to illustrate the effect a captive REIT has on the North Dakota tax base under existing law. The first scenario assumes a corporation and a non-REIT subsidiary are unitary. To determine the tax base for the unitary group, the federal taxable incomes of the two corporations are added together. To avoid double taxation of the subsidiary income, dividends paid by the subsidiary to the parent are then eliminated. The second scenario illustrates the situation for a corporation and a captive REIT subsidiary. The tax base is determined in exactly the same manner, but because of the federal deduction for dividends paid by the captive REIT, the North Dakota tax base is less than in the first scenario. Essentially, in a unitary combined report, the captive REIT is allowed to exclude any income from taxation and then exclude the income again by virtue of the intercompany dividend elimination.

EXPLANATION OF THE BILL

Section 1 – Amends N.D.C.C. 57-38-01.3 to provide for an addition to federal taxable income. Senate Bill 2089 addresses this situation by requiring captive REITS to add back the amount of the dividends paid deduction. The third scenario on the attached illustration shows the result. Senate Bill 2089 acts to counter the double elimination of captive REIT income that occurs under present law.

I want to stress again that this bill affects only captive REITS. Subdivision (2) of the bill, identifies entities which are not affected. These include:

- publicly traded REITS, i.e. those that, similar to a mutual fund, are publicly traded and whose owners are typically large groups of unrelated parties,
- REITs owned by other non-captive REITS
- listed Australian property trusts, and
- qualified foreign entities.

Australian property trusts and qualified foreign entities are, like non-captive REITS, widely held. They are used to encourage investment in United States real estate and are not viewed as vehicles for tax sheltering.

Section 2 – Effective date. This section specifies that the bill is effective for taxable years beginning after December 31, 2008.

CONCLUSION

The Tax Commissioner respectfully requests that you give favorable consideration to Senate Bill 2089.