

New York legislative Changes

Impact on REIT clients



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On August 8, 2010, New York enacted a budget bill that included a provision relevant to real estate clients with captive REITs. Specifically, the law redefines what will be considered a “captive REIT” for purposes of the combined reporting requirements as well as the denial of the dividends paid deduction.

“Captive REIT” redefined to exclude entities owned by a Listed Australian Public Trust (LAPT) or a “qualified foreign entity” that meets certain criteria

Former Definition of a “Captive REIT”

Prior to the recent legislative change, a “captive REIT” was defined to mean a REIT that (1) is not regularly traded on an established securities market and (2) more than 50% of the voting stock which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal taxable income and is not a REIT.

New Definition of a “Captive REIT”

The definition of a captive REIT has been revised to mean a REIT that (1) is not regularly traded on an established securities market, and (2) more than 50 percent or more of the voting stock is owned or controlled, directly or indirectly, by **a single entity treated as an association taxable as a corporation under the IRC** that is not exempt from federal income tax and is not a REIT. (Emphasis on new language.)

Specifically excluded from what is considered “an entity treated as an association taxable as a corporation under the IRC” are three types of entities:

- A LAPT ;
- A trust (owned 75 percent or more directly or indirectly by a LAPT); or
- A “qualified foreign entity.”

A “qualified foreign entity” is defined to mean a corporation, trust, association or partnership organized outside the US that satisfies criteria that mirrors some of those necessary to meet the classification of a REIT for federal tax purposes. This includes but is not limited to: (1) at least 75 percent of the entity's total asset value are in real estate, cash and cash equivalents and US government securities; (2) that the entity distributes at least 85 percent of its taxable income to shareholders on an annual basis; and (3) not more than 10 percent of the voting power or value in such entity is held directly or indirectly or constructively by a single entity or individual (or shares of such entity are regularly traded on an established securities market).

Implications of new “Captive REIT” definition

The change made by the legislation allows clients with REITs owned more than 50 percent or more by a Listed Australian Public Trust (LAPT) or another “qualified foreign entity” that meets certain enumerated criteria, to continue to take the dividend paid deduction (DPD).

Under current law, entities that meet the definition of a “captive REIT” are required to file a combined report with either their parent corporation or their “closest controlling shareholder.”

Generally, a captive REIT will file combined with a corporation that owns or controls over 50 percent of its voting stock if that corporation is subject to the franchise tax under Article 9-A or is required to be included in a combined corporation franchise tax report. If over 50 percent of the voting stock is not directly owned or controlled by such a corporation, the captive REIT must be included in a combined return with its “closest controlling shareholder,” if the shareholder is subject to the franchise tax on business corporations, franchise tax on banking corporations (Article 32), or franchise tax on insurance corporations (Article 33). If the corporation that owns or controls over 50 percent of the voting stock of a captive REIT is not permitted to file a combined report, combined reporting with the closest controlling shareholder is required.

As can be gleaned from this brief summary on the combined reporting requirements with respect to a captive REIT, the rules in New York with respect to combined reports can be complex and provide for unexpected consequences.

The most significant consequence of including a captive REIT in a combined return with its parent corporation or its closest controlling shareholder (as applicable) is the loss of the DPD by the captive REIT. In a combined report, entire net income for a captive REIT is determined in accordance with provisions that govern the net income determination of non-captive REITs and the DPD paid by the captive REIT is disallowed.

It should be noted that qualified REIT subsidiaries (QRS) must be included a combined report with its captive REIT parent and, as such, are denied the DPD. A QRS of a non-captive REIT, however, will be treated as entity disregarded from the REIT and the REIT may still take benefit of the DPD.

Also important to remember is that a captive REIT, not otherwise required to file a combined report under these provisions, would nevertheless be included in a combined report with another corporation if the substantial intercorporate transaction requirement, or intercompany transaction agreement/requirement, is satisfied and more than 50 percent of the captive entity's voting stock and substantially all the capital stock of that other corporation are owned or controlled (directly or indirectly) by the same person.

What is the effective date of the change?

Pursuant to the budget bill as passed, the effect of this new provision is immediate. However, there is an open question as to whether the new definition should apply to years before the enactment date of this legislation.

According to informal conversations with the State, the immediate effect of this provision has not yet been determined. It is likely that the provision will apply to tax years beginning after January 1, 2010, but it is expected that the State will publish further guidance related to this point. While the State may allow the new definition to apply retroactively, for matters under audit, clients should discuss the application of this change in the law to earlier periods. These discussions should be considered reasonable given the intention and policy behind the change in the law was to remove from the definition of a “captive REIT” (and thus the corresponding denial of the DPD), those taxpayers whose ownership arrangements are for good and valid business.

Next Steps

In thinking about the application of the above change, it may be worth it for clients to consider whether certain Sovereign Wealth Funds could meet the definition of a “qualified foreign entity.” An analysis of clients' structures that include a foreign parent may produce some opportunities.

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