

Tax Treatment of Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs)

The Tax Law has been amended concerning the tax treatment of REITs and RICs. A REIT or RIC is generally subject to tax under Article 9-A (franchise tax on general business corporations) of the Tax Law. The amendments change the combined reporting rules for REITs and RICs by now providing that a captive REIT or captive RIC may be required to be included in a combined return under Article 9-A, Article 32 (franchise tax on banking corporations), or Article 33 (franchise tax on insurance corporations). The provisions described below apply to taxable years beginning on or after January 1, 2008, and are repealed for taxable years beginning on or after January 1, 2011.

The information in this TSB-M supplements the information on REITs and RICs contained in TSB-M-08(12)C, *Summary of Corporation Tax Legislative Changes Enacted in 2008*.

General Definitions

The following definitions have been added to Tax Law section 2:

- *REIT* means a real estate investment trust as defined in Internal Revenue Code (IRC) section 856.
- *RIC* means a regulated investment company as defined in IRC section 851.
- A *captive REIT* means a REIT that is not regularly traded on an established securities market and more than 50% of the voting stock of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income tax and is not a REIT. Any voting stock in a REIT that is held in a segregated asset account of a life insurance corporation (as described in IRC section 817) is not taken into account for purposes of determining if a REIT is a captive REIT.
- A *captive RIC* means a RIC that is not regularly traded on an established securities market and more than 50% of the voting stock of which is owned or controlled, directly or indirectly, by a single corporation that is not exempt from federal income tax and is not a RIC. Any voting stock in a RIC that is held in a segregated asset account of a life insurance corporation (as described in IRC section 817) is not taken into account for purposes of determining if a RIC is a captive RIC.

The following definition has been added to Tax Law sections 211.4(a) (Article 9-A), 1462(f)(2) (Article 32), and 1515(f) (Article 33):

- The *closest controlling stockholder* means the corporation: (a) that indirectly owns or controls over 50% of the voting stock of a captive REIT or captive RIC; (b) is subject to tax under Article 9-A, 32, or 33 or otherwise required to be included in a combined return or report under Article 9-A, 32, or 33; and (c) is the fewest tiers of corporations away in the ownership structure from the captive REIT or captive RIC.

The following definition has been added to Tax Law sections 211.4(b)(1)(ii) (Article 9-A), 1462(f)(2)(v)(G) and 1462(f)(3)(ii) (Article 32), and 1515(f)(5)(ii) (Article 33):

- *Affiliated group* means affiliated group as defined in IRC section 1504, but without regard to the exceptions provided for in IRC section 1504(b) (relating to includable corporations).

Combined reporting rules for REITs and RICs

Combined reporting rules under Article 9-A.

The new legislation under Tax Law section 211.4(a)(6) requires a captive REIT or a captive RIC to be included in a combined report under Article 9-A if it meets any of the following conditions:

- a) A captive REIT or a captive RIC must be included in a combined report with the corporation that directly owns or controls over 50% of the voting stock of the captive REIT or captive RIC if that corporation is subject to tax or required to be included in a combined report under Article 9-A.
- b) If over 50% of the voting stock of a captive REIT or captive RIC is not directly owned or controlled by a corporation that is subject to tax or required to be included in a combined report under Article 9-A, then the captive REIT or captive RIC must be included in a combined return or report with the corporation that is the closest controlling stockholder of the captive REIT or captive RIC. If the closest controlling stockholder of the captive REIT or captive RIC is subject to tax or otherwise required to be included in a combined report under Article 9-A, then the captive REIT or captive RIC must be included in a combined report under Article 9-A.
- c) If the corporation that directly owns or controls the voting stock of the captive REIT or captive RIC is a corporation not permitted to make a combined report as provided in Tax Law section 211.4(a)(2), 211.4(a)(3), or 211.4(a)(5), then the rules in condition (b) above must be applied to determine the corporation in whose combined return or report the captive REIT or captive RIC should be included. If the corporation that is the closest controlling stockholder of the captive REIT or captive RIC is a corporation not

permitted to make a combined report as described in Tax Law section 211.4(a)(2), 211.4(a)(3), or 211.4(a)(5), then that corporation is deemed to not be in the ownership structure of the captive REIT or captive RIC, and the closest controlling stockholder is determined without regard to that corporation. The following types of corporations are described in Tax Law sections 211.4(a)(2), 211.4(a)(3), and 211.4(a)(5):

- corporations organized under the laws of a country other than the United States,
- corporations principally engaged in a railroad or trucking business, and
- corporations principally engaged in an aviation business or corporations that are qualified air freight forwarders with respect to an aviation corporation.

d) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in IRC section 856(i)(2)), then the qualified REIT subsidiary must be included in a combined report with the captive REIT.

e) If a captive REIT or a captive RIC is required by any of the conditions under Tax Law section 211.4(a)(6) to be included in a combined report with another corporation, and that other corporation is also required to be included in a combined report with another related corporation or corporations under Tax Law section 211.4(a), then the captive REIT or captive RIC must be included in that combined report with those corporations.

If a captive REIT or a captive RIC is not required to be included in a combined report with another corporation under conditions (a) or (b) above, or in a combined return under the provisions of Article 32 (Tax Law section 1462(f)(2)(v)) or Article 33 (Tax Law section 1515(f)(4)) described later, then the captive REIT or captive RIC is subject to the opening provisions of Tax Law section 211.4(a) and the provisions of Tax Law section 211.4(a)(4). Under these provisions the captive REIT or captive RIC must be included in a combined report under Article 9-A with another corporation if either:

- the substantial intercorporate transaction requirement in the opening provisions of Tax Law section 211.4(a) is satisfied, or
- the intercompany transactions or agreement, understanding, arrangement, or transaction requirement of Tax Law section 211.4(a)(4) is satisfied

and more than 50% of the voting stock of the captive REIT or captive RIC and substantially all of the capital stock of that other corporation are owned and controlled, directly or indirectly, by the same corporation.

Tax Law sections 209.4, 209.5, and 209.7 have been amended to provide that a captive REIT or a captive RIC that is required to be included in a combined return under either Tax Law section 1462(f) or 1515(f) is not subject to tax under Article 9-A. The amendments also

temporarily repeal language added by Chapter 60 of the Laws of 2007 requiring certain REITs and RICs to be included in a combined report under Article 9-A. The 2007 changes are not in effect for taxable years beginning on January 1, 2008, and before January 1, 2011. (See the section titled *Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs)* in TSB-M-08(1)C, *Summary of Corporation Tax Legislative Changes Enacted in 2007 and Expiring Tax Law Provisions*, for a description of the temporarily repealed provisions.)

(Tax Law sections 209.4, 209.5, 209.7, 211.4(a)(6))

Combined reporting rules under Article 32.

Tax Law section 1452(d) has been amended to provide that a captive REIT or captive RIC that is required to be included in a combined return under the provisions of Tax Law section 1462(f) will be subject to tax under Article 32 and will not be subject to tax under Article 9-A. The Gramm-Leach-Bliley (GLBA) transitional provisions do not apply to a captive REIT or a captive RIC required to be included in a combined return under Article 32 as provided by Tax Law section 1452(m)(4).

The new legislation under Tax Law section 1462(f)(2)(v) requires a captive REIT or a captive RIC to be included in a combined return under Article 32 under the following conditions:

- a) A captive REIT or a captive RIC must be included in a combined return with the banking corporation or bank holding company that directly owns or controls over 50% of the voting stock of the captive REIT or captive RIC if that banking corporation or bank holding company is subject to tax or required to be included in a combined return under Article 32.
- b) If over 50% of the voting stock of a captive REIT or captive RIC is not directly owned or controlled by a banking corporation or bank holding company that is subject to tax or required to be included in a combined return under Article 32, then the captive REIT or captive RIC must be included in a combined return or report with the corporation that is the closest controlling stockholder of the captive REIT or captive RIC. If the closest controlling stockholder of the captive REIT or captive RIC is a banking corporation or bank holding company that is subject to tax or required to be included in a combined return under Article 32, then the captive REIT or captive RIC must be included in a combined return under Article 32.
- c) If the corporation that directly owns or controls the voting stock of the captive REIT or captive RIC is a corporation not permitted to make a combined return as provided in Tax Law section 1462(f)(4)(ii) or 1462(f)(4)(iv), then the provisions in (b) above must be applied to determine the corporation in whose combined return or report the captive REIT or captive RIC should be included. If the corporation that is the closest controlling stockholder of the captive REIT or captive RIC is described in Tax Law section 1462(f)(4)(ii) or 1462(f)(4)(iv) as a corporation not permitted to make a

combined return, then that corporation is deemed to not be in the ownership structure of the captive REIT or captive RIC, and the closest controlling stockholder will be determined without regard to that corporation. The following types of corporations are described in Tax Law sections 1462(f)(4)(ii) and 1462(f)(4)(iv):

- corporations organized under the laws of a country other than the United States; and
 - corporations whose greatest tax, computed on a separate basis, is on taxable assets and whose net worth ratio, computed on a separate basis, is less than five percent and whose total assets are comprised of 33% or more of mortgages.
- d) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in IRC section 856(i)(2)), then the qualified REIT subsidiary must be included in any combined return required to be made by the captive REIT that owns its stock.
- e) If a captive REIT or a captive RIC is required by any of the conditions under Tax Law section 1462(f)(2) to be included in a combined return with another corporation, and that other corporation is required to be included in a combined return with another corporation under other provisions of Tax Law section 1462(f), the captive REIT or captive RIC must be included in that combined return with those corporations.
- f) A captive REIT or captive RIC must not be included in a combined return or report under Article 9-A, 32, or 33 if a banking corporation or bank holding company that directly or indirectly owns or controls over 50% of the voting stock of the captive REIT or captive RIC and is the closest controlling stockholder of the captive REIT or captive RIC is a member of an affiliated group (1) that does not include any corporation that is engaged in a business that a subsidiary of a bank holding company would not be permitted to be engaged in, unless the business is de minimus, and (2) whose members own assets the combined average of which does not exceed \$8 billion. In that instance, the captive REIT or captive RIC is subject to the provisions of Tax Law section 209.5 or 209.7 in Article 9-A.

(Tax Law sections 1452(d), 1452(m), 1462(f)(2)(v))

Combined reporting rules under Article 33.

The new legislation under Tax Law section 1515(f)(4) requires a captive REIT or a captive RIC to be included in a combined return under Article 33 under the following conditions:

- a) A captive REIT or captive RIC must be included in a combined return with a life insurance corporation that directly owns or controls over 50% of the voting stock of the captive REIT or captive RIC if that corporation is subject to tax or required to be included in a combined return under Article 33.

- b) If over 50% of the voting stock of the captive REIT or captive RIC is not directly owned or controlled by a life insurance corporation that is subject to tax or required to be included in a combined return under Article 33, then the captive REIT or captive RIC must be included in a combined return or report with the corporation that is the closest controlling stockholder of the captive REIT or captive RIC. If the closest controlling stockholder of the captive REIT or captive RIC is a life insurance corporation subject to tax or required to be included in a combined return under Article 33, then the captive REIT or captive RIC must be included in a combined return under Article 33.
- c) If a captive REIT owns the stock of a qualified REIT subsidiary (as defined in IRC section 856(i)(2)), then the qualified REIT subsidiary must be included in any combined return required to be made by the captive REIT that owns the stock of the qualified REIT subsidiary.
- d) If a captive REIT or captive RIC is required under Tax Law section 1515(f)(4) to be included in a combined return with another corporation, and that other corporation is required to be included in a combined return with another related corporation under Tax Law section 1515(f), then the captive REIT or captive RIC must be included in that combined return with the other related corporation.

(Tax Law section 1515(f)(4))

Computation rules for REITs and RICs that are required to be included in a combined report or return under Articles 9-A, 32, or 33

Computation of tax under Article 9-A.

In the case of a combined report under Article 9-A, the tax is measured by the combined entire net income, combined minimum taxable income, or combined capital of all the corporations included in the report, including any captive REIT or captive RIC. However, the tax measured by combined capital may still not exceed the limitation provided for in Tax Law section 210.1(b).

A captive REIT or captive RIC required to be included in a combined report under Tax Law section 211.4 must compute entire net income as required under Tax Law section 209.5 (in the case of a captive REIT) or Tax Law section 209.7 (in the case of a captive RIC). However, the deduction under the IRC for dividends paid by the captive REIT or captive RIC to any member of the affiliated group that includes the corporation that directly or indirectly owns over 50% of the voting stock of the captive REIT or captive RIC is not allowed for taxable years beginning on or after January 1, 2008, and before January 1, 2011.

(Tax Law section 211.4(b)(1))

Computation of tax under Article 32.

In the case of a combined return under Article 32, the tax is measured by the combined entire net income, combined alternative entire net income, or combined taxable assets of all the corporations included in the return, including any captive REIT or captive RIC.

In the case where a captive REIT is required under Tax Law section 1462(f) to be included in a combined return, *entire net income* means real estate investment trust taxable income as defined in IRC section 857(b)(2) (as modified by section 858), plus the capital gains amount taxable under IRC 857(b)(3), subject to the modifications to entire net income required by Tax Law section 1453.

In the case where a captive RIC is required under Tax Law section 1462(f) to be included in a combined return, *entire net income* means investment company taxable income as defined in IRC section 852(b)(2) (as modified by section 855), plus the capital gains amount taxable under IRC section 852(b)(3), subject to the modifications to entire net income required by Tax Law section 1453.

The legislation temporarily repeals the 2007 changes relating to the disallowed investment proceeds of banking corporations. The 2007 changes are not in effect for taxable years beginning on or after January 1, 2008, and before January 1, 2011.

Under new Tax Law section 1453(e)(18), a deduction is allowed in determining entire net income, to the extent not deductible in determining federal taxable income, for 100% of dividend income from subsidiary capital received during the taxable year. The dividend income must be directly attributable to a dividend from a captive REIT or captive RIC for which the captive REIT or captive RIC claimed a federal dividends paid deduction and that captive REIT or captive RIC is included in a combined return or report under Article 9-A, 32, or 33.

In computing entire net income, the deduction under the IRC for dividends paid by the captive REIT or captive RIC to any member of the affiliated group that includes the corporation that directly or indirectly owns over 50% of the voting stock of the captive REIT or captive RIC will be limited to the following percentages:

- 50% of the federal deduction amount for taxable years beginning on or after January 1, 2008, and before January 1, 2009;
- 25% of the federal deduction amount for taxable years beginning on or after January 1, 2009, and before January 1, 2011; and
- 0% of the federal deduction amount for taxable years beginning on or after January 1, 2011.

(Tax Law sections 1453(e)(11)(ii), 1453(e)(11)(iii), 1453(e)(18), 1453(u), 1462(f)(3))

Computation of tax under Article 33.

In the case of a combined return under Article 33, the tax is measured by the combined entire net income or combined capital of all the corporations included in the return, including any captive REIT or captive RIC.

In the case of a captive REIT required under Tax Law section 1515(f) to be included in a combined return, *entire net income* means real estate investment trust taxable income as defined in IRC section 857(b)(2) (as modified by section 858), plus the capital gains amount taxable under IRC 857(b)(3), subject to the modifications to entire net income required by Tax Law section 1503.

In the case of a captive RIC required under Tax Law section 1515(f) to be included in a combined return, *entire net income* means investment company taxable income as defined in IRC section 852(b)(2) (as modified by section 855), plus the capital gains amount taxable under IRC section 852(b)(3), subject to the modifications to entire net income required by Tax Law section 1503.

In computing entire net income, the deduction under the IRC for dividends paid by the captive REIT or captive RIC to any member of the affiliated group that includes the corporation that directly or indirectly owns over 50% of the voting stock of the captive REIT or captive RIC is not allowed.

The new legislation also temporarily repeals the 2007 changes relating to the disallowed investment proceeds of insurance corporations, as well as the changes regarding subsidiary capital attributable to REITs and RICs. The 2007 changes are not in effect for taxable years beginning on or after January 1, 2008, and before January 1, 2011.

(Tax Law sections 1503(b)(1)(A), 1503(b)(1)(B), 1503(b)(2)(H), 1503(b)(17), 1504(c)(2), 1515(f)(5))

Report on the effect of the new REIT and RIC provisions

The Tax Department is required to prepare a report that will analyze the effect of the REIT and RIC provisions on taxpayers in New York State. This report is due to be issued on June 1, 2009. To enable the Tax Department to prepare the report, taxpayers affected by the amendments should provide the Tax Department with sufficient information about their income,

expenses, and corporate structure by March 31, 2009. All information provided by taxpayers for purposes of this report will be kept confidential by the Tax Department, and will not be used by the Tax Department in auditing the taxpayer's tax liabilities under the Tax Law.

The Tax Department will provide additional information on the format to be used to submit the information at a later date.

NOTE: A TSB-M is an informational statement of existing department policies or of changes to the law, regulations, or department policies. It is accurate on the date issued. Subsequent changes in the law or regulations, judicial decisions, Tax Appeals Tribunal decisions, or changes in department policies could affect the validity of the information presented in a TSB-M.