

Setting the Record Straight on REITs and HB 833

Are REITs tax “loopholes”?

REITs (Real Estate Investment Trusts) are not tax loopholes. A REIT is a corporation that owns, and in most cases, operates income producing real estate. Shopping centers, healthcare facilities, timberland owners, and self storage facilities are types of businesses structured as REITs. Modeled after mutual funds, REITs were created by Congress in 1960 to allow even the smallest investor to own and participate in a diversified portfolio of professionally managed income producing real estate. REITs conform to federal and Montana tax law, and they create jobs and wealth in the state. REITs are a recognized vehicle for investing in real estate in numerous countries around the world.

By law, REITs must follow rules that no other type of corporation is required to follow. REITs are required to pay a minimum of 90 percent of their income in the form of dividends to their stockholders. REITs must follow numerous other rules and regulations on a quarterly and annual basis to ensure that they remain real estate-focused and to preserve their REIT status. In exchange for adhering to these strict requirements, REITs do not pay corporate level income tax on the income they distribute to their shareholders. Instead, REIT shareholders pay income tax on the dividend payments they receive from the REIT. REITs do pay corporate tax on any income they retain, and their subsidiaries pay substantial corporate level taxes.

What does HB 833 do concerning the state taxation of REITs?

The Department of Revenue claims that the REIT provisions of HB 833 will treat REITs “like any other corporation” doing business in Montana by requiring REITs to pay a corporate level income tax. However, as noted above, REITs are not like other corporations. They must comply with numerous operating and administrative rules that other entities are not required to follow, including paying out substantially all of their income to shareholders.

The Department of Revenue also claims that “REITs are the only for-profit corporations that do not pay Montana’s corporation tax.” This is simply not true. S-corporations (generally privately held), pension funds, and mutual funds also do not pay corporate level tax in Montana. Moreover, REITs do pay corporate tax on the portion of their income that they do not distribute to shareholders as well as on income generated by their subsidiaries.

The REIT provisions of HB 833 would create a significant new tax burden for any Montana business organized as a REIT and would discourage REITs and other companies from investing and doing business in Montana.

Montana follows federal tax law on REITs

REITs are not exempted from Montana corporate income tax. In fact, they are subject to the corporate income tax and, as noted above, they (like mutual funds) may reduce their taxable income by the amount of dividends they distribute – the dividends paid deduction or DPD.

Montana's allowance of the DPD was not obtained through a "back door" decision by the Montana Supreme Court. Montana currently follows policies set forth in the federal Internal Revenue Code as a model for its own tax policy, including the treatment of REITs – as does every other state in the country with an income tax except one, New Hampshire.

The Department of Revenue notes that "churches, private schools and hospitals pay corporate income taxes on business income unrelated to their charitable activities." So do publicly traded REITs. Plum Creek's REIT is the entity that owns the company's timberlands. The non-REIT part of Plum Creek's business – manufacturing and development – is conducted through regular taxable corporations that are subject to both federal and state income taxes. The company and other REITs doing business in Montana also pay millions of dollars per year in property and payroll taxes.

Does Plum Creek's REIT status provide an incentive to sell land quickly?

No. Plum Creek has no special incentive from any state, including Montana, to sell land faster and avoid paying state taxes. Plum Creek fully pays both federal and state taxes on sales of land by its taxable subsidiaries. For example, Plum Creek land that is subdivided and sold as lots for residential development is sold by one of the company's taxable subsidiaries, and income from such sales is subject to state and federal income taxes. Thus, if development yields margins above large tract land values, Montana will receive income taxes for these gains.

Plum Creek is not selling all of its land in Montana. The company is selling property that has a much higher value for recreation or conservation than as timberland. Since 2000, Plum Creek has sold 113,000 acres of its 1.3 million acres in Montana to non-timberland buyers. Of this amount, 71 percent was sold for conservation. An additional 80,000 acres were sold to Stimson Lumber Company.

Does Plum Creek Pay for State Services?

Plum Creek and other REITs pay significant property taxes, one of the major sources of revenue for the State of Montana and the mechanism by which many state benefits are funded. In addition, Plum Creek's taxable subsidiaries (manufacturing and development) pay income taxes to the general fund, and all of the company's Montana operations pay significant state payroll taxes. In 2004, Plum Creek paid \$3.3 million dollars in Montana payroll taxes, \$3.7 million in property taxes, and \$1.9 million in corporate income tax.

Plum Creek pays directly for several state services, one of which is fire protection based on acreage owned. Plum Creek is taxed at the rate of \$.205 per acre, every year, for fire protection by the state – the same rate as every other Western Montana timberland owner. The company also pays indirectly for many services such as roads and infrastructure via payments to contractors who purchase fuel and licenses from the state.

Does Plum Creek’s REIT status give it an unfair advantage in bidding for timber against other mills?

Plum Creek’s REIT does not bid on federal, state or private timber sales – the company’s manufacturing subsidiaries (the mill operations) do. And they pay taxes just like any other sawmill competitor. There is no advantage gained from Plum Creek’s REIT structure in bidding for timber sales.

What about companies that use “captive” REITs to avoid state taxes?

As noted in the press recently, a number of regular or subchapter C corporations have created virtually 100 percent owned or “captive” REITs to shield their operations from state taxes. Plum Creek is not a captive REIT but a public REIT owned by thousands of shareholders who pay taxes on REIT income.

Plum Creek and NAREIT, the National Association of Real Estate Investment Trusts®, recognize Montana’s need to limit the inappropriate use of “captive” REITs formed solely to avoid paying state taxes. Plum Creek and NAREIT remain committed to work with the Legislature and the Department of Revenue to draft language disallowing the use of captive REITs.

Have other states enacted legislation to disallow the federal tax treatment of REITs?

To say that “many states” have elected not to follow the federal tax treatment of REITs is simply not true. In fact, the federal tax treatment of REITs as outlined in the Internal Revenue Code is followed by all states with an income-based tax system except one, New Hampshire. Mississippi limits a REIT’s dividends paid deduction to publicly traded REITs, like Plum Creek.

Three states have adopted legislation that eliminates the dividends paid deduction for captive REITs (generally, REITs more than 50 percent held by one taxable, non-REIT corporation) – Louisiana, Kentucky, and New York. The Maryland General Assembly has passed similar legislation that is before the Maryland governor for signature. Further, the Maryland Comptroller has stated that “[w]e value [legitimate REITs]. They provide a very strong public policy purpose, which is to allow individuals and companies to invest in real estate. ... What we are concerned about are captive or subsidiary REITs that are set up by companies to avoid paying state taxes.” The Multistate Tax Commission, an organization of state governments, is currently considering a draft REIT model statute that would continue to allow the dividends paid deduction for all but captive REITs.

California and Connecticut have conformed their tax law to the federal REIT tax treatment concerning REIT shareholders, but they have not addressed REITs themselves. Tennessee continues to follow the federal tax treatment of REITs (but allows Tennessee residents a complete tax exemption for REIT dividends regardless of where the REIT earns income). In sum, these states have carefully considered both public and private REITs and all have chosen to limit captive REITs and fully support and encourage the federal tax treatment of publicly traded REITs, leaving it unchanged.

Aren't Montanans at a disadvantage because most REIT shares are held by taxpayers of other states?

As demonstrated in the Senate Tax Subcommittee hearing on March 26, 2007, there are thousands of Montana residents who own shares of REITs based all over the United States and pay Montana taxes on the dividends they receive from these companies. REIT shareholders who live in Montana pay Montana taxes on their dividends even if the REIT or REITs in which they own shares own no property in Montana and have absolutely no connection whatsoever to Montana.

Plum Creek stock is owned by 4,500 individual Montana residents totaling 2,070,000 shares. The annual Plum Creek dividend paid to Montana residents is \$3.5 million dollars, which is subject to individual state income tax. Interestingly, it is ten times more likely for a Montanan to own a share of Plum Creek than the average American investor.