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ARIZONA CORPORATE TAX RULING CTR 99-7

(This ruling supersedes Arizona Corporate Tax Ruling CTR 99-2)

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ISSUES:

Is a Real Estate Investment Trust (REIT) subject to Arizona corporate income tax and, if so, can a corporate beneficiary qualify for the dividend received deduction of A.R.S. § 43-1122(5)?

APPLICABLE LAW:

Internal Revenue Code (I.R.C.) § 856(a) and (c) sets forth the requirements for an organization to qualify as a REIT. Among other qualifying factors, a REIT must be a corporation, trust, or association which, but for the federal REIT provisions, would be taxable as a domestic corporation.

I.R.C. § 7701(a)(4) defines "domestic", as applicable to a corporation, as a corporation "created or organized in the United States or under the law of the United States or of any State." I.R.C. § 857 provides for the tax treatment of Real Estate Investment Trusts.

Arizona Revised Statutes (A.R.S.) § 43-1122(5) provides a deduction for dividends received from another corporation owned or controlled directly or indirectly by a recipient corporation.

A.R.S. § 43-104(3) defines the types of organizations which are considered to be corporations for Arizona income tax purposes. The term "corporation" includes business trusts and associations, whether incorporated or unincorporated.

A.R.S. § 43-1101(3) defines a "domestic corporation" as "a corporation created or organized in the United States or under the laws of the United States or of any state of the United States or the District of Columbia."

A.R.S. § 43-1101(1) provides that the Arizona gross income of a corporation is its federal taxable income.

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A.R.S. § 43-1101(2) provides that Arizona taxable income is Arizona gross income adjusted by the modifications in A.R.S. §§ 43-1121 through 43-1130.01.

DISCUSSION:

For federal income tax purposes, a domestic corporation, trust, or association that specializes in investments in real estate and real estate mortgages and which meets certain ownership, organization, income and asset tests may elect to be a REIT.

REITs file an 1120-REIT federal income tax form and can generally pass through to their beneficial owners, as ordinary income, any taxable income that is distributed as a dividend to such owners. Capital gains of the REIT, to the extent they are distributed, are also taxed at the beneficiary level as gains from the sale or exchange of a capital asset held more than one year, rather than as ordinary income. I.R.C. § 857(b). A REIT is thus generally taxable only on undistributed income and capital gains as well as on income from foreclosure property and on income from specified prohibited transactions. I.R.C. § 857(b)(4) and (6).

There are no Arizona corporate income tax provisions specifically addressing the taxability of REITs. However, one of the organizational requirements for electing federal REIT status is that the organization, but for the federal REIT provisions, “would be taxable as a domestic corporation.” I.R.C. § 856(a)(3). Arizona imposes a corporate income tax on the Arizona taxable income of every corporation. Arizona defines a “corporation” as a “corporation, ... business trust, ... and any other association whether incorporated or unincorporated.” Arizona defines a “domestic corporation” as “a corporation created or organized in the United States or under the laws of the United States or of any state of the United States or the District of Columbia.” A.R.S. § 43-1101(3). Similarly, the I.R.C. defines “domestic”, as applicable to a corporation, as a corporation “created or organized in the United States or under the law of the United States or of any State.” I.R.C. § 7701(a)(4). Thus, if an organization must be taxable as a domestic corporation in order to qualify for a federal REIT election, such organization will also be an Arizona domestic corporation for Arizona corporate income tax purposes.

Arizona gross income of a corporation is defined as the corporation’s federal taxable income for the taxable year. A.R.S. § 43-1001(1). Arizona taxable income of a corporation means its Arizona gross income adjusted by the modifications specified by A.R.S. §§ 43-1121 through 43-1130.01. Thus, only the portion of a REIT’s income which is subject to federal taxation would flow through to Arizona and potentially become Arizona taxable income. Like the federal tax treatment, the pass-through REIT income is taxable by Arizona at the shareholder level.

At the shareholder level, any dividend distribution received from a REIT is not eligible for the federal dividend received credit under I.R.C. § 34(a), the federal dividend

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received exclusion under section 116, or the federal dividend received deduction under section 243. Reg. 1.857-6(d). Unlike federal law, there is no exclusion from the Arizona corporate dividend received deduction for dividends received from a REIT. Thus, corporate REIT beneficiaries will be entitled to the Arizona corporate dividend received deduction if the corporate recipient meets the control or ownership requirements of A.R.S. § 43-1122(5). However, the control or ownership requirements of A.R.S. § 43-1122(5) will generally not be satisfied after the REIT's first year of existence. See I.R.C. §§ 856(h)(2), 856(a)(6), 542(a)(2) and 544(a)(1).

RULING:

A REIT must file as an ordinary corporation on Arizona Form 120. A REIT operating in Arizona is considered to have Arizona gross income to the extent it has federal taxable income (Note: Arizona Form 120 filed by a Real Estate Investment Trust is subject to the Arizona \$50 minimum tax). Corporate REIT beneficiaries will be entitled to the Arizona corporate dividend received deduction if the corporate recipient meets the control or ownership requirements of A.R.S. § 43-1122(5). However, the control or ownership requirements of A.R.S. § 43-1122(5) will generally not be satisfied after the REIT's first year of existence.

Mark W. Killian, Director

Signed: September 22, 1999

Explanatory Notice

The purpose of a tax ruling is to provide interpretive guidance to the general public and to department personnel. A tax ruling is intended to encompass issues of law that are not adequately covered in statute, case law or administrative rules. A tax ruling is a position statement that provides interpretation, detail, or supplementary information concerning application of the law. Relevant statute, case law, or administrative rules, as well as a subsequent ruling, may modify or negate any or all of the provisions of any tax ruling. See GTP 96-1 for more detailed information regarding documents issued by the Department of Revenue.