# 2017 Tax Reconciliation Bill

## Selected Provisions Impacting Real Estate

(As of January 11, 2018)

# Overview

## Tax Reform Impact on REITs and Other Investors in Real Estate

The enactment of tax reform legislation will have far-reaching consequences and create new planning considerations for REITs and other investors in real estate. This document examines key provisions in the new law and its likely impact on REITs and other investors in real estate.

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| **Individual Tax Rate** | 37% (taxable income over $600,000 for joint filers) + 3.8% NII; 7 brackets; sunsets after 2025. | *39.6% (taxable income over $470,700 for joint filers) + 3.8% NII; 7 brackets.* | Top tax rate for net capital gains and qualified dividend income remains at 20%. |
| **Corporate Tax Rate** | 21% beginning in 2018; capital gains retained by REITs and 10% income, if not distributed, subject to 21% rate. | *Top rate 35%.* | Graduated rate brackets are eliminated. 21% rate also applies to built-in gain tax applicable to REITs and S corporations. Taxable REIT subsidiaries ("TRSs") and regular corporate blockers should incur less tax liability. |
| **REIT Capital Gains/ Dividends** | Ordinary REIT dividends taxed at max 29.6% passthrough rate, accomplished through 20% deduction (see "Passthrough Tax Rate" on page 4). Up to 20% on REIT capital gains dividends and certain C corporation dividends. | *Up to 39.6% rate on REIT dividends; up to 20% on REIT capital gains dividends and certain C corporation dividends.* | • REIT dividends received by mutual funds/RICs may be ineligible for the passthrough rate. Guidance is being sought. |

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| **Passthrough Tax Rate** | • Max 29.6% rate, accomplished through deduction equal to 20% of qualified business income (*i.e.*, U.S. effectively connected trade or business income other than from specified service trade or businesses ("SSTB") and the trade or business of performing services as an employee).<br>• Deduction limited to the greater of (a) 50% of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.<br>• Qualified property generally includes tangible depreciable property used in the qualified trade or business for which the depreciation period has not expired (all property treated solely for this purpose as having a depreciable life of at least 10 years), but does not include land. W-2 wage limit and exclusion of income from specified service businesses do not apply to joint filers with income of $315,000 or less; those benefits completely phased out at $415,000 of income. | *Taxed at owner's individual rate.* | • Consider moving employees to the partnership if employed elsewhere in the structure (*e.g.*, a management company) to provide W-2 wages that could increase passthrough deduction.<br>• Uncertainty exists regarding unadjusted basis calculation, including whether depreciation is section 704(b) or tax, basis to be used for assets acquired through a like-kind exchange or contribution, and whether step-ups are included.<br>• All or part of a management company may be a SSTB. Consider segments that may be a qualified business. Alternatively, consider incorporating all or part of the company.<br>• Consider using subsidiary REITs above or below partnerships to allow investors to benefit from reduced passthrough rate on REIT dividends. |

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| **Carried Interest/ LTIPs** | • Three-year holding period required to claim long-term capital gains with respect to partnership interests granted for providing services. Complex exceptions apply.<br>• Partnership's holding period controls for determining whether gain from the sale of a partnership asset satisfies the three-year holding period requirement.<br>• Except in the case of the sale of a partnership interest to a related person, the holding period requirement for section 1231 assets (including real property used in a trade or business) was not extended and remains one year, but a future technical correction bill may extend that holding period. | *Dependent upon character of income, typically capital gain rates.* | • Consider revising partnership agreements, including carry provisions, where appropriate.<br>• Capital gain dividends from a subsidiary REIT are treated as gain from the sale of a capital asset held for more than one year. It is unclear whether capital gain dividends attributable to the sale of property held by the subsidiary REIT for more than three years would be treated as long-term capital gain under the carried interest provision. Consider restructuring carried interests in partnerships owning one or more subsidiary REITs.<br>• Impact on LTIPs issued by operating partnership of REITs should analyzed. |
| **Like-kind Exchanges** | Allowed only for real property. | *Allowed for a wide range of property held for productive use or investment.* | Personal property transferred as part of a larger like-kind exchange of real property is not tax deferred. |

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| **AMT** | AMT for corporations repealed; AMT retained for individuals; individual exemption and exemption phase out increased, but sunsets after 2025. | *20% rate (corporations) and 26%/28% rate (individuals).* | Corporate AMT credit refundable for taxable years 2018-2021 at 50% (100% beginning in 2021) of the excess of the AMT credit for the year over the amount of the credit allowable for the year against regular tax liability. |
| **Excessive Employee Remuneration** | • Eliminates exceptions for performance-based compensation and commissions.<br>• Expands the definition of "covered employee" to include, among others, the principal financial officer. Status as a covered employee continues after separation from service.<br>• Definition of corporation covered by the provision expanded to include foreign issuers trading through ADR and other corporations with publicly traded debt. | *Deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation is limited to no more than $1 million per year, subject to exceptions for, among others, commissions and performance-based remuneration, including stock options. Principal financial officer not a covered employee. Limitation **not** applicable to employees of partnerships, including operating partnerships of publicly traded REITs* | • Limitation does **not** apply to employees of partnerships, including operating partnerships of publicly held REITs.<br>• Binding contract transition rule may require analysis of plans and employment agreements. |

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| **Interest Deduction** | • Net business interest expense limited to 30% of adjusted taxable income (essentially EBITDA before 2022; depreciation and amortization deducted thereafter).<br><br>• Limitation does not apply if the taxpayer's three-year annual average gross receipts does not exceed $25 million (aggregation rules apply).<br><br>• At taxpayer's election, limit does **not** apply to interest of a real property trade or business ("RPTOB"). If election is made, it is irrevocable and ADS depreciable life must be used for real property and qualified improvement property. See Expensing/Depreciation on page 9.<br><br>• All interest of a corporation is treated as business interest (except for RPTOB) subject to the 30% limitation.<br><br>• RPTOB includes any real property development, redevelopment, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (including lodging and senior living). | *Subject to certain imitations (e.g., certain related party interest), corporations may generally deduct interest expense.* | • Explore the impact of structuring property acquisitions from non-RPTOB C corporations as sale-leaseback transactions.<br><br>- The 30% limitation on net interest deductions applies to owners of leveraged real property that are not in a RPTOB, but no limitation applies to deductions for rent paid in a sale-leaseback transaction.<br><br>- Reduction of the C corporation tax rate from 35% to 21% significantly reduces the tax liability on a sale of property in a sale-leaseback transaction.<br><br>• The 30% limitation on interest replaced prior rules in section 163(j), including the limitations on interest expense claimed by a TRS on interest paid to its parent REIT and interest expense claimed by certain blockers used for non-US investors. |

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| | Considerations / Observations |
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| **Interest Deduction (Continued)** | • Subject to debt/equity, section 385, and potentially concerns under the new provisions addressing related party cross border and hybrid transactions (see "Denial of Deductions involving Related Parties and Hybrids" on page 15), consider adding leverage to C corporation "blockers" owning real estate, if appropriate.<br>– A blocker that owns an interest, directly or indirectly, solely in a REIT and whose three-year average annual gross receipts exceeds $25 million (aggregation rules apply), however, appears to be subject to the 30% limitation on interest expense.<br><br>• In parent-subsidiary relationships involving REITs and C corporations generally, the parent's RPTOB would not be attributed to the subsidiary. Conversely, the subsidiary's RPTOB would not be attributed to the parent.<br>– Note that a parent REIT debtor with subsidiary REITs may need restructuring if parent REIT fails to achieve RPTOB status.<br><br>• Although being owned by a REIT would not automatically cause a TRS to have a RPTOB, a TRS's activities on its own (*e.g.*, operating and managing real property for third parties) may qualify for the RPTOB election out of the interest limitation.<br><br>• Even if a REIT is generally engaged in a RPTOB, it may have activities (*e.g.*, originating mortgage loans) or assets (a TRS) that do not qualify as part of that business. If an allocation of income and interest expense among activities or assets is required, it is unclear how that would be accomplished.<br><br>• It is unclear how disallowed interest expense carryforward amounts under prior section 163(j) are treated. Guidance is being sought. |

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| **Expensing/ Depreciation** | • 100% bonus depreciation generally available for "qualified property" acquired and placed in service after September 27, 2017 and before January 1, 2023; phases out 20% per year thereafter.<br>• If RPTOB election made to be excluded from the interest limitation, residential rental property (30 years), non-residential real property (40 years), and "qualified improvement property" (20 years) held by the taxpayer – including existing property previously placed in service – must be depreciated under ADS, with no bonus depreciation; however, tangible personal property is still eligible for full expensing.<br>• Qualified improvement property is generally any improvement to the interior of nonresidential real property other than enlargements, escalators, elevators, and structural framework. | *MACRS/ADS with bonus depreciation; or accelerated use of AMT credits.* | • RPTOB election subjects all real property and qualified improvement property held by a taxpayer to ADS depreciation.<br>• Mechanism to change existing assets to ADS is uncertain—options are change in method, change in use, or change in useful life. It appears the intent was change in use—which generally requires prospective application.<br>• "Qualified improvement property" replaces "qualified leasehold improvement property," "qualified retail improvement property," and qualified restaurant property" under prior law; issues with statutory language make bonus depreciation and recovery period uncertain for property acquired after September 27, 2017 and placed in service after December 31, 2017. |

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| **Partnership Technical Terminations** | No technical terminations for partnership taxable years beginning after December 31, 2017. | *A partnership technically terminates if more than 50% of capital and profits interests sold or exchanged in a 12-month period.* | • Material partnership ownership changes will not restart depreciation or allow new partnership level elections to be made.<br>• California transfer taxes tied to technical terminations may not apply, although still applicable for actual section 708(b)(1)(A) terminations or changes in control of the partnership under the property tax rules. |
| **Non-Corporate Business Losses** | • Excess business loss of taxpayers other than C corporations not allowed in current year and carried forward.<br>• Excess business loss equals aggregate deductions attributable to trade or business of taxpayer over sum of aggregate gross income or gain of the taxpayer plus a threshold amount ($500,000 for married individuals).<br>• Applied at the partner or S corporation shareholder level. Sunsets after 2025. | *No provision.* | In any year with material net active losses, income tax liability may occur despite the absence of net income or cash flow. |
| **Estate and Gift Tax** | Exemption for estate and gift tax doubled. Sunsets after 2025. | *40% after exemption of $5.5 million/$11 million; $14,000 annual gift exclusion per donee.* | Scheduled sunset of increased exemption will likely cause additional gifting before 2026. |

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| **Itemized Deductions** | • Repeals many. Retains deduction for state and local taxes ($10,000 cap, but cap does not apply to sales and property taxes attributable to a trade or business), home mortgage interest on primary residence and second homes ($750,000 max debt for new mortgages and no deduction for home equity interest), medical expenses (expanded for 2017 and 2018), and charitable contributions.<br>• Increased standard deduction ($24,000 for joint filers) may limit the benefit of those deductions; all provisions sunset after 2025. | *Allowable; home mortgage interest ($1 million max debt), medical and dental expenses, state and local taxes, charitable contributions, business travel expenses, work-related education expenses, etc.* | Consider monitoring state reactions to limitation on state and local tax deduction for potential planning opportunities. |
| **Net Operating Losses** | Generally eliminate NOL carryback and provide indefinite carryforward. Limit current deduction to 80% of taxable income (before the dividends paid deduction) for losses arising after 2017. | *Generally two-year carryback, but no carryback for REITs, and 20-year carryforward allowed to offset taxable income.* | • Ordering rule for use of NOLs after REIT DPD has not changed. Pre-DPD taxable income is used for purposes of calculating the 80% limit on NOL use.<br>• If taking an accelerated deduction, such as bonus depreciation, would create an NOL, it may be better not to accelerate because there would be no 80% limit on the ability of unaccelerated deductions to reduce taxable income. |

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| **FIRPTA** | Withholding rate on FIRPTA distributions by REITs and FIRPTA gains of partnerships reduced from 35% to 21%. Withholding rate for partnerships on effectively connected income allocated to foreign corporate partners reduced from 35% to 21%. | *35% withholding on FIRPTA distributions by REITs and FIRPTA gains of partnerships and effectively connected income allocated to foreign corporate partners by partnerships.* | No substantive changes to FIRPTA rules. |
| **Sale of Partnership Interests** | • A sale of a partnership interest will be considered taxable as income effectively connected with a U.S. trade or business ("ECI") to the extent that income from the sale of the partnership's assets would have been ECI. Coordination of this provision with FIRPTA taxation of such sales is indicated.<br>• 10% withholding by transferees of certain partnership interests is generally required. Notice 2018-8 provides exceptions for publicly traded partnerships. | *On July 13, 2017, the U.S. Tax Court in* Grecian Magnesite, Mining, Industrial, & Shipping Co. SA v. Comm'r, 149 TC No. 3, *ruled that gain recognized by foreign corporation on the redemption of a U.S. partnership interest is not ECI. The court's decision contradicts and effectively overruled IRS guidance in Revenue Ruling 91-32.* | • Essentially overrules *Grecian Magnesite.*<br>• Unclear what inference, if any, courts will draw on the validity of Revenue Ruling 91-32 as applied to prior years.<br>• Treatment of gain as ECI is after the determination of whether gain is subject to tax under FIRPTA. |

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| **Foreign-Source Dividends** | • Closer to a participation exemption regime by providing for 100% dividends received deduction for dividends from foreign subsidiaries to U.S. parent corporation that owns at least 10%, but REITs are not entitled to the dividends received deduction.<br>• Corporations not allowed foreign tax credits associated with the exempt dividends. | *Worldwide regime with deferral and foreign tax credit offsets.* | No change in foreign reporting for REIT income and asset tests, but impact of new addition to Subpart F provisions (see "Global Intangible Low-Taxed Income" discussion on page 14) on income tests should be assessed. |
| **Repatriation Tax** | • One-time deemed repatriation provided as an increase to current year Subpart F income in an amount of accumulated post-1986 net earnings. Effective rate of tax on such earnings tied to 15.5% to extent of cash assets; 8% for remainder for a corporation. Non-corporate effective rate slightly higher. May elect to spread payments over 8 years – 8% in first 5 years, 15% in year 6, 20% in year 7 and 25% in year 8. Such amounts included are viewed as previously taxed income.<br>• Deemed repatriation of accumulated deferred foreign income excluded from REIT gross income tests.<br>• REITs permitted to elect to recognize and thus distribute the accumulated deferred foreign income over an 8-year period using same installment percentages. | *U.S. tax on foreign subsidiary earnings generally deferred until repatriated.* | • Consider impact of repatriation amount on distribution requirement for global REITs and income of fund partnerships owning foreign portfolio companies. Deemed repatriation applies to both controlled foreign corporations ("CFCs") and other foreign corporations with 10% U.S. corporate shareholders.<br>• Accurate historical E&P records are important in computing the deemed repatriation income and cash/non-cash amounts. |

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| **Global Intangible Low-Taxed Income ("GILTI")** | • U.S. shareholder's GILTI includible in its gross income. GILTI is the excess of shareholder's "net CFC tested income" (tested income excludes Subpart F income and certain other amounts) over shareholder's net deemed tangible income return; the latter is (i) 10% of pro rata share of CFC's bases in tangible property used to produce tested income minus (ii) certain CFC interest expense.<br>• Deduction of 50% generally allowed for U.S. corporate shareholders. Deduction reduced to 37.5% for years beginning after 2025. Such deduction not allowed for REITs, RICs, and non-corporate shareholders, but GILTI should be treated as previously taxed income for those taxpayers. | *No provision.* | • For REITs, impact of GILTI inclusion on income tests should be assessed.<br>• For all U.S. shareholders, including REITs, impact of GILTI on previous investments that may have qualified for deferral under prior Subpart F rules could be substantial for non-real estate asset intensive operations. |
| **Base Erosion Anti-abuse Tax ("BEAT")** | • "Applicable taxpayer" (a corporation other than a RIC, REIT, or S corporation) pays tax equal to the excess of (i) a fixed percentage of the corporation's "modified taxable income" (*i.e.*, taxable income before certain deductions for payments to foreign related parties, and generally disregarding a portion of NOL deduction) over (ii) its regular tax liability reduced by certain credits.<br>• Certain payments, including for cost of goods sold, certain at-cost payments for services, and certain derivatives payments, are generally carved out. | *No provision.* | BEAT generally does not apply to a taxpayer whose single-employer group has (i) average (three-year period) annual gross receipts of less than $500 million and (ii) base erosion benefits as a percentage of most deductions is less than 3% (2% in the case of a bank or securities dealer). |

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| **Denial of Deductions involving Related Parties and Hybrids** | • Denies deduction for "disqualified related-party amounts" paid or accrued pursuant to a "hybrid transaction" or by, or to, a "hybrid entity."<br>• Must be payments that are treated as interest or royalties for U.S. federal income tax purposes but are not included in income of such related party for purposes of the tax law of the foreign country where the recipient is resident or is otherwise subject to the tax, or to situations where a deduction is allowed to the related party with respect to the amount under the laws of such country.<br>• Treasury granted broad regulatory authority to provide guidance to carry out purposes of this provision to other arrangements, including conduits and foreign and domestic branches, among others. | *No provision.* | Consider whether leveraged blocker interest payments could be disallowed under this provision. |

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| **Definitions of U.S. Shareholder and CFC** | • The 10% ownership test to determine if a person is a "U.S. shareholder" of a foreign corporation changed to be based upon either vote **or** value (effective for foreign corporation taxable years beginning after December 31, 2017).<br><br>• Generally repeals rule preventing "downward attribution" of ownership through a foreign person for determining if a company is a CFC, effective beginning with foreign corporation's last taxable year beginning before 2018.<br><br>• Repealed requirement that Subpart F inclusions occur only if foreign corporation has been a CFC for an uninterrupted 30-day period (effective for taxable years of foreign corporations beginning after 2017). | *Subpart F taxation imposed upon U.S. shareholders (*i.e., *U.S. persons who are considered to own 10 percent or more of the voting power) only when the foreign corporation is a CFC (*i.e., *more than 50 percent of the stock, by vote or value, is owned by U.S. shareholders).*<br><br>*For this ownership test, former constructive ownership rules prevented a U.S. person from being "downward attributed" stock that is considered to be owned by a non-US person.*<br><br>*Subpart F inclusions from a CFC's tax year applied only once the foreign corporation was a CFC for an uninterrupted period of 30 days or more during the year.* | • Investors in foreign corporations will need to more closely test their ownership and more fully understand the ownership by other shareholders/co-investors to be able to apply these rules.<br><br>• These changes impact inclusions of Subpart F income, US property investments, new law GILTI, and the deemed one-time repatriation tax.<br><br>• Legislative history states that scope of the repeal of rule preventing "downward attribution" is somewhat limited in the case of unrelated investors. Statutory basis for this limit seems absent.<br><br>• Ability to acquire foreign corporations and liquidate within 30 days and avoid CFC treatment is eliminated.<br><br>• Affected taxpayers need to pay close attention to impact of effective dates. |

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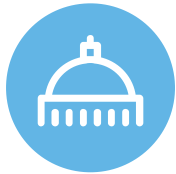
## Other Items Impacting Real Estate



State tax impact of the new legislation may be material and deserves analysis.

Provisions from House and Senate bills that were not included in the final legislation:

- Subjecting “super tax exempts” to UBTI rules.
- Limiting interest deductions of international groups.
- Limiting the capital gain exclusion for the sale of a primary residence.
- Repealing section 956 (Subpart F inclusions for investments in US property).
- Repealing low-income housing tax credit.

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