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Tax Reform: Key Considerations for Real Estate Investment Trusts

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act") into law.[1] Although the individual and collective impact of the Act may not be evident for some time, the Act is generally viewed by the real estate and real estate investment trust ("REIT") community as encouraging investment. While there are certain beneficial tax provisions in the Act relating to REITs, the Act does not change the general manner in which REITs are taxed. Key changes brought about by the Act relating to REITs include the following:

- *Reduction in Tax Rate for Certain Pass-Through Income and Ordinary REIT Dividends for Non-Corporate Shareholders*. The Act generally allows a deduction for non-corporate shareholders equal to 20% of certain income from pass-through entities, including ordinary dividends distributed by a REIT, generally resulting in a maximum effective federal income tax rate applicable to such income of 29.6% compared to 37% (excluding, in each case, the 3.8% Medicare tax on net investment income). We anticipate that this provision could be especially beneficial to REITs for several reasons:
    - the deduction for ordinary REIT dividends is not subject to the wage and tax basis limitations[2] applicable to the deduction for other qualifying pass-through income;
    - related to such limitations, contributors to "UPREIT" operating partnerships could benefit from the larger wage and tax bases of such partnerships when calculating the deduction for income generated by contributed properties;
    - mortgage REITs can distribute their ordinary interest income as REIT dividends eligible for the reduced effective tax rate;
    - the deduction for ordinary REIT dividends provides certainty to investors, whereas the scope of deduction-eligible income ("qualified business income") from other pass-through entities may be somewhat unclear pending IRS guidance (for example, in the case of income from triple-net leasing); and
    - in contrast, the Act does not include ordinary dividends paid by a regulated investment company ("RIC") as eligible income for purposes of this 20% deduction; therefore, holding REIT stock through a RIC will be less attractive.

[1] Pub. L. 115-97. The Act was originally known as the “Tax Cuts and Jobs Act,” but that title was dropped on a point of order in the Senate. Although it is still commonly referred to as the Tax Cuts and Jobs Act, it is actually entitled “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.” The text of the Act, the Conference Report for the Act, our previous Client Alerts, and other tax reform resources are available on our tax reform website at: http://www.mofotaxreform.com. Our prior Client Alerts are also available on our website at: http://www.mofo.com.

[2] For income earned through other pass-throughs (*e.g.,* partnerships) or sole proprietorship, the 20% deduction is generally limited to the greater of (i) 50% of the taxpayer’s share of W-2 wages paid with respect to the qualified trade or business or (ii) the sum of 25% of the W-2 wages and 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.

- *Reduction in the Maximum Corporate Tax Rate.* The Act reduces the corporate income tax rate from 35% to 21% (including with respect to taxable REIT subsidiaries (each, a "TRS")) and eliminates the corporate alternative minimum tax. The reduced corporate tax rate will be beneficial for REITs with TRSs, for REITs that opt to distribute less than all of their taxable income,[3] and for REITs that inadvertently fail to continue to qualify as REITs.

- *Reduction in Certain U.S. Federal Withholding Tax Rates.* The Act reduces the U.S. federal withholding tax rate on distributions made to non-U.S. shareholders by a REIT that are attributable to gains from the sale or exchange of U.S. real property interests (*i.e.*, FIRPTA gains) from 35% to 21%.

- *Restriction on the Deductibility of Interest Expense.* The Act restricts the deductibility of interest expense by businesses (generally to 30% of the adjusted taxable income of the business) except for, among others, real property businesses[4] electing out of such restriction. Generally, most equity REITs would qualify as a real property business, but businesses conducted by TRSs may not so qualify depending on the nature of their businesses. A REIT should determine whether it or any of its TRSs qualifies for such election and, if so, whether it should make such election. Such election would require the use of the slightly less favorable alternative depreciation system ("ADS") to depreciate real property.

- *Repeal of Former Section 163(j)*. As a consequence of the new interest deductibility restriction described above, the former "earnings stripping" rules of Section 163(j) have been repealed outright. Thus, parent REITs with subsidiary REITs may want to revisit the value of such structures.

- *Modified Recovery.* The Act changes the recovery periods for certain real property and building improvements (*e.g.*, to 15 years for qualified improvement property under the modified accelerated cost recovery system ("MACRS"), and to 30 years (previously 40 years) for residential real property and to 20 years (previously 40 years) for qualified improvement property under ADS).

- *Potential Change in Timing of Income Recognition*. The Act requires accrual method taxpayers to take certain amounts into income no later than the taxable year in which such amounts are taken into account as revenue in an applicable financial statement prepared under GAAP. An exception is provided for, among others, items of income that are subject to a "special method of accounting." For example, equity REITs should analyze their leases to determine whether the new provision would accelerate their rental income recognition and/or whether such leases are subject to a "special method of accounting" (e.g., under Section 467) that would exempt such leases from the application of the new provision. Similarly, mortgage REITs should review their income items (such as loan "points") to determine whether the timing of recognizing any such income must be changed.

[3] For REIT qualification purposes, a REIT is only required to distribute 90% of its taxable income annually. However, if a REIT chooses to distribute less than 100% of its taxable income, it will be subject to federal corporate income tax on such undistributed taxable income. For this reason, most REITs typically distribute 100% of their taxable income so as to not incur tax at the REIT level.

[4] Generally, this means real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

- *Preservation of Like-Kind Exchanges for Real Property.* Under prior law, the benefits of Section 1031 like-kind exchanges that defer capital gain or loss for tax purposes extended to both personal property and real property provided certain conditions were satisfied. The Act retains the benefits of Section 1031 like-kind exchanges solely for real property not held primarily for sale. This means that REITs engaging in potential Section 1031 real property exchanges can no longer exchange associated personal property tax-free.

- *Impact of Repatriation Amount on Distribution Requirement*. The Act imposes a one-time deemed repatriation tax on the post-1986 undistributed net earnings and profits of foreign subsidiaries in which a U.S. person (including a REIT) is treated as holding at least 10% of the stock. The deemed repatriation tax is implemented as an increase to 2017 Subpart F income in the amount of the accumulated post-1986 net earnings and profits that have not previously been subjected to tax. While such amounts are excluded from the gross income of REITs for purposes of the gross income tests, they could impact the amount required to be distributed in order to maintain their REIT status. A REIT can elect to include income over eight years for purposes of the REIT distribution requirement. This provision could be material for global REITs with significant foreign operations.

- *Repeal of "Technical Termination" Rule for Partnerships*. The Act repeals the rule that caused a technical partnership termination when 50% or more of the interests in the capital and profits of a partnership were sold or exchanged within a 12-month period. The repeal means sales and exchanges of the interests in a partnership will be less likely to, among other things, terminate the taxable year of, and restart the depreciable lives of assets held by, such partnership for tax purposes.

Except as noted, the above provisions are effective for taxable years beginning in 2018. Many of the provisions in the Act, however, expire in seven years (at the end of 2025). We will continue to monitor market practices and developments in future Client Alerts. Members of our Firm's tax practice are also available to discuss how the changes under the Act may affect your specific current situation or potential future plans.

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If you have any questions regarding this Client Alert, please do not hesitate to contact one of the members of the Firm’s U.S. federal income tax group listed below.

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