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Client Alert

Tax Practice Group

January 12, 2018

Impact of the New Tax Reform Legislation on the Real Estate Industry

On December 22, the President signed the Tax Cuts and Jobs Act ("TCJA") into law. TCJA changes the taxation of individuals and businesses in many ways. While there are still many open questions to be addressed by technical corrections and regulatory guidance, the outlines of the new tax regime are now clear. This Client Alert summarizes a number of TCJA provisions that are expected to be important to the real estate industry, including public and private REITs, real estate fund sponsors, and investors.

Summary

Individual and Corporate Tax Rates. TCJA permanently replaces the current schedule of corporate tax rates (with a maximum rate of 35%) with a flat 21% corporate tax rate. TCJA also permanently repeals the corporate alternative minimum tax. Special rules apply for the recovery of AMT credits accrued under prior law.

TCJA also temporarily lowers individual tax rates across the board, and reduces the maximum individual income tax rate on ordinary income from 39.6% to 37%, with these new rates expiring at the end of 2025. Long-term capital gain and qualified dividend income of individual taxpayers remains subject to a maximum income tax rate of 20%, as under pre-TCJA law.

Deduction for Qualifying Business Income Earned Directly or Through Pass-Through Entities. TCJA provides an effective tax rate reduction for non-corporate taxpayers that earn domestic business income as sole proprietorships or through pass-through entities. Specifically, through 2025, such taxpayers who earn "qualified business income" ("QBI") through these entities will be entitled to a

For more information, contact:

Jonathan Talansky
+1 212 790 5321
jtalansky@kslaw.com

John K. Sweet
+1 212 827 4382
jsweet@kslaw.com

Abraham N.M. Shashy, Jr.
+1 202 626 5614
hshashy@kslaw.com

Peter J. Genz
+1 404 572 4935
pgenz@kslaw.com

L. Wayne Pressgrove
+1 404 572 2722
wpressgrove@kslaw.com

King & Spalding
New York
1185 Avenue of the Americas
New York, New York 10036-4003
Tel: +1 212 556 2100
Fax: +1 212 556 2222

Atlanta
1180 Peachtree Street, NE
Atlanta, Georgia 30309-3521
Tel: +1 404 572 4600
Fax: +1 404 572 5100

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deduction of as much as 20% of such income. Eligible taxpayers are entitled to the deduction whether or not they itemize. The deduction is limited to 20% of taxable income, so it cannot create a net operating loss for a taxpayer. It also does not apply to compensation or guaranteed payments received by partners or S corporation shareholders. Subject to an exception for taxpayers with taxable incomes below certain thresholds, the deduction generally is not applicable to service businesses such as health, law, accounting, and brokerage services, as well as investment management services, and the deduction is capped based on a formula that takes into account the W-2 wages paid by the business and the tax basis of depreciable tangible property used in the business. Based on the new individual maximum income tax rate of 37%, the 20% deduction results in an effective maximum income tax rate of 29.6% on pass-through business income.

REIT Dividends. Ordinary REIT dividends qualify for the same 20% deduction that applies to QBI, resulting in an effective maximum income tax rate of 29.6% on such dividends. The deduction for REIT dividends is not subject to the wage and basis cap that applies to the deduction for QBI.

Expensing of Capital Investments. TCJA allows an immediate write-off of the cost of certain qualified property acquired or placed in service after September 27, 2017 and before January 1, 2023, with a gradual phase-out of expensing after that. Qualified property is generally tangible property with a depreciation recovery period of 20 years or less under current law.

Interest Deductibility. TCJA limits the deduction for net business interest expense to 30% of adjusted taxable income (generally, taxable income without regard to interest income and expense, net operating losses ("NOLs"), and, for taxable years beginning before 2022, depreciation and amortization). Disallowed interest is carried forward indefinitely. The provision does not apply to electing real property businesses, but businesses that make this election are required to use the generally less-favorable alternative depreciation system ("ADS") for most types of real property and certain improvements. In the case of a partnership, the net interest expense disallowance would be determined at the partnership (not the partner) level.

Like-kind Exchanges. TCJA limits like-kind exchanges to real property not held primarily for sale. Personal property is no longer eligible for like-kind exchange treatment under Section 1031, although in cases where the replacement property is tangible property qualifying for expensing, the ability to write off the cost of the replacement property is generally an even better outcome.

Net Operating Losses. TCJA provides that taxpayers will only be able to deduct an NOL carryover arising in 2018 or later years to the extent of 80% of taxable income (determined without regard to the NOL). It also generally eliminates the ability to carry back NOLs, but permits them to be carried forward indefinitely in place of the 20 year limit under prior law.

Capital Gains/Qualified Dividends. TCJA leaves the preferential capital gains and qualified dividends rates (maximum rate of 20%) in place.

Carried Interest. TCJA treats carried interest allocations that would otherwise be long-term capital gain as short-term capital gain (which does not receive the benefit of a reduced tax rate for individuals) to the extent those allocations relate to assets that have been held for three years or less. This new rule would apply to partnership interests received in exchange for services performed as part of an investment management trade or business.

State and Local Taxes. For individuals, TCJA disallows any itemized deductions for state and local income, sales or property tax above a cap of $10,000.

Medicare Surtax. TCJA leaves unchanged the 3.8% net investment income tax and the 0.9% additional Medicare tax that apply to higher-income individuals.

Partnership Technical Terminations. TCJA repeals the technical termination rule under prior law, which treated a partnership as terminating if 50% or more of its interests were transferred within a 12-month period. Upon a technical termination, a partnership was treated as newly formed and was required to make certain new elections and restart depreciation on its assets.

UBTI. TCJA requires tax-exempt organizations to calculate their taxable income separately for each unrelated trade or business, thus eliminating the ability to shelter income from one activity with losses from another.

Mandatory Deemed Repatriation. TCJA imposes a one-time repatriation tax on existing foreign earnings. Earnings held in the form of cash or cash equivalents are taxed at a 15.5% rate, and other earnings are taxed at 8%. Taxpayers may pay the tax in eight annual installments, and foreign tax credits would be partially usable against the tax. For REITs with foreign subsidiaries, the income inclusion is disregarded for purposes of the REIT income tests.

Modified Territorial System. TCJA creates a quasi-territorial international tax regime for certain foreign active business income. Domestic corporations (with the notable exception of REITs) will receive a 100% deduction on dividends received from qualifying 10%-owned foreign corporations. No tax credit or deduction is permitted for foreign taxes paid or accrued with respect to such dividends, including dividend withholding taxes.

Base Erosion Tax. TCJA includes a provision that limits the benefits of deductible payments made by domestic corporations to foreign related parties by imposing a 10% minimum tax (5% in 2018 and 12.5% after 2025) on the domestic corporation's modified taxable income (computed without regard to deductible payments made to foreign related parties). A 25% (or greater) foreign shareholder of a domestic corporation is considered related for these purposes, as is any other foreign entity under common control with the domestic corporation. However, the base erosion tax applies only to a domestic corporation that is part of a group with $500 million or more in annual gross receipts over a three year period and that has made related party deductible payments totaling at least 3% of the corporation's total annual deductions. The base erosion tax does not apply to REITs.

Limitation on Deductions for Hybrid Payments. TCJA disallows deductions for related-party interest and royalty payments if they are paid by or to a hybrid entity or pursuant to a hybrid transaction (*i.e.*, a transaction that gives rise to interest or royalties for U.S. tax purposes, but not for purposes of the relevant foreign tax system).

Withholding. Consistent with the reduction in corporate and individual rates, the withholding rates applicable to FIRPTA distributions from REITs and ECI allocations from partnerships have also been reduced. The backup withholding rate has also been reduced from 28% to 24%.

Discussion

While TCJA includes many provisions that are designed to raise revenue by denying or limiting deductions in various ways (including some that are important to real estate investors), the overall impact of the bill will likely be favorable for most taxpayers due to the large cut in the corporate tax rate and the new 20% deduction for QBI and ordinary REIT dividends. The new lower corporate rate will be very beneficial to non-U.S. and tax-exempt real estate investors that invest through corporate "blocker" entities. Tax-exempt investors that incur UBTI from unblocked investments will also benefit from the reduced rate since those investors are generally subject to tax on UBTI at the regular corporate rates. Additionally, investors that hold real estate in C corporations and generally retain their earnings may be inclined to leave the corporate structure in place as opposed to converting into an LLC or S corporation structure.

In earlier incarnations of TCJA, the 20% deduction for QBI was capped based solely on W-2 wages paid by the relevant business. This formulation would likely not have benefitted real estate businesses, which frequently pay a relatively small amount of W-2 wages compared to the income they generate. Fortunately, Congress ultimately added an alternative limitation that takes into account the business's investment in depreciable tangible property (including depreciable real estate). The 20% deduction also applies to ordinary REIT dividends, which will now be subject to a maximum effective income rate of 29.6%. By contrast, when the 20% income tax rate on qualified dividends to individual shareholders is taken into account, the total effective income tax rate on corporate income distributed to individual shareholders will be 36.8%. Thus, REITs and other pass-through structures will continue to enjoy a material tax rate advantage compared to C corporations.

TCJA imposes a limitation on the deductibility of net business interest expense. Importantly, real property trades or businesses are eligible to elect out of the limitation. For these purposes, a real property trade or business is defined broadly, by reference to the "passive activity" rules of Section 469, to include any "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." The congressional report describing TCJA makes clear that the exception is not limited to rental businesses and that it applies to the management of real estate. This real property exception is a significant benefit for real estate investment, but some technical questions need to be considered. For example, corporate blockers that hold nothing but a direct or indirect interest in a REIT are unlikely to be treated as engaged in a real property trade or business. To ensure that the election out of the interest deductibility limits is available, such investors will want to invest "below" the REIT level. Even in that case, it is somewhat unclear whether the real estate exception will allow partners to be attributed the real estate business of their partnerships. This is an issue where additional guidance from the Internal Revenue Service and Treasury will be needed. Another point of clarification that is expected is whether a partner of a partnership that does not utilize ADS can still benefit from the exemption if the partner itself depreciates its property using the ADS.

The retention of like-kind exchanges for real property is a clear win for real estate investors. The like-kind exchange technique is frequently used by taxable domestic and foreign investors to exit investments while deferring the tax gain, and this use will continue. For REITs, Section 1031 exchanges are important in a number of scenarios, including managing the recognition of FIRPTA gain, complying with the safe harbors for "prohibited transactions," and dealing with tax protection agreements in UPREIT structures that restrict the ability to do taxable sales. Also, since REITs are required to distribute their taxable income in order to avoid corporate tax, like-kind exchanges permit REITs to reallocate and grow their portfolios without being required to distribute capital.

As applied to private equity funds and real estate joint ventures, it appears that Congress largely retained the favorable tax treatment for carried interest. TCJA will treat net capital gain from a carried interest as short-term capital gain that is taxed at ordinary income rates (instead of preferential long-term capital gain rates) to the extent such gain relates to an investment held for three years or less. Holding periods for real estate and private equity/venture capital typically exceed three years. It appears that the three-year holding period applies to the sale of an applicable partnership interest in addition to the sale of underlying assets. Long-term capital gain treatment continues to apply with respect to investments held in excess of three years. The new provision, however, will not apply to income earned by a sponsor partner with respect to its capital interest in a partnership.

Finally, the new base erosion and anti-abuse tax could have a negative impact on blocker corporations formed for the purpose of allowing non-U.S. investors to invest in U.S. real estate without creating a taxable presence in the United States. Such corporations are commonly capitalized with a combination of equity and debt to benefit from deductible interest at the blocker level and the portfolio interest exemption from withholding on interest payments. The tax may apply with respect to interest payments to foreign investors in such corporations if foreign investors are deemed to be related parties (i.e., 25% shareholders or commonly controlled affiliates). The $500 million threshold, however, represents a significant threshold that may exclude many investments from application of the tax, although certain aggregation rules do apply.

Conclusion

TCJA represents the conclusion of a unique, and at times bewildering, legislative process. Real estate investors have many reasons to be pleased with the final outcome, but there are also areas where TCJA is less generous to taxpayers than prior law. Most taxpayers will benefit in one way or another from the headline rate reductions, but there is more variation when it comes to the different deduction limitations that helped raise revenue for the bill. As always, careful analysis will be needed to ensure that taxpayers can benefit from the good parts of TCJA without being unduly burdened by the bad.

For a further discussion of tax reform updates related to real estate, please join us for a webinar at 12:00 p.m. EST on Tuesday, January 16, 2018. Instructions for the webinar can be found in the email and on our website.