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ASSESSING THE IMPACT OF REAL ESTATE TAX REFORM

SUMMARY

On December 22, 2017, President Trump signed into law H.R. 1, known as the “Tax Cuts and Jobs Act” (the “TCJA”). The TCJA is the most far-reaching tax legislation to be passed in over 30 years. The provisions of the TCJA generally apply to taxable years beginning after December 31, 2017. Although the tax changes specifically directed at real estate are modest as compared to other areas, many of the TCJA provisions will have a material impact on real estate investors, REITs and real estate funds and the optimal tax structures for their investments. Below we consider those provisions that we think are most relevant to owners of and investors in U.S. real estate.

Limitations on interest deductibility and the real estate business exception

The TCJA imposes a new limitation on the deductibility of business interest, including interest on existing debt. Absent an exception, the deduction for business interest now generally cannot exceed the sum of the taxpayer’s business interest income plus 30% of its “adjusted taxable income.” For taxable years before 2022, “adjusted taxable income” generally means business taxable income before interest income or expense, net operating losses (“NOLs”), the pass-through deduction discussed below, and depreciation and amortization (i.e., comparable to EBITDA). For taxable years thereafter, adjustable taxable income is reduced by depreciation and amortization (i.e., comparable to EBIT). Any business interest that is not deductible due to this limitation may be carried forward indefinitely. The limitation is applied at the partnership level in the case of partnership debt. The partnership’s non-deductible interest expense is allocated out to the partners and may be carried forward by the partners and used in future years, but only to the extent of any excess taxable income allocated to the partner from the applicable partnership in those years.

Exceptions:

- *Electing real property trade or business.* The limitation does not apply to a “real property trade or business” that affirmatively elects out of the limitation. Eligible real property trades or businesses generally include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Making the election requires the real property trade or business to depreciate its non-residential real property, residential rental property, and qualified improvement property over a longer period using the alternative depreciation system (“ADS”) rather than the general depreciation system.[1]

[1] ADS generally extends the relevant periods from 39 to 40 years for nonresidential real property, from 27.5 years to 30 years for residential rental property and from 15 to 20 years for qualified improvement property.

In addition, the new 100% bonus depreciation deduction generally will not be available to taxpayers that elect out of ADS in certain circumstances. The election, once made, is irrevocable.

- *Small business exception*. The business interest limitation does not apply to small-business taxpayers with average annual gross receipts that do not exceed $25 million. In calculating gross receipts, the gross receipts of all related entities are aggregated under complex attribution rules. As a general matter, entities with more than 50% common ownership will be aggregated.
- *Lending businesses (including mortgage REITs)*. While lending businesses are not specifically carved out, the business interest limit does not apply unless business interest expense exceeds business interest income, thus effectively exempting many (if not most) mortgage REITs and other taxpayers engaged in a real estate lending business, such as certain debt funds.

Practical Observations

- *Real property trade or business election.* Careful consideration will need to be given to whether or not a real property trade or business will wish to elect out of these new interest limitation rules, taking into account the correlative longer depreciation periods and the fact that the election is irrevocable. However, our expectation is that many real estate businesses will make the election if and when the new limitation on deductibility would otherwise apply. The lost interest deduction is potentially permanent, while the extended depreciation life is often primarily a timing difference. In addition, slower depreciation could benefit some corporate taxpayers by preventing or limiting the accrual of an NOL in early years, which after the TCJA is useable only against 80% of taxable income. Businesses otherwise required or that elect to use ADS (such as partnerships with significant tax exempt partners and many REITs seeking to limit return of capital distributions) should have relatively little downside to making the election.
- *Considerations and uncertainties regarding the real property business election***.** There are many uncertainties and computational questions relating to how, whether and when to elect out of the new business interest limitations. Uncertainties include: (i) whether all investments held by a fund, a REIT or an operating partnership constitute a single trade or business, (ii) the extent to which or whether differences in properties may result in separate trades or businesses, (iii) the effects of conducting activities or holding investments through various subsidiary and joint venture structures and (iv) the proper allocation of interest expense among activities, such as where a partnership or REIT uses a credit facility to fund numerous investments (e.g., pro rata based on fair market value or pursuant to rules that “trace” the use of debt proceeds to specific investments). In addition, mere ownership of interests in a REIT subsidiary typically would not be viewed as a real property trade or business. As a result, investors that hold real property indirectly through REIT subsidiaries, such as leveraged corporations found in many fund structures, will want to weigh the potential benefits of investing through the REIT structure against the potential application of the interest deductibility limitations in assessing whether to restructure an investment to avoid those limitations. We expect the election for 2018 will be part of the taxpayer’s 2018 tax return, and hopefully Treasury and the IRS will provide additional guidance in time to help taxpayers assess how, whether and when to make the election.

- *Mitigation Strategy – Preferred Equity*. Mezzanine financing on real estate is not infrequently structured as preferred equity. If properly structured to qualify as equity, rather than debt, for tax purposes, the return on preferred equity financing issued by an entity taxed as a partnership is effectively deductible without limitation under the new rules and without the need for the real property trade or business election. The dividend paid on preferred stock issued by a REIT also can function like interest that is deductible without limitation under the new rules. However, numerous commercial, regulatory and tax considerations may limit the use of preferred equity financings as debt substitutes.
- *Aggregation rules may make it challenging to rely on the small business exception.* In many cases, it will be difficult to determine whether ownership relationships exist that would require aggregation for purposes of the small business exception. Especially challenging may be situations when an unrelated investor owns more than 50% of a fund entity or a JV, so that gross receipts of certain affiliates of the investor, unrelated to the fund or JV, have to be included in measuring whether gross receipts exceed $25 million.

Pass-through deduction

In addition to reducing the maximum individual rate to 37%, the TCJA creates a new deduction (the "Pass-Through Deduction") for non-corporate taxpayers of up to 20% of "qualified business income" from pass-through entities (partnerships, S corporations, and sole proprietorships) plus up to 20% of most ordinary REIT dividends and qualified publicly traded partnership income. When the full deduction is available, it reduces the top effective tax rate on such income (before any additional 3.8% Medicare tax) to 29.6%. The Pass-Through Deduction will expire after 2025.

"Qualified business income" generally means income that is "effectively connected" with any U.S. trade or business, other than the business of being an employee, exclusive of certain investment income such as capital gains, dividends, and investment interest. For high income taxpayers, trades or businesses eligible for the reduced rate do not include any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees, specifically including consulting, investing, and investment management. High income taxpayers also are limited in the amount of qualified business income they can deduct with respect to any particular trade or business to the greater of (i) 50% of the W-2 wages with respect to that trade or business or (ii) the sum of 25% of such W-2 wages plus 2.5% of the aggregate initial basis (i.e. unreduced for depreciation) of tangible depreciable property used in that trade or business that has not been fully depreciated or that has been placed in service by the taxpayer less than 10 years ago (referred to as "qualified property"). Land basis does not count towards the 2.5% qualified property base, as land is not depreciable. This limitation does not apply to the deduction for REIT dividends or qualified income allocated from publicly traded partnerships.

Practical Observations

- *W-2 wages and qualified property limitations.* Outside of some public UPREIT partnerships and publicly traded partnerships, we expect that many real estate partnerships do not have material W-2 employees, so that their partners' ability to claim the Pass-Through Deduction will depend largely on the amount of initial basis in qualified property. Contributing REIT-eligible properties to a subsidiary REIT, especially if the property is not qualified property, is an obvious strategy if Pass-Through Deductions are limited by the amount of W-2 wages and qualified property basis. UPREITs and other "internally managed" partnerships should review their payroll arrangements to assess the W-2 wage base available for the Pass-Through Deduction. Structures that separate

employees from the real estate assets, such as housing employees in taxable REIT subsidiaries to address certain REIT compliance issues or the use of affiliated management companies or common paymasters, may reduce the available W-2 wages and might have to be revisited.

- *Uncertainties regarding qualified property*. The new rules leave many unanswered questions as to how the 2.5% amount is calculated in the case of property acquired in a tax deferred transaction, such as a like-kind exchange, a contribution to a partnership or S corporation or a merger of operating partnerships.
- *Real estate debt.* Qualified property does not include real estate loans. Real estate debt funds and similar other partnerships with individual taxable investors might consider use of a REIT structure in order to benefit from the Pass-Through Deduction in respect of such loan investments.
- *Conflicting tax objectives.* The 20% Pass-Through Deduction creates new conflicts amongst different groups of investors. For example, capitalizing partnerships or private REITs with member loans to mitigate UBTI for tax exempt investors and/or reduce US withholding taxes for non-US investors may now be disadvantageous for non-corporate taxable US investors by converting some income that would be eligible for the Pass-Through Deduction into income that does not qualify.
- *REIT dividends through mutual funds.* Unfortunately, the 20% rate does not appear to apply to REIT dividends earned through mutual funds.

Carried Interest

Unlike prior proposals to tax all carried interest at ordinary income rates, the TCJA largely retains the current taxation of carried interest for non-corporate service partners, but extends the long term capital gain holding period from one year to three years. Capital gains allocated to carried interests from capital assets held for three years or less will be treated as short-term capital gain, which is taxed at ordinary income rates and is not eligible for the 20% Pass Through Deduction. In addition, capital gain on the sale or disposition of the carried interest itself also will be treated as short term capital gain to the extent the service partner has not held the interest for more than three years. The new extended holding period applies to all carried interest, including carried interest granted prior to enactment of the TCJA.

The new rules apply to carried interest issued by a partnership engaged in an “applicable trade or business,” which generally requires both (i) raising or returning capital and (ii) investing in, disposing of, and/or developing investment assets such as stocks, debt, interests in widely held or publicly traded partnerships and other securities, real estate held for rental or investment, and interests in partnerships to the extent the partnership holds any of the foregoing investment assets. The TCJA also added special provisions that can require immediate recognition of short-term capital gain upon certain direct or indirect transfers of carried interest to family members and certain co-workers, including otherwise tax deferred transfers such as gifts.

Exceptions and drafting anomalies

- *Interests commensurate with capital or taxed as compensation.* The three year holding period does not apply if a service provider receives a share of profits commensurate with the service partner’s capital contributions or if such a partnership interest is granted as taxable compensation.

- *Interests held by corporations.* Carried interests held by corporations are not subject to the new rules.
- *Real estate gains not covered.* As drafted, the new rules do not require a holding period of more than three years for carried interest gains from sales of real property used in a trade or business (known as "section 1231 property"). That is, a carried interest holder's share of section 1231 gain remains eligible for long term capital gain treatment so long as the property was held for more than one year. Whether the failure to cover such gains will be corrected in the future remains to be seen.
- *No express rule for REIT capital gain dividends*. The TCJA is silent as to how the carried interest rules apply to capital gain dividends from a REIT subsidiary of a partnership. There is no express "look through rule" that would effectively treat a REIT capital gain dividend attributable to gain from the sale of an asset held by the subsidiary REIT for more than three years as eligible for long-term capital gain treatment or as retaining the character of gain from section 1231 property. We see no indication that Congress intended a different carried interest treatment for assets held through REIT subsidiaries, and we hope that the rules will be clarified in this manner.

Practical Observations

- *Restructuring carried interest for funds with REIT subsidiaries.* In light of the TCJA's failure (at least for now) to extend the three year holding period requirement to section 1231 property, along with the absence of an express look through rule with respect to REIT capital gain dividends, service partners holding carried interest in partnerships with REIT subsidiaries might consider alternative structures, such as issuing the carried interest from a lower tier subsidiary partnership "below" the REIT subsidiary. Whether the countervailing tax and commercial considerations will outweigh the benefits of a below the REIT carry structure will depend on the specific facts.
- *Holding period issues*. Capital gains from taxable sales of carried interest will not qualify for long term capital gain rates to the extent that the carried interest sold had a holding period for tax purposes of three years or less. Under the general holding period rules applicable to partnership interests, a grant of an additional carried interest could start a new holding period for a portion of *both* the newly granted carried interest *and the holder's existing carried interest*. As a result, if an additional carried interest has been granted within the last three years, these rules could characterize a portion of the gain from a taxable disposition of a carried interest held for more than three years as short-term gain. We expect to see this issue arise frequently in connection with "LTIP" issuances by public REITs. On the other hand, the fact that the partnership holds assets with a holding period of three years or less will not limit long term gain treatment from the sale of a carried interest with more than a three year holding period.
- *S corporation holding company.* The new rules exclude a carried interest held by a corporation. The term "corporation" is not defined and questions have been raised as to whether an individual could avoid the carried interest rules by holding carried interest through an S corporation. In light of the general tax rules applicable to S corporations and the manner in which they compute their taxable income, however, we expect that the exclusion for carried interest held by corporations is unlikely to extend to carried interest held through S corporations without future guidance.

- *Co-invest terms.* Although the TCJA allows a service partner to avoid carried interest treatment on a share of profits commensurate with the service partner's capital contributions or if such a partnership interest is granted as taxable compensation, the act does not specifically define "commensurate" or provide any safe harbors. Thus, while the carried interest rules should not apply when a service partner invests on exactly the same terms as third party investors, it is not clear whether some modest favorable terms (such as a fee break) would subject the entire investment to the carried interest rules. The safer path is to invest on the same terms as third party investors. Absent careful structuring, an ability to fund capital contributions through fee waivers will trigger the carried interest rules.

- *Estate planning and family transfers*. While the statutory language is unclear, the provisions on transfers to family members could require recognition of gain based on the fair market value, not merely liquidation value, of carried interest gifted or otherwise transferred, directly or indirectly, to family members. A review of those rules should be part of any estate planning involving carried interests, including existing arrangements.

- *Special allocations of three year gains to carry holders.* For those looking to minimize the impact of the new rules, consideration should be given to limiting carry allocations to gains that would not be recharacterized as short-term under the TCJA. As a general proposition, absent future regulations to the contrary, it should be possible to structure such an arrangement in a manner that should be respected, so long as the carried interest holder takes the economic risk that the carried interest will be limited to the amount of such allocated gains.

Other TCJA Provisions

- *Lower corporate rate.* The TCJA lowers the US federal corporate income tax rate to a flat 21% for both ordinary income and capital gains and repeals the corporate alternative minimum tax. While the reduced rate is a welcome reduction in the US tax costs of structures that incorporate taxable US corporations, including taxable REIT subsidiaries, we do not expect the reduced rate to cause any fundamental shift in how investments into US real property are structured. In the fund context, non-US investors who invested through taxable corporate "blockers" before the TCJA are still likely to desire levered corporate blocker structures to shelter FIRPTA, ECI and tax return filings, and US taxable and tax-exempt investors are still likely to invest into US real property through partnerships and REITs because investing through corporate blockers generally will create more tax cost for those investors, just as they did before the TCJA. REITs will continue to require taxable REIT subsidiaries for dealer investments, impermissible tenants services, and certain other investments such as hotels and qualified health care facilities because those activities cannot be performed by the REIT directly, and they will benefit from the reduced corporate tax rate.

- *UBTI calculated separately for each business*. For a tax exempt organization with more than one unrelated trade or business, this provision requires that unrelated business taxable income be computed separately with respect to each trade or business. A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose. Only positive UBTI, if any, for each separate business is aggregated to determine an organization's overall UBTI. The

use of a net operating loss arising in a taxable year beginning before January 1, 2018 will be grandfathered (i.e., usable against income generated by another business).

- *Like-kind exchanges*. Section 1031 like-kind exchange treatment now applies *only* to real property, the only category of section 1031 transactions to escape unscathed. Thus, like-kind exchanges remain an important tax planning tool for real estate transactions. Under the TCJA, the like kind exchange rules no longer apply to related personal property to the real estate. Therefore, the exchange of any appreciated personal property will result in gain. For REITs, such gain would be non-qualifying income for both the 95% and 75% gross income tests.

- *No change to UBTI rules applicable to government plans.* The final version of the TCJA does not subject government pension plans to tax on UBTI.

- *100% bonus depreciation.* The TCJA increases the bonus depreciation percentage from 50% to 100% for property acquired and placed in service after September 27, 2017 and before 2023 and expands the kind of property covered by bonus depreciation. These percentages phase down to 80%, 60%, 40% and 20%, respectively, for property placed in service in 2023, 2024, 2025 and 2026. Under prior law, the deduction was permitted only if the taxpayer was the first user of the property; the TCJA removed that requirement, allowing a taxpayer to claim the deduction for both new and used property that it acquires, subject to certain anti-abuse rules. However, as previously noted, bonus depreciation is generally not available in certain cases to a taxpayer that decides to avoid the limitations on interest deductibility through the real property trade or business exception.

- *Limitations on excess business losses.* "Excess business losses" of non-corporate taxpayers are disallowed for 2018 through 2025. An "excess business loss" is the amount, if any, by which (i) the taxpayer's aggregate deductions attributable to trades or businesses exceed (ii) the taxpayer's aggregate gross income or gain attributable to trades or businesses plus $250,000 (or $500,000 in the case of a joint return), which dollar amounts are indexed for inflation in subsequent taxable years. Any disallowed excess business loss will be treated as a net operating loss carryover. In the case of partnerships and S corporations, the limitation is applied at the partner level.

- *Corporate NOL limitations*. NOLs that arise in taxable years beginning after December 31, 2017 may no longer be carried back, but can be carried forward indefinitely. Such NOL carryforwards also may only be used to offset 80% of a corporation's taxable income.

- *Other Interest Expense Limitations.* The TCJA imposes additional limitations on the deductibility of interest that likely will not be of general application to real estate investing but could come into play in some structures that include non-US entities or non-US investors and should be part of any structuring or compliance checklist.

    - *Base erosion:* A new base erosion rule requires any US taxable corporation (REITs are excluded) with average annual receipts of at least $500 million to pay no less than 10% tax on its income before taking into account any deductions for payments made to related foreign persons (generally requiring a 25% affiliation). In calculating gross receipts for this purpose, the gross receipts of all related entities are aggregated using the same

challenging aggregation rules as apply to the small business exception to the interest deductibility limitation discussed above.

- *Anti-hybrid rules:* The TCJA denies a deduction for any interest paid to a related party (generally requiring a 50% affiliation) if the interest is not taxed under the law of the related party's country and either (i) the payment is not treated as interest under the tax law of the foreign country where the related party recipient resides, or (ii) either the payor or the related party recipient is treated as a pass-through entity in the US while it is not so treated in the foreign country, or vice versa.

- *Ownership of non-US assets.* While the foregoing discussion focuses on investments in US real estate, many of the TCJA changes discussed above also can apply to non-US real estate investments. The TCJA also made fundamental changes to the US cross-border tax regime, which could materially alter the tax treatment of investments in non-US real estate for US investors.

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