SEYFARTH SHAW

Tax Reform

Management Alert Series Issue 3

Tax Reform for REITs and Real Estate Businesses

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This is the third issue in a planned series of alerts designed to provide an in-depth analysis on topics related to tax reform.

Background

On November 2, 2017, House Republicans introduced the Tax Cuts and Jobs Act (the "House Bill"). On November 9, 2017, the Senate introduced its own version of the Tax Cuts and Jobs Act (the "Senate Bill"). On November 16, 2017, the House passed the House Bill and, on December 2, 2017, the Senate passed the Senate Bill. The House and the Senate both appointed conferees to reconcile differences between the two bills and arrive at a final bill. On December 15, 2017, Congressional Leaders announced that the conferees reached an agreement and unveiled the text of a final bill (the "Tax Bill"). We expect that the Tax Bill will be signed into law this week without further changes.

Most Important Provisions for REITs and Real Estate Businesses

The Tax Bill has many provisions that will impact real estate investment trusts ("REITs") and real estate businesses. We have summarized the most important provisions below.

Pass-through business deduction: The Tax Bill creates a new 20% tax deduction for pass-through businesses. For taxpayers with incomes above certain thresholds, the 20% deduction is limited to the greater of: (1) 50% of the W-2 wages paid by the business, or (2) 25% of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis, immediately after acquisition, of depreciable property (which includes structures, but not land). However, REIT dividends are not subject to this wage restriction.

Business interest deduction: For most taxpayers, the Tax Bill disallows the deductibility of business interest to the extent that net interest expense exceeds 30% of EBITDA (2018 through 2022) or EBIT (beginning in 2022). However, a real property trade or business can elect out of the new business interest disallowance regime. The real estate exception extends to (1) the activities of corporations and REITs, and (2) the operation or management of a hotel. This provisions applies to existing debt and applies at the entity level.

Cost recovery: For certain taxpayers, the Tax Bill permits businesses an immediate write-off of the full cost of new equipment. However, taxpayers that elect to use the business interest real estate exception will see little change to current law cost recovery rules. Such taxpayers must depreciate real property under slightly longer recovery periods: 40 years for nonresidential property, 30 years for residential rental property, and 20 years for qualified interior improvements. However, such taxpayers will be permitted to fully expense land improvements and tangible, personal property used in their real property trade or business from 2018 to 2023.

Section 179 expensing: The Tax Bill increases the maximum amount that a taxpayer may expense under Code Section 179 to $1,000,000, and increases the phase-out threshold amount to $2,500,000. The provision also expands the definition of Code Section 179 property to include: (1) certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging, and (2) any of the following improvements to nonresidential real property placed in service after the date the real property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Like-kind exchanges: The Tax Bill permits taxpayers to continue to defer gain on real estate like-kind exchanges. Improved real estate and unimproved real estate will continue to be considered property of a like kind. However, the Tax Bill does repeal the deferral of gain for other types of like-kind exchanges.

Active loss limitation: The Tax Bill prohibits taxpayers from deducting losses incurred in an active trade or business from their wage income or portfolio income (i.e. interest and dividends). The provision applies to existing investments.

Carried interest: The Tax Bill requires holders of a carried interest in certain types of partnerships, including hedge funds, private equity funds, and real estate, to hold the interest for 3 years in order to receive long-term capital gain treatment. The 3-year holding period applies the partnership interest and to the assets held by the partnership.

Sales of partnership interests by foreign partners: The Tax Bill added a provision that treats gain or loss from the sale of a partnership interest by a foreign partner as effectively connected income ("ECI") that is taxable in the U.S. if the gain or loss from the sale of the underlying assets held by the partnership would be treated as ECI. The provision also requires the purchaser of a partnership interest from a partner to withhold 10% of the amount realized on the sale or exchange of the partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or a foreign corporation. This provision statutorily reverses the Tax Court's recent decision in *Grecian Magnesite Mining, Industrial & Shipping Co., SA vs. Commissioner,* 149 T.C. No. 3 (Jul. 13, 2017) and returns to a rule similar to Revenue Ruling 91-32 (1991-1 C.B. 107).

Other Relevant Provisions for REITs and Real Estate Businesses

We have also summarized some of the other relevant provisions below.

State and local tax deduction: The Tax Bill continues to permit pass-through entities the ability to deduct state and local taxes paid or accrued in carrying on a trade or business or in an activity related to the production of income.

Historic preservation and rehabilitation tax credits: The Tax Bill preserves the 20% tax credit for the rehabilitation of historically certified structures, but now requires that taxpayers claim the credit ratably over a 5-year period. The Tax Bill repeals the 10% credit for the rehabilitation of pre-1936 structures.

Low-income housing tax credit: The Tax Bill retains the low-income housing tax credit without changes.

Partnership technical terminations: The Tax Bill 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.

Observations

Overall, the Tax Bill is benign to even favorable for REITs and real estate businesses. This contrasts starkly with the impact of the landmark Tax Reform Act of 1986, which implemented, among other things, the passive activity loss deduction limitations. The Tax Bill appears to increase incentives for investors to invest in real estate: REIT shareholders and real estate partnerships will enjoy the benefit of the new 20% deduction for pass-through businesses, REITs and real estate businesses can continue to deduct business interest, and like-kind exchanges are preserved. As a trade-off, REITs and real estate businesses will not be able to enjoy the full benefit of the new full and immediate expensing provision. Nonetheless, the Tax Bill should act as a catalyst for investment in REITs and real estate businesses.

Seyfarth will continue to monitor Congressional and regulatory efforts and will provide further alerts as new developments occur. If you would like further information, contact Steve Meier at smeier@seyfarth.com, John Napoli at jnapoli@seyfarth.com, and Michael Lobie at mlobie@seyfarth.com.