REAL ESTATE TAX NEWS AND UPDATES

The Real Estate Industry & Tax Reform

How Tax Reform will Impact the Industry

The New Year seems poised to bring about major changes to the Real Estate industry. New sweeping tax reforms proposed by President Donald Trump and Congressional Republicans are likely to have a significant impact on the industry. Understanding how these reforms could potentially affect the real estate industry requires an examination of relevant proposals laid out in The President's tax plan and House Republicans' *A Better Way – Our Visions for a Confident America* (the "Blueprint") tax plan.

1. Carried Interests

One such proposal, calls for eliminating the so called carried interest loophole, which benefits, for example, real estate fund sponsors who receive a share of the fund profits as compensation for services rendered to the fund. These profits generally are taxed at preferential capital gain rates—a maximum rate of 20 percent. The President's plan calls for eliminating this beneficial tax treatment, and taxing carried interests at ordinary income tax rates—effectively raising the carried interest tax rate. Likewise the Blueprint would tax carried interests "equal to reasonable compensation" as ordinary income. While eliminating the beneficial treatment of carried interests may worry some investors, this change may not have as much of an adverse impact as some fear; both the President's tax plan and the Republican Blueprint call for slashing overall income tax rates.

2. Tax Rates

a. Individual & Corporate Tax Rates

The President's tax plan and the Republican Blueprint each outline significant changes to current corporate and personal income tax rates. Specifically, both plans would collapse the existing seven personal income tax brackets into the following three brackets: (1) 12 percent for taxable income under $75,000; (2) 25 percent for taxable income from $75,000, but less than $225,000; and (3) 33 percent for taxable income in excess of $225,000. In regards to corporate income tax rates, the President's plan would reduce the top corporate tax rate to 15 percent, down from the current maximum rate of 35 percent. Similarly, the Blueprint would impose a flat 20 percent tax rate on C corporations. Further, both plans would eliminate the alternative minimum tax and eliminate or curtail certain itemized deductions as well as raise the standard deduction for individuals. As indicated in the section above, these proposals would amount to considerable tax cuts for investors.

b. Pass-Through Entity Tax Rates

Perhaps more significant than the proposed changes to individual and corporate tax rates, are proposals to replace the current pass-through income tax structure—pass-through income is currently taxed at the ownership level, not the entity level. The President's tax plan would impose a flat 15 percent income tax on undistributed taxable income generated by pass-through entities including sole proprietorships, partnerships, limited liability companies, and S corporations. The Blueprint outlines a similar plan that would create a new business tax rate for small businesses organized as pass-through entities. The Republican plan would impose a maximum tax rate of 25 percent on these small businesses. These proposals could essentially shift the tax burden from real estate investors to real estate funds and provide additional benefits, in the form of lower tax rates, to real estate investors.

3. Capital Investments

Another significant proposal, included in both the President's tax plan and the Republican Blueprint, involves a major change to the current depreciation structure. Specifically, both plans would allow businesses to immediately expense investments in tangible and intangible assets, rather than deducting these investments over time. If implemented, this could be a welcomed change for developers and investors, effectively reducing the tax rate on investments to zero and encouraging greater capital spending.

Although there is little difference between the two proposals regarding capital investments—the main distinction being that the President's plan would require an election, while the Blueprint would not—these changes are not set in stone and could ultimately give way to alternatives. Some experts are concerned about the possible repercussions of implementing such a drastic change. These experts have suggested that a more palatable alternative could involve accelerating the depreciation of real estate assets, allowing real estate investors to write off their investments over a shorter period. This would ultimately cause less disruption to investors whose businesses may rely on the benefits afforded by the current depreciation scheme, while still incentivizing greater capital spending.

4. Credits & Deductions

a. Interest Expense Deductions

In order to balance the benefits of immediately expensing business investments, both plans would disallow deductions for interest expenses associated with debt incurred to finance such investments. The rationale behind disallowing these deductions is that, as some experts have noted, allowing both would essentially result in tax subsidies for debt-financed investments. The Blueprint would go a step further than the President's plan, by also limiting interest expense deductions to interest income; thus "decreasing tax-based incentives for businesses to increase their debt load beyond the amount dictated by normal business conditions." The Blueprint would, however, allow businesses to carry forward unused interest expense that can be used to offset net interest income in subsequent years. In limiting the use of these deductions, the Republican plan seeks to reduce incentives for debt financing of business activities. These changes could have a considerable effect on the commercial real estate industry which relies heavily on debt to finance investments.

b. Mortgage Interest Deductions

Other proposed modifications to standard and itemized deduction rules could potentially affect the residential real estate market by discouraging the use of the mortgage interest deduction—an important benefit of home ownership. While both plans preserve the mortgage interest deduction, each plan calls for substantially cutting itemized deductions and increasing the standard deduction. Specifically, The President's plan would eliminate most itemized deductions and place caps on remaining itemized deductions (e.g. itemized deductions would be capped at: $100,000 for single filers; $200,000 for married filing jointly), while more than doubling the standard deduction (e.g. the standard deduction would: increase from $6,300 to $15,000 for single taxpayers; and increase from $12,600 to $30,000 for married taxpayers filing jointly). Similarly, the Blueprint calls for eliminating most itemized deductions, while combining several existing family tax deductions and credits in order to increase the standard deduction. These proposals are likely to dis-incentivize the use of the itemized deductions, including the mortgage interest deduction; thus, diminishing a key benefit of home ownership.

5. Other Tax Reform Provisions

Other provisions which would affect real estate investors include the possible elimination or curtailment of the like-kind exchange provisions under IRC Section 1031 and the elimination of the estate tax.

6. Conclusion

President Trump and Congressional Republicans are eager to pass tax reform and, for the most part, appear to be on the same page regarding many of the proposals discussed above. However, many of these proposals will likely give way to compromise, as President Trump and Congressional Republicans begin to confront the economic and legislative realities of implementing such radical reform. While there is little certainty that a final bill from Congress would include any of these proposals in their current form, the real estate industry can expect a pro-business tax reform bill that will result in significant tax cuts across the board.

REIT Prohibited Transactions Tax – PLR 201707010

On February 17, 2017, the Internal Revenue Service ("IRS") released Private Letter Ruling ("PLR") 201707010 addressing whether real property sold as part of a liquidation of a REIT would be treated as a sale for purposes of the prohibited transactions tax imposed upon REITs.

A REIT is subject to a 100% tax on the net income from prohibited transactions. Code Section 857(b)(6)(A). A "prohibited transaction" is the sale or disposition of "dealer property" (generally property held primarily for sale to customers in the ordinary course of the REIT's trade or business).

To determine whether a taxpayer holds property "primarily for sale to customers in the ordinary course of its trade or business," the Tax Court has held that several factors must be considered (none of which are determinative by itself). Among those factors are: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the REIT's efforts to sell the property; (3) the number, extent, continuity, and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; and (5) the time and effort the REIT devoted to the sales. (See*, Cottle*, 89 T.C. 467 (1987).

In PLR 201707010, the REIT owned (directly and indirectly through partnerships) multifamily properties. The REIT was organized with the following investment objectives: realizing growth in the value of its real estate assets; preserving, protecting and returning its stockholders' invested capital; investing in a diversified portfolio of real estate assets; and exploring liquidity options in the future, including the sale of either Taxpayer or its assets, potential merger opportunities, or the listing of its common shares on a national exchange.

The amount of capital raised by the REIT through its initial stock offering and a secondary stock offering was significantly less than the capital the REIT anticipated raising when it was formed. As a result, the REIT's board of directors believed that this lack of capital would make Taxpayer too small to effectively list on a public exchange in accordance with its investment objectives.

In addition, repayment or refinancing of most of the outstanding loans on the properties would be required at maturity because Taxpayer does not have sufficient capital to meet the current loan obligations. In addition, because certain properties were owned through joint ventures, there was a risk the joint venture partners may be unwilling to cooperate in the event of a refinancing.

Certain of the partnership agreements contain a provision that limits a partner's ability to buy the other partner's entire interest or sell its entire interest in a property until a specified time period after the completion of the development of a property (the "Buy-Sell Option"). To the extent a partner chooses to exercise its option to sell its entire interest, the other partner is permitted to (1) agree to the terms of the proposed sale, or (2) elect to purchase its entire interest in the property at a price determined under the terms of the agreement. The REIT's intention when entering into a partnership agreement with a Buy-Sell Option was to elect to purchase the entire interest in the property, should the partner exercise its option to sell under the terms of the agreement.

Taxpayer's outside advisor anticipated that all of the joint venture partners would exercise the Buy-Sell Option at the end of the specified time period. To the extent a joint venture partner does exercise the Buy-Sell Option, the REIT would not have sufficient capital to buy out the partner, and it is likely the REIT would be forced to sell the property under the terms of the Buy-Sell Option at a price that may not maximize value to its shareholders.

Moreover, as a result of raising significantly less capital than anticipated in its initial and secondary offerings, the REIT has a small asset base in relation to the costs associated with maintaining a public company. Because Taxpayer would be forced to sell assets due to debt maturities and joint venture partners exercising the Buy-Sell Options, the remaining assets would carry a higher level of fixed costs with a shrinking asset base.

Based on these considerations, the REIT's board of directors determined that a plan of dissolution and sale of the properties through multiple transactions would be in the best interest of the REIT's shareholders.
In applying for the ruling the REIT made the following representations:

- Taxpayer acquired the Properties with the intent to hold the properties for a long-term period and to derive its profits from rental income and capital appreciation, consistent with its operation as a REIT.

- Taxpayer does not intend to reinvest the sales proceeds from the Properties in other real estate interests.

- Taxpayer will take the actions and perform the activities required for winding up its affairs, preserving the value of its assets, and distributing its assets to its shareholders in accordance with the Plan after all of the Properties have been sold.

- After the sale of its final Property, Taxpayer will distribute any remaining assets to its shareholders in a single distribution in accordance with the Plan and file the final income tax returns and all other tax returns, certificates, documents, and information required to be filed by reason of the complete liquidation and dissolution of Taxpayer.

Based on the facts and representations described above, the IRS privately ruled that the sale of the properties pursuant to the liquidation plan would not constitute a prohibited transaction under Code Section 857(b)(6).

The IRS reasoned that the REIT acquired the properties with the intent to hold them for a long-term period and to derive its profits from rental income and capital appreciation. The REIT was only selling the Properties because it was undergoing a complete liquidation of all of its assets and a corporate dissolution. In addition, before the liquidation, the REIT did not make numerous, extensive, continuous, or substantial sales of properties.

While not binding on the IRS, PLR 201707010 demonstrates that a REIT may avoid the prohibited transactions tax on the sale of real property if it can show that there were compelling reasons to liquidate its portfolio.

REIT Spin-Offs – Temporary Regulations

On June 7, 2016, the IRS and the Treasury Department issued temporary and proposed regulations that are intended to tighten the rules prohibiting spin-offs involving REITs. Prior to the Protecting Americans from Tax Hikes Act of 2015 (the “PATH Act”), companies were able to separate real estate assets from other operating assets by spinning off either class of assets into a new company and then electing REIT status for the company that holds the real estate assets. The PATH Act, with limited exceptions, eliminates these types of spin-offs by taxing a spin-off involving a REIT and preventing a spun-off company from electing REIT status within ten years of a spin-off. Subsequent to the PATH Act the IRS became concerned that if two non-REIT companies engaged in a spin-off the one holding the real estate could be acquired by an unrelated REIT, which would bypass the PATH Act provisions. As a result, the temporary and proposed regulations were issued to close this planning opportunity. The regulations provide that if a REIT receives assets from a C corporation and engages in a spin-off within the next ten years the REIT must recognize any built-in gain on the assets it received from the C corporation. In addition, if a C corporation engages in a spin-off, its assets cannot be acquired by an unrelated REIT for ten years or it will be required to recognize gain as if it sold the assets to the REIT in a taxable transaction.

On June 27, 2016, the IRS made a correction to the temporary regulations to make clear that these rules would not apply to spin-offs that either: (1) occurred prior to December 7, 2015; or (2) are described in a ruling request submitted to the IRS on or before December 7, 2015.

Final Regulations Alter Recognition Period for Property Transfers from C Corps to RICs & REITs

1. Summary

On January 17, 2017 the Internal Revenue Service (the “Service”) issued final regulations under IRC § 337(d), altering the built-in-gain recognition period for conversion transactions involving C corporations converting to regulated investment companies (“RICs”) or real estate investment trusts (“REITs”). Specifically, the final regulations shorten the “recognition period” from ten years to five years. Under the final regulations, RICs and REITs may be subject to a corporate level tax on built-in-gain recognized from disposing of converted property within the five year recognition period.

2. Analysis

Generally, if a RIC or REIT acquires property from a C corporation by way of a conversion transaction—through the qualification of a C corporation as a RIC or REIT, or the transfer of property from the C corporation to the RIC or REIT—the RIC or REIT is subject to a tax on any net built-in-gain in the converted property recognized during the “recognition period,” as described in IRC § 1374. Note that IRC § 1374, provides for a five-year built-in gain recognition period on S corporations that were formerly C corporations. Temporary regulations under IRC § 337(d) modified the definition of “recognition period,” providing for a ten-year period beginning on: (1) the first day of the first taxable year in which the C corp qualifies as a RIC or a REIT; or (2) the day the RIC or REIT acquired the property from the C corp.

The final regulations will now adopt the five-year period outlined in IRC § 1374. Under the final regulations, the term recognition period means a five-year period beginning on either: (1) the first day of the first taxable year in which the C corporation qualifies as a RIC or a REIT; or (2) the day the RIC or REIT acquired the property from the C corporation.

3. Effective Date

The final regulations will apply prospectively from February 17, 2017, but taxpayers may choose to apply the definition of recognition period in the final regulations, instead of the ten-year recognition period in the temporary regulations, for conversion transactions occurring on or after August 8, 2016, and on or before February 17, 2017.

Debt versus Equity – Final Section 385 Regulations

On October 13, 2016, the U.S. Treasury Department issued temporary and final regulations under Code Section 385 that dramatically alters the way intercompany debt is treated for tax purposes. These regulations were issued just six months after the release of proposed regulations covering related party debt financing. Like the proposed regulations that preceded them, the final regulations are primarily intended to curtail perceived tax abuses in so-called “inversion” transactions. While the final regulations retain many of the rules set forth in the proposed regulations, they considerably limit the scope of the proposed regulations.

1. Scope of Final Regulations

The final regulations adopt the re-characterization and documentation rules of the proposed regulations. These regulations cover certain debt financing transactions between members of an “expanded group.” The term “expanded group” consists of corporations connected (directly or indirectly) by 80% ownership (by vote or value). This is similar to an affiliated group that files a consolidated federal income tax return, but is based on vote *or* value (as opposed to vote *and* value in the consolidated context) and also would include entities ineligible to be part of a consolidated group (such as insurance companies). Unlike the proposed regulations however, the final regulations apply almost exclusively to debt instruments issued by domestic corporations.

The Final regulations generally exempt REITs and their subsidiaries, except where more than 80 percent of the vote or value of the REIT is owned by a corporate entity. The rules generally do not apply to:

- loans by a public REIT to its taxable REIT subsidiary (TRS);
- loans by a private REIT that does not have an 80 percent corporate shareholder—(common in private equity fund structures)—to its TRS; or
- loans by either the previously-mentioned REITs to their “Baby- REIT” subsidiaries, or by such Baby-REITs to their own TRSs.

The rules would, however, apply to a loan by a non-U.S. or domestic corporation to a subsidiary REIT that is 80 percent owned by that corporation. The rules would similarly apply to a loan by such a subsidiary REIT to its own TRS, although it is unclear why, as a matter of policy, TRS debt in that case should be treated differently than TRS debt in all other cases. Therefore, most REITs can continue to engage in intercompany lending transactions without regard to the new rules, the rules remain relevant to REITs that have corporate owners.

2. The Re-Characterization Rule

In addition to the documentation rule above, the final regulations adopt the re-characterization rule set forth in the proposed regulations. As outlined in the proposed regulations, the re-characterization rule operates in two parts: (1) the general rule; and (2) the funding rule.

The general rule re-characterizes debt as equity if it is distributed or acquired in exchange for stock of an expanded group member; or is issued as consideration in an exchange under an internal asset reorganization of an expanded group member. The funding rule works in conjunction with the general rule and provides a bright line test for determining the character of intercompany debt within an expanded group. Specifically, the funding rule states that if within 36 months before or after a loan is made a subsidiary makes a dividend distribution to the parent (or an affiliate within the expanded group) in excess of the subsidiary’s current earnings and profits, then the loan will be re-characterized as preferred equity.

There are several exceptions to the regulations worth noting. First, as mentioned earlier, an intercompany debt will be respected if the related borrower does not make dividend distributions in excess of its current earnings and profits. Intercompany debt also will be respected if the total amount of the expanded group’s debt does not exceed $50 million. Another exception is for intercompany debt between corporations that file consolidated returns.

3. The Documentation Rule

In addition to the re-characterization rules outlined above, the final regulations adopted the documentation requirements set forth in the proposed regulation. Specifically, if intercompany debt within an expanded group does not satisfy certain documentation requirements, such debt will be treated as equity.

Under the documentation rule, written documentation for the debt must establish: (1) the borrower has entered into an unconditional and legally binding obligation to pay a sum certain on demand or on one or more fixed dates; (2) the lender has creditor rights to enforce the obligation; (3) there is a reasonable expectation that the borrower intended to and would be able to meets its obligations under the loan; and (4) the parties must keep evidence of principal and interest payments.

However, these documentation requirements only apply if the stock of any member of the expanded group is publicly traded, the expanded group has total assets exceeding $100 million or the expanded group's annual total revenue exceeds $50 million.

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