

KING & SPALDING

Tax Reform Considerations for REITs



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Various components of the tax reform proposals that have been put forth by the Congress as well as the President could have significant impacts on REITs. In 2016, the Republican leadership and Republicans on the House Committee on Ways and Means unveiled a plan titled “A Better Way Forward on Tax Reform,” known as the “Blueprint.” Below is a brief summary of some of the highlights of the Blueprint, as well as some of the ways in which recent Trump administration proposals differ, and some of the considerations applicable to REIT investment in particular.

The tax reform process is made unpredictable by the significant differences between the political and policy process in the House and in the Senate tax writing committees. A united Republican majority stands behind the Blueprint. Democratic members of the Ways and Means Committee have thus far withheld their support, and they have not been invited to participate in the discussions. There have not been hearings or an opportunity to vote on the Blueprint as yet. In the Senate, Finance Committee Chairman Orrin Hatch (R-UT) has indicated that the Senate will develop its own version that could differ from the House version. Chairman Hatch seeks to build a consensus within the Senate Finance Committee to draft a package that can win bipartisan support. To that end, he is working with ranking member Senator Ron Wyden (D-OR) and meeting with each of the Republican and Democratic senators of the Finance Committee to seek their views in an attempt to produce bipartisan legislation that can win Republican and Democratic support on the floor of the Senate. Once the Senate has completed its consideration, as in 1986, the House and Senate will hammer out a compromise in consultation with the White House.

The Blueprint proposes to reduce the corporate tax rate to 20% and would eliminate the AMT, while the Trump plan would reduce the corporate tax rate to 15% and also eliminate the AMT. The Blueprint would lower the maximum individual rate to 33% (with lower rates applying at certain income levels), repeal the 3.8% tax on net investment income, repeal the individual AMT, and allow individuals to deduct 50% of their capital gains, dividends and interest income. Accordingly, dividends would be taxed at a maximum marginal effective tax rate of 16.5%. The Trump plan would adopt the same individual tax rates as under the Blueprint but would retain the existing 20% capital gains rate.

Under the Blueprint, interest would no longer be deductible—even by corporations—but depreciable property could be immediately expensed. REITs presumably would be treated the same way. The Trump plan would allow taxpayers to elect the House proposal (no deduction of interest, immediate expensing of business investments) or the current system, which allows interest deductions but recovers the costs of business assets over time through depreciation. It is important to note that neither plan addresses REITs specifically.

A reduction in the corporate tax rate to 15% or 20% could reduce the attractiveness of using a REIT, especially if C corporation dividends are taxed at 16.5% (as called for under the Blueprint). With a 20% corporate rate for non-REITs and a 16.5% effective rate on non-REIT dividends, the all-in tax cost of corporate income would be 33.2%. If ordinary REIT dividends (not designated as capital gains) are not eligible for the lower tax rates on corporate dividends (i.e., ordinary REIT dividends are taxed at a 33% rate), which would seem to be consistent with the apparent integration

policy behind the new rate structures, the benefit of REITs would be largely neutralized. The REIT may still remain a tax-favored alternative to the corporate form for holding real estate, however, if ordinary REIT dividends are also eligible for a reduced rate. There is also a general appeal to single level taxation, even if the all-in rates are comparable.

REITs may still offer a tax-efficient way for certain tax-exempt investors to invest in real estate as compared to an investment through a C corporation. REITs would still operate to insulate foreign investors from “effectively connected income” from U.S. real estate investments and having to file U.S. income tax returns (by effectively converting real estate operating income to dividends), and potentially provide FIRPTA tax advantages if the property exit is structured in the form of a REIT share sale.

Although none of the plans mention like-kind exchanges specifically, it is possible that Section 1031 could be repealed as part of tax reform. This is because the allowance for full expensing of capital investment would render Section 1031 unnecessary, although the expensing proposal carves out land, which may cause like-kind exchanges to survive, albeit with a limited role.

It is not perfectly clear how the ability to write-off capital investment in the year of acquisition would impact REITs in particular. Whereas regular C corporations would use the deduction to offset taxable income in future years, the rules relating to REITs’ usage of NOLs and the required distributions could lead to odd results, especially when considered together with the proposed limitation on NOL usage to 90% of taxable income. A REIT that “relied” on NOL carryforwards (i.e., didn’t distribute 100% of its income) would always have some tax at the REIT level. Furthermore, even a REIT that had NOLs in excess of its taxable income would need to distribute cash equal to at least 48% of its taxable income in order to avoid failing the 90% distribution requirement. Under FIRPTA, there is a lack of clarity as to whether a REIT (and its foreign shareholders) that wrote off an acquisition and subsequently sold the asset would be able to offset the FIRPTA gain by the write-off or by NOL carryforwards.

The disallowance of net interest expense deduction would impact nearly all REITs (other than possibly mortgage REITs). REITs would have to raise additional equity to fund required distributions since interest payments would not reduce taxable income of the REIT. Overall impact of interest disallowance and current expensing depends on hold period and level of income generated by the asset.

Many are predicting a rise in interest rates under Trump, and the conventional wisdom is that REIT stocks (which are owned primarily for their dividend yields) would look less attractive in that environment. However, the macroeconomic impact of rising interest rates is difficult to predict. We are committed to closely monitoring the tax reform landscape and any future developments and to advising our clients and friends in the REIT community in a way that will enable them to efficiently adapt to potentially sweeping changes to the U.S. tax system.

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