March 2014

Camp Tax Reform Proposal Would End or Discourage Many Innovative REIT Transactions and Eliminate Certain Other Favorable Tax Rules

U.S. Representative Dave Camp (R-MI), the Chairman of the House Ways & Means Committee, recently released a discussion draft of the Tax Reform Act of 2014 (the "Discussion Draft"), a comprehensive tax reform proposal. The Discussion Draft includes provisions that would end or discourage many innovative REIT transactions, including tax-free REIT spin-offs, REIT conversions, "dividend access" and "opco/propco" REIT structures, and investments in "non-traditional" REIT asset classes. The Discussion Draft would also eliminate section 1031 "like-kind" exchanges and restrict partnership taxation for publicly traded partnerships ("PTPs") to those PTPs whose activities relate to mining or natural resources. Finally, the Discussion Draft includes several helpful reforms of the REIT tax rules.

Continue reading for some of the more significant changes proposed in the Discussion Draft.

Discussion Draft Would End or Discourage Many Innovative REIT Transactions

Several of the modifications contained in the Discussion Draft constitute significant, and unfavorable, changes to current law:

- End of Tax-Free Spinoffs Involving REITs: Several REITs have completed, or announced their intention to complete, tax-free spinoffs of their subsidiaries under Section 355 of the Internal Revenue Code ("Tax-Free Spinoffs"). The Discussion Draft would make REITs entirely ineligible to participate in Tax-Free Spinoffs. The Discussion Draft would also prevent any corporation involved in a Tax-Free Spinoff from making a REIT election until the 10th taxable year beginning after the taxable year in which the spinoff occurred. This provision, if enacted, would apply to spinoffs occurring on or after February 26, 2014, unless the spinoff was pursuant to an agreement that was binding on that date.

- REIT Conversions Subject to Corporate Tax: Under the Discussion Draft, a C corporation that converted to REIT status would be required to pay corporate income tax on the built-in gain in its assets at the time of the REIT conversion. This provision would also apply if a C corporation transferred assets to a REIT in a carryover basis transaction. Under current law, the tax on the built-in gain on assets a REIT acquires from a C corporation upon a REIT conversion or in a carryover basis transaction is generally paid only if the REIT disposes of the built-in gain property in a taxable transaction during the 10 years following the REIT conversion or carryover basis transaction.

- Limitation on "Dividend Access" and "Opco/Propco" REIT Structures: The Discussion Draft would provide that if rent based on a percentage of gross sales or receipts ("fixed percentage rent") received by a REIT from a single C corporation exceeded 25% of all fixed percentage rent received or accrued by the REIT for the taxable year, then none of the fixed percentage rent from that C corporation would qualify as good income for the REIT gross income tests. A similar provision would apply to interest income based on a fixed percentage of gross sales or receipts that is received on debt instruments issued by a single C corporation. These provisions would severely limit the use of “dividend access” (sometimes called “paired share”) structures, in which a REIT leases its properties to a related C corporation under leases that provide for a significant amount of fixed percentage rent. These provisions would also apply to standard “opco/propco” structures, in which a REIT leases all or a significant portion of its assets to an operating company under a lease providing for fixed percentage rent. These provisions would be effective for leases entered into, and debt instruments acquired, after December 31, 2014.

- Limitation on Good REIT Assets: The Discussion Draft would categorically treat all tangible property that has a class life for tax depreciation purposes of less than 27.5 years as a bad REIT asset. Such tangible property includes assets used in construction, land improvements (e.g., sidewalks and roads) and all personal property. This provision would dramatically change the classification of many assets owned by “traditional” REITs that are treated as good REIT assets under current law, and would also severely limit the ability of REITs to invest in “nontraditional” asset classes, such as data centers and cell towers. The provision would be effective for taxable years beginning after December 31, 2016.

- Reduction in Allowable TRS Holdings: Under current law, up to 25% of the total value of a REIT’s assets may consist of securities of one or more taxable REIT subsidiaries. The Discussion Draft would reduce that limitation from 25% to 20%. This provision would apply to taxable years beginning after December 31, 2016.

Discussion Draft Would Eliminate Certain Other Favorable Tax Rules

In addition, the Discussion Draft contains certain other modifications that are disadvantageous to PTPs, REITs and the real estate industry generally:

- End of Like-Kind Exchanges: The Discussion Draft proposes to end all tax-deferred like-kind exchanges by repealing section 1031 of the Internal Revenue Code. Except for a limited grandfather rule, this provision would be effective for exchanges occurring after December 31, 2014.

- Curtailment of PTP Exception: Under current law, an exception allows a PTP (which is generally taxed as a C corporation) to be taxed as a partnership provided 90% or more of its income is “qualifying income.” Qualifying income currently includes income, dividends, gain and rents from real property; income and gain from certain activities relating to minerals or natural resources; and income and gain from certain commodities and derivatives. The Discussion Draft proposes to limit the qualifying income exception so that it applies only to income and gain from certain activities relating to minerals or natural resources. This provision would be effective for taxable years beginning after December 31, 2016.

Discussion Draft Includes Helpful Reforms of the REIT Tax Rules

The Discussion Draft also includes a number of reforms to the REIT tax rules that the National Association of Real Estate Investment Trusts has advocated for many years, including a reform that would make it easier for REITs to invest in distressed mortgage loans.

View a copy of the Discussion Draft and a copy of the explanation of the Discussion Draft.

Hunton & Williams LLP Tax Practice

Hunton & Williams LLP attorneys are available to provide more information about the Proposed Regulations. If you would like to receive more information, please contact **George C. Howell, III** at 804.788.8793 or ghowell@hunton.com, **Mark C. Van Deusen** at 804.788.8349 or mvandeusen@hunton.com, or **Christopher Mangin, Jr.** at 804.787.8188 or cmangin@hunton.com.