HUNTON& WILLIAMS

Client Alert

December 2017

Tax Reform Approaches the Finish Line: *Impacts on Investments in Real Estate or Mortgage Loans*

Both the House and the Senate have passed a final tax reform bill, and the President is expected to sign it into law in the next few days. This alert highlights a few of the provisions included in the legislation with a focus on provisions that may be relevant to investors in real estate or mortgage loans through investment funds or real estate investment trusts (“REITs”).

Pass-Through Deduction Generally

Under the bill, in general, individual investors would be allowed to deduct 20% of their “qualified business income” from pass-through entities, such as partnerships, and 20% of qualified REIT dividends and qualified publicly traded partnership income (the “pass-through deduction”). For investors with taxable income over $315,000 (for joint filers), the pass-through deduction for qualified business income (but not REIT dividends or qualified publicly traded partnership income) would be limited to the greater of 50% of the W-2 wages paid by the qualified trade or business or the sum of 25% of the W-2 wages paid by the qualified trade or business plus 2.5% of the unadjusted basis of depreciable tangible property used in the production of qualified business income. The ability to take the business’s depreciable tangible property into account in calculating this limit, which was added in the conference version of the bill, benefits businesses that do not have high amounts of wages, but do have depreciable property, such as real estate partnerships. The limitation would be applied at the partner level.

Ordinary REIT dividends and qualified publicly traded partnership (“PTP”) income would be eligible for the pass-through deduction regardless of the amount of W-2 wages or depreciable property owned by the REIT or PTP.

The pass-through deduction would not be available for income from certain businesses, including, among others, law, accounting, consulting, investing and investment management, and trading or dealing in securities, partnership interests or commodities. Thus, income from partnerships that earn investment management fees generally would not be eligible for the pass-through deduction. Income from partnerships that invest in real property, however, generally would be eligible for the deduction, subject to limitations.

Ordinary REIT dividends would be eligible for the pass-through deduction regardless of the REIT’s source of income. Qualified PTP income, however, would not include income from certain businesses, including investing and investment management, and trading or dealing in securities, partnership interests or commodities.

The pass-through deduction also would not apply to dividends (other than ordinary REIT dividends), capital gains, interest income other than interest income allocable to a trade or business, or income that is not effectively connected with a trade or business in the United States. Thus, income from a partnership that is not engaged in a trade or business in the United States would not be eligible for the pass-through deduction, while income from a partnership that is engaged in a trade or business in the United States and that has employees or owns tangible depreciable property may be eligible for the pass-through deduction, subject to limitations. This dichotomy could create a conflict between the tax goals of domestic individual investors and foreign investors.

Corporate Income Tax Rate of 21%

The bill would lower the corporate income tax rate to 21%. Individual income tax rates would also be lowered slightly, and brackets would widen. The lower corporate income tax rate generally should reduce the tax drag from taxable REIT subsidiaries and corporate blockers used by investment funds, subject to the limitation on the net interest expense deduction described below.

Limitation on Deductibility of Interest Expense

Under the bill, the deduction for net business interest expense would be limited to 30% of an amount similar to the taxpayer’s EBITDA for tax years beginning after 2017 and before 2022, and further limited to 30% of the taxpayer’s EBIT for tax years beginning on or after January 1, 2022. Because the limitation applies to net interest expense (i.e., the amount by which interest expense exceeds interest income), businesses that generate interest income may be less affected. Also, the limitation would not apply to real estate businesses that irrevocably elect to be excluded from the limitation. Real estate businesses that make this election would be required to use longer recovery periods to depreciate their nonresidential real property, residential rental property and qualified improvements.

Temporary 100% Expensing for Business Assets

The bill would allow 100% expensing for certain business assets acquired during the next 5 years, with a decreasing percentage allowed for acquisitions over the following 5 years. The 100% expensing would not be available for nonresidential real property, residential rental property or qualified improvement property.

Depreciable Life for Real Property Assets

The default recovery period remains 39 years for nonresidential real property and 27.5 years for residential rental property. The default recovery period for qualified improvement property is 15 years. Real estate businesses that elect not to be subject to the limitation on deduction of business interest, however, must use longer recovery periods of 40 years for nonresidential real property, 30 years for residential rental property and 20 years for qualified improvement property. These amendments would apply to taxable years beginning after December 31, 2017. It is not clear how this would apply to existing property.

Withholding on Sales of Partnership Interests

Under the bill, a foreign investor in a partnership engaged in a trade or business in the United States would recognize effectively connected income (“ECI”) on the sale of its partnership interest to the extent that the foreign investor would have been allocated ECI had the partnership disposed of all of its assets at fair market value and allocated the gain to its partners. The bill would require withholding of 10% of the sales price on the transfer of any interest in a partnership that is engaged in a trade or business in the United States unless the transferor certifies that it is not a foreign person.

3 Year Holding Period for Capital Gain from Carried Interests

If an individual receives a partnership profits interest for performing services for certain partnerships, including a rental real estate or securities partnership, the individual will only receive long term capital gain treatment on the income from the partnership to the extent that the partnership has held the asset being sold for 3 years (rather than the typical 1-year period). The 3 year holding period does not apply to gain derived from a capital interest in the partnership where the allocation of gain is commensurate with capital invested.

Inclusion of Original Issue Discount and Market Discount

Under the bill, accrual method taxpayers generally would be required to include certain amounts in income no later than the time such amounts are reflected on certain financial statements. This may require taxpayers to include original issue discount and market discount with respect to loans or mortgage-backed securities in income earlier than would have been the case under existing tax rules. This acceleration would not apply to mortgage servicing contracts, including any “excess” servicing, which would continue to be taken into income under the stripped coupon rules.

Like Kind Exchanges

Like kind exchanges for real property are unchanged. The bill would eliminate like kind exchange treatment for all assets other than real property.

Suspension of Miscellaneous Itemized Deductions

The bill would eliminate for 5 years all miscellaneous itemized deductions of individuals, trusts, and estates that are currently subject to the 2% floor, including investment expenses such as investment management, administrative, and tax preparation fees.

We will continue to monitor the progress of the tax reform bill, including any administrative guidance that may be forthcoming after the bill becomes law. If you would like more information about the tax reform bill, please contact one of the attorneys listed below.

Authors

Cecelia Philipps Horner
chorner@hunton.com

George C. Howell, III
ghowell@hunton.com

Kendal A. Sibley
ksibley@hunton.com