HUNTON& WILLIAMS

Client Alert

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REITs and the Effect of the Tax Cuts and Jobs Act

Real estate investment trusts (“REITs”) generally benefit from, or at least are not harmed by, the recently signed H.R. 1, informally known as the Tax Cuts and Jobs Act (the “TCJA”). This alert focuses on several provisions in the TCJA that may affect publicly traded REITs.

REITs Compared to C Corporations

The TCJA reduced the tax rate applicable to C corporations to 21%. With the new pass-through deduction, however, REITs continue to maintain a positive rate differential compared to taxable C corporations that distribute their taxable income. For an individual investor that is eligible for the full pass-through deduction, the effective tax rate on REIT dividends would be 29.6%. For an individual investor in a taxable C corporation, the effective tax rate on C corporation dividends (taking into account the tax on the C corporation and the investor-level tax on qualified dividend income) would be 36.8%. Thus, REITs continue to compare favorably to C corporations that are paying taxes and distributing their income. If a C corporation retains its profits and does not pay dividends, the investor-level tax would be delayed.

Section 162(m) and Other Executive Compensation Issues

The TCJA expands Section 162(m) to limit the deductibility of performance-based pay paid by publicly traded corporations to certain top executives, beginning in 2018. The Section 162(m) amendments provide a limited grandfather clause for compensation paid pursuant to a written binding contract that was in effect on November 2, 2017, and that was not modified in any material respect on or after that date. It is not yet clear what modifications will be material, so taxpayers should use caution in amending any agreements. On the other hand, it is not clear whether the amount of the compensation (rather than just the eligibility for compensation) must have been set prior to November 2, 2017, for the grandfather clause to apply.

Performance-based pay generally is not subject to Section 162(m) for 2017. The amount of the performance bonus pool must be finalized prior to the end of 2017 (to be paid in early 2018) to ensure deductibility in 2017. Although the aggregate bonus pool amount that will be paid must be finalized in 2017 to ensure 2017 deductibility, the compensation committee’s written certification that the performance goals have been achieved, which is required by Section 162(m), should not be required in 2017 as long as it is done before the performance bonuses are paid. See our forthcoming client alert “$1 Million Deduction Limit on Executive Pay” for more information regarding changes to Section 162(m).

The Internal Revenue Service has ruled privately that compensation paid by a REIT’s operating partnership attributable to services provided to the operating partnership is not subject to Section 162(m). The TCJA does not appear to affect the reasoning of those prior rulings. REITs without operating partnerships may want to consider establishing operating partnerships in 2018 if new Section 162(m) rules are problematic.

In addition, because stock appreciation rights, options and other performance-based pay, like restricted stock and restricted stock units (“RSUs”), are no longer excluded from the Section 162(m) limitation, REITs may want to consider using operating partnership profits interests, such as long-term incentive profits interests (“LTIPs”), as part of their executive compensation plans. While LTIPs do not result in a compensation deduction, that is no longer a disadvantage if Section 162(m) would disallow a deduction for other types of equity awards. In addition, LTIPs generally are not taxed on grant or vesting and give the executives the possibility of recognizing capital gain rather than ordinary income. LTIPs will be subject to the new three-year holding period rules to achieve long-term capital gain treatment that are applicable to "carried interests." Transfers of LTIPs to family members or another employee prior to the three-year holding period can also trigger recognition of short-term capital gain.

REIT Dividends Eligible for Pass-Through Deduction

The TCJA allows individual investors to deduct up to 20% of ordinary REIT dividends. Ordinary REIT dividends are eligible for the pass-through deduction regardless of the REIT's source of income or the level of the REIT's wages or depreciable property. REIT capital gain dividends continue to be subject to lower capital gains tax rates. Mutual fund dividends are not eligible for the pass-through deduction, even if the mutual fund invests exclusively in REITs.

Taxable REIT Subsidiaries Tax Rate Reduced

As noted above, the TCJA lowers the corporate income tax rate to 21%, which generally will reduce the tax burden on taxable REIT subsidiaries ("TRSs"). TRSs will be subject to the new limitations on the deduction of net business interest expense, which are described below.

Deductibility of Interest Expense

The TCJA limits the deduction for net business interest expense to 30% of an amount similar to the taxpayer's EBITDA for tax years beginning after 2017 and before 2022, and further 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), mortgage REITs, which generate net interest income, generally should not be affected by this provision. Equity REITs generally may irrevocably elect to be excluded from the limitation. Real estate businesses that make this election are required to use longer alternative depreciation system ("ADS") recovery periods to depreciate their nonresidential real property, residential rental property and qualified improvements. For REITs that already use ADS to calculate their taxable income, making this election should not affect depreciation expense.

International Provisions

The TCJA significantly changes the U.S. taxation of international businesses. International businesses will be subject to a one-time deemed repatriation of previously untaxed offshore income. This could impact REITs with offshore TRSs that have income that has not been taken into account under the Subpart F or qualified electing fund rules. Any deemed repatriation income would be excluded from the REIT gross income test, but would increase the REIT's distribution requirement. REITs, like C corporations, may elect to defer the inclusion of the related taxable income over an eight-year period, which would defer the related distribution requirement as well.

For REITs that make capital gain distributions subject to FIRPTA withholding tax, the applicable withholding tax is reduced from 35% to 21%.

Like Kind Exchanges

Like kind exchanges for real property are preserved, but like kind exchanges are no longer available for personal property. REITs planning like kind exchanges of assets that contain both real property and personal property (for example, hotels) should be aware that the personal property component will no longer be eligible for like kind exchange treatment.

Temporary 100% Expensing for Equipment; Shorter Depreciable Life for Qualified Improvements

The TCJA allows 100% expensing for certain equipment acquired during the next five years, with a decreasing percentage allowed for acquisitions over the following five years. The modified accelerated cost recovery system ("MACRS") depreciable life remains 39 years for nonresidential real property and 27.5 years for residential rental property. The MACRS recovery period for qualified improvement property is 15 years, which generally is a reduction from prior law that depreciated such items over the life of the underlying property. As noted above, real estate businesses that elect not to be subject to the limitation on deduction of business interest must use longer ADS recovery periods of 40 years for nonresidential real property, 30 years for residential rental property and 20 years for qualified improvement property.

Acceleration of Income for Accrual Method Taxpayers

Accrual method taxpayers are now required to include certain amounts in income no later than the time such amounts are reflected on their financial statements. This may require mortgage REITs to include original issue discount, and potentially market discount, with respect to loans or mortgage-backed securities in income earlier than would have been the case under the prior tax law. 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.

Impact on Housing Market Generally

The housing market as a whole may be impacted by the TCJA provisions applicable to individuals, thereby indirectly impacting REITs that invest in housing or residential mortgage loans. For example, the TCJA reduces the mortgage interest deduction to interest on the first $750,000 of new mortgage indebtedness and eliminates the mortgage interest deduction for home equity loans. In addition, the TCJA raises the standard deduction, which makes the mortgage interest deduction apply to fewer homeowners. This could affect homeowners' housing purchase decisions. In addition, the limitation on deductions of state and local taxes to $10,000 could affect the marketability of homes in higher-tax states. It remains to be seen how the housing market will react to the various changes in the TCJA.

If you would like more information about how the TCJA affects REITs, please contact one of the attorneys listed below.

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