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The Impact of Tax Reform on Real Estate Investment Trusts

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A real estate investment trust (REIT) has been an attractive investment vehicle for both large and small investors in real estate, largely due to the REIT's somewhat unusual tax status as a quasi-pass-through entity. A REIT is treated as a corporation for most federal tax purposes, but by complying with numerous income, asset, ownership, and operational rules, it incurs little to no corporate level tax. While neither the target nor the beneficiary of recent tax reform under the 2017 tax act,¹ REITs and their investors stand to be affected by quite a few provisions. Moreover, as with other aspects of the 2017 tax act, unanswered questions remain regarding the manner in which these provisions should be interpreted and how they will be enforced going forward.

THE NEW §199A DEDUCTION

First, new §199A generally permits a 20% deduction against taxable income for “qualified business income” (QBI). While regular REIT dividends are not eligible for the favorable reduced tax rate (20%) that generally applies to corporate dividends (referred to as qualifying dividends), the new deduction may help REIT investors by including in the definition of QBI

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¹ Pub. L. No. 115-97.

20% of “qualified REIT dividends.”² Generally, a qualified REIT dividend is any dividend from a REIT that is not a capital gain dividend or a qualifying dividend. While this alone may not compel investors to invest through REITs (unless all income consists of REIT dividend income, which we do not expect to be common) it does factor into this significant, though complex, QBI deduction by increasing how much can be deducted from taxable income.

THE §163(j) LIMITATION

The 2017 tax act also eliminated the so-called “earnings stripping” rules formerly contained in the tax code that were designed to prevent corporations from shifting their income abroad through deductible interest payments to foreign parent or affiliate lenders. The 2017 tax act replaces such rules with new limits that apply generally to all taxpayers — not just corporations — regardless of whether there is a related party lender or guarantor and without any debt-to-equity ratio requirements.

Instead, in each taxable year, a taxpayer's deduction for business interest is limited to an amount (interest limitation) equal to the sum of (A) the taxpayer's business interest income for the year, plus (B) 30% of the taxpayer's adjusted taxable income.³ Business interest income is defined as the amount of interest includible in the gross income of the taxpayer that is properly allocable to a trade or business. Significantly for REITs, the term “trade or business” does not include an “electing real property trade or business,” which means that a taxpayer in a real property trade or business that so elects generally is not subject to the interest limitation.

Although this appears to be more good news for REITs and their investors, particularly where REITs were leveraged in a manner to avoid the old earnings stripping rules (which had a 1.5:1 debt-to-equity limit), questions remain. First, REITs generally cannot

² §199A(b)(1)(B), added by 2017 tax act, §11011(a). All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

³ §163(j)(1), amended by 2017 tax act, §13301(a).

actively engage in a trade or business; indeed, most of the REIT qualifications and requirements are designed for the REIT to function as a passive investor. Significantly, a lessor REIT is prohibited from performing activities under the terms of a lease other than those considered “usual and customary” in the market and otherwise must have the activities performed by an independent contractor. Moreover, a REIT may not own more than 35% of any such independent contractor and also is limited from owning interests in tenants.

Query whether the new rule requires an active trade or business, a requirement that a REIT likely could not satisfy. This certainly is one interpretation, though REITs are not consistently excluded from provisions that require an active business; in some cases, they specifically are addressed. For example, REITs can participate in tax-free corporate spin-offs, which require an “active trade or business,” but rules introduced in 2015 severely limited the ability of REITs to participate in a spin-off.⁴

DOMESTICALLY CONTROLLED REITS

Issues also could come up where a REIT shareholder is a holding company for a majority interest in a REIT. This is raised in the context of a private “domestically controlled” REIT (DCREIT), the interests of which are not considered interests in a “United States real property holding corporation,” which otherwise would subject foreign shareholders to tax and withholding under the Foreign Investment in Real Property Tax Act (FIRPTA).⁵ While FIRPTA is outside the scope of this article, in the case of such a DCREIT, a domestic corporation is formed to hold a majority interest. Many of these domestic corporations were leveraged up to the 1.5:1 debt-to-equity limit formerly allowed under the old earnings stripping rules in order to mitigate entity-level tax. The “new” §163(j) rules would permit these corporations to leverage with foreign shareholder debt subject to the interest limitation (and other applicable limitations).

However, if a REIT has a “real property trade or business” and elects out, query whether such a corpo-

rate shareholder also would be exempt, as it is akin to a holding company to which the trade or business arguably could be attributed. Even if a true holding company is eligible for the exception because its operating subsidiary is eligible, this arguably would be directed at a parent corporation of an affiliated group (which requires 80% ownership by vote and value) that has no other assets besides stock of subsidiaries, rather than a shareholder that happens to have just the interest in a DCREIT (which is just over 50%).

HYBRID RULES

The shift in focus away from related parties under “new” §163(j) is balanced by new so-called “hybrid” rules that specifically limit deductions — including for interest paid to certain related parties. The new hybrid transaction rules deny taxpayers, including REITs, a deduction for interest or royalty payments to a foreign related party in transactions where such payments would not be taxed in either the United States or the other jurisdiction.⁶ These new rules eliminate the benefit of any remaining structures, including those used by REIT investors that survived being eliminated by treaties and foreign tax law (particularly transactions that are treated as loans in the United States but not in the foreign recipient’s jurisdiction). Moreover, in cases where the REIT’s potential status as a hybrid entity is relevant, one can see the tension between treating it as a corporation for these purposes, consistent with their treatment for most other purposes of the tax code, and treating it as transparent, given that a REIT is not subject to entity-level taxation if it complies with distribution and other requirements. This may be an open question unless or until clarified by regulations.

EXEMPT FROM BEAT TAX

Finally, corporations receiving flow-through treatment, such as REITs and S-corporations, are exempt from the new Base Erosion and Anti-Abuse Tax contained in the 2017 tax act.⁷

⁴ §355(h).

⁵ §897, §1445.

⁶ §267A(a).

⁷ §59A(e)(1)(A).