

Client Alert

Tax Practice Group

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REIT Implications of the New “Big Six” Tax Reform Framework

On September 27, the Trump administration and the Republican leadership in the House and Senate released a document called the “Unified Framework for Fixing Our Broken Tax Code” (the “Framework”), which lays out the core principles that are intended to guide the push for tax reform this fall and winter. The Framework updates the 2016 “Better Way Forward on Tax Reform,” commonly known as the “Blueprint.” The impact of the Blueprint on REITs was discussed by [Jonathan Talansky](#) and [Pete Genz](#) in February. While much of the Framework focuses on individual tax changes, there are also a number of important provisions pertaining to business tax that could have an impact on REITs. Here are a few highlights:

Tax Rates. The Framework includes a maximum 20% tax rate for corporations and a 25% maximum tax rate on the business income of “small and family-owned businesses” that are operated as passthroughs. At this point, it is not clear whether there will be any kind of size limit on the 25% passthrough income rate, nor is it clear whether REIT shareholders will benefit from the 25% rate with respect to REIT ordinary dividends. If the 25% rate does not apply to REIT ordinary dividends, then the maximum 35% rate would presumably continue to apply, while C corporation dividends likely would still be taxed at the favorable 20% rate that is currently in effect. In addition, the new maximum 20% C corporation tax rate would reduce the double tax burden that C corporations bear. Since the effective tax rate on alternative investment structures helps define the value of a REIT’s effective exemption from corporate tax, these changes could erode the competitive advantage that REITs have due to their special tax treatment.

On the individual side, the maximum tax rate is currently slated to be 35%, although the Framework leaves open the possibility of adding a higher rate bracket. The Framework does not explicitly address the current 20% tax rate on long-term capital gains (which also applies to capital gain dividends from REITs and all dividends from C corporations), which may indicate that the rate will remain unchanged, although there is uncertainty on this point.

Capital Expensing. The Framework promises that businesses will be allowed to immediately deduct the cost of all depreciable investments other than “structures.” (Land, which is generally nondepreciable, would also be excluded.) The previous Blueprint on tax reform did not exclude structures from the expensing regime. Thus, the Framework seems to indicate that real estate investments generally will now be outside of the regime. Although there were a number of problems and questions around how REITs would take advantage of an expensing regime, this exclusion could be seen as another way in which REITs and other real estate investors are being left out of the tax goodies that other businesses are receiving.

Section 1031. Many REITs are concerned that section 1031 could be repealed as part of a tax reform deal. This concern was discussed in the July edition of REIT Advisor. While the Framework does not address section 1031, the fact that structures are now excluded from the expensing regime could indicate that section 1031 repeal is off the table. In the Blueprint world, the ability to immediately write off the cost of a new building acquired with the proceeds of a real estate sale would take much or all of the sting out of the inability to structure the swap as a tax-deferred exchange under section 1031. By contrast, with the elimination of expensing under the Framework, repealing section 1031 looks to be harder to accomplish politically.

Interest Deductibility. The Framework indicates that the interest deduction will be limited for C corporations. Whether and to what extent this limitation would also apply to REITs is unclear, but if it does, it could create problems for REITs that need to pay enough dividends to comply with the 90% distribution requirement and eliminate their corporate income tax liability. These would arise because nondeductible interest payments would drain cash flow without reducing taxable income. The REIT could be left without enough cash to zero out its taxable income through deductible dividend payments.

“Special Tax Regimes”. The Framework also states that “special tax regimes” applicable to certain industries and sectors will be euphemistically “modernized” such that they provide “little opportunity for tax avoidance.” While this statement is deliberately vague, it should be worrying to any taxpayer that is the beneficiary of favorable tax treatment under current law. Given the concerns that have been widely raised about nontraditional REITs eroding the corporate tax base, it is possible that tax reform could make life harder for REITs with unconventional product types.

While the Framework contains a lot of food for thought, it is still too early to understand the full impact for our REIT clients. In our view, the likelihood that tax reform will be achieved remains a 50/50 proposition. The fact that the Framework did not propose a top individual rate as low as 30% might suggest that the spirit of bipartisan compromise is in the air. If tax reform does happen, we are confident that the corporate tax rate will be reduced to at least 25%, but other specific terms still need to be worked out. As more concrete proposals emerge, we will keep you posted.

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