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Client Alert

Tax Practice Group

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House Releases "Tax Cuts and Jobs Act of 2017" (HR 1)

On November 2, House Ways and Means Committee Chairman Kevin Brady (R-TX) released the "Tax Cuts and Jobs Act of 2017" (HR 1, or the "Bill"). On November 3, the Chairman's Mark of the Bill was released, and Chairman Brady offered further substantive amendments on November 6. Consideration of the Bill will continue, with further mark-up activity expected over the coming days and weeks. While substantial modifications are likely, the Bill contains numerous individual and business tax proposals that will certainly shape the direction of tax reform. Below is a summary of a number of the proposals that are likely to impact our clients and their businesses, as well as commentary on some of the more relevant provisions, with a particular emphasis on REITs and real estate fund participants.

Summary

Individual and Corporate Tax Rates. The Bill reduces the top marginal tax rate on domestic corporations from 35% to 20%. Individual tax rates are proposed to be compressed into four brackets. The highest bracket remains at 39.6% but would kick in at higher income levels (e.g., $1 million for joint filers, as compared to $480,050 for 2018 under current law).

Pass-Through Tax Rate. The Bill provides a new 25% rate for certain income of pass-through entities. Specifically, the net income earned by the owner of a pass-through entity that is treated as passive business income (attributable to a capital investment) is eligible for the 25% rate, with the balance of the net income treated as compensation subject to ordinary income tax rates. Equity owners with respect to active business activities can: (1) treat 30% of income as business income (qualifying for the 25% rate) and 70% as ordinary income, or, alternatively (2) determine the applicable business income percentage using a formula based on capital investment. Equity owners earning income from passive business activities would be able to treat 100% as business income. Income from certain personal service businesses such as law, accounting, and financial services would not be eligible for the new 25% rate.

REIT Dividends. The Bill would apply a maximum 25% rate on ordinary REIT dividends.

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Expensing of Capital Investments. The Bill would allow an immediate write-off of the cost of certain qualified property acquired or placed in service after September 17, 2017 and before January 1, 2023. This expensing allowance would not apply to any property used in a real property trade or business.

Interest Deductibility. Under the Bill, businesses would be subject to a disallowance of a net interest expense deduction in excess of 30% of adjusted taxable income (generally, taxable income without regard to interest income and expense, net operating losses ("NOLs"), and depreciation). Disallowed interest would be carried forward to the succeeding five taxable years. The provision would not apply to real property businesses or to certain small businesses. Moreover, the earnings stripping rule of Section 163(j) would be repealed. In the case of a partnership, the net interest expense disallowance would be determined at the partnership (not the partner) level.

Like-kind Exchanges. The Bill would limit like-kind exchanges to real property. Personal property would no longer be eligible for like-kind exchange treatment under Section 1031 (although the ability to immediately expense the full cost of such property would largely provide the same benefit).

Net Operating Losses. The Bill provides that taxpayers would only be able to deduct an NOL carryover or carryback to the extent of 90% of taxable income (determined without regard to the NOL), similar to the current alternative minimum tax ("AMT") rules. It would also generally eliminate the ability to carry back NOLs, and would add an interest factor to NOL carryforwards, so as to better preserve their value.

Alternative Minimum Tax. The Bill would repeal the individual and corporate AMT.

Capital Gains/Qualified Dividends. The Bill would leave the preferential capital gains and qualified dividends rates (maximum rate of 20%) without change. The Bill also expressly provides that income subject to preferential rates, which includes capital gains and qualified dividends, would not be subject to characterization as business income under the pass-through tax rate proposal, and would retain its character.

Carried Interest. A subsequent amendment to the Bill would treat carried interest allocations that would otherwise be long-term capital gain as short-term capital gain (which does not receive the benefit of a reduced tax rate) to the extent those allocations relate to assets that have been held for three years or less. This new rule would apply to partnership interests received in exchange for services performed as part of an investment management trade or business.

State and Local Taxes. The Bill would disallow any itemized deductions for state and local income and sales tax, but would allow deductions for property taxes up to a cap of $10,000.

Medicare Surtax. The Bill leaves unchanged the 3.8% net investment income tax and the 0.9% additional Medicare tax that apply to higher-income individuals.

Certain Capital Contributions. The Bill would change the treatment of certain contributions of capital to corporations. Specifically, a corporation would be required to include in income the excess of the amount contributed over the value of the stock issued. Similar rules would apply to contributions made to partnerships.

Self-Employment Tax. The Bill would repeal the "limited partner" exception from self-employment taxes.

Partnership Technical Terminations. The Bill would repeal the technical termination rule under current law, which treats a partnership as terminating if 50% or more of its interests are transferred within a 12-month period. At present, upon a technical termination, a partnership is treated as newly formed, must make certain new elections (which in certain circumstances can be used opportunistically by taxpayers) and must restart depreciation on its assets.

State Governments and UBTI. The Bill makes all entities that are exempt from tax under Section 501(a) subject to the unrelated business taxable income ("UBTI") rules. Most notably, this would include state pension funds and other instrumentalities that also qualify under the exemption provided in Section 115(1).

Mandatory Deemed Repatriation. The Bill would impose a one-time repatriation tax on existing foreign earnings. Earnings held in the form of cash or cash equivalents would be taxed at a 12% rate, and other earnings would be taxed at 5%. The Bill would permit taxpayers to pay the tax in 8 annual installments, and foreign tax credits would be partially usable against the tax.

Modified Territorial System. The Bill would adopt a quasi-territorial international tax regime for foreign active business income. Domestic corporations generally would receive a 100% deduction on dividends received from 10%-owned foreign corporations. No tax credit would be permitted for foreign taxes paid or accrued with respect to such dividends.

Tax on High Foreign Returns. In conjunction with the adoption of a territorial system, the Bill would impose a tax on certain "high" returns earned by controlled foreign corporations of U.S. corporations. A high return for these purposes would be a return in excess of 7% plus the applicable federal short-term rate applied to the basis of tangible depreciable property with an adjustment for interest expense. The Bill would tax 50% of the high return at the 20% corporate tax rate (resulting in an effective rate of 10%). U.S. corporations could utilize foreign tax credits for 80% of foreign taxes attributable to the high return income.

Interest Expense of Multinational Groups. Interest payments made by a U.S. corporation to members of the same international financial reporting group would be capped if the U.S. corporation's share of the group's global net interest expense exceeds 110% of the corporation's share of the group's global EBITDA.

Excise Tax on Non-Interest Payments to Related Foreign Corporations. The Bill imposes a 20% tax on certain non-interest payments made by a U.S. corporation to foreign corporations that are part of the same international financial reporting group if the payments would be deductible, includable in depreciable or amortizable basis, or includable in cost of goods sold. As an alternative to paying the excise tax, an election could be made to treat the payments as effectively connected income subject to U.S. federal income tax.

Subpart F Rules. The Bill would keep the Subpart F rules largely intact. Further, the foreign tax credit regime would remain intact and apply to Subpart F and high foreign return inclusions. For corporate taxpayers, Section 956, which deems certain investments in U.S. property and guarantees of certain debt to be taxable repatriations, would be repealed.

Limitation on Reduced Treaty Withholding. The Bill provides that a deductible payment (such as interest or rent) made by a U.S. corporation to a non-U.S. entity would not qualify for reduced treaty withholding rates if both entities are controlled by the same foreign parent and the payment would not have qualified for treaty benefits if made directly to the foreign parent.

Sourcing of Inventory Sales. The Bill would treat inventory produced inside the United States that is sold outside of the United States as solely U.S. source income.

Discussion

One important observation from the Bill is that REITs remain a tax efficient structure for real estate investment. The Bill affords a rate preference to ordinary REIT dividends. Under prior tax reform proposals, which did not include a preferential rate for ordinary REIT dividends, the comparative benefit of REITs was in jeopardy, as the combined tax rate on corporate earnings distributed by C corporations was comparable (if not slightly less than) the individual tax rates applicable to distributed REIT income. The 25% rate on ordinary REIT dividends under the Bill would preserve (for the time being) some of the tax efficiencies of a REIT structure.

The Bill imposes a limitation on net interest expense deductibility on all businesses (other than certain small businesses), regardless of their form. However, REITs won out under this proposal as the Bill contains an important carveout for real estate businesses. For these purposes, a real estate business is defined by reference to the passive activity loss rules under Section 469, which defines a "real property trade or business" very broadly: "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business." This expansive definition likely picks up most equity REITs. Notably, it may not apply to mortgage REITs, but those REITs earn primarily interest income and may not be affected by the net interest deduction limitation anyway. The exception for REITs is extremely important as REITs are very sensitive to nondeductible cash expenses. Such items can force REITs to raise additional equity or pay consent dividends in order to zero out their taxable income.

The interest limitation may dramatically alter the leveraged buyout model utilized by many private equity firms. These deals utilize substantial acquisition debt and rely on the resulting tax shield to reduce the cost of financing. Any limitation on the deductibility of interest increases the cost of borrowing and therefore is likely to impact deal pricing and multiples.

The retention of like-kind exchanges for real property will likely prove useful to REITs that are used by foreign persons to mitigate the impact of FIRPTA tax. Specifically, foreign investors such as sovereign wealth funds often negotiate for real estate funds that invest through private REITs to avoid asset sales at the REIT level. Fully deferred like-kind exchanges do not give rise to FIRPTA gain at the REIT level and therefore do not result in FIRPTA distributions to foreign investors under Section 897(h)(1). On the domestic side, public REITs that utilize UPREIT structures often enter into tax protection agreements with sellers that restrict REIT operating partnerships from engaging in property sales (and refinancings) for a period of time post-contribution. Section 1031 like-kind exchanges have always been an exception to these lockouts and have proven useful for UPREITs that wish to diversify and expand their holdings without triggering a tax liability to minority investors. One additional benefit to REITs from the Bill is that a reduced corporate tax rate will slash the cost of running activities or assets through a taxable REIT subsidiary.

The pass-through tax regime contained in the Bill is expected to help owner-operated small businesses, but will not result in tax savings for service professionals in non-capital intensive businesses. Despite the "guardrails" put in place in the Bill, taxpayers will likely seek ways to creatively increase their capital percentages or achieve treatment as passive participants in their business. There is likely to be a renewed focus on the distinction between active and passive equity owners under Section 469, as this is the standard that will determine what percentage of pass-through income is eligible for the 25% rate. Passive investors in real estate businesses that earn rental income or gain from dealer property stand to benefit greatly from the Bill, as all their income will be taxed at 25% as compared to 39.6% under current law.

Private equity fund management fees presumably will continue to be taxed at ordinary income tax rates, while incentive compensation in the form of carried interest or promote would still be eligible for preferential capital gains rates if they satisfy an extended three-year holding period requirement. While this restriction could affect certain sponsors, many private equity managers are unlikely to be impacted by a three-year holding period requirement, since typical private equity-backed investments are held for a period far in excess of 3 years. In any event, the carried interest proposal by all accounts falls well short of President Trump's stated intention to eliminate the favorable treatment of carried interest. The repeal of the limited partner exception for self-employment tax purposes will eliminate a strategy that many fund sponsors have used in setting up management vehicles as limited partnerships and relying on the statutory exemption under Section 1402(a)(13). Fund managers in high tax states such as New York and Connecticut are likely to see an increase in their individual effective tax rates, which will likely increase the tax distributions that many funds use in order to protect carry participants from timing mismatches.

Under current law, passive U.S. taxable investors in real estate funds and joint ventures may be indifferent between a REIT structure and a flow-through structure. Ordinary REIT dividends are taxed as ordinary income, and the flow-through treatment of rental income is taxed similarly. This generalization does not account for the compliance cost of REITs as well as a REIT's inability to pass through losses to its shareholders. Under the Bill, earning rents as a passive investor in a flow-through entity would qualify for the 25% business tax rate, as would REIT dividends. Accordingly, in addition to the comparative benefit of REITs over C corporations remaining intact, the tax rate similarities between REITs and partnerships or LLCs would be preserved as well. Of course, REITs may also offer significant benefits to foreign investors, especially those that are "qualified foreign pension funds" under recently enacted Section 897(l).

The Bill's treatment of state governments for UBTI purposes would have a dramatic impact on the structuring by state pension funds of their investments in private equity and hedge funds. Historically, many of these pension investors took the position that their exemption under Section 115 made them "super tax-exempt" and thus free of UBTI exposure. The Bill would subject these investors to UBTI taxation, and therefore would force them to consider tax mitigation strategies such as blockers and REITs (where applicable) that are currently used in the investment fund context.

Although the proposal relating to capital contributions would have no impact on typical "value for value" investments made in exchange for equity, it would impose a significant new tax cost on arrangements involving a state or local government offering a subsidy to a local corporation in the form of a gratis capital contribution. Under current law, taxpayers typically rely on Section 118 to exclude from income the receipt of certain payments or grants. If these subsidies were taxable, they would create tax leakage to the participants, and in the case of REITs, could give rise to non-qualifying income.

The NOL limitation in the Bill, if enacted, would force any REIT that "relied" on its NOL carryforwards (i.e., didn't distribute 100% of its income) to incur some tax at the REIT level. Any REIT with positive taxable income would be required to distribute at least 10% of its (pre-dividends paid deduction) taxable income in order to avoid tax at the entity level. The Bill did correct a circularity problem that existed under some of the prior iterations of the government's tax reform proposals, under which the 90% limitation applied after taking into account the REIT's dividends paid deduction, resulting in an artificially high distribution requirement under certain circumstances. The Bill clarifies that as applied to REITs, the 90% NOL limitation applies to REIT taxable income without regard to the dividends paid deduction.

Repeal of the AMT is likely to reduce the costs of tax compliance and reporting for many taxpayers. Similarly, the elimination of the technical termination rule under Section 708 will obviate the need for partners in a partnership to protect against certain transfers, and will thereby facilitate otherwise efficient transfers of partnership interests.

Conclusion

The Bill represents a significant step in the ongoing tax reform effort, as it represents the first legislative language containing comprehensive tax reform proposals. In addition to the provisions discussed herein, it also contains numerous other proposals that impact individuals and businesses, including those relating to home mortgage interest, personal exemptions, estate and gift tax, insurance companies and various tax credits. The prospects for and timing of enactment remain unclear. Republican leadership hopes to pass legislation by the end of the year, but several high-ranking Congressional Democrats have vowed to fight the bill on numerous fronts. A particular point of contention has been the state and local tax disallowance, which is set to disproportionately impact high-tax states such as New York, New Jersey and California. House Ways and Means member Judy Chu (D-Calif.) said eliminating the state and local tax deduction would result in “double-taxing middle-class families.” While REITs and real estate investment appear to have fared well under the Bill, additional compromises and changes are likely. We will continue to closely monitor legislative and political developments that impact tax reform efforts.