AFIRE News 2018 | Issue 2

US Income Tax Reform and the Impact on Real Estate

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The 2017 holiday season delivered a gift to non-US investors in US real estate, in the form of a significant new tax reform package. The real estate industry fared well, overall, under the most sweeping US tax legislation in over thirty years, signed into law on December 22, 2017, and creating the potential for enhanced returns for non-US investors in US real estate. This article provides a high-level overview of the most meaningful changes.

Tax Rates

Under what is likely the most publicized component of the 2017 tax legislation, the federal income tax rate for corporations was permanently reduced from a top marginal rate of 35% to a flat 21% rate. This lower rate also applies to the existing "FIRPTA" (Foreign Investment in Real Property Tax Act) withholding requirements for gain recognized by foreign corporate investors on the sale of US real property interests. Thus, whether US real estate is held through a corporation (e.g., a "blocker" corporation formed to insulate a non-US investor from US tax filing requirements) or directly (in the case of non-US corporate investors), many non-US investors will find their gains from selling the relevant assets subject to a newly-reduced tax rate that is 40% lower, potentially producing a meaningful increase to after-tax returns.

Business Deductions and Losses

The new law creates or modifies a number of limitations on the ability of many real estate businesses to claim certain deductions, depreciate property, and use losses. The 2017 tax legislation caps the deduction available for net business interest expense at 30% of the business's earnings before interest, taxes, depreciation and amortization, or "EBITDA" (30% of earnings before interest and taxes, but taking into account depreciation and amortization, starting in 2022). Any deductions disallowed by the cap are carried forward to be used in future years. Most real property businesses (development, construction, acquisition, conversion, rental, operation, management, leasing, and brokerage) are eligible to make an irrevocable election out of the new limit and, thus, are not subject to this 30% limitation. In addition to providing this exception for many in the real estate industry, the 2017 tax legislation also repealed the prior "earnings stripping" rules, which limited or deferred the deduction of certain interest payments to related non-US investors. In the case of certain structures (e.g., non-US investors investing in real estate through leveraged "blocker" corporations), it is not entirely clear which entities are treated as real property businesses for purposes of the election, or how the election applies to entities that have both real estate and non-real estate activities.

Making the election out of the 30% interest expense limitation requires an electing real estate business to use slightly longer alternative periods to depreciate its property (e.g., the 27.5 year recovery period for residential real property is increased to 30 years, and the 39 year recovery period for nonresidential real property is increased to 40 years). The election also makes real property businesses unable to claim newly increased bonus depreciation deductions in the year that the business places certain improvement property into service.

Extended Holding Period Requirement for Services Partners

The 2017 tax legislation imposes a newly-increased three-year holding period (one year under prior law) for a "promote" or "carried" interest held by a US fund manager to qualify for reduced rates of long-term capital gain taxation. In order to obtain such beneficial treatment under the new law, a partnership must hold an underlying asset for at least three years prior to sale before the general partner or manager is entitled to long-term capital gains treatment with respect to income allocated to its "promote" or "carried" interest. Otherwise, (even if held for longer than one year but less than three years) the gain to the services partner is treated as short-term capital gain, taxed at ordinary income rates––a maximum 37% under the new legislation. The computation of this three-year holding period is complicated in situations where capital is funded in more than one tranche, e.g., in a development scenario where the investment is completed over the course of several years.

The desire to qualify for long-term capital gain treatment may motivate certain service partners to hold assets for at least three years even if disposing of the property earlier could arguably better serve the partnership's interests (or at least the interests of the limited partners, whose required holding period for long-term capital gain treatment remains at one year). However, the new requirement's practical impact on real estate partnerships is likely to be limited, since (1) absent technical corrections, the three-year holding period may not apply to many gains from direct sales of real estate assets used in a trade or business under a strict reading of the statutory language, and (2) in many cases, value for real estate investors will be maximized by holding the underlying assets for longer than three years.

Deductions for Pass-Through Income

Although US individuals are subject to a 37% rate on their ordinary income, the 2017 tax legislation allows non-corporate owners of pass-through entities to claim a new deduction (effective through 2025) on certain pass-through income, which has the potential to lower the effective tax rate on this income significantly. Under the new provision, non-corporate taxpayers can deduct up to 20% of their qualified (1) business income, (2) publicly traded partnership income, and (3) ordinary REIT dividends. Investors in a position to qualify for the maximum deduction will see the tax rates on eligible income reduced from 37% to as low as an effective rate of 29.6%. However, the deduction is subject to a number of limitations:

- First, the aggregate amount deducted under the new provision cannot exceed 20% of the taxpayer's ordinary taxable income (excluding long-term capital gains and certain dividends from the calculation).
- Second, the deduction does not apply to the income of certain businesses and, even if generated by an eligible business, the deduction excludes certain types of income. For example, the portion of the deduction for business income is (with some exceptions) generally unavailable for income generated by service businesses, such as investment professionals and attorneys.
- Third, with respect to the business income that is eligible, the deduction is further limited in amount (for taxpayers with income above a threshold) to the greater of (1) 50% of the W-2 wages an owner pays with respect to each trade or business (which may be inapplicable for many real estate entities, which often do not have their own employees), and (2) 25% of W-2 wages plus 2.5% of the owner's cost of depreciable property used to generate the qualified income of each business.

Ordinary REIT dividends (REIT dividends that are not capital gain dividends or certain other dividends specified in the tax code that are subject to a preferential 20% tax rate) also qualify for the 20% deduction, with fewer restrictions than other income. REIT dividends are not subject to the wage-based cap or the requirement that the underlying activities of the REIT be a US non-service business, and they are not subject to the same restrictions concerning the type of income that may be passed through as deductible dividends (though the rates of withholding taxes on REIT dividends paid to non-US investors, and the ability to reduce the withholding rate in the case of an applicable treaty, are unaffected by the new deduction). For example, a mortgage REIT's interest income, which would not be eligible for the 20% deduction when received directly by a non-corporate investor, would be eligible for the 20% deduction when distributed to the same investor in the form of a REIT dividend. Some practitioners have expressed the view that the absence of certain limitations on REIT dividends is due to a drafting oversight and that some of these restrictions may be imposed on the deduction of REIT dividends in the future.

While this 20% deduction may be of limited value to many non-US investors (many of whom are either taxed as corporations or invest through "blocker" entities that are themselves taxed as corporations), it may incentivize taxable US investors to allocate additional capital to the US real estate industry, driving up valuations in the process.

New Tax Incentives for Investing in Low-Income Communities

Real estate investments qualifying under a new incentive program created by the 2017 tax legislation will be eligible for significant tax benefits. In particular, by reinvesting capital gains (including gains from the sale of stock or other property, whether or not related to real estate) into low-income communities that are designated "qualified opportunity zones," a taxpayer (including a non-US investor generating FIRPTA gains) can achieve three primary benefits: (1) defer recognition of the reinvested capital gains through as late as the end of 2026; (2) permanently avoid income tax on 15% of the reinvested amount after holding the investment for at least seven years (10% if held for at least five years but less than seven); and (3) after holding the investment for at least ten years, permanently avoid income tax on all gain attributable to appreciation occurring after the initial reinvestment. To qualify for the program, capital gains generated by the sale or exchange (between unrelated persons) of any property must be reinvested into a "qualified opportunity fund" within 180 days of the transaction generating the capital gains. Qualified opportunity funds are investment vehicles organized (in the form of corporations or partnerships) for the purpose of investing in "qualified opportunity zone property," with such property making up at least 90% of the fund's assets (among other requirements to maintain "qualified opportunity fund" status). Commercial and residential real estate that is either newly constructed or substantially improved after 2017 falls within the scope of qualifying property. Up to 25% of the low-income communities (as determined by US census data) in each US state may be designated as qualified opportunity zones by the United States Treasury Department after the nomination of areas by state governors. The Treasury Department has established a website with resources identifying over 41,000 areas eligible for such nomination, and the final designations will be made between April 21 and June 21, 2018.

Additional Items Affecting Real Estate

A number of other recent changes are also expected to have a significant impact on the real estate industry. For example, despite largely eliminating the ability to defer gain recognition by exchanging property for like-kind property, the 2017 tax legislation retained this "1031 exchange" mechanism for like-kind exchanges of real property. In March of this year, Congress also amended a number of provisions of the US tax code that were enacted prior to the 2017 tax legislation. The March 2018 amendment clarified certain requirements for a foreign pension fund (or an entity wholly owned by such a foreign pension fund) to qualify for exemption from FIRPTA and provided that a qualified foreign pension fund is not "treated as a nonresident alien individual or a foreign corporation" for purposes of FIRPTA. One possible reading of this language is that REIT interests held by a qualifying pension fund are not considered to be held by a "foreign person" for purposes of determining whether the REIT is "domestically controlled" (which generally permits a seller of REIT shares to avoid FIRPTA tax if less than 50% of the REIT's equity value was owned by foreign persons during the five-year period prior to the sale of REIT stock). However, it is unclear whether the US Internal Revenue Service would give effect to this interpretation, which could, for example, result in a REIT being treated as "domestically controlled" even where a non-US corporate investor owned 48%, a non-US qualified foreign pension fund owned another 48%, and only 4% of the REIT was domestically owned by a US private equity sponsor.

On a net basis, by reducing US corporate and individual tax rates, retaining (or increasing) real estate businesses' ability to deduct interest expense, and providing new incentives for investments in underserved areas, the recent US tax legislation is expected to create meaningful opportunities for enhanced returns from US real estate investments. Each asset and investment structure will have to be separately evaluated given its specific facts, and certain industries and forms of ownership may be more favored compared to others. However, in totality, the rules are expected to encourage the continued flow of non-US capital into the US real estate industry. ★


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