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Tax Reform and REITs

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by David Lee, Washington National Tax*

With both houses of Congress and the White House controlled by Republicans, the likelihood of comprehensive tax reform has increased and so has speculation concerning potential effects on the taxation of businesses, investments, and transactions.[1] Of course, the enactment of significant tax reform legislation is not certain; the details, timing, and effective dates of any legislation are also unclear at this time. Nonetheless, some proposals being considered could (if enacted) affect how a real estate investment trust ("REIT") is perceived based on its tax treatment and how REITs conduct their business operations going forward.[2]

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* David Lee is a partner in the Passthroughs group of Washington National Tax ("WNT") and a member of the REIT Services group in WNT. The authors would like to thank Stephen Giordano, Carol Kulish, and James Sowell, also of WNT, for their thoughtful comments and suggestions.

1 For example, a report by Reuters on December 27, 2016, began: "Investors pulled another $2 billion from U.S. municipal bond funds in the latest week, underscoring fears that potential sweeping tax changes under President-elect Donald Trump and a Republican Congress will undermine the tax-exempt debt market." Available at: http://www.reuters.com/article/municipals-tax-trump-idUSL1N1EE1OS. Also, a joint letter dated December 13, 2016, by 14 national real estate organizations, including National Association of Real Estate Investment Trusts, to Congress noted, "From property values to jobs to retirement savings, real estate is deeply interwoven in the U.S. economy and the American experience," and "Great care must be taken when changing tax rules for long-lived real estate assets, or serious unintended consequences could result." Available at: https://www.reit.com/sites/default/files/2016_12_13-real-estate-tax-reform-ltr.pdf.

2 A REIT modeled after a regulated investment company (or mutual fund) for investments in real estate can claim a deduction for dividends paid to its shareholders to achieve the "conduit" effect. For an entity to qualify as a REIT and maintain the status, it must satisfy requirements concerning share ownership, asset holding, income source, and distributions. Specifically, a REIT must generally distribute at least 90 percent of its "ordinary" taxable income; a REIT generally can reduce its taxable income to zero by distributing an amount at least equal to that income. Thus, the structure provides both current income and inflation protection to investors.

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This article summarizes some key current reform proposals, reviews their possible effects on REITs, and discusses considerations to minimize unintended adverse tax consequences.

Background

In June 2016, House Republicans released a "blueprint" for tax reform (the "Blueprint"), outlining at a high level several key objectives for comprehensive tax reform.[3]

- For individuals, the proposal would simplify and lower tax rates (i.e., three brackets at 12, 25, and 33 percent) and eliminate itemized deductions other than home mortgage interest and charitable deductions; tax "business income" of pass-throughs at a top rate of 25 percent; provide a deduction of 50 percent for net capital gains, dividends, and interest income (leading to top rates of 6, 12.5, and 16.5 percent on such investment income); and eliminate the alternative minimum tax ("AMT"), the estate tax, and the generation-skipping transfer tax.
- For businesses, the proposal would lower the corporate tax rate to 20 percent (with a special rate of 25 percent on small business and pass-through business income), repeal the corporate AMT, allow a full and immediate write-off (or expensing) of investments in tangible property (such as equipment and buildings but not land) and intangible assets (such as intellectual property), eliminate the deduction of net interest expense, and allow net operating losses ("NOLs") to be carried forward indefinitely and used to offset 90 percent of net taxable income of a given year (but not to be carried back).[4]

On the international front, the Blueprint recommends two fundamental changes—replacing the worldwide tax approach with a territorial tax system and implementing a destination-basis, border adjustable, tax system.[5]

During his campaign, President Trump similarly advocated for significant tax reform (the "Trump Campaign Plan").[6] His campaign proposals included lowering individual tax rates (i.e., 12, 25, and 33 percent), increasing the standard deduction and capping itemized deductions, repealing the AMT, retaining the existing capital gains rate (i.e., a maximum rate of 20 percent), and taxing carried interest as ordinary income. The Trump Campaign Plan also proposed to lower the corporate tax rate to 15 percent "to all businesses, both small and large, that want to retain the profits within the business," eliminate most corporate tax "expenditures" except for the research and development credit, and allow

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[3] Available at: http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

[4] The American Business Competitiveness Act, which was cited in the Blueprint and whose main sponsor, Representative Devin Nunes, is a member of the executive committee leading President Trump's Presidential Transition Team, would provide that a REIT still would be entitled to a deduction for dividends paid to achieve the "conduit" effect. Taxwriters, of course, have flexibility to determine what the technical details of tax reform legislation would be as the process develops.

[5] Under the proposal, the taxing jurisdiction for business income would be based on the location of consumption—where goods are sold or services are performed—rather than the location of production. According to the Blueprint, this would be accomplished by providing for border adjustments exempting exports and taxing imports.

[6] Available at: https://www.donaldjtrump.com/policies/tax-plan.

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firms engaged in manufacturing in the U.S. to elect to expense capital investment and lose the deductibility of corporate interest expense. Technical details regarding these proposals are not available. It is not clear how committed the president may be to the specific proposals made during the campaign or what additional tax proposals his administration might push.

On the Senate side, Senate Finance Committee Chair Orrin Hatch had been exploring the possibility of achieving business tax reform at least in part through corporate integration—likely through allowing C corporations deductions for dividends paid. However, during a floor speech on December 9, 2016, Senator Hatch noted that, "after this election, the ground has shifted, and, while we don't know how everything will play out in the coming months, it's safe to assume that the tax reform discussion is shifting as well."[7] Although he was "not walking away from the idea of corporate integration," Senator Hatch stated "[r]ight now, we are seeing more momentum for COMPREHENSIVE tax reform—that is reform that deals with both the individual and business tax systems—than we've seen in a generation or more."[8]

Attractiveness of REITs in a Low Corporate Tax Rate Environment

At this time, many believe that tax reform discussions in 2017 would likely begin with the Blueprint.

While there remain significant uncertainties and lack of details, some tax practitioners have already queried the usefulness of the REIT structure in light of potentially lower rates on corporate earnings and dividend income of individuals and the possibility that a REIT's "ordinary" dividends might not be eligible for the lower individual rates under the Blueprint. That is, would there still be a relative tax advantage for the REIT structure over a regular C corporation if a REIT's earnings were taxed at 33 percent in the hands of its individual shareholders while a C corporation and its individual shareholders have a combined effective rate of 33.2 percent?[9] At first glance, the REIT structure under the Blueprint appears to lose much of its attractiveness relative to a C corporation. However, it is worth noting that there is precedent for taxing REIT dividends by reference to the rates applicable to the underlying income (i.e., capital gain dividends and dividends attributable to taxable REIT subsidiary dividends), and this approach might be expanded in the context of the new tax reform rate structure, and thus, retain a level of relative advantage for REITs.[10]

To complicate matters further, because a REIT generally must distribute at least 90 percent of its ordinary taxable income (and is otherwise taxable on its undistributed income), REITs often prefer to

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[7] Available at: http://www.finance.senate.gov/chairmans-news/hatch-finance-committee-senate-remarkably-productive-in-114th-congress

[8] *Id.*

[9] For example, setting aside state income tax, a corporation's taxable income of $100 could have a combined tax of $33.2 (i.e., 20 percent of $100 at corporate level and 16.5 percent of $80 at individual). In comparison, shareholders of a REIT with the same taxable income of $100 could face a tax of $33 (i.e., the highest individual rate).

[10] According to the National Association of Real Estate Investment Trusts (NAREIT), 22 percent of REIT common share dividends for 2015 were long-term capital gain. Available at: https://www.reit.com/sites/default/files/1099/HistoricalDividendAllocation Summary.pdf.

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minimize cash outflows that do not reduce their taxable income.[11] Thus, a REIT might need to issue equity to replace what presumably would be non-deductible interest payments with deductible dividends, even though those dividends might be taxed at 33 percent if the REIT's "ordinary" dividends were taxed at the regular individual rates described above. Issuing the needed equity could, however, become harder for a REIT to do as the relative advantage to its investors associated with its dividends decreases.[12] The table below illustrates the potential effects of the Blueprint's proposals on a business taxed as a C corporation vs. as a REIT, with the assumption that the REIT replaces debts with additional equity to comply with the distribution requirement:

		Blueprint	
	Baseline	C corporation	REIT
Operating income	200.00	200.00	200.00
Interest payment	(90.00)	(90.00)	0
	110.00	110.00	200.00
Disallowed interest		90.00	
Dividends paid deduction			(200.00)
Taxable income	**110.00**	**200.00**	**0**
Corporate tax (federal)	38.50	40.00	
Distribution	71.50	70.00	200.00
Earnings and profits	71.50	70.00	200.00
Individual tax on dividend (federal)	28.31	11.55	66.00
Individual tax on interest (federal)	35.64	14.85	
Combined	**102.45**	**66.40**	**66.00**

[11] For example, if, during a year, a REIT has net operating income of $200 (before the payment of interest) and pays interest of $90, the REIT would need to make a "dividend" distribution of $180 under the Blueprint merely to maintain its REIT status, but would only have cash of $110.

[12] While under the Blueprint a corporation would not be able to deduct net interest expense, any disallowed interest might still reduce its earnings and profits ("E&P"), thereby producing a lower dividend amount in the hands of shareholders. However, for a REIT, this disallowed interest cannot reduce a REIT's E&P under section 857(d)(1) to support the dividend treatment of distributions for REIT qualification purposes. Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

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In determining how critical the rate structure applicable to REIT dividends would be to the continued viability of REITs, the tax status of the typical shareholder would, obviously, be relevant. According to a Congressional Research Service report, “only about a quarter of corporate stock of U.S. firms is estimated to be owned by shareholders subject to U.S. individual taxes on dividends and capital gains”; the remainder is held by tax-exempt and largely tax-exempt pension and retirement accounts, nonprofits, and foreigners.[13] Under the Blueprint, REITs seemingly might continue to have access to an exemption under the *corporate* tax. For tax-exempt investors (such as pension and retirement plans), therefore, REITs seemingly would provide a more efficient way to invest in real estate as compared to an investment through a C corporation.

Expensing of Capital Improvements: A Good Thing for REITs?

Another issue that could affect the benefits of the REIT structure has to do with the Blueprint’s proposal to allow current expensing of investments that would give rise to significant losses available to offset future taxable income. Under this approach, a C corporation might not have any significant corporate tax liabilities for a number of years. In comparison, as discussed below, without modifying section 316 (concerning taxability of corporate distributions) and section 172 (concerning REITs use of NOL carryforwards):

- A REIT would be subject to a corporate-level tax and possibly fail to satisfy the minimum distribution requirement if the REIT relies on the NOL carryforward to offset a portion of its taxable income.
- The tax benefit of a current write-off would not be enjoyed by the REIT’s shareholders if the REIT continued its regular dividend policy.

Although the Blueprint would allow current expensing of investments, potentially generating an NOL that could be carried forward indefinitely, the Blueprint would limit an NOL deduction in any year to “90 percent of the net taxable amount for such year determined without regard to the carryforward.”[14] For a REIT, pursuant to section 172(d)(6)(B), the portion of an NOL carryforward that could be carried to a year is the “REIT taxable income” for the year (i.e., after the deduction for dividends paid (“DPD”)). In other words, a REIT could use its NOL carryforward against its remaining income only after taking into account the DPD. The combination of this rule and the 90 percent limitation presents a problem of circularity. If the term “net taxable amount” used by the Blueprint is the same as the term used in section 172(d)(6)(B), a REIT would always have income subject to corporate tax if it intends to use NOL carryforward that is limited to 90 percent of after-DPD taxable income. Further, unless a REIT has a

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[13] *See* CRS Report R44638, Corporate Tax Integration and Tax Reform, by Jane G. Gravelle; Steven M. Rosenthal, and Lydia S. Austin, "The Dwindling Taxable Share of U.S. Corporate Stock," Tax Notes, p. 923 (May 16, 2016).

[14] It is worth noting that expensing would be allowed under the Trump Campaign Plan by “firms engaged in manufacturing in the U.S.”; it does not appear that real estate investments would be eligible under the Trump Campaign Plan.

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DPD of at least 48 percent of its REIT taxable income before DPD and NOL, it could fail to meet the minimum distribution requirement.

The table below illustrates a REIT's use of an NOL carryforward (of at least $1,000) under the current rule and the potential effects of the proposed NOL limit on the REIT's ability to satisfy the distribution requirement and to purge all of its taxable income:

	Ex. 1	Ex. 2	Ex. 3
Taxable income	1,000	1,000	1,000
DPD	900	600	470
REIT taxable income (§172(b)(6)(B))	100	400	530
NOL carried to the year (90% limit)	(90)	(360)	(477)
Income subject to tax	10	40	53
REIT taxable income before DPD	910	640	523
DPD	900	600	470
Distribution %	98.9%	93.8%	89.9%

Obviously, this problem—and myriad others that inevitably will arise in connection with any significant attempt at tax reform—should be corrected as part of the legislative process. Hopefully legislators will "sweat the small stuff" and address these issues if they move forward with the Blueprint's proposals.

But the potential problems arising from NOL carryovers likely created by the expensing of capital expenditures do not end here. Pursuant to section 316(a), a dividend is a distribution of property by a corporation to its shareholders out of the corporation's E&P accumulated after February 28, 1913, or out of the E&P of the current tax year. Generally, under section 1.312-6(d), an NOL sustained in a prior year is not taken into account in determining a corporation's E&P for the current year. Thus, a distribution to shareholders by a corporation with an NOL carryforward could still be characterized as a dividend up to the corporation's current E&P. Without modifying the current rules for determining E&P and classifying corporate distributions, the benefit of a current expensing would likely be deferred until the corporation relies on the NOL carryforward to offset the disposition gain but delays distributing sales proceeds after the disposition year.

Also, it is not clear whether there would be recapture provisions similar to sections 1245 and 1250 that would minimize the benefit of lower rates on REIT's capital gain dividend when the "expensed"

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investments are disposed of.[15] In addition, for Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA") purposes, it is not clear whether a REIT would be permitted to net gain from sales or exchanges of U.S. real property interest ("USRPI") with the loss from "expensing" USRPIs in the same year or that is part of the NOL carryforward from prior years.[16]

REITs—It's Not All About Taxes

One final point to make is that REITs generally are not expected to incur any corporate-level tax (i.e., a tax baseline of zero tax), similar to a regulated investment company, so long as earnings are distributed to its shareholders. With this in mind, a REIT is chosen as a form of raising capital for investments in professionally managed real estate (as, with a baseline effective tax rate of zero on operating income and sales proceeds, it behaves more like a partnership, historically the more common tax structure for multi-investor investments in U.S. real estate). Because REITs are required to distribute their earnings and invest in real estate, they attract investors who may have objectives (e.g., current distributions and inflation protection) different from those investing in C corporations, which are not required to distribute earnings. That is, its existence serves purposes beyond merely a tax-efficient structure.[17]

Conclusion

At this point, it is premature to conclude whether the REIT structure would be a "winner" or "loser," as compared with its counterparts (i.e., corporations and publicly-traded partnerships) if tax reform based on the Blueprint were enacted. However, it is certain that, in drafting the technical details of tax reform, modifications and clarifications to existing Code provisions affecting REITs would have to be considered.

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[15] Pursuant to section 857(b)(3)(C), a REIT can designate a portion of its dividend up to its net capital gain as a capital gain dividend. Under section 857(b)(3)(B), a capital gain dividend is treated by REIT's shareholders as a gain from the sale or exchange of a capital asset held for more than one year.

[16] Under section 897(h)(1), a distribution made by a REIT attributable to gain from sales or exchanges by the REIT of USRPI is generally treated as gain recognized by a foreign person from the sale or exchange of a USRPI. For purposes of section 897(h)(1), it seems reasonable for a REIT to net USRPI gains with USRPI losses recognized in the same year. However, if a REIT recognizes a USRPI loss in Year 1 that becomes part of an NOL carryforward (i.e., a section 1231 loss) or a capital loss carryforward, should the REIT be permitted to net a USRPI gain recognized in Year 2 with the USRPI loss that is part of the NOL or capital loss carryforward to the extent such loss is utilized in Year 2?

[17] According to NAREIT, widely held REITs own approximately $1.8 trillion of commercial real estate assets as of November 30, 2016, and paid out dividends of $51 billion during 2015. Also, according to NAREIT, the FTSE NAREIT All REITs equity market capitalization was at $977.9 billion as of November 30, 2016 (compared with $1.5 billion at the end of 1971).

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