REITs in the Aftermath of TCJA:

How are REITs faring in the aftermath of the TCJA?

May 10, 2019

Moderator: Cristina Arumi, Hogan Lovells, Washington, DC.

Panelists: Kimberly Arndt, PwC, Washington, DC; Mark Van Deusen, Deloitte Tax LLP, Richmond, VA; Andrea Hoffenson, IRS Office of Associate Chief Counsel (Financial Institutions & Products), Washington, DC; Grace Cho, IRS Office of Associate Chief Counsel (Financial Institutions & Products), Washington, DC.
Section 199A
Section 199A - REIT Dividends

- Deduction is available for both direct investment in real estate and qualified REIT dividends.

- Qualified REIT dividends *automatically* qualify for deduction.

- For direct investment, the deduction is limited to the amount of real estate investment activity that relates to a qualified trade or business.

- Regulations are not clear as to whether all rental real estate activity is deemed to be a trade or business for purposes of Section 199A.
  
  - IRS issued a proposed revenue procedure with a safe harbor to help mitigate some uncertainty.
Section 199A - Benefits of REITs

- Ordinary REIT dividends automatically qualify for the deduction.
- Beneficial for REIT to hold property instead of a partnership.
- Mitigates issue as to whether rental activities constitute a qualified trade or business (NNN).
- Dividends from REITs investing in either mortgages or real property will qualify.
Section 199A - Mutual Fund Shareholders

- Shareholders of mutual funds with REIT investments are eligible for the deduction.

- Proposed regulations treat any Section 199A dividend as a qualified REIT dividend in the hands of a recipient shareholder, provided the shareholder meets equivalent requirements in respect of its RIC shares as those that apply to qualified REIT dividends.
Section 199A - Limitations

- REIT Dividend Limitations:
  - Deduction is not available for stock held for less than 45 days.
  - Deduction is not available if the shareholder is required to make related payments with respect to substantially similar property.
  - Deduction is not available for investment income – e.g. qualified dividend income or capital gain dividends.
Qualified Opportunity Zones
Overview of Qualified Opportunity Zones ("QOZs")

- Deferral and elimination of up to 15% of the tax on the capital gain invested in QOZs.
  - If the investment is held for ten years, potential full elimination of tax when exiting.
- Taxpayers generally have 180 days from a sale to invest capital gains in QOZs.
- A qualified opportunity fund ("QOF") must derive at least 50 percent of its total gross income from the active conduct of a business within a qualified opportunity zone (3 safe harbors).
  - Ownership and operation (including leasing) is an active trade or business.
  - NNN is not.
Qualified Opportunity Zones - REIT Shareholders

- QOF real estate investment trusts ("QOF REITs") may designate special capital gain dividends.

  - The designated dividends cannot exceed the QOF REIT’s long-term gains on sales of QOZ property.

- To the extent a taxpayer treats QOF REIT shares as qualifying investments the special capital gain dividends are tax free to shareholders.
  
  - The taxpayer may treat the capital gain dividend as a gain from the sale or exchange of a qualifying investment on the date that the QOF REIT identified the dividend; and

  - If the QOF REIT shares were held for at least 10 years, the taxpayer will not pay tax on the dividend.
Qualified Opportunity Zones - 1231 Gains

- 1231 gains are required to be netted by 1231 losses.

- Proposed regulations provide these gains cannot be invested until after the close of the tax year - the start of the 180 day period.
Section 163(j)
Section 163(j) Generally
Section 163(j)
General rules and background

- A taxpayer’s deduction for “business interest expense” (“BIE”) for any year is limited to the sum of
  - the taxpayer’s “business interest income”; and
  - 30 percent of the taxpayer’s “adjusted taxable income” (“ATI”).

- Generally, ATI is a taxpayer’s taxable income without regard to
  - non-business items,
  - Business interest income or BIE;
  - deductions with respect to NOLs and section 199A; and,
  - for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.
Section 163(j)

General rules and background (cont’d)

- The limitation is determined at the **partnership level**.

- Exceptions for certain businesses, including electing **real property trades or businesses (“RPTOB”)**, and an exemption for certain small businesses.
  - RPTOB includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
REIT Safe Harbor
REIT Safe Harbor
When does a REIT qualify as a RPTOB?

- If a REIT holds
  - “real property,”
  - interests in partnerships holding “real property,” or
  - shares in other REITs holding “real property,”

then a REIT is eligible to make a RPTOB election for all or part of its assets.

- The **REIT definition of “real property”** applies for the REIT safe harbor.
  - The more limited definition of “real property” in Prop. Treas. Reg. § 1.469-9 does not apply to the REIT safe harbor.
  - Also, the lower-tier partnership or REIT does not need to make a RPTOB election itself, it just needs to own “real property.”
REIT Safe Harbor
When does a REIT qualify as a RPTOB? (cont’d)

▪ If “real property financing assets” constitute:
  ▪ **10 percent or less** of the *value* of the REIT’s total assets at the close of the taxable year, *all* of the REIT’s assets are treated as **assets of an RPTOB**.
  ▪ **More than 10 percent** of the *value* of the REIT’s total assets at the close of the taxable year, the REIT **must allocate** interest expense, interest income, and other items of expense and gross income between the RPTOB(s) (an excepted trade or business) and non-RPTOB election eligible businesses (a non-exceptioned trade or business).
REIT Safe Harbor

Real property financing assets

- Real property financing assets include interests in:
  - mortgages,
  - guaranteed mortgage pass-thru certificates,
  - REMIC regular instruments, and
  - debt instruments issued by publicly-offered REITs.

- Unsecured loans, equity securities, and other assets not used in a RPTOB are not “real property financing assets” under the proposed regulations.
REIT Safe Harbor

Look-through rules

Shares in Other REITs (subsidiary REIT)

- If all of subsidiary REIT’s assets are treated as assets of an excepted trade or business, the value of subsidiary REIT is treated as a real property asset.

- Otherwise, the partnership look-through rule should be applied to subsidiary REIT (as if subsidiary REIT were a partnership).

Other Equity Interests

- The look-through rules for partnership interests and non-consolidated C corporations under Prop. Treas. Reg. § 1.163(j)-10 apply.
REIT Safe Harbor

Open issues

- Note that **REIT safe harbor does not explicitly apply to a REIT’s operating partnership** or any other lower-tier partnership.
  - Operating partnerships and lower-tier partnerships will have to apply the general rules for electing RPTOB status and for allocating interest to RPTOBs.

- To qualify for the REIT safe harbor, it appears that the REIT must own interests in at least **two partnerships owning real property** or stock in **two REITs owning real property**.
  - An UPREIT that owns an interest in only one operating partnership and no real property directly arguable would **not** qualify for the REIT safe harbor.
REIT Safe Harbor

Open issues (cont’d)

- **Indirect ownership of real property is not enough.**
  - Lower-tier partnerships or REITs appear to have to **hold real property directly**, not through another partnership or another REIT, to allow the parent REIT to make the REIT safe harbor election.
    - Thus, a REIT that owns an interest in a fund that owns only interests in joint ventures that own real property would appear not to be eligible for the REIT safe harbor.
    - Similarly, the REIT safe harbor election appears not to be available when a REIT owns only stock in a lower-tier REIT that owns only interests partnerships or other REITs that own real property.
The Leasing Anti-Abuse Rule
The Leasing Anti-Abuse Rule
Activities that do not qualify as RPTOBs

- Trades or businesses that lease at least **80 percent** of their real property (by value) from a business under common control are not RPTOB.
  - Two trades or businesses are under **common control** if 50 percent or more of the direct and indirect ownership of both businesses is held by related parties within the meaning of sections 267(b) and 707(b).

- This anti-abuse rule does not apply to **REITs** that lease **qualified lodging facilities** and **qualified health care properties**.
  - The REIT exception is **not** limited to qualified lodging facilities and qualified health care properties leased to taxable REIT subsidiaries.
  - REIT exception applies to a REIT but does not apply to a partnership (**e.g.**, an operating partnership) in which a REIT owns an interest.
Consider whether any “OpCo/PropCo” structures are subject to this anti-abuse rule.

- If the anti-abuse rule applies, consider whether PropCo’s activities might not rise to the level of a trade or business (and thus, PropCo’s interest expense would not be subject to section 163(j)).

- PropCo’s position as to whether its activities rise to the level of a trade or business should be consistent for all purposes of the Code.

  - Note special rule treating a PropCo leasing property to a non-C corporation OpCo as in a trade or business for section 199A. Treas. Reg. § 1.199A-1(a)(14).

- If anti-abuse rule prevents a RPTOB election, consider not relying on the proposed regulations for 2018.
Section 163(j) and REITs
Section 163(j) and REITs

Key provisions

ATI Calculation

- ATI is not reduced by the deduction for dividends paid.
- ATI is reduced by the dividends received deduction and other deductions for corporations. See section 857(b)(2)(A) (denying the dividends received deduction to REITs).

Disallowed BIE

- **Disallowed BIE** or excess BIE (allocable share of a partnership’s disallowed BIE) is deductible from a REIT’s earnings and profits in the earlier of the year the disallowed BIE or EBIE becomes deductible or the first taxable year for which the taxpayer is no longer a REIT.
BEAT for REITs?

May 10, 2019
Section 59A

• Section 59A imposes a base-erosion and anti-avoidance tax ("BEAT") on certain corporations that make payments to related foreign persons.
  – The tax is equal to
    – 10% (12.5% after 2025) of the taxpayer’s “modified taxable income” (generally, taxable income increased by certain payments to related foreign persons and a portion of any net-operating loss deduction) minus
    – The taxpayer’s regular tax liability, reduced by certain credits.

• To be an “applicable taxpayer” subject to BEAT in any tax year, corporate taxpayers must meet a three-part test.
  – The taxpayer must be a corporation other than a RIC, REIT or S corporation.
  – The taxpayer must have average annual gross receipts of at least $500 million over the three-year period ending with the preceding tax year.
  – The taxpayer’s “base erosion percentage” must be at least 3%.
Proposed Regulations

• Under Prop. Treas. Reg. 1.59A-3(b)(2)(v)(A) if an “applicable taxpayer” pays or accrues amounts which would be “base erosion payments” except for the fact that the payment is made to a “specified domestic passthrough”, the applicable taxpayer is “treated as making a base erosion payment to each specified foreign related party for purposes of Section 59A and the regulations thereunder.”

  – Prop. Treas. Reg. 1.59A-3(b)(2)(v)(C) defines “specified domestic passthrough” to include a REIT which “pays, or is deemed to pay, a dividend to a specified foreign related party for which a deduction is allowed.”
Typical Structure for Qualified Lodging Facility or Qualified Health Care Property

Description of Structure
- REIT owns “qualified lodging facilities” (“QLFs”) as defined under Section 856(d)(9)(D) or “qualified health care properties” (“QHCPs”) as defined under Section 856(e)(6)(D)(i).
- REIT leases QLFs or QHCPs to TRS.
- TRS engages eligible independent contractor to operate the QLF or QHCP.

Tax Considerations
- TRS will pay 21% federal corporate tax on net income (current rates), plus any state and local taxes, deducting rents paid to REIT under the lease for the QLFs or QHCPs.
REIT with a Significant Foreign Investor

Assume:
• REIT is 30% owned by Foreign Investor.
• Foreign Investor is entitled to a reduced rate of dividend withholding under an applicable treaty.

Question:
• Will TRS be subject to BEAT, as a result of the deductible rent payments made to REIT?
Will TRS be Subject to BEAT?

- For purposes of determining whether a REIT aggregate group meets the three-part test and is subject to BEAT, despite a REIT itself not being subject to BEAT:
  - In order to determine whether the group meets the $500 million average annual gross receipts test, receipts of a REIT are taken into account.
  - In order to determine the group’s “base erosion percentage,” a REITs payment of dividends to a related foreign party (which are not subject to 30% withholding) are a base erosion payment.

- Assuming that TRS is an “applicable taxpayer,” because the REIT group meets the three-part test:
  - If Foreign Investor is subject to 30% withholding tax, rent payments from TRS to REIT are “base erosion payments” under Prop. Treas. Reg. Section 1.59A-3(b)(2) but do not create a “base erosion tax benefit” under Prop. Treas. Reg. 1.59A-3(c)(3).
  - If Foreign Investor is not subject to 30% withholding tax, rent payments from TRS to REIT appear to be “base erosion payments” that create a “base erosion tax benefit”.

Will TRS be Subject to BEAT?
Open Questions

• Was this intentional?

• How does the REIT protect itself from bearing this tax cost?

• How does the REIT protect the other shareholders?
This presentation and related panel discussion contains general information only and the respective speakers and their firms are not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. The respective speakers and their firms shall not be responsible for any loss sustained by any person who relies on this presentation.