An update on US tax reform and potential implications for the real estate industry

January 2017 edition

Building a better working world

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Post-election perspective: the political landscape[1]

On 3 January 2017, the 115th Congress was sworn in, which capped a surprising sweep by Republicans of the House, Senate and White House. Before, during and following the campaigns, President Trump, House Speaker Ryan and Senate Majority Leader McConnell each signaled that comprehensive tax reform was a high priority. This unanimity of purpose among Republicans coupled, now, with their ability to drive the legislative agenda dramatically elevates the prospects for broad-based tax reform.

At this point, the overall process for tax reform in 2017 has not taken shape nor has any detailed legislative proposal been made public. Nevertheless, House leadership has met with the House Ways and Means Committee, and it is aggressively moving forward with efforts to develop legislative language for tax reform. The centerpiece of this legislation will undoubtedly be a broad-based reduction in tax rates, an important policy objective shared by both the House Republicans and President Trump.

Although a detailed legislative proposal has not yet been made public, it is reasonable to expect that the public process for tax reform will start not long after President Trump's inauguration. In anticipation of what the House Ways and Means Committee is presently drafting as legislative proposals, it is appropriate for real estate professionals to carefully review and consider prior iterations of tax legislation since they are a likely and readily available source for current proposals.

The House Republican Blueprint for tax reform[2]

	Blueprint proposal
Top corporate tax rate (now 35%)	**20%, corporate AMT eliminated**
Top pass-through rate (now 39.6%)	25%
Taxation of future foreign earnings	Territorial; 100% exemption for dividends paid from foreign subsidiaries; border adjustment
Mandatory tax, untaxed accumulated foreign earnings	8.75% for cash/cash equivalents, 3.5% otherwise, payable over eight years
Cost recovery	100% expensing: tangible, intangible assets (except land)
Interest	No current deduction will be allowed for net interest expense
Other business provisions	Generally eliminated, except for R&D credit and LIFO
Individual rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)	12%, 25%, 33%
Capital gains and dividends	50% deduction for capital gains, dividends and interest
Carried interest	Not addressed
Estate tax (now 40% rate, $5.45m exemption)	Repealed
State tax deduction	Eliminated (for individuals)
Charitable contribution deduction	Retained, but could be modified
Home mortgage interest deduction	Retained, but could be modified

Many expect that the House Republican tax reform Blueprint (the Blueprint) will be a starting point for tax reform legislative language. While not a legislative draft, the Blueprint, which was released in June 2016, outlines a revenue-neutral approach to tax reform that is intended to spur economic growth. Not surprisingly, the most significant aspect of the Blueprint is a broad-based reduction in tax rates. The Blueprint pays for this rate reduction by eliminating special-interest deductions and credits.

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2 This document was published by the House of Representatives Republican Tax Reform Task Force on 24 June 2016, under the title *A Better Way — Our Vision for a Confident America*.

Broadly speaking, the Blueprint calls for a reduction in the top corporate tax rate from 35% to 20%. Individuals would also see a significant reduction in rates. Under the Blueprint, individuals would be subject to tax rates of 12%, 25% and 33%, depending on their income level. Active income received from pass-through vehicles and sole proprietorships would be subject to a maximum 25% tax rate. Passive investment income (e.g., net capital gains, dividends and interest) would qualify for a 50% exclusion, meaning that individuals would be taxed on such income at graduated tax rates of 6%, 12.5% and 16.5%.

The changes proposed by the Blueprint go beyond just tax rates. Of particular importance, the Blueprint calls for a potentially significant tax benefit in the form of full and immediate business expensing of investments in all tangible, intangible and real property (other than land). At the same time, the Blueprint proposes to eliminate deductibility of net interest expense, which would constitute a repeal of a very significant business tax benefit. The Blueprint also contains other noteworthy proposals that should be monitored. For example, the Blueprint proposes to eliminate Alternative Minimum Tax (AMT) for corporations (as well as for individuals) and would allow net operating losses (NOLs) to be carried forward indefinitely (subject to certain adjustments and limitations), increased by an interest factor. Finally, the tax increases that were part of the Affordable Care Act (the ACA), such as the 3.8% tax on net investment income, the 0.9% payroll tax, the medical device excise tax and other industry-specific tax increases, are also at risk of repeal, although perhaps not immediately, as part of Republican efforts to repeal the ACA.

On the international front, the Blueprint would move to a territorial tax system and provide a 100% exemption for dividends paid from the future active earnings of foreign subsidiaries. An 8.75% tax rate would be imposed on previously untaxed accumulated foreign cash or cash-equivalent earnings, and a 3.5% tax rate would apply to all other accumulated foreign earnings, payable over eight years. The Blueprint also outlines a destination-basis system in which export sales would be exempt from tax and imported "inputs" would not be deductible. While many countries use border adjustments in connection with their value-added taxes, the World Trade Organization prohibits such adjustments as part of an income tax regime; meaning, if enacted, this proposal could be subject to challenge.

Importantly, no revenue estimates were included with the Blueprint. It is, however, intended to be both pro-growth and revenue-neutral (i.e., not increase the deficit). To arrive at this position, the Blueprint relies on several key revenue assumptions. It uses a revenue baseline that assumes current tax policies will be permanently extended. By relying on this assumption, it is estimated that at least $400b of the 10-year cost of the plan can be eliminated because the baseline incorporates permanent extension of the tax provisions that were extended temporarily in last year's legislation. The Blueprint also includes positive revenue effects that its drafters assume will arise from the economic growth they expect from this change in tax policy.

The Camp Plan: a precursor to the Blueprint[3]

In February 2014, then-House Ways and Means Committee Chairman Dave Camp released as a discussion draft a comprehensive proposal for tax reform (the Camp Plan). When it was issued, the Camp Plan was the product of three-plus years of work from the Chairman and his staff and, like the Blueprint, embraced the many trade-offs necessary to significantly lower tax rates, a critical component of realizing economic growth associated with tax reform. Given the similarity of their policy objectives, many believe the Camp Plan to be a precursor of the Blueprint and a ready source of potential tax reform legislative language.

Like the Blueprint, tax rate reduction is the cornerstone of the Camp Plan, along with the curtailment or outright repeal of tax deductions and credits. Under the Camp Plan, the top corporate tax rate would have been reduced from 35% to 25% over a five-year period. The Camp Plan would have repealed the corporate AMT while also providing a limited refund opportunity for pre-existing AMT credits.

Individuals would have also seen a reduction in tax rates under the Camp Plan. Had it been enacted, individuals under the Camp Plan would have seen lower rates that included 10% and 25% brackets. High-income earners would have been subject to an additional 10% surtax, for a maximum tax rate of 35%. Although capital gains and dividends received by individuals would have been taxed at ordinary income rates under the Camp Plan, the plan would have excluded 40% of capital gains and dividends from taxation (with the exclusion applying to all rates, including the 10% surtax). On the individual front, the Camp Plan did not stop at rates. It also proposed significant changes to the calculation of an individual's adjusted gross income and would have changed the standard deductions and the types and amount of expenses that could be itemized.

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3 David Camp, then in his role as House Ways and Means Committee Chairman, released this document on 26 February 2014, as a discussion draft for comprehensive tax reform.

The Camp Plan also proposed changes to the manner in which businesses recover the cost of investments in business assets. Unlike the Blueprint, the Camp Plan proposed to repeal and replace accelerated depreciation with rules substantially similar to the alternative depreciation system. This would have resulted in longer class lives and the use of the straight-line method. The Camp Plan would also have curtailed bonus depreciation for restaurant and retail properties and would have revised Section 179 expensing for smaller taxpayers. The ability of a business to deduct other expenditures would have also been affected under the Camp Plan. Research and development expenditures, amortization of intangible assets, advertising expenditures and expenditures presently eligible for deduction under Section 199 would have all been subject to significant revision. The number and amount of business credits presently available would have also been reduced under the Camp Plan.

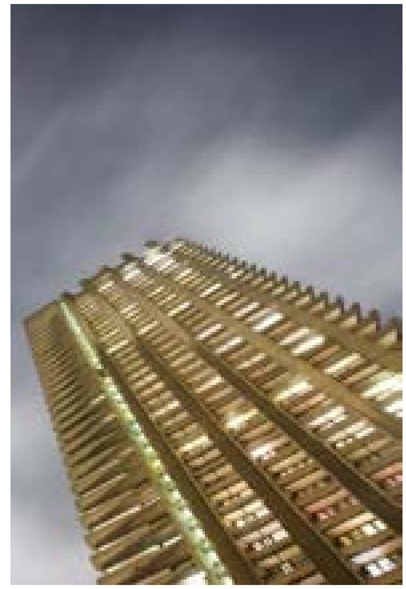
The Camp Plan also contained a number of proposals that would have affected partnerships and flow-through entities. For instance, under the Camp Plan, certain partnership interests held in connection with the performance of services (i.e., carried interests) would have been subject to a rule that characterizes a portion of any capital gains as ordinary income. The rules applicable to carried interests would have also applied to partnership distributions and dispositions of such interests. Importantly, real property partnerships would have been carved out of the rule. The Camp Plan proposed a number of other changes to partnerships that would have affected guaranteed payments and liquidating distributions, required mandatory basis adjustments in certain instances, made changes to the rules governing unrealized receivables and inventory items and limited the exception for publicly traded partnerships to mining and natural resource partnerships. The Camp Plan also contained a number of real estate investment trust (REIT) proposals, many of which were enacted as part of the Protecting Americans from Tax Hikes (PATH) Act.

Ten-year revenue estimates for the Camp Plan[4]

	Camp plan (2014–2023)			
Provision description	*Pass-through businesses*	*Domestic C corporations*	*Multinational corporations*	*Total*
	10-year revenue impact ($billions)			
Rate reduction	(362)	(203)	(478)	(1,043)
AMT repeal	(166)	(58)	(52)	(276)
Rate reduction and AMT repeal	(528)	(261)	(530)	(1,319)
Reform accelerated cost recovery system	121	92	57	270
Industry-specific provisions	25	69	147	241
Amortize R&E expenditures	3	37	153	193
Amortize certain advertising expenses	51	64	54	169
Repeal domestic production deduction	33	39	44	116
Disallow inventory accounting methods	11	38	34	83
Limit use of NOLs	-	39	32	71
International provisions	-	-	68	68
Limit corporate interest deduction	-	-	-	-
Modify R&D credit	-	(7)	(27)	(34)
Other provisions	50	76	68	194
Base-defining provisions	294	447	630	1,371
Total change in tax liability	(234)	186	100	52
Percentage change in tax liability	(8%)	14%	3%	1%

4 See the October 2014 edition of Ernst & Young LLP's *Tax Insights* column titled "Industry analysis of revenue effects of Camp and Wyden-Coats tax reform plans."

On the international front, the Camp Plan proposed a number of substantive changes to the international tax regime. Many of these proposals mirrored those in Camp's October 2011 international tax draft. Like the Blueprint, the Camp Plan contained provisions that focused on the foreign earnings of US companies. Specifically, the Camp Plan proposed that all US shareholders with a 10% or greater interest in a foreign corporation be subject to a one-time transitional tax on their pro rata share of the foreign corporation's post-1986 tax-deferred earnings. This tax could be paid over eight years and would be determined using an 8.75% tax rate in the case of accumulated earnings held in cash, cash equivalents or certain other short-term assets, or 3.5% in the case of accumulated earnings invested in property, plant and equipment. An affected US shareholder with a 10%-or-greater stake in a foreign corporation with a post-1986 accumulated deficit would be able to offset the deficit ratably against tax-deferred earnings of other foreign corporations. The Camp Plan also would have exempted 95% of the foreign-source portion of dividends received by a US corporation from a foreign corporation in which the US corporation owns at least a 10% stake. No exemption would have been provided for income of foreign branches. The Camp Plan also included a number of other international proposals, ranging from new anti-base erosion provisions to changes to the existing foreign tax credit and Subpart F regimes, as well as changes to the international thin-capitalization provisions.



The Trump tax plan: an evolving perspective[5]

Over the course of the campaign, President Trump offered a brief perspective on what tax reform might look like if he were to become President (the Trump Plan). From a high-level policy perspective, the Trump Plan is consistent with the Blueprint and the Camp Plan insofar as the most significant aspect of the Trump Plan is a reduction in tax rates coupled with the elimination of special-interest deductions and credits. Under the Trump Plan, individual income tax rates would be 12%, 25% and 33%, the same as those proposed by the Blueprint. The Trump Plan differs from the Blueprint, however, with respect to the tax rate applicable to corporations and on income from pass-through entities. In each such instance, the Trump Plan calls for a 15% tax rate, which is lower than the rate proposed under the Blueprint or the Camp Plan. The Trump Plan also calls for repeal of the AMT for corporations and individuals. Although the Trump Plan calls for the repeal of the estate tax, Trump has proposed that unrealized capital gains over $10m that are held at death would be subject to tax, although it is unclear under the Trump Plan when or how that tax would ultimately be assessed and collected.

With respect to immediate expensing for investment in business assets and interest deductibility, the Trump position is less well-defined. Initially, Trump as candidate did not propose anything specific regarding immediate expensing. In fact, it wasn't until the release of the last version of his tax plan that Trump indicated support for immediate expensing, which, unlike under the Blueprint, would be elective and limited to manufacturers; for those manufacturers making this election, the deduction for corporate interest expense would be lost. In terms of changes to the international tax regime, the Trump Plan is similarly vague. However, Trump and his staff have expressed support for a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies.

Considerations and questions for real estate

Ambitious tax rate reduction appears to be the common objective of the Blueprint, the Camp Plan and the Trump Plan. This objective and the House leadership's desire for deficit-neutral tax reform make it highly likely that the House tax reform bill will aggressively broaden the tax base by eliminating or significantly curtailing credits, deductions and other preferences. Toward that end, it is reasonable to expect that the House bill will initially approach tax reform from the Blueprint's vantage point. Beginning the legislative process with the House Ways and Means Committee and wary of negotiating with themselves, House leadership is expected to leave virtually no preference untouched, perhaps going even further than the changes proposed in the Camp Plan.

Notwithstanding that the legislation will likely evolve through compromise as it moves through the House to the Senate and then to the White House, real estate companies and professionals should take time now to identify and consider those tax reform proposals that may affect their real estate businesses.

[5] A discussion of Trump's Plan can be found at https://www.donaldjtrump.com/policies/tax-plan.

Macro-level issues and considerations

Both the breadth and specific focus of the various tax reform proposals elicit a number of macro-level issues for the real estate industry. To illustrate a few, consider the following:

Tax rate reduction and choice of tax status: Relative to other industries, real estate has historically made very good use of tax-efficient vehicles, including REITs and partnerships, to achieve a single layer of taxation. In fact, in many instances, taxpayers have been willing to accept a heightened degree of tax complexity to realize this tax-efficiency. A significant reduction in tax rates could affect the cost/benefit analysis of more complex structuring to achieve tax efficiency.

For example, the proposed reduction in tax rates could affect a corporation considering a conversion to REIT status. While each conversion situation is different and each company has its own set of facts and drivers, some of the reasons typically cited when making the decision to convert to REIT status include, but are not limited to, access to efficient capital markets, overall cost of capital and a reduced tax burden. If corporate and individual tax rates are significantly reduced such that the tax cost of operating in corporate form becomes closer to that of operating as a REIT, then at least one factor in the calculus will have changed for a company considering a conversion to REIT status in the future.

Immediate expensing and the velocity of the transaction market: For many companies and investors, real estate is one of the largest and most valuable assets they own. In the event that the immediate expensing provision does, as proposed by the Blueprint, include real estate (other than land), one can easily foresee an incentive to purchase real estate, thereby increasing in the number and speed of real estate transactions.

To illustrate this point in its simplest form, a taxpayer with $200m in unexpected taxable income may decide to acquire (or simply accelerate the acquisition of) $200m of real estate in an effort to avoid a $40m tax liability. In addition, public companies such as retailers that own a substantial amount of real estate and have chosen not to engage in a sale/leaseback of such property due to the tax liability associated with the sale may reconsider that decision, assuming they have other capital expenditures that would offset the gain. Given the number of other variables in play at this juncture (e.g., elimination of net interest, tax rate reduction, a rising interest rate environment), it is difficult to determine the full impact that this change could have and whether it could cause the real estate transactions market to become overheated and diverge from its underlying fundamentals.

Elimination of net interest deduction: Real estate is, by its nature, both capital intensive and illiquid. Thus, leverage and the ability to deduct interest have always been important to the industry. The inability to deduct interest would undoubtedly have a major impact on the manner in which real estate transactions are priced and capitalized. For example, a REIT that is moderately or highly leveraged (relative to its peers) may be particularly sensitive to this proposed change. If such a REIT is not acquisitive and, therefore, unable to take full advantage of the proposal calling for full expensing of business investment, then the cash flow impacts of the elimination of net interest could be severe. This is because, in addition to paying the interest cost directly to its lenders, the REIT's taxable income would be increased by the amount of the interest cost that is no longer deductible, and, absent any further legislative proposals, the REIT would have to distribute to its shareholders 90% of this increase in taxable income in order to maintain its REIT status. Because only net interest expense is disallowed, this change generally will not adversely affect mortgage REITs.

The lack of an interest deduction could provide an incentive for companies to lease rather than own real estate (as the rental payment is fully deductible, including the implicit time-value-of-money component), although this benefit would have to be weighed against the ability to immediately expense the cost of the building.

Border adjustments: One might easily dismiss the potential impact on the US real estate industry of the proposed changes around border adjustments. While the full impact of this proposal is difficult to predict, in the short term, the cost of materials (such as steel, lumber and other raw materials) that are used in real estate construction could be directly affected by these proposals, depending on whether they were produced in the US or abroad. Similarly, these proposals could drive higher costs and lower margins for industries that rely heavily on imports, such as the retail industry. Many of these companies lease their locations, meaning the additional pressure they might feel as a result of the border adjustment proposals could translate into indirect but meaningful pressure on the owners of that real estate.

Mortgage interest and other housing incentives: As noted previously, the elimination or significant reduction of a wide array of tax preferences, credits and deductions is the means to achieving broad-based tax rate reduction. Both the Blueprint and the Camp Plan propose to retain, but curtail, the mortgage interest deduction. The Camp Plan also proposed significant reductions to the exclusion for gain from the sale of a principal residence as well as an outright repeal of first-time homebuyer credit. These proposals, if enacted, could present significant head winds for the homebuilding industry, which has historically fought hard to preserve these preferences. The effect of the possible head winds felt by homebuilders could potentially be magnified if the Federal Reserve raises interest rates at or around the same time. Conversely, a reduction in the tax benefits associated with home ownership could benefit multi-family REITs.

Specific issues and considerations

In addition to the macro-level issues mentioned earlier, there are a number of specific questions and issues relating to tax reform proposals that may be relevant to the real estate industry. A small sample of specific questions follows:

- How would the 25% pass-through tax rate be applied? Would it apply to all types of partnerships and all types of partners? Would it apply to all types of income earned by the partnership (e.g., rental income or dealer income)? To what extent would the tax rate applied to a specific partner depend on the level of that partner's involvement in the partnership's business? Would the tax be imposed at the partnership level rather than the partner level (to ensure that the 25% tax rate is appropriately limited to eligible partnership income)?

- Would tax reform change the way carried interest is taxed and, if so, in what way? Both the Trump and Camp Plans proposed to tax all or a portion of the income attributable to a carried interest as ordinary income. The Camp Plan, however, exempted real estate partnerships from such treatment.
- Would REIT dividends (both ordinary and capital) qualify as dividends that are eligible for the 50% income exclusion for interest, dividend and capital gains? If ordinary dividends are not eligible for this preference, would they be eligible for the 25% rate to the extent they are attributable to rental income? Would the earnings and profits ordering rules, which are important for REITs, be modified to adjust for timing differences that could arise as a result of immediate expensing?[6]
- Would capital gain recognized from the sale of non-dealer real estate, as opposed to capital gain from the sale of stock, be eligible for the 50% income exclusion for interest, dividend and capital gains?
- Would the gain deferral rules of Section 1031 be completely or partially repealed? Would any such repeal extend to all types of real estate and segments of the real estate industry? How detrimental would a repeal be for REITs that have tax protection agreements in place in connection with their operating partnerships?
- To what degree would loss limitation provisions be retained, revised or repealed? A small sample of such provisions include (i) the Section 469 passive activity loss rules, (ii) the Section 465 at-risk rules, (iii) the Section 267 and 707 related-party loss rules, and (iv) the mandatory partnership basis adjustment rules of Sections 704(c)(1)(C), 734(d) and 743(d).
- How would the revisions to the estate tax proposed by Trump affect how long people hold interests in real estate partnerships, including REIT operating partnerships?
- In light of the proposal to immediately expense certain types of business assets, would the depreciation recapture rules of Sections 1245 and 1250 be repealed, retained or revised, and, if revised, revised in what manner? Similarly, would new anti-churning rules or related-party transaction rules be required?
- How would the partnership allocation and basis rules (including Sections 704 and 752) be affected, if at all, by the proposal to immediately expense certain types of business assets?

[6] Section 320(a) of the PATH Act revised Section 857(d) and the REIT E&P rules in an effort to prevent REIT shareholders from being taxed on the same income twice as a result of timing differences that existed for purposes of calculating certain items for E&P and taxable income.

- Will the Foreign Investment in Real Property Tax Act (FIRPTA) be completely repealed or will it simply be revised further (e.g., additional clarifications to the recently enacted exemption from FIRPTA for interests held by qualified foreign pensions)? If FIRPTA is repealed or substantially modified, how will those changes affect the manner in which foreign investors structure their investments in US real estate?
- Given the enormity of the potential changes, what form will the rules around effective dates and transition rules take? For example, will all or some of the tax rate reductions be effective in calendar year 2017? Will there be a transition period for the limitation on net interest deductibility? To what extent will taxpayers be able to immediately deduct the remaining tax basis in their existing business assets?

The foregoing list is a very small sample of some of the specific questions arising from the various tax reform proposals. What is clear, however, is that the answer to any of these questions (as well as other discrete questions not presented) will significantly affect the real estate industry. Accordingly, professionals in the real estate industry should be mindful of the various provisions and keep a close tab on developments as the legislative process moves forward from here.

The legislative process and potential timing

The legislative process will begin with the House Ways and Means Committee producing a bill for consideration by the House. Once a bill is introduced, it will then have to be passed by the House before it can move on to the Senate and, ultimately, to the White House.

The Republicans anticipate that there will be little or no Democratic support on tax reform. Given the disparate views, many expect the Republicans to use the budget reconciliation process to pass tax reform legislation. While the reconciliation process may be a path of lesser resistance than regular order, 51 votes are still needed required in the Senate in order to pass the bill (or 50 votes with Vice President Pence breaking the tie). In other words, every Senate Republican will be pressed by Republican leadership to support the tax reform bill once in the Senate. Whether Senate Majority Leader McConnell is able to deliver the entire Republican caucus or needs support from a handful of Democrats will depend, in large part, on his ability to compromise on a handful of limited issues. Expect Senate Majority Leader McConnell to make those deals once he believes that passing legislation that enacts comprehensive pro-growth tax reform is within reach.

A timeline for tax reform legislation

- **Early January:** House and Senate consideration of the FY17 budget resolution that includes repeal of the ACA. Senate expected to act first. House Ways and Means Committee Republicans form informal tax reform working groups.

- **January into March:** Once the FY17 budget resolution is finalized and passed, House and Senate committees will begin crafting reconciliation legislation to reduce the deficit by the amount specified in the budget resolution. If House and Senate approve reconciliation legislation with ACA repeal included, it goes to the President for signing. Meanwhile, the House Ways and Means Committee develops tax reform legislation.
- **March:** If/after the FY17 reconciliation process is complete, budget committees begin the FY18 reconciliation process and consider a FY18 budget resolution that directs Congress to enact tax reform under expedited procedures.
- **March into April:** If FY18 budget resolution is approved, the House Ways and Means Committee can act on tax reform in response to reconciliation instructions.
- **April through May:** Reconciliation legislation (including tax reform) moves through the House; Senate may consider the House's tax reform legislation before passing its own version.
- **June through September:** Differences between House and Senate tax reform legislation would need to be addressed, likely in conference committee, before a final vote in both chambers.

At this point, perhaps the only thing about tax reform that is truly certain is that the bill that ultimately reaches the President's desk will be far different than any bill initially produced and passed by the House. In fact, many observers familiar with the legislative process believe that the final tax reform bill that will be signed by the President will be, in large part, written either in the Senate or in a Conference Committee following House and Senate passage of their respective tax reform measures.

It should come as no surprise that this entire process may take the better part of 2017, notwithstanding what appears to be a unanimous desire on the part of the Republicans for comprehensive tax reform.

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