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Tax Reform and Real Estate: Impact of the Tax Cuts and Jobs Act on Real Estate

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In brief

Today, President Donald Trump signed the "Tax Cuts and Jobs Act" (TCJA or Act) that lowers business and individual tax rates, modernizes US international tax rules, and provides the most significant overhaul of the US tax code in more than 30 years.

On December 20, Congress gave final approval to the House and Senate conference committee agreement on the Act, which reconciles differences in the versions of the TCJA previously passed by both the House and Senate. The text of the final bill closely resembles what was already passed by the Senate and maintains key provisions such as permanent reduction in corporate tax rates as well as temporary tax relief for pass-through businesses and individuals.

There are a variety of provisions in the TCJA that are expected to be particularly impactful on the real estate industry and these are addressed in more detail below. For background and a detailed discussion of the broader impact of the TCJA, please see PwC's Tax Insight, Congress give final approval to tax reform conference committee agreement. PwC's Tax Policy team also offers tax reform insights as part of its Inside Tax Policy series. For more information and to subscribe to a free two week trial of Inside Tax Policy, please see Inside Tax Policy: Watch policy unfold.

In detail

Business interest deductibility - Exceptions applicable to real estate

While the TCJA limits the deductibility of a taxpayer's net interest expense to 30 percent of its taxable income with certain adjustments, a real property business may elect to be exempted from the limits. A real property business includes a real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. The conference report indicates that it is intended that a real property business includes the operation or management of a lodging facility.

There are some questions regarding the scope of the type of real estate businesses. For example, it is not clear how real property would be defined for purposes of the provision and the extent to which a taxpayer would be subject to the interest limitation if it engages in both real estate and other activities. In addition, it is not clear whether real estate activities undertaken by a subsidiary entity would be attributed to its owner if the owner borrows money to finance the operations of the subsidiary.

In addition to the exception for a real property business, the interest deductibility limits in the TCJA also generally do not

apply to taxpayers with annual gross receipts of less than $25 million. The gross receipts of certain related taxpayers will be combined for purposes of determining if the gross receipts are less than $25 million.

To the extent a business is subject to the interest deductibility limits, the TCJA allows the disallowed interest to be carried forward indefinitely. The changes are effective for taxable years beginning after December 31, 2017.

Observation: Taxpayers may want to restructure the entities that engage in operations and are borrowers for a variety of reasons. For example, borrowers that hold interests in entities that engage in real estate activities will want to consider whether restructuring would be needed so that the borrowing is undertaken by the entity engaged in the real estate activities. In addition, to the extent a borrower is not in a real estate business (or elects to not be treated as being in a real estate business) there may be limits on the ability of taxpayers to use the income of one entity to increase the allowable interest deductions of another entity.

Observation: Proper alignment of the interest expense with the legal entity engaged in real estate may also be relevant in states that impose corporate income tax on a separate company basis. In evaluating whether to restructure to ensure qualification as a real estate business, careful consideration of the potential indirect tax costs is necessary, including real estate transfer tax and property tax reassessments, as well as whether the entity qualifies as a "financial institution" for state income tax purposes. To the extent states adopt the 30 percent limitation, they may choose to apply the limitation to "state taxable income" rather than "federal taxable income," in which case the amount deductible could vary. Since many states already limit certain types of interest expensing, it's not yet clear how these provisions would co-exist. For example, many states require interest paid to a related party to be added back in computing state taxable income. Given the potential 30 percent limitation, businesses may need to reassess intercompany debt.

Observation: A real property business must elect to be exempt from the interest limitations discussed above. However, as noted below, there is a cost to the election as the business must utilize the alternative depreciation system (ADS) for its real property, which may lengthen the depreciable lives for certain taxpayers. Rules regarding the election are to be prescribed by the Secretary. Taxpayers will want to consider whether they should make the election.

Observation: If states conform to the election under the TCJA, questions could arise as to whether taxpayers may make state-only elections. Differences in election status for federal versus state purposes and across legal entities in separate filing states may further complicate state depreciation tracking. In addition, while the disallowed interest may be carried forward indefinitely for federal purposes, states may impose carryforward limitations. A state that conforms to the carryover provisions would need to enact rules to determine whether the carryover would be applied on a pre- or post-apportionment basis.

Expensing of assets

Bonus depreciation

The TCJA generally provides for immediate expensing by changing the deduction for assets eligible for bonus depreciation so that 100 percent of the cost of those assets can be taken in the year of acquisition. However, the percentage of a purchase eligible for immediate expensing declines for certain assets beginning in 2023 and is phased out by 2028.

The ability for real property businesses to utilize the immediate expensing will be limited. As a general matter, land and buildings are not eligible for bonus depreciation. Further, although certain improvements to the interior to nonresidential real property made after an acquisition may be eligible for immediate expensing, the ability to utilize immediate expensing would not be available if the entity makes an election to treat the business as a real property business to be exempt from the interest deductibility limits.

The new bonus depreciation provisions generally are effective with respect to property acquired after September 27, 2017 and placed in service after that date.

Observation: Given that the effective date for the bonus depreciation provisions applies to some property placed in service in 2017, which is before the effective date of the interest expense limitations, there may be more latitude for businesses that elect to be a real property trade or business in 2018 to utilize immediate bonus depreciation provisions in 2017.

Asset life of real property

Although the Senate Bill had reduced the depreciable life of real estate assets to 25 years, the TCJA does not include that change. However, the TCJA reduces the ADS life of residential real property to 30 years. It also appears, according to the Conference Report, that the TCJA intended to provide that the useful life of qualified improvements would generally be 15 years. However, the language in the text does not appear to accomplish this objective.

The TCJA does increase the scope of property eligible to be treated as a qualified improvement. Under current law, it covers qualified leasehold improvements, qualified restaurant improvements and qualified retail improvements. The TCJA revises the definition to cover all improvements to the interior of nonresidential real property other than expenditures attributable to the enlargement of the building, elevators and escalators and the internal structural framework of the building.

However, the TCJA requires ADS for real property and qualified improvement of an entity that elect to be treated as a real property business, which a taxpayer would do if the businesses did not want to be subject to the interest deduction limitations.

These changes in the TCJA are generally scheduled to apply to property placed in service after December 31, 2017. However, the change that requires ADS for real property businesses that elect to be exempt from the interest limitations is scheduled to apply to taxable years beginning after December 31, 2017 without regard to when the property was placed in service.

Observation: A business that currently utilizes the general MACRS depreciation lives and elects to be treated as a real property business may have longer useful lives under the TCJA than they do today as they would be required to use ADS. It is not clear how ADS would work with respect to assets that were placed in service prior to December 31, 2017.

Observation: Since most states already decouple from or modify accelerated depreciation lives, we expect continued nonconformity in this area. Given full expensing for federal purposes, businesses should consider the need to track depreciation for state purposes only.

Additional expensing

Under current law, businesses can deduct up to $500,000 of qualifying property, although the eligibility for the deduction is reduced to the extent the amount of qualified property exceeds $2 million. From a real estate perspective, qualifying property includes certain improvements to real property: qualified leasehold improvements, qualified restaurant improvements and qualified retail improvements.

The TCJA increases the cap from $500,000 to $1 million and the amount of purchases at which the phase-out begins is increased from $2 million to $2.5 million.

The TCJA also allows a taxpayer to elect to expand the property eligible for the expensing all improvements to the interior of nonresidential real property (other than expenditures attributable to the enlargement of the building, elevators and escalators and the internal structural framework of the building) and to certain other improvements to nonresidential real property (roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems). The TCJA also repeals an exclusion that applied to certain lodging facilities.

The changes are scheduled to apply to property placed in service in taxable years beginning after December 31, 2017.

Like-kind exchanges

While the TCJA generally eliminates like-kind exchanges, it preserves like-kind exchanges for real property.

Observation: While like-kind exchanges have been preserved for real property, taxpayers exchanging real property will still need to consider the implications of any personal property transferred with real property.

The changes to like-kind exchanges generally apply to exchanges completed after December 31, 2017. However, there is a transition rule for property disposed if one leg of the exchange is completed in 2017.

Carried interest

The TCJA provides that a partner who receives a carried interest in exchange for certain specified services, including investment management, is only eligible for long-term capital gains with respect to the carried interest derived from capital assets that the partnership has held for at least three years. This would mean that partnerships that hold interests in REIT stock or real estate as an investment (as opposed to an asset used in a trade or business) must hold the real estate or the REIT stock for at least three years for a partner that has a carried interest to benefit from the lower long-term capital gains rates on the carried interest's portion of the gain from the sale of REIT stock or real estate. The ACJA has an exception for partnership interests that are capital interests for which the right to share in income is commensurate with the amount of capital contributed by the partner.

The carried interest provisions are scheduled to be effective for taxable years beginning after December 31, 2017.

Observation: REITs that issue OP units to employees under and LTIP (long-term incentive plan) program will need to consider the implications of the carried interest provisions, as well.

Observation: In the last two years we have seen increasing interest by state legislatures to impose significant surcharge taxes on carried interest. New York, New Jersey and, most recently, Illinois, have all introduced bills to varying degrees of success (though none have become law) to

impose a 19-20 percent tax on such income. While we may see a continued interest to reintroduce these bills to generate additional revenue for states and allow the state legislatures to claim their own version of tax reform, the landscape may be more difficult with the loss of so many state tax deductions.

Treatment of business income

The TCJA provides a new deduction of 20-percent of business income. For this purpose, unless the income of the taxpayer does not exceed certain thresholds, business income would not include income from an activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, trading or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more employees including businesses that deal in securities, partnership interests, or commodities.

The ability to take a deduction for business income is limited for taxpayers above certain thresholds to the extent of W-2 wages and tax basis of the assets used in the business. Specifically, the TCJA provides that the business income deduction will only be allowed to the extent that the deduction does not exceed the greater of (i) 50-percent of the partner's share of the W-2 wages, elective deferrals and deferred compensation of the partnership made to the business' employees or (ii) half of the amount included in (i) plus 2.5-percent of the unadjusted tax basis of the depreciable assets used in a business. The unadjusted tax basis is the tax basis of the assets at the time of the acquisition but is only included during the applicable life of the property under the general MACRS rules. In other words, after 39 years (27.5 years for residential real property) the basis of a building will no longer be included in the calculation. Since land is not a depreciable asset, basis in land will not increase the amount of business income that can be deducted (although it is hard to understand why the basis from land should be excluded from a policy perspective).

Observation: The TCJA clarifies that the 20-percent deduction is not allowed in computing adjusted gross income but instead is allowed as a deduction reducing taxable income. Since most states adopt adjusted gross income as their starting point for determining the tax base for individuals, conformity issues arise. Taxpayers are advised to consider the differing starting points for determining the state tax base.

These provisions are to be effective for taxable years beginning after December 31, 2017 and are set to sunset for taxable years beginning after December 31, 2025.

REIT dividends

The TCJA effectively treats REIT ordinary dividends as business income. Therefore, 20-percent of REIT ordinary dividends would be deductible. The limitations described above for business interest deduction with respect to particular business and with respect to the need for the business to have sufficient W-2 wages or adjusted basis in its assets to support the deduction do not apply to REIT dividends.

The relevant provisions are to be effective for taxable years beginning after December 31, 2017 and are set to sunset for taxable years beginning after December 31, 2025.

FIRPTA - Taxation of non-us holders of real estate

The TCJA does not make any material changes to FIRPTA, which affects the taxation of non-US investors in US real estate.

Observation: While the FIRPTA rules would not be materially revised, many non-US investors in US real estate would see significant rate reductions under the TCJA. Since the FIRPTA rules effectively subject non-US persons to US taxation on sales of US real property interests, the lower rates for US taxpayers also would apply to non-US persons.

Changes for tax exempt investors

The TCJA provides the loss from one unrelated trade or business cannot be used to offset income from another unrelated trade or business for purposes of calculating a tax exempt organization's unrelated business taxable income (UBTI). It is not clear to what extent different real assets will be treated as different businesses under this provision. Therefore, tax exempt investors, and entities in which they invest, will need to consider they need to report the activities from different properties separately.

This provision generally applies for taxable years beginning after December 31, 2017. However, the TCJA specifically provides that tax exempt organizations will be able to utilize pre-2018 net operating losses to offset its unrelated business taxable income in future years.

While the House Bill provided that the tax on UBTI would apply to all entities exempt from tax under Section 501(a) notwithstanding the entity's exemption under any other section of the Code, the TCJA did not include such a provision.

Observation: The description in the summary of the House bill referred to this change as a clarification. As a result, even though this provision is not in the TCJA, state pension plans may be more likely to take into account a risk that they are subject to UBTI for purposes of making investments.

Observation: With an increased focus on the taxation of UBTI, this will affect how funds deal with exemptions from state pension plans for withholding, and state pension plans may pay closer attention to states with a regime to tax UBTI.

Home mortgage interest deduction

Under the TCJA, the loan size eligible for the mortgage interest deduction is reduced from $1 million to $750,000 (for married filing jointly) for interest incurred for taxable years beginning in 2018 through 2025 on mortgages incurred after December 15,2017. The TCJA also provides that no interest would be deductible on a home equity loan for taxable years beginning between 2018 and 2025.

Observation: There may be some pressure at the state level to keep certain popular deductions, at least in higher tax states where the price of real estate is more expensive (e.g. California, New York).

State tax deductions

The TCJA revises the state and local income and sales tax itemized deductions for noncorporate taxpayers and limits the itemized deduction for non-business and non-investment state and local tax deductions to $10,000 for property taxes and either income or sales taxes. With the limitation on the deduction of state and local taxes, many taxpayers had considered prepaying 2018 state and local income taxes before year end. The TCJA contains a provision that eliminates the ability to deduct any such prepayments. Taxpayers may still consider the prepayment of property taxes.

The changes related to the deduction of state and local taxes are effective for taxable years beginning between 2018 and 2025.

Observation: With the state and local income tax deduction to be significantly reduced there may be increased pressure to reduce individual income taxes. The New York State Senate has already introduced a bill providing a credit equal to the amount of additional tax an individual pays as a result of tax reform.

Rehabilitation, historic and low income housing tax credits

The TCJA repeals the general rehabilitation tax credit but retains the historic tax credit. The Act has a transition rule that applies for properties owned or leased by the taxpayer as of December 31, 2017 and for which the 24 month period selected by the taxpayer to cover expenses by the credit (or the 60 month period if applicable under the statute) must begin not later than 180 days after enactment.

The TCJA did not make dramatic changes to the Low Income Housing Tax Credit (LIHTC). However, the TCJA did change the name of the credit to the Affordable Housing Credit and made other modifications.

Observation: Although the LIHTC was not materially modified, the reduction in corporate tax rates is expected to reduce demand for corporate investors in LIHTC transactions.

Observation: Although the House Bill had repealed the income exclusion for private activity bonds, this was not included in the TCJA. This is important for transactions that utilize LIHTC as these transactions often rely on private activity bonds.

Net operating losses (NOLs) and loss limitations

The TCJA limits a taxpayer's ability to utilize its net operating loss deduction to 80 percent of taxable income (determined without regard to the deduction). For REITs, the limit is applied against real estate investment trust taxable income, determined without regard to the deduction for dividends paid. In addition, the TCJA eliminated NOL carrybacks but made NOL carryforward in perpetuity.

This new 80% limit applies for losses and net operating losses arising in taxable years beginning after December 31, 2017.

Observation: While unused NOLs generally carry over, corporations that recognize significant gain in a year of liquidation may not be able to use all of its NOLs to offset taxable income and there will not be future taxable years to carry over the benefit. This might mean that a corporation that has prior depreciation deduction that was not used to offset income in prior years, might result in an effective 20 percent tax on the deduction.

Observation: Limitations on the NOL deduction have been used by states in recent years to address budget deficits. Thus, the federal limitation should be considered in conjunction with any state limitations. States which either do not follow the IRC rules or which conform to them as of a specific date would presumably not be affected by this change. Nevertheless, this could cause further disparities in taxable income between federal and state which will likely continue to raise questions about disparities in real estate investment trust taxable income at the federal and state level.

Contribution to capital

Under current law, contributions to the capital of a corporation are not included in the income of a corporation. The TCJA provides that contributions to capital do not include contributions in aid of construction or any other contribution as a customer or potential customer or any contribution by any governmental

entity or civic group (other than as a shareholder).

The amendment to the contribution to capital provision is generally applicable to contributions made after the enactment of the TCJA. However, the changes do not apply to contribution made by a government entity pursuant to a master development plan that has been approved prior to the date of enactment by the government entity.

Observation: This provision has used by real estate companies that receive incentives from the government to incentive projects or to defray the cost of infrastructure related to projects so that the payments are not included in income. As revised, real estate companies will need to give more thought as to how these types of payments should be treated.

New loss limitation rules

The TCJA adds a new loss limitation on losses for business losses for taxpayers other than a corporation to the extent that they exceed $500,000 (in the case of a joint return) indexed for inflation. Any excess amounts are included as a net operating loss in future years.

This provision applies to taxable years beginning after December 31, 2017 and before January 1, 2026.

Book-tax conformity

The TCJA adds a provision which indicates that certain accrual method taxpayers will be required to recognize certain income not later than the taxable year in which the income is taken into account as revenue in an applicable financial statement.

This provision applies to taxable years beginning after December 31, 2017.

Observation: The Conference Report provides additional color on the provision and indicates that, among other things, the provision does not affect when income is realized for tax purposes and, therefore, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. Presumably a similar conclusion would be reached with respect to real estate that might be marked to fair value in an applicable financial statement.

Repeal of technical terminations

Under current law, a sale or exchange of 50-percent or more of the capital and profits of a partnership within a 12-month period causes a "technical termination" of the partnership. The TCJA repeals technical terminations for partnership tax years beginning after December 31, 2017.

Observation: The repeal of this rule eliminates the need to file short-period returns due to such technical terminations. Therefore, notwithstanding a 50-percent or greater change in ownership, a partnership would continue, retaining all tax attributes, accounting methods and elections, including any remaining cost recovery periods.

Observation: In addition to the elimination of the need to file short period returns for state purposes, the California Documentary Transfer Tax (DTT) can be triggered when partnerships owning real property are terminated. The repeal of this rule may limit the application of the DTT but observation of charter city rules will be necessary to determine whether the TCJA will be followed or the Internal Revenue Code of 1986.

Provisions applicable to non-US operations

Territorial system

Under the TCJA, US corporations generally would be eligible for a deduction on dividends received from non-US corporations in which they hold at least a 10-percent interest. However REITs would not be eligible for this deduction, because the deduction would not be taken into account in determining REIT taxable income. Therefore, distributions from non-US corporations to a REIT still would be included in a REIT's taxable income and still would need to be distributed by the REIT in order for the REIT to eliminate its tax liability.

These provisions generally apply to distributions made after December 31, 2017.

Repatriation toll charge

While REITs would not be eligible to deduct dividends from non-US corporations, the TCJA provides that REITs (as well as all other US persons that are treated as holding at least 10-percent of the voting stock of any such non-US corporation (10-percent US Shareholders)) would be subject to the repatriation toll charge.

The repatriation toll charge applies to any non-US corporation that is a controlled foreign corporation (CFC) or that has a domestic corporation which is a 10-percent US Shareholder. The toll charge applies to a REIT's (or any other US Shareholder's) pro rata share of its foreign subsidiaries' post-1986 undistributed Earnings & Profits (E&P) as of November 2, 2017 or December 31, 2017, whichever is higher. The TCJA contains provisions permitting reductions of undistributed E&P by certain E&P deficits.

The toll charge would be imposed after allowing deductions for a portion of the income, with a smaller

deduction allowed to the extent that the non-US corporation has cash on hand. The toll charges effectively would be 15.5 percent on E&P to the extent of foreign cash and other liquid assets, and 8 percent on all residual E&P. However, as a practical matter for REITs the real question is how much of the income a REIT would be required to distribute.

Because deductions are used to arrive at the effective toll charge tax rates described above, REITs would only need to distribute a portion of its post-1986 undistributed E&P. A foreign subsidiary's post-1986 undistributed E&P would be included in the REIT's gross income as a Subpart F inclusion and the REIT would be entitled to a deduction, so that the income subject to tax would yield an effective tax rate of 15.5 percent or 8 percent depending on the category of E&P (before the dividends paid deduction).

For example, if a REIT had $100 of post-1986 undistributed E&P and $100 of foreign cash, it would have income of $100 and be entitled to a deduction of 55.72 percent (or $55.72), leaving a net income inclusion of $44.28 (which, if subject to a 35-percent rate, would result in a toll charge tax of $15.50). Therefore, a REIT would have an income inclusion of $100 and net income of $44.28 that would be subject to the distribution requirement.

The TCJA permits a US shareholder to elect to include pay the tax liability imposed under the toll charge over a period of up to eight years. In addition, it permits a REIT to elect to include the accumulated deferred foreign income over an eight-year period under the same installment percentages as apply to US corporations that elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective date undistributed earnings in eight installments.

Finally, while there is some uncertainty under current law regarding the treatment of Subpart F income received by REITs for purposes of the REIT income tests, the TCJA excludes the accumulated deferred foreign income from the REIT gross income tests.

Observation: While conforming states are not likely to question an entity's status as a REIT, and therefore their distribution requirement (provided they maintain their REIT status for federal income tax purposes), many states have very different policies when it comes to calculating E&P, Subpart F income and foreign dividend received deductions (DRD). While many states provide some level of deduction for domestic and foreign dividends (including Subpart F income), not all states provide a 100% deduction. Taxpayers will also need to consider whether states will follow the Section 965 partial deduction from the gross inclusion. To the extent the toll charge is subject to state tax, businesses should consider whether the dividends are included in the receipts factor used to apportion income, and where such receipts should be sourced. Importantly, it is unlikely that states would provide taxpayers the option to pay the 965 toll charge over a period of years. For those states that don't automatically conform to the deemed repatriation, taxpayers still may need to consider the state tax impact of any eventual distributions. In evaluating how to invest the capital upon repatriation, businesses should consider state credits and incentives.

Inclusion of "global intangible low taxed income" (GILTI)

Under the TCJA, 10-percent US shareholders (including REITs) in a CFC are required to include their share of the CFC's "global intangible low taxed income" in their current income. GILTI is intended to approximate active business income over a set return of 10 percent on tangible business assets (depreciable tangible property used in a trade or business). Foreign tax credits would be available to corporate 10-percent US shareholders for 80 percent of the foreign taxes imposed on a GILTI inclusion. However, a REIT may not be able to practically utilize the credit.

Regular US corporations are entitled to reduce their net GILTI inclusion by deducting a portion of its gross GILTI inclusion (initially 50 percent, then 37.5 percent for taxable years beginning after December 31, 2025). However, US REITs are not be able to use GILTI deductions to reduce their net GILTI inclusions, because those deductions are not taken into account in determining REIT taxable income. As a policy matter, the GILTI deduction is intended to ensure a minimum level of combined US and foreign tax on foreign business income.

The GILTI income inclusion provisions apply to taxable years of foreign corporations beginning after December 31, 2017 and the deductions apply to taxable years beginning after December 31, 2107.

Observation: Because REITs cannot use GILTI deductions and the ability to utilize a credit may be limited, any GILTI inclusions will require more cash to be distributed than would otherwise be the case.

Observation: Land is not included in the calculation of the assumed return on tangible business assets that generally reduces the GILTI inclusion. Only depreciable tangible business assets are taken into account for that purpose. As a result, a company that has valuable land may have a higher GILTI inclusion even if it is just earning a reasonable return on its land.

Observation: The TCJA is silent as to the treatment of GILTI inclusions for purposes of the REIT gross income tests.

Observation: While income inclusions in the past might have been viewed as an acceleration of income that was included prior to repatriation to the US shareholder, now that US corporate shareholders may be entitled to a dividends paid deduction with respect to dividends received from non-US corporations, these income inclusions are actually an increase in the total amounts subject to tax over time.

Observation: Businesses should consider whether the GILTI is deductible for state purposes under the state DRD or foreign income exclusion provisions. The impact of shifting from a worldwide to a territorial system must also be evaluated by examining how foreign affiliates are treated under the various state filing methods for reporting income among affiliates. Certain states require or permit corporate taxpayers to be subject to tax on a worldwide basis, or require certain foreign affiliates with more than 20 percent of their activity within the US to be included in the combined group. In recent years, we have seen an increasing number of states adopt legislation which requires certain foreign affiliates located in 'tax haven' jurisdictions to be included in the combined report. With the proposed shift towards a territorial system, there may be additional scrutiny of these state regimes, including legal challenges to such statutes under the Foreign Commerce Clause of the US Constitution.

Special deduction for "foreign derived intangible income" (FDII)

The TCJA also provides regular US corporations with a deduction equal to a portion of their "foreign derived intangible income" (FDII) (initially 37.5 percent, then 21.875 percent for taxable years beginning after December 31, 2015). Foreign derived intangible income broadly includes intangible income associated with (i) property sold to foreign persons for foreign use, and (ii) services provided to a person, or with respect to property, located outside the US. However REITs would not benefit from FDII deductions, because they would not be taken into account in determining REIT taxable income. As a policy matter, the FDII deduction (together with the GILTI provision) is intended to significantly reduce the tax benefit to US corporations of locating higher value business assets and activities outside the United States.

The FDII deduction applies to taxable years beginning after December 31, 2017.

30-day Subpart F rule

Currently, a US shareholder can only have a Subpart F inclusion from a foreign corporation that has been a CFC for an uninterrupted period of 30 days or more during the taxable year. The TCJA eliminates the 30-day requirement and applies for taxable years of foreign corporations beginning after December 31, 2017.

Observation: Most Umbrella Partnership REITs (UPREITs) are not able to make Section 338(g) elections to obtain basis step-ups for US tax purposes when acquiring stock of a foreign corporation if the UPREIT wants to treat the target foreign corporation as either a disregarded entity or partnership for US tax purposes. Accordingly, provided that the UPREIT is able to make an entity classification election within 30 days of acquiring the target foreign corporation (assuming it was not a CFC prior to acquisition), an UPREIT can achieve a tax-free step-up in the basis of the target foreign corporation's assets without a corresponding Subpart F inclusion. The step-up would be equal to the inside Section 336 gain recognized as a result of the deemed Section 331 liquidation (the Section 336 gain otherwise often would be foreign personal holding company income as in most cases the rental property acquired would not generate 'active' rents under Section 954). This is a common method used to achieve a step-up in the basis of the assets of such a target foreign corporation, as it is often difficult to convince the foreign target's selling shareholders to sign a Form 8832 to make the election to treat the target foreign corporation as either a disregarded entity or partnership effective prior to the acquisition date (i.e., to treat the acquisition as an asset or partnership interest purchase). If the 30-day rule is eliminated, UPREITs wishing to achieve a US tax step-up either will need to push harder for pre-effective date entity classification elections or will need to analyze whether the 'relevance' rules in Treas. Reg. Sec. 301.7701-3 are applicable to make 'initial' entity classification elections effective on the date of acquisition, thereby achieving asset or partnership interest purchase treatment.

No section 956 exclusion

Unlike the Senate and House bills, the TCJA does not amend section 956 to exclude US corporations from its application. Therefore 10-percent US shareholders of a CFC (including REITs) would continue to be required under section 956 to include currently in income its pro rata share of the CFC's untaxed earnings invested in certain items of US property, including tangible property located in the United States, stock of a US corporation, and an obligation of a US person (including an obligation of a partnership with US partners or an obligation of a foreign DRE of a US person). Section 956 can also require inclusions when stock or assets of a

CFC are pledged against debt of a US person (or otherwise such a CFC is providing a guarantee or other type of credit support).

Expanded definition of US shareholder

The TCJA expands the definition of US shareholder under Subpart F to include any US person who owns 10 percent of the total value of shares of all classes of stock of a foreign corporation. Under current law US shareholder is defined as any US person who owns 10 percent or more of the total combined voting power of all classes of stock in a foreign corporation. This provision applies for taxable years of foreign corporations beginning after December 31, 2017.

Observation: Real estate funds and other owners of real estate that have non-US entities in their structure with non-US investments will want to review their structures to determine if additional US persons may be impacted by Subpart F inclusions as well as if additional information returns may be required.

Deductions limits on payments to non-US persons

No new worldwide interest limitation

Unlike both the Senate and House bills, the TCJA does not include a new worldwide interest limitation for global affiliated groups.

Limits on hybrid payments

The TCJA disallows any deduction for disqualified related party amounts (DRPA) paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. DRPA includes an interest (or royalty) payment to the extent (i) there is no corresponding inclusion to the related party under the tax laws of the country of which such related party is a resident for tax purposes, or (ii) such related party is allowed a deduction with respect to such amount under the tax law of such country. A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for US income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient is resident for tax purposes or is subject to tax.

The new hybrid provisions are effective for taxable years beginning after December 31, 2017.

Observation: It will be important to understand the regulatory guidance that follows as the provision grants the IRS a wide range of authority to address several areas of potential abuse. The use of hybrid entities and instruments used in inbound structures will need to be reviewed to determine the potential impact of this provision.

Observation: The DRPA proposal is reminiscent of related party addback legislation enacted by many states beginning in the 1990s to address perceived income shifting. Since this was an issue that was heavily scrutinized under audit and an area of significant litigation, the lessons learned by the states may be influential. The state statutory framework for the deduction disallowance and safe harbors may serve as a model for the federal legislation or regulatory guidance.

Base erosion tax (BEAT)

The TCJA includes a base erosion tax on certain deductible payments by corporations with significant revenues to related non-US persons, to the extent those payments represent 3 percent or more of the corporation's deductible expenses (excluding certain deductions). The BEAT tax operates similarly to an alternative minimum tax in that applies to the extent a corporation's regular US tax liability is less than it would be if its modified taxable income without deducting the base erosion payments were taxed at the BEAT rate (5 percent for calendar years beginning in 2018, then 10 percent for taxable years beginning before January 1, 2026, and thereafter 12.5 percent).

The BEAT tax generally applies to corporations that have average annual gross receipts of at least $500 million (aggregating the income of certain related entities). However the BEAT does not apply to REITs.

The BEAT applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

Sale of partnership interests in a us trade or business

The TCJA treats gain or loss from the sale of exchange of a partnership interest as income that is effectively connected with a US trade or business (ECI) to the extent that the transferor would have had ECI if the partnership sold all of its assets at fair market value on the date of the sale. This provision effectively codifies the result in Revenue Ruling 91-32, which the Tax Court recently declined to follow in *Grecian Magnesite Mining*. The provision is scheduled to be effective for sales and exchanges after November 27, 2017.

In addition, the TCJA requires the buyer to withhold 10-percent of the amount realized in connection with the sale or exchange of a partnership interest, unless the seller certifies it is not a foreign person. If the buyer fails to withhold the amount required, then the partnership would be required to withhold on amounts distributable to the buyer. This provision is scheduled to be effective for sales and exchanges after December 31, 2017.

Observation: States have taken a different approach to Revenue Ruling

91-32. For individuals, most states have rejected Revenue Ruling 91-32 for individual investors, and this has remained a separately stated item sourced to the individual's domicile unless the partnership interest itself was utilized in a trade or business in a certain state. Corporate taxpayers have historically picked up sales of partnership interests as income subject to allocation or apportionment but how the factors of the partnership flow up to the corporate partner, if at all, differ among the states. Notwithstanding the above, how IRC 897(g) or other State FIRPTA provisions apply to the states can also significantly vary.

Impact on state taxation

In addition to the items discussed above, it should also be noted that for state income tax purposes, states which conform to the Internal Revenue Code as of a certain date or adopt specific provisions will be required to enact legislation to conform to the federal changes, if enacted. Given that more than half of the states are currently facing budget deficits, the state legislatures may decide to decouple from all or part of the provisions, if necessary, to avoid revenue loss. We have seen this in the past, with the majority of states decoupling from bonus depreciation and section 108(i), cancellation of debt income tax deferral provisions. Absent a tax rate reduction by the states, state effective tax rates would immediately become more material to taxpayer's overall US tax footprint given the reduction of federal tax rates.

The takeaway

Today's enactment will have a significant impact on the real estate industry. Taxpayers should begin to analyze how their federal and state tax calculations may be impacted. For our most recent updates, please see Inside Tax Policy: Watch policy unfold.

Let's talk

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