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TCJA IMPACTS ON REITS AND REIT TRANSACTION STRUCTURES

REIT Series – Q1 Update

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TODAY'S PANEL



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Seminars & Continuing Legal Education Programs

REITs and Infrastructure Investment

Thursday, April 19, 2018

Speakers: Daniel LeBey; Chris Green; Chris Mangin

DISCUSSION TOPICS

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TAX CUTS AND JOBS ACT

GENERAL SUMMARY

- Tax Cuts and Jobs Act (“TCJA”) enacted December 22, 2017
- Provisions generally took effect January 1, 2018
- Big Picture Changes:
 - Reduction to corporate tax rate to 21%
 - Pass-through tax rate-20% deduction for “qualified business income” attributable to U.S. trades or businesses
 - Drastic carveback of state and local tax deduction for individuals (\$10k limit)
 - 7 individual tax brackets, with top rate reduced from 39.6% to 37.0%
 - Corporate AMT repealed; individual AMT remains with increased exemptions and phase-out thresholds.
 - Migration to modified “territorial” system of international taxation
 - Corporate tax cuts “permanent”
 - Individual and pass-through breaks generally expire after 2025

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Treatment of Pass-Throughs (Including REITs)
 - 20% deduction on 37.0% top individual rate (resulting in 29.6% effective tax rate) with respect to qualified business income from each qualified U.S. trade or business
 - Applicable to REIT dividends (other than capital gain or qualified dividends which are already taxed at preferential rates)
 - Deduction subject to limits (importantly, limits not applicable to REIT dividends)
 - Limit is greater of:
 - (a) 50% of W-2 wages paid with respect to trade or business; or
 - (b) sum of (i) 25% of W-2 wages plus (ii) 2.5% of the unadjusted tax basis of qualified property (i.e. tangible property subject to depreciation and used in a trade or business)
 - “qualified property” is tangible property used in a trade or business for which “depreciable period” has not ended
 - “depreciable period” means later of 10 years from date placed in service or last day of the last full year in the regular depreciation recovery period
 - TCJA specifically directs Treasury to issue regulations specifying operation of rules in “tiered” partnership structures
 - Requirement that partnership be engaged in one or more U.S. trades or businesses could create diverging incentives for U.S. and unblocked foreign investors (who will not want to be engaged in a U.S. trade or business)

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Treatment of Pass-Throughs (Including REITs), cont'd.
 - Planning opportunities
 - UPREIT contribution transactions could become more attractive to those who are limited out of deduction in their existing structures
 - UPREIT operating partnership provides access to a larger pool of property from which to draw the 2.5% of unadjusted tax basis on qualified property for purposes of the deduction
 - Private REITs could become more attractive as a planning vehicle
 - Taxpayers could drop assets upon which they have fully utilized the 2.5% of unadjusted tax basis for pass-through deduction purposes into REITs
 - No limit on ability to take the pass-through deduction with respect to REIT dividends, including dividends from private REITs
 - Taxpayers could drop assets which would not otherwise give rise to the pass-through deduction into private REITs in order to get the pass-through deduction on REIT dividends
 - Mortgage assets and REIT qualifying loans
 - REIT qualifying foreign trades or businesses (which would not benefit from pass-through deduction if held in a partnership structure)

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Treatment of Pass-Throughs (Including REITs), cont'd.
 - Pass-through rate applies to both common and preferred dividends paid by REITs
 - Pass-through rate applies to private REITs as well as public REITs
 - Due to a technical glitch in the law, mutual funds currently are not able to pass the favorable rate on REIT dividends through to their shareholders
 - This is a mistake from a policy perspective (e.g., “qualified dividends are able to be passed through to shareholders in mutual funds)
 - NAREIT, ICI, and others are meeting with Treasury on this point in the event that a technical corrections bill does not materialize
 - Administration is on record as stating they do not believe technical corrections are a priority
 - Any technical corrections bill would not be subject to reconciliation process, thus requiring 60 Senate votes

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Cost Recovery (Depreciation) for Real Estate
 - 30 years for residential real property and 40 years for non-residential real property if taxpayer engaged in real property trade or business opts out of limit on interest deductibility (discussed below), 27.5 years and 39 years, respectively, otherwise
 - “Real property trade or business” very broadly defined; will cover nearly any business equity REITs are engaged in
 - 10 year reduction in ADS period for residential real estate (i.e., apartments and single family) (period was 40 years under prior law) could be a significant benefit for multifamily and single family REITs
 - Immediate expensing provisions in TCJA generally not applicable to real estate (which continues to depreciate over time)
 - Excludes residential rental property, nonresidential real property, as well as goodwill and other intangible assets, but includes qualified improvement property (improvements to interior of nonresidential buildings if placed in service after date building was placed in service)
- Like Kind Exchanges
 - Preserved by TCJA with respect to real property only (personal property excluded)
- NOLs
 - Carryover may eliminate 80% of taxable income; eliminates carrybacks and makes carryforwards indefinite
 - REITs with substantial NOLs may see the value of NOLs slightly decreased due to additional time required to burn them off under 80% limit (down from 90% under prior law)

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Interest Deductibility
 - Limits net interest deduction to 30% of EBITDA through 2021, thereafter 30% of EBIT
 - Disallowed interest may be carried forward indefinitely
 - Taxpayers engaged in “real property trade or business” may elect out of limitation
 - Mortgage REITs, though unlikely to be considered to be engaged in a real property trade or business, should generally not be impacted because 30% limitation applies to net interest expense (i.e., the amount by which interest expense exceeds interest income)
 - Importantly, new rules apply to partnerships and corporations; prior section 163(j) applied only to corporations
 - REITs need to model to determine whether it is necessary or advisable to elect out (and be forced into ADS depreciation)
 - Election out is permanent and irrevocable, so proceed with caution
 - Taxable REIT Subsidiaries (“TRSs”) are now subject to this regime instead of prior “earnings stripping” rules under old section 163(j)
 - Limitation applies to all business interest regardless of whether the payee is a related party

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Interest Deductibility, cont'd
 - Application to partnerships:
 - Interest limit applies at partnership level
 - Deduction for interest is taken into account at the partnership level and not separately stated
 - “Excess business interest” for a year is allocated out to the partners and carried forward at the partner, not the partnership, level and is deducted by the partner in later years to the extent the partner has “excess taxable income” from the partnership
 - Importantly, the partner’s outside basis in its partnership interest is reduced by excess business interest allocated to the partner
 - Upon a later sale of partnership interest, partner’s outside basis is increased prior to the sale by the amount of the unused excess business interest

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- LTIP Units
 - TCJA maintains current law treatment but adds 3-year hold requirement for capital gains treatment, applicable after December 31, 2017
 - Use of LTIP Units (profits interest in UPREIT operating partnership) to compensate executives survives, with additional holding period requirement for capital gain treatment
 - Major bullet dodged; most analysts had predicted that carried interest would not survive the tax reform process
 - 3 year hold applies regardless of whether a person has made an 83(b) election
 - In the absence of further guidance, it is unclear exactly how the 3 year hold is supposed to apply
 - Holding period rules for partnership interests generally provide for a “fragmented” holding period
 - In other words, holders of LTIP Units could have a blended holding period for all of their units due to issuances of some units in earlier periods than others
 - Unclear how 3 year hold is supposed to apply in this context, pending guidance from Treasury
 - As partners in the REIT’s OP for tax purposes, LTIP Unit holders can potentially benefit from reduced pass-through rate on income allocations from the OP, to the extent of their allocable share of either wages or 2.5% of the unadjusted tax basis of qualified property
 - See earlier note regarding application to tiered partnership structures

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Migration from “Worldwide” to Modified “Territorial” tax system
 - One time “transition tax”-would apply to foreign TRSs of a REIT
 - 15.5%/8% income inclusion on cash/non-cash accumulated foreign earnings
 - REITs can take into account over 8 year period for purposes of easing burden on REIT distribution test
 - Transition income inclusion is ignored for purposes of REIT gross income tests
 - General Subpart F/CFC rules remain
 - Current income inclusions continue for Subpart F income earned by CFCs
 - Subpart F concept expanded-Global Intangible Low-Taxed Income (“GILTI”)-imposes a minimum tax on foreign earnings
 - Generally applies to the extent a CFC’s income exceeds 10% of the CFC’s aggregate basis in tangible depreciable business property minus certain interest expense
 - Treatment of GILTI inclusions for purposes of REIT gross income tests unclear
 - IRS has issued multiple PLRs on treatment of Subpart F income for gross income tests, but GILTI is technically not Subpart F income within the meaning of those PLRs
 - GILTI inclusions will constitute “phantom income” to REITs and are included in REIT taxable income for purposes of the distribution test

TAX CUTS AND JOBS ACT

IMPACTS TO REITS

- Corporate Tax Rate
 - Reduced from 35% to 21% by TCJA
 - Reduction represents a benefit for TRSs
 - Reduction could make retention of capital gain and payment of tax a more realistic capital recycling strategy for REITs
- Technical terminations of partnerships
 - Eliminated by TCJA
 - Cuts down on tax return compliance costs but also narrows planning opportunities
 - Generally a positive for REITs because technical terminations of partnerships triggered a restart of depreciation periods on assets, resulting in reduced depreciation deductions

TAX CUTS AND JOBS ACT

DO REITS STILL MAKE SENSE IN LOWER CORPORATE RATE ENVIRONMENT?

REIT VS. C-CORP TAX EFFICIENCY

| | Pre-TCJA | | Post-TCJA | |
|-----------------------------|-------------|---------|-------------|---------|
| | REIT | C-Corp | REIT | C-Corp |
| Taxable Income | 100.00 | 100.00 | 100.00 | 100.00 |
| Entity Level State Tax | 0.00 | (6.00) | 0.00 | (6.00) |
| Entity Level Federal Tax | 0.00 | (32.90) | (0.00) | (19.74) |
| Distribution to Shareholder | 100.00 | 61.10 | 100.00 | 74.26 |
| Shareholder State Tax | (6.00) | (3.67) | (6.00) | (4.46) |
| ObamaCare Tax | (3.80) | (2.32) | (3.80) | (2.82) |
| Shareholder Tax Federal | (37.22) | (11.49) | (29.60) | (14.85) |
| Net Cash to Shareholder | 52.98 | 43.63 | 60.60 | 52.13 |
| Total Tax | 47.02 | 56.37 | 39.40 | 47.87 |
| Delta vs. C-Corp | 9.35 | | 8.47 | |

Notes

- The above assumes a state corporate and individual tax rate of 6.0% for illustrative purposes. Increasing that rate is generally more favorable to REITs.
- Current law calculation assumes state income tax paid by individual recipient reduces federal taxable income from dividends dollar for dollar (rather than being spread among all of recipient's federal taxable income).
- Without that assumption, prior law delta vs. C-Corp. was approximately 7.71
- State and local tax deduction now capped at \$10,000.
- There is a significant reduction in total tax paid and a significant increase in net cash to shareholders under TCJA vs. prior law.
- Under TCJA, advantage of REIT as compared to C-Corp. is reduced slightly as compared to current law (but is increased significantly over prior law when factoring in the elimination of deductions for state income tax (delta of 7.71 prior law vs. 8.47 under TCJA).

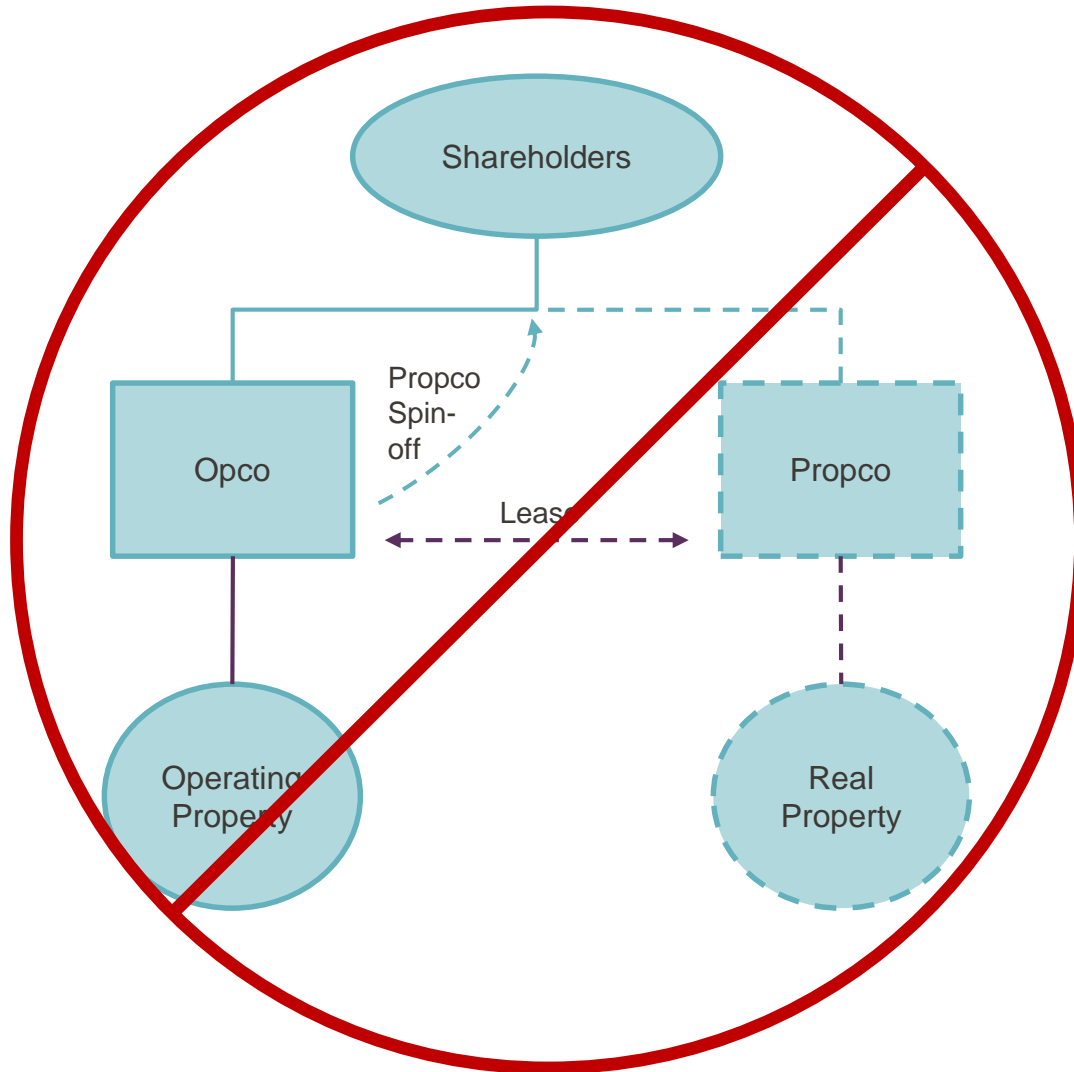
TAX CUTS AND JOBS ACT

DO REITS STILL MAKE SENSE IN LOWER CORPORATE RATE ENVIRONMENT?

- Under all scenarios, tax-exempt investors will continue to heavily prefer REITs, as any corporate tax paid (even at a reduced rate) reduces their returns
 - TCJA disallows aggregation (netting of gains and losses) of UBTI from different sources, making REITs' function as an efficient UBTI blocker even more important
- Foreign investors will similarly continue to prefer REITs for investing in real estate as any corporate-level tax paid reduces their return and C-Corporations are not treated any more favorably than REITs with respect to outbound withholding on dividends
 - Foreign investors may still exit projects tax-free through the sale of domestically-controlled REIT shares
- Electing corporate status is a one way street; re-electing REIT status down the road comes with significant difficulties
 - E&P Purge
 - Sting tax on assets
 - Lockout period on re-electing REIT status
- How “permanent” is the 21% corporate rate?
 - Changing landscape related to tax reform and subsequent Congresses and Presidents-risk of buyers remorse
 - TCJA passed with no Dem votes; politically easier to raise corporate rate in the future

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

SPIN-OFFS



- REIT spin-offs of C-Corp and vice versa denied tax-free treatment under PATH Act (2015) and accompanying Temporary Regulations
- Exceptions:
 - Spin REIT out of REIT
 - Spin TRS out of REIT (minimum 3-year hold)

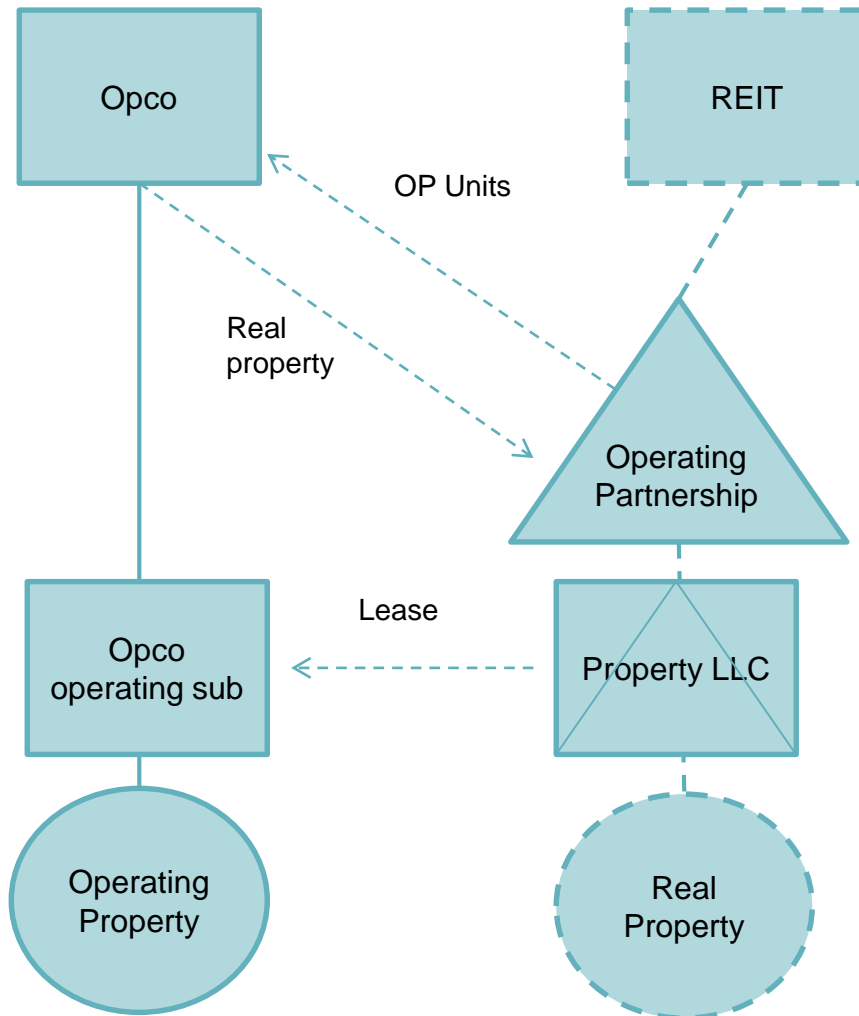
TCJA IMPACT ON REIT TRANSACTION STRUCTURES

SPIN-OFFS

- Difficulty of Tax Free Spin-Offs
 - Limited Universe:
 - REIT out of REIT
 - Very difficult to achieve due to 5 year “active trade or business” requirement
 - TRS out of REIT
 - Possible for REIT with significant third party asset management platform held through a TRS; or third party construction/development property management business held through a TRS
- Taxable Spin-Offs More Attractive Post-TCJA?
 - 21% corporate tax rate (for spin-offs being conducted out of C-Corps.)
 - No active trade or business requirement
 - Post-transaction flexibility
 - If spin conducted out of a REIT, REIT gets DPD for distribution
 - Potential capital gain treatment for REIT shareholders; reduced 29.6% rate otherwise on REIT dividends

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

SYNTHETIC SPIN-OFFS



- REIT raises funds from equity offering and contributes cash to operating partnership for interests therein
- Opco contributes real property to the operating partnership joint venture in exchange for interests therein and, potentially, cash
- Operating partnership leases properties to sub of Opco. No partner-to-partner attribution under REIT related-party rent rules
- Opco can eventually exchange OP units for REIT stock

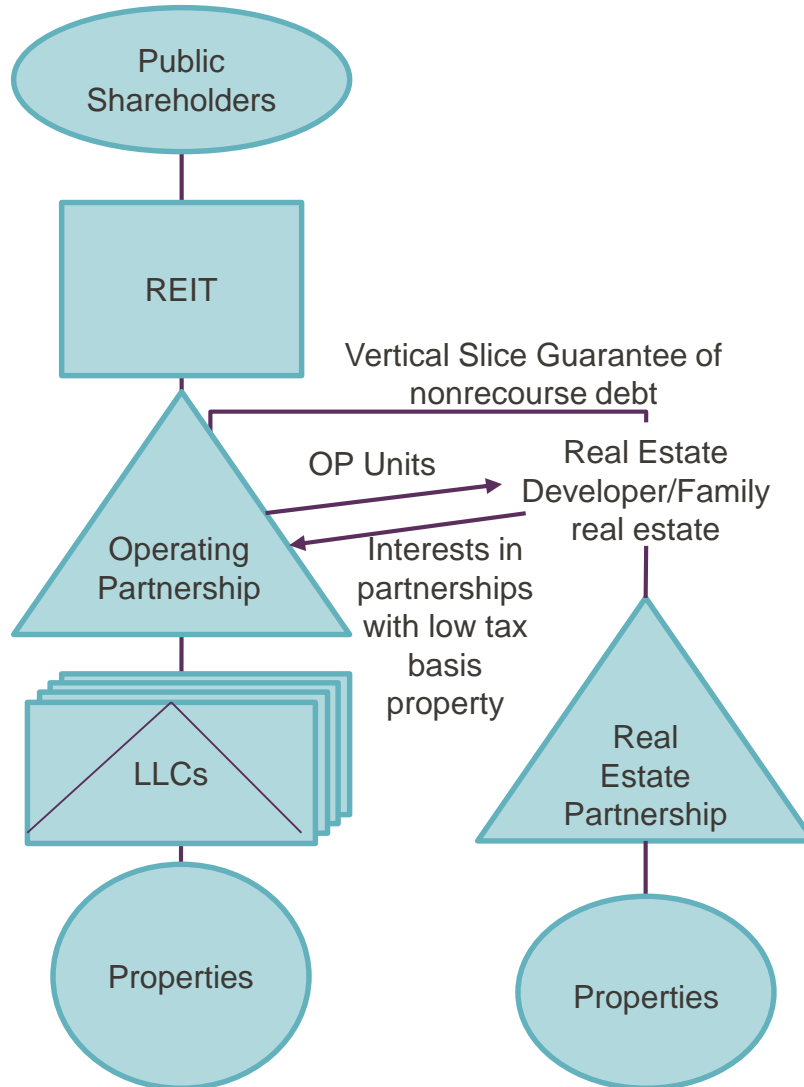
TCJA IMPACT ON REIT TRANSACTION STRUCTURES

SYNTHETIC SPIN-OFFS

- Still attractive for monetizing real estate on a tax-deferred basis
- To the extent C-Corp. owns OP Units, while it will not benefit from the pass-through rate, it will benefit from the lower 21% corporate tax rate on income allocations from the OP, and C-Corp. shareholders will have “qualified dividends” taxed at 20% rate
- REIT shareholders will benefit from 29.6% effective rate on dividends from REIT
- Structures typically involve de-levering the real estate, but to the extent leverage is increased, need to take account of potential interest expense limitation on the OP level under new 163(j) (dealing with limitations on the deductibility of interest)
 - Decision to elect out of interest expense limitation regime comes with a cost-must use ADS depreciation
 - Election is permanent and irrevocable

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

UPREIT TRANSACTIONS



- Property has been depreciated and/or has low basis because of use of 1031s
- Property leveraged with nonrecourse debt
- Negative tax capital accounts supported by nonrecourse debt
- Liability shift occurs upon contribution
- Deferral maintained with use of guarantees

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

UPREIT TRANSACTIONS

- OP Unitholders have opportunity to benefit from 20% pass-through deduction on qualifying business income (“QBI”)
- QBI limited to greater of (a) 50% of W-2 wages paid by the partnership or (b) 25% of W-2 wages plus 2.5% of depreciable tax basis of qualifying property
 - Query: what happens when a partnership acquires carryover basis property through a 721 contribution or in a 1031 exchange?
- UPREIT contribution transactions could become more attractive to those who are limited out of deduction in their existing structures
 - UPREIT operating partnership provides access to a larger pool of property from which to draw the 2.5% of unadjusted tax basis on qualified property for purposes of the deduction
- Will the amount of debt contributor needs OP to maintain create a problem under 163(j) and force an election out and thus longer depreciation periods?
 - This will negatively impact the REIT to the extent it does not already use ADS as depreciation will be allocated toward REIT under 704(c) principles
 - If no election out of 163(j) regime, need to be mindful of outside basis reductions for excess business interest

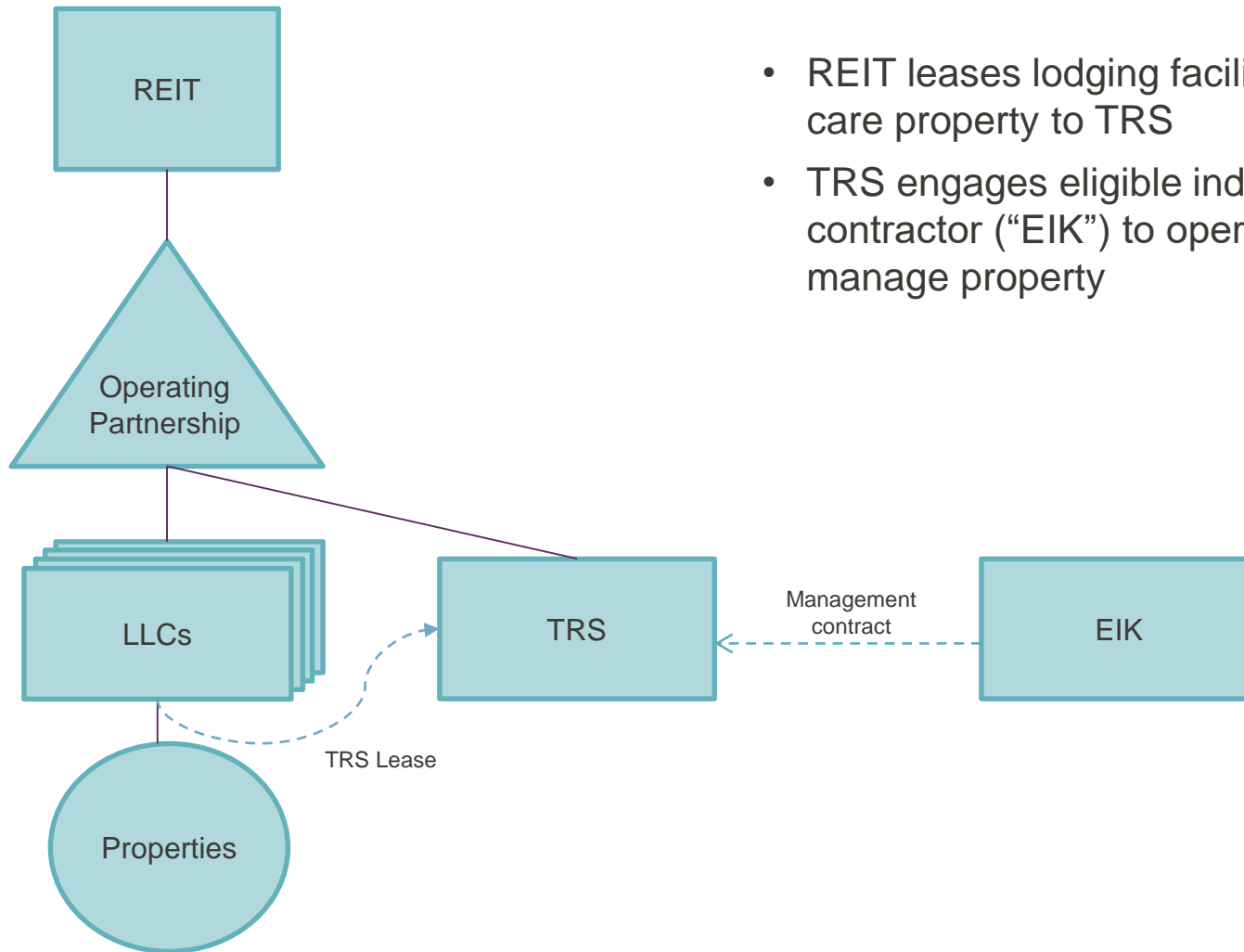
TCJA IMPACT ON REIT TRANSACTION STRUCTURES

UPREIT TRANSACTIONS

- Will there be a move toward REIT joint ventures instead of OP Unit transactions?
 - When it can be done without triggering tax (navigating 351(e) and 368(c) issues and 357(c) issues), a REIT JV may be more efficient because the QBI limits discussed above do not apply to REIT dividends
 - Potential to structure JVs with partnership on top of a REIT for select assets following Treasury guidance on application of pass-through deduction to tiered partnership structures
 - Private REITs could become more attractive as a planning vehicle
 - Taxpayers could drop assets upon which they have fully utilized the 2.5% of unadjusted tax basis for pass-through deduction purposes into REITs
 - No limit on ability to take the pass-through deduction with respect to REIT dividends, including dividends from private REITs
 - Taxpayers could drop assets which would not otherwise give rise to the pass-through deduction into private REITs in order to get the pass-through deduction on REIT dividends
 - Mortgage assets and REIT qualifying loans
 - REIT qualifying foreign trades or businesses (which would not benefit from pass-through deduction if held in a partnership structure)

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

RIDEA STRUCTURES



- REIT leases lodging facility or health care property to TRS
- TRS engages eligible independent contractor (“EIK”) to operate and manage property

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

RIDEA STRUCTURES

- Income earned in TRS now subject to lower 21% tax rate (down from 35%)
- New 163(j) applies to TRSs
 - To the extent REIT's have levered TRS with intercompany or third party debt to reduce taxable income, such debt may no longer be effective to reduce the TRS's taxable income
 - Unlikely many TRSs would have the ability to elect out of 163(j) limits by virtue of being in a "real property trade or business"
- 163(j) limits place increased importance on overhead sharing agreements allowing for overhead to be allocated to TRS
 - Increased scrutiny on sharing arrangements and importance of documentation and recordkeeping to substantiate cost-sharing deductions
- Consider potential application of GILTI income inclusions with respect to offshore TRSs
 - Phantom income and gross income test consequences of GILTI inclusions

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

CAPITAL RECYCLING

- 1031 exchanges still available for real property only
- Lower corporate tax rate may cause REITs to consider retaining capital gains when other options (i.e., 1031) are not available or attractive
- Capital gains are excluded from the definition of REIT taxable income for purposes of the 90% distribution test applicable to REITs
 - REITs are therefore permitted to “retain” and pay tax on capital gains, which tax would be at the new 21% corporate tax rate (down from 35% in 2017)
 - If REIT makes this election, shareholders take into account their proportionate share of capital gain and then are deemed to have paid their share of the tax, which is credited to them, and their basis increases
 - In the past, this mechanism was rarely used, but with reduced corporate tax rate of 21%, REITs may view as viable
 - Not subject to restrictions of 1031 rules
 - Retain cash and reinvest at times when REIT cannot raise capital or it would be too dilutive to do so

TCJA IMPACT ON REIT TRANSACTION STRUCTURES

OVERSEAS OPERATIONS

- TRS vs. Pass-through decision point has been altered by TCJA
- Previously, foreign TRS would generally keep earnings offshore unless TRS earned Subpart F income
- New GILTI rules change planning considerations
 - GILTI requires U.S. recognition of offshore income deemed in excess of a specified return
- GILTI income is similar to subpart F income, but is not subpart F income
- Unclear how GILTI inclusions are treated for purposes of REIT gross income tests
 - Prior PLRs issued by IRS on subpart F inclusions for REITs not necessarily applicable to GILTI
 - GILTI inclusions constitute phantom income for REIT distribution test



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