How Will Trump’s Tax Reform Affect Real Estate Investments and Capital Markets?

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Introduction

In late September, the White House released an outline of the Republican plan for tax reform. This plan was preceded by plans released by the House Republican caucus in June 2015 and by House Ways and Means Committee Chairman Dave Camp in February 2014. While much of the attention by commentators and public policy groups has been focused on the plans’ effects on household income and general tax liability, the real estate finance community should also take note of how these new structures would play a role in capital and investment.

Among its many tools, the real estate sector has always found the tax laws of the United States to be one of its most powerful and effective instruments for success. Real estate developers and investors, as well as their lawyers and financial advisors, have become accustomed (dare one say, have embraced) the incredible complexity that is entailed in navigating a tax system that provides significant benefits to those who develop or invest in real property.

But because of this complex system and the way one can take advantage of a rather byzantine structure of taxation, even small changes to parts of the regime can have significant impacts on the tax benefits associated with real estate development. And a greatly simplified tax system that removes these many advantageous complexities could be even more impactful—at least without the enactment of offsetting benefits. This Article takes a broad look at the tax plan currently being considered by Congress and promoted by the Trump Administration, focusing particularly on how these reforms would affect the financing of, and investment in, real estate.

Overview of the Trump Tax Plan

The plan calls principally for a reduction in the marginal tax rate paid by individuals (a change from the current seven brackets to a set of three that builds from 12 to 25 to 35 percent). The current top tax rate is a little over 39 percent, generally applicable to

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individuals with income of over roughly $418,000. On the other end of the spectrum, to make up for an increase in the lowest bracket, the plan calls for a larger child tax credit and a jump in the standard deduction. Also on the chopping block is the estate tax, which imposes liability on those who inherit $5.49 million or more.\(^5\)

In light of the increase in the standard deduction (a near doubling of current amounts\(^6\)) and the near elimination of itemizing deductions, the administration’s plan would make up for the lost revenue by abolishing a number of current, “special interest” deductions and credits.\(^7\) The plan states, however, that the mortgage interest and the charitable giving deductions would survive.

From an income perspective, another important part of the plan is the creation of a 25 percent tax on the income of pass-through entities, such as partnerships, S-corporations, and sole proprietorships. Since about 95 percent of businesses in the United States elect to be taxed on a flow-through basis, this change is important.\(^8\) For large businesses that are taxed in this way, the shift in the marginal rate from a top 39.6 percent to a mere 25 percent represents a significant tax advantage.

For those entities taxed at the corporate rate, the amount will be decreased from 35 percent to 20 percent (although Trump has said he would prefer 15 percent). And host of deductions and credits, as in the case of changes to the personal income tax structure, will be repealed.\(^9\) The only two credits that the plan states will be maintained are those dealing with low-income housing (the federal Low-Income Tax Credit) and with research and development.

Lastly, the Trump plan would leave the current long-term capital gains rates in place, but the short-term rate would be reduced because it is, under current law, taxed at the rate of ordinary income.

**How Would The Plan Affect REITs?**

The real estate investment trust (the REIT) is one of the most popular real property-related tax devices in the country.\(^10\) The designation was created in 1960 under the Eisenhower administration to assist individuals with investing in commercial real estate projects by

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\(^6\) See *id*. For 2017, the amount for married, filing jointly is $12,700 and the amount for single filers is $6,350. *Id.*


providing for favorable tax treatment.\textsuperscript{11} The central purpose was and is to allow small investors to have access to large, income-producing real estate developments in the same way that mutual funds give small investors access to stocks. REITs are essentially business entities that qualify, based on a number of requirements, for a particularly favorable tax treatment despite the fact that they normally would be taxed like a corporation.

Entities taxed as corporations pay taxes on their income at the entity-level\textsuperscript{12} and then shareholders who receive dividends from these corporations also pay taxes on those distributed amounts.\textsuperscript{13} This is often referred to as the problem of “double taxation.”\textsuperscript{14} The REIT designation addresses this problem by basically dispensing with the need to pay taxes on corporate income at the entity-level. This results in REITs being frequently called “conduit entities.”\textsuperscript{15} REITs are traditionally state-created corporations, but can also include trusts, partnerships, and limited liability corporations.\textsuperscript{16}

From the perspective of stock trading, the Trump administration’s reduction in the corporate tax rate will likely produce a benefit in stock prices. That’s the good news. The bad news is that it might not quite be so positive for REITs. The reason for this has to do with the fundamental nature of this type of investment entity.

In order for an entity to qualify for this designation, a REIT must make dividends to its shareholders of at least 90 percent of its taxable income each year.\textsuperscript{17} In other words, REITs cannot easily hold on to large amounts of their earnings. And 90 percent is a pretty significant number when compared to the dividend practices of corporations, which on average only distribute about 25 percent of their taxable income annually.\textsuperscript{18} And aside from the inability to retain their earnings, REITs must abide by a number of income and asset requirements, such as the need to contract with third parties for the management of certain types of properties. For instance, because earning a profit from a hotel managed by its owner is considered to be taking an active role in the operation of the real estate, hotel REITs must employ third party management companies.\textsuperscript{19}

The tax liability for shareholders who receive such dividends varies depending on the source of the income being distributed by the REIT. For instance, if the dividend is made up of the general operating profit of the REIT, then the shareholder will pay ordinary income taxes in accordance with his or her marginal rate. But if the REIT sells a capital asset, then the income from that sale will be taxed, in the hands of the shareholder, at the

\textsuperscript{12} I.R.C. § 11(a).
\textsuperscript{13} I.R.C. § 61(a)(7).
\textsuperscript{14} Jeffrey L. Kwall, The Uncertain Case Against the Double Taxation of Corporate Income, 68 N.C. Law Rev. 613 (1990).
\textsuperscript{15} See 26 C.F.R. § 1.58-2 (“General rules for conduit entities; partnerships and partners.”)
\textsuperscript{16} I.R.C. § 856(a)(3); see also Reg. §§ 301.7701–1 & –3.
\textsuperscript{17} See I.R.C. § 857(a)(1)(A).
\textsuperscript{18} See Borden, supra note 10, n. 45.
\textsuperscript{19} 26 U.S.C. § 856(l)(3)(A) (prohibition on certain REITs from directly or indirectly operate or manage a lodging facility or a health care facility).
applicable capital gains rate. Whether the rate is short-term or long-term capital gains depends on how long the asset was held by the REIT. In this way, the shareholder’s tax liability for a dividend depends on where it came from in connection with the REIT itself. Often the dividend will be made up of percentages of funds from different sources, making the calculation of the applicable tax liability a bit complicated. REIT investors receive a Form 1099-DIC each year giving the breakdown. In general, most of the income paid out in dividends by REITs is taxed as ordinary income.20

So what does the Trump tax plan do to REITs? Well, the reduction of the corporate tax rate to 20 percent (or 15 percent, if Trump has his way) could mean changes for real estate investment trusts. One of the entity’s major advantages—favorable tax treatment—would be curtailed. Much of a REIT’s stock value comes from its beneficial tax treatment. If that advantage is trimmed, the attractiveness of REITs may well be diminished. As a result, fewer businesses may choose to structure themselves as REITs, thereby freeing themselves of, among other things, the inability to retain their earnings.

With respect to the creation of a tax on pass-through entities, the thrust of the proposal is geared toward creating a roughly comparable tax environment for income derived from corporate dividends (from entities taxed as corporations) and pass-through dividends (from entities taxed on a flow-through basis). Depending on the ultimate rate (and whether the rate of taxation for REIT dividends is also changed), this could also diminish the comparative advantages of organizing as a REIT. In the end, the diminishment of the REIT as an attractive investment vehicle may result in investment capital flowing into other sectors.

**What about Interest Expense and Depreciation Deductions?**

As noted above, part of the Trump tax plan involves an elimination of numerous deductions. This might include the deduction for capitalized interest expenses. 21 Capitalized interest expenses are those costs that a business incurs in connection with obtaining credit for the purposes of purchasing property. Federal tax law allows a business to take those interest expenses and use them to reduce the company’s tax liability, provided that the deduction is spread over a period of time.

Further, the elimination of tax deductions might also include the elimination of the one related to depreciation. 22 This is a tax benefit that allows individuals to generally recoup the cost of purchasing property by availing themselves of an annual allowance related to the wear and tear on the property. While land is not depreciable, buildings and items such as equipment and furniture that relate to the development of real estate are depreciable.

So what would the result for the real estate community be if both of these important deductions were eliminated? Admittedly, some proposals floating around the Republican

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21 26 U.S.C. § 163(a) (“There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.”).
caucus call for the interest expense deduction to be limited, rather than eliminated. For instance, a plan championed by House Republicans would generally remove the interest deduction, but would allow it to continue in a limited form by giving individuals the ability to fully expense the cost of buildings at the time they are acquired. Thus, the trade-offs that might arise and balance other aspects of the reform of these important deductions remain to be seen.

How Might 1031 Exchanges Be Impacted?

Section 1031 of the Internal Revenue Code allows those who sell commercial real estate to put off paying taxes on capital gains resulting from such dispositions. This tax provision allows a person or business to essentially change the form of an investment, without recognizing a capital gain or cashing out. What this means is that the value of the investment can continue to grow, but the taxes on that growth are deferred (although the number of times this can be done is limited). Each time one piece of property is exchanged for another, there may very well be a profit achieved. Nevertheless, the payment of taxes on that profit is pushed off to another day—hopefully one where the individual only pays the lower, long-term capital gains tax rate.

While not explicitly mentioned in the Trump tax plan, the elimination of these like-kind exchanges is also an apparent part of the reform package. Whether the provision will be partially or completely repealed is unclear, but in either case it would have a negative impact on the real estate community. This is particularly true for REITs because of the obligations contained in their tax protection agreements. These are provisions that are contained within operating agreements that prohibit certain activities that will trigger a change in the tax basis of investor-partners. The repeal of 1031 could have serious consequences on the ability of REITs to abide by these tax protection agreements.

Conclusion

The good and the bad of the tax proposal being pushed by the Trump White House and the Republican members of Congress is that it is merely a broad outline with very few details. From this perspective, it might be that general statements relative to the repeal of “special interest credits and deductions” actually belie a great deal of wiggle room. Thus, certain tax benefits may remain in place provided that sufficient advocacy work is conducted by the real estate industry. On the other hand, many Republican members of Congress are committed to the removal of special interest “loopholes” from the tax code, thereby suggesting that an end to many of these benefits is forthcoming. In the end, the real estate community may have to adjust to the fact that the intricate tax system that has for so long benefited the industry may be coming to an end. Then again, as former Louisiana governor

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and U.S. senator Huey P. Long once said: “[A tax loophole is] something that benefits the other guy. If it benefits you, it is tax reform.”

We’ll see what happens.

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