The Graduate Tax Program Presents:

TAX PLANNING FOR U.S. REAL ESTATE AFTER THE TAX CUTS AND JOBS ACT

How does the Tax Cuts and Jobs Act impact domestic and foreign investment in U.S. real estate? Come to this timely and lively discussion to find out!

Date: Thursday, May 31, 2018
Time: 12:30 p.m.–1:50 p.m. (Light lunch will be served at 12:15 p.m.)
Location: New York Law School, W320
185 West Broadway, New York, NY 10013
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Tax Planning for U.S. Real Estate After the Tax Cuts and Jobs Act

May 31, 2018

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KEY TCJA PROVISIONS IMPACTING U.S. REAL ESTATE INVESTMENT
TCJA: Summary

- Corporate income tax rate reduced to 21%; Individual income tax rate reduced to 37%
- Up to 20% deduction for individuals for U.S. qualifying business income
- Maximum capital gains rate remains 20% for individuals
- Interest deductions limited to 30% of taxable income; real estate election out
- Anti-hybrid rules introduced limiting deductions where no income inclusion
- NOLs limited to 80% of taxable income; business loss use for individuals limited
- 100% expensing for qualifying property - real property improvements
- Like-kind exchanges preserved for real property with changes
- 3 year holding period for carried interests in partnerships
- Non-resident Aliens (NRAs) subject to 10% withholding on sales proceeds from disposition of partnership that owns a U.S. business or real property
- U.S. estate tax exposure for NRAs unchanged – 40% on U.S. situs assets
TCJA: Lower Rates

- **Lower Individual Income Tax Rates**
  - Maximum rate lowered from 39.6% to 37%
  - 3.8% Net Investment Income tax (NIIT) retained for unearned income
  - Rate reduction set to expire after 2025, unless renewed

- **Lower Corporate Income Tax Rates**
  - Corporate tax rate permanently reduced from 35% to 21%
  - Graduated corporate tax rate structure is eliminated
  - Corporate AMT is eliminated
TCJA: New Pass-Through Deduction

- New complex rules apply to determine the tax rate applied to pass-through income of non-corporate taxpayers
- Deduction of up to 20% of domestic “qualified business income” (QBI) from a partnership (including an LLC taxed as a partnership), S corporation, or sole proprietorship – sunsets after 2025
- Reduces top marginal rate to 29.6% for QBI [(100%-20%) * 37%]
- QBI is income effectively connected with a qualified U.S. business, but excluding professional services businesses, including investing services
- Deduction is subject to limitation based on wages paid, or on wages paid plus a capital assets factor (i.e., value of tangible, depreciable property)

QUESTION – WHICH REAL ESTATE ACTIVITIES WILL BE A QUALIFIED BUSINESS?
TCJA: Interest Deductibility Limitation

- Deduction for business interest expense limited to 30% of “adjusted taxable income”
- Adjusted taxable income based on EBITDA until 2022, then EBIT
- Disallowed deduction may be carried forward indefinitely
  - Utilization in future years subject to applicable interest deductibility limitations
  - Complicated mechanics for partnerships and S-corporations – limitation applies at entity level
- Exception from 30% limitation:
  - Small Business Exception: revenues of less than $25M
  - Electing Real Property Trade or Business Exception (RPTB Exception)
- Repayment of principal permits repatriation to shareholder on tax-free basis
- Avoid or reduce withholding tax via treaty or portfolio interest exemption
- Ensure debt respected as debt not equity by demonstrating loan documents, maturity date, interest rate (not excessive), not thinly capitalized
TCJA: Interest Expense Limitation
Exceptions for Real Property Businesses

- Real property trade or businesses (RPTB) may elect to be excluded from the interest deductibility limitation
  - Election is irrevocable once made

- RPTB includes, *inter alia*, real property development, redevelopment, construction, rental, management, leasing trade or business

- Election requires using the ADS with respect to depreciable real property - generally requires use of straight line method depreciation and longer recovery periods than under usual depreciation method

- Recovery periods for nonresidential depreciable real property, residential depreciable real property and qualified improvements are extended to 40, 30 and 20 years, respectively
TCJA: Depreciation Changes
100% Expensing

- 100% of cost basis of qualifying property placed in service can be expensed in that tax year from September 2017 through 2022
- After 2022, percentage phases down to 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026
- No “original use” requirement – applies to purchases of used and new equipment
- Excludes property acquired from affiliate or in a tax free transaction (i.e., like kind exchange)
- Qualified property generally includes assets with recovery periods of 20 years or less
  - Real estate related property eligible for 100% expensing likely includes heating, lighting, plumbing, cooling, fire protection, and alarm systems
TCJA: Loss Limitations

 Corporations

- NOLs arising in a taxable year after 2017 can offset up to 80% of current year taxable income
- No NOL carry-back, but unlimited carry-forwards
- Result: combined with lower CIT, NOLs now less valuable
- Planning considerations:
  - Accelerate vs. delay deductions
  - Will entire NOL carry-forward be available to offset gain on exit?

 Individuals

- “Excess business losses” (business loss in excess of $500k for married/$250k for individuals) now disallowed, but can be carried forward as an NOL for future years
- Limits ability to use losses from an active business to offset other income sources
TCJA: Like-Kind Exchanges

- “Like-kind” exchange provisions are limited to real property
  - No dealer property (property primarily held for sale)
  - No domestic-foreign property exchanges

- Personal property transferred as part of a larger like-kind exchange of real property no longer qualifies for tax deferred treatment

- Transition Rule
  - Restriction to real property does not apply to an exchange if the relinquished property is disposed of or the replacement property is received on or before December 31, 2017
  - 45-day identification and 180-day exchange deadlines still apply
TCJA: Carried Interest
3 Year Holding Period

- Partnership interests held by individuals in exchange for performance of substantial services for an “applicable trade or business” (AKA “carried interest”) must be held for at least 3 years to qualify for long term capital gain rates

- Applicable trade or business includes one conducted regularly, continually, and substantially and may include real estate development for rental or investment

- Holding period applies not just with respect to sale of the partnership, but also regarding the flow through gains upon sale of assets by the partnership

- Confusion regarding application if individual holds partnership interest through an S-corporation - U.S. Treasury has indicated intent to close apparent loophole
Termination of partnership after material ownership change is repealed for partnership tax years beginning after December 31, 2017

Under prior law, technical termination resulted from sale or exchange of 50% or more of the total interest in partnership capital and profits during a 12-month period

Material partnership ownership changes will no longer restart partnership depreciation or allow new partnership level tax elections to be made
TCJA: Residential Real Estate

- Deduction for state and local property (and income and sales) taxes is limited to $10,000 per year
  - Limitation does not apply to taxes incurred in connection with a trade or business

- Deduction for interest incurred on debt used to acquire, construct or improve a principal residence is limited to interest on up to $750,000 of debt (down from $1,000,000)

- Deduction for interest on home equity debt eliminated
  - Exception for home equity loans used to buy, build or substantially improve the taxpayer’s qualified residence

- Caps apply beginning in 2018 and expire after 2025, unless renewed
TCJA: Anti-Hybrid Rules

- No deduction for related party (RP) (50% connection) interest if the amount:
  - is not included in RP’s taxable income, or
  - generates an RP deduction

  **AND** the amount is:
  - paid pursuant to a hybrid transaction (i.e., treated as interest under U.S. tax law but not under the RP’s tax law), or
  - paid to, or by, a hybrid entity (i.e., transparent for U.S. tax law but not under RP’s tax law, or vice versa)

- Must revisit cross border financings for U.S. real estate investment that exploited differing tax treatments and are now in cross-hairs of anti-hybrid rules in U.S. and across EU (BEPS, ATAD).
Foreign Partners’ Gain From Disposition of Partnership Interest

- Foreign partner gain from disposition of a partnership interest is ECI to the extent disposition of partnership assets would generate ECI
  - Overturns Tax Court’s recent 2017 Grecian Magnesite decision
- 10% withholding tax applies to the amount realized from such sale; the ultimate tax on the sale may be higher than the 10%, and it is incumbent on the seller to file a U.S. tax return to pay balance or claim refund.
- Notice 2018-8 suspended withholding for PTPs until guidance is issued; Notice 2018-29 announced intention to issue regulations under Section 1446(f) regarding sales of private partnership interests, and suspended withholding on non-recognition dispositions.
Expanded CFC Rules: More CFCs

- 10% US shareholder expanded to include 10% ownership by vote *or value*
- New downward attribution of stock owned by a foreign person to a US person applicable starting 2017 (repeal of 958(b)(4))
  - Foreign parented groups with even one US sub will see all foreign subs classified as CFCs
  - Potential for unexpected Subpart F inclusions for direct/indirect US shareholders, and 5471 reporting obligations (but reporting for resulting constructive owners not applied in 2017).
- 30-day grace period for Sub F inclusion repealed
- CFC high tax kick out retained
- Section 956 requiring current inclusion of CFC earnings invested in US property remains
  - Continued limitations on CFC guarantees and stock pledges as collateral for financings in order to avoid deemed repatriation of CFC E&P equal to guaranteed amount
POST- TCJA
U.S. REAL ESTATE INVESTMENT
Income Taxation of Non-Resident Aliens (NRA) and Foreign Corporations (FC)

- **Income Taxation**
  - Limited to income effectively connected with a U.S. Business (ECI)
  - ECI taxed on a net basis at regular rates
  - FC also subject to branch profits tax (BPT) at 30% or lower treaty rate

- **Withholding Taxation**
  - Fixed, Determinable, Annual or Periodical Income (FDAP) from U.S. sources
  - Gross basis taxation at 30% or lower treaty rate
  - FDAP includes interest, dividends, rents, royalties, but excludes:
    - portfolio interest, described below
    - sovereign investor recipients
    - FDAP subject to net income election
    - Capital gains
      - Limited exception if NRA in U.S. for 183 Days and other requirements satisfied
  - U.S. tax treaties often reduce or eliminate withholding

- **Net investment income tax (NIIT) of 3.8% not applicable**
Estate and Gift Taxation of NRAs

- Only U.S. situs assets subject to estate and gift tax

- **U.S. situs assets include:**
  - Real property located in the United States
  - Shares of stock in a U.S. corporation
  - Tangible personal property located in the United States
  - Certain debt obligations of U.S. issuers
  - Intangible property used in the United States

- **As in domestic context, value reduced by NR debt**

- **Intangibles exempt from gift tax**
  - Stock of U.S. corporation
  - Probably a partnership interest, but unresolved
    - IRS does not concede; may argue for aggregate approach
    - Cf. Rev. Rul. 91-32
**FIRPTA - Overview**

- **Foreign Investment in Real Property Tax Act (FIRPTA)** – taxes foreign persons selling U.S. real estate (Section 897)
  - Generally retained as is under TCJA

- **NRAs and FCs taxed on gain from disposition of U.S. real property interest (USRPI) as ECI**
  - Generally, same tax rates apply as to U.S. persons
  - BPT may also apply to FC income
  - Look-through rules apply for USRPIs held through a partnership
  - Must file return to report FIRPTA liability!

- **Buyer of USRPI required to withhold 15% on amount realized (FIRPTA Withholding)** (Section 1445)
  - Amount realized = cash + FMV of transferred property + assumed liabilities
  - Arbitrary and may exceed tax due, requiring refund application
  - Withholding base includes value of assumed debt
  - Application of FIRPTA to partnerships is complex
  - Parties may request withholding certificate from IRS prior to sale to reduce or eliminate FIRPTA Withholding (FIRPTA Certificate, Form 8288-B)
What is a USRPI?

- An interest, other than solely as a creditor, in real property located in the United States or Virgin Islands, including:
  - Land, building, improvements; leasehold, life estates, remainder interests in U.S. real property; options to acquire U.S. real property

- An interest, other than solely as a creditor, in any U.S. corporation that is (or, during 5-year or shorter look-back period, was) a U.S. real property holding corporation (USRPHC)
  - A USRPHC is a corporation for which the FMV of its USRPIs is 50% or more of the total FMV of its USRPIs + its foreign real property + any other trade or business assets.
    - “Rookies” are cautioned that not all assets enter the denominator
  - Cleansing Exception: stock of former USRPHC is “cleansed” of being a USRPI if all USRPIs have been sold, and the corporation recognized all gain

- USRPI does not include debt secured by real property, BUT
  - Caution! Equity kickers can transform a debt interest into a USRPI
What is a USRPI? (cont’d)

- **Partnership Interests**
  - Partnership interest treated as a USRPI only to the extent gain on its disposition is attributable to USRPIs
  - As a result, disposition of a partnership owning USRPIs triggers ECI and withholding under FIRPTA with respect to the NRA/FC partner’s allocable share of the ECI (Section 897(g), Notice 88-72)

- **FIRPTA Withholding only applies to “50/90” partnerships**
  - If >=50% of partnership assets are USRPI and >=90% of partnership assets are USRPI, cash, and cash equivalents, entire partnership interest classified as USRPI for FIRPTA Withholding purposes (but not Section 897 purposes).
  - On sale of a 50/90 partnership interest, FIRPTA withholding applies to entire amount realized unless reduced by FIRPTA Certificate
FIRPTA Exceptions

- **Like-kind exchanges (Section 1031)**
  - U.S. and foreign property cannot be like-kind

- **Certain publicly traded USRPHC stock**
  - If do not own interest of greater than 5% (including during look back period)
    - Subject to REIT-related revision under the PATH Act

- **Purchase of a residence under $300k**
Portfolio Interest Exemption

- Interest rate must be fixed
  - No equity kicker allowed

- Lender may not be “10% shareholder” of borrower
  - For corporate borrower, based on voting power
  - For partnership borrower, based on capital or profits interests
  - Limitation N/A to trusts

- Lender may not be a bank making loan in ordinary course or a CFC related to borrower

- Income cannot be ECI

- Must certify foreign status to benefit from exemption (Form W-8)
Structure 1: Direct Investment by NRA

Foreign Individual

Must File Personal 1040 Return
- Possible deal breaker!

Rental Income:
- Gross rent subject to 30% withholding by lessee; or
- Net rental income subject to tax up to 37% (+SALT)

Long Term Capital Gains:
- Taxable at 20% (+SALT)
- FIRPTA Withholding on sales proceeds (subject to any FIRPTA Certificate)

Gift/Estate Tax:
- Applies at 40% (+SALT) on the USRPI value
- Purchase term insurance to mitigate risk
- May use non-recourse debt to reduce value
Structure 2: Investment by NRA Through Foreign Corporation

To Foreign Corporation

Filing
- 1120 F filing will require disclosure of owners

Rental Income:
- Gross rental incomes subject to 30% withholding by lessee; or
- Net rental income subject to tax up to 21% (+SALT)
- BPT may apply at 30% or lower treaty rate

Gain from Sale of USPRI:
- Taxable at up to 21% (+SALT)
- FIRPTA Withholding on sales proceeds (subject to any FIRPTA Certificate)
- BPT may apply at 30% or lower treaty rate

To NRA Shareholder

Income Tax:
- No tax on dividends or § 301(c)(3) amounts
- No tax, including FIRPTA, on sale of FC stock

Gift/Estate Tax:
- None
Structure 3: Investment by NRA Through Domestic Partnership (DP)

- **Foreign Individual**
  - Distributions of Rent and Capital Gains
  - Other Investors
- **US Partnership**
  - Rent

**NRA Partner Must File Personal 1040 Return:**
- Possible deal breaker!

**Rental Income:**
- Partner level taxation (same as direct investment in Structure 1)
- If new pass-through deduction applies, then rate could be reduced to 29.6%
- No withholding by lessee on rent
- DP withholds on ECI rent allocable to NRA partner (Section 1446).

**Long Term Capital Gains:**
- Same as direct investment in Structure 1, except instead of FIRPTA withholding on sales proceeds paid to DP, DP must withhold on amounts allocable to NRA partner.

**Gift/Estate Tax:**
- Tax-free gifts should be possible pursuant to intangible exception.
- No clear authority on whether DP is U.S. situs asset
Structure 4: Investment by NRA Through Foreign Partnership (FP)

NRA Partner Must File Personal 1040 Return:
- Possible deal breaker!

Rental Income:
- Same as with investment through DP, except lessee must withhold on non-ECI rent paid to FP.

Long Term Capital Gains:
- Same as with DP, except FIRPTA withholding on sales proceeds paid to FP (subject to FIRPTA certificate).

Gift/Estate Tax:
- Same as with DP, but stronger argument that FP is not a U.S. situs asset.
Structure 5: Foreign Trust Alternative

Settlor transfers cash to foreign trust (FT); then trustee buys the USRPI.

Settlor must have no right to use trust property, no dominion or control over the trust. This is often a deal-breaker.

If properly structured, no gift tax when trust funded and no estate tax when settlor dies.

Income tax consequences same as for NRA direct investor, e.g., LTCG rates apply upon sale of USRPI.

Can also use domestic trust, but then 3.8% NIIT also applies.
Structure 6: Investment by NRA Through Foreign and U.S. Corporation

To U.S. Corporation

- Rental income and gain taxable at up to 21% (+SALT)

To Foreign Corporation

- Dividends and interest from USCo subject to 30% withholding or lower treaty rate.
  - Portfolio interest exemption may be available
- Disposition of USCo stock subject to up to 21% tax as ECI under FIRPTA if USCo is a USRPHC
- If USCo liquidates after Cleansing Exception applies, then liquidating distribution may be tax-free

To Foreign Individual

- No U.S. income/gift/estate tax consequences.
Profits and losses may be offset.

However, when US 1 sells property at a substantial gain, difficult for USCo to repatriate proceeds without dividend WHT, unless treaty permits a zero rate.
Structure 8: Multiple Properties – Distribution of Sale Proceeds Priority

Profits and losses may not be offset.*

However, when US 1 sells all property at a substantial gain, can liquidate tax-free per Cleansing Exception.

* Consider merger!
Structure 9: Leveraged U.S. Blocker with Treaty Benefits

Benefits

- Income allocated to U.S. Blocker by SPE
- U.S. Blocker pays deductible interest (fixed plus contingent interest on certain gains and income), reducing U.S. tax base, BUT subject to new 30% deductibility limitation unless Small Business Exception or electing RPTB Exception
- Beware of new anti-hybrid rules preventing interest deduction if interest is not taxed in Barbados/Norway
  - Pre-TCJA this was a double dipping strategy, i.e., deduction + no inclusion
- No U.S. withholding tax on the interest payments if tax treaty applies
- Dividends paid by U.S. Blocker to Norway subject to 5% withholding tax, and <1% effective tax in Norway
  - Beware of changing hybrid and treaty rules under BEPS/MLI
- Norway dividends to EU FC likely not taxed under EU participation exemption
Structure 10: Portfolio Interest Partnership Lender Structure For Investor Group

Foreign Partners

All foreign partners have less than 10% of FP.

Foreign Partnership

Foreign Corp.

Loan

Interest

US Corp.

USRPI
Structure 11: Portfolio Interest
Split Vote/Value Structure – Does it Work?

100% Foreign Individual

0% Vote 95% Value

100% FC 1

0% Vote 95% Value

FC 2

100% FC 3

100% Other Shareholder

10% shareholder test based on voting power.

Split must be real!

IRS will examine closely.

Portfolio Interest

Loan*

US Corp.

USRPI
Professor Alan I. Appel

Professor Alan I. Appel specializes in international and domestic tax planning. He is on the Board of Advisors for the Journal of International Taxation and the Journal of Taxation and Regulation of Financial Institutions. He was formerly Council Director for the International Tax Committees as well as the Chair of the U.S. Activities of Foreigners and Tax Treaties Committee of the American Bar Association Section of Taxation. Professor Appel holds a J.D. from New York Law School and an L.L.M. from New York University. At New York Law School, he is the Director of the International Tax Program. He teaches courses in International Tax, Corporate Tax, and Federal Income Tax. Prior to joining New York Law School, he spent 13 years in the New York office of Bryan Cave LLP.
Eric Homsi is a member of the Tax Advice and Controversy Group. Mr. Homsi’s practice concentrates primarily on advising public and private companies with respect to business tax issues associated with structuring, negotiating, and executing domestic and cross-border acquisitions, as well as mergers and restructurings. Mr. Homsi also provides guidance to clients on federal income tax issues associated with equity and debt securities offerings. In addition, he assists multi-national businesses with inbound and outbound tax planning and strategy.

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New Jersey, 2010
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New York University, LL.M., 2013
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Mr. Homsi is also a certified public accountant, and his prior professional experience includes practice with a Big Four accounting firm.

Professional Affiliations

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As co-head of Gide’s New York office and head of Gide’s U.S. Tax practice, partner Vanessa Tollis specializes in the U.S. tax aspects of cross-border transactions, both inbound and outbound. Ms. Tollis advises a wide range of U.S. and foreign clients on tax planning for starting or expanding operations abroad or in the U.S. market, including through mergers, acquisitions, reorganizations, and joint ventures, and she advises both participants and sponsors in the global capital markets on securities offerings and tax efficient structured finance, including cross border securitizations. Ms. Tollis also counsels investors and funds regarding the tax aspects of structuring and financing cross border fund structures and investments, and she advises high net worth individuals on international tax compliance and disclosure concerns.

With more than 16 years of experience, Ms. Tollis has developed significant expertise advising corporate and finance clients on a broad range of key U.S. international tax matters, including U.S. trade or business thresholds, tax treaty application, withholding taxes, entity classification, debt/equity characterization, foreign tax credits, Passive Foreign Investment Company (PFIC), Controlled Foreign Corporations (CFC) and Subpart F, Foreign Investment in Real Property Tax Act (FIRPTA), the Foreign Account Tax Compliance Act (FATCA) regime, and a broad range of domestic tax rules. Ms. Tollis also has significant experience in related non-tax transactional work, including general corporate and secured transactions.

Ms. Tollis headed the U.S. Tax practice at Gide for 9 years, then spending several years as Chair of the International Tax practice in the New York City office of an AMLAW 100 firm before rejoining Gide in 2016.

She also speaks French and Swedish.