JUNE 11, 2018
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Real Estate Finance & Investment

USING THE SECTION 199A QUALIFIED BUSINESS INCOME DEDUCTION

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On December 22, 2017, H.R.1, commonly referred to as the Tax Cuts and Jobs Act, was signed into law. One of the most significant changes affecting the real estate industry is the new 20 percent business income deduction available to pass-through entities and real estate investment trusts. This article provides a brief analysis of the implications of the deduction and offers insights into structuring your real estate investment vehicle to reduce the income tax imposed on rentals and other business income.

OVERVIEW OF THE QBI DEDUCTION

The 20 percent deduction is available to non-corporate taxpayers for their qualified business income. REIT shareholders are eligible for the deduction with respect to dividends paid by the REIT other than capital gain dividends. As pass-through entities and REITs are typically the vehicles of choice for real estate transactions in the United States, the QBI deduction represents a significant opportunity for the industry.

QBI is the net amount of qualified items of income, gain, deduction and loss, to the extent such items are effectively connected with a qualified domestic trade or business, which generally includes real estate businesses. Interest, dividends (other than REIT dividends), capital gains, and other types of investment income are not treated as QBI.

As a result of the QBI deduction, the top marginal federal tax rate on QBI is potentially reduced from 37 percent to 29.6 percent.

LIMITATIONS OF THE QBI DEDUCTION

The QBI deduction is subject to several limitations. The Tax Act generally limits the deduction attributable to a particular pass-through business to the greater of: (i) 50 percent of the individual's W-2 wages paid with respect to the qualified trade or business, or (ii) the sum of 25 percent of such W-2 wages plus 2.5 percent of the tax basis, immediately after its acquisition, of the business's qualified property (i.e., tangible property subject to depreciation or held by the business for less than 10 years and used, during the taxable year, to produce QBI).

Primarily due to the W-2 wage limitation, the full benefit of the QBI deduction is likely to be out of reach for many real estate businesses since they do not employ workers directly. Rather, these entities typically engage a third-party or related manager that employs the workers. In this circumstance, the QBI deduction is effectively limited to 2.5 percent of the purchase price of the depreciable real estate.

Another limitation is that the QBI Deduction is not a permanent fixture in the tax code and is set to expire on December 31, 2025.

RESTRUCTURING TO UNLOCK LARGER QBI DEDUCTIONS

In light of the QBI deduction limitations, we discuss below two possible restructuring techniques real estate businesses may implement to increase the QBI deduction available to the business's owners.

Increasing Direct Employment as a Means to Increase the QBI Deduction

A real estate holding company may consider taking steps to increase its W-2 wages by employing workers directly. Companies can also work with their accountants to explore whether commonly-owned companies or partnerships that are currently set-up as separate entities for tax purposes can be consolidated and reorganized such that their activities are more likely to be viewed as a single integrated business in an effort to put income and W-2 wages in the same business. This analysis will necessarily vary on a case-by-case basis.

The owners and managers of related entities will naturally have chosen to operate their businesses in separate legal entities for good reason (to avoid liability for employee claims and the obligation to maintain workers compensation insurance, for instance). While the increased risks associated with holding assets and liabilities under the umbrella of a single entity potentially make such restructuring undesirable, it may be possible to ring-fence certain liabilities in a limited liability company or limited partnership that is wholly owned by, and treated for tax purposes as part of, another entity that directly or indirectly owns the real estate.

Private REITs: QBI Deductions without Wage or Basis Limitations, but Beware of Higher Administrative Costs and Capital Reserve Limitations

A second option is to use a private REIT in the same way one would use an LLC as the real estate holding vehicle. REITs are generally not taxed at the corporate level, but in effect, are treated like quasi pass-through entities as at least 90 percent of a REIT's net income must be distributed annually to its shareholders, who are then taxed at their respective individual tax rates on such dividend distributions. Under the Tax Act, REIT shareholders may take advantage of the QBI deduction, treating dividends attributable to operating income ("ordinary REIT dividends") as QBI. Importantly, REIT shareholders are not subject to the wage or basis limitations discussed above, allowing them to more easily obtain the full benefit of the QBI deduction.

However, there are certain drawbacks that should be considered before making the decision to structure as a private REIT. Namely, the costs associated with forming a REIT and maintaining its tax status are typically significantly higher when compared to an LLC that is taxed like a partnership, for example.

The most costly of the formation requirements is the 100 shareholder rule. In order to qualify as a REIT, REITs must have a minimum of 100 shareholders by around the thirtieth day of their second taxable year. To accomplish this, private REITs will often look to a third-party private placement agent to locate a sufficient number of shareholders, usually preferred shareholders, and to provide administrative support related to those shareholders (e.g., issuing dividend checks, fulfilling IRS reporting requirements, etc.). For its shareholder placement services, agents will charge a number of fees. To illustrate, the proceeds from the issuance of shares having a face value of $1,000 to 115 preferred shareholders will be $115,000. For its administrative services, the agent will generally charge a funding fee of $11,500 plus an initial fee of $1,000, and annual fees between $5,000 and $9,000. Thus, the cost in the first year may exceed $20,000, and there may be recurring annual costs of up to $9,000.

In addition to the 100 shareholder requirement, REITs are also subject to other requirements in order to maintain their preferential tax status. Principal among these are the quarterly asset test and annual income test. The asset test requires that at least 75 percent of a REIT's assets consist of real estate assets (land, buildings, and other improvements), cash, shares of other REITs, debt securities of public REITs, and government securities. The first prong of the two-pronged income test requires that 75 percent of a REIT's gross income be derived from certain real estate related sources (including rents from real property, gains from the sale of real property and interest income from debt secured by real property). The second prong requires that 95 percent of a REIT's gross income be derived from the sources qualifying under the first prong, plus interest income, dividend income and gain from the sale or disposition of stocks and securities. The costs of complying with these tests, primarily stemming from audit and tax return preparation fees, will vary, but can exceed $75,000 each year.

Further, the annual distribution requirement poses a potentially significant burden for certain types of projects, namely redevelopment and other project types where significant ongoing capital expenditures are anticipated and there is positive cash flow that is reinvested in the project.

REITs generally are unable to accrue capital reserves to meet upcoming needs without the imposition of tax. Because of this, where a project is producing significant net cash flows which would otherwise be held for on-going capital needs, the private REIT structure may not be more efficient than a partnership structure.

Accordingly, where a project is large enough and currently stabilized, a REIT structure has the potential to result in significant tax savings.

The decision whether or not to restructure a real estate business to take advantage of the QBI deduction will necessarily call for a fact-specific inquiry into the needs and demands of both the project and its investors. For additional information relating to the impact of the QBI deduction in your particular circumstances, or any other real estate or tax question or concern, please contact any of the authors mentioned below.

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