KPMG

What's News in Tax

Analysis that matters from Washington National Tax

Possible Issues for Real Estate under the House Republican Blueprint

January 16, 2017

by James B. Sowell, Washington National Tax, and Dene A. Dobensky, NYFS Real Estate*

As prior experience has shown, changes in the tax law can have significant implications for specific industries. Many believe that changes detrimental to the real estate industry made during the last major tax reform effort in 1986 had material ripple effects throughout the economy, contributing to the savings and loan crisis and the subsequent real estate depression of the late 1980s and early 1990s.[1] Accordingly, the real estate industry will have a keen interest in the implications of current tax reform proposals under consideration.

Although a number of tax reform proposals have been formulated and discussed in recent years, the one that is the subject of most current discussion is referred to as the House Republican "Blueprint."[2] The Blueprint is a high level, conceptual document that was released by House Republicans last June; no statutory language has been proposed or released. The discussion below addresses a number of issues raised by the Blueprint that could be highly relevant to the real estate industry if tax reform based on the Blueprint ultimately were enacted.

---

* James B. Sowell is a principal in the Passthroughs group of Washington National Tax ("WNT"). James is a former associate tax legislative counsel and attorney advisor at the U.S. Treasury's Office of Tax Legislative Counsel. Dene A. Dobensky is a is a principal in the NYFS Real Estate practice. The authors would like to thank Guy Bracuti, Ron Dabrowski, and Carol Kulish for their helpful comments in connection with this article.

1 *See*, *e.g.*, W. Starbuck and P.Pant, *Trying to Help S&Ls: How Organizations with Good Intentions Jointly Enacted Disaster*, Organizational Decision Making pp. 35-60 (Cambridge Univ. Press 1996) http://pages.stern.nyu.edu/~wstarbuc/sl/trying.html.

2 *A Better Way—Our Vision for a Confident America*, (June 24, 2016) (a document referred to as the "Blueprint" published by the House of Representatives Republican Tax Reform Task Force).

Tax Rates

The Blueprint proposes creating three effective top marginal rate brackets applicable to different categories of income earned by individuals:

- 25% applicable to certain "business income" of pass-through entities and sole proprietorships,
- 16.5% (by virtue of a 50% deduction) applicable to capital gains, dividends, and interest, and
- 33% applicable to other income.

For real estate, the proposed 25% rate on business income might seem at first blush to be quite beneficial, but this determination really depends on what types of income would be subject to that 25% rate. To the extent that dealer property sales and rent would be subject to tax at a 25% rate, and capital gains would be subject to the more beneficial 16.5% effective rate, the proposed rate structure looks favorable. If, however, some rent were subject to tax at a 33% rate and capital gains from the sale of property derived in the conduct of a real estate trade or business became subject to the 25% rate (rather than benefiting from a 16.5% rate), the proposed rate structure starts to look less beneficial.

With regard to the proposed 25% rate applicable to pass-through entities and sole proprietorships, the Blueprint, in different sections, references both "business income" and "active business income." The Blueprint does not define either term, but generally indicates that the tax treatment of business income will build on concepts set forth in the Main Street Fairness Act (H.R. 5076) (the "MSF Act"), which references an "active conduct of a trade or business" standard in describing qualifying business income.[3]

Current authority interpreting the "active conduct" standard in the context of rental real estate generally would require that the taxpayer, through its officers and employees, must provide substantial management and operational activities while property is leased, and activities of independent contractors would not be taken into account for these purposes.[4] Self-managed property likely would qualify under this standard, so long as such property is not "net" leased. When a third party manager is hired for some or all of the rental activities, such a standard could establish a difficult facts and circumstances determination, with close call scenarios encouraging significant IRS audit activity. As a separate concern, real estate competes for capital from the same individuals who invest in debt instruments and C corporation stock. If the law were changed so that passive rental real estate income (i.e., net lease rental and rent with respect to property managed by independent contractors) were

---

[3] H.R. 5076, §2(a)(i)(2).

[4] *See* Rev. Rul. 2001-29, 2001-1 C.B. 1348 (section 355); Rev. Rul. 73-126, 1973-1 C.B. 183 (section 355); G.C.M. 35121 (Nov. 18, 1972) (section 355); G.C.M. 35119 (Nov. 16, 1972) (section 35); section 1.954-2(c)(1)(ii) (section 954); section 1.1362-2(c)(5)(B)(2) (section 1362); Rev. Rul. 2006-34, 2006-1 C.B. 1172 (section 6166). Activities with respect to net lease property also may not rise to the level necessary to constitute an active trade or business. Section 1.1362-2(c)(5)(B)(2) (section 1362). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

taxed at a rate that is double that of interest and dividends, this could put some real estate at a considerable disadvantage when competing for capital in the marketplace.

The Blueprint also proposes that families and individuals would be entitled to deduct 50% of their net capital gains, dividends and interest, resulting in a maximum effective rate for such income of 16.5%. The Blueprint does not state any restrictions as to the type of capital gain, dividends, or interest to which such rates would apply or whether alternate standards might be adopted for purposes of determining activities that would give rise to such qualifying income. A separate bill introduced by Rep. Nunes entitled the American Business Competitiveness Act (H.R. 4377) (the "ABC Act"), however, proposes a number of provisions similar to those contained in the Blueprint, including a 25% rate applicable to business income.[5] The statutory language in this bill raises concerns as to the rate applicable to real estate capital gains. Specifically, the ABC Act would tax at 25% all gain from the sale of property recognized by a business entity,[6] except to the extent that the receipts represent "financial receipts," which would apply only to the sale of stock, other ownership interests in business entities, and other financial instruments.[7] Under the ABC Act, proceeds from the sale of real property would not appear to qualify as financial receipts and thus seemingly would not qualify for the more favorable rate applicable to capital gains. The MSF Act, mentioned above, specifically carves out net capital gains from qualified business income, which might provide some indication regarding what is intended under the Blueprint.[8] Nonetheless, the ABC Act is referenced in other parts of the Blueprint, so implications raised by that legislation also could be relevant. Keep in mind, of course, that taxwriters have flexibility to flesh out the details of the Blueprint as they see fit as the legislative process evolves.

Finally, in the context of the 25% rate business income discussion, the Blueprint indicates that owner-operators of pass-through entities and sole proprietorships would be taxable at the higher 33% rate on "reasonable compensation." Adopting a reasonable compensation standard could implicate the "carried interest" debate that has generated significant controversy in recent years.[9] In addition, application of

---

[5] Unlike the MSF Act, the ABC Act references a standard of "business income" for qualifying 25%-rate income rather than "income from the active conduct of a trade or business." Receipts from "the use of property" are specifically included as business income for these purposes. H.R. 4377, §1421(b)(1).

[6] H.R. 4377, §1421(a) and (b)(1).

[7] H.R. 4377, §1421(b)(5)(A) and (B)(iii).

[8] H.R. 5076, §2(a)(i)(4).

[9] Representative Kenny Marchant (R-Texas), a member of the House Ways and Means Committee, is reported as stating that one option for addressing the reasonable compensation issue would be to create a safe harbor providing that, so long as at least 70% of a service partner's income is treated as compensation, the arrangement would be respected. K. Basu and L. Davison, *Ways and Means Talks Final Details of Passthrough Tax Plan*, BNA Daily Tax Report G-5 (Jan. 11, 2017). Such an approach might be similar to a previous proposal made by former Ways and Means Chairman Dave Camp in the context of determining the amount of a pass-through entity's income allocated to an active interest holder that would be subject to the self-employment tax. Tax Reform Act of 2014, 113th Cong., 2nd Sess. §1502 (2014). In a separate article published on the same day, Rep. Marchant suggested that the capital gains tax rate should remain in place with respect to carried interest. L. Davison, *Carried Interest Tax Break Might be Safe in House Plan*, BNA Daily Tax Report G-2 (Jan. 11, 2017). This suggests that the reasonable compensation recast of partnership income might apply only with respect to business income otherwise taxable at a 25% rate. Importantly, however, other members of the Ways and Means Committee quoted in the same article,

the reasonable compensation concept in the corporate context (both C corporations and S corporations) has generated substantial audit activity and litigation over the years.

Trade-off of Interest Deduction and Immediate Expensing of Capital Improvements

The Blueprint would provide for the deduction of interest expense against interest income, but no current deduction would be allowed for net interest expense.[10] Obviously, losing the ability to deduct net interest, in isolation, could negatively affect real estate businesses.

Some supporters of the Blueprint suggest that this detriment would be “offset” by the ability to immediately deduct capital expenditures with respect to tangible and certain intangible property (such as intellectual property), but excluding land. In isolation, the ability of real estate businesses to deduct the cost of buildings and other non-land improvements would seem to be favorable and might possibly be an acceptable tradeoff for the loss of deductibility for net interest expense. But the devil would be in the details, and the results of this tradeoff likely would be different for different taxpayers.

The ability to deduct the cost of purchasing or constructing buildings would make it highly likely that a taxpayer engaging in such activities would have net operating loss carryovers for a number of years. The Blueprint proposes that net operating losses could be carried forward indefinitely and indexed for inflation. Net operating losses could not be carried back, and the deduction allowed for net operating loss carryovers would be limited to 90% of the net taxable amount for each applicable year determined without regard to the net operating loss carryover.

As mentioned above, the net benefit or detriment of the proposed tradeoff would depend on the specific facts. In general, the present value reduction in taxes resulting from the immediate expensing of capital expenditures would have to be compared with the present value of additional taxes incurred as a result of the loss of net interest deductions. An example is helpful in illustrating this analysis. For purposes of illustration, assume that a taxpayer 100% finances the construction of a building for $1,000 in a situation in which the taxpayer already owns the underlying land (and the land serves as additional collateral that makes 100% financing of the building possible). The debt is a 15-year interest-only loan with interest at 5% (annual interest of $50). The property generates $100 of annual net operating income before interest. The building is sold for $1,000 after 11 years. (The impact of the land is ignored for purposes of this example.)

Under the Blueprint, it appears that the taxpayer would have no taxable income in the first year, and would have taxable income of $10 for the remaining 10 years.[11] The taxpayer would have taxable gain of $1,000 in the year of disposition, which would be partially offset by a remaining net operating loss

---

including Chairman Kevin Brady, stated that the taxation of carried interest was still under consideration. *Id.* Further, President-elect Trump supported taxing carried interest as ordinary in the election campaign.

[10] Query the treatment of guaranteed payments for the use of capital under section 707(c) under a regime when deductions for net interest are disallowed.

[11] The limitation on net operating loss carryovers to 90% of the income earned would mean that the $900 carryover would be exhausted after 10 years of income earned at a rate of $100/year.

carryover of $93 which would exist due to compounding for inflation.[12] Presumably that gain would be taxed at the recapture rate equal to the rate of tax applied to the income against which the expensing deduction was taken.[13] Accordingly, the taxpayer would recognize total income and gain (presumably all taxed at a 25% rate) of $1,007 over the life of the investment.[14] Assuming a 6% discount rate, the present value of taxes incurred over the 11 year period would equal $136.70.[15]

By comparison, applying current-law rules applicable to the expensing of interest and depreciation, the taxpayer would recognize annual taxable income of $25, based on a 40-year depreciable life for the property ($25 depreciation annually) and full deduction of the $50 of interest each year. The taxpayer would recognize gain of $275 ($1,000 amount realized—$725 adjusted basis)[16] upon disposition of the property at the end of the 11th year. Accordingly, the taxpayer would recognize total net taxable income over the life of the investment equal to $550.[17] Assuming application of the 25% business income tax rate to all income, the present value of taxes incurred after 11 years, assuming a 6% discount rate, would equal $85.51. [18]

Under these facts, the benefit from immediate expensing of capital expenditures would not offset the detriment associated with the loss of the deduction for net interest incurred (i.e., in this scenario, there would be a 60% increase in the present-value tax cost to the individual). Major factors to consider in determining whether this calculation could result in a benefit or detriment for a taxpayer include: (1) interest incurred with respect to the investment and timing of the interest, (2) the tax that is avoided in early years by virtue of the immediate deduction of capital expenditures and the timing of avoided taxes, (3) the discount rate applied to taxes paid, (4) the inflation rate applied to, and amortization period of, the net operating loss, and (5) the holding period of the property, which will determine when the benefit of immediate expensing would be recaptured as recognized gain.

---

[12] This growth in the net operating loss carryover assumes that the rate of inflation applicable to growth of the net operating loss equals 1.7% (the U.S. 12-month inflation rate as of the end of November 2016), which would result in a growth in the net operating loss carryforward by $93 over the life of the investment. Note that the indexing of the net operating loss for inflation provides some offset to the loss of the interest deduction, as the additional $93 deduction would not be available under the current tax system.

[13] It seems unlikely that Congress would permit taxpayers to fully expense the cost of property in a single year, deducting such amounts against business income taxable at a 25% rate, and potentially recognize an equivalent amount of capital gain taxable at an effective rate of 16.5% one year later by selling the property for an amount equal to its original cost. This drives the assumption that the gain equal to the prior capital expenditure deduction would be taxable at recapture rates rather than the 16.5% effective rate applicable to net capital gain.

[14] That is, $100 per year from operations for 11 years and $1,000 of gain on sale of the property, offset by the $1,093 net operating loss generated by deduction of the cost of the building and indexed for inflation.

[15] For purposes of this calculation, applying the 25% tax rate, taxes incurred would be $0 in year 1, $2.50 in years 2-10 ($10 x 25%), and $229.25 in year 11 ((($100 + $1,000) - $183 remaining NOL) x 25%).

[16] The $725 adjusted basis is the result of the reduction of property basis for $25 of annual depreciation over 11 years (i.e., $275).

[17] That is, $25 per year from operations for 11 years and $275 of gain on sale of the property,

[18] For purposes of this calculation, applying the 25% tax rate, taxes incurred would be $6.25 in years 1-10, and $75.00 in year 11.

Other Issues Raised by Proposed Immediate Deductibility of Capital Expenditures

As previously mentioned, taken in isolation, the proposed ability to immediately deduct capital expenditures seems like it would result in a benefit to taxpayers in virtually all instances. Without certain adjustments to the current tax rules in other contexts, however, this may not be the case.

As one example, the likelihood of significant net operating loss carryovers for real estate investment trusts ("REITs") raises the prospect of material double-taxation of REIT shareholders without modification to the rules applicable to earnings and profits. The public REIT market generally expects that a REIT will pay dividends that yield a certain return without regard to the taxable income of a REIT. Distributions payable by a REIT are taxable as dividend income if paid out of current or accumulated earnings and profits. Under the current tax rules, a net operating loss carryover will not reduce current earnings and profits.[19] Accordingly, even when a REIT would have a cumulative deficit in earnings due to the deductibility of capital expenditures, its shareholders still would recognize dividend income to the extent the REIT has current earnings and profits in the year of the distribution, determined without regard to any net operating loss carryover.[20]

Similar problems could exist for foreign corporations owning real estate (including foreign "blocker" corporations used in the real estate fund context). For example, if a foreign corporation acquires real property in one year, deducting the cost of all structural improvements, and sells that property the following year for an amount equal to the original purchase price, the foreign corporation would have current earnings and profits in the year of disposition, and assuming that the corporation is not liquidated, significant dividend withholding would be required even though no economic profit was realized with respect to the property.

As these situations highlight, the deductibility of capital expenditures would necessitate modifications to the earnings and profits rules in order to prevent the inequitable results described.

A problem analogous to that generated by the earnings and profits rules also could arise in the context of the Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"). The problem would arise in virtually all situations in which a REIT with non-US owners (other than qualified foreign pension funds or less than 10% owners of a public REIT) sells real estate. Specifically, the immediate expensing of buildings and improvements would magnify the FIRPTA gain for such shareholders, and it would appear that no offset to that gain would be allowed for any net operating loss carryforward created by the expensing.

---

[19] Section 1.312-6(d).

[20] Distributions treated as dividends would not reduce the shareholder's basis in its stock. Accordingly, upon a taxable disposition of the stock, gain would be reduced or loss increased as a result of the treatment of such prior distributions as dividends rather than as a return of capital.

Admittedly, problems related to not being able to reduce REIT earnings and profits or offset FIRPTA gain with net operating loss carryovers exist under current law,[21] but with the likely magnification of such carryovers by virtue of expensing buildings and improvements, the gravity of the problem could become much more severe.

Separately, some are questioning whether the rules providing for nonrecognition under section 1031 for like-kind exchanges would survive in a tax regime with immediate expensing of capital expenditures. In many circumstances, full expensing of capital expenditures effectively allows for a replication of the results under section 1031 so long as the taxpayer fully reinvests cash attributable to recognized gain in qualifying capital expenditures in the same tax year. For real estate, however, the inability to deduct the cost of land makes the comparison imperfect, because a taxpayer selling land and a building, recognizing gain with respect to each component of the property, cannot offset the gain on the land component by reinvesting in building and land when the land has a value equal to the land sold.

Finally, it is unclear how the net operating loss carryover would operate in the context of pass-through entities such as partnerships. The Blueprint references the ABC Act as describing a similar business cash-flow tax system to that described in the Blueprint. In the context of pass-through entities, there may be some indication in the ABC Act that a net operating loss carryover would be deductible by the pass-through entity rather than the partners.[22] If such treatment is intended, this would represent a significant departure from the current treatment of losses with respect to pass-through entities and, given the divergent treatment of many pass-through items by different partners, would raise concerns.

Flexibility of Pass-through Entities

Under current law, entities taxed as partnerships are very flexible, with contributions to, and distributions by, these entities generally qualifying for nonrecognition treatment. This flexibility is very important to the portability of real estate, thus facilitating the development of real estate and increasing commerce. It is unclear how a tax system that includes deductibility of capital expenditures might affect the nonrecognition treatment currently applicable to entities taxed as partnerships. Although the Blueprint provides no details in this regard, in the ABC Act, nonrecognition treatment would continue to apply to contributions to partnerships, while property distributions would be treated as purchases by the distributee except with respect to distributions received by a controlling business entity (i.e., a business

---

[21] *Cf. ABA Members Comment on Guidance Addressing Distributions Between Foreign Governments, REITs*, 2008 Tax Notes Today (June 12, 2008) (report issued by American Bar Association in response to Notice 2007-55 makes recommendation that REIT shareholders should be able to offset FIRPTA gain by net operating loss carryovers related to disposed property).

[22] H.R. 4377, §1421(c)(1)(D). This provision references as a "deductible amount," a business entity's loss carryover deduction (determined under section 172). For these purposes, a business entity includes "any corporation (including an S corporation), unincorporated association, partnership, limited liability company, proprietorship, independent contractor, individual, or any other person, engaging in business activity in the United States." H.R. 4377, §1421(e)(1). It is possible that the reference in the ABC Act is intended to apply only to business entities, such as corporations, that traditionally could have a net operating loss determined at the entity level. If that is the case, the concern raised above would not exist.

entity that owns more than 50% of the profits or capital interest of the partnership).[23] Any such material alterations with respect to nonrecognition treatment for partnership contributions and distributions would raise significant concerns for the real estate industry.

Destination-Based Territorial Tax System

The United States currently operates under a worldwide tax regime under which U.S. taxpayers are taxable on their worldwide earnings, but are permitted a credit, subject to certain limitations, for taxes paid to foreign jurisdictions. In general, non-U.S. taxpayers are subject to tax on income that is “effectively connected” with a trade or business conducted within the United States (or under an applicable tax treaty with respect to income attributable to a permanent establishment within the United States) and with respect to passive FDAP (fixed, determinable, annual and periodic) income from sources within the United States, such as dividends, rents, and interest. Under current law, a non-U.S. person’s sale of U.S. real estate is deemed to be “effectively connected” under the FIRPTA rules.

The Blueprint describes an entirely new, and radically different, international tax system:

> Under a destination-basis approach, tax jurisdiction follows the location of consumption rather than the location of production. This Blueprint achieves this by providing for border adjustments exempting exports and taxing imports, not through the addition of a new tax but within the context of the transformed business tax system. The Blueprint also ends the uncompetitive worldwide tax approach of the United States, replacing it with a territorial tax system that is consistent with the approach used by our major trading partners. These two fundamental structural changes in turn allow other important aspects of the international tax rules to be simplified and streamlined significantly.

The Blueprint description outlines broad concepts, but does not provide adequate detail to allow one to confidently determine how those concepts would play out in the real estate context. As a threshold matter, the Blueprint’s border adjusted, destination-based system appears to apply to all business income, but as noted above, with different rates for sole proprietorships and pass-through business entities, as opposed to corporations.

Under this new business tax, it appears that transactions would be taken into account only if the counterparty is a U.S. taxpayer. Accordingly, income received from customers that are U.S. taxpayers would be taken into account, but expenses (consumption) paid to non-U.S. taxpayers would not. It would appear that, in a typical scenario, a U.S. business purchaser of imported goods would not receive any basis for cost of goods sold related to these products, so that 100% of the sales proceeds of any subsequent sale of such goods within the United States would be subject to tax. Correspondingly, a U.S. business that purchases property for use in its business from a non-U.S. seller would be unable to recover these costs through expensing or offset in a gain computation. Such a

---

[23] H.R. 4377, §§1422 and 1422A.

result obviously could be significant for real estate developers in determining how they source their supplies for construction of buildings. For example, a direct purchase of Italian marble from Italy could result in the denial of any cost recovery for this portion of the capital expenditures incurred in the construction of the building.

With respect to non-U.S. persons, one gating issue regarding their taxation is determining when they became U.S. taxpayers, which is tied to the U.S. trade or business standard. It is unclear whether or how the U.S. trade or business standard will change through tax reform and, as a related point, in what contexts rules similar to the current FDAP rules might be applied.[24] Accordingly, it is unclear in what contexts rent on U.S. property paid to a foreign person will be treated as FDAP and subject to withholding tax or whether it will be deemed associated with a U.S. trade or business and hence subject to tax at applicable rates under the destination-based system. The resolution of this issue might be affected by the treatment of rental income as "active business income" subject to the 25% tax for sole proprietors and members of pass-through entities, an issue discussed above. It seems clearer that rent paid to a U.S. business by non-U.S. taxpayers with respect to foreign property would not be considered income for the U.S. business. Similarly, income for management services provided overseas with respect to the management of real estate investments would seem not to be subject to U.S. tax. There would be no crediting of non-U.S. taxes under such a regime, so payment of taxes in foreign jurisdictions would appear to be irrelevant to the calculation of U.S. tax liability.

The implications for FIRPTA are unclear under the Blueprint. House Ways and Means Chairman Kevin Brady has been reported to say that repeal of FIRPTA is on the table in the context of comprehensive tax reform centered around the Blueprint.[25] The Chairman's statements suggest that he favors moving the current U.S. trade or business line to take an otherwise non-U.S. taxpayer's sale of U.S. real estate out of the U.S. tax net. In the context of the Blueprint regime, a few ancillary issues could arise from such a move of the trade or business line: Would a U.S. business buying such real estate from a non-U.S. taxpayer get a deduction (or basis in land) under border adjustability? Would a U.S. business's sale of such U.S. real estate to a foreign person be similarly exempt under border adjustability? These are undoubtedly issues to watch as tax reform moves forward.

Transition Rules

Finally, there is the issue of transition rules. In moving to such a radically different tax system, the potential transition issues are seemingly limitless.

The Blueprint notes that the Ways and Means Committee "will craft clear rules to serve as an appropriate bridge from the current tax system to the new system, with particular attention given to

[24] It also is unclear to what extent tax treaty permanent establishment provisions will continue to apply.

[25] *Legislative Update: Comprehensive Tax Reform in 2017, Predicts Brady,* https://home.kpmg.com/us/en/home/insights/2016/11/tnf-legislative-update-comprehensive-tax-reform-in-2017-predicts-brady.html (reporting on statements made by House Ways and Means Chairman Kevin Brady at an event sponsored by Bloomberg BNA and KPMG LLP).

comments received from stakeholders on this important matter." However, it does not get into the details of possible transition rules.

One issue of great significance relates to the deductibility of remaining adjusted basis for capital assets purchased prior to the effective date of legislation. Without a transition rule for earlier purchasers, in many situations those taxpayers who purchase property after the effective date would be provided a significant competitive advantage. The Blueprint provides no signal as to what form transition rules might take in this context. The ABC Act, like the Blueprint, would provide for the immediate expensing of the cost of "business purchases" and would repeal existing rules relating to depreciation. In general, the transition relief provided by the ABC Act would permit amortization of the adjusted basis of the pre-effective date property on the same schedule and method that applied to the property before enactment of the legislation.[26] Thus, if taxwriters decide to take this approach as they flesh out the details of tax reform, there could be winners and losers based upon the timing of property purchases before or after the effective date of such legislation.

Another issue of key concern to the real estate industry would be transition rules relating to the deductibility of interest for debt outstanding prior to the effective date of the legislation. Given that such debt would have been incurred with the expectation that interest related to such debt would be deductible, it might be argued that equities should favor continuing to allow deduction of interest with respect to such debt. Again, the Blueprint does not say whether transition relief might be provided in this context. To the extent the ABC Act might provide a signal as to what course of action ultimately might be pursued, this signal would not be encouraging. Like the Blueprint, the ABC Act would disallow the deduction for net interest expense.[27] Transition relief would be provided only with respect to existing debt issued by a corporate taxpayer, and the transition relief effectively would phase out the deduction for interest on such debt over time based on a formula.[28] As noted above, however, the Blueprint does indicate that attention will be given to stakeholder comments in crafting transition rules.

Conclusion

As the discussion above highlights, there are many issues in the context of tax reform in line with the Blueprint that could affect the real estate industry. This article merely scratches the surface with respect to some of the most significant issues.

The Blueprint describes only high-level concepts. Without statutory language addressing these concepts and how existing law might change in other contexts in response to adoption of these concepts, it is impossible to accurately evaluate the net tax benefit or cost that could result from the legislation.

---

[26] H.R. 4377, §5(2)(B).

[27] H.R. 4377, §§6(b) and 11(a).

[28] H.R. 4377, §11(a).

And beyond the tax cost associated with the changes, there also are behavioral changes that could be significant. For example, might the tax benefit associated with immediate expensing of capital expenditures, such as the cost of buildings, encourage an increase in the incidence of owner-occupied business property? Also, if debt loses part of its attractiveness in the capitalization of real estate due to the non-deductibility of interest, might there be a shift toward adding additional equity, an expensive proposition, possibly pushing cap rates up and values down?

One point seems likely—there will be winners and losers among various business industries and investment groups in connection with fundamental tax reform. It will be important that members of the real estate industry remain informed as to the possible implications of legislation in order to avoid a repeat of the 1986 experience.

□ □ □ □