

# Client Alert

Capital Transactions and Real Estate Practice Group

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## Comprehensive Tax Reform Remains a Top Priority for Key Members

### *Congressional Consideration Continues, Including Provisions That Would Impact the Real Estate Industry*

The House Ways & Means Committee is currently holding Member-level discussions on tax reform and is in the process of drafting a comprehensive tax reform package that reduces both business and individual tax rates, and broadens the base by eliminating tax expenditures and closing loopholes.

Ways & Means Committee Chairman Dave Camp (R-MI) has made it clear he intends to move tax legislation through his Committee this year, and that process began in earnest following the summer break. The Committee is holding Member-level meetings to discuss tax reform options, building on the more than 20 hearings held over the past three years, the tax reform working group process from this past spring, and the discussion drafts Chairman Camp has already released.

The House meetings continued largely unabated through the month of September as part of a push to consider tax reform this fall. The stepped up pace is intended to culminate in Committee action on a comprehensive tax reform bill, targeting October. The Committee already has discussion drafts issued for public comment in the areas of international tax, financial products, and small business and pass-through taxation.

The Senate Finance Committee is holding its own version of Member-level discussions, with Chairman Max Baucus (D-MT) meeting one-on-one with fellow Senators. Chairman Baucus has said that he too intends to put forth, and if possible mark-up, a tax reform package this fall. However, Chairman Camp and Chairman Baucus face a variety of issues that may affect the timing of tax reform consideration.

First, in spite of the progress Chairman Camp has made in developing tax reform legislation, the House leadership has not made it a priority for this year. It remains uncertain whether any bill that might be marked-up will actually be considered by the full House. Second, Ways and Means Committee Democrats have been reluctant to participate in the process. Any legislation that the committee passes will be accomplished only with Republican votes.

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Comprehensive tax reform will be a difficult thing to accomplish, and nearly impossible without some measure of bipartisanship. Even so, the two primary committees of jurisdiction are working overtime to advance the ball and will set the table for any future tax reform that will inevitably come.

In the meantime, Chairman Camp and Chairman Baucus face a variety of issues that may affect the timing of tax reform, including consideration of an increase in the national borrowing limit, or debt ceiling. The nation reached its \$16.699 trillion debt limit on May 19, 2013, but several factors, including the Treasury Department deploying “extraordinary measures” via a variety of financial transactions, have allowed the government to continue operating. Treasury Secretary Lew recently indicated that it would exhaust those measures no later than October 17.

## **Proposed Tax Amendments Impacting the Real Estate Industry**

While the momentum behind comprehensive tax reform legislation has slowed significantly over the past few months, mainly due to the growing divide between the President and Senate Republicans over corporate taxes, the tax writing committees continue to focus on identifying proposals for possible inclusion in a comprehensive deal. A significant amount of work has already been done in this area, evidenced by the reports and options papers released by the House Ways & Means and Senate Finance Committees (available [here](#)). Whether the committees move forward with a comprehensive or sector-specific approach, tax reform legislation will likely include provisions that will significantly impact the real estate industry. The following legislative proposals are currently being discussed by the Congressional tax-writing committees and the Obama Administration:

### **Foreign Investment in Real Property Tax Act (FIRPTA)**

Legislation (H.R. 2870/S. 1181) to expand certain exceptions to the “FIRPTA” tax on U.S. real estate property gains recognized by non-U.S. investors has significant bipartisan support. The FIRPTA exception for sales of stock of publicly traded U.S. real estate corporations, which currently applies to 5% or less non-U.S. shareholders, would be expanded to non-U.S. shareholders owning 10% or less of the publicly traded corporation’s shares. Similar relief would be provided for 10% or less non-U.S. shareholders receiving capital gain distributions from a publicly traded REIT. Distributions in liquidation or redemption of a shares of a public or private REIT would be exempt from FIRPTA tax, thus legislatively repealing an adverse IRS notice issued in 2007.

Finally, under current law, a sale of shares of a “domestically controlled REIT” is not subject to FIRPTA tax. The proposed legislation would make certain changes, which are generally favorable to the manner in which the “domestically controlled” status of a REIT is determined. There have also been proposals to repeal FIRPTA altogether or substantially limit its scope. Proposed legislation to amend FIRPTA are included in the following tax writing committee documents:

- **JCT Report** (p.543)
- **SFC Options Paper**

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## Real Estate Investment Trust (REIT) Rules

Reform proposals for REITs have included expanding the prohibited transactions tax safe harbor for potential dealer property sales to include a three-year alternative averaging test for determining whether the amount of the REIT's property sales exceeds the safe harbor limits, and using a 20% volume test rather than 10% for any one year as long as the three-year average does not exceed 10%. In addition, legislative proposals would repeal the preferential dividend rule for publicly offered REITs and provide relief measures for violations of the rule where it still applies.

- **JCT Report** (p.543)

## Carried Interest

“Carried interest” legislation has been a particularly popular legislative initiative for a number of years now because its most publicly known targets are hedge fund and private equity fund managers. However, all of the proposals have also covered real estate fund promoters and developers who receive a “carried” interest in a real estate partnership for their sweat equity. Current law permits such an interest to be received without current taxation, with back-end taxable profit often coming in the form of low-rate capital gain rather than high-rate ordinary income.

The carried interest legislation would tax such income as ordinary income, even if attributable to the sale of the partnership's real estate. Existing partnerships would not be grandfathered. It would be horrifically complex to apply in practice. Although the measure has not been scored as an eye-popping revenue raiser, it is still real money and is politically attractive because it has been sold as a “get the Wall Street fat cats” measure. It has refused to die a peaceful death. The real estate industry has urged Congress to exclude real estate from the provision should some version of it ultimately be enacted.

- **JCT Report** (p.542)
- **SFC Options Paper** (p.15)

## Unrelated Business Income Tax (UBIT)

One tax reform proposal recommends that the debt-financed UBIT exception for leveraged real estate investments by tax-exempt pension funds and endowments be expanded to cover other types of tax-exempt investors, such as IRAs, charities and foundations.

- **JCT Report** (p.542)
- **SFC Options Paper**

## Section 1031 Like Kind Exchanges

Present law permits taxpayers to exchange in forward and reverse exchanges of property of like kind, which permits virtually any real property to be swapped tax-free for other real property (including agricultural property) if the taxpayer observes the prescribed formalities for the exchange. As real estate values begin to recover, section 1031 swaps are

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taking on increasing importance because they allow taxpayers to reinvest sales proceeds in new real estate investments while deferring tax on the gain.

Because section 1031 is viewed by Congress as a tax expenditure, it is potentially vulnerable to being repealed or curtailed. The White House tax reform proposals mentioned this highly popular and widely used deferral provision as a possible target.

## *Depreciation of Commercial Buildings*

Residential commercial real estate, such as multifamily properties, is currently depreciable over 27.5 years, while non-residential commercial real estate is depreciable over 39 years. The tax advantage to residential is under review and could be curtailed. Other reform proposals have urged Congress to shorten the depreciation periods or to provide for depreciation periods that correspond to actual useful lives. Another proposal is to tax the portion of gain on sale of depreciable real estate that is attributable to prior depreciation deductions at the rate applicable to ordinary income, instead of the maximum 25% rate that currently applies to individuals, estates and trusts.

- **JCT Report** (p.541)

## **For further reading:**

### **Tax Reform: An Insider's View**

*Gov. Robert L. Ehrlich*

We often hear the question asked why the parties are unable to begin a Reagan-esque style tax reform effort if both are seemingly committed to the concept. These folks point to the bipartisan "listening tour" House Ways and Means Committee Chairman Dave Camp and Senate Finance Committee Chairman Max Baucus are conducting in order to generate interest in a more sensible tax code. **More »**

### **A Deep Divide Over Corporate Tax Reform**

*Hon. Michael A. Andrews*

While the debate over reforming the nation's tax code continued after Congress returned after Labor Day, over the past few months the momentum has slowed significantly because of the hardened positions of the Senate Republican leadership and the President. **More »**

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