Chapman and Cutler LLP
Attorneys at Law · Focused on Finance®

Client Alert

Current Issues Relevant to Our Clients

December 13, 2013

Recent Tax Reform Proposals Affecting Real Estate and Equipment

Recent legislative tax reforms proposed by Senate Finance Committee Chairman Max Baucus could have far reaching tax and other economic consequences to many holders of interests in real estate and tangible personal property, whether as investors, lessors, or other business users. Among other changes, the proposals would reduce depreciation benefits associated with real estate and equipment, would treat increased amounts of gain from such property as ordinary income, would repeal the longstanding tax-free like-kind exchange rules, and would reform some of the rules applicable to foreign investment in US real estate through REITs. Apart from generally increasing the immediate direct tax cost (or reducing direct tax benefit) associated with holding and disposing of affected property, it seems reasonable to expect a corresponding adverse effect on property values from most of the proposed changes. While the prospect for any near term enactment (or even consideration) of these proposals appears limited in the current political climate, affected taxpayers should recognize that, as revenue raisers, most of these proposals may well resurface in future tax legislation.

Depreciation Reform and Gain on Sale

The proposed depreciation reform would repeal present-law rules, replacing them with a "pooling" cost recovery system for most tangible personal property, and a slower cost recovery system for real property. The pooling system applicable to tangible property -- intended as a simplification as well as an immediate (if not long term) revenue raiser -- would represent a particularly dramatic shift in how depreciation expense is determined for tax purposes; however, the changes to real property cost recovery would also be significant in extending recovery periods (particularly for residential real property). Both would have even broader effect given their immediate transition application, applying not only to property acquired after enactment, but also to existing "in service" property held on enactment but not yet fully depreciated.

Tangible Personal Property

Under current law, depreciation is determined under the "modified accelerated cost recovery system" (known as "MACRS"), which is applied to each item of property individually based on its statutory type, which in turn determines the property's recovery period and depreciation method. Recovery periods for tangible personal property range from three to 20 years, and methods generally front-load depreciation under accelerated accounting conventions, allowing write-off faster than economic life. Each property removed from service -- *i.e.*, sold or otherwise disposed of -- generally gives rise to immediate gain or loss based on its individual adjusted basis, which generally equals its original cost reduced by prior depreciation deductions; gain is generally ordinary income to the extent of prior depreciation deductions (and capital gain to the extent of any excess), while loss is generally ordinary.

The proposed pooling system would substantially diminish the need for individual property accounting in determining depreciation deductions and gain or loss on property sale. Individual items of property would be classified (using a system based on that predating the 1986 adoption of MACRS) and assigned to one of four "pools" (which for rough illustrative purposes would include properties such as (i) autos, software and computers, (ii) light trucks, (iii) furniture and fixtures, and (iv) land improvements), each such pool having a specified recovery rate (which would be (i) 38 percent, (ii) 18 percent, (iii) 12 percent and (v) five percent, respectively). The cost of all property in each pool would be recovered (and depreciation determined) by multiplying the applicable recovery rate by the related pool balance at year-end. While the substantial shift in approach this pooling system represents from MACRS complicates direct long-term comparisons, the immediate revenue anticipated from this change alone suggests that the pooling approach would substantially reduce immediate depreciation deductions for many taxpayers.

Gains or losses on sales of particular items of property generally would be addressed through adjustments to overall pool balances, generally causing ordinary income treatment of any gain (through the resulting depreciation adjustment), and deferral of any ordinary loss. (Deferral of gain is also possible, depending upon relevant pool particulars.) These results arise through the prescribed pool adjustments for sales (which reduce pool balance by sales proceeds, not property basis), and a requirement that negative pool balances be currently included as ordinary income.

Real Property

Under current law, the recovery period for real property is generally 39 years for nonresidential real property and 27.5 years for residential real property, and the straight line method is required to be used. The proposals -- which would not adopt the pooling approach with respect to real property -- generally would impose a 43 year recovery period for all real property, which would remain recoverable under the straight line method. As a transition matter, however, these new rules would be applied to existing, currently in service property, extending their recovery periods to reflect the new, proposed 43 year period. Under current law, gain on a sale of real property is generally capital, subject to limited exceptions; the proposal would require ordinary income treatment to the extent of prior depreciation deductions.

Repeal of Like-Kind Exchanges

Under current law, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind," which is to be held for productive use in a trade or business or for investment. The proposals would repeal this tax-free exchange treatment. In part, the rationale seems to be that, at least with respect to tangible personal property, limited deferral of gain still may be provided under the proposed pooling system of cost recovery proposed above; clearly, however, that rationale does not extend to real property (which generally would not be subject to the pooling regime), as to which repeal would represent the loss of a widely used, longstanding tax deferral tool.

FIRPTA Reforms

The proposals include several discrete reforms affecting non-US investment in US real estate through real estate investment trusts, or REITs. From a taxpayer perspective, several of these changes to the so-called “FIRPTA” rules -- *i.e.*, the rules enacted by the “Foreign Investment in Real Property Tax Act” of 1980 -- are favorable. For example, the proposal would increase from five to 10 percent the percentage ownership of a class of REIT shares traded on an established securities market which might be disposed of without being subject to tax under FIRPTA. Similarly, the proposal would increase from 5 to ten percent the ownership threshold below which shareholders in certain publicly traded REITs qualify for an exemption from FIRPTA with respect to distributions attributable to FIRPTA gains at the REIT level. The proposal also would add certain additional exemptions from FIRPTA, benefiting foreign government REIT shareholder recipients of such distributions, and exempting qualifying foreign pension plans from FIRPTA.

The proposal would, however, preclude REIT shareholders from continuing to avail themselves of the longstanding FIRPTA exemption extended to non-US corporate shareholders generally on selling stock, currently applicable where the underlying corporation (or REIT) holds no US real property interests at the time of disposition, and disposed of all real property interests that it held during the preceding 5 years in taxable transactions. Instead, under the proposal, REIT shareholders would avoid FIRPTA on a sale of their REIT shares only in the unlikely event that the REIT was not a US real property holding company (*i.e.*, did not hold more than 50% of its assets in real property) during the five years preceding sale.

For More Information

To discuss any of the topics covered in this Client Alert, please contact any member of the Tax Department or visit us online at Chapman.com.