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Taking Advantage of Tax Breaks on REITs and QSBS

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When there is certainty in the tax law early in the year, advisors have ample time to help clients analyze various options for optimizing their returns.

The Protecting Americans From Tax Hikes Act approved at the end of last year made "permanent" the QSBS (Qualified Small Business Stock) benefit and a variety of other tax breaks advisors may also want to look into for their clients. (The government could, of course, make more changes to these breaks in the future.)

First off, with QSBS: Since September 27, 2010, investors buying QSBS were offered a 100% exclusion from federal tax on gains after holding QSBS for five years or more. Completely tax free gains can be quite an attractive inducement.

This exclusion was only 50% when first introduced in 1993, and that is what the law would have returned to if Congress had not acted at the end of last year; there was also an AMT add-back in the older provision.

The permanent provision has no AMT add-back, and a 100% exclusion from federal tax, along with the stipulation that these tax-free gains cannot exceed more than 10 times the cost basis (or $10 million, whichever is greater).

A TIMELY BENEFIT

This permanent move to 100% tax free gains is particularly timely, because shares bought in 2010, when the law doubled the benefit, recently extended beyond the five-year prerequisite for the tax break. Now that we know we can depend on this inducement of tax-free gains, there may be more IPOs of companies fitting the definition of a qualified small business.

Another permanent change involves benefits for foreign clients investing in U.S. REITs.

Up until now, foreign clients were limited to owning no more than 5% of a REIT without being hit with the FIRPTA withholding tax (a tax put in during the 1980s, when we were worrying about foreign investors buying up our real estate). Foreign clients can now own up to 10% of a REIT and still get the FIRPTA exception.

A further boost to foreign interest in U.S. real estate came with a complete waiver from tax on the profits foreign pension funds earn from owning U.S. real estate properties. Lawmakers were bolstered in their decision by a 2014 paper titled The Impact of Foreign Withholding Taxes on REIT Investors and Managers, crafted by Margot Howard of the University of North Carolina, Katherine A. Pancak from the University of Connecticut and Douglas A. Shakelford from the University of North Carolina and the National Bureau of Economics. The study looks to a withholding tax change made in 2004 that was only applied to a few countries. The paper found that foreign investors from countries with a recently reduced withholding tax increased their ownership of REITs over those from countries not so favorably changed.

There are other permanent changes that will come off as helpful for clients. For example, the R&D tax credit will no longer need to be revived each year. Product teams at brokerages can explore creating pooled investments in the R&D arena. For example, Oppenheimer in the past created partnerships to invest in such projects, including Learjet and DeLorean. The R&D credit significantly reduced the amount of money put at risk by clients invested in such projects.

The taxable investment landscape has again been redefined, this time by PATH, and may warrant some tax planning redirection for clients. Time will tell whether the government will be successful in redirecting investor interest where they would like it to go.