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Luxe real estate projects in Philly benefit from Trump tax cut for 'Main Street' businesses

by Jacob Adelman, Updated: November 10, 2019

Investors in big real estate funds are benefiting from a provision of the Trump tax cut pitched as a boon for mom-and-pop businesses, potentially costing the federal government billions in revenue each year.

The 2017 tax law lets real estate investment trust (REIT) shareholders of any income qualify for the same break as less-than-super-rich business owners. Among the law's beneficiaries are investors in mortgage funds like the one financing construction of the Laurel, a luxury residential tower rising near Rittenhouse Square that's marketing a $25 million penthouse.

Managers of existing mortgage funds are now redefining their businesses as REITs — a type of property business that returns all or most of its profits to investors in the form of dividends — to claim that deduction for their shareholders.

Among them is William "Billy" Procida, whose 100 Mile Fund has since 2009 financed $175 million in Philadelphia projects, including North Broad Street's Met concert venue.

The tax cut for REITs is "bringing more capital into the real estate space, which, in turn, will produce more housing, more office renovation, more jobs," said Procida, based in Englewood Cliffs, N.J..

But the growth of those claiming the break could sharpen sentiment that the 2017 law was overly generous to the real estate industry.

Skepticism is already growing among lawmakers and others over the "opportunity zone" incentive, which lets investors in projects within designated areas claim tax savings. Some say developers are being rewarded for building in already prosperous areas while ignoring needy communities.

Steven M. Rosenthal, a senior fellow at the nonpartisan Tax Policy Center in Washington, said "rich investors, not small businesses," are benefiting from the break that's going to REITs.

"It is a windfall for investors who aren't really benefiting the economy in any material fashion," he said.

Advocates of what became the Tax Cuts and Jobs Act of 2017 billed it as a way to make the United States more competitive for business by slashing corporate tax rates. But those lower rates did little for non-corporate enterprises, such as family-owned businesses and law partnerships, which asked for their own cuts.

The bill's drafters responded by devising a deduction for what are known as "pass-through" entities — enterprises that pay all of their profits directly to their owners — portraying the provision as a benefit for small-business owners.

Many taxpayers earning more than $250,000 a year, or $500,000 for joint filers, were blocked from qualifying for the full break, which allows 20 percent of business profits to go untaxed.

The deduction "reduces the tax rate on the hard-earned business income of Main Street job creators," Rep. Kevin Brady (R., Texas), then chair of the House Ways and Means Committee, said in a press statement in November 2017, when an earlier version of the benefit was being discussed.

REITs successfully argued that they also qualify as pass-through entities, but that the earnings cap shouldn't apply to their investors.

"When everyone was getting a tax cut, they were in there with a 'me, too,' " Rosenthal said. "When the feed is being put in the trough, the farm animals get at it."

Congress' Joint Committee on Taxation estimates that the "pass-through" deduction will cost the U.S. Treasury about $50 billion each year between 2019 and 2025, when the benefit expires, but it doesn't specify how much of that comes from forgone taxes on REIT dividends.

REITs returned about $61.6 billion to investors in 2018, according to the National Association of Real Estate Investment Trusts (NAREIT), a trade group. If all of those dividends were taxed at the top income bracket for investors of 40.3 percent, lost revenue would come out to about $5 billion.

Rosenthal said that $5 billion figure should be seen as "an upper bound," since REITs are often held by tax-exempt investors such as retirement-account holders and nonprofits, and sometimes by lower-bracket taxpayers.

The 2018 total also includes capital gain distributions that are not eligible for the 20 percent deduction, which would bring that figure down further.

REITs are generally divided into two categories: property-owning equity REITs, which earn rental income that they return to investors as dividends; and mortgage REITs, which pay investors using interest from the loan portfolios they manage.

Philadelphia-based equity REITs include some of its biggest property owners, including Brandywine Realty Trust, the city's dominant office landlord, and Pennsylvania Real Estate Investment Trust, co-owner of the newly opened Fashion District Philadelphia, formerly the Gallery at Market East.

On the mortgage side, a REIT affiliate of New York-based Mack Real Estate Group lent $220 million to finance the construction of the 48-story Laurel condo-and-apartment building, which is marketing the potentially record-setting $25 million penthouse, according to transaction records filed with the city.

A unit of Starwood Real Estate Trust of Greenwich, Conn., the largest commercial mortgage REIT in the United States, meanwhile, lent nearly $129 million toward the conversion of the historic Atlantic Building at Broad and Spruce Streets into apartments, records show.

Property-owning funds that aren't REITs are often organized as limited-liability corporations or partnerships, which also qualify for the pass-through deduction. Non-REIT mortgage funds, on the other hand, are organized as a type of complex debt pool that doesn't qualify for the benefit.

That's what's prompting some mortgage funds to reconfigure themselves.

"Every mortgage fund that's out there right now, if they're not looking at conversion to a mortgage REIT, then they should be," said Kurt Koegl, a real estate tax specialist with the New York-based accounting firm Marcum LLP. "It's kind of a no-brainer."

So far this year, at least two publicly traded mortgage funds have reconstituted themselves as REITs, according to company disclosures tracked by NAREIT: Old Greenwich, Conn.-based Ellington Financial Inc. and Arlington Asset Investment Corp. of McLean, Va.

An Ellington spokesperson declined to comment, and Arlington did not respond to a phone message.

Since NAREIT only tracks companies that trade on public exchanges, it was unaware of any privately held mortgage funds that have become non-traded REITs.

Procida said it was easy to convert his privately held 100 Mile Fund to a REIT because it already met the main criteria to qualify under the law: at least 90 percent of profits returned to investors and at least 100 shareholders.

"We were already doing what a REIT does," he said. "It was just like a layup for us."