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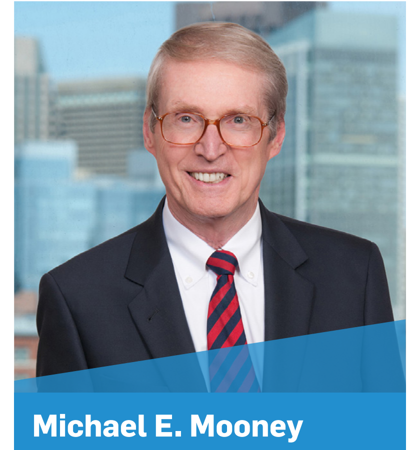
LEGAL UPDATE

PRACTICAL INSIGHTS ON TAX REFORM: IMPACT ON THE REAL ESTATE INDUSTRY



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On December 22, 2017, President Trump signed into law legislation, known as the Tax Cuts and Jobs Act ("TCJA"), which is the most extensive overhaul of the United States of the Internal Revenue Code (the "Code") in 30 years. In December, we issued a general advisory outlining the major changes in the Code made by TCJA. This advisory focuses on the provisions of TCJA that affect the real estate industry. Unless otherwise noted, the changes described below are effective for taxable years beginning on or after December 31, 2017.

20% DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THROUGH ENTITIES

One of the most significant changes in TCJA is a new 20% deduction from taxable income for qualified business income received from certain pass-through business entities, which include partnerships, S corporations, LLCs, and sole proprietorships. The qualified business income deduction effectively reduces the maximum individual rate of 37% applicable to individuals to 29.6%. Individuals also may be able to deduct 20% of ordinary dividends paid by REITs and qualified income of a publicly-traded partnership. Income paid as compensation to owners is not eligible for the deduction. For taxpayers whose income exceeds $315,000 for married couples, or $157,500 for single individuals, the deduction is limited to the greater of the taxpayer's proportionate share of (1) 50% of W-2 wages paid by the pass-through entity or (2) 25% of W-2 wages paid plus 2.5% of the unadjusted basis of business tangible property used in the business of the pass-through entity. This latter provision on basis, which was added during the legislative process, is especially beneficial to the real estate industry. The limitations apply separately to each "qualified, trade or business" of a pass-through entity, which likely will result in complex allocations of W-2 wages and 2.5% of unadjusted basis of property held by the entity where it is engaged in more than one qualified trade or business. To date, there is no guidance as to how this allocation must be made.

LIMITATION ON THE DEDUCTION OF BUSINESS INTEREST

While many provisions of TCJA are beneficial to the real estate industry, new Section 163(j) of the Internal Revenue Code will be less well received. Under this provision, all business interest expense deductions for taxpayers, including interest expense for the acquisition, development, or financing of real estate, are subject to a cap equal to the sum of the taxpayer's business interest income and 30% of EBITDA for 2018 through 2021 and 30% of EBIT beginning in 2022. This limitation will not apply, however, to any interest paid or accrued by a trade or business whose annual average gross receipts for the three preceding taxable years do not exceed $25 million. TCJA also provides an exception from the limit for any real property trade or business that "elects out" of the limitation. The cost of doing so, however, is a requirement that the trade or business apply longer Alternative Depreciation System (ADS) depreciation lives to its properties, increasing the lives of such property from 15, 27.5, and 39 years to 20, 30, and 40 years, respectively. The election, once made, is irrevocable. The amount of any business interest not allowed as a deduction to a partnership for any taxable year under the new rules will be treated as business interest paid or accrued in a succeeding taxable year.

DEPRECIATION AND COST RECOVERY

One potentially significant benefit for all businesses, including real estate, is a special rule allowing a taxpayer to elect 100% bonus depreciation for any property acquired and placed in service after September 27, 2017 and before January 1, 2023 with a tax life of 20 years or less that is not subject to ADS depreciation. While one might be tempted to make this election, taxpayers should review their income and projected income carefully to determine if foregoing the election might result in more favorable tax benefits over a number of years due to such factors as net operating losses. While the depreciation lives of residential and nonresidential rental property were unchanged by TCJA, the rules applicable to qualified leasehold improvement property, qualified restaurant property, and qualified retail

improvement property were simplified by being combined into a single permanent 15 year life for newly defined "qualified improvement property." That term means basically any improvement to an interior portion of a building that is nonresidential real property and that is placed in service after the date the building is first placed in service.[1]

LIKE-KIND EXCHANGES

A long-time popular provision in the real estate sector, like kind exchanges, survived modification by TCJA, but only for real property. Such exchanges were eliminated for all types of property other than real estate.

NET OPERATING LOSSES

Net operating losses ("NOLs") that arise in 2018 or later years are no longer eligible to be carried back and must instead be carried forward, but they can be carried forward for an unlimited number of years. Any such carryforward may be used, however, to offset only 80% of a future year's taxable income. Prior to TCJA, NOLs could be carried back two years and forward twenty years to offset 100% of taxable income.

LIMITATION ON EXCESS BUSINESS LOSSES OF NON-CORPORATE TAXPAYERS

For taxpayers other than corporations, beginning in taxable years after December 31, 2017 and before January 1, 2026, the aggregate deduction the taxpayer may claim attributable to all trades or businesses of the taxpayer are limited to the sum of the taxpayer's aggregate gross income or gain that is attributable to the taxpayer's trades or businesses plus $250,000 ($500,000 in the case of a joint return). This cap will be adjusted for inflation in future years. Any loss that is disallowed under this rule will be treated as a net operating loss carryover to the following taxable year.

CARRIED INTERESTS

Responding to criticisms that carried interests provide special preferential tax treatment to certain taxpayers, TCJA includes new provisions on such interests, basically requiring that, in order to qualify for long-term capital gains treatment, the interest must be held for more than three years rather than more than one year. While the provision will require further clarification by the Treasury, it appears that it will not apply to a real estate venture that does not raise capital on a "regular, continuous and substantial basis." The new holding period will apply notwithstanding any rules under section 83 of the Code or any election in effect under section 83.

REITS

The rules applicable to REITs remain generally the same under TCJA, although a taxable REIT subsidiary, or the REIT itself if it does not distribute all of its taxable income, could benefit from the lower 21% corporate tax rate. As noted above, the 20% qualified business income deduction will apply also to REIT ordinary dividends, making them eligible for the lower effective rate of 29.6%.

STATE INCOME TAX DEDUCTION

Although TCJA added a new limitation on the deduction for individual state and local taxes to no more than $10,000 annually, the limitation does not apply to state and local taxes paid or accrued in carrying on a trade or business. Taxes paid or accrued in an activity entered into for the production of income under section 212 of the Code, however, may not be deductible due to the elimination (through December 31, 2025) of the allowance for miscellaneous itemized deductions.

REHABILITATION TAX CREDIT

TCJA retains the 20% credit for qualified rehabilitation expenditures with respect to certified historic structures, but allows a taxpayer to claim the credit only ratably over a five year period, beginning with the year that the qualified rehabilitative building is placed in service.

PARTNERSHIP "TECHNICAL TERMINATIONS"

What for many years proved to be an annoyance, if not more, to real estate partnerships was a rule that resulted in a technical termination of the partnership if there was a sale or exchange within a 12 month period of 50% or more of the interests in the partnership's capital and profits. This rule is eliminated beginning in 2018, thus allowing partners to transfer their interests more freely without requiring the partnership to adjust depreciation schedules and sometimes file new tax elections.

THIS ADVISORY WAS PREPARED BY MICHAEL E. MOONEY, CHAIRMAN OF NUTTER AND A MEMBER OF NUTTER'S TAX DEPARTMENT. PLEASE STAY TUNED FOR THE NEXT ADVISORY IN OUR *PRACTICAL INSIGHTS ON TAX REFORM* SERIES. LEARN MORE ABOUT THIS LEGISLATION BY CONTACTING A MEMBER OF OUR TAX DEPARTMENT AT 617.439.2000.

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