

Tax Reform Advisory: Real Estate Industry

December 29, 2017

On December 22, 2017, the President signed into law H.R. 1, informally known as the "Tax Cuts and Jobs Act" (the "Act"). The Act will have a significant impact on many sectors of the economy including the real estate sector. Significant aspects of the Act relevant for commercial real estate include:

Changes to Individual and Corporate Tax Rates. The corporate tax rate is reduced to a flat 21%. The highest individual income tax rate is reduced from 39.6% to 37%. As described below, a new deduction available to individuals for certain pass-through business income further reduces the effective maximum tax rate on income qualifying for the deduction to 29.6%.

Pass-Through Deduction. Individuals, trusts, and estates may be eligible for a 20% deduction on certain income earned through a partnership, S corporation or sole proprietorship (including a wholly-owned disregarded LLC).

Income eligible for the deduction. The type of income eligible for the pass-through deduction includes: (1) the net income of a US trade or business (excluding compensation or guaranteed payments to the taxpayer); and (2) dividends from a REIT that are taxable at ordinary income rates. Investment-type income such as dividends and short-term or long-term capital gains (including for this purpose capital gains from the sale of an asset used in the trade or business) are excluded. Interest income is excluded unless it is allocable to the trade or business.

Limitations on the deduction. There are two principal limitations on the availability of this deduction for income from a trade or business: (1) an exclusion imposed on certain service businesses; and (2) a limit based upon the amount of wages paid by the business and the unadjusted cost basis of the depreciable tangible property of the business. Both of these limitations do not apply to taxpayers with taxable income below \$157,500 individually (or \$315,000 for joint filers) and are phased in for taxpayers with taxable income above that threshold. These limits do not apply to REIT dividends.

With respect to service businesses, including law firms and accounting firms as well as businesses that provide investment management services, taxpayers whose income is above the applicable thresholds are not able to utilize the pass-through deduction with respect to income from such service businesses. It is not anticipated that real estate sponsors receiving promote payments in their capacity as partners would be treated as earning income from investment management services for this purpose.

The second limitation caps the deduction at the greater of: (1) 50% of the wages paid by the business; or (2) the sum of 25% of the wages paid by the business and 2.5% of the unadjusted cost basis of the depreciable tangible property of the business.

Calculating the Deduction. The deduction is calculated at the individual level, and the net income or loss, and the limitations noted above, are calculated separately for each trade or business. It is not clear whether a trade or business will be grouped by entity, activity, or some combination of the two for purposes of calculating the deduction and the applicable limitations. An individual partner's share of W-2 wages for limitation purposes is determined based upon the partner's allocable share of the partnership's wage expenses. An individual partner's share of unadjusted basis for limitation purposes is determined based upon the partner's allocable share of depreciation. Partnerships will need to provide additional information regarding the allocable shares of such items to their partners to allow their partners to determine their individual deductions. After an individual's tentative net income or loss and limitations are calculated for each trade or business, these amounts are netted such that a net loss from one trade or business may reduce the deduction allowable for a separate trade or business.

Commercial Observations. Real estate businesses, although capital-intensive, are generally not labor intensive. Therefore, many real estate business owners may not see a benefit from this deduction. For example, developers of for-sale condominiums do not generally have a large amount of depreciable tangible property or W-2 wages. The same may be true for long-term owners of appreciated real estate with low unadjusted cost basis. On the other hand, newer investments with lower cap rates may generate a material amount of income that would be deductible under the new provision. Guidance is needed to determine whether partnership basis adjustments allocable to depreciable tangible property would count toward the 2.5% unadjusted cost basis.

Limits for Interest Deductions. The Act limits the deductibility of interest for every business, regardless of its form, to 30% percent of adjusted taxable income (defined similarly to "EBITDA" by adding back to taxable income interest, any NOL or pass-thru business deduction, and (until 2022 only) depreciation). This limitation does not apply to: (1) taxpayers with less than \$25 million of gross receipts; and (2) real property trades or businesses that elect out of the limitation. Real property trades or businesses include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (including management and operation of lodging facilities). Interest in excess of 30% is carried forward indefinitely.

Special Rules for Partnerships. The limitation applies both to partnerships at the partnership level and separately for the partners at the partner level. For partnerships subject to the interest limitation, the interest deductions from the partnership will not be separately stated items, but will flow through to the partners as part of the partnership's non-separately stated income. Individual partners will then make certain adjustments in calculating their own interest deduction limitation to ensure that the limitation at the partner level takes into account any interest that flows through the partnership. Special rules are provided for partnerships that have excess business interest carryforwards. Partners are allocated a share of the partnership's excess business interest, which they can use in any future year against excess taxable income from the partnership giving rise to the carryforward.

Election out for Real Estate Businesses. Taxpayers electing to use the real property trade or business exception to the interest limitation will be required to use the less than favorable

alternative depreciation system (ADS) that applies to tax-exempt use property. Under the Act, the ADS recovery period for: (1) residential real property is 30 years (instead of the 27.5-year recovery period otherwise available); (2) nonresidential real property is 40 years (instead of the 39-year recovery period otherwise available); and (3) qualified improvement property (e.g., leasehold improvements) is 20 years (instead of the 15-year recovery period otherwise available). Bonus depreciation on such qualified improvement property will also not be available for taxpayers electing out of the interest deduction limitation. It is anticipated that most real estate businesses that are eligible to elect out of the interest limitations will do so. Further guidance is needed to determine how a change to the recovery period of existing depreciable property will be adjusted for (and whether any excess income will result from such an adjustment). However, for property placed into service prior to the January 1, 2018, effective date of the Act's amendments to ADS, the applicable ADS recovery period for residential real property is 40 years (rather than 30 years). It appears that a taxpayer who elects into ADS to avoid the 30% interest limitation with respect to existing residential property that was placed in service prior to the Act will be required to recover its remaining basis in such property over the remaining term of the 40-year period running from the date the property was placed into service. This will give some pause to taxpayers considering making the election for residential real property. For partnerships, the election out of the limitation must be made at the partnership level.

Bonus Depreciation. Under pre-Act rules, the cost of certain non-structural improvements to the interior of a nonresidential building and of other new tangible property that has a recovery period of 20 years or less was generally eligible for bonus depreciation in the year the property was placed in service. Under the Act, bonus depreciation is expanded to include the purchase of used property. Further, new and used property that qualifies for bonus depreciation, and was acquired and placed in service after September 27, 2017, may generally be fully expensed in the year the property is placed in service. The bonus expensing rate gradually steps down beginning in 2023. This provision does not apply to structural improvements or to the qualified improvement property of taxpayers with a real property business who elect out of the 30% limitation on interest deductions described above. This additional depreciation may create extra incentives for purchasers of used property to structure such acquisition as an asset purchase. However, if such used property has already been subject to bonus depreciation, sellers of such property may be subject to ordinary income recapture under section 1245.

Like-Kind Exchanges Retained for Real Property. The Act eliminates the use of like-kind exchanges for all assets other than real estate. This will have a particular impact on hotel operators who have frequently taken advantage of like-kind exchanges to defer gain on the sale of FF&E at their properties, but will now be unable to defer gain allocable to FF&E under section 1031 and may be subject to tax on such gain at ordinary income rates as a result of previous bonus depreciation taken on such property.

Carried Interest. Any gain with respect to partnership interests held in connection with the performance of investment or development services (including investing in and developing real estate) will be long-term capital gain only if a three-year holding period is met. An exception is provided for capital interests which provide the taxpayer the right to share in the partnership's

capital that is commensurate with the amount of capital contributed by the partner or with the amount taxed to the partner under section 83. It is uncertain whether the holding period applies only to the partnership interest, to assets of the partnership generating capital gain, or to both.

Contributions to Capital. Corporate developers can no longer exclude cash payments or property contributions from governmental or civic entities from taxable income by treating such payments as nontaxable capital contributions. A transition rule provides an exception in the case of certain payments made in connection with master development plans that have already been approved.

State and Local Taxes. Individuals, trusts, and estates cannot deduct state and local taxes in excess of \$5,000 individually (\$10,000 for a joint return). This limit does not apply to (i) state and local property taxes incurred in carrying on a trade or business; (ii) taxes imposed on a pass-through entity at the entity level (e.g., the New York City Unincorporated Business Tax); and (iii) corporations.

Tax Credits. The Act does not change the Low Income Housing Tax Credit or the New Markets Tax Credit. The 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure is amended to spread the credit ratably over the 5 year period beginning with the placed in service date of the rehabilitation. The 10% credit with respect to pre-1936 buildings is repealed. A special transition rule will make the old rules applicable with respect to certified historic structures or pre-1936 buildings owned or leased by the taxpayer at all times after December 31, 2017, if certain other conditions are satisfied.

Technical Terminations. The Act eliminates the rule providing that an entity classified as a partnership for tax purposes will be deemed to terminate for tax purposes upon a transfer of 50% or more of the capital and profits of the entity. The repeal of this rule will eliminate some flexibility partnerships previously had to terminate elections and restart depreciation recovery periods. However, it may provide for additional structuring opportunities in a like-kind exchange where some partners wish to cash out of their investment and others wish to do a like-kind exchange. Additional detail regarding the above items and further discussion of other elements of the Act is available in the following Client Advisories.

- [Corporate and General Business](#)
- [Exempt Organizations](#)
- [International Provisions](#)
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