Real Estate Aspects of Tax Reform

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On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA), the most extensive overhaul of the United States tax regime in over thirty years. The new tax laws will have a significant impact upon taxpayers in all income tax brackets, all businesses and every sector of the economy, including real estate. This alert provides a brief summary of some of the provisions that are likely to impact real estate developers and investors, both at the fund level and the property level, and provides some insight in terms of what real estate developers and investors should consider in their tax structuring going forward.

TAX RATE CONSIDERATIONS

- The top corporate income tax rate is now 21%.
- The top individual income tax rate is now 37%.
- There is no change in the maximum 20% capital gains rate.
- There is no change in the 3.8% "net investment income" tax rate.

Observation: The reduction in corporate tax rates will impact yield and reduce equity pricing on tax credit investments such as the low income housing tax credit ("LIHTC"). Reduced pricing will likely translate into larger amounts of deferred developer fees. In addition, the new Base Erosion Anti-Abuse Tax (described below) may adversely impact certain corporate tax credit investors that make certain deductible payments to non-U.S. affiliates.

20% DEDUCTION WITH RESPECT TO PASS-THROUGH BUSINESS INCOME

The TCJA adds a new deduction for non-corporate taxpayers of 20% of such taxpayer's share of domestic "qualified business income" from "qualified trade or businesses" carried on by pass-through entities (e.g., partnerships, S corporations, sole proprietorships, etc.). The deduction is limited to the lesser of:

- 20% of the taxpayer's share of domestic qualified business income, or
- The greater of:
  - 50% of the W-2 wages of the business or
  - 25% of the W-2 wages of the business plus 2.5% of the initial asset basis of the tangible depreciable assets of the business.

"Qualified business income" DOES NOT include –

- Long or short term capital gain;
- Dividend or dividend equivalent income;
- Interest or annuity income which is not properly allocable to a trade or business; and
- Various types of foreign source income.

In general, "qualified trade or business" DOES NOT INCLUDE –

- The trade or business of performing services as an employee, or
- Any trade or business invoking the performance of services of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services or any trade or business where the principle asset of such trade or business is the reputation or skill of one or more of its employees or owners, or
- Any trade or business involving the performance of services that consist of investing and investment management, or trading or dealing in securities, partnership interests or commodities.

Observation: Given the ambiguous language of the statute, a determination of whether a particular business constitutes a qualified trade or business can be quite nuanced and require interpretation of rulings and other precedent issued under existing Code Section 1202(e)(3)(A). Taxpayers who operate management, maintenance, landscaping and similar businesses should consult with their tax advisors.

LIMITATION ON BUSINESS INTEREST DEDUCTION

- In general, the deduction for business interest is effectively capped at the sum of business interest income plus 30% of earnings (generally calculated as EBITDA for four years, and EBIT thereafter).
- Interest not allowed as a deduction is to be carried forward for five years.
- Electing Real Property Trade or Business Exception – A "real property trade or business" (meaning any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business) may elect to be exempt from the business interest deduction limitation. Any such election shall be made at such time and in such manner as the Secretary shall prescribe, and, once made, shall be irrevocable. An electing real property trade or business is required to depreciate its real property under the alternative depreciation system (which generally requires longer methods of depreciation recovery).

Observation: For residential rental property and nonresidential real property placed in service after December 31, 2017, the alternative depreciation recovery periods are 30 and 40 years, respectively. It is not clear whether the applicable recovery period for existing residential rental property held by an electing real property trade or business will be based on the new recovery period for alternative depreciation provided in the TCJA (30 years) or the longer 40 year recovery period in effect under prior law.

Observation: The business interest deduction limitation is determined at the partnership, not the partner level. Whether a particular real estate partnership should elect to be exempt from the business interest deduction limitation will have to be determined on a case-by-case basis. In the case of an equity fund that invests in real estate partnerships, an election out of the business interest limitations would only be applicable with respect to interest on indebtedness incurred by the equity fund itself, such as bridge financing to meet operating-tier capital contribution obligations prior to the receipt of corresponding capital contributions from investors in the fund. However, it is not clear whether the interest on such indebtedness could be characterized as incurred in connection with a real estate trade or business, as the equity fund is not acquiring or

operating real estate – it is acquiring interests in pass-through entities that own and operate real estate.

- Small Businesses Exception – the limitation on interest deductions does not apply to businesses with average gross revenue of $25 million or less for the past three years.

  Observation: The small business exemption is satisfied if the corporation or partnership in question is not a tax shelter (within the meaning of Code Section 448(a)(3)) and has average annual gross receipts of less than $25 million for the three previous taxable years (or such shorter period in which such corporation or partnership was in existence). Many real estate partnerships will not qualify for the small business exemption because the term "tax shelter" for this purpose includes a partnership in which more than 35 percent of its losses are allocated to limited partners.

CARRIED INTERESTS

- Three-year holding period in order to qualify for long term capital gains rates with respect to profits interests held in connection with the performance of services in the business of raising or returning capital and either (i) investing in stocks, securities or real estate held for rental or investment or (ii) "developing" such assets. The three-year holding period applies both at the carried interest level and at the partnership asset level – meaning that a sale of the carried interest or of an asset held by the partnership within three years of acquisition could result in short-term capital gain to a holder of the carried interest.
- Although most promote interests are held for longer than three years (and thus should not be impacted by this change), capital gains in respect of real estate investments disposed of within the three years of the investment may be subject to these limitations.

EXPENSING CAPITAL EXPENDITURES

- Section 168 permits taxpayers to claim bonus depreciation equal to 100% of the cost of certain qualified property acquired and placed in service after September 27, 2017.
  - Bonus depreciation phases out from 2023 through 2026.
- Section 179 permits taxpayers to expense up to $1 million of the cost of certain depreciable property (including qualified real property) acquired and placed in service by a trade or business.
- For purposes of Section 179, "Qualified Real Property" generally includes the following:
  - Any improvements to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service (other than expenditures attributable to enlargement of a building, any elevator or escalator, or the internal structural framework of a building); and
  - Any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:
    - Roofs.
    - Heating, ventilation, and air-conditioning property.
    - Fire protection and alarm systems.
    - Security systems.

REAL PROPERTY DEPRECIATION

- Cost recovery periods for residential and nonresidential real property remains unchanged (27.5 years and 39 years).
- Alternative depreciation recovery period for residential rental property is shortened from 40 years to 30 years.

Observation: Under prior law, partnerships with non-profit general partners were often required to provide for "qualified allocations," limit annual fees to fixed amounts, or admit a wholly owned subsidiary of the non-profit as the general partner and make a Code 168(h)(6)(F) election unless investors were willing to accept 40-year depreciation. Investors may be willing to tolerate more flexibility under the new law in cases such as LIHTC projects where the consequence of having a portion of the property being treated as tax exempt use property will be limited to the difference between a 30-year and 27.5-year recovery period.

LIKE KIND EXCHANGES

- Like-kind exchange treatment limited to exchanges of real property not held primarily for sale.
- Exchanges of personal property for personal property no longer qualify.

NET OPERATING LOSS LIMITATIONS

- NOLs are deductible only to the extent of 80% of the taxpayer's taxable income starting in 2018.
- While NOLs may be carried forward indefinitely, there will be no carrybacks of NOLs.
- These rules are only effective for NOLs arising in taxable years beginning after 2017.
- Existing NOLs are subject to the rules in existence prior to the enactment of the TCJA (i.e., may be carried back 2 years, carried forward 20 years, and offset 100% of taxable income).

Observation: Newly created NOLs will not be as valuable as they have been in prior years, and taxpayers that engaged in taxable transactions in 2017 with the idea that they would be able to carryback future NOLs to offset any income triggered will not be able to do so.

PARTNERSHIP TECHNICAL TERMINATIONS

- The partnership technical termination provisions of Code Section 708(b)(1)(B) are repealed.

Observation: Repeal of the technical termination rule will avoid having to restart depreciation and file short taxable year returns in connection with a sale of a partnership interest would have otherwise given rise to a technical termination.

TAX CREDITS AND PRIVATE ACTIVITY BONDS

- The low-income housing tax credit (LIHTC) is preserved.
- The tax exemption for private activity bonds is preserved.
- The new markets tax credit (NMTC) is preserved for 2018 and 2019 allocation application rounds.

- Existing phasedowns for the renewable energy investments tax credit (ITC) and production tax credit (PTC) are preserved.
- The TCJA eliminates the 10 percent historic tax credit (HTC) for non-certified buildings placed in service before 1936 and requires the 20 percent HTC be taken over five years, rather than when the property is placed in service, as under previous law.

Observation: Despite preservation of prior law with respect to the LIHTC, NMTC, ITC and PTC, tax credit transactions will be impacted by reduction in yield, decreased investor appetite and pricing adjustments, resulting from reduced tax rates, increased bonus depreciation and implementation of the new Base Erosion Anti-Abuse tax discussed below. In addition to these impacts, HTC transactions will likely be subject to additional pricing adjustments due to the deferral of the HTC over 5 years.

THE BASE EROSION ANTI – ABUSE TAX

- Starting in 2018, an excise tax is imposed on certain large U.S. corporate taxpayers that make certain "base erosion" (i.e., deductible) payments to non-U.S. affiliates (including, for example, interest, royalties, service fees marked up above cost, etc.). This excise tax will be equal to the amount by which (i) a specified percentage (i.e. 5% for 2018, 10% for 2019 through 2025, and 12.5% thereafter) of the U.S. corporation's "modified taxable income" (generally, the corporation's regular taxable income calculated without regard to the deduction of any "base erosion" payments made to non-U.S. affiliates) exceeds (ii) its regular income tax liability reduced by the amount of certain tax credits. Prior to 2026, though, for purposes of this computation a corporation's regular tax liability will be not be reduced by the amount of any Section 41(a) research credit, and will be reduced by only 20% of the amount of any Section 38 credits (i.e., the LIHTC, the PTC and the Energy ITC). Beginning in 2026, a corporation's regular tax liability will be reduced by the amount of all allowable tax credits.
- This base erosion tax operates, in some ways, as a form of alternative minimum tax.

Observation: The Base Erosion Anti-Abuse Tax may cause certain large corporate taxpayers making deductible payments to foreign affiliates to be at risk of losing up to 20 percent of the value of the LIHTC, PTC and Energy ITC and, for taxable years beginning after December 31, 2025, the entire benefit of such tax credits to such a taxpayer could be lost. Accordingly, the Base Erosion Anti-Abuse Tax could significantly and negatively impact the appetite of certain multinational investors in the tax credit equity markets (particularly after 2025).

This alert is intended to briefly summarize certain key provisions of the TCJA that will have an effect upon real estate transactions. It should be noted that there are many other provisions in the TCJA which will impact real estate developers, investors and landlords, including provisions relating to international taxation, compensation, and REITS. Further, Treasury Regulations are expected to be issued in the future, which may change the way some of these provisions operate. As such, it is important to contact one of the attorneys listed below to discuss these new laws and how they may impact you, especially when considering any new transactions, as such transactions will most definitely be impacted by the new laws.

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