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The Tax Cuts and Jobs Act: impacts on the real estate industry

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P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act (the Act), passed both houses of Congress on Dec. 20, 2017, and was signed by President Trump on Dec. 22, 2017. The Act includes several major changes to the Internal Revenue Code (the Code). This update explores the aspects of the Act which have the most significant impact on taxpayers engaged in real estate.

The Act is generally effective for tax years beginning after Dec. 31, 2017, requiring prompt review to determine whether changes to the structure of your operations are warranted to improve your tax situation.

Tax rates lowered

The Act lowers some individual income tax rates beginning in 2018 and expiring after 2025, unless renewed before then. The Act reduces the highest marginal income tax rate applicable to ordinary income of individuals from 39.6% to 37%.

The maximum marginal tax rate applicable to long-term capital gains and dividends remains unchanged at 20%. The Medicare portion of the self-employment tax and net investment income tax rates remain unchanged at 3.8%.

For tax years beginning after Dec. 31, 2017, the Act permanently changes the corporate income tax rate to a flat 21%. Accordingly, the aggregate maximum federal income tax rate on income of a C corporation distributed to its shareholders will be 36.8% of pre-tax corporate income (21% + (dividend rate of 20% * proceeds remaining after payment of corporate tax (100% - 21%)) = 36.8%), plus the 3.8% net investment income tax, where applicable.

20% deduction for qualified business income of pass-through entities

For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, an individual may deduct as an itemized deduction up to 20% of "qualified business income" (defined below) earned through partnerships, S corporations, and sole proprietorships (such as disregarded entities). This deduction will result in an effective maximum marginal tax rate of 29.6% (plus the 3.8% net investment income tax, where applicable) on qualified business income.

While the low corporate rate may appear attractive in the short run to decrease the tax rate while real estate debt is being amortized, the potential for higher taxation on dividends, higher taxation (or lower purchase price) on sale and the need to avoid the personal holding company tax and accumulated earnings tax requires a careful analysis of the alternatives.

Meaning of "qualified business income"

Qualified business income means any trade or business income that is effectively

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connected with the conduct of a trade or business in the United States ***other than***:

- Income from "specified services" which is defined as involving the performance of services (i) in the fields of, among others, health, law, accounting consulting, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or (ii) consisting of investing or investment management, trading, or dealing in securities, partnership interests or commodities. Importantly, the exclusion of specified services income from the definition of qualified business income only applies to taxpayers whose taxable income exceeds $157,500 (or $315,000 for taxpayers who are married and file jointly).
- The trade or business of performing services as an employee, which includes Code § 707(c) guaranteed payments for services paid by a partnership, amounts paid by S corporations that are treated as reasonable compensation of the taxpayer, or, to the extent provided in regulations, amounts paid or incurred for services by a partnership to a partner who is acting other than in his or her capacity as a partner.

Qualified business income does not include capital gain, dividends and interest income.

In the real estate context, qualified business income could include income from real estate development and leasing. Qualified income would not, however, include gain from the sale of real estate. Further, income received from consulting regarding real estate matters would likely be a "specified service" which would not constitute qualified business income for high income taxpayers.

Limitations on deduction

Additionally, for taxpayers whose taxable income exceeds $157,500 (or $315,000 in the case of taxpayers filing a joint return), the qualified business income deduction is limited (the Wages Limitation) to the greater of (i) 50% of the W-2 wages paid with respect to the trade or business or (ii) the sum of 25% of the W-2 wages paid with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of depreciable property used in the qualified trade or business that was purchased in the last 10 years or is still being depreciated. The Wages Limitation does not apply to income earned through publicly traded partnerships.

For example, the taxpayer bought a building 12 years ago for $500,000, 8 years ago bought new trucks for $75,000, and 11 years ago bought new snow equipment for $25,000. The limit computed with respect to depreciable property is 2.5% of $500,000 + $75,000, or $14,375. If the taxpayer paid $100,000 of W-2 wages with respect to the business, the total limitation in the first prong would be $50,000 (50% * $100,000) and the total limitation under the second prong would be $39,375 ($14,375 computed above + (25% * $100,000).

The second prong of the Wages Limitation was added relatively late in the legislative process in what some view as an accommodation to the real estate industry.[1] Real estate leasing operations typically generate taxable income with a relatively small amount of W-2 wages paid. The addition of the second prong significantly increases the maximum deductible amount applicable to taxpayers making large capital expenditures for depreciable capital assets (e.g., rental real estate).

The deduction is limited to 100% of the taxpayer's net qualified business income from all activities. In other words, if the taxpayer has losses from one qualified business that exceed the income generated from a second qualified businesses, the taxpayer's qualified business deduction would be $0.

Application to REITs

A separate 20% deduction is also allowed for a taxpayer's aggregate amount of qualified REIT dividends, causing the effective maximum federal tax rate on REIT income to be 29.6% (as calculated above) plus the 3.8% net investment income tax, where applicable. The reduced maximum rate for REIT dividends is scheduled to expire after 2025 under the Act.

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[1] *See* Lynnley Browning and Ben Bain, "Trump, Real Estate Investors Get Last-Minute Perk in Tax Bill," Bloomberg Law, Dec. 25, 2017.

Carried interests

Real estate developers often receive carried interests in exchange for managing a real estate project or fund. A carried interest is an ownership interest in a tax partnership entitling the holder to receive future profits and appreciation of the partnership, but not the right to receive money or other property if the partnership were liquidated immediately after grant. Typically, a carried interest allows the manager/developer to share in a pro rata amount of income from operations, then share in a portion of proceeds from the disposition of the underlying property after the other partners have received a return of their capital contributions.

Generally, a service provider can receive a profits interest tax-free in exchange for services. The economic benefit of the profits interests often comes in the form of capital gain allocations from the partnership or capital gain recognized on sale of the partnership interests.

The Act generally changes the holding period required to receive long-term capital gain treatment with respect to a carried interest from one year to three years with respect to businesses raising or returning capital and investing in rental or investment real estate. Specifically, in order to receive long-term capital gain treatment any gain allocable to the carried interest must be attributable to assets held for more than three years or, if the carried interest is sold, it must have been held for more than three years.

Changes regarding depreciation

The Act allows full expensing of qualified depreciable property placed in service after Sept. 27, 2017, and before 2023. After 2022, the 100% expense is phased down in succeeding years as follows: 80% bonus depreciation for property placed in service in 2023; 60% bonus depreciation for property placed in service in 2024; 40% for property placed in service in 2025; and 20% for property placed in service in 2026. The Act modifies current law by allowing immediate expensing to purchases of used as well as new items.

For purposes of the foregoing paragraph, "qualified depreciable property" includes (i) property with an applicable MACRS recovery period of 20 years or less; (ii) water utility property; (iii) certain computer software; and (iv) qualified improvement property. "Qualified improvement property" means any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the building is placed in service. A qualified improvement, however, does not include an elevator or escalator, an improvement to enlarge the building or an improvement relating to the internal structural framework of the building.

Interest expense deduction limitation and exceptions

Subject to certain exceptions discussed below, beginning in 2018, the Act generally limits the annual deduction for business interest expense to an amount equal to the sum of: (i) business interest income, (ii) 30% of "adjusted taxable income" (as defined below), and (iii) the floor plan financing interest (which relates to certain indebtedness of automobile dealers) of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, subject to generally applicable interest deductibility limitations and to certain restrictions applicable to partnerships created by the Act.

For purposes of the interest expense deduction, "adjusted taxable income" means the taxable income of the taxpayer computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business and by adding back (i) any business interest expense or business interest income, (ii) the amount of any net operating loss deduction (iii) the 20% deduction for pass-through income, and (iv) for taxable years beginning before Jan. 1, 2022, any deduction allowable for depreciation, amortization or depletion.

The limitation on interest deductibility does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business for which the taxpayer makes an election. If, however, such an election is made, the taxpayer must utilize the alternative depreciation system with respect to its depreciable real property, which generally requires longer depreciation

lives. Under the alternative depreciation system, the recovery periods for nonresidential real property, residential depreciable real property and qualified improvements are 40 years, 30 years and 20 years, respectively.

The interest expense limitation also does not apply to taxpayers whose average annual gross receipts for the three-tax-year period ending with the prior tax period do not exceed $25 million.

The interest expense deduction limitation is calculated at the partnership and shareholder level.

Contributions to capital of corporations by a governmental entity or civic group no longer tax-free

Prior to the Act, Code § 118 allowed a corporation to exclude from income any contribution to capital, including a contribution by a party who is not a shareholder (such as a government grant as a contribution from a potential customer). The Act modifies Code § 118 so that a corporation can no longer exclude contributions by any governmental entity or civic group. Real estate developers frequently used this provision to receive tax increment financing on a tax-deferred basis. The Act's modification of Code § 118 is effective for contributions received after Dec. 22, 2017, but does not apply to contributions made after such date if the contribution occurs pursuant to a master development plan that has been approved prior to such date.

Section 1031 tax-free exchange treatment limited to real property exchanges

The Act modifies the Code § 1031 exchange provisions by limiting their application to real property. The portion of any exchange that includes personal property will no longer qualify for tax deferred treatment under Code § 1031; however, the acquisition of the personal property may qualify for full expensing or accelerated depreciation, discussed above, which would offset the gain from the sale of the personal property.

Change in tax credits

The initial tax reform bill passed by the House of Representatives would have significantly altered many project-based tax credits including the Low-Income Housing Tax Credit, the New Markets Tax Credit, the Historic Tax Credit and Production Tax Credit and Investment Tax Credit for renewable energy projects. The Act largely leaves these credits in place, although the Historic Tax Credit is limited for certain projects and the timing of receipt of the benefit of the credit has been lengthened. Further, the credits may be more difficult to monetize due to other changes made by the Act. For more details, click here.

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