IMPACT OF TAX REFORM ON COMMERCIAL REAL ESTATE

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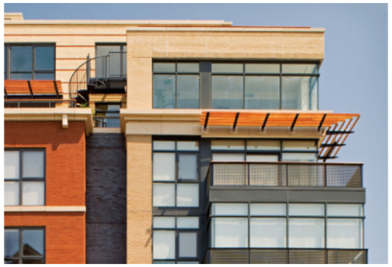

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MOST SWEEPING TAX REFORM SINCE 1986

- Tax Cuts and Jobs Act signed December 22, 2017
- Generally effective for taxable years beginning after December 31, 2017
- Comprehensive tax reform affecting virtually all taxpayers
- Requires immediate attention to evaluate impact
- Requires planning to maximize tax efficiency, minimize negative effects, and determine actions required to comply

TAX REFORM HAPPENED QUICKLY

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- 7 weeks from start to finish
- Partisan reform using budget reconciliation process that triggered some awkward results
  - Temporary provisions
  - Phase-ins/phase-outs/thresholds/rate changes
- Fast pace/process led to drafting errors, lack of clarity, gaps, overlaps, inconsistencies and unintended consequences

TODAY'S AGENDA

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- Changes affecting commercial real estate
- Tax rates
- Special rules for pass-throughs
- Cost recovery
- Interest expense and other deductions/credits
- Investment incentives
- What's next?
- Questions?

IMPORTANT THEMES

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- Winners and losers
- Different tax treatment for similarly situated taxpayers
- Most significant spread between corporate and individual rates since 1982
- Corporate changes permanent; individual changes temporary
- Increased complexity

CHANGES IN TAX RATES

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TAX RATE CHANGES ACROSS THE BOARD

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- **Corporations:**
  - Before: Graduated rate structure, topping out at 35%
  - Now: Flat rate of 21% (corps below $50K could see tax increase)
- **Individuals:**
  - Before: Seven income brackets, highest 39.6%
  - Now: Seven income brackets, 10%, 12%, 22%, 24%, 32%, 35%, 37%
- **Pass-through entities:**
  - Before: Income flows to individual and is taxed at individual's normally applicable rate
  - Now: Lower effective tax rate for certain pass-through businesses due to a 20% deduction on some income

PASS-THROUGH DEDUCTION

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- Section 199A or “Super 199” Deduction
  - Intended to put pass-throughs on equal footing with corporate rate cut
  - Simply put, a 20% deduction against qualifying income (many exceptions)
  - Effective tax rate 29.6%
  - Deduction defined by reference to:
    - Qualified Business Income (“QBI”)
    - W-2 wages of the business
    - Adjusted basis in depreciable assets
    - Taxable income
    - REIT and publicly traded partnership income

PASS-THROUGH DEDUCTION, CONT.

- Only income arising from a qualified trade or business
  - Almost every type of business
  - Includes rents and lease income
- Limited availability for “specified services”
  - Consulting, accounting, medical, investment management, other, where *reputation or skill* is a principal asset of the business
- Excludes:
  - Certain “passive” categories: capital gain or loss, commodities gain, dividends, interest, foreign currency gain, and deductions related to same
  - “Reasonable compensation” for services provided by taxpayer to the business, W-2 income; guaranteed payments

- So, who does Super 199 help?
  - Commercial real estate, retail, manufacturing, farming, service providers under certain income thresholds
- How much is the deduction?
  - Generally, lesser of 20% of qualified business income or 20% of taxable income (less capital gains), subject to W-2 and basis limitations
  - Complicated multi-step computation with many exceptions to the general rule

PASS-THROUGH DEDUCTION – CALCULATION 1

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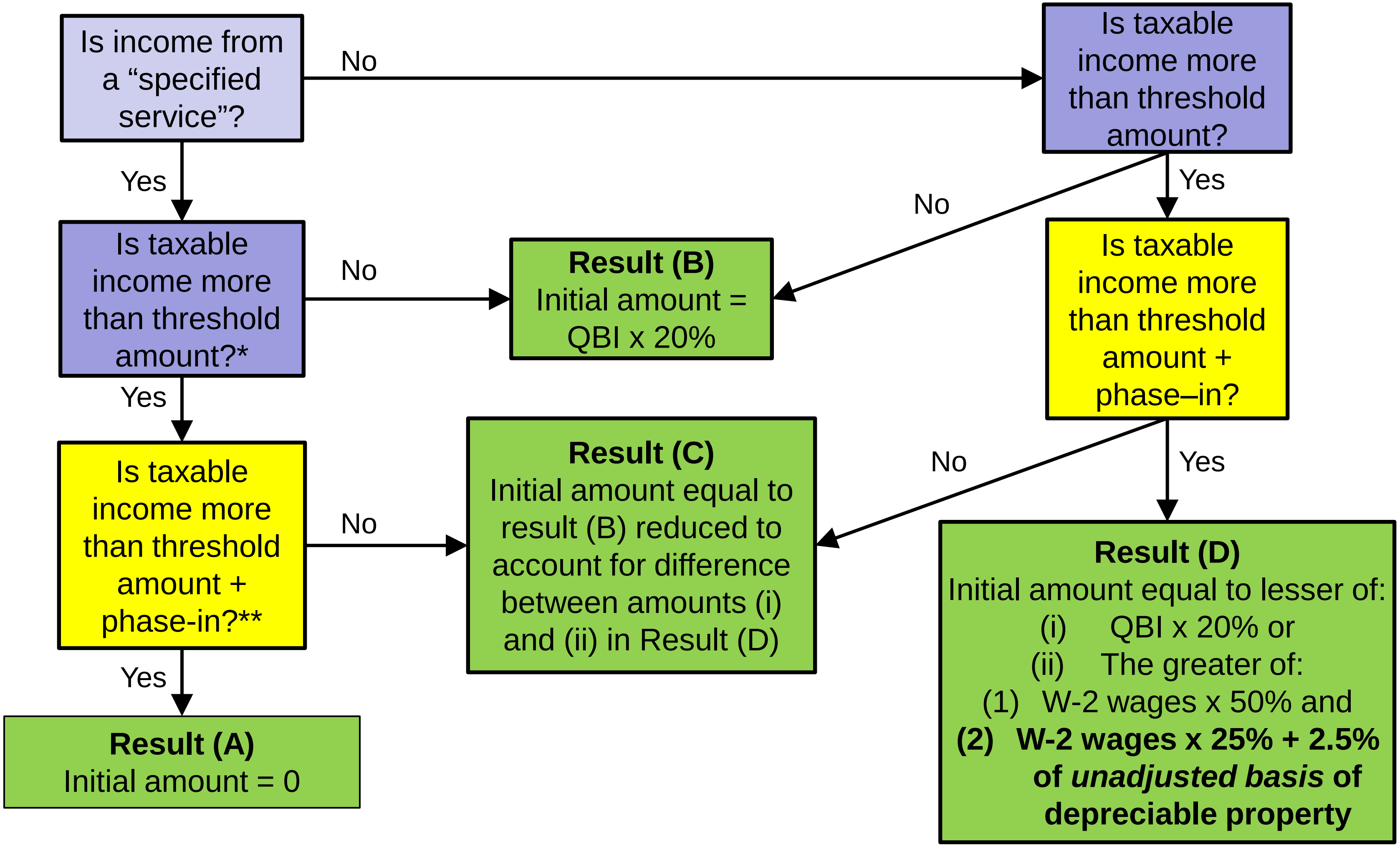

* Threshold Amount is $315,000 of taxable income if filing jointly and $157,000 in all other cases.
** Phase-In is $100,000 of taxable income if filing jointly and $50,000 in all other cases.

PASS-THROUGH DEDUCTION – CALCULATIONS 2 & 3

- Calculation 2
  - **Initial Amount**, plus
  - 20% of certain REIT dividends, plus
  - 20% of certain income from publicly traded partnerships
- Calculation 3
  - Super 199 deduction equal to the lesser of (i) Calculation 2 amount or (ii) 20% of taxable income, less net capital gain (and other minor adjustments)
- *2.5 percent depreciable assets provision and 20 percent REIT dividends provision are major wins for commercial real estate!*

PASS-THROUGH DEDUCTION – SIMPLIFICATION?

- $D199A = MIN\,[CQBAI, 0.2 * (TI - CAPGAIN)] + MIN[(TI - CAPGAIN), 0.2 * COOP]$

  where,

  $CQBAI = 0.2 * (REIT + MLP) + MIN\,[(0.2 * QBI_i), MAX\,(0.5 * W2_i), (0.25 * W2_i + 0.025 * UNADJ_i)]]$

- *Economic Analysis: Farm Cooperative Patrons Get a Nice New Pickup*, Martin A. Sullivan, Tax Notes, January 16, 2018

COST RECOVERY

CHANGES TO COST RECOVERY

- Expanded section 179 expensing
- Expanded bonus depreciation (full expensing)
- Changes to depreciable lives of real property
- Like-kind exchanges

SECTION 179

- Section 179 thresholds increased to allow the expensing of up to $1,000,000 per year of otherwise depreciable assets ($500,000 under current law). Phase-out at $2.5M of assets. Indexed for inflation. This is a permanent change.

- Scope of section 179 now includes “qualified real property”
  - Qualified improvement property
  - Roofs
  - HVAC
  - Fire protection and alarm systems
  - Security

SECTION 168(k): BONUS DEPRECIATION, aka "FULL EXPENSING"

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- Section 168(k) bonus increased to 100% of cost
- Also known as "full expensing"
- Includes new AND used tangible property, but generally not real property
- Also includes qualified improvement property (at least it's *intended* to)
- Transactions between affiliates not eligible
- Temporary – begins phase out 12/31/2022
- Ends completely 12/31/2026
- Can elect out (consider interaction of new NOL rules, interest deduction limits and the new 179 expensing rules)

SECTION 168: QUALIFIED IMPROVEMENT PROPERTY/OTHER

- Tax reform seems to intend to provide a 15-year depreciation period for qualified improvement property
  - Defined as improvements to nonresidential real property that occur after initial placed-in-service date of the property
  - Qualified restaurant, leasehold, and retail improvement property is eliminated – one bucket called qualified improvement property
  - *A drafting glitch left the actual depreciation period uncertain*
  - One of many potential areas for a corrective fix

- Non-residential real property: 40-year life
- Residential real property: 30-year life

LIKE KIND EXCHANGES

- *Retained for real property – big win for CRE!*
- Repealed for personal property
  - Full expensing seen as a proxy
  - Some Members of Congress view as a loophole
  - Revenue raiser
- <u>Permanent</u> repeal of LKEs for personal property coupled with <u>temporary</u> full expensing results in a cliff, or slope, beginning in 2025
- Considerable uncertainty in planning – no guarantee full expensing will be extended
- K&L Gates leads LKE Coalition to "toggle" personal property LKEs back into Code after full expensing expires

DEDUCTIONS AND CREDITS

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INTEREST DEDUCTION LIMITED TO 30% OF EBITDA (AFTER 2022, EBIT)

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- In general, interest deductions of taxpayers are limited to 30% of “adjusted taxable income”

- *But*, any electing real property trade or business is excepted from interest limitation
  - Permanent election
  - Must use alternative depreciation system (a trade-off)

INTEREST DEDUCTION LIMITATION, CONT.

- Adjusted taxable income for any year is taxable income determined without regard to interest (received or paid), the NOL deduction, and the Super 199 deduction
  - In years before 2022, adjusted taxable income is calculated without regard to depreciation or amortization deductions
- Disallowed interest may be carried over indefinitely, treated as incurred in the next year
- Not part of NOL deduction
- Limitation applies at partnership level

LIMITS ON NOL DEDUCTION, NON-CORPORATE LOSSES

- NOLS
  - NOLs may be used to shelter only 80% of taxable income in years after 2017
  - In general, NOLs may not be carried back beginning in 2018
  - NOLs may be carried forward indefinitely
  - Changes are effective for losses arising in taxable years after 12/31/2017 (limits don’t apply to old NOLs)

- EXCESS LOSS LIMITATION (NON-CORPORATE)
  - Limited to $500,000/year
  - Partner level
  - Carryover allowed

- 3-year Holding Period for Certain Profits Interests
  - Gain from allocations in respect of, or on sale of, certain partnership profits interests held for less than 3 years is taxed as short-term capital gain
  - Only applies to “Applicable Partnership Interests”, i.e., “profits interests” issued for *services* in the business of:
    - Raising or returning capital
    - Investing in or developing “specified assets” (securities, *rental or investment real estate*, cash or cash equivalents, options or derivatives)
  - Secretary authorized to issue regulations to limit to assets held for portfolio investment on behalf of third party investors

REPEAL OF OTHER DEDUCTIONS

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- Fringe benefits repealed
  - Transportation fringes
    - Parking, subway, bicycles
    - Commuting reimbursement, except for safely of employee
  - Employee incentives
    - Cash, cash equivalent employee awards
    - Trips, tickets, non-tangible personal property
    - Exception: Gift certificates where employee can select are allowed
- Meals and entertainment repeals
  - Business-related entertainment expenses, including membership dues at clubs
  - 50% deduction for food expenses for on-site eating facilities such as cafeterias (deduction eliminated entirely after 2025)

COMPENSATION LIMITATION

- Employee compensation limited to $1M for publicly traded companies
  - Performance-based compensation no longer qualifies
  - Covered employees = CEO, CFO, other Top 3
  - Once on the list, always on the list

FAMILY & MEDICAL LEAVE CREDIT

- New business tax credit for paid family and medical leave
  - 12.5% of wages paid to employees during the time employees are on family or medical leave
  - Employees must be paid at least 50% of usual pay, credit percentage rises if greater than 50%
  - Temporary - only effective for wages paid in 2018 and 2019

INVESTMENT INCENTIVES

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- Tax is deferred on capital gains if invested in Opportunity Development Fund with 180 days
- ODF invests in Opportunity Zones identified by governors (similar criteria to New Markets Tax Credit areas)
- QDF must hold at least 90% of assets in OZs
- Amount of deferral dependent upon length of holding period
- Gains from ODF investment also receive preferential treatment

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- Rehabilitation credit limited
  - Pre-'36 building credit repealed
  - 20% credit spread over 5 years
  - Limited window to make expenditures
- New Markets Tax Credit repealed in House bill, but ultimately retained
- Advance refunding bond exemption repealed
  - PABs repealed in House bill, but dropped in conference
  - White House infrastructure plan would expand PABs and P3s

ESTATE TAX

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- Exemption thresholds doubled until end of 2025
- *This is another tax reform benefit to the real estate industry – heirs will not be forced to sell property because of major tax bills*

STATE AND LOCAL TAX DEDUCTIONS

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- In one of its most controversial provisions, the new tax law imposes a $10,000 aggregate limit on *individual* deduction for state and local income, property, sales and use taxes
- But, state and local taxes incurred while running a real estate *trade or business* or in any activity related to producing income will still be fully deductible

INDIVIDUAL HIGHLIGHTS

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INDIVIDUAL HIGHLIGHTS

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- All temporary – expire 12/31/2025
- Lower tax rates
- Estate tax exemptions doubled, indexed for inflation
- Double standard deduction
- No Pease limitation
- No personal exemptions
- State and local itemized deduction limited to $10,000
- Home mortgage deduction limited on new mortgages to $750K debt
- No miscellaneous deductions
- Medical threshold 7.5% AGI (down from 10%)
- Contributions limited to 60% AGI (up from 50%)
- Increased AMT thresholds

WHAT’S NEXT?

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- Pace and process of tax reform led to errors, omissions, unintended consequences that need to be fixed
  - Legislative (technical corrections, other corrective legislation, cutting room floor issues)
  - Regulatory (Treasury/IRS regulations and guidance)
  - Joint Committee on Taxation Bluebook (submit comments)
  - Other legislative vehicles (any bills with tax titles could present an opportunity to effect change)

WHAT'S NEXT?

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- Outlook for legislative corrections in 2018 is doubtful
  - 60 votes in Senate hard to get
  - Why would Democrats vote to fix a bill they don't like and didn't vote for in the first place?
  - Contentious atmosphere in DC
  - Election year
- Treasury and IRS will bear the brunt
  - How broad is their authority?
  - Can they find a way to work around drafting errors? Risk of "legislating."
  - How much can they get done? Stretched staff and resources.
  - Administrative Procedures Act imposes restrictions on process and timing

WHAT'S NEXT?

- Stakeholder input important!
- Will shape priorities, outcomes
- Treasury and IRS need to know:
  - What's confusing, what doesn't work
  - How things work in "real life"
  - Examples
  - Suggestions on how to implement, administer
  - Regs, guidance, forms and procedures
- *What will be your role in the process?*

QUESTIONS?

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For tax reform information, please visit:

http://www.klgates.com/taxreform/

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