Tax Law Impacts of the 2017 Tax Reform on Real Estate Industry

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Generally, the new tax reform act (P.L. 115-97) enacted into law in December 2017 represents a boon for the real estate industry. The law offers additional incentives for investors in real estate, both by offering lower tax rates and preserving like-kind exchange treatment for real property. Furthermore, real estate businesses are allowed to elect out of the new rules limiting interest deductions, although at a cost of foregoing shorter depreciable lives.

The following is a brief summary of the Act, as it relates to taxpayers engaged in the real estate business.

Changes in Tax Rates

- *Corporations*

The tax rate for C corporations (including personal service corporations) is capped permanently at 21%. The portion of dividends received by corporations that are not taxed has been reduced.

- *Sole Proprietorships and Real Estate Development and Investment Entities*
  - A 20% deduction for qualified business income allocated by a pass-through entity (which includes trusts and estates) is created, limited to the greater of (i) 50% of wage income paid by the entity or (ii) the sum of (a) 25% of wage income paid by the entity and (b) 2.5% of the unadjusted cost of tangible depreciable property owned by the entity. Such property enters into the determination if it had been used in the business and the depreciable period for the property (the greater of ten years or the depreciable life of the property) has not expired before the close of the taxable year. The wage/property limitation applies to an owner of an entity with income for joint filers of more than $315,000 (that amount is indexed for inflation).
  - The deduction is claimed at the partner level for a partnership and the shareholder level for an S corporation. The deduction is claimed against taxable income, whether or not the partner or shareholder itemizes deductions. The deduction is limited to 20% of the partner's or shareholder's taxable income after deducting net capital gain and non-business losses and deductions.
  - This deduction applies only to income generated within the United States. It does not apply to passive investment income (such as dividends, capital gains, and interest and annuity income if not related to a trade or business); however, rental or royalty income, and depreciation recapture income, are treated as generated in an active trade or business.
  - The deduction does not apply to reasonable compensation paid by an S corporation or to guaranteed payments made by a partnership.
  - Dividends from a qualified REIT and payments from a qualified publicly traded partnership are eligible for the deduction. The wage/property limitation does not apply to such income.
  - The provision does not apply to real estate held as an investment (rather than in an active trade or business); therefore, it would not apply to income from a triple-net lease property.

- If the entity works in a service business, such as health care, law, accounting, actuary, performing arts, consulting, athletics, financial services or brokerage, or if the entity's principal asset is the reputation or skill of an owner or employee (without regard to the business operated by the entity), the deduction can be claimed only by an owner who has up to $315,000 of income (for joint filers), with a phase-out of the deduction over the next $100,000 of income. Both amounts are indexed for inflation.
- This deduction ends after 2025.

- Impact of these Changes on Real Estate Development and Investment Entities:
  - The property factor in the formula limiting the deduction cited above (2.5% of the unadjusted cost of tangible depreciable property owned by the entity) was devised specifically for real estate owners, who typically do not have high wage bills but often have large capital investments in property.
  - If a real estate business does not have significant amounts of depreciable property (such as a home builder or a condo developer, which own non-depreciable inventory) and has relatively small wages, this deduction may have minimal benefit.
  - If a real estate business has a separate management company to operate its properties, the wages paid by that management company would likely not enter into the calculation of wages paid by the real estate business, and, therefore, the amount of the allowable deduction for income generated by that business could be limited.
  - If that were to be the case, a restructuring of the business may be in order. However, since the deduction right now has an eight-year life, caution should be taken as to what is done now (like incorporating a business) that may be expensive to undo after 2025, when the deduction is scheduled to end.
  - In this regard, in order to add to the "wages paid" factor, a real estate business that commonly issues a "profits" interest to a senior employee may find that a cash payment may be more beneficial.

- *Tax Rate Changes*

- The reduction in the corporate tax rate means that the overall Federal income tax rate for individual shareholders is 36.8% for higher earning taxpayers (down from 48% previously), while the overall Federal income tax rate on qualified income for individual owners of a pass-through entity (including a sole proprietorship) is 29.6%. Therefore, most business income has received a significant tax cut, although the one for sole proprietorships and pass-through real estate developers and investors expires in 2026.
- The lower tax rates means that deductions, and net operating loss carryovers, will be less valuable.
- Even though a C corporation faces a lower tax rate, the corporation cannot simply amass earnings and profits without making distributions since (1) all accumulated earnings and profits not intended to be reinvested in the business face a 20% accumulated earnings tax and (2) if the passive income on the accumulated earnings exceeds 60% of the corporation's income, it would face a 20% tax as a personal holding company.

- ➢ Moreover, when the time comes to sell the business, buyers will still reduce the value of the company if they have to buy corporate stock, as opposed to assets of the corporation, since the purchase of corporate stock does not afford an opportunity to increase the depreciable basis of the assets to fair market value. The "hair-cut" may be less than previous due to lower tax rates, but it may still be a significant amount.
- ➢ Also, it is very difficult to distribute assets from a C corporation to its shareholders in a tax-free manner.
- ➢ An S corporation offers the benefits of the pass-through entity deduction, and preferential treatment on self-employment taxes as compared to a partnership. But an S corporation does not offer a mechanism similar to a "profits interest" for a tax partnership to grant an equity interest to employees tax-free.
- ➢ If an operating agreement of a tax partnership contains a mandatory tax distribution agreement which sets forth a stated assumed tax rate, such provision should be amended to more closely reflect the new tax rates.

Tax Deduction for Interest Paid by a Real Estate Business

- Interest expense deductions for business are limited to the sum of (i) interest income plus (ii) 30% of adjusted taxable income (basically, EBITDA). After 2021, the limitation will be 30% of EBIT (earnings after interest and taxes (but not taking depreciation into account), which means that the amount of interest deductible will be less). These rules apply to existing debt.
- These deduction limitations will not apply to businesses with less than $25 million (this amount is indexed for inflation) of average gross receipts over a three-year period. Note that this exemption from the limitation on interest deductions does not apply to a tax partnership where 35% or more of the entity's losses are allocated to limited partners.
- A real property business (broadly defined, including hotels and lodging facilities) can elect out of these rules (on an irrevocable basis), but then cannot use the shorter and more favorable MACRS depreciation method (which features a 15 year life for improvements made to non-residential real property, a 27.5-year life for residential real property and a 39-year life for non-residential real property). Rather, an electing business must use the ADS system of depreciation (30-year and 40-year lives, respectively, for such property, and a 20-year life for qualified improvements). The term "real property business" includes the operations of a corporation or an REIT.
- This limitation is applied at the partner level for a partnership borrower and the shareholder level for an S corporation borrower. Complex rules define how the interplay between a partnership or an S corporation, on the one hand, and a partner or a shareholder, on the other hand, is handled.
- The current limitation on deduction of interest expense based upon the debt-equity ratio of the payor is repealed.
- <u>Impact of this Change on Real Estate Development and Investment Entities</u>:
  - ➢ The major limitations on the interest expense deductions for businesses could significantly rebalance the previous tax bias which favored debt capitalization, leading to more equity

capitalization in some businesses. However, real-estate businesses can and most likely will elect not to have these rules apply to them.

- Businesses that continue to rely on deducting their interest expenses must keep in mind that some of the other deductions made available by the Act, as described below, will reduce their earnings, and thus their interest deductions.
- Similarly, incurring depreciation deductions after 2022, when the formula for determining allowable interest expense changes, must be considered by any business subject to the interest deduction limitation.

Additional Tax Law Changes that Impact Real Estate Businesses

- *Expensing of Acquired Assets*
  - A business may expense the entire cost of qualified property (tangible personal property but not a structure with a depreciable life of not more than 20 years) acquired after September 27, 2017, rather than claim depreciation on the asset. This provision does not apply to real estate except for tangible personal property (like office equipment) used in a real estate business. With respect to property acquired after 2022, this benefit is phased out over five years. This provision applies whether or not the property is new or used, but the property cannot be acquired from a “related party”.
  - A real estate business that elects out of the new interest expense deduction limitations may not take advantage of this expensing option.
- The §179 expensing program for small businesses is increased from $500,000 per annum (with a cutback for purchases of more than $2 million of eligible property) to $1 million per year (with a cutback after purchases of more than $2.5 million of eligible property). The class of property eligible for this program has been expanded to include tangible personal property used in connection with furnishing lodging, and many types of improvements to nonresidential real property made after the real property was first placed in service (such as installment of new roofs, HVAC equipment, fire protection and alarm systems and security systems).
- Accrual basis taxpayers must include an item in income not later than the taxable year when the item is included in its financial statement.
- The corporate alternative minimum tax is repealed.
- The net operating loss carryover/carryback rules are revised to prohibit any carryback (absent a disaster) and to limit a carryover to 80% of current year’s taxable income. Carryovers are allowed indefinitely.
- For active businesses not operated by a C corporation, excess business losses (the amount that exceeds business income plus $500,000 in a taxable year) cannot be applied to offset non-business income, but must be carried over to future taxable years. Then, the carryover can offset 80% of taxable income. This calculation is made at the partner level in a partnership. The current passive loss rules continue to apply to losses incurred before these new rule are applied. The net operating loss rules previously in effect continue to apply to pre-2018 net operating losses.

- Publicly-traded companies are prohibited from deducting compensation of more than $1 million paid to its five highest-paid executives, with the performance-based and commission exclusions previously allowed being repealed. This rule applies to employment contracts entered into after November 2, 2017.
- Like-kind exchange treatment will be limited to real property. However, since §1031 no longer applies to the sale or exchange of personal property (like furniture and equipment), a portion of any gain realized in connection with an otherwise tax-free like-kind exchange of real property which includes such personal property will be taxable.
- Deductions for business entertainment expenses, local lobbying expenses, moving expenses for employees, on-premises perks and transportation fringe benefits for employees are repealed or more restricted. The costs of meals provided by an employer on its premises are 50% deductible, but such expenses will not be deductible at all after 2025.
- Capital contributions to a corporation by non-shareholders (such as aid in construction of a facility) will be treated as taxable income.
- Employees of non-public companies who receive stock options or restricted stock units as compensation for services may elect to defer recognition of the income for up to five years, but with many conditions. However, an employee who makes such election will be taxed on the value of such stock when the election was made, even if the value of that stock has declined at the end of the five-year deferral period.
- *Tax Benefits for Smaller Real Estate Companies*
    - Businesses with up to $25 million (this amount is indexed for inflation) of average gross receipts over a three-year period may use the cash method of accounting. Such a business may also avail itself of more liberal inventory accounting methods than those required for larger businesses.
    - The more favorable tax treatment does not apply to a tax partnership where 35% or more of the entity's losses are allocated to limited partners.

Tax Law Impacts on Real Estate Partnerships

- The taxation of carried interests (profits interests) in a partnership is changed to require that the interest must be held for three years before it could be sold in order to be eligible for long-term capital gain treatment. This new rule applies to all profits interests, no matter when they were issued, but is restricted to investment funds and real estate partnerships holding real property for investment or rental. The three-year period applies both to the holding period for the partnership interest itself and the assets of the partnership. This rule does not apply to a carried interest held by a corporation, nor to an interest in the capital of the business proportionate to the amount of capital invested.
- The Act legislatively reverses a decision of the Tax Court which held that a non-US person who transferred an interest in a US partnership was not subject to US taxation on any gain realized on the transaction. Therefore, under the Act, if the gain or loss on the sale of the assets of a US partnership would produce income "effectively connected" with the US, a non-US partner is subject to US tax on the sale of an interest in that partnership. Further, the buyer must withhold

10% of the sales price and pay the funds over to the IRS (on behalf of the seller), unless the seller certifies that it is neither a nonresident alien nor a foreign corporation.

- *Technical Termination*
  - The rule as to a technical termination of a partnership upon the sale or exchange of 50% or more of the interests in partnership capital or profits within a 12-month period has been repealed. This action avoids a "terminated" partnership having to restart its depreciation schedule. Therefore, transfers of partnership interests will be more easily accomplished without running up against the previous artificial barrier that has been removed.
  - <u>Analysis</u>: many existing partnership agreements and operating agreements contain provisions prohibiting transfers of interests if the transfer would cause the entity to terminate for Federal income tax purposes. Such provisions may now be treated as moot, depending on how the provision was worded.
- Although not part of the Act, partners and members should recall that the new partnership audit rules have gone into effect for most tax partnerships starting January 1, 2018.

Tax Law Impacts on Condominium Developers

- *Itemized deductions*
  - <u>Mortgage Interest</u>

Mortgage interest for a taxpayer's principal residence or second home (deductions for interest on a home equity loan, even if currently existing, are not allowed) is deductible on up to $750,000 of acquisition indebtedness. This rule applies to mortgages issued after December 15, 2017. Existing mortgages (and refinancing of the same) will remain subject to the current rules (interest deductible on up to $1,000,000 of indebtedness).

  - <u>State and Local Income Taxes, Sales and Property Taxes</u>

The deduction for state and local income taxes, sales taxes and property taxes (but foreign property taxes are not deductible at all) is limited to $10,000 (the amount will not be subject to increase for inflation), unless incurred in the conduct of a trade or business or in connection with the production of income.

- The rules as to not taxing the first $500,000 (for joint filers) of capital gain realized on the sale of a primary residence were not changed.
- <u>Impact of this Change on Condominium Developers</u>
  - In high-tax states where the limitation of the state and local tax deduction can have a significant effect, and in high home-price areas where the further limitation on the mortgage interest deduction can also have a serious effect, the impact on pricing and sales of both new homes and existing homes may range from adverse to very adverse, depending upon the specific housing market. The former tax advantages of home-owning in those areas may have shifted towards more activity in the rental market.

Changes in Tax Credits

- Tax credits for rehabilitation of certified historical structures can be claimed over five years (rather than immediately, as under prior law), but no credits are allowed for rehabilitation of non-certified structures.
- The low income housing credit is retained; the new markets tax credit for the 2018 and 2019 allocation application rounds was also retained. The proposed restrictions on private activity tax-exempt bonds, many of which are used to finance housing on which low-income housing tax credits are claimed, were not enacted.
- Analysis: Real estate development businesses that depend on rehabilitation tax credits, low income housing tax credits and/or new markets tax credits for financing sources may experience difficulties since the demand for such credits from their usual corporate buyers may, as a result of the reduction in corporate tax rates, significantly decline.

Corporations with Non-US Connections

- The Act made no changes to the current US withholding tax on dividends paid by a US corporation to a non-US shareholder, nor to the “branch profits” tax on US income earned by a non-US corporation within the US.
- However, the Act does contain a minimum tax (5% during 2018, then 10% during 2019 through 2025, and 12.5% thereafter) on payments (like interest, royalties, and service fees charged higher than cost) made by a US corporation to non-US related parties (the “Base Erosion Anti-Abuse Tax”). Prior to 2026, the calculation of this tax can have the effect of reducing the value of a corporation’s tax credits, which is effectively a new alternative minimum tax on corporations subject to its application.

If you require further explanation or information on these matters, please contact Alvin J. Goldman, Hinshaw & Culbertson LLP, at (212) 471-6207 or agoldman@hinshawlaw.com.

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