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Impact of the Tax Cuts and Jobs Act on Real Estate

The following is a summary of the real estate provisions of the Tax Cuts and Jobs Act (TCJA) signed into law by President Trump on Dec. 22, 2017.

Individual Rates (Temporary)

General tax rate and bracket reductions for individuals (top rate of 37 percent applies to income above $600,000 for joint filers, $500,000 for single filers). Increases the AMT exemption level and AMT exemption phase-out level. New rates and AMT rules expire after 2025. The 3.8% net investment income tax remains in effect.

Itemized Deduction Limit (Temporary)

Miscellaneous itemized deductions, previously subject to the two percent floor (*e.g.*, investment management fees), are no longer deductible. Expires after 2025.

Corporate Tax Rate (Permanent)

Flat 21 percent tax rate for C corporations; repeals the corporate AMT.

Disallowance of Deductions for State and Local Income Tax and Property Tax (Temporary)

- Limited to $10,000 per year.
- No limit for real property taxes paid or accrued in connection with a trade or business. However, state income taxes that are payable by a non-corporate investor in a pass-through entity are subject to this $10,000 aggregate deduction limitation. For example, assume that Jeff is a 50 percent member of an

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LLC which owns an office building in Illinois. The LLC pays $200,000 in real property taxes, and has total net income of $500,000. Jeff's 50 percent share of the property taxes ($100,000) is fully deductible for federal income tax purposes, but the Illinois income taxes that he pays on his 50 percent share of the net income (the state tax on his $250,000 share of the profits), along with (i) any other state income taxes he pays and (ii) any real property taxes he pays that are not associated with a trade or business, are subject to the $10,000 limit on state and local taxes that would be allowed as a deduction.

- Expires after 2025.

Pass-Through Business Income – 20 Percent Deduction (Temporary)

- Non-corporate taxpayers (individuals, trusts, and estates) are entitled to a new deduction that has the effect of potentially reducing the highest tax rate on non-wage business income and qualified REIT dividend income to 29.6 percent. This is accomplished by providing a deduction that is generally equal to 20 percent of the person's business income from a "qualified trade or business" and 20 percent of the person's qualified REIT dividend income. However, in no event may the total deduction exceed 20 percent of the taxpayer's taxable income (less any net capital gain income).
- The deduction with respect to a taxpayer's qualified business income is subject to certain additional limitations (which relate to the amount of wages paid by the business and the cost basis of certain assets owned by the business) (the "wage and basis cap").[1] However, these additional limitations do not apply to the deduction with respect to qualified REIT dividend income.
- Qualified REIT dividends include all dividends from a REIT that are not (i) capital gain dividends or (ii) dividends traceable to distributions from a taxable REIT subsidiary, both of which are taxable to non-corporate shareholders at more favorable capital gain rates (i.e., generally a 20 percent maximum rate, which is unchanged by the TCJA).[2] Thus, 20 percent of all qualified REIT dividends may be deducted, subject to the overall taxable income limit described in the first bullet point above. Because qualified REIT dividend income is not subject to the wage and basis cap, the new law encourages real estate investors to own real property through a REIT, particularly where the investors would otherwise be subject to the cap. Existing real estate partnerships may wish to consider the advisability of transferring their real property to a new subsidiary REIT so that the income from the property is not subject to the wage and basis cap.
- A "qualified trade or business" is any trade or business except (i) the business of being an employee and (ii) specified service businesses. It is unclear whether the ownership of a triple net leased property would constitute a qualified trade or business.

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[1] With respect to each qualified trade or business, the new deduction is limited to the lesser of (a) 20 percent of the qualified business income from that business; or (b) the greater of (i) 50 percent of the W-2 wages paid by the business or (ii) 25 percent of the W-2 wages paid by the business plus 2.5 percent of the original unadjusted basis of the tangible depreciable property (including real estate other than land) owned and used by the business and for which the "depreciable period" has not yet ended. Thus, even if a real estate business does not pay any wages, it may qualify for the new deduction, subject to a cap equal to 2.5 percent of the original unadjusted basis of the tangible depreciable property used in the business. The business income, as limited by the foregoing cap, is computed separately for each qualified trade or business, and the income and loss of each such business is aggregated to determine the total qualified business income. For purposes of the basis limitation in clause (ii) above, the "depreciable period" ends on the later of (x) 10 years after the asset is placed in service or (y) the end of the asset's normal depreciation recovery period. A partner's share of the partnership's unadjusted basis of the tangible depreciable property is the same as his share of the partnership's depreciation expense.

[2] By way of comparison, the definition of qualified business income that a taxpayer derives from a sole proprietorship, partnership or other pass-through entity (other than a REIT), and which likewise is potentially eligible for a 20 percent deduction, excludes investment-related income (*e.g.,* capital gains, dividends and interest).

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- Specified service businesses (such as health, law, accounting, consulting, brokerage services, financial services, or any business where the principal asset is the reputation or skill of one or more of its employees or owners, and businesses which involve the performance of services consisting of investing and investment management, trading or dealing in securities) are not eligible. Note that engineering and architecture businesses are eligible.
- The wage and basis cap and the restriction on specified service businesses do not apply to taxpayers with taxable income below $157,500 ($315,000 for joint returns) and apply on a phased basis for taxpayers with taxable income between $157,500 and $207,500 (between $315,000 and $415,000 for joint returns).
- Expires after 2025.

Business Interest Deductions – 30 Percent ATI Limitation (Permanent)

- Businesses with average annual gross receipts of $25 million or less are exempt from this limitation.
- Starting in 2018, "business interest" expenses are deductible only to the extent of business interest income plus 30 percent of "adjusted taxable income."
- From 2018-2021, "adjusted taxable income" means taxable income from trade or business activities before any deductions for interest, depreciation, amortization (i.e., EBITDA), NOLs, and the new pass-through deduction.
- After 2021, "adjusted taxable income" means taxable income from trade or business activities before any deductions for interest (i.e., EBIT), NOLs, and the new pass-through deduction. Thus, after 2021, there is a more stringent limit on the amount of interest that may be deducted.
- Disallowed amount may be carried forward indefinitely and treated as interest expense in succeeding taxable years.
- "Business interest" is interest paid or accrued with respect to indebtedness allocable to a trade or business. It does not include investment interest expense.
- A real property trade or business may elect not to be subject to this limit, but a business that so elects must use the longer ADS depreciation periods (see below). A real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Once made, this election is irrevocable.
- Non-U.S. investors owning U.S. real estate, directly or indirectly, through a corporate blocker should consider modeling the effect of this 30 percent limitation on the deductibility of interest on loans from investors to the blocker corporation that are intended to reduce the corporation's U.S. taxes. It appears that the interest paid by such a leveraged blocker is subject to the new limitation, but it is not clear whether the blocker is entitled to elect out of this new limitation as a real estate business at the cost of using the slower ADS depreciation for its depreciable property where the real estate business is conducted through a lower-tier entity in which the corporate blocker holds an interest. Even if the interest deduction is limited, a foreign investor may benefit from the fact that the corporation is now taxed at a 21 percent rate instead of a 35 percent rate. However, distributions from the blocker (other than final liquidating distributions made after all of its U.S. real property interests have been sold) will continue to be subject to a 30 percent (or lower treaty rate) U.S. withholding tax. Any investor in this position should compare the benefits of the pass-through deduction and the capital gains rate on dispositions where a corporate blocker is not used with the 21 percent corporate rate of tax and applicable withholding rate that will result from use of a corporate blocker.

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- The previous "earnings stripping" rules in section 163(j) of the tax code are repealed.

New Alternative Depreciation System (ADS) Depreciation (Permanent)

- If the taxpayer has a real property trade or business, and elects not to be subject to the interest deduction limitation, the taxpayer must use the ADS depreciation periods prospectively for all real estate (residential, non-residential, and qualified improvement property), including real estate acquired prior to the election:
    - Residential real estate: 27.5-year regular period and new 30-year ADS period.
    - Non-residential real estate: 39-year regular period and 40-year ADS period.
    - Qualified improvement property: new 15-year (straight-line) regular period and 20-year ADS period.

Depreciation Expensing for New or Used Personal Property and Qualified Improvement Property (Temporary)

- 100 percent immediate expensing for property placed in service between Sept. 27, 2017, and Dec. 31, 2022.
- 80 percent immediate expensing for property placed in service in 2023.
- 60 percent immediate expensing for property placed in service in 2024.
- 40 percent immediate expensing for property placed in service in 2025.
- 20 percent immediate expensing for property placed in service in 2026.

First Year Expensing (Permanent)

- Apart from the temporary provisions for immediate expensing as described above, taxpayers may immediately expense up to $1,000,000 of property placed in service during a year.
- But if the taxpayer places more than $2,500,000 in service in the year, then the amount allowed to be expensed is reduced.
- Applies to (i) personal property used in a trade or business, (ii) personal property used predominately in a lodging business, (iii) qualified improvement property, and (iv) with respect to <u>non-residential</u> real property only, the roof, HVAC, fire, and security systems.

Qualified Improvement Property (Permanent)

- Repeals provisions relating to qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property provisions, and recharacterizes such property as qualified improvement property.
- Qualified improvement property is any improvement to an interior portion of a non-residential property.
- The improvement must be constructed after the building was placed in service.
- Does <u>not</u> include: enlargements of the building, improvements to an elevator or escalator, or improvements to the internal structural framework.

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Limit on Aggregate Losses (Temporary)

- In any year, non-corporate taxpayers may not deduct more than $250,000 ($500,000 for joint returns) of net losses from trade or business activities against income from other sources (such as investment income).
- The excess becomes part of the taxpayer's NOL carry forward (see below).
- Limitation applies at the partner/S corp shareholder level.
- Rule applies after the application of the passive loss rules.
- This rule expires after Dec. 31, 2025.

Limit on Net Operating Losses (NOLs) (Permanent)

- Limits the use of NOLs to offset only 80 percent (reduced from 100 percent) of taxable income generated in the later year to which the NOL is carried forward.
- The two-year carry back and 20-year carry forward are repealed. No carry backs are allowed; must carry forward, but may carry forward indefinitely.
- Applies only to NOLs incurred in 2018 and subsequently.

No Technical Termination on Sale of More than 50 Percent of a Partnership (Permanent)

- Effective for tax years beginning after 2017, the sale of more than 50 percent of the interests in a partnership during a year will no longer cause a technical termination of the partnership.
- Thus, no new tax elections are permitted to be made and there is no need to restart depreciation in such cases.

Carried Interests (Permanent)

Effective for tax years beginning after 2017, gain allocable to the holder of a carried interest will be treated as short-term capital gain (taxed as ordinary income) unless the property being sold has been held for at least three years.

Rehab Credit (Permanent)

- Only available for certified historic buildings.
- 20 percent credit, claimed ratably over five years.

Unrelated Business Taxable Income (UBTI) (Permanent)

If a tax-exempt organization has more than one unrelated business, UBTI must be calculated separately for each separate trade or business (so that losses from one business cannot shelter UBTI from another business).

Contributions to Capital (Permanent)

A corporation must report as income any non-shareholder contribution by any governmental entity or civic group.

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Like-Kind Exchanges (Permanent)

Tax-deferred like-kind exchanges under section 1031 of the tax code are now restricted to real property (excluding dealer property held primarily for sale). Previously, these rules also applied to exchanges of personal property. Thus, any personal property included in an exchange of real estate will no longer qualify for deferral under the like-kind exchange rules. This may have a significant impact on 1031 exchanges of commercial and residential real estate projects which have allocated a material portion of the basis to personal property per a cost segregation study.

Home Builders (Permanent)

Effective for contracts entered into after 2017, taxpayers with average gross receipts of less than $25 million (indexed for inflation) for the prior three taxable years are exempt from the requirement to use the percentage-of-completion accounting method for long-term construction contracts to be completed within two years, regardless of entity structure. Taxpayers that meet such exception would be permitted to use the completed-contract method (or any other permissible exempt contract method).

For more information on the Tax Cuts and Jobs Act, please click here.

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