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Impact of H.R.1, the Tax Cuts & Jobs Act, on Real Estate Investments and Private Equity Funds

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The Tax Cuts and Jobs Act (the "Act") materially alters the federal income tax landscape for operating domestic real estate businesses and will require a rethinking and restructuring of these businesses. There are five major and two minor changes that impact domestic business operations of the real estate industry. The major changes are: 1) the reduction in the corporate income tax rate from 35% to 21%; 2) a 20% deduction available to certain pass-thru entities; 3) modification of the net operating loss provisions for both corporate and non-corporate taxpayers; 4) a limitation on the deductibility of net interest; and 5) an option to expense 100% of certain capitalized costs. The two minor changes are (i) a limitation on the deductibility of state and local taxes by non-corporate taxpayers; and ii) repeal of the alternative minimum tax ("AMT") on C corporations and the modification of the AMT on individuals. In this Bulletin, after describing these provisions in general, we will discuss our preliminary thinking on tax planning and structuring opportunities under the new law. It is important to note, however, that certain of these provisions were drafted (1) behind closed doors, (2) without industry input, (3) with minimal (if any) debate and (4) with no input from the Democratic minority, and will require so-called "technical corrections and substantial administrative input to become functional. We plan to provide periodic updates as issues become manifest and guidance emerges.

1. Changes to Nominal and Effective Tax Rates

All clients should be considering at this time whether to operate as a pass through or C corporation, although for our domestic private clients, it will be the rare situation in which rental or investment real estate should be owned in a C corporation. The Act permanently reduces the maximum incremental federal corporate income tax rate from 35% to a flat 21% tax rate effective for taxable years beginning after December 31, 2017, reduces the maximum incremental income tax rate on individuals from 39.6% to a maximum incremental 37% for taxable years 2018 through 2025 (reverting to the pre-Act rates after 2025), and leaves the income tax rate on capital gains imposed on non-corporate taxpayers unchanged at 15% or 20% (25% for unrecaptured section 1250 gain). The new 20% deduction for certain income from "passthroughs" may, where applicable, reduce the maximum effective rate from 37% to 29.6%. At the same time, for individuals for taxable years 2018 through 2025, the Act limits the deduction for state and local income taxes (whether or not related to a trade or business) and real property taxes unrelated to a trade or business or investment to $10,000 (without adjustment for inflation) and eliminates the deduction for miscellaneous itemized deductions (including legal fees for the determination of any tax). Nevertheless, C corporations will in most cases not be good vehicles for owning real estate held for rental or investment for several reasons, including: potential tax consequences from distributing refinancing proceeds to shareholders; inability to obtain a step up in basis in the property (as opposed to the shares of stock) on death of a shareholder; higher combined taxes on taxable sale of the property if the corporation is liquidated after the sale; higher effective state and local tax rates on corporations than on individuals (even after taking their

deductibility into account) in certain jurisdictions (e.g., New York City); and the potential application of an additional 20% tax on accumulated earnings in excess of the reasonable needs of the business or, alternatively where the corporation is controlled by 5 or fewer persons, the potential application of the 20% personal holding company tax on undistributed income.

In contrast, our recommendations may differ for operating businesses – for which the 21% corporate tax rate my offer a significant advantage over the effective rates applicable to passthroughs and individuals. There are a variety of factors including the higher ordinary income rates for individuals, availability of an unlimited deduction for state and local corporate income and property taxes, reduction in self-employment tax for shareholders who are active in management of the business, and possible avoidance of current state and local income taxation at the shareholder level on dividend income (versus current state and local taxation of income from pass through entities regardless of the owner's state of residence) may create a bias toward operating as a C corporation, particularly where the business is growing and its earnings are being reinvested in the business.

2. Limitation on Deductibility of State and Local Taxes

For taxable years beginning after December 31, 2017 and ending before January 1, 2026, non-corporate taxpayers will only be entitled to deduct non-trade or business state and local taxes up to $10,000 (whether or not married and filing a joint income tax return with their spouse) and will not be entitled to deduct state and local income taxes applicable to their trade or business income except as part of the $10,000 allowance. In contrast, C

corporations will continue to deduct state and local taxes that are imposed on their trade or business activities or income. High tax states, such as New York, New Jersey, Connecticut and California have been considering strategies for circumventing the $10,000 limitation but in our view it is unlikely that whatever approach they adopt (apart from a modification of the federal income tax) will succeed.

3. 20% Deduction for Certain Pass Through Income

For taxable years beginning after December 31, 2017, and ending on or before December 31, 2025, new section 199A of the Internal Revenue Code of 1986, as amended (the Code"), allows taxpayers other than corporations a 20% deduction for income from qualifying businesses, whether conducted through sole proprietorships, partnerships or limited liability companies, or S corporations. To the extent applicable, this deduction reduces the maximum incremental federal income tax rate on these businesses from 37% to 29.6% (equal to 80% of 37%). Various limitations make the deduction inapplicable to capital gain. The 20% deduction is also available for qualified REIT dividends (by definition, excluding capital gain dividends) and qualified publicly traded partnership income. The deduction does not apply to W-2 wages, guaranteed payments paid to a partner for services rendered to the partnership, or reasonable compensation paid by S corporations. Since the deduction does not reduce adjusted gross income, for taxpayers in the top brackets, the deduction will not reduce taxable income for New York State personal income tax purposes.

Clients need to be aware of several limitations to the 20% deduction. First, the deduction is limited to taxable income reduced by net capital

gains. Thus, the 20% deduction will not increase a net operating loss carryover. Second, qualifying businesses do not include any "specified trade or business." A specified trade or business consists of: (1) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, 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 (2) a trade or business involving the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities. Taxpayers must await guidance on the scope of the highlighted language, in particular. There is a de minimis exception that allows specified trades or businesses to qualify for the deduction: taxpayers whose taxable income is less than the sum of $157,500 (inflation adjusted) plus $50,000 (or twice these numbers for joint tax return filers) are able to claim the 20% deduction (or some fraction thereof). In certain cases it may be possible to structure operations of professional practices to reduce the amount of income subject to the "specified trade or business" taint.

Clients also need to be aware of the wage and capital limitations to the deduction and the potential advantages to taxpayers that conduct their qualifying business through multiple entities to combining them in a single entity. The 20% deduction is reserved for qualifying businesses that have either payroll and/or tangible (depreciable) property. The amount of the deduction for each qualified business is limited to either (whichever is greater): 50% of the taxpayer's share of W-2 wages paid by the qualified business (the "wage limitation") or the sum of 25% of the taxpayer's share of W-2 wages paid by the business plus 2.5% of the original "unadjusted"

basis of tangible (depreciable) property held or available for use in the business at the close of the taxable year and used at any point during the year in the production of qualified business income (the "wage/asset limitation"). Property is only included in the determination of the wage/asset limitation during its "depreciable period," being the longer of 10 years or the statutory recovery period for depreciation purposes determined without regard to the (longer) alternative depreciation system. Here, too, there is an exception: Taxpayers whose taxable income is less than the sum of $157,500 (inflation adjusted) plus $50,000 (or twice these numbers for joint tax return filers) will be able to claim the 20% deduction (or some fraction thereof) without regard to the wage or wage/asset limitations.

Taxpayers need guidance on how the wage or wage/asset limitations will be applied where a trade or business is conducted through several entities, and the extent to which ownership of the various entities must overlap for the entities to constitute a single trade or business. Clients may have several qualified businesses, some subject to the limitations and others not. If, for example, the profitable businesses are subject to the wage/asset limitations while less profitable businesses are not so limited, there may be opportunities to reallocate (within reason) wages and/or assets among these businesses to maximize the 20% deduction. You might say there could be trafficking in excess wage/asset limitations among affiliates to maximize the deduction.

Clients should examine whether to take such self-help measures, for instance, to merge or consolidate entities conducting the same trade or business in cases where some entities have high profits and a low wage or wage/asset limitation and other entities have low profits and a relatively

high wage or wage/asset limitation. Alternatively, in cases where a pass-through entity is conducting several activities, some of which generate a loss and some a profit, it may be an advantageous to restructure operations to separate the loss activities into a separate entity to minimize the risk of having the losses reduce the amount of the 20% deduction. Of course, any such restructuring must be done with caution in the absence of administrative guidance as to the application of these provisions.

4. New Limitation on "Excess Business Losses"

The "passive activity loss" limitations have long limited the ability of many taxpayers (other than real estate professionals) to use losses from passive activities such as rentals, etc. to shelter other types of income (whether active trade or business, wages or interest and dividends). The Act adds an additional limitation – it limits the ability to use losses from an active trade or business to shelter other types of income. This limitation, if applicable, could, for example, limit the ability to deduct losses from a startup business against income from wages, deferred compensation, or interest and dividends.

Thus, for taxable years beginning after December 31, 2017 and ending before January 1, 2026, the Act limits the ability of non-corporate taxpayers to deduct so-called "excess business losses" against non-business income (e.g., wages, deferred compensation, qualified plan distributions, interest, dividends, etc.) and requires any such excess business loss to be carried forward to the next taxable year as a net operating loss ("NOL"). Excess business losses are defined as the excess of: (1) the aggregate deductions from all trades or businesses of the taxpayer; over (2) the sum of: (a) the aggregate gross income or gain from

all such trades or businesses plus (b) $250,000 (inflation adjusted) ($500,000 for joint tax return filers). The limitation applies after the application of the passive loss limitations under section 469 of the Code, which we believe means that the calculation of excess business losses excludes items of income and deduction from businesses that are passive activities until such time as the passive activity that gave rise to the passive activity losses is terminated. It also means that the availability of any losses "freed up" upon disposition of a passive activity under section 469 of the Code will be subject to the new excess business loss limitation.

5. Limitation on Deductibility of Business Interest

The Act imposes new limitations on the ability to deduct interest on business related indebtedness. As will be explained below these limitations may not be applicable to many of our real estate clients and, even if applicable, clients may opt out of these limitations by electing longer depreciation lives.

Thus, the Act adds a new provision applicable to all taxpayers limiting the deductibility of interest allocable to a trade or business ("business interest") for taxable years beginning after December 31, 2017, to the sum of: (A) a taxpayer's business interest income; plus (B) 30% of the taxpayer's "adjusted taxable income" for the taxable year; plus (C) interest paid or accrued on floor plan financing indebtedness (indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired). Business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Adjusted taxable income for this purpose means the taxpayer's taxable income computed without regard to

(i) income or losses not allocable to a trade or business, (b) business interest or business interest income, (iii) any NOL deduction, (iv) any section 199A deduction, and (v) for taxable years beginning before January 1, 2022, deductions for depreciation, amortization or depletion. Special, complex rules apply for taxpayers conducting business through partnerships or limited liability companies or S corporations when the entity's deduction for business interest is limited by these rules.

Clients will first need to determine whether any of the entities through which they conduct business are subject to the business interest limitation rules. There is a general exception for taxpayers whose average annual gross receipts for the 3-year period ending with the prior taxable year do not exceed $25 million. Aggregation rules apply in computing gross receipts, and taxpayers owning multiple closely held entities may find themselves subject to the business interest limitation rules notwithstanding that individual entities on a stand-alone basis do not average $25 million in gross receipts.

Clients conducting "real property trades or businesses" (as defined in the real estate professional rules), including any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operating, management, leasing or brokerage trade or business, can make an irrevocable election not to have this limitation on the deductibility of business interest apply in exchange for subjecting their nonresidential real property, residential rental property, and qualified improvement property to the alternative depreciation system. This will mean that electing real property trades or businesses will not be entitled to elect bonus depreciation, nonresidential real property will be subject to a 40-

year depreciation life (as opposed to 39 years), residential real property will be subject to a 30-year recovery period (as opposed to a 27.5 year recovery period) and (apparently) qualified improvement property will be subject to a 20-year recovery period (as opposed to a 15-year recovery period). However, an electing real property trade or business will still be permitted to claim a section 179 deduction of up to $1 million for "qualified real property" (see part 6, below).

Clients subject to the business interest limitation rules, including real property trades or businesses that choose not to elect out, should consider the possibility of restructuring their businesses to avoid these provisions. It may be possible to change which businesses incur debt and which do not in order to minimize this limitation.

In some cases, it may be possible to change the ownership of entities to avoid having entities aggregated for purposes of the $25 million gross receipts test. It may sometimes be advantageous to merge or consolidate entities, even if conducting different businesses, if it means increasing the adjusted taxable income of the entity for purposes of computing the business interest limitation. In other cases, where a single entity conducts multiple businesses, some of which generate losses, it may be advantageous for purposes of these rules to separate the businesses into separate entities.

6. Expensing and Cost Recovery of Certain Improvements to Real Property

Clients owning real property should be aware that the Act made a number

of changes to the law affecting the ability to expense or recover costs associated with improvements to real property. The provisions for immediate expensing are applicable only to certain improvements to nonresidential real property, and clients owning such property who undertake renovation projects should be aware of the new rules and consider their applicability. New rules creating a 15-year depreciable recovery period for qualified improvement property also impact owners of nonresidential real property.

Owners of residential rental property continue to eligible for bonus depreciation for property having a recovery period of 20 years or less. However, in the case of residential rental property, improvements to the building will not qualify for any of section 179 expensing, 100% bonus depreciation, or a 15-year recovery period.

a. Section 179 Expensing Revised and Expanded

Taxpayers owning nonresidential real property may take advantage of the expense allowance under section 179, which the Act increased from $500,000 to $1,000,000 (inflation adjusted). Section 179 property includes "qualified real property," which under the Act was revised and expanded to include "qualified improvement property" and any of the following improvements to nonresidential real property placed in service after the date the building was first placed in service: (A) roofs; (B) heating, ventilation, and air-conditioning property; (C) fire protection and alarm systems; and (D) security systems. Qualified improvement property, in turn, means "any improvement to an interior portion of a building which is nonresidential property if such improvement is placed in service after

the date such building was first placed in service," but excluding any improvement for which the expenditure is attributable to (i) the enlargement of the building, (ii) any elevator or escalator, or (iii) internal structural framework of the building. A new roof to a commercial building, for instance, will apparently qualify for section 179 expensing (and also 100% bonus depreciation) assuming it was not added in connection with an enlargement of the building.

b. Allowance for 100% Bonus Depreciation

For owners of nonresidential real property, expenditures attributable to qualified improvement property placed in service after September 27, 2017 and before January 1, 2023 (before January 1, 2024 for real property with longer production periods) may also be eligible for 100% bonus depreciation (which means immediate expensing), assuming all other requirements for bonus depreciation are met. Taxpayers have the option to elect 50% bonus depreciation (i.e., expensing 50% of the basis and depreciating the balance) for property placed in service during the first taxable year ending after September 27, 2017. The Act also expanded eligibility for bonus depreciation to include previously used property as long as it was not used by the taxpayer claiming the bonus depreciation prior to acquisition and is acquired by purchase from an unrelated person. Claiming bonus depreciation will not impact the "unadjusted basis" or recovery period of property in determining the wage/asset limitation for purposes of the 20% deduction under section 199A of the Code. As noted above, in our view a new roof to a commercial building, for instance, will qualify for 100% bonus depreciation assuming it was not added in connection with an enlargement of the building.

c. 15-Year Recovery Period for Qualified Improvement Property

Based on the Conference Report, the Act intended to add (although it appears to have inadvertently failed to do so) qualified improvement property to the list of "15-year property," meaning such property is deprecated over a 15-year recovery period rather than 39 years. The effect of the change is to simplify the tax law by making the same improvements to nonresidential real property that qualify for bonus depreciation (and section 179 expensing) also qualify for a 15-year recovery period. The recovery period will become relevant, for instance, for taxpayers choosing to elect out of bonus depreciation. Although the 15-year recovery period is not optional under the regular depreciation rules, taxpayers wishing to depreciate improvements to a building over a longer recovery period may make an irrevocable election to depreciate such property using the (longer) alternative depreciation system.

d. Heightened Significance of Alternative Depreciation System

The Act also revised and expanded the list of property covered by the alternative depreciation system to include nonresidential real property, residential rental property, and qualified improvement property held by an electing real property trade or business, i.e., a real property trade or business that irrevocably elects out of the business interest limitation rules. Real property depreciated under the alternative depreciation system is depreciated using a longer scheduled recovery period and is not eligible for bonus depreciation. Under the alternative depreciation system, as modified by the Act, the recovery period is 40 years for nonresidential real property, 30 years for residential rental property, and (purportedly) 20 years for qualified improvement property. As noted above, taxpayers

subject to the alternative depreciation system are not entitled to use the longer recovery period under that system as the depreciable period when determining the wage/asset limitation for purposes of the 20% deduction under section 199A.

[1] Virtually every piece of major income tax legislation is followed by a "technical corrections bill" that is needed to address defects in the legislation. That will be particularly challenging in the current environment as a technical corrections bill will not qualify for reconciliation and will therefore require 60 votes in the Senate and thus the cooperation of the Democratic minority. As an example of Washington gridlock, H.R. 6439, the Tax Technical Corrections Act of 2016, which was needed to make technical corrections to the partnership audit provisions and should have been noncontroversial, was never passed by Congress.

[2] The Conference Report diverted from early versions of the bill by specifically excluding engineering and architecture, but one wonders whether, if they are famous enough, persons performing these services could still be picked up by the text language in bold.

[3] In fact, the Act inadvertently removed "qualified improvement property" as a type of property qualifying for bonus depreciation. This will likely need to be remedied in the technical corrections legislation.

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