# The Tax Cuts and Jobs Act

## Implications for the real estate industry

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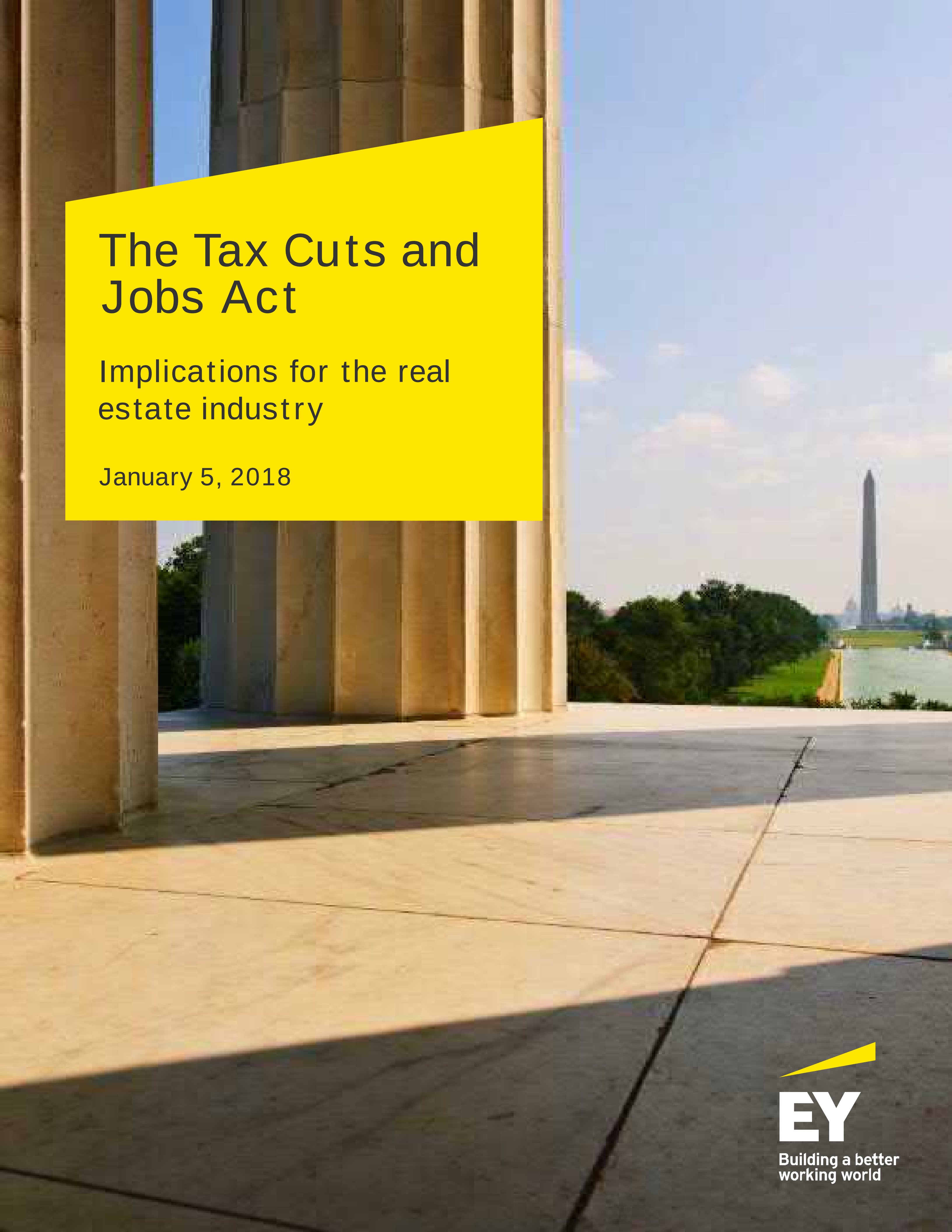

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# The Tax Cuts and Jobs Act

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (the Act), which capped almost eight years of tax reform discussions among Republicans and represents the first major overhaul of the federal income tax system in more than 30 years. The Act also constitutes the first significant legislative achievement for the administration and is an important milestone for the Trump presidency.

As the legislative process marched toward its conclusion, a number of important changes were made to the legislation reflecting compromises necessary to garner the votes to pass it. Among the more notable changes were significant modifications to the new pass-through tax regime, the elimination of the corporate alternative minimum tax (AMT) regime (while retaining AMT for individuals), an increase in the corporate tax rate from 20% to 21%, and increases the tax rates for the transitional toll charge on certain US shareholders' shares of a foreign corporation's post-1986 tax-deferred earnings (now 15.5% and 8%, applicable to earnings that are held in cash and cash equivalents or illiquid assets, respectively).

Broadly speaking, we view the legislation as favorable to the real estate industry for a number of reasons. It allows qualifying real property trades or businesses to elect out of the limitation on the deductibility of interest expense. It also contains a new 20% deduction on certain pass-through income (which includes ordinary REIT dividends) and the carried interest provision is not nearly as onerous as some earlier legislative proposals.

Significantly for individuals, the current 39.6% maximum tax rate is reduced to 37% for couples with income of more than $600,000. The bill does eliminate many existing individual tax benefits, including the personal exemption. However, the standard deduction is roughly doubled from the existing amount to $12,200 for individuals and $24,400 for married couples. The bill does not include major changes to 401(k) plan contributions that had been under discussion and the remaining changes to retirement plan provisions are modest. Limitations are now imposed on the mortgage interest deduction and, as anticipated, the deduction for state and local income taxes and property taxes is capped at $10,000.

# The Act: key provisions for the real estate industry

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| Corporations | ▶ 21% tax rate applicable to all corporations<br>▶ Dividends-received deduction for dividends received from a domestic corporation reduced<br>▶ Effective for tax years beginning after December 31, 2017 |
| Pass-through tax rate | ▶ 20% deduction applicable to "qualifying business income" (QBI) effectively connected with a domestic trade or business<br>▶ QBI limited to greater of: i) 50% of wages or ii) 25% of wages plus 2.5% of depreciable tax basis of qualifying property<br>▶ Income from professional services generally excluded from QBI<br>▶ Ordinary REIT dividends and income from certain publicly traded partnerships eligible for this deduction<br>▶ Effective for tax years beginning after December 31, 2017 |
| Individual tax rate | ▶ New tax brackets 10%, 12%, 22%, 24%, 32%, 35% and 37%<br>▶ No change to capital gains tax rates or net investment income tax<br>▶ Personal exemptions repealed and standard deduction increased<br>▶ Individual deduction limited to $10k for state income and property taxes<br>▶ Applies to tax years beginning after December 31, 2017 |
| Interest deduction | ▶ Interest deduction limited to 30% of adjusted taxable income (i.e., EBITDA for 4-years and then EBIT for years thereafter)<br>▶ Does not apply to electing real property trade or business<br>▶ Pass through of unused limitation capacity allowable for partnerships<br>▶ Applies to tax years beginning after December 31, 2017 |
| Immediate expensing | ▶ Bonus depreciation increased to 100% for qualifying property (which does not include buildings or land) acquired after September 27, 2017, and before 2023<br>▶ Elective transition rule allows 50% expensing for first tax year ending after September 27, 2017 for assets placed in service after September 27, 2017<br>▶ Original use of property need not commence with the taxpayer<br>▶ Bonus depreciation expense percentage steps down by 20% annually beginning in 2023 |
| Carried interest | ▶ Long-term capital gains from an applicable partnership interest held less than three years recharacterized as short-term capital gains<br>▶ Applicable partnership interest must be received in exchange for services<br>▶ Applies to tax years beginning after December 31, 2017 |

# The Act: key provisions for the real estate industry

**Base erosion and anti-abuse tax (BEAT)**

- Applicable to corporations (except for REITs, RICs and S-Corps) with three-year average annual gross receipts of $500m (aggregation rules apply)
- Modified taxable income calculated after adding back certain payments, including interest, to related foreign parties
- Minimum tax of 10% of modified taxable income over regular tax liability (5% for 2018, 12.5% for 2026 and forward)
- Effective for tax years beginning after December 31, 2017

**AMT**

- AMT repealed for corporations
- Transition rules allow unused AMT credits to be used to offset regular tax liability
- AMT retained for individuals, but impact should be diminished
- Generally effective for tax years beginning after December 31, 2017

**Net operating losses (NOLs)**

- NOLs arising in tax years beginning after December 31, 2017, now only carried forward and eligible to offset only 80% of corporation's taxable income for year into which loss is carried forward
- For losses occurring in tax years after December 31, 2017, carryback rules generally repealed and unused NOLs carry forward indefinitely
- Generally, effective for tax years beginning after December 31, 2017

**International tax regime**

- Moves to a territorial international tax regime
- 100% exemption for dividends received by US corporation from foreign corporation in which it owns 10% stake
- One-time 15.5% and 8% tax on cash and noncash accumulated foreign earnings, respectively, payable over eight year period upon election
- Inclusion of anti-base erosion provisions
- Modifications to the controlled foreign corporation (CFC) and Subpart F rules
- Excess returns on tangible business assets of CFC subject to immediate inclusion under Global Intangible Low-Taxed Income (GILTI) provisions
- Various effective dates

**Like-kind exchanges**

- Section 1031 repealed for assets other than real property
- Section 1031 remains available for exchanges of real property
- Transition rule allows completion of open transactions
- Applies to tax years beginning after December 31, 2017

# The Act: key provisions for the real estate industry

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| Estate tax | ▶ Retained with the standard exclusion for estate, gift and generation skipping taxes doubled to more than $10 million<br>▶ Basis step up upon death retained<br>▶ Effective for tax years after December 31, 2017 |
| Home mortgage deduction | ▶ Deduction for home mortgage interest retained<br>▶ Amount of principal eligible for deduction capped at $750k for joint filers<br>▶ Deduction available for second homes, not home equity lines of credit<br>▶ Effective for tax years after December 31, 2017, with grandfathering for existing home mortgage debt |
| Revenue recognition | ▶ Significant changes made to the revenue recognition rules under Section 451<br>▶ Unless governed by specific recognition provision in Code or otherwise expressly excluded from the rule, accrual-basis taxpayers subject to all-events test must recognize items of income no later than taxable year in which such income is taken into account for financial statement purposes<br>▶ Any change in revenue recognition caused as result of new law treated as change in accounting method, with any corresponding deferred revenue recognized as accounting method changes<br>▶ Applies to tax years beginning after December 31, 2017 |
| Section 460 / CCM | ▶ Although does relax certain accounting method rules for small businesses and contains some conforming amendments, final legislation does not extend availability of completed contract method under Section 460 to include vertical condominium development |
| Partnership provisions | ▶ Section 708(b)(1)(B) technical terminations of partnerships repealed<br>▶ Codification of Revenue Ruling 91-32 (overturning Grecian Magnesite case) concerning character of gain or loss to foreign partner on disposition of interest in a partnership conducting US trade or business, together with new 10% withholding requirement (section 1446(f)) that can be imposed on partnership as well as selling partner<br>▶ Expansion of the substantial built-in loss rules of Section 743(d) to include transfers of partnership interests where, upon hypothetical liquidation of partnership at FMV, transferee would be allocated a net loss in excess of $250,000<br>▶ Basis rules affecting partnership interest basis modified to provide that basis shall be reduced by partner's distributive share of charitable contributions and foreign taxes (described in Section 901) made or incurred by partnership |

# The Act: key provisions for the real estate industry

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| Excess business loss limitation | ► Non-corporate taxpayers excess business losses no longer available to offset income from other sources (e.g., wage or investment income)<br>► Disallowed losses treated as an NOL and carried forward into next tax year<br>► For partnerships and S corporations, limitation applies at the partner or shareholder level<br>► Applies to tax years beginning after December 31, 2017 |
| Real estate related tax credits | ► Low-income housing tax credit regime retained without change<br>► Rehabilitation tax credit regime is changed, with credit repealed for pre-1936 buildings<br>► Subject to transition rules, rehabilitation credit for certified historic structures reduced to 10% for amounts paid or incurred after 2017 |
| SALT adoption | ► Adoption of new legislation at the state and local level will depend on each state's posture as conforming, partially conforming, selectively conforming or non conforming |
| REIT regime | ► Other than conforming amendments, no substantive changes to REIT regime, although the Act will have major implications for current and contemplated REIT structures<br>► Inclusion of accumulated foreign E&P applicable to REITs, but not a tax, instead a net income inclusion that may be spread over eight years at REIT's election<br>► REITs not eligible for 100% exemption in new international regime |
| FIRPTA regime | ► Other than conforming amendments, no changes to the FIRPTA regime |
| BBA partnership audit regime | ► No revisions or corrections to the partnership audit rules<br>► Notwithstanding lack of changes to BBA regime in the Act, Treasury recently released additional guidance, including guidance concerning "push-out" of adjustments, intended to facilitate implementation of BBA and generally effective beginning January 1, 2018 |

# The Act: preliminary comments and observations specific to the real estate industry

The speed at which the legislation developed over the past few months reflects the urgency of Republican congressional leaders and the administration to realize this important legislative priority.  Although speed was an important and necessary element of this legislative success, that success came at the expense of the opportunity to fully identify, consider and, where appropriate, modify the impact of its various provisions.

Consequently, real estate owners, operators and investors should carefully review the provisions of this new legislation and consider how it may impact their real estate businesses.  Some points worthy of consideration and further discussion include:

- Tax rate reduction and choice of entity:   Real estate owners, operators and investors have made very good use of existing tax-efficient vehicles, including REITs and partnerships, often accepting heightened complexity to achieve a single layer of taxation.  As noted above, the legislation reduces corporate tax rates, introduces a new deduction for pass-through income and recharacterizes certain income attributable to carried interests as short-term capital gains.  Given the significant changes in the tax rates applicable to various entities and income streams, it is appropriate for taxpayers to reassess whether existing structures will continue to provide the most advantageous results in the context of their projected business needs and activities.   For example, the 21% corporate tax rate may tilt the scales against a REIT conversion for an existing C corporation whose business may be enhanced by being able to retain more cash, recycle capital through short-term sales, or grow revenue through service offerings.

- What is a real property trade or business?:   A real property trade or business can elect out of the interest expense limitation at the modest cost of slightly-longer depreciable lives and not being able to take advantage of the new provision allowing immediate expensing.  Under the new law, a real property trade or business includes “any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.”  While at first this definition seems straightforward, it does present questions when applied in various situations. As an example, consider a corporation that owns a limited partnership interest in a partnership that owns and operates real estate.  Is the corporation in a real property trade or business?  Similarly, consider a company that operates a thriving retail business through real estate that it owns, operates and manages. Is this company in a real property trade or business?  Given the manner in which the legislation has been drafted, the answers to questions such as these will dramatically affect taxpayers investing or engaging in real property businesses (i.e., deducting interest if it elects out of the interest expense provision and what additional steps a taxpayer should consider to mitigate any negative results).

- The 20% pass-through deduction for qualified business income:  It appears that income from rental real estate constitutes QBI and is eligible for the new pass-through deduction (a question that concerned many when the pass-through tax rate was originally proposed).  However, if the rental income is earned directly through a partnership, the amount of the pass-through deduction may be subject to a two-pronged limitation based on the partnership level wages and the tax basis in depreciable property used in the trade or business.  In comparison, if the rental income had been earned through a REIT and passed through as ordinary dividends to a partnership, the wage and tax basis limitations would not apply.  In other words, although the nature of the income is the same, the vehicle through which the income is earned (a partnership versus a REIT) may alter the amount of the pass-through deduction available to the taxpayer.

# The Act: preliminary comments and observations specific to the real estate industry (continued)

- Carried interest: The carried interest rules cause long-term capital gains attributable to an applicable partnership interest to be recharacterized as short-term capital gains and taxed at ordinary income tax rates. This recharacterization occurs when the property giving rise to the long-term capital gains (i.e., the partnership interest or the underlying partnership asset) has been held for less than three years. Not surprisingly, a number of criteria must exist for this provision to apply (e.g., the interest must have been transferred in exchange for services) and the rule provides several exceptions (e.g., both partnership interests owned by corporations and capital interests are excluded). A host of questions surround this new provision. Among these questions are: (i) is an S corporation considered a corporation for purposes of the exclusion that applies to partnership interests held by a corporation, (ii) how the rule applies in situations where the gain potentially subject to the provision is characterized as long-term capital gain without an express reference to Section 1222 (i.e., Section 1231 gains and REIT capital gain dividends), and (iii) how the rule applies when the partnership interest and the asset giving rise to the gain have different holding periods.

- Continuation of Section 1031 for real estate: Tax-free exchanges of non-dealer real estate survived under the final bill. Even with the retention of this useful rule, care will need to be taken in the future to understand the nature of the property being exchanged because personal property is not eligible for tax-free exchange treatment.

- Accounting methods: The final legislation includes an important revision to the income recognition rules applicable to accrual-basis taxpayers. Under the new rule, an accrual-basis taxpayer that is subject to the all-events test must recognize income for federal tax purposes no later than the taxable year in which the income is taken into account on the taxpayer's financial statements. Excluded from this rule is income from mortgage servicing rights, as is any item of gross income that is subject to a special method of accounting provided in the code. When this language appeared in the Senate bill, many were concerned about the potential breadth of the provision. For example, would this new rule extend to situations where a real estate fund marks its investments to fair market value? Thankfully, and perhaps in response to these concerns, the legislative history of this new rule makes it clear that it is not intended to accelerate the time at which an item of income is realized for federal income tax purposes (instead to the point at which such income is recognized once it has been realized). As such, it seems clear that the provision would not accelerate income from securities that are being marked to market for financial reporting purposes or income from investments in corporations and partnerships that are accounted for under the equity method for financial reporting purposes. Notwithstanding the clarity provided by the legislative history, it remains to be seen which other situations might be ensnared in this provision unless, it can be determined that they are subject to a special method of accounting (e.g., Section 467 relating to the timing of recognition of lease payments).

The foregoing points represent a very small sampling of the considerations and questions that exist with respect to the new legislation. Many more considerations exist and additional questions and issues will arise in the coming months and years as the legislation is applied and additional guidance is issued.

# What should you do now?

While this new tax legislation will be welcome by many businesses, especially those within the real estate industry, the uncertainty around its final provisions, coupled with the timing of its passage, may present challenges, particularly for those who are mid-transaction or have significant year-end processes just about to start. With these challenges in mind, here are three things that real estate owners, operators and investors should do now.

1

## Identify

- The Act is signed and is now the law of the land. Businesses need to carefully review the provisions of the new legislation and develop an inventory of provisions that may be applicable to their business.
- Businesses should, to the extent not readily available, pull together information that clearly reflects: (i) its tax structure, (ii) all third- and related-party debt, (iii) any international operations, and (iv) the flow of funds (operational and capital) within the structure.
- Businesses should immediately identify any transactions presently underway and scheduled to close in the near term.

2

## Evaluate

- Investors and businesses should evaluate immediately the impact that the Act may have, if any, on transactions scheduled to close before or shortly thereafter year end.
- Businesses should evaluate immediately the impact that the Act may have on the organization's financial reporting, including its tax provision. Careful consideration should be given to the development and documentation of estimates, as well as any uncertain tax positions that may arise in connection with the sweeping changes.
- Businesses and investors should model their current circumstances (i.e., tax structure, debt and flow of funds) to determine whether the anticipated tax consequences remain consistent with original expectations and planning or have changed.

3

## Plan

- Investors and businesses should pursue strategies that could improve the efficiency of transactions that are scheduled to close in the near term, recognizing that risk-assessments and disclosures may be advisable due to uncertainties with respect to the new law.
- Businesses and investors need to pursue those strategies that produce more favorable tax consequences for the business and its stakeholders.

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