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TAX REFORM BILL: TAKEAWAYS FOR REAL ESTATE BUSINESSES AND INVESTORS

by Dan Kroll
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The Tax Cut and Jobs Act of 2017 signed on December 22, 2017, will have significant effects upon taxpayers in the real estate business and owners of real estate. Major changes to the Internal Revenue Code (the "Code") include a lower corporate tax rate (reduced from 35 percent to 21 percent), and, for eligible pass-through entities, a new deduction on up to 20 percent of certain pass-through income (which can reduce individual tax rates from 37 percent to 29.6 percent on such income) until 2025. Major takeaways for real estate businesses and investors include the following:

1. Real Property Section 1031 Exchanges Untouched; Technical Terminations Eliminated
First, the good news. While personal property is no longer eligible for Code section 1031 exchanges, the rules for tax-free exchanges of real property are not affected by the new law. Also, technical terminations were eliminated from the Code.

2. Section 199A Deduction
A new individual deduction for up to 20 percent of "qualified business income" was established by Code section 199A. Qualified business income includes rental income, but not capital gains. It is not clear whether Code section 1231 assets (which include real estate used in a trade or business) will be treated as capital gains for this purpose – see paragraph 3 below for more discussion on this issue. Certain professional services and taxpayers with taxable income greater than $157,500 ($315,000 if married) are further restricted by the "W-2 limitation", which is the greater of

- (a) 50 percent of wage expense allocated to an owner, or
- (b) the sum of
  - (i) 25 percent of wage expense allocated to an owner, and
  - (ii) 2.5 percent of the unadjusted basis of all qualified property allocated to an owner.

Many real estate development and investment entities do not pay wages; thus, the section 199A deduction may be significantly less than 20 percent of qualified business income. Also, because guaranteed payments to partners are currently excluded from the definition of W-2 wages, an S corporation may in some cases provide an enhanced section 199A deduction as compared to a partnership. In some cases it may be beneficial to refinance debt in order to generate additional qualified business income (by reducing interest expense), or by combining or dividing certain business activities in multiple entities.

3. Carried Interest Taxation
In general, gains from the sale of carried interests (including profits interests) or the sale of specified underlying assets resulting in gains allocated to holders of carried interests now require a three year holding period in the carried interest or asset to obtain long-term capital gain rates. The House version of the bill clearly intended that most real estate carried interests would be subject to this rule. However, the final version of the law uses the term "capital gain" rather than section 1231 gain. Thus, there is some question about the applicability of the carried interest rule and qualified business income with respect to Code section 1231 assets that need to be addressed by future Treasury Regulations or other Internal Revenue Service guidance.

4. Interest Expense Limitation
Businesses with average annual gross receipts of more than $25,000,000 for the three prior years will no longer be able to currently deduct interest expense in excess of 30 percent of "adjusted taxable income" (taxable EBITDA prior to 2022, and taxable EBIT from and after 2022). Non-deductible interest expense is carried forward indefinitely until the business has sufficient EBITDA to take the deduction. Most real estate development and rental businesses may elect out of this restriction, but the election out will slightly increase depreciation lives (30 years for residential property and 40 years for nonresidential property) and thus increase taxable income as a result of less annual depreciation. Decisions to elect out will turn on amounts borrowed, interest rates involved and unadjusted tax bases of assets. As with the Section 199A W-2 limitation, combining or dividing certain business activities may result in triggering or avoiding the 30 percent interest expense limitation. Preferred returns on equity contributions do not appear to be treated as interest for this purpose.

5. Bonus Depreciation
Qualified depreciable personal property placed in service after September 27, 2017, and prior to January 1, 2023, may be fully expensed. After 2022, the expense amount is reduced 20 percent per year. The deduction was expanded to apply to purchases of used items, and may encourage more cost segregation studies and accelerating deductions for qualified personal property.

6. Lower Corporate Tax Rate May Provide Planning Opportunities
Taxpayers have traditionally avoided corporate ownership of real estate development and investment opportunities due to the prior 35 percent corporate tax rate. With the reduction in corporate tax rates to 21 percent, corporations may serve to block unwanted short-term gain or dealer gain until such time as the owner determines to liquidate the corporation. A corporate structure may also serve a purpose similar to a section 1031 transaction, but without the identification and timing rules and boot restrictions that accompany tax-free exchanges.

Please let us know if you have questions about these takeaways or would like to discuss these or any related matters in more detail.

ABOUT THE AUTHOR

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A former certified public accountant, Dan Kroll advises individuals and companies on federal income tax issues related to a variety of transactions including joint venture formations, acquisitions, operations and dispositions. He also advises sellers and buyers in transactions involving master limited partnerships (MLPs) and private equity funds. Some of Dan's specialized niches include the compensation of key employees using profits interests and phantom equity, and structuring investments by tax-exempt investors to minimize or avoid unrelated business taxable income (UBTI). Dan earned his undergraduate degree and J.D. from the University of Oklahoma.