

The Effects of the Tax Cuts and Jobs Act on Real Estate

January 9, 2018

On Friday December 22, 2017, President Trump signed into law H.R.1, commonly referred to as the Tax Cuts and Jobs Act (TCJA). This is the most sweeping change to the U.S. federal income tax laws in over three decades, and it will have an effect on every U.S. taxpayer, including real estate investment trusts (REITs) and taxpayers engaged in the real estate business. The purpose of this blog is to focus on some of the provisions of the TCJA that we believe will significantly impact the real estate industry. For background and a more detailed discussion of the TCJA provisions generally, please see, [House of Representatives and Senate Conferees Reach Agreement on the Tax Cuts and Jobs Act \(H.R. 1\)](#).

Corporate tax rate lowered to 21 percent; corporate alternative minimum tax repealed

The TCJA changes the corporate tax rate from a graduated scale with a 35% maximum rate to a flat 21% corporate rate and repeals the corporate alternative minimum tax (AMT), effective for tax years beginning on January 1, 2018. Although many real estate businesses are organized as pass-throughs, large corporate real estate operating companies will benefit greatly from this provision alone. Unlike many of the provisions discussed below, this rate reduction is permanent.

Individual tax rates and state and local income tax deduction limited; individual AMT retained

The TCJA reduces the top individual tax rate from 39.6% to 37%, effective January 1, 2018 (there are some adjustments to the brackets as well). There are no changes to the current 20% maximum rate for net long-term capital gains (including qualified dividend income) and the 25% rate applicable to unrecaptured gain under Section 1250 of the Internal Revenue Code of 1986, as amended (Code), as well as the 28% rate on 28%-rate gain. The 3.8% surtax on net investment income is also retained under the TCJA.

The reduction in rates comes at the cost of eliminating or limiting certain deductions. In states that impose a high income tax rate, one of the most costly limitations is the \$10,000 cap on the itemized deduction of state and local income and property taxes. It is important to realize however that property taxes that are incurred in the operation of a real estate business are not affected by this limitation.

The reduction in individual tax rates and the cap on the state and local tax deduction expire after December 31, 2025.

The TCJA retains the individual AMT, but increases the individual AMT exemption amount to \$109,400 for married taxpayers (\$70,300 for single taxpayers) from \$84,500/\$54,300 under prior law, and increases the AMT exemption phase-out to \$1,000,000 (joint filers) and \$500,000 (all other taxpayers) from \$160,900 and \$120,700, respectively.

Pass-through business deduction

Subject to limitations discussed below, the TCJA provides for a maximum effective tax rate of 29.6% on an individual's domestic "qualified business income" from a partnership, S corporation, or sole proprietorship. The reduced maximum rate arises from a 20% deduction ($[100\% - 20\%] \times 37\%$ top individual marginal rate = 29.6%). Qualified business losses carry forward to the next tax year and reduce the amount of qualified business income included in determining the amount of the deduction for that year.

Qualified business income is net income and gain arising from a "qualified trade or business." A qualified trade or business is generally any business other than certain service businesses, referred to as "specified service trades or businesses." Importantly, since most "specified service trades or businesses" do not include traditional real estate businesses, a qualified business should include a trade or business of the renting of real property and real estate development. Accordingly rental income and ordinary income from real estate development should now be subject to the new maximum 29.6% rate. However, rental income from the triple-net leasing of real estate is not generally considered a trade or business and would not be entitled to the 29.6% pass-through rate, unless the real estate is held through a REIT, as described below.

“Qualified business income” must be income that would be treated as effectively connected with a U.S. trade or business if earned by a non-U.S. person, and does not include certain forms of “investment” income (e.g., capital gain, most dividends, and interest that is not allocable to a qualified trade or business). Thus, real estate rental income will qualify for the 29.6% rate; long-term capital gain income will continue to be taxable at 20%, and short-term capital gain will now be taxable at the maximum 37% individual rate.

The deduction for qualified business income is effective for taxable years beginning after December 31, 2017 and sunsets after December 31, 2025.

The amount of the deduction available to a taxpayer from a partnership, S corporation or sole proprietorship cannot exceed the greater of (a) 50% of the taxpayer’s share of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all “qualified property.” “Qualified property” is defined as depreciable tangible property that is held by and available for use in a qualified trade or business at the close of the taxable year and is used in the production of qualified business income for the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date or (b) the last day of the last full year of the applicable recovery period that will apply to the property under Code Section 168 (without regard to Code Section 168(g)). This period is the “depreciable period.”

As a result of the new test, the owners of a pass-through business with no employees that is engaged in a qualified trade or business can benefit from the deduction (and the 29.6% effective rate) with respect to a return of up to 12.5% per year on its investment in depreciable tangible property. To illustrate, a taxpayer with a \$10,000x qualified property investment will be eligible for a deduction of up to \$250x (2.5% of \$10,000x). If the taxpayer earned a 12.5% return on its capital investment, resulting in qualified business income of \$1250x ($12.5\% \times \$10,000x$), the taxpayer could deduct 20% of the entire return ($20\% \times \$1250x = \$250x$) without exceeding the cap, thereby being taxed at a maximum effective rate of 29.6% on the \$1250x.

The W-2 wage/qualified property limitation will not apply to individuals with taxable incomes at or below \$315,000 for married individuals filing jointly or \$157,000 for single individuals, but will phase-in completely over the next \$100,000 or \$50,000, as applicable, of taxable income. Qualified business income earned through a publicly traded partnership and otherwise eligible for the deduction, as well as REIT dividends (discussed below) also will not be subject to the limitation.

Business interest expense limitation - exception for real estate business

Under the TCJA net business interest deductions are generally limited under Code Section 163(j) to 30% of a taxpayer's adjusted taxable income, which for taxable years beginning before January 1, 2022 is calculated under a formula similar to earnings before interest, taxes, depreciation, and amortization ("EBITDA"), and for taxable years beginning on or after January 1, 2022 under a formula similar to earnings before interest and taxes ("EBIT"). "Business interest" includes any interest paid or accrued on indebtedness "properly allocable to a trade or business" but does not include "investment interest" (as defined in Code Section 163(d)). To the extent a business is subject to the interest deductibility limits, the TCJA allows the disallowed interest to be carried forward indefinitely. The changes are effective for taxable years beginning after December 31, 2017 through taxable years ending on December 31, 2025.

Most importantly for the real estate industry, real property development, construction, rental, management, leasing or similar businesses (including REITs), may elect out of this limitation (although making such an election will impact depreciation and the applicability of the new expensing provisions described below). The limitation also does not apply to taxpayers with average annual gross receipts of \$25 million or less for the three-taxable year period ending with the prior tax year. An election once made will be irrevocable and guidance is required on the time and manner of making such an election (including in the context of a real property trade or business that operates through multiple regarded legal entities).

Depreciable lives of real property modified

Under the TCJA, the MACRS recovery period for “qualified improvement property” (which includes qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) is now 39 years, rather than 15 years, due to an apparent drafting oversight. The TCJA preserves cost recovery periods under MACRS for residential rental and nonresidential real property at 27.5 years and 39 years, respectively. Under the TCJA, the “alternative depreciation system” (“ADS”) recovery period for qualified improvement property is 20 years. The ADS recovery period for nonresidential real property remains at 40 years, but the ADS recovery period for residential rental property is shortened to 30 years under the TCJA.

The TCJA requires a real estate business that elects to be excluded from the interest deductibility limitations described above to utilize the ADS recovery periods with respect to its residential rental, nonresidential real and qualified improvement property. As modified under the TCJA, this would mean that a real estate business electing out of the interest deductibility limitations would be required to use a recovery period of 40 years for nonresidential real property, 30 years for residential rental property and 20 years for qualified improvement property.

These revised recovery periods are effective for property placed in service after December 31, 2017.

Expensing of business assets; other cost recovery changes

The TCJA expands and extends bonus depreciation under Code Section 168(k) to allow for 100% immediate expensing of the cost of certain business property placed into service after September 27, 2017 and before January 1, 2023. Code Section 168(k) continues to apply only to MACRS property with a depreciable life of 20 years or less, water utility property, and computer software. As mentioned above, given a drafting oversight, qualified improvement property placed in service on or after January 1, 2018, has a 39-year recovery period, and it will not be eligible for bonus depreciation under Code Section 168(k). Beginning in 2023, bonus depreciation will be reduced to 80%, followed by 60% in 2024, 40% in 2025, 20% in 2026, and reduced to 0% thereafter. A transition rule in the TCJA allows taxpayers to elect to expense 50% of the cost of eligible business property rather than the full 100% for their first tax year beginning after September 27, 2017.

Bonus depreciation will be available only to taxpayers subject to the net interest deduction limitation in Code Section 163(j) (described above). Therefore, real property businesses electing out of Code Section 163(j) will not be entitled to bonus depreciation under this provision for property subject to ADS, as described above.

Under amended Code Section 179, the TCJA allows immediate expensing for up to \$1,000,000 of the cost of qualifying tangible personal property placed into service after December 31, 2017, an increase from the \$500,000 cap under the pre-TCJA Code, and expands the definition of qualified real property eligible for Code Section 179 expensing to include certain improvements (e.g., roofs, heating, and alarms systems) made to nonresidential real property after the property is first placed in service. This benefit is reduced (but not below zero) to the extent the value of qualifying property placed into service during a taxable year exceeds \$2,500,000 for the tax year (compared to \$2 million under current law). These changes take effect for tax years beginning after December 31, 2017 and will be permanent. Unlike the limitation on bonus depreciation under Code Section 168(k) described in the paragraphs above, real property businesses can use this provision for immediate expensing even if they elect out of the net interest deduction limitation in new Code Section 163(j) (described above).

Limitation on losses for taxpayers other than C corporations

For taxable years beginning after December 13, 2017 and before January 1, 2026, “excess business losses” will not be allowed for a taxable year but must be carried over as part of that taxpayer’s net operating loss. “Excess business losses” are defined as losses attributable to the taxpayer’s trades or businesses in excess of \$500,000 for married individuals filing jointly or \$250,000 for other individuals. The provision is applied at the partner or shareholder level for partnerships and S corporations. This provision applies after the application of the passive loss rules.

The effect of this provision is to limit a taxpayer’s ability to use losses from a non-passive business activity to offset other sources of income. This will directly affect any real estate professional who used more than \$500,000/\$250,000 of real estate losses to offset unrelated income.

Extended 3-year holding period required for partnership interests transferred for services

Under the TCJA, individual holders of partnership interests transferred to, or held by, a taxpayer in connection with the performance by that taxpayer (or a related party) of substantial services for an any “applicable trade or business,” commonly referred to as “carried interests,” must satisfy a 3-year holding period to qualify for long-term capital gains rates. An “applicable trade or business” is one that is conducted on a regular, continuous, and substantial basis (and may include activity by multiple entities) and consists of the development of real estate held for rental or investment or certain other specified assets or the investment in and/or disposition of real estate held for rental or investment or other specified assets (including identification of specified assets for investment and/or disposition).

The 3-year holding period will apply to allocations of income relating to the sale or other disposition of assets held by the partnership as well as transfers of partnership interest itself. The provision does not apply to profits interests held directly or indirectly through a corporation, apparently including S corporations. Thus, this carried interest provision seems to be avoidable by holding the carried interest through an S corporation. However, a technical correction (or possibly regulations) could change this result retroactively.

Like-kind exchange treatment of real property preserved

The TCJA limits non-recognition treatment under Code Section 1031 only to like-kind exchanges of real property. However, the TCJA repeals the deferral of gain for all other types of property. Because personal property is now excluded from Section 1031 exchanges, there could be gain recognition in Section 1031 exchanges of real property that include a significant personal property component, such as restaurants and hotels.

Changes to rehabilitation credit

The TCJA limits the rehabilitation tax credit to certified historic structures for amounts paid or incurred after 2017. Although the credit for certified historic structures remains at 20%, it must be claimed ratably over a five-year period beginning in the taxable year in which the qualified rehabilitated structure is placed in service. The TCJA includes a transition rule that applies to all properties (whether historic or not) owned or leased by the taxpayer as of December 31, 2017 if the 24 month period selected by the taxpayer to cover expenses by the credit (or the 60 month period if applicable under the statute) begins no later than 180 days after date of enactment of the TCJA.

Net operating loss deductions limited

The TCJA limits deductions for net operating losses (“NOLs”) to 80% of taxable income for any taxable year. NOLs will no longer expire after 20 years but will be carried forward indefinitely to future tax years. However, the current two-year carryback of NOLs will no longer be available to most taxpayers.

Reduced FIRPTA withholding tax rate applicable to REIT capital gain distributions

Under the TCJA, transactions that were subject to a 35% withholding tax rate under the Foreign Investment in Real Property Tax Act (FIRPTA), including capital gain dividends and liquidating distributions paid by REITs, are now subject to FIRPTA withholding at the highest corporate tax rate in effect for the taxable year, which is 21% effective January 1, 2018.

REITs

REITs are treated quite favorably under the TCJA. The most important changes that affect REITs specifically are:

- Ordinary REIT dividends (i.e., dividends that are not declared as capital gain dividends or qualified dividend income) are entitled to the 20% pass-through deduction discussed above. However, these REIT dividends are not subject to the wage/capital limitation. Accordingly, noncorporate taxpayers would be subject to a maximum effective tax rate on ordinary REIT dividends of 29.6% (or 33.4% including the 3.8% surtax on net investment income). However, it is possible that noncorporate investors in UPREITs and DownREITs who are invested in the operating partnership rather than the REIT itself would be subject to the wage/capital limitation on the pass-through deduction and may be subject to tax at a higher rate on ordinary income allocated to them by the operating partnership than investors in the REIT who would receive the same income in the form of an ordinary REIT dividend. The pass-through deduction is also available for REIT dividends received from mortgage REITs, but is not available for interest on a mortgage held directly. Therefore, mortgage REITs should become the preferred vehicle for investing in real estate mortgages. The taxation of capital gain dividends and qualified dividend income from REITs has not changed. Finally, the benefit of the reduced tax rate on ordinary REIT dividends will sunset for tax years beginning after December 31, 2025.

- Equity REITs generally would be entitled to elect out of the interest expense limitation discussed above. Mortgage REITs generally would not be subject to the interest expense limitation because they do not have net interest expense. If a REIT elects out of the interest expense limitation, it will not be eligible for bonus depreciation with respect to certain property as discussed above, and it will be required to use the revised ADS recovery periods for depreciation discussed above. However, because residential rental property and nonresidential real property are not eligible for immediate expensing in any case, the main impact of electing out of the interest expense limitation, other than having to use the ADS recovery periods, would seem to be the inability to benefit from bonus depreciation on qualified improvement property (assuming a technical correction is made to set the recovery period for qualified improvement property to 15 years).
- REITs, as corporate taxpayers, are subject to tax at corporate rates on any income they do not distribute in a tax year to their shareholders. Accordingly, REITs that do not distribute 100% of their taxable income in any year will be taxed as the new lower corporate tax rate of 21% on any undistributed income.
- REITs are subject to the changes to NOLs discussed above and benefit from the repeal of the corporate AMT. However, in order to determine the 80% annual limit for a REIT, the TCJA reorders the application of the dividends paid deduction (“DPD”) in determining the REIT’s “REIT taxable income.” Accordingly, a REIT’s taxable income for this purpose is its “REIT taxable income” prior to the application of the DPD. Absent this change, REITs would have calculated the limitation after the DPD, which would have had the effect of even further reducing the utilization of NOL carryforwards.
- Capital gain dividends and liquidating distributions paid by REITs to non-U.S. shareholders generally are treated as the sale of U.S. real property interests, and therefore, as effectively connected income under FIRPTA. As discussed above, the TCJA reduced the FIRPTA withholding rate on these types of distributions from 35% to the highest corporate tax rate in effect for the taxable year, which is now 21%.

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