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# Tax Planning for Real Estate Under the TCJA

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By now, you have been bombarded with summaries and articles on the 507-page tax bill, formerly known as the "Tax Cuts and Jobs Act" of 2017, and signed into law by President Trump on Dec. 22, 2017 (the Act). Of all the massive changes included in the Act, those affecting real estate owners, investors and developers may be the most difficult to navigate. In all cases, significant number-crunching will be required to decide on how to react to and take advantage of the changes. Many decisions will be delayed until the IRS and Treasury have a chance to digest the changes and tell taxpayers (through regulations and notices) what is and is not permitted in terms of planning. This article offers a preliminary take on how the new §199A deduction, the new 30% limit on business interest expense, changes to the like-kind exchange and cost recovery rules and other provisions work and interact to inform real estate investment and development decisions.

## New §199A Deduction for Pass-through Income

New §199A of the Internal Revenue Code (Code) generally allows taxpayers a deduction equal to 20% of ***domestic*** "qualified business income" (QBI) from a pass-through entity (S corporations, partnerships, trusts and estates), a sole proprietorship (Schedule C), tenant-in-common owners, and other owners of and rental real estate owners (Schedule E). To the extent the deduction is not otherwise capped or limited, the effective top-tax rate for individuals, estates and trusts after claiming the 199A deduction equals 29.6% (37% top individual rate * (1-20% QBI deduction)). The deduction is taken after computing adjusted gross income (AGI). Also, there is no alternative minimum tax adjustment for the deduction (which is good news!). Note that the deduction is not available for income generated from activities conducted outside the United States; only domestic activities are covered.

Most importantly, the QBI deduction sunsets after Dec. 31, 2025, like many of the other changes affecting individuals under the Act. So, any decision to take advantage of the §199A deduction (such as converting from a C corporation into a pass-through entity) only should be made after considering the overall cash flows of the businesses with and without the deduction; the new, reduced corporate tax rate of 21% (which is "permanent" under the law); the effect on leverage on the property (as well as the disallowance of interest deductions on higher value properties) and the effect of the expiration of the new provision.

## ***Limitations and Definitions***

As noted above, the basic deduction is 20% of QBI. ***QBI*** refers to the net domestic business taxable income, gain, deduction and loss from any qualified trade or business. QBI specifically excludes the following items of income, gain, deduction or loss: (1) investment-type income such as dividends, investment interest income, capital gains, commodities gains, foreign currency gains and similar items; (2) any Code §707(c) guaranteed payments paid in compensation for services performed by the partner to the partnership (or to an LLC treated as a partnership); (3) Code §707(a) payments for services rendered with respect to the trade or business and (4) qualified REIT dividends, qualified cooperative dividends and qualified publicly traded partnership income. Any losses that are carried forward can offset future QBI.

*Limitation 1:* If taxable income exceeds certain taxable income thresholds, the deduction is limited to the greater of 50% of W-2 wages of ***all*** employees of the entity, or 25% of W-2 wages, ***plus*** 2.5% of the unadjusted basis immediately after acquisition of qualified property. The taxable income threshold is $415,000 for married couples filing jointly and is phased out for taxable income between $315,000 and $415,000. The phase-out threshold for single persons, estates and non-grantor trusts begins at $157,500. The deduction is unavailable to ***specified service business owners*** (defined below) with taxable income in excess of the thresholds.

*Limitation 2:* The deduction also cannot exceed the lesser of the Combined QBI Amount or 20% of taxable income reduced by any capital gains income. The "***Combined QBI Amount***" is the deduction for each qualified trade or business, plus 20% of REIT dividends and income from publicly traded partnerships.

For purposes of the new statute, several definitions apply.

- "***W-2 wages***" refers to wage expense paid to employees only, plus elective deferrals under a §401(k) plan and nonqualified deferred compensation paid to employees during the taxable year. It does **not** include guaranteed payments to partners or payments to independent contractors.
- "***Qualified property***" includes tangible property (real and personal) used in a "qualified trade or business" in the production of QBI at the close of the taxable year, is capable of being depreciated (e.g., excluding land) and has a remaining "depreciable period."
- A "***qualified trade or business***" includes any trade or business other than a "specified service trade or business" or the trade or business of performing services as an employee. The IRS previously has interpreted the term to include the business of owning and operating rental properties.

- The "***depreciable period***" is the later of the regular depreciation period for the property (under the IRS' cost recovery rules) or 10 years, measured from the date on which the property was placed in service. So, if the property is old and has been fully depreciated, it will not be qualified property and therefore cannot be used to increase ability to claim the §199A deduction. For commercial real estate, the regular cost recovery/depreciation period remains at 27.5 years; for residential real estate, it is 39 years (the Act shortened the ADS period for residential real property from 40 years to 30 years and the regular cost recovery period for "qualified improvement property from 39 years to 15 years, as discussed below under "Cost Recovery Changes"). If you recently purchased tangible personal property (e.g., a washer and dryer) for your rental property, the new property's depreciable period is limited to the cost recovery period for that asset.
    - **Question** – What happens if someone dies holding fully-depreciated property that gets stepped up to fair market value at death under Code §? Arguably, you should get a new unadjusted basis with a new cost recovery period that runs from the date of death. The same result should obtain for a partnership where a partner dies or a partnership interest is sold and a §754 election is made with respect to the deceased/selling partner's interest. We will need confirmation of the suggested answers from the IRS.
- "***Specified service businesses***" include services in the fields of health, law, accounting, actuarial science, performing arts, athletics, consulting, brokerage services, or any trade or business where the *principal asset is the reputation or skill of 1 or more of its employees*. Oddly, the statute was revised at conference to exclude architects and engineers. The italicized language regarding reputation or skill is particularly troublesome. Does the language mean any service business (e.g., real estate property management) that has dynamic, influential owners and employees will be captured by this phrase, making it impossible for the business to utilize the QBI deduction? IRS and Treasury regulations undoubtedly will address the scope of this phrase, and even then, disputes with taxpayers are highly likely to arise.
- "***Unadjusted basis***" equals the cost basis of the qualified property immediately after acquisition and is not adjusted for depreciation or for increases in fair market value. As noted, it appears that property inherited at death gets a step-up in tax basis not only for cost recovery, but also for purposes of determining unadjusted basis under §199A.

<u>Simple Example</u>: Assume Leslie owns an industrial warehouse that she leases to a feed and grain distributor. She bought the warehouse 12 years ago for $10 million and has repaid the debt she incurred to purchase it. Taxable income (after expenses and depreciation are subtracted from rental income) equals $200,000. She hired independent contractors for all the labor needed, so she has no W-2 wages since she has no employees. Before applying any other limitations, Leslie's 199A deduction is limited to the lesser of (a) $200,000 * 20%, or $40,000, and (b) $10,000,000 * 2.5%, or $250,000.

Less Simple Example: Assume Gillian owns a hair salon in an S corporation that has taxable income (QBI) of $100,000. Also, Gillian has total taxable income of $500,000 from all sources (including the S corporation) and no capital gains (so, the overall limit is $500,000 * 20% = $100,000). Gillian's hair salon has $50,000 in W-2 wages and has qualified property with an adjusted basis of $25,000. The overall deduction cannot exceed $20,000 ($100,000 QBI * 20%). The W-2 wage limitation (50% * $50,000 = $25,000) applies, because it is greater than the W-2 wage and unadjusted basis limitation [(25% * $50,000) + (2.5% * $25,000 qualified property)]. Since the overall deduction cannot exceed 20% of QBI, however, the §199A deduction is $20,000. Simple?

Complex Example: Dave, who is married and files jointly, owns an interest in a real estate rental LLC taxed as a partnership that allocates $600,000 in pass-through income and $60,000 of wages paid by the LLC to his share of the LLC in 2018. Also, $2 million of unadjusted basis of the LLC property is allocated to Dave's share of the LLC. Dave and his wife have $250,000 in other non-business income and $50,000 in itemized deductions. Their §199A deduction is limited to $65,000, which equals the ***lesser of*** (a) 20% of QBI [***$120,000*** = 20% * $600,000], (b) 20% of taxable income [***$160,000*** = [($600,000 + $250,000 – $50,000) * 20%]], and (c) the ***greater of***(i) 50% of W-2 wages from the LLC [***$30,000*** = $60,000 * 50%], or (ii) 25% of W-2 wages + 2.5% of unadjusted basis of the LLC property [***$65,000*** = ($15,000 = $60,000 * 25%) + ($50,000 = $2,000,000 * 2.5%)].

More Complex Example: Chuck and Kathy (married filing jointly) own 1,000 apartment units in an LLC taxed as a partnership. The units, acquired in 1985, have been fully depreciated, but are undergoing renovations in 2018 that will be placed in service July 1t, will cost $6 million, will be depreciated under the new ADS cost recovery system over 30 years on a straight-line basis and will be 80% bank-financed, resulting in interest deductions of $240,000 in 2018. The net income from the LLC will be $2.5 million, including $500,000 in W-2 wages paid to all employees. They have three kids and seven grandchildren. Assuming they have taxable income after deductions of $2.2 million, Chuck and Kathy will have a §199A deduction of $275,000, equal to the ***lesser of*** (a) 20% of QBI [***$500,000*** = $2.5 million * 20%], (b) 20% of taxable income [***$440,000*** = $2.2 million * 20%], and (c) the greater of (i) 50% of W-2 wages [***$250,000*** = $500,000 * 50%], or (ii) 25% of W-2 wages + 2.5% of unadjusted basis of the LLC property [***$275,000*** = ($125,000 = $500,000 * 25%) + ($150,000 = $6 million * 2.5%)]. Note that Chuck and Kathy arguably could increase their §199A deduction by shifting pieces of the LLC and other wealth into non-grantor trusts for the benefit of their children and grandchildren, so that their taxable income is less than $315,000 and the QBI deduction available to all parties is spread out so the full 20% of QBI of $500,000 is utilized. The calculation of the deduction is done on an entity-by-entity basis.

Since the corporate tax rate has dropped to 21%, should you jump into a C corporation for your real estate? No! You still will have double taxation in a C corporation, whether you distribute the real estate to the shareholders in kind (which would cause the corporation to pay tax at the

corporate level on the built-in gain, albeit at a reduced tax rate of 21%, and the shareholders would pay tax on the dividends at rates up to 20%) or sell the property, pay tax on the gain at the corporate level and distribute the net proceeds. If current rates remain in effect, the highest marginal tax rate of opting to be treated as a C corporation after distributions to shareholders still may exceed rates payable as a pass-through entity! Also, consider what would happen if Congress later increases the "permanent" corporate rate.

## New Limitation on Interest Expense Deduction

The new law will disallow interest expense in excess of 30% of a business' "adjusted taxable income." Businesses with average gross receipts that do not exceed $25 million annually are exempt from the limitation. The $25 million threshold is determined at the tax-filer level (e.g., the partnership and not the partners would be subject to testing), but it is determined at the consolidated return level for an affiliated group of corporations.

Specifically, the limitation is calculated as an amount of business equal to the sum of (i) the business interest income of the taxpayer for the taxable year, (ii) 30 % of the "adjusted taxable income" of the taxpayer for such taxable year (which may not be a negative amount) and (iii) the "floor plan financing interest" of the taxpayer for such taxable year (which is relevant only to auto dealers). For this purpose, "business interest" is defined as any interest expense paid or accrued on any indebtedness that is properly allocable to the taxpayer's trade or business and expressly excludes investment interest expense. Similarly, "business interest income" is defined as interest income that is allocable to the taxpayer's trade or business and expressly excludes investment interest income. This limitation is only applied after other Code sections that may require deferral or capitalization of interest (e.g., §263A, which requires capitalization of certain interest expense is applied before the new 30% business interest limitation).

For purposes of the new limitation, "adjusted taxable income" is the entity's taxable income computed without regard to business interest or business interest income, net operating loss deductions, §199A deductions, and before 2022, deductions allowable for depreciation, amortization or depletion. Also, at the taxpayer's election, certain real property trades or businesses, construction businesses and farms are exempt from the limitation as long as they elect to use ADS cost recovery for properties placed in service after the election is made. For entities that operate multi-family housing units, once made, the election is irrevocable. Any interest disallowed in one year can be carried forward indefinitely and used in future years.

Certain small businesses are exempt from the business interest limitation if they meet the gross receipts test of Code §448(c). This latter test is whether the corporation or partnership in question has average annual gross receipts of less than $25 million for the three previous taxable years (or such shorter period in which the corporation or partnership was in existence).

However, the foregoing exemption from the 30% limitation does not apply to an entity that is prohibited from using the cash method of accounting under Code §448(a)(3) because it is characterized as a "tax shelter." For this purpose, a "tax shelter" includes a partnership (or LLC treated as a partnership) in which more than 35 % of its losses are allocated to limited partners under Code §1256(e)(3)(B). Accordingly, the gross receipts small business exemption will be unavailable to most real estate partnerships that engage in rehabilitation or low-income housing projects or in other real estate development activities, since most of the investors in these deals are either limited partners or LLC investors that would be treated like limited partners for tax purposes.

Example: Bob and Sheila (and various family trusts) own the stock of Apartments Plus Inc., a national corporation that operates 1,500 real estate ventures and projects. The average gross receipts of the corporation is around $400 million, and adjusted taxable income is $15 million, so Apartments Plus is definitely subject to the new limitation. The corporation has significant annual capital expenditures and has annual interest deductions of $6 million. Under new Code §163(j), the corporation's deduction would be limited to $4.5 million ($15 million * 30%), resulting in a carryforward of $1.5 million. Because it operates a real property trade or business (as defined in Code §469(c)(7)), the corporation could avoid the limitation by electing to depreciate its new tangible assets under the ADS cost recovery system, which generally extends the depreciation period of the assets (i.e., 30 years for residential rental property, 40 years for non-residential property) and makes the assets ineligible for bonus depreciation. In deciding whether to elect ADS, Apartments Plus should have its accountants run pro forma present value calculations with and without the ADS election to determine if the interest limitation is more costly to the corporation than claiming more accelerated methods of cost recovery. Ironically, if the interest expense is limited under §163(j) and Apartments Plus is a pass-through entity (i.e., S corporation), the corporation's QBI would increase resulting in a potentially higher §199A deduction. Finally, adjusted taxable income will decrease substantially in 2022 and beyond because depreciation and amortization will be included in the calculation of the limitation.

## Repeal of Partnership Technical Terminations

The Act repeals the partnership technical termination provisions of Code §708(b)(1)(B) effective for taxable years beginning after Dec. 31, 2017. Under prior law, a partnership would be terminated for federal income tax purposes if 50 % or more of the interests in capital and profits were transferred within a 12-month period. This unheralded but important change will prevent real estate partnerships and LLCs from having to restart depreciation and file short taxable year returns when the sale of an interest in the real estate partnership or equity fund would have otherwise caused a technical termination and could lead to increased liquidity for such investments.

## Cost Recovery Changes

Various cost recovery incentives were introduced and expanded under the new tax law. Assets qualifying for bonus depreciation will be entitled to write-off 100% of the cost of assets placed in service after Sept. 27, 2017, and through Dec. 31, 2022. The bonus depreciation rate declines by 20% every year thereafter until 2026 when the maximum first-year depreciation will be 20%. Notably, the bonus depreciation rules were expanded to include used as well as new property.

Section 179 allows taxpayers to expense up to 100% of the cost of certain tangible assets when they are placed in service. The limitation on this accelerated cost recovery deduction was increased to $1 million in property (up from $500,000), with a phase-out of the deduction if the business places over $2.5 million in assets during the tax year (up from $2 million prior to the Act). Similar to bonus depreciation, expanded §179 now applies to both new and used property. In addition, the definition of qualified tangible personal property and qualified real property was expanded to include tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging, and improvements to nonresidential real property placed in service after the date on which the original property was placed in service. These latter improvements include roofs, HVAC systems and components, fire protection and alarm systems and security systems.

While the regular recovery periods for residential (27.5 years) and nonresidential (39 years) real property remain unchanged, the new ADS periods for real property were changed to 30 years for residential real property and 40 years for nonresidential property. The decrease in the differential between regular depreciation and ADS for residential property may provide additional flexibility to have non-profit general partners receive similar fees to the for-profit GPs in tax-exempt use property deals.

“Qualified improvement property” consolidates the old qualified leasehold improvement, qualified restaurant, and qualified retail improvement property categories and have a 15-year general recovery period, 20-year ADS period and 10-year straight-line depreciation period.

## New Loss Limitation

The new tax law introduces new Code §461(l), which adds a fourth limitation on the ability of real estate business owners and investors to claim losses from their activities. In addition to the basis limitations, at-risk limits of §465 and passive loss limits of §469, the new law imposes a limitation on “excess business losses” from active trades or businesses. The limit applies to taxpayers with incomes exceeding $500,000 for married filing jointly taxpayers ($250,000 for other individuals) and is applied at the shareholder or partner level. These amounts are indexed

for inflation. Any unused, excess loss is carried forward indefinitely. This provision expires on Dec. 31, 2025 (like many of the other individual tax changes).

Example: Jeannie, who is married and files jointly with her spouse John, owns a business in which she materially participates (the business generates "active loss," so it is not subject to the passive loss rules). The business generates a $900,000 loss in a year in which the couple has joint income from other non-business sources of $1.2 million. Under prior law, Jeannie and John only would have reported $300,000 of taxable income on their tax return. Under the new law, the loss is limited to $500,000 and increases their taxable income to $700,000, which more than doubles their tax liability and results in a $400,000 loss carryforward to future years.

## Carried Interest Limitation

In general, the receipt of a capital interest for services provided to a partnership results in taxable compensation for the recipient. However, under a safe harbor rule, the receipt of a profits interest in exchange for services provided is not a taxable event to the recipient if the profits interest entitles the holder to share only in gains and profits generated after the date of issuance (and certain other requirements are met).

Typically, general partners in real estate partnerships guide the real estate investment and development strategy and act as general partners to the partnership, while outside investors act as limited partners. The GPs generally are compensated in two ways. First, to the extent that they invest their own capital in the funds, they share in the appreciation of fund assets. Second, they charge the outside investors two kinds of annual "performance" fees: a percentage of total fund assets, typically 2%, and a percentage of the fund's earnings, typically 20%, respectively. The 20% profits interest is often carried over from year to year until a cash payment is made, usually following the closing out of an investment. This is called a "carried interest."

Under pre-Act law, carried interests were taxed (i.e., the GP) at favorable capital gain rates instead of as ordinary income, although carried interests have been in the crosshairs of prior Congresses and administrations to be taxed at ordinary rates. For now, carried interest holders (including hedge fund managers and many others) have dodged a bullet. Instead, effective for tax years beginning after Dec. 31, 2017, the new law imposes a three-year holding period requirement in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain rather than ordinary income.

## Like Kind Exchanges

Another provision that *almost* was eliminated in the Act was §1031, permitting taxpayers to exchange certain property in tax-deferred, like-kind exchanges. Prior to the Act, this provision was available for both real property and tangible personal property. Effective for new transactions after Dec. 31, 2017, like-kind exchange treatment is now limited to like-kind real property only. For taxpayers who desire like-kind treatment but have done cost segregation studies, the tangible property will have to be separated from the real property and non-tangible personal property improvements to secure like-treatment for the real property portion going forward. It is worth noting, however, that the Act does allow transactions that were in the "open" replacement period at the end of 2017 to be completed in 2018.

## Net Investment Income Tax Issues (NIIT)

To help pay for various incentives under the Affordable Health Care Act, Congress enacted the net investment income tax, which imposes a 3.8% tax on certain net investment income of taxpayers. The tax generally applies to passive investors and may apply to certain real estate professionals, although a safe harbor is available for them. It does not apply to the investment income of real estate professionals with a trade or business. One issue that has not yet been resolved is whether the NIIT applies to the income of irrevocable non-grantor trusts that own interests in real estate partnerships and LLCs. It is also unclear whether the new §199A deduction reduces net investment income, although it arguably should not reduce NII if the new deduction is applied after calculation of adjusted gross income and the new statute says the §199A deduction only applies in determining the income tax (and not the NII) of affected taxpayers.

## Rehabilitation Credit

The Act eliminates the 10% rehabilitation credit that was available for certain buildings constructed before 1936 but retains the 20% credit for rehabilitation of historic structures. However, the revamped credit must be taken over five years instead of the year the property was placed in service.

## Opportunity Zones

An often overlooked provision in the new Act provides incentives for locating businesses in certain opportunity zones, which are located in low-income urban and rural communities. The Opportunity Zones program offers investors the following incentives for putting their capital to work in low-income communities:

- A **temporary tax deferral** for capital gains reinvested in an Opportunity Fund. The deferred gain must be recognized on the earlier of the date on which the opportunity zone investment is sold or Dec. 31, 2026.
- A **step-up in basis** for capital gains reinvested in an Opportunity Fund. The basis of the original investment is increased by 10% if the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years and by an additional 5% if held for at least seven years, excluding up to 15% of the original gain from taxation.
- A **permanent exclusion from taxable income of capital gains** from the sale or exchange of an investment in a qualified opportunity zone fund, if the investment is held for at least 10 years. (Note: this exclusion applies to the gains accrued from an investment in an Opportunity Fund, not the original gains).

Some have criticized this incentive as an opportunity for abuse, but the idea is gaining traction quickly across the U.S.

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*If you need assistance in effective tax planning for transfers of closely held business interests, please contact* ***Wayne Zell*** *at 703-218-2177 or email at* ***wayne.zell@ofplaw.com****.*