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January 2018

THE NEW TAX ACT'S CHANGES AFFECTING INCOME PRODUCING REAL ESTATE

The new *Tax Act* (the *Tax Act* was originally known as the ñ*Tax Cuts and Jobs Act*ò but for technical reasons the *Tax Act* dropped this name) includes numerous changes affecting the taxation of real estate. These new tax provisions will generally apply to tax years beginning on and after January 1, 2018. Below are summarized the more important provisions of the *Tax Act* which affect commercial and rental real estate, along with planning strategies. In the immediate future it is expected that the IRS and Treasury Department will issue guidance and the Joint Committee on Taxation will issue its ñbluebookò to help interpret these new *Tax Act* changes.

1. ***New 20% Deduction Will Reduce the Tax on Real Estate Income.***

Real estate owned by a partnership or limited liability company (a so called ñpass-throughò entity) passes its net income through to its partners and members (**"Partners"**) to be taxed at those Partnersô individual tax rates. Under the new *Tax Act* there is now a deduction of twenty percent (20%) allowed by non-corporate taxpayers pass-through entities against its qualified business income. This deduction also applies to sole proprietorships owning income producing real estate. The result of this new 20% deduction is to reduce the maximum effective federal income tax rate on real estate income to 29.6%.

This deduction generally cannot exceed (the **"Threshold Test"**) 50% of the Partnersô share of the W-2 wages paid by the qualified trade or business. However, there is an <u>alternative</u> Threshold Test (favorable to real estate owners) of using twenty-five percent (25%) of the Partnersô share of wages, <u>plus</u> two and half percent (2.5%) of the ñunadjusted basisò of the entityôs <u>depreciable</u> property (which is that depreciable propertyôs original purchase price). Only depreciable property is included in this 2.5% calculation, and thus, the tax basis of non-depreciable land is excluded from this calculation. If the Threshold Test amount is equal to or greater than the flat 20% deduction then the real estate entity gets to use the full 20% deduction. If not, then this 20% deduction is reduced to the Threshold Test limitation. The favorable alternative Threshold Test allows commercial real estate owners with few employees, but owning significant depreciable real estate, to use this new 20% deduction.

This new deduction, unless extended by future legislation, will expire on December 31, 2025.

2. ***<u>New Limitations on Using Interest Deductions.</u>***

For tax years beginning after December 31, 2017, the *Tax Act* limits a businessõs net interest expense deduction to thirty percent (30%) of the taxpayerõs ñadjusted taxable incomeò. For taxable years beginning after December 31, 2017, and ending January 1, 2022, ñadjustable taxable incomeò is computed without regard to deductions allowable for depreciation, amortization and depletion (known as ñEBITDAò). Beginning in 2022, depreciation, amortization and depletion are <u>not</u> added back in the computation of adjusted taxable income (known as ñEBITò), thus making the thirty percent (30%) interest deduction limitation even stricter. Generally, this limitation on the deductibility of interest is determined at the entity level. Interest deductions which are disallowed are carried forward and remain subject to this interest limitation calculation on their deductibility.

This interest limitation does not apply if certain gross receipt limitations are not met.

There is a **"Real Estate Interest Exception"** to this new interest deduction limitation. <u>If</u> a taxpayer (who owns real property) <u>elects</u> to use this Real Estate Interest Exception for its interest tax deductions then that taxpayer will be limited in its use of the new more favorable cost recovery rules and will have to depreciate and amortize their real estate over longer recovery periods.

3. ***<u>Recovery Period for Real Estate; Special Recovery Period for Qualified Improvement Property.</u>***

Residential real property depreciation recovery periods remain at 27.5 years and non-residential real property recovery periods remain at 39 years. If the taxpayer elects to use the Real Estate Interest Exception, then that taxpayer will have longer recovery periods of the real estate: 40 years for non-residential real property and 30 years for residential real property, as well as being limited on the use of the more favorable cost recovery rules.

For property placed in service after December 31, 2017 the *Tax Act* <u>eliminates</u> the prior tax lawõs definitions of ñqualified leasehold improvement propertyò, ñqualified restaurant propertyò, ñqualified retail improvement propertyò, and instead provides a general fifteen (15) year recovery period (utilizing a straight line method) for what is known as ñqualified improvement propertyò and a twenty (20) year <u>alternative</u> depreciation recovery period for this qualified improvement property. If the real estate business elects to use the Real Estate Interest Exception to the interest limitation rules then that real estate business will have to use the longer alternate depreciation recovery period.

4. ***<u>New Ability of a Real Estate Business to Take Bonus Depreciation.</u>***

The *Tax Act* allows ñbonus depreciationò for certain <u>personal property</u> placed into service between September 27, 2017 and January 1, 2023. These bonus depreciation provisions apply to both new and used personal property. There are provisions for phasing down the qualified property between January 1, 2023 and December 31, 2026, which then subjects such property to partial expensing. Note that real estate businesses that elect to use the Real Estate Interest Exception to the interest limitation rules will <u>not</u> be able to use this bonus depreciation.

5. <u>***Expansion of Real Estate Owner's Ability to Expense Items Under §179.***</u>

The *Tax Act* increases the ability of real estate owners to expense qualifying property under §179 (rather than capitalizing and depreciating the cost of such property). This §179 expensing provision increases the expensing limitation to $1 million, with a phase-out at $2.5 million (in other words, the $1 million amount is reduced by the amount which the qualifying property placed in service during the tax year exceeds $2.5 million). Both of these dollar amounts are indexed for inflation starting in 2018.

Section 179 qualifying property includes depreciable tangible personal property to furnish lodging. Qualified improvement property for §179 also includes improvements to non-residential real property placed in service after the date the underlying real property was first placed in service for: new roofs, heating, ventilating and air conditioning systems, fire protection and alarm systems and security systems. This new §179 provision applies to property placed in service beginning after December 31, 2017.

6. <u>***Changes to §1031 Tax-Deferred Exchanges Rules Makes §1031 Only Apply to Real Estate.***</u>

Commencing January 1, 2018, §1031 tax-deferred exchanges under the *Tax Act* are limited to solely real estate, and §1031 no longer applies to personal property. This means that any §1031 exchange of real estate, which might otherwise also include small amounts of personal property, should allocate in a purchase and sale agreement the <u>entire</u> purchase price to the qualifying real estate. Personal property could arise in a real estate sale or exchange, for example, where cost segregation studies have been previously performed on the relinquished property real estate, or will be performed upon the replacement property real estate. Personal property can also arise on a real estate sale where there is personal property included as part of the real estate sale, such as refrigerators or stoves in an apartment building, movable modular units in office buildings, or where there is separate equipment and machinery as part of the real estate sale.

7. <u>***Changes to the Taxation of Carried Interests.***</u>

It is common for real estate partnerships (or limited liability companies) to have ñwaterfallò distributions of income, in which the manager, general partner or promoter receives a promotional or service partnership interest without having contributed any capital to the partnership. These promotional interests are referred to as ñprofits interestsò or ñcarried interestsò. The new *Tax Act* requires that partnership interests issued in connection with the performance of services (so called ñcarried interestsò) be held for at least three (3) years in order for such partnership interests to receive favorable long-term capital gain treatment when the underlying partnership property is sold. This same required three (3) year hold period for the service partner to receive long-term capital gain treatment applies if the partnership interest is sold.

Thus, unless the requisite three (3) year hold period is met this new carried interest rule denies long-term capital gain treatment to a promoterôs or managerôs disposition of its partnership interest or upon the partnershipôs sale of an underlying asset. If long-term capital gain treatment is denied under the new carried interest rule then the promoterôs or managerôs income from its sale of its partnership interest or from the partnershipôs sale of its property is taxed as a short-term capital gain.

> **EXAMPLE:** A managing partner contributes no capital but only services to the newly created real estate partnership, while the investor partners contribute $5 million of cash. The partnership then purchases a retail shopping center for $6 million (using the $5 million of investor partner capital and $1 million of debt borrowed from a bank). Two years later the partnership sells the shopping center for $8 million. Under the terms of the partnership agreement ñwaterfallò distribution formula the $1 million of debt is repaid and the first $5 million of net sales proceeds are distributed to the investor partners, and then the remaining $2 million of net sales proceeds ($8 million less $6 million) is split and distributed fifty percent (50%) to the managing partner ($1 million) and fifty percent (50%) to the investor partners ($1 million). The tax result under the new carried interest rule is that the managing partner receives short-term capital gain treatment on its received $1 million, while the investor partners receive long-term capital gain treatment on their received $1 million.

8. ***Tax Credits.***

The *Tax Act* modifies the prior historic rehabilitation tax credit. For amounts paid or incurred after December 31, 2017, the ten percent (10%) credit for qualified historic rehabilitation expenditures with respect to a pre-1936 structure is repealed. A twenty percent (20%) historic tax credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. The historic rehabilitation credit can be claimed over a five (5) year period beginning in the tax year in which the qualified structure is first placed in service. There are transition rules.

The low income housing tax credit program for low income housing was preserved in the *Tax Act*.

9. ***<u>The Tax Act's New Individual Tax Rates.</u>***

Real estate is commonly owned in partnership or limited liability company form, where the entityôs income is taxed to the partners or members at individual tax rates. Under the new *Tax Act* the highest individual ordinary income tax rate is lowered to thirty-seven percent (37%) for taxable incomes in excess of $500,000 for single filers and $600,000 for joint filers. Gain from real estate depreciation recapture remains subject to the current 25% tax rate. Long-term capital gains continue to be taxed at the current maximum twenty percent (20%) rate and there continues to apply the 3.8% net invest income tax under the *Affordable Care Act*.

10. ***<u>State, Local, and Property Tax Deductions are Not Restricted for Income Producing Real Estate.</u>***

The new *Tax Act* still allows state, local, and property taxes to be deducted under §162 or §212 by owners of real estate which is a trade or business. Thus, the *Tax Act*ôs new limitations on personal deductions of state, local, and property taxes do <u>not</u> apply to real estate partnerships and limited liability companies which own and operate income producing real estate (or to individuals as to their real estate trade or business interests).

However, for California commercial property owners there is now a new threat of higher property taxes by a pending proposed ballot initiative to remove the protections of Proposition 13 against annual reassessments. Proposed California *Ballot Initiative 170055* is an effort to have a split California property tax roll so that each year California commercial properties would be reassessed (specifically excluding residential properties and apartment buildings). This ballot initiative is currently pending with the California Attorney Generalôs Office, and it is not clear if this split property tax roll initiative will be placed on the California ballot for a vote.

11. ***<u>REITs are Favorably Treated by the New Tax Act.</u>***

REITs are treated favorably under the new *Tax Act*. For example, the wage limitation for the new twenty percent (20%) deduction does not apply to REITs. Thus, REIT investors benefit from this new 20% deduction and the dividends that the REIT investors receive are covered by this 20% deduction. Also, the REIT can benefit by the tax deduction for business interest (even if there then may be restrictions on the REITôs deductions as to its real property).

Nothing in this Newsletter shall be deemed legal or tax advice as to any person, transaction or as to any estate plan. Please feel free to contact Robert A. Briskin if you have any questions as to items in this Newsletter.