Robinson+Cole

Federal Tax

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Federal Tax Reform — Key Provisions for the Real Estate Industry

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (H.R. 1), or the "Act," a comprehensive tax reform package representing an overhaul of federal taxation arguably on a level not seen in more than 30 years. The sweeping piece of legislation makes significant changes that affect the real estate industry, including:

REDUCTION IN TAX RATES

One of the key provisions of the Act is the reduction in corporate and individual tax rates. The Act eliminates the graduated corporate rate structure with a maximum graduated rate of 35 percent and instead taxes corporate taxable income at 21 percent effective for taxable years beginning after December 31, 2017. In addition, the Act replaces the existing tax rate structure applicable to ordinary income earned by individuals with a new rate structure with a maximum graduated rate of 37 percent, which sunsets in taxable years beginning after December 31, 2025. The Act generally retains the present-law maximum rates on net capital gain and qualified dividends earned by individuals.

DEDUCTION FOR INCOME EARNED BY PASS-THROUGH BUSINESSES

The Act adds new Section 199A, which generally allows noncorporate taxpayers to deduct up to 20 percent of "qualified business income" derived from a "qualified trade or business" that operates as a partnership (or other entity taxed as a partnership), S corporation, or sole proprietorship[1]. The deduction sunsets for taxable years beginning after December 31, 2025.

A qualified trade or business generally is defined as any trade or business, other than a "specified service trade or business" and performing services as an employee. A specified service trade or business means (a) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, and (b) service businesses involving investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Importantly, the exclusion for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a threshold amount. The threshold amount for 2018 is $157,500 ($315,000 for a married couple filing a joint return) and is inflation adjusted for tax years after 2018.

Under the Act, a taxpayer's Section 199A deduction generally is limited to the lesser of:

(a) 20 percent of the taxpayer's qualified business income; or

(b) the greater of:

(1) 50 percent of the taxpayer's allocable share of the W-2 wages paid in respect of such qualified trade or business; or

(2) the sum of 25 percent of the W-2 wages paid in respect of such qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property used in such qualified trade or business.

For taxpayers whose taxable income does not exceed a threshold amount, the deduction is applied without regard to the wage limitation in (b) above. The threshold amount for 2018 is $157,500 ($315,000 for married individuals filing a joint return) and is inflation adjusted for tax years after 2018.

TAXATION OF CARRIED INTERESTS (PROFITS INTERESTS)

The Act adds new Section 1061, which re-characterizes certain gains as ordinary income in the case of partnership profit interests held in connection with the performance of investment services. In effect, Section 1061 imposes a three year holding period in the case of certain net long-term capital gain with respect to any "applicable partnership interest" held by the taxpayer. Notably, the Act does not change existing U.S. federal income tax law as it relates to the issuance, and economic characteristics of, profits interests. The three year holding period imposed under Section 1061 applies regardless of the application of Section 83 or any related Section 83(b) election.

An "applicable partnership interest" generally is any interest in a partnership (including any legal entity that is taxed as a partnership) that is transferred to (or is held by) the taxpayer in connection with the performance of substantial services in any "applicable trade or business." An applicable trade or business generally means any regular activity that consists, in whole or in part, of raising or returning capital and either investing, developing, or disposing of certain specified assets (i.e., securities, commodities, real estate held for rental or investment, cash or cash equivalents, and options and derivative contracts).

LIMITATION ON DEDUCTIBILITY OF INTEREST

Prior to the Act, Section 163(j) (more commonly known as the "earnings-stripping" rules) limited a corporate taxpayer's deductions of "disqualified interest" if, among other things, the taxpayer's debt to equity ratio exceeded 1.5 to 1. Disqualified interest generally meant certain interest paid or accrued to (1) a related party if no U.S. federal income tax was imposed with respect to the interest income, (2) an unrelated party if a related party guaranteed the debt, or (3) a "real estate investment trust" (REIT) by a taxable REIT subsidiary.

The Act removes the earnings-stripping rules from the Code. In its place, new Section 163(j) generally limits a taxpayer's deduction of "business interest" for any taxable year to 30 percent of the taxpayer's adjusted taxable income for that year. For tax years beginning after December 31, 2017, and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion. Commencing in 2022, adjusted taxable income is further reduced by depreciation, amortization, and depletion. Except for partnerships and S corporations, any business interest that is not allowed as a deduction can be carried forward to a succeeding taxable year.

Importantly, the limitation on deductibility of interest generally does not apply to interest incurred by taxpayers in the real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business if such taxpayers elect out of the limitation. If a taxpayer elects to exclude a real property trade or business from the business interest limitation, then the business must use the alternative depreciation system (ADS) for certain property. There is also an exception for certain small businesses.

SHORTENING OF RECOVERY PERIODS FOR REAL PROPERTY

A taxpayer generally must capitalize the cost of real property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation. Tangible property, such as real property, generally is depreciated under the Modified Accelerated Cost Recovery System (MACRS), which determines depreciation for different types of property based upon an assigned applicable depreciation method, recovery period, and convention. An alternative depreciation system (ADS) is required to be used for tangible personal property used outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain exported property covered by Executive Order.

The Act eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property and provides a general 15-year MACRS recovery period and a 20-year ADS recovery period for "qualified improvement property." In addition, the Act shortens the ADS recovery period for determining the depreciation deductions with respect to residential rental property from 40 years to 30 years.

IMMEDIATE EXPENSING OF CAPITAL EXPENDITURES

Under existing U.S. federal income tax law, a taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income, and recover such cost over time through annual deductions for depreciation or amortization. For certain "qualified property" acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024 for longer production period property and certain aircraft), the Act generally allows an additional first-year depreciation deduction of 100 percent of the property's adjusted basis. The bonus depreciation percentage phases down for property placed in service in 2023 and each year thereafter until 2027. The provision applies to certain arm's-length purchases of used, as well as new, property.

"Qualified property" generally includes tangible property to which MACRS applies with an applicable recovery period of 20 years or less; water utility property; computer software (other than computer software covered by Section 197); qualified improvement property; and certain qualified film, television, and live theatrical productions. The Act excludes property that is primarily used in certain businesses not subject to the limitation on interest expense under the Act (e.g., certain energy and utility businesses).

LIKE KIND EXCHANGES

The Act includes a major change to the like kind exchange rules under Section 1031. Under U.S. federal income tax law prior to the Act, taxpayers generally could avoid recognition of gain or loss when they exchanged "like kind" property held for productive use in a trade or business or for investment. Both tangible and certain intangible property qualified for like kind exchange treatment, as well as real property. Pursuant to the Act, for taxable years beginning after December 31, 2017, the nonrecognition of gain in like kind exchanges is limited to the exchange of real property that is not held primarily for sale. Tangible and intangible personal property no longer qualifies for like kind exchange treatment. This is a win for the real estate industry, as prior bills had proposed eliminating Section 1031 entirely or limiting the annual deferral to $1 million.

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[1] All Section references are to the Internal Revenue Code of 1986, as amended.

For more information, or if you have questions about how the issues raised in this legal update affect your policies, practices, or other compliance efforts, please contact [Christine E. Bromberg] or [Michael B. Kaufman] in the firm's [Tax Group].

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