TAX REFORM ACT - IMPACT ON REAL ESTATE INDUSTRY

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On December 20, 2017, Congress passed a tax reform act (formerly known as the Tax Cuts and Jobs Act or the "Act"). President Trump is expected to sign the Act into law. The Act includes several major changes to many areas of the Internal Revenue Code (the Code) impacting taxpayers who are engaged in the real estate business and who otherwise own real estate. These changes are summarized below. Because most of the changes are effective January 1, 2018, prompt review of your structure and operations is warranted to understand how the new legislation will impact you and whether restructuring in early 2018 might improve your tax situation.

Individual Income Tax Rates Lowered

Beginning in 2018, the Act lowers the maximum marginal income tax rate applicable to individuals from 39.6% to 37% (plus unearned income Medicare tax, where applicable). This rate reduction is scheduled to expire after 2025 under the Act, unless renewed before then. The maximum marginal tax rate applicable to long-term capital gains of individuals remains at 20% (plus unearned income Medicare tax, where applicable) under the Act.

Corporate Tax Rates Lowered

The Act permanently reduces the corporate tax rate to a flat 21% beginning in 2018. When combined with the maximum 20% tax rate on qualified dividends paid by a C corporation to an individual shareholder, the effective tax rate on income of a C corporation distributed to its shareholders will be 36.8% (or 39.8% after the 3.8% Medicare tax on dividends).

Up to 20% Deduction for Qualified Business Income of Pass-Through Entities

Beginning in 2018, the Act provides for up to a 20% deduction for individuals for qualified business income earned through pass-through entities, such as partnerships and limited liability companies taxed as partnerships, S corporations, disregarded entities and trusts. This deduction (when combined with the reduction in individual income tax rates) theoretically would result in an effective maximum marginal tax rate of 29.6% (plus unearned income Medicare tax, where applicable), for taxpayers entitled to the full 20% deduction. However, the deduction is subject to several limitations that are likely to materially limit the deduction for many taxpayers. These limitations include the following:

- Qualified business income does not include IRC Section 707(c) guaranteed payments for services, amounts paid by S corporations that are treated as reasonable compensation of the taxpayer, or, to the extent provided in regulations, amounts paid or incurred for services by a partnership to a partner who is acting other than in his or her capacity as a partner.
- Qualified business income does not include income involving the performance of services (i) in the fields of, among others, health, law, accounting consulting, financial services, brokerage services, or 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 or owners, or (ii) consisting of investing or investment management, trading, or dealing in securities, partnership interests or commodities.
- Qualified business income includes (and, thus, the deduction is applicable to) only income that is effectively connected with the conduct of a trade or business within the United States.
- The deduction is limited to 100% of the taxpayer's combined qualified business income (e.g., if the taxpayer has losses from certain qualified businesses that, in the aggregate, exceed the income generated from other qualified businesses, the taxpayer's deduction would be $0).
- The deduction is limited to the greater of (i) 50% of the W-2 wages paid with respect to the trade or business or (ii) the sum of 25% of the W-2 wages paid with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of all depreciable property used in the qualified trade or business.

This last limitation does not apply to income earned through publicly-traded partnerships or to taxpayers whose taxable income does not exceed $315,000 (in the case of taxpayers filing a joint return) or $157,500 otherwise. The last limitation may particularly impact real estate private equity funds and real estate ventures that do not have their own employees but, instead, rely on services performed by employees of general partners or managing members or affiliated management companies.

This 20% deduction is scheduled to expire after 2025 under the Act, unless renewed before then.

Interest Expense Deductions Generally Limited, But Not for Electing Real Property Businesses

Subject to certain exceptions discussed below, beginning in 2018, the Act generally limits the annual deduction for business interest expense to an amount equal to 30% of the "adjusted taxable income" (as defined in the following paragraph), plus the business interest income, plus the floor plan financing interest (if any), of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely and utilized in future years, subject to this and other applicable interest deductibility limitations and to certain restrictions applicable to partnerships.

"Adjusted taxable income" generally means the taxable income of the taxpayer computed without regard to any item of income, gain, deduction, or loss which is not properly allocable to a trade or business and by adding back (1) any business interest expense or business interest income, (2) the 20% deduction for pass-through income, (3) the amount of any net operating loss deduction and (4) ***for taxable years beginning before January 1, 2022***, any deduction allowable for depreciation, amortization, or depletion.

There are several exceptions to this new limitation on interest deductibility, including the following:

- At the taxpayer's election, the limitation does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business;
- The limitation does not apply to interest incurred by taxpayers in the trade or

business of the furnishing (which includes generation, transmission and/or distribution) or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative; and
- The limitation does not apply to taxpayers whose average annual gross receipts for the three-tax-year period ending with the prior tax period do not exceed $25 million.

Special rules apply in the case of partnerships. The limitation on the deduction is determined at the partnership level, and any deduction available after applying such limitation is included in the partners' nonseparately stated taxable income or loss from the partnership. Any business interest that is not allowed as a deduction to the partnership for the taxable year is not carried forward by the partnership but, instead, is allocated to each partner as "excess business interest" in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by such partnership. The "excess taxable income" with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as (a) the excess of (i) 30% of the adjusted taxable income of the partnership, over (ii) the amount (if any) by which (x) the business interest expense, minus the floor plan financing interest, exceeds (y) the business interest income of the partnership bears to (b) 30% of the adjusted taxable income of the partnership. A partner's share of excess taxable income is determined in the same manner as nonseparately stated income and loss. Any disallowed interest expense allocated to a partner immediately reduces the unitholder's basis in its partnership interest, but any amounts that remain unused upon disposition of the interest are restored to basis immediately prior to disposition.

Depreciable Lives for Real Property Modified

The Act requires any real property trade or business that elects to be excluded from the interest deductibility limitations described above to utilize the alternative depreciation system with respect to its depreciable real property. Under the alternative depreciation system, as modified by the Act, the recovery periods for nonresidential depreciable real property, residential depreciable real property and qualified improvements are 40 years, 30 years and 20 years, respectively.

The Act did not adopt the Senate proposal to reduce the MACRS depreciable lives on residential and nonresidential depreciable property.

Immediate Expensing of Qualified Depreciable Personal Property

The Act extends and modifies the additional first-year depreciation deduction for qualified depreciable personal property by increasing the 50% allowance to 100% for property placed in service after September 27, 2017, and before 2023. After 2022, the bonus depreciation percentage is phased-down to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026. The bill removes the requirement in current law that the original use of qualified property must commence with the taxpayer. Thus, immediate expensing applies to purchases of used as well as new items.

Qualified property does not include generation, transmission, distribution or transportation assets of a public utility.

Carried Interests

The Act leaves largely untouched the favorable tax treatment provided for so-called "carried interests" (e.g., an interest entitling the sponsor/general partner/managing member of a real estate private equity fund or joint venture to receive a higher percentage of distributions from the fund or venture once all investors receive back their capital plus, in many cases, a specified preferred return on their capital). The only change is that, to receive favorable long-term capital gains treatment, any gain allocable to the carried interest must be attributable to assets held for more than three (3) years (or, if the carried interest is sold, it must have been held for more than 3 years). This change does not apply, however, to gain attributable to assets not held for portfolio investment on behalf of third party investors or to carried interests held (directly or indirectly) by corporations.

REITs Retain Most of Benefits Relative to C Corporations

The Act provides for a 20% deduction for REIT dividends, beginning in 2018. That deduction (when combined with the reduction in individual income tax rates) will result in an effective maximum marginal tax rate of 29.6% on REIT dividends received by individual investors (plus unearned income Medicare tax). The maximum marginal tax rate under current law is 39.6% (plus unearned income Medicare tax). The Act provides for a reduction in the tax rate of C corporations from 35% to 21%, with the result that the effective maximum tax rate on corporate earnings that are distributed as dividends will be reduced to 36.8% for individual investors (plus unearned income Medicare tax), as compared to a rate of 48% (plus unearned income Medicare tax) under current law. Thus, REIT earnings that are distributed as a dividend will receive a favorable rate differential of 7.2 percentage points as compared to C corporation earnings that are distributed as dividends. This represents a small reduction in the 8.4 percentage point rate differential that exists under current law.

The reduced maximum individual 37% rate and the 20% deduction for REIT dividends, but not the reduced 21% rate on income of a C corporation, are scheduled to expire after 2025 under the Act. Thus, after 2025, the effective tax rate on REIT dividend income will be slightly higher than the effective tax rate on C corporation income distributed as a dividend (39.6% for REIT dividends and 36.8% for C corporations, in both cases before the 3.8% Medicare tax), unless the individual reduced rates and the 20% deduction are extended before then. Because many other favorable provisions of the Act sunset after 2025, it is possible that future legislation will extend the REIT dividend effective tax rate benefit beyond 2025.

Technical Terminations

The Act permanently repeals the partnership technical termination rule contained in Section 708(b)(1)(B) of the Code, effective in 2018. This repeal allows an MLP or other partnership to continue—without resetting depreciation periods and without allowing or requiring new elections—even after the disposition by partners of more than half of the partnership's outstanding capital and profits interests in a twelve-month period.

Contributions to Capital of Corporations by a Governmental Entity or Civic Group No Longer Tax-Free

The Act amends Section 118 of the Code, which generally provides that a corporation is not taxed on property contributed to it, so that it will now not apply to contributions by any governmental entity or civic group (other than any such contributions made by a shareholder as such). Thus, for example a contribution of land by a City to a developer corporation would be taxed to the corporation at the land's fair market value. The explanation to the bill further provides that "[t]he conferees intend that section 118, as modified, continue to apply only to corporations." This may be read to imply that a partnership (or any other type of entity other than a corporation) also would be taxed on such a contribution, as well as any contribution that might otherwise qualify for nonrecognition treatment under section 118 if made to a corporation.

NOL Usage Partially Limited and No NOL Carrybacks

The Act generally limits the amount of net operating loss (NOL) that may be utilized in any taxable year to 80% of the taxpayer's taxable income (determined without regard to the NOL deduction) with respect to losses arising in taxable years beginning after

December 31, 2017. Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely. The bill also generally repeals provisions allowing for the carryback of NOLs effective for losses arising in taxable years after December 31, 2017.

Section 1031 Tax-Free Exchange Treatment Retained for Real Property Exchanges

The Act modifies the IRC Section 1031 exchange provisions by limiting their application to real property that is not held primarily for sale. Thus, properly structured real property exchanges will continue to enjoy tax deferred treatment under IRC Section 1031. However, the portion of any exchange that includes personal property will no longer qualify for tax deferred treatment under IRC Section 1031.

Provisions Potentially Impacting Residential Real Estate

The Act caps the deduction for state and local property (and income and sales) taxes to $10,000 per year. This cap does not apply, however, to taxes incurred in a connection with a trade or business. The bill also (i) limits the deduction for interest incurred on debt used to acquire, construct or improve a principal residence to interest on up to $750,000 of debt (down from $1,000,000) and (ii) eliminates the deduction for interest on home equity debt. These caps apply beginning in 2018, but are scheduled to expire after 2025 under the Act, unless renewed before then.

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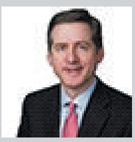

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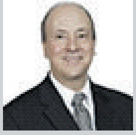

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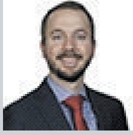

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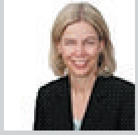

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