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# The Tax Cuts and Jobs Act: Considerations for Real Estate Investors and Developers

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On December 22, 2017, President Trump signed a tax reform bill known as the Tax Cuts and Jobs Act (the "TCJA"). The TCJA is the most sweeping tax reform package passed in the last thirty (30) years. Most provisions of the bill took effect on January 1, 2018, amongst much uncertainty as to what the full effects of the new provisions would be. With 2017's taxes now behind most companies, it is time to focus on the TCJA to determine (i) what its anticipated consequences will be for the real estate industry, and (ii) how, if at all, the uncertainty of these consequences has solidified and materialized over the first quarter of 2018.

## Key Provisions of the TCJA and their Impacts

The following is a brief overview of certain provisions of the TCJA of particular relevance to real estate investors and developers and some impacts of, or issues raised by, each new provision:

1. Rate Changes: The most obvious changes made by the TCJA were the changes to the basic income tax rates. The top rate applicable to corporate income was significantly reduced from a top rate of 35% to a flat rate of 21%, while the top rate applicable to individuals was reduced from 39.6% to 37%. While the substantial corporate rate reduction is permanent, the reduction to the individual rate eventually sunsets. When combined with the unchanged maximum 20% rate applied to qualified dividends, the effective rate on corporate income distributed

to its shareholders is now 36.8%. Also of note, the maximum capital gains rate remained at 20% (and 25% for depreciation recapture and 28% for collectibles gain), and the 3.8% Medicare tax (i.e., the Net Investment Income Tax) continues to apply.

With these changes, corporate taxation has become much more palatable. Nonetheless, for the real estate industry, pass-through taxation will likely continue to dominate as the effective rate, once distributions/dividends are considered, is likely still lower (see below) and moving or disposing of property is still easier from a tax-planning standpoint when using an entity taxed as a partnership. For a non-real estate-owning entity, particularly one that intends to reinvest a substantial portion of its profits, corporate taxation may now be a more useful tool in organizational structuring. Further, while the lowered corporate and individual rates will certainly be beneficial to most real estate investors, long-term capital gains treatment remains the gold-standard, and planning strategies that attempt to preserve or promote such treatment will still be desirable in nearly every situation.

2. Like-Kind Exchanges: After years of being on the legislative chopping-block, like-kind exchanges under Section 1031 survived. However, under the TCJA, only real property qualifies for like-kind exchange treatment. Thus, exchanges of both multi-family residential and commercial properties need to segregate and account for the personal property which is involved in the transaction.
3. Carried Interests: Carried interests or "promoted interests" were largely unchanged by the TCJA but are subject to a new three (3) year holding period to qualify for long-term capital gains treatment. Importantly, it appears that this holding period requirement may also apply to pure profits interests. The required holding period applies at both the carried interest-level and the partnership-level – meaning that short-term capital gains (taxed at ordinary income rates) will apply to income from the sale of the carried interest by the promoter or the sale of the underlying asset by the partnership if the three (3) year holding period is not met. This will affect only a small subset of promoters who expect to (or are otherwise forced to) recognize income from a carried interest within the three (3) year holding period. In deals where an equity partner may have an interest in selling the asset within three (3) years, promoters may consider including terms in their joint venture documentation preventing a sale until the third (3rd) anniversary of the acquisition or otherwise limiting an equity partner's exit options prior to such anniversary to a sale of the equity partner's ownership interest in the entity. Also, it is important for promoters to clarify in the joint venture agreement how much of their interest is based on actual capital contributed, to avoid that portion of their interest being swept up into the carried interest.
4. Business Interest Deduction: Under the TCJA, all business interest expense deductions are limited to 30% of adjusted taxable income. The limitation only applies to taxpayers with average annual gross receipts for the prior three (3) tax years in excess of $25,000,000, but only to the extent that the entity is not

considered a "tax shelter." A significant exception to this new provision allows a "real property trade or business" to elect out of the limitation as a trade-off for applying longer depreciation life spans to certain real property. If the limitation applies, deductions have unlimited carry-forward at the entity-level. It is still unclear whether an upper-tier entity (such as an equity fund) that indirectly invests in real estate assets through a lower-tier entity will be considered a real property trade or business, such that it can elect out of this limitation.

5. Net Operating Losses: Net operating losses ("NOLs") arising after 2017 are no longer able to be carried-back to prior tax years and are only deductible on a carry-forward basis, up to 80% of a taxpayer's taxable income. This will materially limit the value of NOLs created in 2018 and beyond, and will impact the decision of whether to do a cost segregation study, which might generate unusable NOLs.
6. Excess Business Losses: The TCJA added another hurdle to the deduction of losses, to go along with the basis limitations, at-risk rules, and passive loss rules. Any "excess business loss" for a taxable year is not deductible and is carried-forward as a NOL. An "excess business loss" is the loss from a non-corporate taxpayer's trades or businesses in excess of $250,000 ($500,000 if filing jointly). Thus, excess business losses may not offset non-business income such as interest income or other portfolio income or gain.
7. Pass-Through Deduction: To provide some balance to the materially lowered corporate rate, the TCJA provides for a new 20% deduction for certain non-corporate taxpayers, which is currently scheduled to sunset beginning in 2026. Unfortunately, the deduction is not as simple as is sounds, as it only fully applies to domestic, non-investment, "qualified business income" from a "qualified trade or business" carried on by a sole proprietorship or a pass-through entity (partnerships, S corporations, etc.). Ultimately, if a taxpayer in the top individual tax bracket is able to claim the full deduction, it will lower his or her effective federal income tax rate applicable to non-corporate income to 29.6%. This deduction is not available to corporations that are owners of qualified pass through entities, although trusts and estates can utilize the deduction.
    a. Generally, the definition of "qualified trade or business" does not include: (i) performing services as an employee, (ii) most professional service businesses, (iii) investment management or securities trading businesses, and (iv) any trade or business where the principal asset is the skill or reputation of one or more of the employees or owners. Typical real estate developers (both horizontal or vertical developers) should fit within the definition of qualified trade or business, but certain entities providing real estate services, such as management or brokerage services, may not qualify. Notably, this qualified trade or business requirement does not apply to taxpayers with income below the lower threshold amount for the phase-in set forth in subsection (b) below. There is still no guidance as to whether a business engaged in both a qualified trade or business and a non-qualified trade or business (where the income is difficult or impossible to separate) will be able to claim the deduction as to some or any portion of that income.

Once this question is answered, there will likely be a rush to structure ownership so as to most benefit taxpayers by either (i) segregating different lines of business entirely so as to not taint qualified trades or businesses, or (ii) combining lines of business such that non-qualified trades or businesses are always under any allowable threshold for the combined entity to still claim the deduction.

b. Subject to a phase-in beginning at individual income of $157,500 ($315,000 if filing jointly) and being fully phased in at $207,500 ($415,000 if filing jointly), the deduction is limited to the greater of two amounts: (i) 50% of the taxpayer's allocable share [1]of W-2 wages [2]of the business, or (ii) 25% of the taxpayer's allocable share of W-2 wages of the business, plus 2.5% of the unadjusted basis of all depreciable property owned by the business. Most real estate developers and owners subject to this limitation will need to use clause (ii) above to maximize the value of this deduction as W-2 wages may be minimal. Similar to how the qualified trade or business definition may encourage combining or segregating certain lines of business, these limitations will also encourage companies to hold certain employees and/or assets in certain entities – specifically trying to maximize W-2 wages and depreciable property attributable to any taxpayer which is likely to have substantial income. Further, to boost W-2 wages for partnerships or sole proprietors without employees, some planners may increase the use of S corporations which can treat payments to owners as wages.

## Conclusions

The TCJA is a substantial change in the taxation of real estate investors and developers, and the foregoing points are, by no means, a comprehensive discussion of all of the new provisions affecting the real estate industry. Many of the TCJA's provisions are complex and currently without supporting rulings, regulations, or case law. For the many questions raised by these provisions, it is likely that there will not be many, if any, answers until at least a year from now.
Nonetheless, in the meantime, preparing for and understanding the potential effects of the TCJA is still an important task for real estate professionals in 2018. Discussions need to be had about certain issues like (i) how to structure asset ownership so as to maximize a taxpayer's pass- through deduction, and (ii) how to draft joint venture documents to assure long-term capital gains treatment for promoters. The issues raised by the TCJA are each complex and need to be addressed on a case by case basis. We recommend that you consult with your tax advisors to set a strategy for to how to best take advantage of the many benefits conferred upon real estate investors and developers by the TCJA. Importantly, once that strategy is set, we encourage you to occasionally reflect on that strategy and determine if it needs to be updated as additional guidance is released over the next few years.

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[1] Calculations are made at the partner/shareholder-level, not the entity-level.

[2] The definition of W-2 wages likely does not include payments received by a partner or a sole proprietor as the IRS has consistently held that these payments are not W-2 wages. See Rev. Rul. 69-184.

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