2017 Tax Act Overview: A Helpful Hand for Most Real Estate

By Philip Richard Hirschfeld

Philip Richard Hirschfeld is an associate in the New York office of Cole Schotz PC. He is a Section Fellow and Vice-Chair of the Section's Federal Taxation of Real Estate Committee.

The 2017 Tax Act (often referred to as the Tax Cuts and Jobs Act) contains or preserves some very generous tax benefits for investments in real estate and partnerships. Pub. L. No. 115-97, 131 Stat. 2054 (Dec. 22, 2017). Apart from lowering the maximum individual tax rate to 37%, a new tax deduction equal to 20% of qualified business income may be available to individuals who own income-producing real estate either directly or through a partnership or S corporation. Planning is needed to take full advantage of these changes and to avoid some new pitfalls.

Real estate investors can avoid newly-adopted restrictions on the deduction of business interest by making an election, which slightly expands the period for depreciating their real estate. Like-kind exchanges (but only for real estate) survive. Carried interests also survive, subject to new limitations that are manageable in the real estate sector. The reduction in the corporate tax rate to 21% will benefit foreign investors, who often form U.S. corporations to own their U.S. real estate. The greatest harm may come with new limits on the deduction for real property taxes and other changes that may dampen the home sales market. Overall, the Act offers a helping hand to most of the real estate industry.

Qualified Business Income Deduction Applicable to Real Estate

For individual investors in partnerships or S corporations and sole proprietors, the Act adds a new deduction equal to 20% of qualified business income (QBI). Internal Revenue Code (IRC) § 199A(a). QBI is income from a qualified business (QB). This deduction is available to both passive and active investors. Because the maximum individual income tax rate is now 37%, the QBI deduction reduces the effective tax rate on business income to 29.6% (that is, only $80 of $100 of QBI is taxed at 37%, which results in this 29.6% effective tax rate). The deduction is effective for taxable years beginning after December 31, 2017, but it will expire after 2025.

Qualified Business

Rental of real property can be a QB if the leasing activity rises to the level of being a trade or business. IRC § 199A(d). The net lease of a single property to a single tenant would not be considered a trade or business. E.g., Rev. Rul. 73-522. By contrast, the leasing of several real estate parcels (five or more parcels) or the lease of a single property to several tenants (such as in a single apartment house or office building) should be a trade or business eligible for the QBI deduction. Alternatively, QB status should apply when the lessor has employees of its own that perform significant services relating to its properties. Because the IRC lacks any objective, bright-line test to apply, IRS guidance is needed to offer guidelines that taxpayers can follow to insure the QBI deduction can be obtained.

QB does not generally include the performance of services, which would cover real estate management, brokerage, and other services performed in the industry. IRC § 199A(d)(1). A limited exception allows architectural and engineering services to qualify. This special treatment for architects and engineers contains a catchall phrase stating that a business whose principal asset is based on the reputation or skill of the owner or employees cannot take the deduction. IRC § 199A(d)(2). A senior Treasury official has indicated, however, that this phrase will not be applied to undermine treating architects and engineers as eligible for the QBI deduction. L. Davison, Architects, Engineers Will Get Pass-Through Tax Break: Official, DTR 24 (Feb. 5, 2018).

Despite the general prohibition on services income, a moderate-income taxpayer is permitted to treat income from any service as QBI. IRC § 199A(d)(3). A "moderate-income taxpayer" (a term not actually used in the Code) is an individual whose taxable income for the year is equal to or less than $315,000 for married filing jointly taxpayers; for other taxpayers, the threshold is reduced to $157,500. When these thresholds are exceeded, the restriction on services income phases in and once the taxable income of married filing jointly taxpayers reaches $415,000 (or $315,000 for other taxpayers), the service income is fully excluded from QBI. All of these dollar thresholds will be adjusted for inflation starting in 2019.

Wage and Property Limitation

The QBI deduction cannot exceed an amount equal to a "wage and property limitation" (a term also not actually used in the Code). IRC § 199A(b)(2). The purpose of this limitation is to ensure that this deduction can be used only by partnerships that employ many people and create jobs. Although many real estate partnerships employ very few people, this limitation was modified late in the legislative process to assist the real estate industry. The final wage and property limitation provides that the QBI deduction cannot exceed the greater of (1) 50% of the wages paid by the partnership or (2) 25% of the wages paid by the partnership plus 2.5% of the original cost basis of depreciable tangible property placed in service in the last 10 years. A partnership's investment in depreciable real estate (not including land) can now serve to avoid this limitation from reducing or eliminating the QBI deduction.

Consider an illustration of how this new deduction can benefit a real estate partnership. In 2019, the partnership has $1 million of QBI from rental income, which will produce a $200,000 QBI deduction. That deduction, however, cannot exceed the wage and property limitation. The partnership has no employees, as independent contractors and its partners handle all its work. In 2018, the partnership purchased its residential office complex for $11 million; $10 million of the price is allocable to the building, which is depreciable property, and $1 million is allocable to land. The wage and property limitation is the greater of (1) 50% of W-2 wages ($0 x 50%) or (2) the sum of 25% of W-2 wages ($0 x 25%) plus 2.5% of the unadjusted basis of the building immediately after acquisition: ($10 million x 2.5% = $250,000). Because the wage and property limitation is $250,000, then the full $200,000 QBI deduction can be claimed.

Even if the wage and property limitation is less than 20% of the QBI, there is still one other avenue the law allows to nullify its effect. If the taxpayer is a moderate-income taxpayer, then this limitation does not apply. IRC § 199A(b)(3). This moderate-income taxpayer is defined in the same way as defined previously, with the result that the wage and property limitation does not apply to an individual whose taxable income for the year is equal to or less than $315,000 for married filing jointly taxpayers; for other taxpayers, the threshold is reduced to $157,500. In this case, the wage and property limitation is "phased in" if income exceeds those thresholds and is totally applicable once taxable income reaches $415,000 for a married filing jointly taxpayer (or $315,000 for other taxpayers).

If all else fails, one should consider making independent contractors employees or taking other steps to increase the wage and property limitation. In practice, however, these alternative options may be difficult to accomplish.

Eliminating the New Limits on Interest Deduction

Taxpayers often use leverage in real estate investments. The Act adds a new roadblock to getting full benefit of leverage by providing that a taxpayer's net business interest expense deduction cannot exceed 30% of its adjusted taxable income (ATI). IRC § 163(j)(1). The ATI starts with taxable income from the property but then allows for certain add-backs that lessen the effect of this rule (for example, interest expense is added back). IRC § 163(j)(8). The ATI is computed without regard to depreciation, amortization, and depletion for taxable years beginning before January 1, 2022; after 2021, those beneficial modifications are eliminated. IRC § 163(j)(8)(A)(v). In the case of a partnership, the limitation is determined at the partnership level, subject to certain adjustments. IRC §163(j)(4)(A). Any interest deduction disallowed under this rule is carried forward indefinitely to use in the next year, but is subject to this rule in that year. IRC § 163(j)(2).

This limitation does not apply to small businesses. IRC § 163(j)(4). A small business is a business that has $25 million or less in annual gross revenues. IRC § 448(c). As a result, many real estate partnerships will be excluded from this interest deduction limitation.

For larger businesses, this limitation does not apply to an "electing real property trade or business." IRC § 163(j)(7)(A)(ii). An electing real property trade or business must use the alternative depreciation system (ADS). IRC § 168(g)(1)(F). The ADS uses a longer recovery period for depreciating assets than what is otherwise allowed. But the ADS recovery period for real estate is only slightly longer than the regular recovery period, and thus does not materially reduce the annual depreciation deduction that can be claimed.

Commercial or residential real estate is depreciated on a straight-line basis under both the regular depreciation system and the ADS. The regular recovery period for commercial real estate (for example, an office building) is 39 years, yet the ADS period is a mere one year longer, 40 years. IRC §§ 168(c), (g)(2). For commercial property, the effect of the ADS is generally to reduce annual depreciation by only 2.5%. The regular recovery period for residential real estate is 27.5 years, but the Act reduced the ADS period from 40 years to 30 years. IRC §§ 168(c), (g)(2). For residential property, the effect of the ADS is generally to reduce annual depreciation by 9%.

As a result, real estate can either avoid these new limitations under the small business exception or elect out of the rules and use the ADS. One question that the IRS needs to address is how to apply the ADS if the partnership placed its property in service before 2018. The election should still be available, but the mechanics of how to apply it were left unaddressed in the Act.

Like-Kind Exchanges Preserved

The Act eliminates tax-free, like-kind exchanges (LKE) for all property except for business or investment real estate. IRC § 1031(a)(1). Real estate that is held primarily for sale to customers is not eligible, however, for LKE treatment, which may affect condo developers. IRC § 1031(a)(2). Although LKEs cannot normally be made for a partnership interest, the Act clarified that if a partnership elected out of Subchapter K (that is, the partnership is not treated as a partnership for tax purposes), then the partnership interest is treated as ownership of the underlying assets of the partnership, and LKE treatment can apply if those assets are real estate. IRC § 1031(e). As a result, the LKE technique will continue to be a valuable option when real property is to be sold. The one caveat is that the portion of the real estate that includes personal property (for example, kitchen appliances in an apartment building) may no longer get LKE treatment.

Technical Termination Rule Terminated

Under pre-Act law, a partnership was deemed terminated for tax purposes if, within a 12-month period, there were sales or exchanges of interests in a partnership that equaled or exceeded 50% of the total interest in partnership profits and capital. IRC § 708(b)(2) (as in effect before the Act). A new partnership was then deemed formed. This rule would cause the new partnership to treat its depreciable property as newly acquired. In that case, the time period for depreciating partnership assets was extended, and thus the annual depreciation deduction was reduced. IRC § 168(i)(7).

The Act eliminates this partnership termination rule. Tax Act § 13504. Many partnership or LLC operating agreements contain prohibitions on transfers of partnership interests that could have caused a technical termination. Those clauses may need to be amended to allow for flexibility to transfer partnership interests.

Business Losses, NOLs, and Tax Credits

Real estate investors have had to live with the passive loss rules and the at-risk rules, which can affect their ability to use tax losses. IRC §§ 469, 465. The Act adds a new hurdle to use of business losses, which is not limited to real estate. Business losses of individuals in excess of $500,000 for married filing jointly taxpayers (or $250,000 for other taxpayers) are not allowed. IRC § 461(l) (these amounts are adjusted for inflation starting in 2019). Excess business losses are carried forward to the next year as part of the taxpayer's net operating loss (NOL) carryforward and subject to new NOL restrictions discussed below. This limitation is applied at the partner level. IRC § 461(l)(4).

NOLs can be valuable in the real estate and commercial world. The Act restricts NOL carryovers generated in taxable years beginning after 2017 to offset only 80% of a taxpayer's taxable income; carryovers of pre-2018 NOLs are not limited by this rule. Generally, all carrybacks are repealed. Carryforwards would be allowed indefinitely; the current 20-year limit is repealed.

The low-income housing tax credit remains after the Act, but the new markets tax credit is now gone. As a result, affordable housing, but not community development, still gets a helping hand from the tax law. The rehabilitation tax credit remains, but only for historic buildings; the available 20% credit is no longer given in one year but is now stretched over five years. IRC §§ 47(a)(2), (c)(1). Rehabilitating older properties that are not historic will no longer be eligible for this credit.

Leasehold Improvements

Before the Act, qualified leasehold improvements along with qualified restaurant property and qualified retail improvement property (collectively called "leasehold improvements") could be depreciated over a 15-year period. IRC § 168(e)(3)(E) (as in effect before the Act). A qualified leasehold improvement is an improvement made to the interior portion of a nonresidential building, made under a lease between unrelated parties, and made more than three years after the building was first placed in service. IRC § 168(k)(3) (as in effect before the Act).

The Conference Report indicated that the Act was simplifying the tax treatment of improvement property while retaining the 15-year recovery period. H.R. Rep. No. 115-466, at 367 (Dec. 15, 2017) (the Conference Report states, at 367, the Act provides a "15-year MACRS recovery period for qualified improvement property"). But the Act inadvertently eliminated the 15-year recovery period for leasehold improvement property, which then mandates use of a 39-year recovery period. A technical correction bill can fix this glitch, but that may be hard to achieve soon in politically divided Washington. Although the IRS may fill the gap and state that improvements can be written off over 15 years, this pronouncement may be difficult for an agency charged with applying the law as written, and so one should not assume that it will be made.

The Act caused this problem by first amending IRC § 168 to eliminate reference to qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property. The goal was to then consolidate those three concepts into a single term, qualified improvement property (QIP), and assign a 15-year recovery period for QIP. The drafters unfortunately forgot to include reference to QIP as 15-year property in IRC § 168.

Carried Interests: A Viable Planning Tool Continues

The grant of carried interests in a partnership has been a long-standing, tax-favored way to reward sponsors, managers, developers, and other service providers involved in the creation and syndication of real estate or investment partnerships. The carried interest can be granted tax-free as long as it is only an interest in future partnership profits and not existing partnership capital and if it meets other requirements. See Rev. Proc. 93-27, Rev. Proc. 2001-43, and Notice 2005-43.

The Act changes the treatment of carried interests in a very limited manner. For the owner of a carried interest, the holding period for long-term capital gain treatment for a sale of the carried interest or a sale of the underlying partnership assets is increased from more than one year to more than three years. IRC § 1061(a). This change affects only the owner of the carried interest and does not affect any other partner. Because real estate is often held for more than three years before it is sold, this change should not affect many carried interest holders.

IRS clarification is also needed for this change. The IRS has indicated that an S corporation receiving a carried interest is subject to these rules. Notice 2018-18. C corporations holding carried interests are not, however, affected by the new law. IRC § 1061(d) provides that when carried interest is transferred to a related person, income recognition may occur. IRS guidance is needed to determine when and how such income may result.

Foreign Investment in U.S. Real Estate Aided

Many foreign investors use U.S. blocker corporations to own U.S. real estate in order to reduce or eliminate direct exposure to U.S. taxes. These corporate blockers can now benefit from the new 21% corporate tax rate. This 21% tax rate on a sale of real estate makes taxation on the corporate transfers almost comparable to the 20% long-term capital gains tax rate that individuals can use, and for operating income the corporations pay a much lower tax than individuals, even taking into account the new 37% maximum individual tax rate.

The portfolio interest exemption is a valuable tool that allows interest paid to many foreign investors to be paid free of any U.S. withholding tax. IRC §§ 871(h), 881(c). The Act leaves the portfolio interest exemption untouched, so foreign money can continue to be lent to finance U.S. real estate projects without incurring U.S. tax.

Reduced Tax Assistance for Single-Family Home Ownership

In the past, the tax law has been very supportive of single-family home purchases. The tax deduction for real property taxes and home mortgage interest (subject to certain limits) has assisted in making home ownership a reality and not just a dream for many Americans.

The Act reduces that support. The deduction for real property taxes and state and local income and sales taxes cannot exceed $10,000. IRC § 164(b)(6). The Act retains the deduction for interest on acquisition indebtedness but only for interest on up to $750,000 of acquisition indebtedness ($375,000 for a married person filing a separate return). A grandfather rule is provided for mortgages of homes that a taxpayer already owns. The Act repeals the mortgage interest deduction on home equity loans. IRC § 163(h)(3)(F).

The Act adds a higher standard deduction: $24,000 for a joint return or a surviving spouse; $18,000 for an unmarried individual with at least one qualifying child; or $12,000 for single filers. IRC § 63(c)(7). The effect of this higher standard deduction is that itemizing tax deductions may not be worthwhile for millions of Americans who may then be less motivated to buy rather than rent a home.

Conclusion

The bottom-line assessment is that the real estate industry (other than residential home sales) is generally treated well under the Act. The IRS must now implement these new rules by issuing new regulations or other guidance. Most importantly, taxpayers need to fully understand these rules, so they can take full advantage of opportunities and avoid pitfalls; documents may also need to be updated. The 2018 year should be busy for all as we continue to digest the 2017 Tax Act. n