

# TAX LAW CHANGES IMPACTING REAL ESTATE OWNERS, DEVELOPERS, AND INVESTORS

Tax Alert March 8, 2018

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act") into law. The Act provides the most sweeping change to the U.S. federal income tax laws in decades and will impact taxpayers engaged in the real estate industry. This alert provides brief answers to some of the important questions we are being asked by real estate owners, developers, and investors concerning the Act and the new partnership audit rules that apply beginning with the 2018 tax year.

#### Should I change my structure?

Although the federal tax rate for corporations was permanently reduced to 21%, the choice of entity for businesses owning real estate generally continues to be an entity taxed as a partnership, such as an LLC or LP ("tax partnerships"). Among other reasons, tax partnerships are subject to only one level of tax (at the owner level), the partners are permitted to increase their tax basis, *i.e.*, investment for tax purposes, by their share of partnership liabilities, and tax partnerships may adjust the basis of entity assets in certain circumstances, including death of a partner. These benefits significantly outweigh the reduced corporate tax rate in most cases; however, corporate ownership of interests in tax partnerships or related management companies may make sense in certain situations.

Key takeaway: While a change from a tax partnership owning debt-financed, depreciable real estate to a corporation generally is not advantageous, a prompt review of the structure of such entity, related management company, or holding company may be beneficial to determine whether restructuring in 2018 may improve your ability to take advantage of the provisions in the Act described below.

# What's the new pass-through deduction?

New Code section 199A provides a 20% deduction for an individual's domestic "qualified business income" from a partnership, S corporation, or sole proprietorship, which reduces the maximum effective tax rate on such income to 29.6%. Income from the development and rental of real property generally should qualify for the deduction. For owners of such businesses with taxable income exceeding \$315,000 (joint filers) or \$157,500 (other filers), the 20% deduction cannot exceed the greater of (1) 50% of the W-2 wages of the business allocable to the owner or (2) 25% of the W-2 wages of the business plus 2.5% of the unadjusted tax basis of qualified property

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of the business allocable to the owner. Thus, owners of a business with no employees can still benefit from the deduction, so long as the business has invested in a sufficient amount of qualified property.

Key takeaway: Optimize your structure to maximize the benefit of this deduction.

# How did the business interest expense limitations change?

Net business interest deductions generally are limited to 30% of a taxpayer's adjusted taxable income. The limitation, however, does not apply to taxpayers with average annual gross receipts of \$25 million or less for the three-taxable year period ending with the prior tax year. In addition, taxpayers in the real estate industry, real property development, construction, rental, management, leasing or similar businesses, may elect out of this limitation.

If a real estate business elects to be excluded from the interest deductibility limitations, it must utilize the ADS recovery periods with respect to its residential rental property, nonresidential real property, and qualified improvement property, which requires a recovery period of 40 years for nonresidential real property, 30 years for residential rental property, and 20 years for qualified improvement property.

Key takeaway: Analyze whether the benefit of electing out of the interest deduction limitations, if applicable, exceeds the impact to depreciation.

# What are some other notable changes?

- <u>Net operating loss deductions</u>: limited to 80% of taxable income for any taxable year. The two-year carryback of NOLs is no longer available to most taxpayers; however, NOLs no longer expire after 20 years but will be carried forward indefinitely to future tax years.
- Excess business losses: disallowed for a taxable year and must be carried over as part of that taxpayer's net operating loss. This will limit a taxpayer's ability to use losses from a non-passive business activity to offset other sources of income. "Excess business losses" are defined as losses attributable to the taxpayer's trades or businesses in excess of \$500,000 (joint filers) or \$250,000 (other filers).
- Code section 1031: only like-kind exchanges of real property entitled to non-recognition of gain treatment.
- <u>Rehabilitation tax credit</u>: limited to certified historic structures for amounts paid or incurred after 2017. Although the credit for certified historic structures remains at 20%, it must be claimed ratably over a five-year period beginning in the tax year in which the qualified rehabilitated structure is placed in service.
- Bonus depreciation: expanded to provide for 100% immediate expensing of the cost of certain assets placed into service after September 27, 2017 and before January 1, 2023. A real property business's ability to use this will be limited, as land and buildings are not eligible for bonus depreciation; however, certain improvements to the interior of nonresidential real property may be eligible.
- Section 179 expensing: limit expanded to \$1 million and the phase-out amount increased to \$2.5 million, both indexed for inflation. The definition of eligible qualified real property also was expanded to include certain improvements to residential real property (e.g., roofs; heating, ventilation, and air condition; fire protections and alarm systems; and security systems).



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# How have audits of partnerships changed?

With the focus on tax reform, the substantial changes to the partnership audit rules have taken a back seat. However, because these changes apply to tax years beginning after December 31, 2017, they should not be overlooked. Under these rules, the IRS will conduct examinations of entities taxed as partnerships, such as LLCs and LPs, and make adjustments at the partnership level (rather than the partner level), and the partnership (and indirectly current year partners) will pay the tax, interest and penalties on any underpayments related to prior year adjustments.

These examinations will be handled by a "Partnership Representative" who is granted broad authority to resolve any partnership audits and make decisions binding on all of the partners. If a partnership fails to appoint a Partnership Representative, the IRS has the authority to appoint the Partnership Representative. An opt-out election for some partnerships with 100 or fewer partners may be available; however, many partnerships whose partners include any trust, LLC, or other partnership are not eligible for this election. In addition, it may be possible to make an election to shift the burden of any adjustment from current year partners to partners who held a partnership interest during the year of examination.

Key takeaway: Partnership agreements need to be reviewed and revised to address the appointment of a Partnership Representative and how prior year adjustments will impact current year partners.