BURR ALERT 2018

The "Real Dirt" Tax Reform and the Real Estate Industry

By Jim McCarten and Scott G. Miller January 2018

Just prior to 2017 year end, Congress passed tax legislation that legislators and tax pundits alike describe as the most significant overhaul of the Internal Revenue Code since the 1986 Tax Act championed by President Ronald Reagan. President Donald Trump signed that legislation into law shortly thereafter. It is not surprising that tax professionals are feverishly at work analyzing the impact of the Tax Cuts and Jobs Act of 2017 ("TCJA") on clients and industries. Similar to the 1986 Tax Act, expect the TCJA to significantly impact real estate businesses. However, that impact likely will be the exact opposite of the industry impact of the 1986 tax legislation.

A Brief Summary of the TCJA Provisions Affecting All Businesses

Many businesses view the recent tax reform positively in terms of development for the U.S. economy and businesses. While certain expenses may no longer be deductible, most corporations favor trading the loss of those deductions in exchange for a maximum corporate tax rate of 21% (down from 35%). Additionally, if the business is organized as a *pass-through* tax entity (where the tax on business income is paid by the owners and not the operating company), trading the loss of deductions in exchange for a reduction in the effective Federal income tax rate imposed on the business income passing through to the owners of approximately 10% to 12% (from a maximum rate of nearly 40% to something closer to 30%, perhaps even less) is a significant benefit. Most of the rate reduction for pass-through entities comes from the new 20% qualified business income deduction (which is discussed in more detail below). Generally, the real estate industry benefits just like any other business from the tax rate reductions even before considering those provisions of the TCJA which specifically impact real estate businesses.

Digging a Little Deeper on the 20% Qualified Business Income ("QBI") Deduction

For the owners of and investors (including trusts and estates) in real estate businesses, the new 20% QBI deduction will require an analysis of the legal structure of their related entities. For business reasons, as well as income tax planning purposes, owners of real estate often utilize legal structures in which most of the employees receive compensation from a single operating entity, with individual projects and properties owned in separate pass-through entities. This typical structure now may limit the benefit of this new tax deduction.

The QBI deduction is calculated on a business-by-business basis. Accordingly, the QBI deduction must be "earned" by real estate owners and investors. Once a real estate pass-through entity's owner reaches the income threshold amount ($315,000 for married couples filing jointly) plus an additional phase-in amount ($100,000 for married couples filing jointly), the QBI Deduction is limited to the lesser of 50% of the W-2 wages paid by the entity or 50% of the company's W-2 wages plus 2.5% of the value of the depreciable property held by the company. If the limitation applies and no W-2 wages have been paid by the pass-through entity, the deduction is severely reduced if not

unavailable. As a result, real estate companies which have the majority of their employees in a single operating entity likely ought to revisit their legal structure.

Further, the existing legal structure is not the only item to be examined in light of the new tax law. Many real estate companies likely should review their chosen method of employee compensation. For example, the QBI Deduction excludes amounts paid by an S corporation to an owner as reasonable compensation. The deduction also excludes guaranteed payments to a partner in a partnership and any amounts paid to a partner acting in a capacity other than as a partner. Therefore, rather than using "profits interests" or other equity to reward key employees, it may be preferable for real estate businesses to pay more in wages and/or bonuses to increase the QBI deduction available (by increasing the limitation amount).

The Limitation on Interest Deductions

Pursuant to the new tax law, the deduction for business interest is now limited to a percentage of the company's earnings before interest, tax, depreciation and amortization ("EBITDA"). Prior law allowed for full deductibility. For tax years beginning after 2017 and before 2022, the interest deduction is limited to 30% of EBITDA. After 2021, the limitation expands to 30% of the taxpayer's earnings before interest and tax. A small business exception to the limitation applies when the taxpayer's average annual gross receipts for the current and two prior taxable years do not exceed $25 million. Finally, real estate companies can elect out of the interest limitation rules so long as the interest is incurred in real property development, redevelopment, construction, acquisition, conversion, rental, operation, management, leasing or brokerage trades or businesses. Interestingly, the election out is also available to entities operating or managing lodging facilities (e.g., hotels, motels and similar properties where more than one-half of the units are used on a transient basis). Like the QBI deduction's wage limit, the business interest limit applies at the entity level. Once elected, such election is irrevocable. Further, any interest disallowed carries forward indefinitely. The IRS is to issue guidance on the process of electing out of the interest limitation.. The election also requires the entity making it to use the alternative depreciation system (ADS) on all non-residential real property, residential real property and qualified improvement property.

Other Important Changes

In addition to the major changes noted above, 2017's TCJA contains a number of other changes which will impact real estate businesses and their owners.

- The Alternative Minimum Tax ("AMT"). As part of the focus on making U.S. business more competitive, the new tax law repeals the corporate alternative minimum tax. Unfortunately for individuals, including those owners and investors in real estate companies structured as S corporations, partnerships and/or LLC's, the AMT calculation remains, but with an increased exemption amount of $109,400 for married couples filing jointly. The exemption phases out when an individual taxpayer's alternative minimum tax income exceeds $1 million for married couples filing jointly ($500,000 for individual taxpayers). Trusts and estates are also subject to the AMT.

- Corporate Net Operating Losses ("NOLs"). The TCJA limits the deduction for NOLs to 80% of the corporation's taxable income while generally disallowing the ability to carryback NOLs. However, NOLs can be carried-forward indefinitely.

Partnership Changes. 2017's tax reform includes several partnership tax changes that impact real estate companies treated as partnerships for tax purposes.

- Technical Terminations of Partnerships. The rule providing that a technical termination of a partnership occurs whenever 50% or more of the interests in both profits and capital are transferred during any 12 month period is repealed. With the elimination of technical terminations, partnerships and LLCs whose agreements prohibit transfers that could result in a technical termination likely should review whether prohibiting such transfers still makes business sense.

- Changes Impacting Carried Interests. Now known as "applicable partnership interests," carried interests must now be held for three years to be eligible for long-term capital gain treatment upon sale or redemption. This new provision covers partnership interests when the partnership conducts its business activities on a regular, continuous and substantial basis, and those activities consist of: raising or returning capital, and either developing, or investing in or disposing of (or identifying for investing or disposition) "specified assets," a term which includes securities, commodities, real estate held for rental or investment, or cash or cash equivalents. If the partnership interest in question is a capital interest (e.g., one that provides the partner with the right to share in partnership capital upon receipt or vesting), it escapes treatment as an applicable partnership interest.

Changing Real Estate Depreciation Deductions. In addition to the changes covered above, the TCJA also changes certain depreciation calculations impacting real estate businesses.

- Bonus Depreciation. As modified by the TCJA, the bonus depreciation rules of Code Section 168(k) now provide that 100% of the cost of depreciable property placed in service after September 27, 2017 and before January 1, 2023 can be expensed without limitation. However, bonus depreciation is phased out over five years beginning January 1, 2023 in a manner which results in a 20% reduction in the amount which can be expensed each year. Another beneficial modification to bonus depreciation is that property is no longer required to be "original use" property in order to qualify for bonus depreciation.

- Expanding the Depreciable Life of Certain Property. The trade-off when the election for the full deduction of all business interest expense is utilized is an increase in the ADS recovery periods for non-residential depreciable real property (pushing its depreciation period to 40 years), residential depreciable real property (recoverable over 30 years after an election) and qualified improvements (which are recovered over 20 years).

- Like-Kind Exchanges. The availability of like-kind exchanges is limited by the 2017 act. Only real property not held as inventory is eligible for like-kind exchange treatment; tangible and intangible personal property no longer qualify.

The Industry Verdict. Overall, it appears that real estate businesses, owners and investors fare favorably as a result of 2017's tax reform. However, the usual caveat applies to our discussion of tax reform's impact on real estate businesses. Each taxpayer should consult with its own tax advisor/professional in order to make sure that the business, its owner(s) and investors properly understand these new rules and appropriately analyze the unique circumstances of each Especially when evaluating what is the most tax effective legal structure.

If you would like more information on the real estate changes identified above, to discuss the application of any of those concepts to you or your business, or if you want more information on any other tax matter, please feel free to contact any of the following tax or real estate lawyers directly:

Burr's Tax Team:

- Ed Brown and/or Jim McCarten in Atlanta at (404) 815-3000;
- Jim McCarten, Josh Ehrenfeld, Tucker Herndon or Maureen Beaver in Nashville at (615) 724-3200;
- Allen Sullivan or Bruce Rawls in Birmingham at (205) 251-3000;
- Warren Matthews in Montgomery at (334) 241-7000; and
- Scott Miller in Orlando at (407) 540-6600.

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- Doug Anderson, Patrick Clarke, Robert Matthews or Charles Tait in Mobile at (251) 344-5151
- Lindsey Arnold, Madison Conquest, Tucker Herndon or John Rogers in Nashville at (615) 724-3200;
- Jeff Baker, Damon Denney, Ronald Farley, Heather Lee, Gail Mills, Dwight Mixson, Norman Orr, Jay Price, Melinda Sellers, George Taylor, Donald Warren, Andrea Weed or Callie Whatley in Birmingham at (205) 251-3000;
- Scott Brown or Scott Steady in Tampa at (813) 221-2626;
- Chip Collins, Gary Farris, Tully Hazell, Erin Hewitt, Rocky Horde, Bill McKenzie or Kelly Waits in Atlanta at (404) 815-3000;
- Douglas Gartenlaub, Lisa Geiger, Vivien Monaco, Jim Pratt, Rob Rosen or Keith Waters in Orlando at (407) 540-6600.
- B.J. Ibach, Timothy May or Chris Strohmenger in Jacksonville at (904) 232-7200.

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