Navigating the Swamp: Tax Reform Impact on Commercial R.E.

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Don counsels business owners and corporations in areas of commercial real estate, M&A, tax litigation, entity selection and organization, and tax and business planning. He assists clients in structuring, negotiating, documenting and closing transactions. Don works closely with businesses on federal, state and local tax matters including incentive opportunities.

Clay Stoker is a senior manager in the firm’s timberland and real estate investment practice. He serves as an advisor to domestic and international investment funds that hold alternative assets such as timberland and real estate. He assists fund managers in tailoring investment structures to accommodate their investors, advises on offering documents and LPAs and provides federal, state and international tax planning and compliance throughout the term of the investment. He has strong experience in structuring investments within a REIT structure, advising fund managers on waterfall provisions in an LPA, tax issues such as UBIT and effectively connected income and works closely with management on buy/sell transactions.

Clay has significant experience with multi-state partnerships, public and private REITs and other blocker corporations that hold assets of institutional investors from around the globe.
The Real Estate Industry was a net winner under the **Tax Cuts and Jobs Act**:  

1. **The 100,000-foot View**: New Brackets, Standard Deduction, New Brackets & Mtg. Rule (Clay)  
2. SALT and the **Property Tax Rule** (Don)  
3. **Pass-Thru Entity** favorable to Real Estate industry. (Clay queue-up / Don close)  
4. **Interest Limitation** election structured for High-Leverage industries - auto & R.E. (Don)  
5. **Depreciation and ADS** – Alternative Depreciation System for Real Estate (Clay)  
6. **Expensing** (Clay)  
7. **Losses**: New Active Loss & 80% NOL Rule (Don)  
8. **1031 Exchange** left alone for the most part – It survived. (Don)  

**Pros and cons of the new tax law for real estate owners**  

#1: Summary of Provisions: The 100,000 Ft. View (Clay)

<table>
<thead>
<tr>
<th>Area</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brackets and rates</td>
<td>Seven tax brackets—10, 12, 22, 24, 32, 35, and 37 percent. The top individual rate of 37 percent will apply at incomes of $500,000/$600,000.</td>
</tr>
<tr>
<td>Brackets and rates for estates and trusts</td>
<td>Condenses the number of tax brackets from seven to four, including 10, 24, 35 and 37 percent brackets</td>
</tr>
<tr>
<td>Alternative minimum tax</td>
<td>Retained with higher exemptions ($70,300/ $109,400); phase-out of exemption increased to $500,000/$1,000,000</td>
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<tr>
<td>Standard deduction</td>
<td>Doubles to $12,000/$24,000; retains additional deduction for blind and elderly</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>Limits to interest on $750,000 of indebtedness on newly purchased principal and second residences incurred after Dec. 15, 2017; not allowed for home equity loans.</td>
</tr>
</tbody>
</table>
Summary of Tax Bill from 100,000 feet

The actual legislation – from 100,000 feet!

- Cuts $1.5 trillion of taxes over the next 10 years
  - 3.5 percent of otherwise expected federal revenues
  - But not everyone gets a simple 3.5 percent tax cut

Who gets a tax cut? Individuals vs business

- 56 percent of the tax cuts go to individuals
- 44 percent of the tax cuts go to business

Revenues in 2016

<table>
<thead>
<tr>
<th>Revenue Category</th>
<th>Billions of Dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Income Taxes</td>
<td>$1,546 Billion</td>
</tr>
<tr>
<td>Payroll (Social Insurance) Taxes</td>
<td>$1,115 Billion</td>
</tr>
<tr>
<td>Corporate Income Taxes</td>
<td>$300 Billion</td>
</tr>
<tr>
<td>Other</td>
<td>$306 Billion</td>
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</tbody>
</table>
State and Local Tax Deduction

- The Act provides that individual taxpayers may elect to deduct state and local sales, income, or property taxes up to $10,000 ($5,000 for a married taxpayer filing a separate return) for tax years 2018-2025.

- State and local tax deductions incurred in a business activity (Schedules C and E) are not limited.

- Look for states to create programs, such as the Alabama scholarship program, which permit dollar-for-dollar credits against state income taxes, where such payments are classified as charitable contributions for federal income tax purposes.

- Other approaches may include employer-level tax arrangements.

- Look for IRS scrutiny over techniques to avoid these limitations.
#3: Pass-Thru Entity: (Clay & Don)

Pass-Through Entities – 20% Deduction – Section 199A

- For tax years 2018-2025, taxpayers who have domestic “qualified business income” (QBI) from a partnership, S Corporation, or sole proprietorship are entitled to deduction of the lesser of such QBI or 20% of taxable income. The deduction reduces taxable income, not adjusted gross income, and eligible taxpayers are entitled to the deduction whether or not they itemize. Further limitations to the 20% deduction apply.

- Taxpayers with pass-through income from specified service businesses in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and other businesses where reputation and skill of owners or employees are the principal asset of the business are not eligible for the full deduction if taxpayer’s overall taxable income levels exceed $315,000 (MFJ).

- REIT income is not generally subject to limitations.
#4: Interest Limitation: (Don)

Limitation on Business Interest Expense Deduction – Section 163(j)

- The Act limits the deduction for net interest expenses incurred by a business to the sum of business interest income, 30% of the business’s adjusted taxable income (EBITDA until 2021, then in 2022 EBIT is used), and floor plan financing interest.

- Businesses with average annual gross receipts of $25 million or less are exempt from the limitation. Disallowed interest could be carried forward indefinitely.

- The Act allows real property trades or business that use the ADS and farming businesses to elect not to be subject to the business interest deduction limitation.
#5 & #6: Depreciation & Expensing: (Clay)

Ultimate changes to depreciation complex and hard to analyze at this point, but generally speaking –

- Basic, pre-bonus depreciation rules, viewed as non-economic by some, remain in baseline
- 100 percent bonus depreciation through 2022, then phased out through 2026. Applies to new and used property acquired
- $1 million permanent expensing under section 179, subject to limitations and phase-outs
- Changes to real property depreciation complex and may depend on choice of whether to apply business interest limitations
1031 Exchanges (Limited to Real Property)

- Under prior law, no gain or loss was recognized to the extent that property held for productive use in the taxpayer's trade or business, or property held for investment purposes, was exchanged for property of a like-kind that was also held for productive use in a trade or business or for investment.

- **The Act limits 1031 exchanges to real property** that is not held primarily for sale. Grandfathering is provided for 1031 exchanges in progress on January 1, 2018.

- Personal property no longer eligible for 1031 exchange treatment (vehicles, equipment, aircraft, etc.). However, new expensing rules may potentially mitigate the effect of this provision.
#8: Losses: (Clay)

NOL Deduction – Section 172

- The Act limits the NOL deduction to 80% of taxable income and provides that amounts carried to other years be adjusted to account for the limitation for losses arising in tax years beginning after December 31, 2017.

- NOLs of property and casualty insurance companies may be carried back two years and carried forward 20 years to offset up to 100% of taxable income in such years.

- The Act eliminates carrybacks (except for farming NOLs, which would be permitted a two-year carryback) and allows most other unused NOLs to be carried forward indefinitely.

- Effective for tax years beginning after December 31, 2017, the Act disallows an excess business loss of a taxpayer other than a C Corporation. However, an excess business loss is treated as part of the taxpayer’s net operating loss carryover to the following year. An excess business loss for the tax year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount ($500,000 for married taxpayers filing jointly; $250,000 for all other taxpayers (indexed for inflation)). The limitation applies at the partner or S Corporation shareholder level. The limitation expires after December 31, 2025.
Thank you!