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"Impact of Tax Cuts and Jobs Act Provisions on Commercial Real Estate"

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The new tax act signed into law on December 22, 2017, known as the “Tax Cuts and Jobs Act” (“TCJA, represents the most sweeping changes to the federal income tax law since the passage of the Tax Reform Act of 1986. This article highlights aspects of some of the key provisions that affect the commercial real estate business and the need to clarify some of the ambiguous provisions; it is not intended as a comprehensive analysis of these complex provisions. This article does not discuss the impact of these provisions on REITs**.**

I 20% Pass-Through Deduction: New section 199A, known as the Qualified Business Income Deduction or the 20% Pass-Through Deduction, represents the most significant change for real estate owners. It may allow an individual who owns real estate through a pass-through entity (“PTE”) – a partnership, LLC (including a single-member LLC), or S corporation as well as others **–** a deduction of up to 20% of his or her share of the PTE’s Qualified Business Income (“QBI”). QBI represents the PTE’s taxable income excluding capital gains, interest and dividends, as well as certain compensation paid to the owners. The deduction is available to non-corporate taxpayers, whether they are active or passive.

If the full 20% deduction is available, it will have the effect of reducing the taxpayer’s maximum effective income tax rate (highest marginal effective tax rate) on his flow-through income from 37% to approximately 29.6% (a 20% reduction from the 37% rate). However, some taxpayers who have an ownership interest in a PTE that owns real estate will be entitled only to a limited deduction or even no deduction.

The amount of the deduction that is available to the individual taxpayer depends on his or her total taxable income from all sources including QBI. If the taxpayer’s income falls below the threshold - $317,000 for joint filers or $157,500 for single filers - the taxpayer is entitled to the full 20% deduction. The deduction phases out at $417,000 and $207,5000 for joint and single filers, respectively.

If the taxpayer’s total income exceeds the phase out, then the deduction may be limited. In that case, the deduction will be available only if the business meets certain wage and asset-based limitations. For most real estate properties, the asset-based limitation is more likely to result in a meaningful deduction. The amount equals 2.5% of the taxpayer’s share of the business’s unadjusted tax basis in depreciable property. Assuming the PTE does not pay wages to employees, the deduction is equal to the lesser of the taxpayer’s share of (1) 20% of QBI or (2) 2.5% of the unadjusted depreciable basis.

For example, consider a single-member LLC that acquires a building for $10 Million, of which $5 Million represents land basis and $5 Million represents the building’s basis. The building’s annual rental income equals $750,000 and no wages are paid to employees. The maximum 20% deduction would equal $150,000. Based on the depreciable basis limitation, the deduction is limited to $125,000 (2.5% x $5 Million). If instead, the building’s basis allocation were $6 Million, then the full $150,000 deduction would be available (2.5% x $6 Million).

The amount of the deduction available to two taxpayers, each owning 50% of a PTE that owns an apartment building, might differ dramatically. If the taxable income of partner A is less than $317,000 and partner B’s income exceeds $417,000, A would be entitled to his share of the full 20% deduction irrespective of the building’s basis, and B’s deduction would be limited to 2.5% of his share of the PTE’s tax basis in the building, but not to exceed his share of 20% of QBI.

The deduction is based on the PTE’s “trade or business” income as defined by reference to the relatively obscure “Effectively Connected Income” rules of the Internal Revenue Code (the “Code”) applicable to certain foreign taxpayers. Based upon some interpretations of these rules, an entity that owns a building leased to tenants under a triple net lease might not qualify as a trade or business, especially if it does not provide significant management services. Thus, if that standard applied, the income would not constitute QBI because the income would not be derived from a "trade or business." Accordingly, no deduction would be available even though the property is depreciable.

The trade or business requirement creates the possibility for owners of another type of business line to avail themselves of the deduction – a condominium project. Although a residential condominium building for which units are offered for sale is not depreciable property, an owner of the PTE might be entitled to a Section 199A deduction if his taxable income is less than the threshold because the sale of condominium units by a developer under existing law qualifies as inventory held for sale in a trade or business. Thus, the ordinary income derived from the sale of the units should qualify as QBI. However, any owner of the PTE whose taxable income exceeds the threshold would not be entitled to a deduction unless the PTE pays wages because the condominium units are not depreciable.

It appears that the deduction is separately calculated for each qualified business owned by a PTE based on its QBI and the wages-depreciable basis limits. Arguably, if a PTE owns a fully-depreciated, older building with a high QBI, and another new building (high basis) with low QBI, neither would generate a substantial 20% Pass-Through Deduction viewing each building on its own. However, if the two buildings' QBI and depreciable basis could be aggregated, a substantial tax basis supporting a deduction might exist. Generally, subject to a limited 10-year exception, if the building is fully depreciated its basis does not count towards the deduction.

On the other end of the spectrum, a PTE that owns vacant land and constructs a building might not qualify for the deduction. The basis that counts towards the deduction is the depreciable property's "unadjusted basis immediately after [its] acquisition." This means that the property's original basis is not reduced by any depreciation deduction. This rule is easy to apply to the acquisition of an existing building. However, unless the construction of a building after a land acquisition is construed to be a separate asset acquisition for these purposes, the PTE's basis in the new building would not count. If the taxable income of the owner of the PTE were less than the threshold, he would qualify for the deduction because at that level the deduction is not dependent upon the PTE's basis in the property. In contrast, if his income exceeded $417,000, he would not be entitled to the deduction if the depreciable basis did not count. Given that the depreciable basis alternative was added during the Conference Committee session to expand the use of the deduction by real estate owners who would otherwise be phased out, it would not be surprising if IRS takes a liberal view of the activities that qualify. Alternatively, to utilize the deduction, the PTE might consider a sale or transfer of the completed building to a related entity or third party.

It appears that capital gain from the sale of real estate by a PTE will not give rise to the pass-through deduction because capital gains are excluded from the QBI calculation. Some might argue that gain on the sale of Section 1231 property – real estate used in a trade or business and held for more than one year – will generate the deduction because under the Code the property is not a "capital asset." However, this seems to be a stretch since under Section 1231 the gain on its sale is "treated as" long-term capital gain. Similarly, it appears that the depreciation recapture component should also not count towards the deduction because the 25% flat tax is imposed under Section 1(h) on the relevant part of the "net capital gain."

II **New Limits on Business Interest Expense Deduction**: New Section 163(j), applicable to both PTEs and corporations, imposes new limits on the deduction of business interest. In general, the deduction is limited to the sum of 30% of Adjusted Taxable Income.

However, the provision has two important exceptions. It exempts any taxpayer with average annual gross receipts of less than $25 Million for the previous three years; however, it requires aggregation among entities under common control. In addition, it allows "real property trade or businesses" to elect not to be subject to the limitation. For these purposes, the broad definition already contained in the Passive Activity Loss rules applies.

The tradeoff for electing out is the requirement that slightly longer depreciation recovery periods apply, thereby decreasing the annual depreciation deduction. For commercial property, the period is generally extended from 39 years to 40 years (or 2.5% of depreciable basis per year vs. 2.6%) and for residential rental property, the period is extended from 27.5 years to 30 years (or 3.6% per year vs. 3.3%). In addition, it appears that the deduction for qualified interior improvements to nonresidential rental property would have been extended from 15 to 20 years. However, due to a legislative drafting oversight, this provision will not be clear until Congress adopts technical corrections. Furthermore, the electing business will not be eligible for bonus depreciation or the newly expanded provision to allow the immediate expensing of "qualified property," including certain improvements to nonresidential real property including roofs and HVAC systems.

It is anticipated that many real property owners that are highly leveraged will conclude that the incremental interest expense deduction will exceed the reduced depreciation expense and thus, file the election to avoid the limitation. The limitation applies to existing debt, but does not apply to investment interest expense or to capitalized interest, such as that incurred during the construction period.

III **Carried Interest**: The capital gains treatment of carried interest was a controversial issue during the 2016 Presidential campaign: both candidates vowed to correct this perceived abuse. Although the focus was carried interest in the hedge fund context, the promote is the equivalent in the real estate world. The promote entitles the developer (service partner) to a greater split of the profits – disproportionate to the capital contributed by the developer - after the preferred return is achieved.

Congress could have eliminated capital gains treatment by simply changing the characterization of the income allocable to the promote to ordinary income to reflect its true character as compensation for services. Instead, new Section 1061 merely extends the holding period requirement from one year to three years for long-term capital gains treatment to apply to the service partner's promote. The holding period applies to the underlying property and apparently to the service partner's interest.

Despite this change, the developer's promote will continue to enjoy capital gains treatment in many real estate joints ventures. The required three-year holding period is shorter than the typical life of a joint venture, especially one that develops property. In addition, a technical argument can be made that the new law does not apply to real estate used in a trade or business. Finally, note that the capital gains treatment generally has no applicability to a joint venture for the sale of condominium units because all income derived from condominium unit sales including the share allocated to the promote interest will be taxable as ordinary income under established tax law principles.

IV Conclusion: Tax experts might be looking to the IRS or Treasury Department for answers to questions relating to these and other changes introduced by the tax overhaul. However, the federal government will be challenged to release revised tax forms and regulations to address these issues in a timely manner in the face of budget cuts. Instead, the answers might await IRS audit and judicial interpretations. As an illustration of the controversy created by these favorable changes, the Wall Street Journal recently reported that one of the most respected tax lawyers at the Treasury Department, who would have been at the center of writing the regulations, abruptly resigned amid questions whether Congress could have truly intended to write such provisions.

This article highlights only some of the key provisions of the TCJA affecting commercial real estate. It demonstrates that while these provisions benefit commercial real estate, they certainly do not achieve tax simplification.

For a more comprehensive discussion of the new tax law's impacts on real estate, see **[https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-tax-reform-and-real-estate-impact-of-the-tax-cuts-and-jobs-act.pdf.](https://www.pwc.com/us/en/tax-services/publications/insights/assets/pwc-tax-reform-and-real-estate-impact-of-the-tax-cuts-and-jobs-act.pdf)**