

# The Impact of the New Tax Reform Legislation on Business Real Estate and Partnerships



The real estate industry was given some generous tax gifts in H.R. 1, originally called the Tax Cuts and Jobs Act (the Act), signed into law by the President on December 22. Special tax deductions allowed to certain partnerships investors were extended to investors in real estate partnerships. Ways to eliminate the impact of new limitations on deductibility of business interest expense were added, which aid the real estate investor. While Congress was not intentionally trying to aid foreign investors, the changes will also favorably affect foreign investors in U.S. real estate.

Carried interest is modified, but not in a way that will harm those granted in many real estate partnerships. Like-kind exchanges were eliminated, but not for real estate. Rehabilitation tax credits for pre-1936 buildings are gone, but they remain for historic properties. The new markets credit is eliminated, but not the low-income housing credit. The greatest harm to the industry may come with further limits on the itemized deductions for home mortgage interest and new limits on the deduction for real property taxes, which may dampen the home sales market.

As we enter the new year, the real estate industry can generally raise a glass and toast these major and generally helpful changes in the tax law. Below is a summary of the Act's impact on business real estate and partnerships.

## Favorable Partnership Income Deduction Extended to Business Real Estate Ownership

For investors in partnerships, S corporations or sole proprietors, the Act adds a new deduction equal to 20% of qualified business income (QBI). The deduction is subject to a Wage Limitation whose purpose was to make sure this deduction can only be used by partnerships that employ many people and create jobs. Many real estate partnerships employ very few people so this Wage Limitation effectively means that investors in real estate partnerships would have received little or no benefit from the 20% deduction.

Late in the legislative process, a change was made to the Wage Limitation to allow investors in many real estate partnerships to use this deduction. The Wage Limitation had earlier provided that the new deduction cannot exceed 50% of wages paid by the partnership. The final Wage Limitation now provides that the new 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 (but not land) can now justify claiming this new deduction.

For example, a partnership purchases a residential office complex for \$110,000,000; \$100,000,000 of the price is allocable to the building, which is depreciable property, and \$10,000,000 to land. The partnership has no employees with all its work being handled by independent contractors and their parties. The Wage 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: (\$100,000,000 x 2.5% = \$2,500,000). The amount of the limitation is \$2,500,000.

One stated rationale for this new addition was that jobs will be created with new construction. However, the rule does not require that only new construction is to be used in the Wage Limitation. Any purchase of depreciable property counts. The bottom line is the 20% deduction may now help investors in real estate partnerships.

## Ways to Eliminate New Limits on Interest Deduction for Real Estate Ownership

Leverage lies at the heart of most real estate investments. The Act adds new roadblocks to getting full use of interest deductions by providing that a taxpayer's net business interest expense deduction cannot exceed 30% of its adjusted taxable income (ATI). 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. In the case of a partnership, the limitation is determined at the partnership level, subject to certain adjustments. Any interest disallowed under this rule is carried forward indefinitely to use in the next year, but subject to this rule in that year.

Late in the legislative process, an election was added to eliminate application of this new limit. In order to take advantage of this election, the taxpayer must agree to depreciate its assets under the Alternative Depreciation System (ADS). While the ADS can significantly lower the annual depreciation deduction for personal property, its impact on real estate is more modest so this election may be a valuable option for the real estate investor.

To elect or not to elect, that is the question. Here are the relevant parameters: Commercial or residential real estate is depreciated on the straight-line basis under both the regular depreciation system and ADS. The recovery period for commercial real estate (e.g., an office building) is 39 years while the ADS period is a mere one year longer, 40 years. For newly acquired commercial property, the impact of ADS is to reduce annual depreciation by only 2.5%. The recovery period for residential real estate is 27.5 years while the Act reduced the ADS period from 40 years to 30 years. For newly acquired property, the impact of ADS is to reduce annual depreciation by 9%.

If the interest limitation may apply, a comparison with the impact of moving to ADS must be done to make the best choice. As a general rule of thumb, the election will usually be helpful for commercial real estate and may be helpful for residential real estate. One issue not addressed in the legislation is how to apply this election to an existing partnership. That issue will be one of many that the overworked Internal Revenue Service (IRS) will have to address in connection with the Act.

## Like-Kind Exchanges Alive While Real Estate Depreciation Left Alone

The Act's elimination of tax-free like-kind exchanges (LKE) does not apply to real estate. LKEs will thus remain as a valuable technique to dispose of real estate with little or no current tax. The LKE technique is especially valuable since any type of business or investment real estate can be exchanged for other business or investment real estate property. For example, a skyscraper in Manhattan can be exchanged for farmland in Iowa.

Despite the Senate's attempt to reduce the recovery period for real estate, the Act abandoned making any changes. While the Act allows for expensing the cost of new investments in qualified depreciable assets, those benefits do not apply to real estate. Nonetheless, the Act's decision to not allow for expensing for real estate gave the industry support for keeping real estate LKEs alive, which carried the day in the final legislation.

## Tax Credits: Pluses and Minuses

The low-income housing tax credit is untouched by the Act and remains as a valuable tool to assist construction of affordable housing. However, community development was dealt a blow by elimination of the new markets tax credit. The Act allows the rehabilitation tax credit to remain, but only for historic buildings and initially that will retain a 20% credit. Rehabilitating certain older properties will no longer be eligible for this credit.

## **Carried Interests: Still a Viable Planning Tool**

The grant of carried interests in a partnership has been a long-standing tax-favored way to reward sponsors, managers and other service providers involved in the creation and syndication of a real estate or investment partnership. 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; later, capital gains on the sale of partnership property flow through to the carried interest holder.

Over the last few years, there have been numerous bills introduced to end favorable treatment for carried interest. The Act changes the treatment of carried interests, but in a very limited manner. With respect to a carried interest, the holding period for long-term capital gain treatment for underlying assets held by the partnership would be increased from more than one year to more than three years. For the real estate industry where real estate is often held for more than three years before it is sold, this change will not harm many carried interest holders.

## **Foreign Investment in U.S. Real Estate: *Indirect* New Incentives**

The Act does not add any new rules specifically targeted to foreign investment in U.S. real estate. However, many foreign investors have U.S. real estate owned by U.S. blocker corporations to reduce or eliminate direct exposure to U.S. taxes. A 35% federal income tax was imposed on their operating income as well as their gain from a sale of real estate. These corporate blockers can now benefit from the new 21% corporate tax rate. On a sale of real estate, this 21% tax rate makes them almost comparable to the 20% long term capital gains tax rate that an individual can use, and for operating income they pay a much lower tax than individuals even taking into account the new 37% maximum individual tax rate. This new 21% corporate tax rate may spur further foreign investment in U.S. real estate.

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. 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. Under pre-Act law, the earnings-stripping rules often applied to limit the deduction for interest paid to a related foreign lender where a tax treaty or the portfolio interest exemption eliminated U.S. withholding tax on the interest paid to the lender. The Act's new interest limitation that applies to *all* debt (not just debt from a related foreign lender) replaces the earnings-stripping rules in Sec. 163(j). As discussed above, real estate investment may escape that new restriction if a slightly longer depreciation period is used. This is also an indirect benefit to foreign investors in U.S. real estate.

## **Net Operating Losses**

Net operating losses (NOLs) can be valuable in the real estate and commercial world. The Act allows NOL carryovers to offset only 80% of a taxpayer's taxable income for taxable years beginning after December 31, 2017. Generally, all carrybacks would be repealed. Carryforwards would be allowed indefinitely; the current 20-year limit is repealed.

## **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 a dream for many Americans.

The Act dampens that attitude. The deduction for real property taxes and state and local income and sales taxes cannot exceed

\$10,000. This new \$10,000 limitation will not permit full deductibility for both new and existing homeowners in many locales across the country. 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 with respect to homes that a taxpayer already owns. The Act repeals the mortgage interest deduction on home equity loans.

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. The impact 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. Fortunately, earlier proposals to limit the exclusion of gain up to \$500,000 on sale of a principal residence were not retained in the Act.

### **Partnership Technical Termination Rule Eliminated**

If within a 12-month period, there are sales or exchanges of interests in a partnership that equal or exceed 50% of the total interest in partnership profits and capital, then the partnership is deemed terminated for tax purposes. This hyper-technical rule can serve to reset the clock for depreciating the partnership's assets, which can lower the annual depreciation deduction and increase a partner's tax bill. The Act eliminates this rule.

### **The Takeaway**

The bottom-line assessment is that the real estate industry (other than residential home sales) is breathing a sigh of relief, and there is actually some joy in looking to the New Year. IRS now must turn to implementing these new rules and updating forms, publications and regulations. Hopefully, their review and actions do not limit any of these outcomes or uncover some errors made in this very quickly adopted Act, which may require Congressional technical corrections in 2018 to fix. For more information on the Act and how it may impact other areas of taxation, please see our recent [Tax Release](#).

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