The Impact of the Tax Reform Plan on Business Real Estate and Partnerships

ANDERSEN TAX

Commercial real estate and partnerships generally fared well under recently introduced Republican tax legislation in the House of Representatives, *Tax Cuts and Jobs Act* (the *House bill*), and in the Senate (the *Senate bill*), which includes many differences from the House bill. There will be changes as the legislation proceeds through further mark-up and full review by the House and Senate, but as the proposals stand currently, the real estate industry and partnerships may have cause to be optimistic (except for some builders of single family homes).

Business interest deductions, like-kind exchanges, net operating losses, depreciation deductions and the tax termination rule applicable to partnerships are areas where there are some potential changes, but most proposals are not harmful to the industry. Carried interest is modified but not in a major way. The House bill eliminates the rehabilitation tax credit while the Senate bill allows it to remain, but only for historic buildings in a more limited manner. Both bills allow the low-income housing credit to remain. The greatest harm to the industry comes with further limits on the itemized deductions for home mortgage interest and real property taxes, which may dampen the home sales market if adopted. Below is a highlight of the potential impact of the Republicans' current tax plans on business real estate and partnerships.

Real Estate Industry

Most real estate is acquired with significant debt. Both bills limit business interest deductions to 30% of adjusted taxable income (with an exception for small businesses). However, real estate used in a trade or business (e.g., rental real estate), no matter how large, escapes these new limitations. Also, 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. Both bills leave the portfolio interest exemption untouched so that foreign money can still be tapped for U.S. real estate projects.

As a tradeoff for favorable interest expense provisions, both bills do not allow any real estate trade or business to use the temporary 100% bonus depreciation provision. The House bill did not change the recovery (or depreciation) period for real estate. However, the Senate bill would shorten the recovery period for nonresidential real and residential rental property to 25 years and would allow qualified improvement property to be depreciated over 10 years. The Senate bill would require real estate businesses that elect out of the interest expense limitation to depreciate real property using alternative depreciation lives of 30 years for residential rental property, 40 years for nonresidential real property and 20 years for qualified improvement property.

Like-kind exchanges (LKEs) have been a long-standing way to exchange business or investment property for other business or investment property of a like kind, generally without paying tax. Both bills eliminate the use of LKEs, but not for real estate owners, who can still take advantage of this tax-deferred way to sell real estate. 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.

Net operating losses (NOLs) can be valuable in the real estate and commercial world as illustrated in last year's Presidential election that highlighted President Donald Trump's use of a 1995 $916 million NOL deduction. The House bill allows NOLs arising in taxable years beginning after 2017 to be increased by a factor reflecting inflation and the real return to capital. However, both bills limit the NOL deduction to only 90% of current-year taxable income, and the House bill generally eliminates NOL carrybacks, except for one-year carrybacks for certain disaster losses, while the Senate bill generally eliminates all carrybacks.

Active participants in partnerships or S corporations can often escape the impact of the passive loss rules. However, the Senate bill adds a new limit on active participants. The Senate bill expands the present law excess business loss provision from farming to any business activity conducted through a partnership, S corporation or even as a sole participant by a person who is an active participant. Under the proposal, excess business losses can be used to offset non-business income (e.g., compensation or portfolio income) but only up to $500,000 for a married couple filing a joint return or $250,000 for other taxpayers, these amounts are to be indexed for inflation. Losses that are limited can be carried forward to use in another year as a net operating loss. The House bill contains no similar limitation.

The low-income housing tax credit is untouched by both bills and remains as a valuable tool to assist construction of affordable housing. However, historic preservation and community development were dealt a blow by the House bill's elimination of the rehabilitation tax credit and the new markets tax credit. By contrast, the Senate allows the rehabilitation tax credit to remain, but only for historic buildings and initially, only at a lower 10% rate. The Senate then relaxed its view and allowed a 20% credit to continue for historic properties. The Senate bill also allows the new markets credit to remain as is.

Single Family Home Ownership: Subsidizing Tax Reform?

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. As a way to pay for major tax reform, both bills may dampen that reality and lessen home sales by reducing or eliminating these deductions. While the House bill limits real property tax deductions to $10,000, the Senate bill totally eliminates this itemized deduction. The House bill limits home mortgage interest deductions to only interest paid on up to $500,000 principal on a primary residence ($1,000,000 grandfathered for existing residences). The Senate bill allows the deduction for home mortgage interest to remain on up to one million dollars of principal on a primary residence. Both bills eliminate the additional deduction on home equity indebtedness of up to $100,000. The House bill, but not the Senate, would repeal mortgage interest deductions for second homes starting in 2018, with no grandfather rule for existing second homes. Also, both bills will increase the standard deduction and eliminate many other deductions. The impact of these added changes 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.

Partnerships

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. Despite the many bills introduced over the last few years to tax the holder on receipt of the carried interest or otherwise alter its tax treatment, the *initial version* of the House bill did not change the treatment of carried interests.

Within days of its release, Congressman Kevin Brady (R-Texas), who leads the Ways and Means Committee and is a principal author and sponsor of the House bill, decided to change the treatment of carried interests, but in a very limited manner. Long-term capital gain treatment on gain allocations from a carried interest will only apply if a three-year (rather than a one-year) holding period is met with respect to the underlying assets. For the real estate sector where real estate is often held for more than three years before it is sold, this change may not harm many carried interest holders. However, this change of heart by Congressman Brady shows that carried interests are quite vulnerable and others may seek to limit their use further. While the

Senate initially declined to change the treatment of carried interests, the Senate later decided to adopt the House approach.

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 House bill would eliminate this tax termination rule and this trap for the unwary. Regrettably, the Senate bill did not adopt this change.

Under the House bill, the tax rate on partnership business income that flows through to its partners has been lowered to as little as 25%, which is more than a third less than the regular maximum individual tax rate of 39.6%. The 25% rate would apply to business income (such as real estate rental income) as long as the investor is a passive investor in the partnership as determined under the long-standing passive-activity loss rules. If the investor is active, then the 25% rate applies only to 30% of the business income, with the remainder taxed at regular tax rates, unless the active investor can support a higher percentage by application of a formula based on ordinary returns to capital assets invested in the business. REIT ordinary income distributions would also be eligible for the 25% rate. While capital gains are not eligible for this special rate, the House and Senate bills do not eliminate the preferential tax rate for long-term capital gains (LTCGs) recognized by individuals. Thus, LTCGs of individuals would still be taxed at a maximum rate of 20%. The House and Senate bills do not change the 3.8% net investment income tax, thus passive investors would be subject to a total rate of 23.8% for capital gains and 28.8% for other business income.

In contrast to the House bill, the Senate bill does not change the tax rate applicable to partnership income, but adds certain deductions relating to partnership income to lower the tax burden on some, but not all, partners. After 2017, the Senate bill would generally allow an individual taxpayer to deduct 17.4% of domestic qualified business income from a partnership. The deduction would be limited to 50% of W-2 wages paid in the trade or business, which may be a significant limiter for rental real estate where there are few employees. Qualified business income would not include income from specified service trades or businesses, except for taxpayers beneath the taxable income threshold amount of $500,000 married filing joint ($250,000 single). If an individual is subject to the Senate's maximum individual tax rate of 38.5% (reduced from the current 39.6% rate), then the impact of this deduction is to lower the effective tax rate to 31.8%, which is a much smaller tax break than that given by the House bill.

The Takeaway

The bottom line assessment is that the real estate industry (other than residential home sales) may be generally breathing a sigh of relief by the terms of these bills. However, these bills are the start of a process that will see many changes, some good and some bad. Stay tuned as we keep you apprised of the ever-changing efforts in the Beltway to enact significant tax reform. For more information on these bills and how it may impact other areas of taxation, please see our recent Tax Release.

For further information please contact your Andersen Tax advisor.