

# 2017 Tax Cuts and Jobs Act: Impact on U.S. Real Estate Businesses

January 30, 2018

The new tax act signed into law on December 22, 2017, popularly known as the Tax Cuts and Jobs Act (“TCJA”), affects U.S. real estate businesses in significant ways. For example, under the TCJA:

- **Changes in Tax Rates:** Tax rates are permanently reduced on businesses conducted by taxable corporations (“**C Corporations**”) and are temporarily reduced (at varying rates) on individuals who own businesses through flow-through entities (including partnerships, REITs, S corporations, limited liability companies that are taxed as partnerships or disregarded entities, and sole proprietorships) (“**Pass-Through Businesses**”);
- **New Deduction for Pass-Through Businesses:** A new temporary 20% deduction is provided for qualified income of qualified Pass-Through Businesses;
- **New Limits on Interest Deductions (Elective for Real Estate Businesses):** New limitations on interest deductions are imposed (both on C Corporations and Pass-Through Businesses), with an exemption for electing real estate businesses (with consequential effects on depreciation deductions);
- **Depreciation Expensing Rules for Qualifying New or Used Property—with Drafting Glitch:** 100% expensing deductions are provided for taxpayers that acquire and place in service qualifying property—whether the property is new or used—between September 28, 2017 and December 31, 2022, with annual 20% step-downs generally from 2023-2026, but an apparent oversight in the legislative drafting creates uncertainty as to the appropriate depreciation period for qualified interior improvements to nonresidential real property;
- **New Limits on State Income Tax Deductions:** New temporary limitations are imposed on deductions by individuals for state and local income taxes, including taxes in respect of income from Pass-Through Businesses such as real estate businesses (but not on income taxes paid by C Corporations);
- **Revisions to Rules Governing Profits Interests:** New rules require partnerships engaged in specified businesses, including real estate businesses, to hold investments giving rise to “net long-term capital gain” for more than three years in order for carried interest allocations of gain from the sale or disposition of such investments to qualify for reduced rates applicable to long-term capital gains, but the new provision does not expressly apply by its terms to—and thus appears not to reach—gains from sales of real estate assets used in a trade or business;
- **New Loss Limitation Rules for Pass-Through Businesses:** New temporary loss limitation rules are imposed on business income, including real estate business income, of Pass-Through Businesses;
- **Changes in Net Operating Loss Limitations:** Net operating loss (“**NOL**”) carryforwards (of C Corporations and individuals) arising in tax years beginning after 2017 now may reduce only 80% of taxable income for any year (and NOLs in tax years ending after December 31, 2017 can no longer be carried back to prior years, but they may be carried forward indefinitely);
- **Revisions to Rehabilitation Tax Credits:** The 10% tax credit for rehabilitation of pre-1936 buildings is repealed, and the 20% tax credit for rehabilitated historic buildings is retained but must be deducted ratably over a five-year period;

- **New Tax-Advantaged “Qualified Opportunity Zones”:** Significant tax advantages are offered for real estate businesses conducted in designated “qualified opportunity zones”;
- **Like-Kind Exchanges Preserved for Real Estate:** The rules providing for non-recognition of gains or losses on like-kind exchanges of property are repealed for personal property but preserved for real property (but now-taxable exchanges of tangible personal property may be eligible for immediate expensing);
- **Changes to Rules for Taxable Year of Inclusion:** New timing rules will require that certain income be reported for tax purposes no later than when it is recognized for book purposes;
- **Changes to Partnership Tax Provisions:** The TCJA includes revisions to several partnership tax rules that may affect partnership deductions and allocations; and
- **Changes Affecting Real Estate Market More Generally:** Various other changes will affect the real estate market more generally.

**Partnership Audit Rules.** In addition, on December 15, 2017, the IRS released proposed regulations under the new partnership audit rules (which affect tax years beginning after December 31, 2017) permitting “push-out elections” to be made by partnerships whose partners include pass-through entities.

This memorandum, one of a series of Davis Polk memoranda on the TCJA, summarizes some of the most significant legislative changes relevant to the U.S. real estate industry as well as the new proposed regulations under the partnership audit rules. Click this [link](#) to access other memoranda in the series.

## Changes in Tax Rates

For individuals, the highest marginal federal income tax rate on ordinary income is temporarily<sup>1</sup> reduced from 39.6% to 37%, while the maximum tax rate on qualified dividends and capital gains remains at 20%. For C Corporations, the tax rate is permanently reduced from a top marginal rate of 35% to a flat rate of 21%.<sup>2</sup>

Before the TCJA, the highest effective federal income tax rate on business income earned by C Corporations and distributed as dividends to individuals was 48%,<sup>3</sup> while the highest effective federal income tax rate on business income earned by individuals from Pass-Through Businesses was 39.6% (an 8.4% difference).

Under the TCJA, the highest effective federal income tax rate on business income earned by C Corporations and distributed as dividends to individual shareholders is 36.8%,<sup>4</sup> while the highest effective tax rate on business income earned by individuals from Pass-Through Businesses is 29.6%<sup>5</sup> if the new pass-through deduction is fully available (a 7.2% difference, in favor of Pass-Through Businesses) and 37% if the pass-through deduction is not available (a 0.2% difference, in favor of C Corporations).

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<sup>1</sup> The rate reduction for individuals expires after 2025.

<sup>2</sup> This discussion does not include the effects of the 3.8% tax on net investment income under Section 1411, which may apply, for example, in the case of dividends paid by C Corporations, or the effects of limitations on deductions of state and local income taxes by individuals holding businesses through pass-through entities.

<sup>3</sup> The 48% is calculated as follows:  $35\% + (20\% * (100\% - 35\%))$ . The 48% rate may be overstated in that it ignores the fact that the second level of tax (on the shareholder) is not due until the shareholder receives a distribution or sells his or her stock.

<sup>4</sup> The 36.8% is calculated as follows:  $21\% + (20\% * (100\% - 21\%))$ . The 36.8% rate may be overstated in that it ignores the fact that the second level of tax (on the shareholder) is not due until the shareholder receives a distribution or sells his or her stock.

<sup>5</sup> The 29.6% is calculated as  $37\% * (100\% - 20\%)$ .

## Observations Regarding Changes in Tax Rates

- Before the new legislation was enacted, a number of factors would affect the decision whether to operate a real estate business through a C Corporation or Pass-Through Business, including (i) the fact that income of a corporation is taxed twice (once at the corporate level and then again when corporate earnings are distributed or stock of the corporation is sold), (ii) the relative tax rates imposed on various types of income received by corporations and individuals, (iii) the fact that losses from pass-through businesses may be available to offset taxable income from other sources, while losses from C Corporations generally do not pass-through to owners, and (iv) the fact that it is generally not possible to remove appreciated assets from a corporation without triggering tax on those assets.
- Under the TCJA, a Pass-Through Business that is expected to be eligible for current deductions under Section 199A<sup>6</sup> will be taxed at significantly lower rates than a C Corporation that pays its earnings out currently as dividends—as noted above, the differential would be over 7% in favor of the pass-through structure.<sup>7</sup>
- The question becomes closer, however, in circumstances in which the pass-through deduction is not expected to be available (which, as discussed below, may be unpredictable given the qualified business loss netting rule and other uncertainties). Without the Section 199A pass-through deduction, the rate differential shifts slightly (0.2%) in favor of corporations. Moreover, in cases in which business earnings will be reinvested in the business for significant periods, the current corporate tax rate of 21% may compare favorably with the current pass-through business tax rate of 29.6%. If the Section 199A deduction is unavailable, new factors arising under the TCJA may also warrant consideration, including the elimination of state and local income tax deductions for individuals earning income through Pass-Through Businesses and the elimination of the corporate (but not the individual) alternative minimum tax.

## The New 20% Deduction for Pass-Through Businesses

The TCJA establishes, in new Section 199A, a temporary<sup>8</sup> 20% deduction for Pass-Through Businesses that will reduce the effective tax rate on:

- “Qualified business income” from a “qualified trade or business” conducted by a Pass-Through Business;
- Ordinary dividends received from REITs;
- Qualified income from a publicly traded partnership, or “MLP”; and
- Qualified dividends received from certain cooperatives.

The deduction is generally capped at an amount equal to 20% of the excess (if any) of the taxpayer's taxable income for the year over any net capital gain (as defined in Section 1(h)) for the year.

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<sup>6</sup> Section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>7</sup> This is without accounting for the 3.8% Medicare tax on net investment income or other provisions affecting effective tax rates.

<sup>8</sup> Section 199A does not apply to taxable years beginning after 2025.

## Qualified Business Income from Qualified Trades or Businesses

Under Section 199A, non-corporate owners of Pass-Through Businesses that conduct a “qualified trade or business” (a “**QTB**”) will generally be entitled to a deduction equal to 20% of the taxpayer’s “qualified business income” with respect to the QTB (subject to wage and asset-based limitations discussed below).

**Qualified trade or business vs. “specified service trade or business”.** A QTB is generally any trade or business other than a “specified service trade or business.”<sup>9</sup> A specified service trade or business includes (i) a variety of traditional service businesses specified in the Code, including “any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners,”<sup>10</sup> and (ii) any trade or business “which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in Section 475(c)(2)), partnership interests, or commodities (as defined in Section 475(e)(2)).” This language will undoubtedly raise numerous issues.

The exclusion for specified service businesses does not apply to individuals whose taxable income is below certain prescribed limits.<sup>11</sup>

The legislation provides Treasury with authority to issue regulations for application of Section 199A in the case of tiered entities.

**Qualified business income.** Qualified business income generally means the net amount of qualified items of income, gain, deduction and loss with respect to the QTB. An item of income, gain, deduction or loss is generally considered a “qualified item” only if the item is:

- income from a U.S. business (including Puerto Rico): that is, if the item is effectively connected with the conduct of a trade or business within the United States (within the meaning of Section 864(c)), with a special rule treating business income from sources within the commonwealth of Puerto Rico as qualified for this purpose if the taxpayer is subject to U.S. tax on the income;
- not a specific type of excluded investment income (rent is not excluded): that is, if the item is not (among other things): (i) capital gain or capital loss (whether long-term or short-term), (ii) dividend (or similar) income (other than ordinary dividends from REITs and certain dividends from certain cooperatives), (iii) interest income (other than interest income properly allocable to a trade or business), (iv) an item relating to certain transactions in commodities, foreign currencies or notional principal contracts or (v) a deduction or loss properly allocable to the foregoing;
  - note that rental income is not excluded income for this purpose; and
- not compensation to the taxpayer: that is, if the item is not compensation for services rendered by the taxpayer to the QTB. For this purpose, compensation includes (i) reasonable compensation paid to the individual by a QTB of the taxpayer for services rendered with respect to the QTB, (ii) any guaranteed payment paid to a partner for services rendered with respect to the QTB and (iii) to the extent provided in regulations, any payment described in Section 707(a) to a partner for services rendered with respect to the QTB.

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<sup>9</sup> The business of performing services as an employee is also excluded from the definition of a QTB.

<sup>10</sup> These include services in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services or brokerage services, as well as any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

<sup>11</sup> The exclusion for specified service income does not apply to an individual whose taxable income is less than \$157,500 (or, in the case of a joint return, \$315,000). For individuals with taxable income up to \$207,500 (or, in the case of a joint return, \$415,000), the exclusion for specified service income is phased in on a proportionate basis.

**Qualified business loss.** If an individual's share of the net amount of qualified items of income, gain, deduction and loss with respect to one QTB is less than zero (a "**QTB Loss**"), the QTB Loss will (in general) reduce the amount of the Section 199A deduction otherwise available to the individual in respect of a different (and profitable) QTB. Further, if an individual's net share of qualified items from all QTBs is less than zero for a taxable year, that amount is treated as a loss from a QTB in the next taxable year.<sup>12</sup>

It is not clear how the rules apply if (for example) there is an overall QTB loss (which Section 199A deems to be a loss from a QTB in the next taxable year) but that loss is actually used in the current taxable year to offset business income from a specified business or non-qualified items from a qualified business.

- **Inconsistent consequences.** The application of the rules in loss contexts can produce different results depending on whether each business owned by the taxpayer is a "qualified trade or business." A loss from one qualified business will reduce the Section 199A deduction in respect of income earned by another qualified business (or, possibly, from a REIT or publicly traded partnership). However, a loss from a non-qualified business will not reduce the Section 199A deduction in respect of income from a qualified business.
  - **Example.** Assume that Individual owns investments in two partnerships and also has \$100 of taxable ordinary income from other sources. Partnership One owns and operates a commercial building in Manhattan—a "qualified trade or business"—in which it generates \$100 of taxable income. (Assume also that Partnership One has sufficient assets to satisfy the asset-based cap discussed below.) Partnership Two has a loss of \$100.
    - If Partnership Two's business is a "qualified trade or business," its \$100 loss is netted against Partnership One's \$100 profit, so Individual **is not** entitled to a Section 199A pass-through deduction in respect of his income from Partnership One.
    - Alternatively, if Partnership Two's business is not a "qualified trade or business" (e.g., because it is a "specified business") or if Partnership Two does not earn "qualified income" (e.g., because it operates in Europe), it appears that Individual **is** entitled to a Section 199A pass-through deduction in respect of his income from Partnership One.

**Wage or asset-based cap.** The amount of qualified business income that is deductible is capped at the greater of (i) 50% of the taxpayer's share of the "W-2 wages" paid to employees in connection with the qualified trade or business and (ii) the sum of 25% of such W-2 wages and 2.5% of the taxpayer's share of the tax basis, immediately after acquisition, of "qualified property."

- **Wage-based cap.** For the purpose of calculating the taxpayer's share of W-2 wages, wages include only amounts that are (i) remuneration for certain services (including non-cash compensation) performed by an employee for his or her employer and (ii) properly included in a return filed with the Social Security Administration on or before the 60th day after the due date

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<sup>12</sup> The Conference Report includes an example that demonstrates the QTB Loss rule. In the example, H and W file a joint tax return on which they report taxable income of \$200,000 prior to application of Section 199A. Each of H and W (separately) owns a qualified trade or business. H's QTB income for the year is \$150,000 whereas W has a QTB loss for the year of \$40,000. In addition, H and W have a carryforward QTB Loss of \$50,000 from a prior year. First, the pass-through deduction with respect to H's \$150,000 of QTB income is determined to be \$34,500 (23% of \$150,000). W's QTB Loss reduces the pass-through deduction by \$9,200 (23% of \$40,000). And finally, H and W's carryforward QTB Loss reduces their pass-through deduction by an additional \$11,500. Ultimately, H and W are entitled to a pass-through deduction of \$13,800 for the year. Note that in the final TCJA, the pass-through deduction was reduced from 23% to 20% of QTB income, but the example nevertheless illustrates the mechanics of the QTB Loss rule.

(including extensions) of the return.<sup>13</sup> Thus, W-2 wages do not include amounts treated as “guaranteed payments,” Section 707(a) payments for services to partners, payments made to independent contractors or payments made pursuant to profits interests issued to service partners.

- **Asset-based cap.** For purposes of calculating 2.5% of the taxpayer’s share of the tax basis, immediately after acquisition, of qualified property, the term “qualified property” means tangible depreciable property held in the business at the close of the taxable year<sup>14</sup> and used in production of qualified business income if the “depreciable period” has not ended before the close of the taxable year. The term “depreciable period” means the period beginning on the date the property was first placed in service by the taxpayer and ending 10 years after that date (or later, if the regular depreciation “applicable recovery period” is longer). Section 199A includes anti-abuse rules and directs Treasury to issue regulations prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

For example, if a real estate business had no employees and thus paid no “W-2 wages,” but held and used in its business (through the last day of the taxable year) qualified nonresidential real property with a present tax basis of \$48.7 million that it had acquired 20 years ago for \$100 million, its owners would be entitled to claim the pass-through deduction for up to 2.5% of \$100 million, or \$2.5 million, in each of the next 19 years as long as the business continues to own the property.<sup>15</sup>

**Application to partnerships and S corporations.** In the case of a partnership or S corporation, Section 199A is applied at the partner (or shareholder) level. Each partner (or shareholder) takes into account its allocable share of the partnership’s (or S corporation’s) (i) qualified items of income, gain, deduction and loss, (ii) W-2 wages and (iii) unadjusted basis immediately after acquisition of qualified property. (The allocation of W-2 wages is determined in the same manner as the allocation of wage expenses among partners, and the allocation of unadjusted basis immediately after acquisition of qualified property is determined in the same manner as the allocation of depreciation among partners.)

The application of Section 199A at the partner level prevents partners who do not share in certain partnership expenses from benefiting from a Section 199A deduction.

For example, assume that Partner A is a 5% partner in Partnership Y, that Partnership Y earns \$1000 of qualified business income and pays wages of \$500 and that all of Partnership Y’s wage expenses are allocated to a partner other than Partner A. Partner A would be allocated \$50 (5% of \$1000) of Partnership Y’s qualified business income but none of Partnership Y’s wage expenses. Partner A would not be entitled to any Section 199A deduction in respect of his \$50 share of Partnership Y’s qualified business income, because he was allocated none of Partnership Y’s wage expenses.

If Section 199A applied at the partnership level rather than at the partner level, Partnership Y would have been entitled to a Section 199A deduction of \$200 (20% of \$1000 qualified business income) in calculating its taxable income. As a result, Partner A would have been allocated \$40 (5% of \$800) from

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<sup>13</sup> W-2 wages also exclude (among other things) (i) amounts paid for certain services rendered outside the U.S. and (ii) certain amounts that are not taxable to the employee.

<sup>14</sup> Section 199A directs Treasury to provide rules for its application in cases of short taxable years or where taxpayers acquire or sell major portions of a business or business unit during the taxable year. Real estate businesses should carefully evaluate the potential effect of property sales on the availability of the 20% deduction in particular situations.

<sup>15</sup> The depreciation recovery period for nonresidential real property is 39 years.

Partnership Y and thus would have enjoyed the benefit of a Section 199A deduction even though he bore no portion of the partnership's wage expense.

## Publicly Traded Partnerships (MLPs)

**Deduction for income from publicly traded partnerships without regard to wage or asset-based cap.** Section 199A permits non-corporate taxpayers to claim a deduction equal to 20% of "qualified publicly traded partnership income." Qualified publicly traded partnership income is defined to mean, with respect to any qualified trade or business, the sum of (i) the net amount of qualified items<sup>16</sup> from a publicly traded partnership that is not treated as a corporation under Section 7704 and (ii) any gain recognized upon a disposition of the interest in such a partnership to the extent such gain is treated as ordinary income under Section 751(a). Thus, income from a publicly traded partnership is subject to the requirements that the income not be from a specified service trade or business and that it be effectively connected with a U.S. trade or business and not be a specific type of excluded investment income. However, income from publicly traded partnerships is not subject to the wage or asset-based cap.

## REIT Dividends

**Deduction for qualified REIT dividends without regard to wage or asset-based cap or QTB or qualified business income limitations.** REIT dividends are also eligible for the Section 199A deduction with fewer restrictions than either of the alternatives discussed above. A taxpayer other than a corporation is entitled to deduct 20% of dividends from REITs to which ordinary income tax rates apply without regard to the W-2 wage or qualified property cap and without regard to the QTB / specified service business or qualified business income limitations. As a result, ordinary REIT dividends are now subject to a maximum tax rate of 29.6% (excluding the additional 3.8% Medicare tax on investment income), even in cases where the REIT's income is not effectively connected with a U.S. trade or business or where it consists of the type of investment income that is excluded from Section 199A eligibility for ordinary pass-through businesses or publicly traded partnerships.

This is a significant reduction from the pre-TCJA maximum tax rate of 39.6% (excluding Medicare investment taxes) that applied to ordinary REIT dividends.<sup>17</sup> However, given the TCJA's reduction of the corporate tax rate to 21%, the TCJA slightly reduces the tax rate differential between REITs and C Corporations. Prior to the TCJA, assuming maximum tax rates and the distribution of all earnings in the year they are earned, for every \$100 earned by a REIT, shareholders of the REIT would pay \$8.40<sup>18</sup> less in tax than would shareholders of a C Corporation. Under the TCJA, the spread is now \$7.20.<sup>19</sup>

## Lower Penalty Threshold

Despite the complexities and ambiguities inherent in Section 199A, the threshold for determining whether an understatement of income tax is "substantial" (and thus whether it is subject to a 20% accuracy penalty) is reduced from 10% to 5% of the tax required to be shown on the return for taxpayers claiming the Section 199A deduction.

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<sup>16</sup> For purposes of Section 199A, "qualified items" from a publicly traded partnership may include rents from real property and gain from the sale of real property if such gain is not treated as capital gain. These items may also be "qualifying income" for purposes of Section 7704.

<sup>17</sup> REIT dividends that did not qualify as capital gain dividends or qualified dividend income distributions were subject to tax at ordinary income tax rates.

<sup>18</sup>  $\$100 - .35(\$100) = \$65$ ;  $\$65 - .2(\$65) = \$52$ ;  $\$100 - .396(\$100) = \$60.40$ .  $\$52$  is  $\$8.40$  less than  $\$60.40$ .

<sup>19</sup>  $\$100 - .21(\$100) = \$79$ ;  $\$79 - .2(\$79) = \$63.20$ ;  $37(\$100 - \$20) = \$70.40$ .  $\$63.20$  is  $\$7.20$  less than  $\$70.40$ .

## Observations Regarding The New 20% Deduction for Pass-Through Businesses

- **Incentive to convert real estate businesses to REITs or MLPs.** The W-2 wage and asset-based qualified property cap does not apply to the 20% deduction for qualified REIT dividends or qualified income from publicly traded partnerships, and REITs are also not subject to the Section 199A QTB and qualified business income limitations. This may create incentives for real estate businesses to operate as REITs or publicly traded partnerships.
- **Conflicting employment incentives.** Real estate business owners and their employees may face conflicting incentives in light of the new rules. Because business payments of W-2 wages to employees will increase the cap on the pass-through deduction, owners may be inclined to convert independent contractors to employee status and to otherwise take steps to maximize payments of W-2 wages. On the other hand, service providers will prefer to be compensated via profits interests eligible for the pass-through deduction rather than by wages.
- **Consequences of selling “qualified property” before end of taxable year.** In order to constitute “qualified property” that counts toward the 2.5% asset-based cap, the property must be “held by, and available for use in,” the business “at the close of the taxable year” in which the pass-through deduction would be claimed. Although Section 199A directs the Treasury to provide rules for its application in cases where taxpayers acquire or sell major portions of a business during the year, selling qualified property before year-end could result in loss of otherwise-available pass-through deductions and should be carefully evaluated.
- **Mixed businesses, tiered entities, separate businesses and lower penalty thresholds.** Beyond the general interpretive questions posed by the “specified service” definition, it is unclear how the rules will apply in the case of businesses that conduct “qualified” businesses (for example, the ownership and operation of commercial real estate) but also may conduct “specified service” businesses (for example, the performance of services that consist of investing or investment management of securities, partnership interests or commodities), either directly or through tiered partnerships. Moreover, whether a tiered or related business is treated as a separate business or is aggregated with other businesses will be relevant for determining the wage and asset-based qualified property caps, which apply on a business-by-business basis. These ambiguities should be evaluated in light of the reduced threshold for application of the substantial understatement penalty.
- **Non-qualified business income earned by REITs passed through as qualified dividends.** The 20% deduction under Section 199A in respect of qualified REIT dividends appears to be available even if the underlying income received by the REIT would not have been “qualified business income” if received by a partnership because, for example, it was not effectively connected with a trade or business conducted within the United States or because the underlying investments consisted of otherwise-excluded investment assets such as mortgages.

## New Limits on Interest Deductions (Elective for Real Estate Businesses)

The TCJA imposes new limitations on the deduction for business interest, applicable both to Pass-Through Businesses and C Corporations, in the case of real estate businesses that do not elect to be exempted from the limitations. In general, new Section 163(j) of the Code limits the deduction for “business interest” for any taxable year to the sum of the taxpayer’s “business interest income” and 30% of the taxpayer’s “adjusted taxable income” (“ATI”) for the taxable year. In general, ATI is defined as EBITDA before 2022 and EBIT thereafter. “Business interest” means any interest paid or accrued on

indebtedness properly allocable to a trade or business.<sup>20</sup> Interest expense that exceeds this limit is not deductible in the current tax year but may be carried forward to subsequent years.<sup>21</sup> Unlike Section 199A, Section 163(j) applies at the partnership level.<sup>22</sup>

An “electing real property trade or business” may elect to be excluded from these limitations. An electing real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business that makes an election to be excluded from the application of new Section 163(j).<sup>23</sup> As discussed under “Changes in Real Estate Expensing and Depreciation Rules” below, if a real property trade or business elects out of the Section 163(j) interest limitation rules, (i) the cost recovery period for residential real property is extended from 27.5 years to 30 years; (ii) the cost recovery period for non-residential real property is extended from 39 years to 40 years; and (iii) the cost recovery period for qualified improvement property is extended, but the period over which it is extended is unclear due to apparent TCJA drafting errors discussed at “Changes in Real Estate Depreciation and Expensing Rules” below.

The text of Section 163(j) provides that the election by a real property trade or business to be excluded from the interest limitations “shall be made at such time and in such manner as the Secretary shall prescribe, and, once made, shall be irrevocable.” Until guidance is issued, real estate businesses should carefully evaluate their entitlement to make, and the optimal timing of, any such election.

## Observations regarding new interest deduction limitations

- **Sale/leaseback alternatives to debt financing.** Rent deductions are not subject to limitations correlative to the new interest deduction limitations. Real estate businesses that desire to preserve the regular cost recovery periods for their nonresidential real property, residential rental property and qualified improvement property may wish to consider sale/leaseback arrangements with respect to other assets as alternatives to debt financings. Alternatively, other businesses that own real estate but are ineligible to elect out of the interest limitation rules may wish to consider sale/leaseback arrangements with real estate businesses.
- **Partnership-level application of limitation.** Because the business interest limitation applies at the partnership level, real estate businesses operating separate properties through separate partnerships may be entitled to determine whether to elect out of the limitation on a partnership-by-partnership basis.
- **Partnership-level application of limitation—disparities between partner and partnership taxable income.** In addition, because the business interest limitation applies at the partnership level, a single taxpayer’s total direct and indirect ATI and total direct and indirect business interest expense are not aggregated across partnerships. As a result, situations may arise in which a partner is left with an aggregate interest deduction limitation more onerous than 30% of its total direct and indirect ATI. Real estate businesses that operate across multiple entities should evaluate the location of debt within their overall structures in light of these rules.

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<sup>20</sup> The term “business interest” does not include investment interest (as defined in Section 163(d)). Legislative history indicates that the investment interest limitation appears to have been intended to apply only to non-corporate entities.

<sup>21</sup> Certain small businesses, generally those with average annual gross receipts for the prior three years of \$25 million or less, are exempt from this limitation.

<sup>22</sup> For further detail, see our memorandum “Changes to the Rules Governing Interest Expense and Net Operating Loss” dated December 20, 2017 at this [link](#).

<sup>23</sup> The Conference Report states that a mortgage broker who is a broker of financial instruments is not a real property trade or business for this purpose.

## Changes in Real Estate Depreciation and Expensing Rules

**Regular depreciation period for residential rental property and nonresidential real property unchanged; alternative depreciation period reduced for residential real property.** Under the TCJA, residential rental property continues to be depreciable over 27.5 years and nonresidential real property continues to be depreciable over 39 years for regular depreciation purposes, but the “alternative” depreciation schedule (which applies to certain property, such as “tax-exempt use property,” as a matter of law) is reduced from 40 years to 30 years for residential rental property.

**100% expensing, including for used property.** Tangible property with a recovery period of 20 years or less and which is not subject to the alternative depreciation system is eligible for 100% expensing if placed in service after September 27, 2017 and before January 1, 2023,<sup>24</sup> and for phased-down amounts (20% annual reduction of the percentage) generally through 2026. The recovery period for real estate assets exceeds 20 years and thus real estate assets do not qualify for expensing, but other associated tangible personal property may qualify. (See also the discussion of qualified improvement property immediately below.) The TCJA expressly permits expensing in the case of used property, so long as the taxpayer claiming the deduction has not used the property previously and it is not acquired from a related party.

**Qualified improvement property—and drafting glitch.** The Conference Report describes an intention to treat “qualified improvement property,” which generally includes any improvements to the interior portion of nonresidential real property that do not enlarge the building or improve its internal structural framework (other than elevators or escalators), as 15-year property—which would in turn render it eligible for the 100% expensing—but the legislative text does not appear to achieve this.<sup>25</sup> The potential consequences of this drafting error may vary depending on whether qualified improvement property was placed in service in 2017 or 2018<sup>26</sup> and on when technical corrections legislation is enacted.

**“Stretched” depreciation deductions under alternative depreciation system for real estate businesses that elect out of interest deduction limitations.** In the case of a real property trade or business that elects out of the Section 163(j) interest limitation rules (discussed above): (i) the cost recovery period for residential rental property is extended from 27.5 years to 30 years; (ii) the cost recovery period for non-residential real property is extended from 39 years to 40 years; and (iii) the cost recovery period for qualified improvement property is extended, but the period of extension is unclear due to what appear to be TCJA drafting errors.

**Additional improvement expensing for small expenditures.** Under a revised version of Section 179, taxpayers can elect to deduct the entire cost of up to \$1 million in “qualified real property” (as well as certain other types of eligible property) in the year it is purchased. Qualified real property for this purpose includes qualified improvement property (discussed above) as well as any of the following improvements

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<sup>24</sup> Certain types of property with longer production periods are eligible for 100% expensing if placed in service prior to 2024.

<sup>25</sup> It appears that qualified improvement property was intended to be added as a category of “15-year property” to Section 168(e)(3), which in turn would have made it eligible for 100% expensing. See Conference Report at 205 (“In addition, the conference agreement provides a general 15-year MACRS recovery period for qualified improvement property.”). Instead, the TCJA deleted references in Section 168(e)(3) that provided recovery periods for “qualified leasehold improvement property,” “qualified restaurant property” and “qualified retail improvement property,” but failed to replace them with a reference that provides a recovery period for qualified improvement property.

<sup>26</sup> This is because the elimination of specified depreciation rules for “qualified leasehold improvement property,” “qualified retail improvement property” and “qualified restaurant property” (intended to be replaced with “qualified improvement property”) is generally effective for property placed in service after December 31, 2017, but the expensing provisions are generally effective for property placed in service after September 27, 2017.

to nonresidential real property placed in service after the date such nonresidential real property was placed in service: roofs; heating, ventilation and air-conditioning property; fire protection and alarm systems; and security systems. The amount eligible for the Section 179 election is reduced by the amount by which the cost of eligible property placed in service during the taxable year exceeds \$2.5 million (and thus the election under Section 179 is unavailable for a taxpayer that places \$3.5 million or more of eligible property in service during the taxable year).

## New Limits on State and Local Income Tax Deductions

The TCJA introduces a temporary<sup>27</sup> \$10,000 cap (\$5,000 for married individuals filing separate returns) on deductions by individuals for state and local income taxes, real property taxes, and personal property taxes.<sup>28</sup> The limitations do not apply to state and local real or personal **property** taxes paid or accrued in carrying on a trade or business or other activity for the production or collection of income, but they do apply to business-related **income** taxes imposed on individuals. The legislative history indicates that the new rules were not intended to limit the deduction of business taxes directly imposed on pass-through entities rather than on individuals. Thus, it would appear that business taxes, such as the New York City unincorporated business tax, that are imposed on pass-through entities will not be subject to the new limitations.

As a result, individual owners of real estate businesses will continue to be entitled to deduct all of their business-associated state and local real and personal property taxes, but they will not be entitled to deduct state and local income taxes in excess of the cap discussed above. These income tax deduction limitations do not apply to state and local income taxes imposed on C Corporations.

In general, the owners of a Pass-Through Business must pay income taxes in each state in which the business operates based on an apportionment of the income of the business. The differing treatment of state and local income taxes for Pass-Through Businesses and C Corporations may (in certain cases) be an additional factor to evaluate in deciding whether to hold a business in corporate or pass-through form, particularly where the business operates in a high-tax state and the individual owner would otherwise be taxable only in a low-tax state.

## Revisions to Rules Governing Profits Interests

New Section 1061 imposes a three-year holding period requirement for long-term capital gain treatment to apply to certain capital gains passed through to service partners holding profits interests or carried interests,<sup>29</sup> but it appears that the legislation does not extend to gain on sales of real estate used in a business.

The TCJA requires that, if a partnership conducts an “applicable business” and allocates “net long-term capital gain” to service partners holding profits interests, the partnership generally must have held the underlying assets generating the gain for more than three years in order for the gain to pass through to the service partner as long-term capital gain. (The three-year holding period requirement also appears to apply to the service-partner’s gain on sale of his or her partnership interest—i.e., the service partner must

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<sup>27</sup> This provision applies only in the case of an individual, and only in the case of a taxable year beginning after December 31, 2017 and before January 1, 2026.

<sup>28</sup> This limitation also applies to deductions of sales taxes for taxpayers that elect to deduct sales taxes in lieu of income taxes.

<sup>29</sup> A capital interest in a partnership that provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed by that partner is not subject to these rules.

have held the partnership interest for more than three years in order to qualify for long-term capital gain treatment on the sale of the partnership interest.)

An “applicable business” is an activity that consists of (i) raising or returning capital and (ii) investing in, disposing of, identifying or developing “specified assets.” Specified assets include real estate held for rental or investment.

However, the text of new Section 1061 refers to Section 1222, which is the provision that defines the term “long-term capital gain” with reference to gains from sale of “capital assets” held for more than one year. Real property used in a trade or business is not a “capital asset” but rather is a “section 1231 asset,” the sale of which is governed by section 1231 rather than Section 1222. Although Section 1231 generally “treats” gain on sale of real property used in a trade or business as “long-term capital gain,” the term “long-term capital gain” as defined in Section 1222 does not cover real property used in a trade or business. Thus, the new provision appears **not** to apply to gains from sales of real estate assets used in a trade or business, even though real estate held for rental or investment is expressly treated as a “specified asset” to which this new provision applies.

## The New Loss Limitation Rule for Pass-Through Businesses

Under new Section 461(l), the “excess business loss” of a taxpayer other than a corporation is limited to \$250,000 per year (\$500,000 for joint returns) for taxable years beginning after December 31, 2017 and before January 1, 2026. An “excess business loss” means the excess of the aggregate deductions attributable to the taxpayer’s trades or businesses over the sum of the aggregate gross income or gain of such taxpayer attributable to such trades or businesses.

Such disallowed losses can be carried forward as net operating losses, subject to new limitations on net operating loss deductions that generally limit the amount deductible to 80% of taxable income.

The limitation is applied at the partner or shareholder level in the case of partnerships or S corporations. It applies after application of the passive loss rules.

This provision will prevent real estate businesses that are not conducted through C Corporations from using active business losses to offset investment income in excess of the threshold amounts discussed above. Existing law already prevented non-corporate taxpayers from using passive business losses to offset active business income or investment income and from using investment losses to offset business income.<sup>30</sup>

This provision is not limited to business losses generated by businesses eligible for the 20% Section 199A deduction.

## Changes in Net Operating Loss Limitations

Under prior law, NOLs generally could be carried back to the two preceding taxable years and then carried forward to the 20 years following the year of the loss. The TCJA generally repeals the NOL carryback but permits an indefinite carryforward, for losses arising in taxable years ending after December 31, 2017. However, the amount of an NOL carryforward that is deductible in any taxable year is limited to 80% of that year’s taxable income, for losses arising in taxable years beginning after December 31, 2017.

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<sup>30</sup> See Sections 469 and 163(d). The passive activity loss rules of Section 469 also apply to closely held C corporations and personal service corporations.

## Revisions to Rehabilitation Tax Credits

Under prior law, there were two types of tax credits available for qualified rehabilitations of certain buildings. A 10% credit was provided for expenditures for rehabilitating qualified buildings placed in service before 1936, and a 20% credit was provided for qualified expenditures with respect to “certified historic structures,” i.e., buildings (and their structural components) that are listed in the National Register or located in a registered historic district and certified by the Secretary of the Interior as being of historic significance. The TCJA repeals the 10% credit and revises the 20% credit so that instead of being available in the year the property is placed in service, the 20% credit is deducted ratably over five years.

## Tax-Advantaged “Qualified Opportunity Zones”

The TCJA added a provision to the Code that is intended to provide two main tax incentives for investment in real estate in low-income communities: (i) a deferral (to no later than 2026) of inclusion in gross income for capital gains on any property if the sales proceeds are reinvested in a “qualified opportunity fund,” and (ii) an exclusion from gross income for post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years.

A “qualified opportunity fund” is a partnership or corporation organized for the purpose of investing in “qualified opportunity zone property” that holds at least 90% of its assets in qualified opportunity zone property, measured semi-annually. Qualified opportunity zone property includes real property that has been “substantially improved” (which generally means that the cost of improvements made within the 30-month period after the acquisition exceeds the cost of acquiring the property). As a result, real estate businesses that perform substantial construction in areas designated as qualified opportunity zones may be entitled to significant tax benefits.

Qualified opportunity zones are census-designated tracts nominated by the governor of a state or U.S. possession (including Puerto Rico) and certified by the U.S. Treasury. In order to be designated, the tract must be a “low-income community” as defined in Section 45D(e)<sup>31</sup> or, subject to certain limitations, contiguous with such a community. Governors must nominate census-designated tracts and notify the Secretary of the Treasury in writing of these nominations within 90 days of the enactment of the TCJA (the “**determination period**”).<sup>32</sup> The Secretary of the Treasury must then certify the nomination within 30 days of receiving notice of the nomination (the “**consideration period**”). Governors may request that the Secretary of the Treasury extend either the determination period or the consideration period for an additional 30 days.

## Like-Kind Exchanges Preserved for Real Estate

The TCJA preserves the benefit of Section 1031 non-recognition on like-kind exchanges of real property held for use in a trade or business or for investment but eliminates the benefit for all other types of property. (Assets other than real estate transferred in now-taxable exchanges may qualify for immediate expensing, however.) Real property held primarily for sale continues to be ineligible for Section 1031 non-recognition.

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<sup>31</sup> A tract is a low-income community if the poverty rate for such tract is at least 20%, or the median family income for such tract does not exceed 80% of the median family income in the metropolitan area in which it is located (or, if it is not located in a metropolitan area, the state in which it is located).

<sup>32</sup> The TCJA was enacted on December 22, 2017. Ninety days later is March 22, 2018.

## Changes to Rules for Taxable Year of Inclusion

The TCJA makes two significant changes to the timing rules for inclusion of gross income: (i) it revises the general “all events” test for many accrual method taxpayers, and (ii) it provides a special rule relating to advance payments.

**Revisions to “all events” test.** Accrual-method taxpayers generally must include items in gross income when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Under the TCJA, a new Section 451(b) provides that the all events test is to be treated as being met no later than when the item is taken into account in an “applicable financial statement,” which would include audited financial statements used for credit purposes or to report income to shareholders or partners. These rules do not apply to income earned in connection with a mortgage servicing contract or to income reported under special tax methods of accounting (but they do apply to debt instruments subject to the original issue discount rules). They apply only for gross income inclusions and not for loss inclusions. Taxpayers reporting income for tax purposes later than for financial statement purposes should evaluate the potential consequences of these new rules.

**Special elective rules for advance payments.** New Section 451(c) codifies an exception from the all events test for certain types of advance payments received by accrual method taxpayers. Under this exception, an accrual method taxpayer that receives an advance payment in a taxable year may elect to include for that taxable year the portion taken into account as revenue in an applicable financial statement and include the remaining portion in revenue in the following taxable year. An advance payment that qualifies for this election must meet the following criteria: (i) full inclusion of the payment in the year of receipt must be a permissible method of accounting; (ii) a portion of the payment must be included in revenue in the taxpayer’s financial statements in a subsequent year; (iii) the payment must be for goods, services or such other items as are identified by the Secretary; and (iv) the payment must not be on a list of excluded types of payments, which list includes rent payments.<sup>33</sup>

## Various Changes to Partnership Tax Provisions

**Repeal of partnership technical terminations.** Prior to the enactment of the TCJA, real estate businesses could be affected by “partnership technical terminations” that occurred when, within a twelve-month period, there was a sale or exchange of 50% or more of the total interest in partnership capital and profits. As a result of a partnership technical termination, the partnership was required to “restart” depreciation on the depreciable property owned by the partnership at the time of the termination. The basis of the property was unaffected but this basis was spread across a “restarted” depreciable life, resulting in a reduced annual deduction for depreciation (and a longer cost recovery period). The TCJA eliminates partnership technical terminations from the Code.

**Revisions to built-in loss allocation rules.** Prior law included rules providing that when partnership interests were sold, the tax basis of property held by partnerships with “substantial built-in loss” (i.e., when tax basis exceeds fair market value by more than \$250,000) must be adjusted to account for the difference between the buyer’s proportionate share of the adjusted basis of partnership property and his or her basis in the partnership interest. The TCJA expanded these rules to also reach circumstances in which the buyer would be allocated a loss of more than \$250,000 if the partnership assets were sold. This

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<sup>33</sup> Certain payments are excluded from Section 451(c), including rent, insurance premiums, payments with respect to financial instruments, certain payments under warranty or guarantee contracts, payments received by foreign persons that are not effectively connected with a U.S. trade or business, certain payments in property in connection with the performance of services and any other payment identified by the Secretary.

provision thus reaches partnerships that make special allocations of losses but do not have an overall built-in loss.

**Basis limitation modified to account for partnership charitable deductions and foreign taxes.** The TCJA modifies the rules applicable to limitations on a partner's share of partnership losses by requiring that the partnership take into account the partner's share of the partnership's charitable contributions and payments of foreign taxes.

## Changes Affecting Real Estate Market More Generally

The new limitations on deductibility of state and local property and income taxes<sup>34</sup> may adversely affect the residential real estate market in locations with high property or income taxes. New limitations on the deduction for interest on home mortgage indebtedness (and the elimination of the deduction for interest on home equity indebtedness) may also negatively affect the residential real estate market in broader geographic areas.

## “Push-Out Elections” Under the Partnership Audit Rules

For taxable years beginning after December 31, 2017, a new partnership tax audit regime (enacted prior to the TCJA) applies to businesses organized as partnerships for U.S. federal income tax purposes. Recently issued proposed regulations clarify important aspects of the new rules.

The new regime requires each partnership to designate a “partnership representative” to control the audit process. The partnership representative has the sole authority to bind the partnership and all of its partners with respect to all audit-related matters of the partnership.

In addition, the new regime requires an audited partnership itself (rather than its partners) to pay any “imputed underpayment” of tax that results from an adjustment to partnership taxable income arising from an audit unless certain elections are made. This liability of the partnership must be paid in the year the adjustment becomes final, even if the partners for the reviewed year are no longer partners in the partnership at that time. However, once a partnership receives notice from the IRS of a final partnership adjustment, its partnership representative can elect to “push out” the adjustments that resulted in the imputed underpayment of tax from the partnership to the partners (such election, a “**push-out election**”). A push-out election causes the partners (rather than the partnership) to become liable for the underpayment of tax. Until last month, it was unclear whether push-out elections would be permitted in the case of tiered partnerships.

On December 15, 2017, the IRS released proposed regulations that clarify that, if a partnership representative properly makes a push-out election, any partner that is itself a partnership or other pass-through entity (a “pass-through partner”) may take the adjustment into account in one of two ways: (i) the pass-through partner may elect to push out the adjustment to its partners; or (ii) the pass-through partner may pay tax on the adjustment calculated by multiplying the total netted adjustment by the highest rate of tax in effect for the reviewed year.<sup>35</sup> The same two options apply regardless of whether the pass-through partner received the pushed-out adjustment directly from the audited partnership or from a pass-through partner of the audited partnership in which it was a pass-through partner.

In order to avoid liability for a partner's underpayment of tax, real estate businesses organized as partnerships for U.S. federal income tax purposes may wish to make a push-out election upon the receipt

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<sup>34</sup> See discussion at “New Limits on State and Local Income Tax Deductions for Pass-Through Businesses” above.

<sup>35</sup> Separate calculations must also be made for each year between the reviewed year and the adjustment year.

of a notice of a final partnership adjustment. Under proposed IRS regulations, audited partnerships (and pass-through partners who receive pushed-out adjustments from audited partnerships) will be eligible to push out adjustments only if they include with the push-out election all information that IRS forms, instructions and other guidance require them to include. Because IRS guidance is not yet finalized and may evolve over time, it would be prudent for all real estate businesses organized as partnerships for U.S. federal income tax purposes to include in their operating agreements provisions that bind current and former partners to provide the partnership representative with all information necessary to make a push-out election.

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If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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