Tax Impacts Bulletin

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Tax Cuts? What They Mean for the Real Estate Industry

In light of the recent Tax Cuts and Jobs Act (TCJA) that was passed this past December, Perkins & Co's real estate team hosted a Real Estate Connection event for leaders in the industry that explained how the tax reform might impact their businesses. The discussion was led by a distinguished panel consisting of senior leadership from Perkins & Co and Schwabe, Williamson & Wyatt shareholder, Dan Eller. While our blog post about the event covers the various topics at a high level, many attendees expressed interest in obtaining in-depth information, which we've provided below.

Author: Kimberly Woodside, CPA, Shareholder

PARTNERSHIP AUDIT RULES

In an effort to raise revenue and increase audit effectiveness, new rules, which are effective as of January 1, 2018, introduced the concept of "partnership representative" vs. Tax Matters Partner (TMP). This can be anyone; it doesn't have to be a partner of the partnership. The representative will have full authority to make elections and deal with the IRS. And the IRS no longer has to provide notice to all partners. They now communicate only with the representative—the IRS may assign a representative if one isn't provided by the partnership. A major change is that the audit adjustments are made at the partnership level. Now tax is assessed at the highest marginal tax rate of the members of the partnership, and the tax is paid at the partnership level. Extra due diligence is recommended for new partners entering existing partnerships. The audit assessment year may be post entry, but the review year is related to the year prior to becoming a partner. So one could be paying tax for a year they were not a partner!

Here are a couple of key considerations to address now:

- Identify the partnership representative
- Consider partner indemnifications with partnership interest changes post 1/1/2018

CARRIED INTEREST (ALSO KNOWN AS PROMOTED INTEREST)

Carried interest represents the amount paid to the general partner or developer upon sale as a return for the risks taken during development or on the investment. Also, effective January 1, 2018, both the partnership interests and the underlying property must be held for more than three years (vs. one year as was the case in the past). If this holding period is not met the income on disposition will be treated as short-term capital gain rather than long-term capital gain (LTCG) and thus, likely taxed at ordinary rates rather than at the LTCG 20% tax rate. Note: the IRS is on alert that several hedge funds rushed to set up a bunch of shell pass-through entities known as S Corporations before the end of 2017 after the new law passed (in the hopes of qualifying for the corporate exemption and skirting the carried interest restriction). Currently there is a loophole in the new tax law which simply refers to "corporations" where the intent was to only apply to C-corporations. The Treasury Secretary commented that they are aware of this strategy and intend to shut it down in future guidance.

Holding period of the partnership interest:

To determine if the three-year holding period is met we must look at how the partnership interest and the underlying property were acquired, such as follows:

a. Equity interest: Begins on the date of acquiring the capital interest (they can have multiple holding periods if interest is acquired over time.)

b. Profit interest: Begins on the date substantially vested, such as when you file the 83b election. Typically, the amount included in income is zero as the fair market value (FMV) of the compensatory receipt of the interest is equal to the liquidation value of that interest. Companies may want to re-visit the vesting schedules when providing profit interests to employees. Look at the timing of vesting and the anticipated holding period of property and consider whether it makes sense to provide for 100% vested interest at the time of issuance to

For any questions or additional clarification, please contact your Perkins & Co real estate tax advisor:

Tim Kalberg, Shareholder
(503) 221-7511
tkalberg@perkinsaccounting.com

Gary Reynolds, Shareholder, Chairman of the Board
(503) 221-7505
greynolds@perkinsaccounting.com

Brigitte Sutherland, Shareholder
(503) 802-8613
bsutherland@perkinsaccounting.com

Kimberly Woodside, Shareholder
(503) 221-7592
kwoodside@perkinsaccounting.com

Celeste Ames-Duncan, Senior Manager
(503) 488-8842
cduncan@perkinsaccounting.com

Trent Baeckl, Senior Manager
(503) 802-8626
tbaeckl@perkinsaccounting.com

Trina Headley, Senior Manager
(503) 221-7593
kheadley@perkinsaccounting.com

Isaac Jones, Senior Manager
(503) 221-7559
ijones@perkinsaccounting.com

Alla Meyers, Senior Manager
(503) 221-7517
avmeyers@perkinsaccounting.com

Shawna Parrish, Senior Manager
(503) 802-8610
sparrish@perkinsaccounting.com

Sara Schmitz, Senior Manager
(503) 221-7522
sschmitz@perkinsaccounting.com

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maximize the benefit.

c. What about equity interest with a waterfall upon liquidating transaction?

    1. The carried interest law only applies to interest issued in connection to performing services such as raising or returning capital of investing or disposing of certain assets (e.g. securities or real estate held for rent and investment).

    2. The one-year hold for the LTCG rule still applies to the equity investor.

    3. In summary, you may obtain LTCG on normal equity investment but LTCG only if the property and interest were held for more than three years for promote, carry or waterfall upon sale. We are hoping for more guidance from the IRS on waterfall allocations.

d. Holding period of property: See rules under the bonus depreciation section below.

BUSINESS INTEREST DEDUCTION LIMITATION

The business interest deduction limitation doesn't apply unless the average gross receipts for the prior three years exceeds $25 million. Net interest deduction (you can net your business interest income against your interest expense) is limited to 30% of taxable income without consideration of 20% pass-through deduction, net interest expense, taxes, depreciation, amortization and any NOLs (think earnings before interest, taxes, depreciation and amortization (EBITDA)) through 2021. It will then convert to earnings before interest (EBIT) beginning in 2022, at which time the deduction of depreciation and amortization must be included when computing net income for the 30% limitation. Taxes in this calculation mean "state income taxes" vs. property taxes, thus are more helpful for C Corporations.

How does this limitation work?

a. The limitation is applied at the entity level; C Corporation or pass-through level. Excess interest of a partnership gets passed to the member/partner for future use against business income; tax basis is decreased for full interest expense without regard to limitation.

b. Electing Real Property trade or business may avoid limitation if one elects to use alternative depreciation system (ADS) depreciation (there's a longer depreciable life using the straight-line (SL) method and bonus depreciation is not allowed). This is an irrevocable election. One must use the ADS method for all future years, and this is only for 1250 property (building, land improvements, etc.), not personal property.

c. Planning point: consider accelerating depreciation deductions now before 2022 when depreciation and amortization are then included in determining the overall net taxable income for limitation purposes.

d. Tax shelter rules: What are they? A partnership or non-C Corporation where 35% or more of its losses are allocated to limited partners/limited entrepreneurs is a syndicate which is considered to be a tax shelter. However, there is an exemption for active management. That exemption includes:

e. Individuals who actively manage the entity;

    1. Individuals who actively manage the entity;

    2. The spouse, children, grandchildren, and parents of an individual who actively manages the entity;

    3. Individuals who actively managed the entity for at least 5 years;

    4. Estates of individuals who actively managed the entity or their spouse, children, grandchildren or parents; and,

    5. Others whom the Secretary determines should be treated as active management and the interest is not used for tax avoidance purposes.

f. What if I have an LLC structure? Will it be considered a tax shelter? We don't believe so if proper management rights are written into the agreement.

g. Electing ADS depreciation method in item b above gets around these rules.

20% PASS-THROUGH DEDUCTION FOR QUALIFIED BUSINESS INCOME (QBI) (see item f below)

Note: IRC Sec. 199A deduction, DPAD deduction is eliminated (IRC Sec. 199)

The breakpoints for the ordinary income, long-term capital gains, and qualified dividends tax brackets would be adjusted in future years for inflation. However, inflation would be measured using the Chained Consumer Price Index (C-CPI), which generally provides a slower inflationary adjustment than the current Consumer Price Index (CPI) measurement. This measurement of inflation is applied for all individual tax inflation adjustments permitted in the Act and would be permanent, not expiring in 2025 with the other individual provisions.

IRS clarification is to come on what constitutes a "trade-or-business." Does a triple net lease structure with little management qualify? Does rental real estate activity qualify? Generally, a commercial or multifamily residential rental real estate entity should qualify. Code Sec. 1411 defines which activities may be considered a trade-or-business including passive activities such as rental real estate which are exempted from the 3.8% NIIT Obamacare tax. Thus, we are to look to this code section for determination of trade-or-business classification until clarification is received from the Treasury.

The Corker rule was added to help equalize the loss of DPAD and rate differential of C Corp. rates of 21% (see the flow chart from our Real Estate Connection presentation for further details). The key take-aways include:

a. Determination of "active" vs. "passive" participation is not a consideration. Thus, a Limited Partner/LLC Member receiving income from a partnership/LLC that has QBI may take the deduction. Further, income from a publicly traded partnership and ordinary REIT dividends qualifies as QBI for the 20% deduction.

b. You may receive the deduction on all QBI (even if you have a service business) if your AGI is less than $315K. The deduction is phased out at $415K for those married filing jointly (MFJ) (halve this amount for single filers). The limitation is 20% of QBI or 20% of taxable income before 20% deduction.

c. Taxable income does not include capital gains. You must subtract the net capital gains to determine the deduction limitation. Watch netting rules for 1231 gains from the sale of real estate. Any unrecaptured 1231 losses will be taxed at ordinary rates; thus, not considered capital gain and therefore not subtracted from income for limitation purposes (income characterized as ordinary income upon sale does not decrease your income for these purposes).

d. Real estate owners will generally use the 25% of W2 wages plus 2.5% of unadjusted basis of qualified property to determine the deduction limitation. But what is unadjusted basis?

    1. It represents the "depreciable" basis immediately after acquisition that is used in the trade or business at the end of the current tax year.

        i. For tangible personal property, the basis is available for up to 10 years. (Note: it's not tied to depreciable life.)

        ii. For other property, basis is included for the normal depreciable life such as 15, 27.5 or 39 years.

            (1) For both above, it is the "depreciable basis" without consideration of any prior depreciation taken.

iii. Any asset sold during the year is not available (it's not used in business as of the end of the tax year)

iv. Do Sec. 754 assets qualify? Can the 754 step-up basis be considered? It's questionable. Per Sec. 179(d)(2), acquisition from related party is NOT considered an acquisition of property for these purposes. Thus, would exclude any basis adjustments due to inherited property from a decedent. But what about a taxable sale? We need further guidance from the IRS!

e. What is a "service business?" It's any business that relies on the "reputation or skill of employees or its owners." The IRS is to provide further guidance on what this means.

1. Definitely included – attorneys, accountants, investment advisors

2. Definitely excluded – architects, engineers, contractors

3. TBD

i. "Brokers"

(1) For realtors—commercial or residential—this doesn't look good, but perhaps you might get lucky. Maybe you should consider calling yourselves "property relocation specialists"?

ii. "Consultants"

(1) Are developers in trouble here? Possibly, but with DPAD eliminated, they seem to be okay.

iii. Asset Managers

(1) Will they differentiate between asset management in the real estate sector compared to hedge fund asset managers/investment advisors? This is another area where we need further clarification.

4. Property managers are probably okay and qualify

f. Oregon is not expected to connect to federal law and will deny deduction. (Note: the pass-through entity reduced rates are still available for Oregon to the extent that you qualify.)

SECTION 179 DEDUCTION & BONUS DEPRECIATION

a. The 179 expense election increased the limitation to $1 million and the phase-out threshold to $2.5 million of asset additions each year. It also expanded qualifying real property to include roofs, HVAC, fire protection and alarm systems, and security systems, but there is a caveat: This is meant for certain real property components, so landlords, don't go crazy here! This is more for tenants and real property used in a "true" trade or business, which is never defined in the tax code anywhere.

b. Bonus Depreciation

1. Old rules: 50% for 2017 phases down to 40% in 2018, 30% in 2019, and expires after 2019

2. New rules: effective for assets both "acquired" and "placed in service" (PIS) after September 27, 2017. There's a 100% depreciation until 2022, then it decreases to 80%, and drops 20% per year thereafter until it's eliminated in 2027. But beware of the binding contract and the work of the significant nature rules, which we'll cover in section 3(b) below.

3. Acquisition rules depend on whether the asset is self-constructed or acquired.

i. Acquired property: Look at the written contract date to determine when the bonus depreciation is effective. The contract must be legally binding under state law, and it can't specify a limit of damages (unless damages are limited to 5% of the contract price).

(1) What if I have a tenant improvement (TI) that is PIS in 2018, but I had a contract to do the TI work before 9/28/17? Answer: you fall under old bonus depreciation rules, and thus may take 40% bonus depreciation for 2018.

ii. Self-constructed property: One must begin the manufacturing, construction or production during the specified bonus date. This date begins when significant physical activity occurs. This doesn't include preliminary activities such as planning, designing, securing financing, exploring or researching. Physical work of significant nature doesn't begin until the taxpayer has incurred more than 10% of the total cost of the property (10% safe harbor rule).

4. Applies to both "new or used" property; transfer from related party doesn't qualify

5. Dropped "pursuant to a lease" rule and "PIS more than three years after date building first placed in service" rule

6. The new "qualified improvement property" (QIP) concept combines old separate retail, restaurant and leasehold improvement real property definitions. Now all are 15 years using straight-line depreciation. The law's intent is that QIP qualifies for bonus depreciation. However, we will need a technical correction passed and signed into law to implement this intent. Currently it still falls under 39-year property rules (no bonus). As of the creation of this bulletin, the IRS clarified that they will allow 100% bonus depreciation on asset expensing for QIP effective for assets PIS after 9/27/17 through 12/31/17. These new rules can be incorporated in the preparation of 2017 income tax returns. Unfortunately, the IRS must wait until a technical correction is made for 2018 additions. Thus, QIP is 39-year property with no bonus until such time.

7. What about new construction? Can I take bonus depreciation?

i. Generally, if the tenant improvements were part of the contract for the original construction of the building, bonus depreciation is not available. It's only available for improvements made subsequent to the original placed-in-service date.

ii. If you construct a building and then later construct and complete tenant improvements, so long as those TIs are completed after the building has been constructed and placed-in-service, they should qualify for bonus depreciation. Look to the building contract and PIS dates vs. TI improvement contract and PIS dates.

8. Planning point: consider the new business loss and net operating loss (NO)L rules as you may benefit from electing Sec. 179 expense deduction vs. bonus depreciation to avoid business loss or NOL limitations.

9. Oregon is expected to remain connected here and follow federal rules.

EXCESS BUSINESS LOSS LIMITATION

Combined trade-or-business loss cannot exceed $500K MFJ ($250K for everyone else). The disallowed excess is carried forward as part of your NOL to future years, but it is limited to 90% of that year's taxable income instead of the normal 80% limitation discussed below. See our presentation slide examples for further details.

a. Note that this limitation applies after application of the passive loss rules.

b. For pass-through entities, this limitation is applied at the individual partner/shareholder level.

c. This provision only applies through 2025.

NET OPERATING LOSS (NOL) LIMITATION

The NOL is carry forward only without any expiration (two-year carryback period, and 20 year carryforward period are gone). Carryforward is limited each year to 80% of that year's taxable income before any NOL deduction (if you have an excess business loss, which is outlined above, that loss retains its 90% NOL limitation to offset future taxable income). Again, please reference our slide examples for further details.

1031 EXCHANGES

These are available for real property only. Personal property, equipment, vehicles, etc. no longer qualify. Items to consider in relation to this rule:

a. Trade-in/exchange of personal property will result in recognized gain on the old property, but you may take a Sec. 179 expense deduction, or claim 100% bonus depreciation on the acquired property. Thus, you'll likely offset any taxable income implications unless you overlap a tax year.

b. Watch cost segregation studies where personal property is carved out of building cost basis. The personal property will not qualify for tax deferral. But again, it maybe not so bad if you can claim bonus or the 179 deduction on the replacement property.

ENTITY CHOICE

Should I convert to a C Corporation? The decision is very fact specific, and one needs to consider operations (keeping money in business vs. distributing profits to owners), exit strategy to pass on at sale, death, etc.

a. Benefits

    1. Can deduct state and local income taxes

    2. AMT not applicable

        i. Section 1202 small business stock 100% gain exclusion for shareholders selling their stock in the C corporation if held > 5 yrs.

        ii. The 21% flat federal tax rate (though note that every dollar of taxable income is taxed at this rate. The former lower phased rates are gone.)

b. Challenges

    1. Intention for cash generated from operations. Double taxation if you don't plan to retain in the business unless paid out as rent or salary, but those need to be "reasonable". Deduction for the C corp. but included in the shareholders' taxable income.

    2. Dividends paid are taxed at only the maximum capital gains' 20% tax rate, but double taxation occurs as the corporation does not get a deduction for dividends paid to its owners

    3. Exit strategies

        i. May receive step-up in stock upon death, but cannot push that benefit through to the assets of the corporation without liquidating it like you can with partnerships/LLCs.

        ii. What if a buyer wants to purchase your assets? You're stuck with the double taxation issue again to get your cash out.

    4. Other than salary, there's no flexibility to allocate profits/deductions among owners compared to a partnership/LLC structure

One can always convert from a partnership to a C Corp. later once the Sec. 199A 20% deduction sunsets, if it makes sense with little to no income tax consequence. But the same cannot be said for getting out of a C Corp. structure.

OTHER ITEMS FOR BUSINESS

a. The rehab tax credit has been modified. Eliminated is the 10% credit for pre-1936 buildings and retained 20% credit for certified historic structures, but instead of getting 100% of the credit in the first year in service, one must now claim the credit equally over a 5-year period.

b. Entertainment expenses are not deductible (bye-bye Blazers, Mariners, Timbers and Thorns ticket deductions)

c. All meals are limited to a 50% deduction (even those provided for convenience of the employer); exempted are holiday parties/those provided for all employees

d. Transportation fringe benefits, such as parking, transit passes, and bicycles

    1. Are now non-deductible for the employer unless they're included in the wages of the employee.

    2. If there's a cafeteria plan, the employee may still exclude up to $260 per month from their wages if the employer provides a plan for parking and mass transit; however, no deduction is allowed if the employee excludes the cost from their income.

    3. Bicycle reimbursement is gone: no deduction is allowed and taxable wages go to the employee.

e. Expanded the ability for taxpayers to use the overall cash method of accounting

f. Luxury automobile depreciation limitations have increased

g. Research & Development (R&D) tax credit IRC Sec. 41 language wasn't changed, but the benefit after 12/31/17 was increased since the maximum corporate tax rate is going down from 35% to 21%, AMT repeal, and, if 80% NOL limitation applies, you can still use R&D credit to offset federal tax liability. However, Sec. 174 deduction for research expenditures paid or incurred in a tax year beginning after 12/31/21 will no longer be able to be immediately expensed. Instead they must be capitalized and amortized over a five-year period. While costs for research conducted outside of the US will be amortized over a 15-year period.

INDIVIDUAL PROVISIONS

a. Reduced tax rates: please see slides from our presentation

b. State and Local Tax (SALT) limitation is $10K

1. It applies to all state and local income and property taxes deducted on Sch. A – Itemized deductions
2. State workarounds? Some examples include: Sue the feds, make a charitable contribution in lieu of state income tax payment, payroll tax instead of income tax, etc.
3. 3.8% NIIT impact is limited to Sch. A deduction, or $10K

c. Home mortgage interest expense

1. Home equity interest deduction for $100K is suspended through 2025.
   i. The IRS recently clarified that if such a home equity line, HELOC, etc. (label doesn't matter) is used to acquire, construct or substantially improve the home secured by such debt, it is still deductible, so long as you are under the overall $750K limitation.
2. Former $1M limitation on qualified acquisition indebtedness is reduced to $750K
3. Debt prior to 12/15/2017 is grandfathered, including later refinances so long as the new debt does not exceed the original debt amount.
4. Still allowed on primary, plus one other residence

d. Misc. itemized deductions are suspended through 2025

1. Examples include: employee business expenses, tax preparation fees, investment advisor fees, private equity fund expenses via K1s, etc.; these examples are no longer deductible.

b. Personal exemption is suspended through 2025.

c. Pease limitation is suspended through 2025.

d. Charitable contributions cash increased from 50% to 60% of AGI, but no deduction is allowed for payments in exchange for sports seating rights.

1. Consider donor advised funds (DAF) to help with "bunching" of charitable contributions
2. If over 70.5 years old, consider a direct from IRA to charity transfers of up to $100K each; it counts toward your required minimum distribution requirement, but there's no taxable income and no charitable deduction.

e. Charitable contributions cash increased from 50% to 60% of AGI, but no deduction is allowed for payments in exchange for sports seating rights.

f. Standard deduction increased to $24K ($12K single) through 2025 (such amounts are to be indexed for inflation)

g. After 2018, alimony is no longer deductible nor includable in income. This includes revisions to current divorce agreements, though pre-2018 agreements are otherwise grandfathered and retain prior law rules.

ESTATE AND GIFT TAX LIFETIME EXEMPTION

This exemption was increased to approximately $11.2 million per person from $5.49 million per individual. However, please note that state exemptions remain same: $1 million for Oregon and $2 million for Washington.

a. 2025 sunset is a use it or lose it opportunity. You may ask, "My estate is $5M single/$10M joint, why should I bother using the additional exemption now?" Here are some reasons:

1. Compounding/future growth for younger taxpayers: think of doubling of value over 10 years
2. Likelihood the exemption will be reduced
3. Oregon and Washington don't track/tax lifetime gifts

b. Step-up in basis: Sec 754 basis adjustment

1. Step-up was retained with the new tax law, but you need to own the assets when you die
2. Need to carefully plan what assets are gifted vs. held
3. Consider structuring trusts that can exchange low basis with high basis property

c. Spousal access trusts provide flexibility

CITY/COUNTY RULE REGARDING 754 (STEP-UP) DEPRECIATION/AMORTIZATION DEDUCTION

In October 2017, the City of Portland Revenue Bureau issued a policy to disallow the deduction for City of Portland and Multnomah County tax returns for Sec. 754 depreciation. This depreciation is typically passed through and reported on the partner's schedule K1 line 13W rather than deducted within the body of the partnership return. It is their opinion that this is an individual partner level deduction. What is of importance is this is not only a matter of the current year depreciation deduction but they are essentially not recognizing the entire 754 step-up basis of partnership assets, and thus, will disallow the stepped-up tax basis upon disposition of the underlying asset as well. A hearing is expected to be scheduled later in April; more to come whether this will stand. Several accounting professionals are opposing this policy. We encourage you to contact your representatives in the City/County or submit a letter of opposition to the proposed rule prior to the hearing.

TAX EXTENDERS ISSUED FEBRUARY 2018

In addition to tax changes under TCJA, there are many existing provisions which were extended through 2017, such as:

Exclusion from gross income of discharge of qualified principal residence indebtedness (often, foreclosure-related forgiveness)

Deduction for qualified tuition and related expenses

179D – an energy-efficient commercial building tax deduction up to $1.80/sq. ft.

45L Tax Credit – a residential energy-efficient credit of $2,000 per dwelling unit to developers of energy efficient homes and apartment buildings.

We hope you found these elaborations on specific real estate industry-related tax reform topics helpful. We will provide updates as they become available and, as always, if you have any questions or need further clarification, we recommend contacting your Perkins & Co tax advisor.
