Client Alert: "Tax Reform" Highlights for Real Estate Businesses

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The Tax Cuts and Jobs Act (the "**Act**") was signed into law on December 22. The Act brings about immediate, sweeping changes to the federal income tax laws—especially relating to the commercial and residential real estate industries.

Highlights of the Act relating generally to U.S. real estate businesses and their owners are described below (Click here for our recent Client Alert covering the Act generally). Given the extensive nature of the changes and complexities of the Act, the ultimate impact of tax reform on each taxpayer is highly individualized. Taxpayers are encouraged to discuss with their tax advisors the impact of the new tax reform law on their business structure and operations.

Like-Kind Exchanges

Under the Act, taxpayers will continue to be able to defer gain recognition on the sale of real estate by structuring the sale as a Section 1031 like-kind exchange. Beginning in 2018, however, like-kind exchanges of personal property no longer are permitted.

Federal Income Tax Rates

Flat Corporate Rate. Beginning in 2018, all C corporations will be subject to a 21% federal tax rate on net income, regardless of income level. This new rate is set to continue indefinitely.

Graduated Individual Rates. Beginning in 2018, the seven tax brackets applicable to individuals will shift in scope and the rates applicable to these brackets will be somewhat lower than current rates, with a 37% maximum rate (down from the current 39.6% maximum rate). Qualified dividends and capital gains will continue to be subject to tax at a maximum rate of 20%. Unrecaptured Section 1250 gain (reversing prior depreciation deductions) will continue to be taxed at a maximum rate of 25%. The new graduated individual rates are set to expire after 2025.

Carried Interest

Real estate businesses often are organized as limited partnerships or LLCs treated as partnerships for federal income tax purposes. Typically, the manager of such a partnership receives an interest in the partnership's profits (a "carried interest") in connection with the management services that they provide. Prior to 2018, items of partnership income allocated to a manager with respect to such carried interest could retain its character as ordinary income, long-term capital gain or short-term capital gain, that it had when earned by the partnership. Beginning in 2018, the Act effectively imposes a 3-year holding requirement in order for capital gain recognized with respect to such carried interests to be taxed as long-term capital gain. If the 3-year holding period is not satisfied, then any such capital gain will be treated as short-term gain and taxed at ordinary income rates.

20% Deduction for Qualified Business Income of Individuals

Beginning in 2018, an individual taxpayer generally may deduct 20% of his or her share of net qualified business income from a U.S. trade or business operated through a partnership, S corporation, sole proprietorship, or LLC treated as a partnership or disregarded entity for federal income tax purposes. Qualified business income generally excludes investment items, such as gains or losses from the sale of capital assets.

For individuals with taxable income above $156,500 ($315,000 for married filing jointly), the deduction generally will be limited to the greater of 50% of the individual's share of wages paid by the business or, alternatively, the individual's share of 25% of the wages paid by the business *plus* 2.5% of the purchase price of qualified property. Qualified property generally includes all depreciable property used in the trade or business (e.g., buildings and other improvements) for which the recovery period has not ended.

The 20% deduction for qualified business income is set to expire after 2025. Look for an upcoming Vorys Client Alert for a more detailed discussion of this deduction and applicable limitations.

Business Interest Deduction Limitation

Beginning in 2018, the deduction for interest expense available to most businesses for a taxable year will be limited to 30% of the adjusted gross taxable income of the business for such year, computed without reduction for interest, taxes, depreciation, amortization or depletion. Beginning in 2022, this limit will be further reduced by taking into account depreciation, amortization and depletion (though not interest or taxes) in the computation of adjusted gross taxable income. Interest expense deductions that are disallowed as a result of the limitation described above could be carried forward indefinitely.

Real estate businesses can affirmatively elect out of the new interest business interest deduction limitation, but will be required to use the alternative depreciation system ("ADS") discussed below. Businesses with an average of not greater than $25,000,000 in annual items of gross receipts for the immediately-preceding 3-year period are exempt from the limitation, regardless of depreciation schedule.

If a business is organized as a partnership, the limitation generally will be calculated at the partnership level. Determining each partner's allocable share of the business interest deduction can be complex. The business interest deduction limitation is set to continue indefinitely.

Modification of the Net Operating Loss Deduction

Currently, net operating losses ("**NOLs**") generated by a business in a taxable year may be carried back 2 years and carried forward 20 years. NOLs generated in taxable years ending after December 31, 2017 generally may not be carried back, but may be carried forward indefinitely. In addition, the Act limits the available deduction for such NOLs to 80% of taxable income in the year of deduction (computed before the NOL deduction). These changes are set to continue indefinitely.

Limitation on State and Local Tax Deduction for Individuals

Beginning in 2018, the Act generally limits an individual's ability to claim federal itemized deductions for state and local (and certain foreign) taxes. The Act provides that, for any taxable year, an individual may claim an itemized deduction of up to a maximum amount of $10,000 for aggregate state and local personal property taxes, real property taxes, and income taxes (and certain foreign and sales taxes) paid or accrued during that year. The limit for a married individual filing separately is $5,000 per year.

The limitation does not apply to state, local, or foreign property taxes, or to state or local sales taxes, in each case that are paid or accrued in carrying on a trade or business or for the production of income. Such property taxes and sales taxes generally are allowed as a deduction and will not be included in the $10,000 aggregate limit. The limitation does, however, apply to state and local *income* taxes paid or accrued in carrying on a trade or business or for the production of income.

The limitation on state and local tax deduction is set to expire after 2025.

Cost Recovery

For property placed in service after December 31, 2017, the Act eliminates the separate definitions of qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property and provides a 15-year recovery period for all "qualified improvement property" and a 20-year ADS recovery period for such property. The Act also lowers the ADS recovery period to 30 years for residential rental property. Any real property trade or business electing out of the interest expense deduction will be required to use the ADS.

Temporary 100% Expensing of Certain Business Assets

The Act temporarily expands the "bonus depreciation" provisions to allow for full expensing of qualified property. Businesses generally will be able to expense 100% of the cost of qualified improvement property and other tangible, personal property used in the trade or business, which property is acquired and placed into service after September 27, 2017 and before January 1, 2023. The expensing allowance decreases by 20% per year after 2022, and is completely eliminated after 2026. Generally, used property acquired and placed in service after September 27, 2017 will be eligible for 100% expensing. In addition, property that was acquired (but not placed in service) prior to September 27, 2017 may be eligible for a reduced percentage of expensing, depending on when it is ultimately placed in service.

Expanded Section 179 Expensing

Beginning in 2018, the Act increases from $500,000 to $1,000,000 (subject to adjustment for inflation) the amount that certain businesses may immediately expense for the cost of "Section 179 property" placed in service during a taxable year. If the business places in service more than $2,500,000 (subject to adjustment for inflation) of Section 179 property in a taxable year (up from $2,000,000), then the amount available for immediate expensing is reduced by the amount by which the cost of such property exceeds $2,500,000. The Act also expands the definition of "Section 179 property" to include tangible business assets as well as qualified improvement property and certain other improvements (specifically, roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems) made to nonresidential real property.

Conclusion

The Act changes the federal income taxation of real estate businesses in many material respects. Contact your Vorys attorney if you have any questions about the application of the Act to your business, or if you would like assistance in adapting your business to these changes.