CLEARY GOTTLIEB

ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Real Estate Industry

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On December 22, 2017, the President signed into law the 2017 U.S. tax reform bill formerly known as the Tax Cuts & Jobs Act (the "TCJA"). This event marks the culmination of an extremely rapid legislative process, beginning with the bill's introduction in the U.S. House of Representatives on November 2, 2017. Most of the TCJA's provisions took effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system that are likely to have a profound impact both on the economy as well as the structuring of organizations and transactions. This memorandum sets forth a few key observations about the TCJA that may be relevant to the real estate industry.

Executive Summary

This memorandum describes four key issues for real estate businesses and investors to focus on, which are described in more detail below:

- Significant reductions to the headline tax rates for U.S. corporations, most business income earned through partnerships, and dividends from real estate investment trusts (REITs) could impact the decision of which entity to choose for a real estate investment.
- The value of net operating losses (NOLs) may be significantly reduced as a result of the lower tax rates and new limitations on their use.
- New rules that allow the immediate expensing of assets would not apply to most real property.
- Acquisition financing structures may be affected by limitations on net interest expense deductions, but favorable rules allow real property businesses to elect out of this limitation, with seemingly little penalty.

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Additionally, this memorandum describes (1) changes to individual taxation that could impact the economics of real estate transactions and the real estate market overall, that investors should take into account as part of their strategic planning and (2) other changes specifically addressing common real estate transactions.

1. **Reduction in Headline Tax Rates and Implications on Entity Choice**

— Changes to the tax rates imposed on corporations, flow-throughs, REITs and individuals will influence the decision for which entity form to use for a particular investment. The most tax-efficient choice will depend on a number of factors, including the type of assets the entity will hold, the type of business it will conduct, the identity and tax classification of its owners, and the desirability of distributing cash to the owners versus re-investing the cash in the business.

— For corporations:

- The TCJA lowers the U.S. corporate tax rate to 21%, with corresponding changes to the deduction for dividends received from U.S. corporations. The rate reduction is effective starting in 2018.
- The corporate alternative minimum is repealed.

— The TCJA changes tax rates for other types of entities used in the real estate industry:

- For businesses operating in flow-through form (including through partnerships, S corporations and sole proprietorships), the TCJA provides for a deduction from income equal to 20% of "qualified business income" earned by non-corporate taxpayers through the flow-through entity, which would result in a marginal federal tax rate of 29.6% for an individual in the top tax bracket. Unlike the change in corporate tax rate, this deduction is not permanent: it is scheduled to expire after 2025.
  - Qualified business income generally includes income from real estate businesses.
  - The total amount of income eligible for the deduction is capped for each taxpayer at the greater of (a) 50% of the taxpayer's allocable share of the W-2 compensation paid by the flow-through entity or (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the flow-through entity's tangible assets.
  - Real property businesses and other businesses that hold a large amount of depreciable tangible assets but might not have employees can be expected to benefit specifically from the second prong of this cap. For example, a real property business that purchased property for $100 million with a 39-year depreciable life would have a minimum cap of $2.5 million per year over the depreciable life of the property, which cap could be further increased by employee compensation and other tangible assets. It appears that assets eligible for immediate expensing (see section 3 below) are included as tangible assets for purposes of calculating this cap.
  - The TCJA also includes a carried interest provision that is significantly narrower than carried interest provisions that have previously been proposed. *It is not a "broad attack" on carried interest.* Rather, for certain partnership profits interests (of the sort that generally would be issued by an investment partnership), it applies a 3-year holding period requirement for capital gains derived by the partnership (or from the disposition of the profits interest) to qualify for the long-term capital gains rate. Given the fact that investment partnerships often hold investments for longer than three years before realizing capital gains, in many cases the effect is unlikely to be material.
- The TCJA provides a similar deduction equal to 20% of certain dividends from REITs (other than capital gain dividends) and income from publicly traded partnerships (*i.e.* MLPs). Neither of these deductions is

subject to the W-2 wages cap. As with the deduction for flow-through entities, these provisions expire after 2025.

— These changes in tax rates may impact the decision to operate a business in corporate form vs. as a flow-through, and whether to use a REIT to hold real estate assets.

- For example, business income earned by individuals in the top tax bracket through a partnership is subject to an effective federal tax rate of 29.6%, while such income received as dividends from a corporation would be taxed an a combined effective rate of 36.8% (21% at the corporation level, with the remaining 79% taxed to the individual at the capital gains rate of 20%). However, there may be offsetting advantages of operating in corporate form, particularly if the business does not intend to distribute its cash flows regularly, or if there are significant foreign operations:
  - If the corporation does not regularly distribute its earnings, then earnings would be taxed at a rate of 21% until dividends are paid (or an anti-abuse rule applies to subject them to tax earlier).
  - If a portion of the business operates through foreign subsidiaries, then a U.S. corporate owner of those subsidiaries would be eligible for an exemption from the tax that would be imposed on dividends from the foreign subsidiaries. Non-corporate taxpayers are not eligible for the exemption.
- It may also be desirable to hold real estate assets (such as mortgage receivables) in a REIT. The REIT would not be subject to an entity-level tax on its income provided it complies with REIT qualification and distribution rules, and under the TCJA, that income would be taxed at an effective rate of 29.6% when distributed to an individual shareholder in the highest marginal tax bracket (due to the 20% deduction). This effective rate is the same as the rate applicable to flow-through income, but unlike flow-throughs where the 20% deduction is subject to a cap, there is no cap on the deduction for dividends paid by a REIT. Therefore an investor may achieve a higher after-tax return by placing real estate assets in a REIT compared to a partnership or corporation.

2. **Limitations on the Use of NOLs**

— Under the TCJA, carrybacks of NOLs are no longer allowed, while carryforwards become indefinite. The carryback and carryforward rules apply only to NOLs that arise in taxable years *ending after* December 31, 2017 – *i.e.*, they capture some 2017 NOLs for non-calendar year taxpayers.

— A company may use NOLs to offset only 80% of the company's taxable income (with unused NOLs carried forward into future years). This 80% cap applies to NOLs that arise in taxable years beginning after December 31, 2017.

— These changes will be relevant in modelling returns on investments.

— Additionally, the reduced 21% corporate tax rate could significantly reduce the benefit of existing NOLs (which prior to the TCJA were valued assuming they offset income taxed at a higher rate).

3. **Expensing and Depreciation**

— **Expensing:**

- *Immediate Expensing For Equipment, But Not Real Property.* The TCJA allows U.S. taxpayers to immediately deduct 100% of the cost of certain qualified property acquired after September 27, 2017, and placed in service before January 1, 2023.

  - "Qualified property" is, generally, depreciable tangible property (including used property) with a depreciation recovery period of 20 years or less, and therefore does not include shares in corporations, or intangibles such as goodwill and intellectual property. It does not include property that is leased rather than purchased. And it does not include real property.
    - Qualified property may also include a new category of "qualified improvement property," which is defined under the TCJA as any improvement to the interior of nonresidential real property, other than (x) enlargements of the building, (y) elevators and escalators, and (z) internal structural frameworks, provided that the improvement is placed in service after the nonresidential property is placed in service. As described below under "Depreciation," according to the Joint Explanatory Statement accompanying the TCJA, qualified improvement property is intended to have a recovery period of 15 years, and would therefore appear to be eligible for immediate expensing under this rule. However, the text of the TCJA did not specifically assign a recovery period to this type of property, and therefore its eligibility for immediate expensing is uncertain.
  - Immediate expensing is also allowed for qualified property placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it reverts to the previously existing depreciation schedule for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods).
  - The short life of the rule may create an incentive to acquire assets eligible for immediate expensing within the next 5 years (or accelerated expensing in years 6 to 10).
- *Additional expensing for small businesses.* In addition to the rules above, an election for small businesses to immediately expense certain qualified property (including certain types of real property, discussed below) now allows a maximum annual expense of $1,000,000, compared to the pre-TCJA maximum of $500,000, for all taxable years after 2017. This $1,000,000 cap is reduced, dollar-for-dollar, by the amount by which the aggregate cost of such property exceeds $2,500,000 in a taxable year (compared with $2,000,000 under pre-TCJA law). These amounts are indexed for inflation for taxable years beginning after 2018.
  - The TCJA expands the classes of real property-related assets that are eligible for immediate expensing under this rule compared to pre-TCJA law. Specifically, it includes "qualified improvement property" (defined above), as well as improvements to roofs, heating, ventilation and air conditioning property, fire protection and alarm systems, and security systems of nonresidential property (if the improvement is placed in service after the nonresidential real property is placed in service). This replaces the narrower pre-TCJA rule that limited immediate expensing to certain leasehold improvement, restaurant, and retail improvement properties. Under the TCJA, immediate expensing is now also permitted for certain tangible personal property used predominantly in connection with the furnishing of lodging.

— **Depreciation:**

- The TCJA generally maintains the depreciation recovery periods for real property.
  - Nonresidential real property and residential rental property keep their 39 and 27.5 year depreciation recovery periods, respectively.
  - According to the Joint Explanatory Statement describing the legislation that accompanied the TCJA, "qualified improvement property" (described under "Expensing" above) is intended to have a 15 year depreciation recovery period. However, the actual text of the TCJA does not specifically categorize

qualified improvement property as 15-year property. This appears to be an oversight, but whether or not this Congress or a future one enacts a technical correction to fix the mistake is uncertain.

- Longer recovery periods continue to apply for property that is required to be depreciated (or if a taxpayer elects to depreciate it) under the alternative depreciation system ("ADS"). In the case of residential rental property, the ADS recovery period is shortened under the TCJA from 40 years to 30 years.
  - As described below under "Limit on Net Interest Expense Deductions," real property trade or businesses may elect not to be subject to new rules that limit the deductibility of business interest. If they do so, such businesses would be required to use the longer ADS recovery periods for nonresidential real property, residential rental property and qualified improvement property, such that: the depreciation recovery period for nonresidential real property (other than land) is extended from 39 years to 40 years, and the recovery period for residential rental property is extended from 27.5 years to 30 years.[1] These new recovery periods would apply for all such property held by the taxpayer at the time the election is made (*i.e.*, there is no grandfathering for previously acquired property).

4. **Limit on Net Interest Expense Deductions**

— The TCJA limits the deduction for net business interest expense. The rule applies to any debt outstanding on January 1, 2018. There is no grandfathering.

— *Election out for real property businesses.* However, the impact on the real estate industry will likely be limited, because certain real property businesses can make an irrevocable election not to be subject to the limitation. Specifically, a "real property trade or business" – which includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business – may elect out of the interest deduction limitation that would otherwise apply. The Secretary of the Treasury is charged with providing guidance on making the election.

- If a real property business makes this election, the depreciation recovery periods applicable to real property are slightly extended, as discussed in section 3 above. Given the very minimal extensions of the applicable recovery periods, it would seem preferable in nearly all circumstances for a real property trade or business with net interest expense that would otherwise be subject to this limitation to make the election out.

— *Impact if no election is made.* If an election out is not made, the new rule limits the deduction for net business interest expense to 30% of adjusted taxable income.[2] "Adjusted taxable income" is similar to EBITDA for taxable years 2018 through 2021, and EBIT for 2022 and later years. Disallowed interest expense can be carried forward indefinitely.

- This rule, when it applies, may raise the cost of financings for higher-leveraged companies, including capital intensive companies, recently acquired companies and companies in a growth mode funded by debt.

[1] As discussed above, the recovery period for qualified improvement property is not specified in the legislative text. However, it seems intended to be extended from 15 years to 20 years if the taxpayer elects out of the interest expense limitation.

[2] The separate limitation on interest expense deductions based on a worldwide leverage test, which was included in prior versions of the TCJA, was not adopted.

- It is consistent with similar changes in law that have been enacted recently by some of our trading partners (*e.g.*, Germany, UK) as a result of the OECD Base Erosion and Profit Shifting (BEPS) project.
- Particularly in 2022 and later years, the change from EBITDA to EBIT may mean that businesses with significant expenditures eligible for expensing will have little or no capacity for interest deductions. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect; therefore U.S. borrowers should take into account the switch to EBIT in considering their current debt profile.
  - Additionally, this change may encourage acquisitions of tangible assets eligible for 100% expensing (described in section 3 above) in taxable years before 2022, to accelerate depreciation deductions into earlier years and increase capacity for interest expense deductions in 2022 and later years.
- The rule is expected to apply on a U.S. consolidated group-wide basis for domestic corporations. Partnerships are evaluated on a separate entity basis, with rules to allow "excess" adjusted taxable income to tier up. The location of debt financing among partnerships or non-consolidated companies may affect deductibility.

5. **Changes to Individual Taxation Could Impact the Residential Real Estate Market**

— The TCJA contains other changes to the taxation of individuals that could potentially impact the frequency and value of transactions in the residential real estate market. Most significantly:

- The TCJA reduces the principal amount of a mortgage for which the mortgage interest deduction could be taken from $1 million to $750,000 for newly purchased homes.
- The itemized deduction available for non-business state and local property taxes is capped at $10,000 for married persons filing jointly, and no deduction is allowed for foreign real property taxes. However, deductions for real property taxes attributable to a trade or business are allowed.

— These changes could chill activity in the residential real estate market, the prices that taxpayers are willing to pay for new homes, and the terms of their financing, but their impact may be offset by other aspects of the bill, including rate reductions. All of these changes expire after 2025.

6. **Other Changes Relevant to Common Real Estate Transactions**

— The rule providing for deferred taxation of "like-kind exchanges" is retained but only for transactions involving real property not held primarily for sale. The modified "like-kind exchange" provision applies to exchanges completed after December 31, 2017.

— Non-shareholder contributions to the capital of a corporation by governmental entities or civic groups are taxable to the corporation. This includes, for example, a contribution of municipal land to an entity by a municipality (but not, by contrast, a municipal tax abatement).

— The TCJA repeals the general rehabilitation tax credit that applies to any building placed in service before 1936. However, it has retained the rehabilitation tax credit that applies to expenditures with respect to certified historic structures, with a modification providing that the credit is taken ratably over the 5-year period after rehabilitated property is placed in service.

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