CLEARY GOTTLIEB

ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Real Estate Industry

November 14, 2017

On November 2, 2017, the much anticipated Tax Cuts & Jobs Act was introduced in the U.S. House of Representatives. The bill was amended several times before being approved by the House Ways & Means Committee on November 9.

On November 9, the Senate introduced its own version which, while having many similarities, is also significantly different (although the Senate's version is reflected only in a description, not legislative text).

This memorandum sets forth a few key observations about the proposed bills that may be relevant to the real estate industry. It must be emphasized, however, that the House and Senate bills are likely to go through many additional changes before a single agreed-upon version becomes law, if ever.

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1. **Key Benefits for U.S. Corporations**

— The bills would lower the US corporate tax rate to 20%. Under the House bill, the rate reduction would be effective starting in 2018. The Senate bill would delay this for one year and have the rate reduction effective starting in 2019.

- However, the deduction for dividends received from less-than-80% owned U.S. corporations would be reduced such that the effective tax rate for these dividends is the same as under current law (*i.e.*, unaffected by the lower 20% corporate rate).

— The corporate alternative minimum tax would be eliminated

2. **Non-Corporate Tax Rate Changes**

The bill proposes rate changes to other types of entities used in the real estate industry:

— Under the House bill, real estate income earned by individual owners of partnerships, S corporations and sole proprietorships would be taxed at a maximum rate of 25%, except that managers that actively participate in

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the entity's business would pay tax at the standard marginal rate for the labor component of that income, which is presumed to be 70% of the entity's income (subject to modification for capital-intensive businesses). The special 25% rate does not apply to certain investment-related income (capital gains, dividends, interest and similar items, which will continue to be taxed as under current law), nor to certain services companies.

- For these purposes, rental income from real property is generally considered passive business activity income, except with respect to owners that perform more than half of their services (and over 750 hours of services) for real property businesses in a given year.
- Certain dividends received from a real estate investment trust (other than capital gain dividends) would also be taxed at a 25% rate.

— The Senate bill does not include the 25% rate for pass-through income, but instead provides for a 17.4% deduction for business income (including real estate income) received through pass-through entities, with a cap equal to 50% of the W-2 compensation treated as paid by the taxpayer.

— The House bill proposes a carried interest provision. The Senate bill does not have a similar provision. The provision in the House bill is considerably simpler 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.

3. **Limits on Deductibility of Net Operating Losses (NOLs)**

Both bills would place limits on the ability to deduct NOLs by companies that operate in corporate form:

— Carrybacks of NOLs would be repealed, while carryforwards would become indefinite (with an inflation adjustment, in the House bill). The carryback and carryforward rules would apply only to NOLs that arise in taxable years beginning *after* December 31, 2017.

— A company would be able to deduct NOLs only to the extent of 90% of the company's taxable income under the proposal, consistent with the rules under the existing AMT. Since this rule applies in the AMT context under current law this means that, in many cases, the effective tax rate for the use of NOL carryovers is not changing materially.

- The 90% restriction would apply to taxable years beginning after December 31, 2017.
- Under the House bill (but not the Senate bill), unlike the repeal of NOL carrybacks discussed above, the 90% restriction would *not grandfather preexisting NOLs*. Consequently, companies with substantial existing losses to carryforward would still pay some federal income tax in future years.
- To the extent you have existing NOLs, this rule – together with the reduced 20% corporate tax rate – could significantly reduce the benefit of those NOLs.

4. **Expensing and Depreciation**

— Under both bills, U.S. taxpayers would be able to immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023. However, the proposals would exclude real property, and the House bill (but not the Senate bill) would also exclude any other property used in a "real

property trade or business" (including development, construction, acquisition, conversions, rental, operation, management, leasing, or brokerage businesses).

- The short life of the rule would create an incentive to acquire assets eligible for immediate expensing within the next 5 years.

— In the Senate bill (but not the House bill), the recovery period for depreciation of real property (other than land) would be reduced to 25 years (from 39 years under current law).

— The maximum annual amount of the immediate deduction available for certain qualified property (including certain types of real property) acquired by small businesses would be increased from the current law maximum of $500,000. In the House bill, the maximum would be $5,000,000 for taxable years through 2022. In the Senate bill, the maximum would be $1,000,000 for all taxable years after 2017.

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

The bills propose 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 House bill (but not the Senate bill) would reduce the principal amount of a mortgage for which the mortgage interest deduction could be taken from $1 million to $500,000 for newly purchased homes, and would eliminate the deduction with respect to indebtedness used to acquire a second home.

— In both bills, the $250,000 capital gains exemption for gain on the sale of a principal residence would apply only if the owner used the property as a principal residence for at least five out of the eight years preceding the sale (compared to two out of five under current law). The House bill also includes a new phaseout based on the taxpayer's adjusted gross income.

— In the House bill, the itemized deduction available for state and local property taxes would be capped at $10,000 for married persons filing jointly, and there would be no deduction for foreign real property taxes. The Senate bill would not allow any deduction for real property taxes (except to the extent imposed on business assets).

These changes (plus other smaller changes like the elimination of mortgage credit certificates in the House bill) 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.

6. **Limits on Net Interest Expense Deductions**

— Both bills propose two separate limits on net interest expense deductions. In each bill, the "worst of" the two rules will apply. The proposals would apply to any debt outstanding on Jan. 1, 2018. There is no grandfathering.

— However, the impact on the real estate industry may be limited, due to the exclusion in one of the rules for interest income incurred in connection with a real property business, and the application of the second rule only to corporations that are members of a multinational group. To the extent these rules do apply, the overall effect of the limitations will depend on all of the bill's other provisions, including the proposed corporate tax rate of 20%.

— *First Rule. 30% Earnings Limit.* The first rule limits the deduction for net business interest expense to 30% of adjusted taxable income (similar to EBITDA in the House bill and EBIT in the Senate bill). This rule does

not apply to interest income incurred in connection with a real property business. Disallowed interest expense can be carried forward, for 5 years in the House bill and indefinitely in the Senate bill.

- This 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.
- 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.
- 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.

— *Second Rule. Limit based on Groupwide Leverage*. The other new rule is intended to limit the net interest expense deductions of companies that are overleveraged in the United States compared to the company's global operations. Unlike the first rule, this rule does not expressly carve out interest expense for real property businesses. The net interest expense of U.S. borrowers would be capped at 110% of the U.S. share of the group's overall EBITDA (in the House bill) or the group's global leverage ratio (in the Senate bill).

- This rule is a blunt instrument. It may deny interest expense deductions if U.S. operations have higher leverage as a result of different capital needs for different types of business inside and outside the United States. The rule could also affect groups with low overall leverage, if that leverage is unevenly distributed between the group's U.S. and global operations. There is no de minimis exception.

7. **Other Changes Relevant to Real Estate Transactions**

— The rule providing for deferred taxation of "like-kind exchanges" would be retained but only for transactions involving real property not held primarily for sale.

— The House bill (but not the Senate bill) would provide that non-shareholder contributions to the capital of a corporation or other entity, other than contributions in exchange for stock or equity, would be taxable to the entity. This would include, for example, a contribution of municipal land to an entity by a municipality (but not, by contrast, a municipal tax abatement).

— The House bill (but not the Senate bill) would provide that interest income on private activity bonds, and bonds used to finance sports facilities, issued in the future, can no longer be tax-exempt.

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