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ALERT MEMORANDUM

Tax Cuts & Jobs Act: Considerations for Real Estate Industry

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If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors

NEW YORK

Corey Goodman
+1 212 225 2812
cgoodman@cgsh.com

Yaron Reich
+1 212 225 2540
yreich@cgsh.com

Jason Factor
+1 212 225 2694
jfactor@cgsh.com

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"). Most of the TCJA's provisions take effect January 1, 2018.

The TCJA introduces significant changes to the U.S. tax system. This memorandum sets forth a few key observations about the TCJA that may be relevant to the real estate industry.

1. **Key Benefits for U.S. 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— The corporate alternative minimum is repealed.

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

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

— It provides for a deduction for purposes of income tax equal to 20% of qualified business income (including real estate income) earned by non-corporate taxpayers through pass-through entities, with a cap equal to the greater of (a) 50% of the taxpayer's allocable share of the W-2 compensation paid by the partnership, S corporation or sole proprietorship or (b) the taxpayer's allocable share of 25% of such W-2 compensation plus 2.5% of the unadjusted acquisition cost of the pass-through entity's tangible assets. Real property 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.

— The TCJA also provides for a deduction equal to 20% of certain dividends from real estate investment trusts (other than capital gain dividends) and income from publicly traded partnerships, and neither of these deductions is subject to the W-2 wages caps.

— These provisions expire after 2025.

— The TCJA also includes a carried interest provision. The provision 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)**

The TCJA places limits on the ability to deduct NOLs by companies that operate in corporate form:

— 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 a maximum of 80% of the company's taxable income, for taxable years beginning after December 31, 2017 (with unused NOLs carried forward into future years).

— To the extent you have existing NOLs, the reduced 21% corporate tax rate could significantly reduce the benefit of those NOLs.

4. **Expensing and Depreciation**

— The TCJA allows U.S. taxpayers to immediately deduct 100% of the cost of certain qualified property acquired and placed in service before January 1, 2023. Immediate expensing is also allowed for property placed in service in 2023 and afterwards, with the percentage of cost that is immediately deductible stepping down annually until it is phased out completely for property placed in service after 2026 (or 2027, in the case of certain property with longer production periods). However, the immediate expensing rule does not apply to real property.

  • The short life of the rule may create an incentive to acquire assets eligible for immediate expensing within the next 5 to 9 years.

— For any real property business that elects not to be subject to the interest expense limitation described in "Limit on Net Interest Expense Deductions" below, 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, in each case for all taxable years beginning after December 31, 2017 (*i.e.*, there is no grandfathering for property placed in service before 2018).

— The maximum annual amount of the immediate deduction available for certain qualified property (including certain types of real property) acquired by small businesses is increased to $1,000,000 from the current law maximum of $500,000, for all taxable years after 2017.

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

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

— However, the impact on the real estate industry may be limited, because real property businesses can elect not to be subject to the limitation. To the extent the rule does apply, the overall effect of the limitation will depend on all of the bill's other provisions, including the proposed corporate tax rate of 21%. If a real property business makes this election, the depreciation recovery periods applicable to real property are slightly extended, as discussed in "Expensing and Depreciation" above.

— If the provision applies (and if an election out is not made), the new rule limits the deduction for net business interest expense to 30% of adjusted taxable income. "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.
- 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, for companies with significant expenditures eligible for expensing, there may be little or no capacity for interest deductions, due to the change from EBITDA to EBIT. That change would apply to any debt instruments that exist at that time (there is no grandfathering), creating a cliff effect, and 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 "Expensing and Depreciation" 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.

6. **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.

7. **Other Changes Relevant to 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.

— 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).

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