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Tax Reform: Impact on REITs, Real Estate Businesses and Investors

Pass-Through Business and Interest Deductions, Cost Recovery, Carried Interest, Sale of Partnership Interests, and More

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SEYFARTH SHAW

Tax Reform: Impact on REITs, Real Estate Businesses, and Investors

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Agenda

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06 Like-Kind Exchanges

07 Carried Interest Holding Period

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Overview: Status of Treasury/IRS Guidance

- What guidance has been issued since our February 2018 presentation?
  - 199A:
    - Final Regulations (Set 1) – January 18, 2019 (replacement version issued on February 1, 2019)
    - Temporary Regulations (Set 2) – January 18, 2019
    - Revenue Procedure 2019-11 – January 18, 2019
    - Notice 2019-7 with Proposed Revenue Procedure – January 18, 2019
  - Business Interest:
    - Proposed Regulations – November 26, 2018
    - Revenue Procedure 2018-59 – November 27, 2018
    - Notice 2018-28 – April 2, 2018
  - Cost Recovery:
    - Proposed Regulations – August 8, 2018

Overview: Status of Treasury/IRS Guidance

- What have we received so far?
  - Like-Kind Exchanges:
    - Nothing (except the 199A-related guidance we will discuss)
  - Carried Interest Holding Period:
    - Notice 2018-18 - March 1, 2018
  - Qualified Opportunity Zone Funds:
    - Proposed Regulations (Set 1) – October 19, 2018
    - Proposed Regulations (Set 2) – April 17, 2019
    - Revenue Procedure 2018-16 – February 8, 2018
    - Revenue Ruling 2018-29 – October 19, 2018
    - Notice 2018-48 – July 9, 2018

199A & Real Estate Businesses

- Deduction for non-corporate taxpayers equal to 20% of **qualified business income** from a qualified trade or business, plus 20% of **qualified REIT dividends**
- Qualified business income does not include:
  - Income (received by taxpayers with income above $315,000 if filing a joint return or $157,500 otherwise) from a "specified service trade or business"
    - Health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing or investment management, trading, or dealing in securities, partnership interests, or commodities, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners

199A & Real Estate Businesses

- Deduction amount limitation:
  - "Wage limitation" and "basis limitation"
  - For taxpayers with incomes above certain thresholds ($315,000 joint return or $157,500 otherwise), the 20% deduction is limited to the greater of:
    - 50% of the W-2 wages paid by the business, or
    - 25% of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis, immediately after acquisition ("**UBIA**"), of depreciable property (which includes structures, but not land)

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - Provides rules for determining the 199A deduction for individuals and for Relevant Pass-through Entities ("**RPEs**") (generally, a partnership (other than a PTP) or an S corporation that is owned, directly or indirectly, by at least one individual, estate, or trust)
    - Trade or business:
      - Determined using the 162 standard
      - For real estate activities, the IRS issued Notice 2019-7, which created a safe harbor that we will discuss next

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - Trade or business:
      - Outside of the safe harbor (as described in Notice 2019-7), relevant factors might include:
        - the type of rented property;
        - the number of properties rented;
        - the owner's or the owner's agents day-to-day involvement;
        - the types and significance of any ancillary services provided under the lease; and
        - the terms of the lease.
      - There is also an aggregation rule for instances where a taxpayer rents to a commonly controlled trade or business

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - Possible to have multiple trades or businesses within the same entity, but the Treasury is skeptical
      - Treasury and IRS believe that “multiple trades or businesses will generally not exist within an entity unless different methods of accounting could be used for each trade or business”
      - Must keep separate books and records for each
    - UBIA
      - Partner’s/shareholder’s share of UBIA of RPE’s property is same as his/her share of tax depreciation for the property

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - UBIA
      - For property that does not produce tax depreciation, the partner's share is based on 704(b) allocation (allocations in accordance with the partner's interest in the partnership)
      - 721/351 contributions: entity's UBIA is contributor's basis on the date he/she placed the property in service
      - 1031 replacement property: will not use 1031(d) because it would require, among other possible adjustments, a downward adjustment for depreciation deductions
        - Instead, will use relinquished property UBIA adjusted for cash or other property received or provided during the exchange

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - UBIA
      - 743 adjustments are qualified property, but 734 adjustments are not
      - Qualified property acquired from a decedent has a UBIA equal to fair market value on the decedent's death under 1014
    - Aggregation
      - Individuals and RPEs may aggregate multiple trades or businesses for purposes of determining whether the wage or basis limitations apply

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations(January 18, 2019):
    - Aggregation - Can aggregate if:
      - The same person or group of persons, directly or by attribution under sections 267(b) or 707(b), owns 50 percent or more of each trade or business to be aggregated
      - The above ownership exists for a majority of the taxable year, including the last day of the taxable year
      - All of the items attributable to each trade or business to be aggregated are reported on returns with the same tax year
      - None of the trades or businesses to be aggregated is a specified service trade or business

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Final Regulations (January 18, 2019):
    - Aggregation - Can aggregate if:
      - The trades or businesses to be aggregated satisfy at least two of the following factors:
        - The trades or businesses provide products, property, or services that are the same or customarily offered together;
        - The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or
        - The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - Provides a safe harbor that taxpayers can use to treat their real estate activities as a "rental real estate enterprise" (an "**RREE**") that qualifies as a "trade or business" under 199A and thus qualifies for the deduction
    - An RREE is "an interest in real property held for the production of rents and may consist of an interest in multiple properties"
    - Available to both individuals and RPEs, but must hold real estate either directly or through a DRE

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - Requirements:
      - Tax years beginning before 1/1/23: 250 or more hours of "rental services" are performed per year with respect to the rental enterprise
      - Tax years beginning after 12/31/22: in any three of the five consecutive tax years that end with the taxable year (or in each year for an RREE held for less than five years), 250 or more hours of "rental services" are performed per year with respect to the rental real estate enterprise
      - Separate books and records are maintained to reflect income and expenses for each RREE

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - Requirements:
      - Contemporaneous records, including time reports, logs, or similar documents, regarding the following:
        - hours of all services performed;
        - description of all services performed;
        - dates on which such services were performed;
        - who performed the services.

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - "Rental Services" includes (non-exhaustive list):
      - Advertising to rent or lease the real estate;
      - Negotiating and executing leases;
      - Verifying information contained in prospective tenant applications;
      - Collection of rent;
      - Daily operation, maintenance, and repair of the property;
      - Management of the real estate;
      - Purchase of materials; and
      - Supervision of employees and independent contractors.

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - "Rental Services" does not include financial or investment management activities, such as (non-exhaustive list):
      - Arranging financing;
      - Procuring property;
      - Studying and reviewing financial statements or reports on operations;
      - Planning, managing, or constructing long-term capital improvements; or
      - Hours spent traveling to and from the real estate.

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - "Rental Services" may be performed by owners or by employees, agents, and/or independent contractors of the owners.
    - Excluded Properties:
      - Real estate used by the taxpayer as a residence for any part of the year under 280A
      - Triple-net leases: a lease agreement that requires the tenant or lessee to pay taxes, fees, and insurance, and to be responsible for maintenance activities for a property in addition to rent and utilities.

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - Grouping: Must either treat each property held for the production of rents as a separate RREE or treat all similar properties held for the production of rents as a single RREE
      - Exception: Cannot group commercial and residential
      - Exception: Cannot include Excluded Properties in a group
      - Cannot change grouping from year-to-year unless there is a significant change in facts and circumstances

199A & Real Estate Businesses

- Treasury/IRS Guidance:
  - Notice 2019-7 (and its Proposed Revenue Procedure)
    - If a taxpayer is claiming to be within the safe harbor, must include a signed statement attesting to qualification
    - If your real estate activities do not qualify for the safe harbor, they may still be a 199A trade or business
  - Revenue Procedure 2019-11
    - Provides three safe harbor methods for calculating W-2 wages for purposes of the Wage limitation

199A & REIT Dividends

- REITs are considered a pass-through business for purposes of this deduction
- As a result, REIT most dividends qualify for the deduction
  - REIT qualified and capital gains dividends do not qualify for the deduction
- REIT dividends are not subject to the wage and basis limitations
- Effective maximum U.S. federal income tax rate on REIT dividends is 29.6% (plus additional 3.8% Medicare tax on dividends)

199A & REIT Dividends

- Treasury/IRS Guidance:
  - Temporary Regulations
    - Under certain circumstances, if a RIC receives REIT dividends, then it may be able to pay 199A-eligible dividends to its shareholders and its non-corporate shareholders can treat those dividends as though they came directly from a REIT
    - There is a holding period requirement for the RIC shareholders in order to qualify for the deduction
      - Must have held the RIC stock for more than 45 days during the 91-day period beginning 45 days before the ex-dividend date

Implications: 199A

- The combination of the new deduction and the reduction of the maximum individual tax bracket from 39.6% to 37% will result in significant tax savings for real estate investors
- The carve out for “specified service trade or business” may mean that service professionals should consider whether it makes sense to run their business through a personal service corporation
- For REITs, the reduced corporate tax rate (now 21%) reduces, but does not eliminate, the benefit to choosing REIT rather than corporate form
  - The Act reduces the favorable rate differential between qualified REIT dividends and C corporation dividends from 8.4% to 7.2%
  - However, C corporation tax rate does not expire, but the pass-through deduction will expire, unless extended, after 2025

Business Interest Deduction

- Business interest deduction (Generally):
  - "Business interest" = any interest paid or accrued on indebtedness properly allocable to a trade or business, excluding "investment interest"
  - New Code Section 163(j): for most taxpayers, the Act disallows the deductibility of business interest to the extent that net interest expense exceeds 30% of EBITDA (2018 through 2022) or EBIT (beginning in 2022)
    - EBITDA = taxpayer's earnings before interest, taxes, depreciation and amortization
    - EBIT = taxpayer's earnings before interest and taxes
    - EBITDA is the bigger number

Business Interest Deduction

- Business interest deduction (Generally):
  - The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely
  - This provision applies to existing debt and applies at the entity level
  - The limitation does not apply to taxpayers whose average annual gross receipts for the three-tax-year period ending with the prior tax period does not exceed $25 million

Business Interest Deduction

- Business interest deduction (Real Estate):
  - A real property trade or business can elect out of the new business interest disallowance regime
    - Any business engaged in real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business
  - The real estate exception extends to:
    - The activities of corporations and REITs
    - The operation or management of a hotel
  - The election out is irrevocable

Business Interest Deduction

- Notice 2018-28
  - IRS outlined the substantive topics to expect in future regulations
- Revenue Procedure 2018-59
  - Certain infrastructure arrangements are eligible to make the real property trade or business (RPTB) election

Business Interest Deduction

- Proposed Regulations 1.163(j)-1 through -11
  - Released: November 26, 2018
  - Hearing held on February 27, 2019
  - Highlights:
    - Definition of Interest
    - Ordering rules for taxpayers to address 163(j) limitation and foreign derived intangible income
    - Rules for consolidated groups, pass-through entities Controlled Foreign Corporations, and Foreign Persons with Effectively Connected Income
    - Elections
    - Allocation of Interest between rental trade or business and non-rental trade or business
    - Special Rules for REITs

Business Interest Deduction

- Interest Definition - Proposed Treas. Reg. 1.163(j)-1
  - Any amount paid or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275-1(d)
    - Conventional debt instruments, as well as transactions that are indebtedness in substance although not in form
    - Interest under other provisions in the Code (i.e. OID and accrued market discount)
    - Certain amounts that are closely related to interest and that affect the economic yield or cost of funds of a transaction involving interest (i.e. substitute interest paid under sale-repurchase transaction or securities lending, commitment fees, or debt issuance costs)

Business Interest Deduction

- Interest Definition - Proposed Treas. Reg. 1.163(j)-1
  - Anti-Avoidance Rule:
    - Interest can include any expense or loss predominantly incurred in consideration of the time value of money in a transaction or series of integrated or related transactions in which a taxpayer secures the use of funds for a period of time

Business Interest Deduction

- RPTB Election – Prop. Reg. 1.163(j)-9
  - Real property trade or business under section 469(c)(7)(C) or certain trades or business conducted by REITs
    - Applicable to REITs holding real property, an interest in a partnership holding real property, or shares in other REITs holding real property
  - Anti-Abuse Rule:
    - If 80% or more of the business's RP is leased to a trade or business under common control of the RPTB, then not considered a RPTB eligible to make the election
      - Exception for REITs with leases to a TRS of qualified lodging facilities under section 856(d)(9)(D) and qualified health care properties under 856(e)(6)(D)

Business Interest Deduction

- Look-Through Election
  - Partners may elect to look-through the partnership, unless partner owns directly or indirectly 80% or more of the capital or profits
    - If election is made, then the partner must determine the tax basis in the assets which are allocated to excepted and non-excepted trade or business
      - If 90% or more of the partnership's basis in the assets are allocable to excepted businesses, then the partner's entire basis in the partnership is allocable to excepted trades or business
      - If 90% or more of the partnership's basis in the assets are allocable to non-excepted businesses, then the partner's entire basis in the partnership is allocable to non-excepted trades or business
    - If no election is made, then the partnership interest would be treated as a non-excepted trade or business asset, and subject to the business interest deduction limitation

Business Interest Deduction

- Look-Through Election
  - REITs that own shares in other REITs (lower-tier REITs); if the lower-tier REIT's assets are of an excepted trade or business, then all of the shareholder REIT's adjusted basis in the shares of the lower-tier REIT is allocable to an excepted trade or business
    - If the lower-tier REIT's assets are not of an excepted trade or business, then the look-through rule applies as though the lower-tier REIT were a partnership Prop Reg. 1.163(j)-10(c)(5)(ii)(A)(2)

Business Interest Deduction

- Allocation of Interest Expense – Proposed Regulation 1.163(j)-10
  - The regulations provide that a taxpayer eligible to make the RPTB election may allocate interest income and interest expense between **excepted** and **non-excepted** trades or businesses
  - Bifurcation system for taxpayer with multiple trades or business
    - Bifurcating the tax basis of assets based on:
      - The relative amount of gross income the asset generates with respect to the trades or businesses
      - The relative amount of the asset's physical space used by the trades or businesses (for land or inherently permanent structures); or
      - The relative amount of output generated by trades or businesses that generate the same unit of output

Business Interest Deduction

- Allocation of Interest Expense – Proposed Regulation 1.163(j)-10
  - REITs may make the RPTB election for all or part of its asset. If the REIT's real property financing assets is less than 10% all of the assets are under the RPTB exception, then REIT does not allocate tax basis
    - However, if there is real property financing assets that *exceed* 10%, then the REIT must allocate between excepted and non-excepted items. 1.163(j)-10(g)(3)
    - Real Property Financing Assets include mortgages, deeds of trust, and installment land contracts; mortgage pass-thru certificates guaranteed by certain entities

Business Interest Deduction

- ATI Calculation for REITS 1.163(j)-4(b)(4)(ii)
  - The ATI for a REIT would be computed without regard to the dividends paid deduction, but is reduced by the dividend received deduction
  - REIT's earnings and profits would not be reduced by a disallowed business interest expense deduction in the year it was disallowed or any excess business interest expense allocated form a partnership

Cost Recovery

- Cost recovery (Generally):
  - "Bonus depreciation"
  - The Act permits businesses an immediate write-off of the full cost of qualified property
    - After 2022, the bonus depreciation percentage is phased-down to 80% for property placed in service in 2023, 60% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026
  - The Act removes the requirement in current law that the original use of qualified property must commence with the taxpayer
    - Thus, immediate expensing applies to purchases of used as well as new items

Cost Recovery

- Cost recovery (Real Estate):
  - Taxpayers that elect to use the business interest real estate exception will be permitted to fully expense land improvements and tangible, personal property used in their real property trade or business from 2018 to 2023
  - However, such taxpayers must depreciate real property using ADS under slightly longer recovery periods: 40 years for nonresidential property, 30 years for residential rental property, and 20 years for qualified improvement property (interior)
  - The switch to ADS applies to all nonresidential rental property, residential rental property, and qualified improvement property, not just property placed in service beginning in 2018
  - The Act did not adopt the Senate proposal to reduce the MACRS depreciable lives on residential and nonresidential depreciable property

Cost Recovery

- Proposed Treasury Regulations 1.168(k)-1 through -2
  - Released: August 8, 2018
- Highlights:
  - Taxpayer eligibility for bonus depreciation depends on meeting the four requirements
    - Qualified Property
    - Original or Used Property
    - Placed-in Service
    - Acquisition of Property

Cost Recovery

- Qualified Property Requirement
  - Qualified Property includes qualified leasehold property, MACRS property with 20-year recovery period, qualified restaurant property, qualified retail improvement property, computer software, water utility, qualified improvement property, qualified television or film, qualified theatrical production, and specified plants
    - Does not include property under 168(f), property subject to ADS, election out of bonus depreciation, specified plant election, property outlined by statute (Sections 168(k)(4), (k)(9)(B), (k)(9)(A))

Cost Recovery

- Original Use Requirement
  - Property must be new property that originates with the taxpayer or used property acquired by the taxpayer
  - Conversion of Personal property
    - If prior use as personal property by the taxpayer and converted to business property, then the property will meet original use requirement
    - If prior use as personal property by prior owner and acquired by the taxpayer to use as business property, then the property will not meet the original use requirement
  - Conversion of Inventory
    - If prior use as inventory by the taxpayer and converted, then the property will meet original use requirement

Cost Recovery

- Original Use Requirement
  - Conversion of Inventory
    - If prior use as inventory by prior owner and acquired by the taxpayer to use as business property, then the property will meet the original use requirement
- Used Property Requirements - Prop. Treas. Reg. 1.168(k)-2(b)(3)(ii)
  - Three Requirements:
    - No prior ownership
    - Property acquired by purchase as defined in 179(d)(2)(A)-(C)
    - Acquisition meets the cost requirements of section 179(d)(3)

Cost Recovery

- Used Property Requirements
  - Prior Ownership
    - Determined by whether the taxpayer or predecessor had a depreciable interest in the property prior to acquiring
    - Related-Party Acquisition
      - Series of Transfers:
        - IRS will look at the relationship between the **original transferor** and **ultimate transferee**
      - Treasury requested comments on **how many taxable years** a taxpayer or a predecessor should look back to determine if the taxpayer or the predecessor previously had a depreciable interest in the property

Cost Recovery

- Partnerships
  - Section 721(a) Contributions
    - Bonus depreciation is allocated entirely to contributing partner prior to the Section 721(a) transaction, and not the partnership
  - Remedial Allocations
    - Do not qualify for bonus depreciation/immediate expensing Sec. 168(k)(2)(E)(ii)(II)/Sec. 179(d)(2)(C)
    - Occurs when book basis in property exceeds tax basis in contributed property and the excess amount is allocated under the remedial method. Partnership regulations permit a taxpayer to use any reasonable depreciation method. The proposed regulations disallow bonus depreciation
  - Reverse 704(c) Allocations
    - Do not qualify for bonus depreciation/immediate expensing
    - Occurs when partnership property is revalued upon the entrance/exit of partner

Cost Recovery

- Partnerships
  - Section 754 Elections
    - Property subject to adjustments do not qualify for bonus depreciation
    - Partnership Adjustment Sec. 734(b) – fails the original use requirement and used property Sec. 168(k)(2)
    - Partner Adjustment Sec. 743(b) – fails the original use requirement, but may satisfy the used property requirement; take an aggregate view and look at whether used property requirements are met through the acquirer or predecessor's proportionate share of the partnership property.
    - Applies the same for new and existing partners purchasing another's partnership interest

Cost Recovery

- Partnerships
  - Zero Basis Property
    - Property contributed with a zero basis cannot be depreciated using the bonus depreciation system contrary to Reg. 1.704-1(b)(2)(iv)(g)(3)
  - Section 732 Distributions of Property to Partner
    - Liquidating and Non-Liquidating Distributions of partnership property to a partner does not satisfy the acquisition requirements of Sec. 168(k) or requirements under Section 179(d)(2) and (d)(3)
- Placed-In Service Requirement
  - Placed in service (planted or grafted) after September 27, 2017, but before January 1, 2027
  - Special rules for specified plants, qualified film or television productions, and qualified live theatrical productions

Cost Recovery

- Acquisition Requirement
  - Property acquired or taxpayer entered a binding, written contract after September 27, 2017
  - Binding, written contract for manufacturing, construction, or producing property for the taxpayer prior is treated as acquired
  - Binding contract retains the same definition under Treas. Reg. 1.168(k)-1(b)(4)(ii)
  - Letter of Intent is not a binding contract
  - Contract for Self-Construction is not a binding contract
  - Taxpayer must begin manufacturing, construction, or producing the property after September 27

Cost Recovery

- Constructed Property
  - Third Party Contractor - treated as acquired when enter into a written binding contract prior to the manufacture, construction, or production of property
- Self-Constructed Property
  - Retains the same rules under Reg. 1.168(k)-1(b)(4)(iii), the acquisition date occurs when more than 10% of the total cost of the property has been incurred
  - Acquired Components
    - If enter a binding contract before September 28, then the acquired component is not eligible for bonus depreciation but the larger self-constructed property may be eligible. If the actual manufacturing, construction, or production of the larger self-constructed property began before September 28, then the acquired component will not eligible for bonus depreciation

Cost Recovery

- Constructed Property
  - Self-Constructed Components
    - If taxpayer begins manufacturing, constructing or producing a component of larger self-constructed property before September 28, then will not preclude the larger property from being eligible. However, if the process begins on the larger self-constructed property, then it will not be eligible for bonus depreciation.
- Certain Aircrafts/Property with Longer Production period must be acquired prior to January 1, 2027
  - Self-Construction of Certain Aircrafts/Property with Longer Production Periods must be manufactures, construed, or produced for its own use before January 1, 2027

Cost Recovery

- Like-Kind Exchanges
  - New Property:
    - Exchanged basis and excess basis of replacement property is eligible for bonus depreciation if the replacement property is qualified property
  - Used Property:
    - Only the excess basis of replacement property is eligible for bonus deprecation if the replacement property is qualified property and meets the used property requirements
  - Place in Service and Sale in the Same Taxable Year
    - Taxpayer may not use bonus depreciation

Cost Recovery

- Taxpayer may elect out of bonus depreciation
  - Election is made on an asset class level and applies to all property within that class for the year; add 743(b) basis adjustment as a separate class of property
- Taxpayer may elect to instead apply 50% bonus depreciation in lieu of 100% bonus depreciation
  - Election is applied to all qualified property, and not applied on an asset class level
- Taxpayer may make both elections

Implications: Business Interest Deduction & Cost Recovery

- Real estate trades and businesses will need to decide which is more important to their business
  - Companies that rely heavily on leverage, may choose to elect out of the business interest deduction limitation
  - Companies that do not rely heavily on leverage may find that the shorter depreciable lives of real property (and expensing for qualified improvement property) may outweigh any detriment from the limitation on interest deductions
  - The interest limitation will be less onerous initially because adjusted taxable income will not include deductions for depreciation, amortization, or depletion until to 2022. This may mean that the depreciation and expensing benefits could justify deferring the election for exemption from the interest limitation until 2022

Like-Kind Exchanges

- The Act permits taxpayers to continue to defer gain on real estate like-kind exchanges.
- Improved real estate and unimproved real estate will continue to be considered property of a like kind.
- However, the portion of any exchange that includes personal property will no longer qualify for tax-deferred treatment under Code Section 1031
- No Treasury/IRS Guidance

Like-Kind Exchanges

- **General Implications:**
  - This is very good for real estate because it will continue to generate interest in real estate investments
  - Not a significant change from current law
  - Most focus more on personal property when selling real estate other than vacant land
  - May be able to offset gain on relinquished property's personal property with bonus depreciation deduction with respect to replacement property's personal property
- **Cost Segregation Implications**

Carried Interest Holding Period

- The 3-year holding period applies to holders of an "**applicable partnership interest**"
- An **applicable partnership interest** is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with **performance of services in any "applicable trade or business"**

Carried Interest Holding Period

- An **applicable trade or business** means any activity (regardless of whether the activity are conducted in one or more entities) that consists in whole or in part of the following:
  - **raising or returning capital**, **and**
  - **either**
    - **investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition)**, or
    - **developing specified assets**

Carried Interest Holding Period

- **Specified assets** means:
  - securities (generally as defined under rules for mark-to-market accounting for securities dealers)
  - commodities (as defined under rules for mark-to-market accounting for commodities dealers)
  - **real estate held for rental or investment**
  - cash or cash equivalents
  - **options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents**
  - **an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing**

Carried Interest Holding Period

- Examples of investors/businesses **NOT** affected by this new rule:
  - Non-investment services businesses
  - Investors that do not receive their interest in exchange for services
  - Most real estate partnerships that hold their rental or investment real estate for longer than 3 years
- Focus is clearly on profits interests issued by private equity, venture capital, and other investment funds

Carried Interest Holding Period

- Notice 2018-18:
  - The new provision says that an “applicable partnership interest” does not include any interest in a partnership held by a “corporation”
  - Many wondered if “corporation” includes an S corporation.
  - The IRS says no, an S corporation is not a corporation for these purposes

Qualified Opportunity Zone Funds

- We could (and Strafford does) have a whole program just on QOZ Funds
  - Just a few basics since this is very important for the real estate industry
- Hybrid of a Section 1031 (or more precisely, a Section 1033) Exchange and New Markets Tax Credits program
- Qualification Requirement: Reinvestment of gains in a "Qualified Opportunity Zone Fund"
- 2 stages
  - Each stage provides a different tax benefit for investors in a QOZ Fund

Qualified Opportunity Zone Funds

- Stage 1 – Tax benefits with respect to “old” investment
  - Deferral of gain to latter of disposition of new investment or December 31, 2026
  - Elimination of 10% of gain on old investment if new investment held for at least 5 years
  - Elimination of 15% of gain on old investment if new investment held for at least 7 years
- Stage 2 – Tax benefits with respect to “new” investment
  - Elimination of gain on new investment if new investment held for at least 10 years

Overall Impressions

- Benign to favorable for real estate
- New pass-through deduction is helpful for bringing in new investors
- Real estate businesses will need to choose between avoiding the new business interest deduction limitation or enjoying the new full and immediate bonus depreciation
  - May cause a shift away from debt financing towards equity financing
- Retention of 1031s for real property is critical
- Carried interest left largely unharmed

Questions?