The Real Estate Roundtable

Tax Cuts and Jobs Act Conference Agreement

Major Real Estate Provisions

December 15, 2017

Commercial Real Estate

- **Business Interest Deduction.** Under the conference agreement, a real property trade or business can continue to deduct net interest expense. Taxpayers must elect out of the new interest disallowance regime. The legislative history clarifies that the real estate exception extends to the operation or management of a hotel. It also clarifies that the activities of corporations and REITs can qualify for the exception. The new interest limit is effective in 2018 and applies to existing debt. The new regime disallows the deductibility of interest to the extent that net interest expense exceeds 30% of EBITDA (EBIT beginning in 2022). The interest limit, and the real estate election, applies at the entity level.

- **Cost recovery.** The conference agreement generally maintains current law cost recovery rules for real property. However, taxpayers electing to use the real estate exception to the interest limit must depreciation real property under slightly longer recovery periods—40 years for nonresidential property, 30 years for residential rental property, and 20 years for qualified interior improvements. Land improvements (parking lots, drainage, etc.) and tangible, personal property used in a real property trade or business are eligible for 100% expensing for the next 5 years.

- **Like-kind exchanges.** Taxpayers can continue to defer gain on real estate like-kind exchanges. The conference agreement repeals the deferral of gain for other types of like-kind exchanges, beginning in 2018. The legislative history reaffirms that improved real estate and unimproved real estate are generally considered property of a like kind.

- **Pass-through tax relief.** The conference agreement creates a new tax deduction of 20 percent for pass-through businesses. For taxpayers with incomes above certain thresholds, the 20 percent deduction is limited to the greater of: (a) 50% of the W-2 wages paid by the business, or (b) 25% of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis, immediately after acquisition, of depreciable property (which includes structures, but not land). REIT dividends and distributions from publicly traded partnerships are not be subject to the wage restriction. Estates and trusts are eligible for the pass-through benefit. Income from certain specified services businesses is ineligible (*e.g.*, health, law, financial services, etc.)

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- Example. *A business purchases an office building for $10 million ($7 million attributable to the structure, $3 million attributable to the land). The building generates annual rental income of $500,000. The maximum allowable pass-through deduction would be $100,000 (20% of $500K). Even if the business paid no wages, the business would qualify for the full deduction because 2.5% of $7 million is $175,000. For a taxpayer subject to the maximum 37% tax rate, the rental income would be taxed at an effective rate of 29.6%.*

- **Active loss limitation.** The conference agreement prohibits taxpayers from deducting losses incurred in an active trade or business from their wage income or portfolio income (generally, interest and dividends). The provision applies to existing investment and takes effect beginning in 2018.

- **Carried interest.** The conference agreement creates an extended 3-year holding period for long-term capital gain treatment with respect to carried interests received in certain types of partnerships, including hedge funds, private equity funds, and real estate. The 3-year holding period applies to the assets held by the partnership, as well as the partnership interest itself. The 3-year requirement applies to dispositions of assets and interests beginning in 2018.

- **State and local tax deduction.** The conference agreement limits the annual deductibility of individual state and local taxes to no more than $10,000. State and local taxes paid or accrued in carrying on a trade or business, or in an activity related to the production of income, remain deductible. Thus, for example, an individual may deduct property taxes imposed on a business asset, such as residential rental property. The $10,000 limit can include a combination of state and local property and income taxes, or state and local property and sales taxes.

- **Historic preservation and rehabilitation tax credits.** The conference agreement preserves the 20% tax credit for the rehabilitation of historically certified structures, but taxpayers must claim the credit ratably over a 5-year period. The bill repeals the 10% credit for the rehabilitation of pre-1936 structures.

- **Low-income housing tax credit.** The conference agreement retains the low-income housing tax credit without changes.

- **Private activity bonds.** The conference agreement retains the tax exclusion for interest on private activity bonds.

- **Contributions to capital.** The conference agreement limits the ability of corporations to receive certain state and local subsidies on a tax-free basis, including contributions in aid of construction and contributions from a governmental entity or civic group. For example, the legislative history clarifies that a contribution of land by a municipality would be taxable, whereas a municipal tax abatement would not. The provision applies to contributions after the date of enactment.

- **Mortgage servicing income.** The conference agreement includes a special rule for the recognition of income with respect to mortgage servicing. Mortgage servicing contracts are excluded from a provision that accelerates the recognition of income in certain situations where financial accounting and tax accounting diverge.

- **Public pension plans and real estate investment.** The conference agreement does not include a House proposal to subject governmental pension plans to tax on their unrelated business income.

- **Interest limitation – multinational group.** The conference agreement does not include a proposal to limit the amount of U.S. interest expense that a domestic corporation that is a member of an international financial reporting group can deduct.

Homeownership

- **Mortgage interest deduction.** The conference agreement provides that a taxpayer may treat no more than $750,000 as debt eligible for the home mortgage interest deduction ($1 million in the case of debt incurred before Dec. 15, 2017). Interest on debt used to acquire a second home will continue to qualify for the deduction. Beginning in 2018, the conference agreement eliminates the deduction for interest paid on a home equity loan, including existing home equity loans.

- **Capital gains exclusion – principal residence**. The conference agreement maintains the current exclusion of gain on the sale of a principal residence without extending the length of time a taxpayer must own and use the residence to qualify (2 of the last 5 years).