REAL ESTATE OPERATIONS UNDER THE TAX CUTS AND JOBS ACT OF 2017

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GENERAL COMMENTARY

The Tax Cuts and Jobs Act of 2017 has had a major impact on real estate operations of every size and type. Enclosed you will find a summary of the Act prepared by our firm in October of 2018 which outlines some important provisions which affect all taxpayers. This memorandum focuses on real estate operations, significantly expanding comments applicable to such operations contained in our October 2018 summary, and reflecting regulations and official interpretations issued after that date.

We would like to emphasize that the 2017 Act, if fully utilized, is a major gift to real estate operators. The three most beneficial provisions for real estate operations are:

I. New deduction of up to 20% of net income under Sec. 199A.
II. Immediate write-off of substantial amount of qualified property and capital improvements under Sec. 168(k) and Sec. 179.
III. Allowance of deferral of capital gain tax on sale of almost any type of asset if the gain is invested in a "Qualified Opportunity Zone" and potential elimination of capital gain tax upon ultimate sale of property acquired in the "Qualified Opportunity Zone."

I. QUALIFIED BUSINESS INCOME DEDUCTION (SEC. 199A)

A) Introduction

The Qualified Business Income (QBI) deduction provisions of the Act typically apply to real estate operations and can be very valuable. A threshold requirement is that the real estate operations must constitute a "trade or business". However, the rules, regulations and official interpretations since enactment have been quite liberal.

Some activity is required by real estate operators. However, even relatively small real estate rental operations can qualify. There are some exclusions, however, from classification as a "trade or business" which qualifies for the QBI deduction. For example, situations in which the operators have very little activity, such as in the case of a single "triple net lease" do not qualify. If any significant activity is required, even in the case of a single property, that operation will likely be considered to be a qualified "trade or business" eligible for the deduction, subject to the general limitations discussed in the following sections.

Recently finalized Revenue Procedure 2019-38 creates a "safe harbor" for treatment of rental operations as a "trade or business". The requirements for qualifying for

this “safe harbor” are quite restrictive and there is little guidance as to its application. However, we believe that this “safe harbor” will be useful mostly to smaller real estate operations where the owner’s activities are limited, thereby raising a real question as to whether a “trade or business” in fact exists. Note that even if a real estate operation does not utilize the “safe harbor,” it can qualify as a “trade or business under the general rules. (See Note #1 for a summary of the rather strict requirements of this Revenue Procedure.)

It should be noted that there is a special rule which specifically allows a real estate operation renting to only one operating entity to be considered a “trade or business” if the entity and the real estate operation are commonly controlled (meaning 50% or more common ownership, directly or indirectly). (Reg. §1.199A-1(b)(14))

B) Taxable Income Limitations

The deduction is 20% of the lesser of the QBI or taxable income calculated without qualifying dividends and capital gains. The deduction may be phased-out when the owner’s taxable income is between $321,400 and $421,400 for married persons and between $160,700 and $210,700 for all other taxpayers. When taxable income is above the upper limits of these ranges, the QBI deduction cannot exceed the greater of (a) 50% of wages related to the activity paid during the year or (b) 25% of wages plus 2.5% of the unadjusted basis of depreciable assets of the activity immediately after acquisition (UBIA). When taxable income is within the above described ranges, the wage and asset limitations are phased-in.

(See Note #2 & #3 for examples)

C) Increasing Wages to Avoid the Taxable Income Limitations

The first means to minimize the taxable income limitations is to increase wages since wages are an important means of enhancing the QBI deduction. There are two approaches to increasing wages for a real estate operation for the purpose of increasing the QBI deduction in situations where there is more than one real estate operation under common control.

One approach is the use of a “common paymaster”. In this approach, wages paid by the “common paymaster” are attributed to each entity on behalf of which the wages are paid. (The wages must be paid to someone who actually works for such entity.)

The other approach is to make use of the “aggregation rules.” These rules allow combining separate entities under common control and determining QBI on a combined approach. This approach, however, requires common control and all entities to be aggregated must have the same tax year, in addition to other requirements under “E”, below. (Note that the requirement for each entity to have the same tax year does not apply under the “common paymaster” approach.)

(See Notes #3 & #4 for examples)

Separately, it could be advisable to treat certain independent contractors as employees. (This requires a careful comparison of the additional cost of treating individuals as employees versus the savings achieved by an enhanced QBI deduction.)

Another approach is to utilize an “S” corporation (either existing or newly formed) and have the owners become employees of the “S” corporation. (Again, an analysis should be done to determine if the savings of the enhanced QBI deduction justify the additional payroll taxes to be incurred.) Depending on the amount of QBI, there is a maximum amount of owner’s wages which would be ideal since the owner’s wages would reduce QBI for the full amount of the wages and the increased QBI deduction would be limited to 50% of the wages. (The result is that the maximum amount of wages which would be beneficial is equal to approximately 28.5% of QBI before the owner’s wages.)

(See Note #4 for example)

D) Increasing UBIA to Avoid the Taxable Income Limitations

The second means of enhancing the QBI deduction for high income operators is to increase the total investment in real estate prior to year-end (since the deduction will not be less than 2.5% of UBIA plus 25% of wages.) Again, “aggregation” can be used where there is more than one entity under common control and the combined entities have the same tax year.

(See Note #5 for example)

E) Aggregation Rules

a) Many real estate operations are conducted through several or more entities. The requirements for aggregation of multiple entities are as follows:

   1) All entities to be aggregated, must have at least 50% common ownership and each component entity must be held for the majority of the taxable year.
   2) Each component entity must itself be a “trade or business”.
   3) All entities to be aggregated, must have the same tax year.
   4) At least two of the following factors must be satisfied:

      i.) The trades or businesses must provide products or services that are same or similar. (Surprisingly, commercial real estate and residential real estate are generally not considered the same or similar for purposes of this requirement.)

ii.) The trades or businesses must share facilities or share significant centralized business elements (such as personnel, accounting, legal, manufacturing, purchasing, human resources or information technology).

iii.) The businesses must be operated in coordination with or in reliance on each other (e.g. a gas station and a convenience store).

(See Note #3 for example)

II. IMMEDIATE EXPENSING FOR QUALIFIED PROPERTY AND IMPROVEMENTS UNDER SEC. 179 AND SEC. 168(K)

A) The Tax Cuts and Jobs Act Greatly Increased Taxpayers' Ability to Immediately Write Off Qualified Property and Qualified Improvements.

Real Estate Professionals who have long complained that substantial capital expenditures had to be written off over long periods of time will benefit from an immediate tax savings and resulting positive cash flow.

B) Section 179 Election

A taxpayer who meets the active trade or business requirements may elect to expense the cost of any Section 179 property and deduct it in the year the property is placed into service.

The new law greatly increased the maximum deduction to $1 million (from $520,000) for the 2018 year, to be adjusted for inflation. The law also increased the phase-out threshold from $2 million to $2.5 million for 2018, to be adjusted for inflation. (See differences between Section 179 and 168(k) at D below.)

The new law also expands the definition of Section 179 property to allow the taxpayer to include the following improvements made to non-residential real property made after the date when the property was first placed in service:

1. Qualified Improvement Property means any improvement to the interior of a non-residential building. However certain improvements do not qualify if they are attributable to:

   a. The enlargement of the building.
   b. Any elevator or escalator.
   c. The internal structural framework of the building.

2. Roofs, HVAC, Fire Protection, Alarm and Security Systems are allowed for Section 179 expensing.

3. Exhaustive list of property with a recovery period of 20 years or less.

C) 100% "Bonus Depreciation" Under Sec. 168(k)

The new law greatly increases the bonus depreciation to 100% (from 50%) and this deduction has no limitations.

1. The 100% bonus depreciation applies to:

    a. Qualified Improvement Property (See Section 179 above).

    b. Exhaustive list of property with a recovery period of 20 years or less.

    Note that Roofs, HVAC, and Fire Protection Alarm and Security Systems do not qualify under bonus depreciation.

2. The definition of property eligible for 100% bonus depreciation was expanded to include used qualified property acquired if all the following factors apply:

    a. The taxpayer did not use the property at any time before acquiring it.

    b. The taxpayer did not acquire the property from a related party.

    c. The taxpayer did not acquire the property from a controlled group.

D) Key Differences Between Section 179 Expensing and 168(k) Bonus Depreciation

1. Section 179 expensing is limited in two ways:

    a. The deduction is not allowed to the extent that the cost of eligible assets placed into service during the year exceeds the taxable income for the year, and the taxable income is determined at the entity level.

    b. If the taxpayer places into service over $2.5 million of eligible assets during the year, the deduction starts to phase-out and is completely phased-out over $3.5 million.

2. Bonus Depreciation is, as mentioned earlier, unlimited. This means that any bonus depreciation can result in a net loss that a partner or S-Corporation shareholder can deduct against their other income (assuming that the partner/shareholder is a real estate professional and has At-Risk Basis).

3. State Income Tax Ramifications

   a. Many states use Federal income as the starting point in calculating State income taxes.

      Many states including New York State do not recognize bonus depreciation and require taxpayers to add back the bonus depreciation deducted on the Federal tax return.

   b. Many states including New York State <u>fully allow</u> Section 179 expensing.

      Note that there are varying factors which require careful consideration of whether to choose Section 179 expensing or Section 168(k) bonus deprecation.

E) <u>The Value of Immediate Expensing is Significant.</u>

For example, if a business person deducts $1,000,000 under Section 168(k), that person can immediately save up to $370,000 (37%) of Federal income tax. Alternatively, up to $500,000 combined taxes for a New York State and New York City taxpayer (37%+9%+4%=50%) could be saved under Section 179. (The New York State and New York City savings of $130,000 would not be available under Section 168(k) bonus depreciation.)

F) <u>Important Note Regarding Bonus Depreciation</u>

Due to a drafting error in the Tax Cuts and Jobs Act of 2017 “qualified improvement property” is not technically eligible for bonus deprecation.

The conference committee agreement made it clear that lawmakers intended to consolidate prior law categories of qualified leasehold property, qualified restaurant property and qualified retail improvement property into “qualified improvement property”, all of which were eligible for a 15-year recovery period versus 39-year recovery period but they forgot to include “qualified improvement property” as 15-year property.

The Treasury has acknowledged this concern raised by practitioners and it is widely expected that guidance will be forthcoming shortly. In the meantime, many taxpayers have taken bonus depreciation for qualified improvements on their tax returns. If they have not taken this deduction, they will have to amend their tax returns after guidance has been issued.

III. QUALIFIED OPPORTUNITY ZONES

A) Brief Overview

The Tax Cuts and Jobs Act of 2017, through two new Code sections, §1400 Z-1 and §1400 Z-2, provides significant federal income tax benefits for investing in property located in Qualified Opportunity Zones.

Benefit 1: A taxpayer who has sold property of almost any kind and realized capital gains may defer recognizing the gains until as late as December 31, 2026, for the portion of such gains invested in an Opportunity Zone Fund within 180 days of the sale.

Benefit 2: A permanent reduction in such gains can be achieved through investment in an Opportunity Zone Fund, by means of a 10% step-up in basis for a minimum five- year investment (or a 15% step-up for a seven-year investment, but which would require investment by December 31, 2019).

Benefit 3: Perhaps the primary benefit is that if the new Qualified Opportunity Zone investment is held for 10 years or more the taxpayer will not pay any tax on the appreciation when the investment is sold or exchanged.

B) Some Important Features

1) A Qualified Opportunity Zone Fund can be established by any taxpayer and the form of organization can be most types of legal entities (e.g. a limited liability company, a partnership, a corporation, etc.).

2) The amount of the gain on the sale of the original property (not the entire proceeds of sale) must be contributed to the Fund within 180 days of the sale.

3) The maximum amount of deferral and step-up benefits (1 and 2 above) is limited to the amount of gain on the original sale, while the avoidance of tax on the new investment includes the total amount invested in the Opportunity Zone.

4) The Fund has 31 months, with possible extensions of time, to make the investment(s) in "qualified property."

5) "Qualified property" is original use property, or non-original use property which is substantially improved within 30 months of acquisition. (Improvements must exceed the cost of the property, excluding land.)

6) Investment in single family homes in Opportunity Zones can qualify but investment in condominiums does not qualify.

7) As an alternative to forming a private Qualified Opportunity Zone Fund, common funds are available to investors.

8) New York State provides benefits similar to the federal tax benefits.

C) <u>General Comments</u>

As you can see, the Qualified Opportunity Zone rules are quite complex, and two sets of federal income tax regulations have already been issued and the third set is expected by the end of 2019. Therefore, establishing and utilizing a private Opportunity Zone Fund is only for the sophisticated real estate investor or operator.

Another important point to remember is that "Opportunity Zones" are generally distressed, low-income communities. Approximately 8,700 of such communities have been identified in the fifty states. However, many have already experienced some improvement. Again, having the expertise and sophistication to accurately identify the most promising zones is essential.

Of course, if long-term deferral of recognizing real estate gains is the main objective, the alternative of utilizing the like-kind exchange provisions of Code Section 1031 should be seriously considered. The most significant deferral difference between use of Opportunity Zones and Section 1031, is that deferral under the Opportunity Zone rules is limited to the period ended December 31, 2016, while Section 1031 provides deferral until the replacement property is sold, and perhaps permanent deferral if the property passes through an estate. (Note that Section 1031 does not provide an up to 15% increase in basis and the elimination of tax upon the disposition of the replacement property as under the Opportunity Zone rules.)

NOTES

Note #1: Revenue Procedure 2019-38

In this Revenue Procedure and the accompanying News Release (IR 2019-158, 9/24/2019) the IRS has finalized the rules for a "safe harbor" for treating a real estate enterprise as a "trade or business" under Section 199A. If the "safe harbor" rules are met a rental real estate enterprise will be treated as a "trade or business" as defined in Sec. 199 A(d), including the application of the aggregation rules under Reg. §1.199A-4.

For purposes of the "safe harbor", a real estate enterprise may consist of an interest in a single property or interests in multiple properties. Each rental real estate enterprise is treated as a separate "trade or business" for purposes of applying Sec. 199A and the regulations thereunder.

The requirements for qualifying under this "safe harbor" are:

1) Separate books and records must be maintained for each rental real estate enterprise.

2) (a) For each rental real estate enterprise that has been in existence less than four years, 250 or more hours of "rental real estate service" must be performed per year.
   (b) For each rental real estate enterprise that has been in existence for at least four years, in any three of five consecutive years, 250 or more hours of "rental real estate services" must be performed per year.

3) The taxpayer must maintain contemporaneous records, including time reports, logs or similar documents regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) date on which such services were performed; and (iv) who performed the services.

4) The taxpayer must attach a statement to a timely filed return for each year in which the taxpayer relies on the "safe harbor", containing the following information: (i) description of all real estate properties that are included in each real estate rental enterprise; (ii) description of rental real estate properties acquired or disposed of during the year; and (iii) a representation that the requirements of the Revenue Procedure have been satisfied.

5) "Rental real estate services" include: (i) advertising; (ii) negotiating leases; (iii) verifying information provided by prospective tenants; (iv) collection of rent; (v) daily operation, maintenance and repair of the property; (vi) management of the real estate; and (vii) supervision of employees and independent contractors. Specifically excluded are: arranging financing, procuring property, reviewing financial statements, or hours spent traveling to and from the real estate.

6) The following types of properties are not eligible for the "safe harbor": (i) real estate used as a residence under Sec. 280A(d) (which provides that even minimal use as a residence would disqualify the real estate from use of the "safe harbor"; (ii) real estate rented under a "triple net lease"; (iii) real estate rented to a "trade or business" under common control; (iv) the entire rental real estate interest if any portion of the interest is treated as an SSTB under Reg. §1.199A-5(c)(2).

Note #2: Example

Assume in each case below that an individual taxpayer has $1,000,000 of non-SSTB QBI from an unincorporated entity and taxable income of over $1,000,000 without capital gains, putting the taxpayer in the highest Federal Income Tax bracket of 37%. Note that in all cases the maximum potential QBI deduction is $200,000 (QBI of $1,000,000 x 20%) since taxable income exceeds QBI.

A. The source of the QBI paid no wages and has no unadjusted basis in the assets (UBIA) of the activity. As a result, the taxpayer is not entitled to any deduction.

B. The source of the QBI has paid wages of $400,000. As a result, the taxpayer is entitled to the maximum potential deduction of $200,000 ($400,000 x 50%). This deduction results in $74, 000 in Federal tax savings ($200,000 x 37%).

C. The source of the QBI has paid wages of $200,000 and has unadjusted basis in assets (UBIA) of the activity of $3,000, 000. As a result, the taxpayer is entitled to $125,000 of the maximum potential deduction ($200,000 x 25% plus 2.5% of $3,000,000). This deduction results in a tax savings of approximately $46,000 ($125,000 x 37%).

D. If the taxpayer in examples A or C has the ability to control what is paid in wages and or make investments in assets that are appropriate for the circumstances, it can result in incremental tax savings.

   For example, in A above, if the taxpayer decided to form an S-Corporation and pay wages of $280,000 to the owners, the QBI would be reduced to $720,000, which would result in a maximum deduction of $144,000 ($720,000 x 20%), but the wage limitation would result in a $140,000 deduction ($280,000 wages x 50%). This deduction results in tax savings of approximately $52,000 ($140, 000 x 37%).

Note #3: Example

An individual, X, owns a 100% interest in four LLCs, each of which is involved in active commercial real estate operations, each producing $250,000 of net income. X also owns a 100% interest in an S-Corporation which provides the employees and administrative services for the real estate operations. The S-Corporation pays wages of $300,000 and is operated on a break-even basis. X has taxable income of $800,000. It is assumed that there is very little UBIA since the buildings were acquired over 50 years ago. It is also assumed that all conditions for "aggregation" are met (see I(E)) since (a) all entities are in the commercial real estate business and (b) they share significant centralized business elements.

A. If X does not "aggregate", X' s QBI deduction is "0" since the real estate operations produce income but have no wages and the S-Corporation has wages but no net income.

B. If X elects to "aggregate", X 's QBI deduction would be $150,000. X has QBI of $1,000,000 ($250,000 x 4) resulting in a tentative QBI deduction of $200,000. However, this deduction is limited to 50% of wages paid ($300,000 x 50% = $150,000).

C. If X pays himself additional wages of $100,000 (assuming his total wages are deemed reasonable), his tentative QBI deduction would be $180,000 ($1,000,000 - $100,000= $900,000 x 20%). Since total wages are now $400,000, the 50% of wages limitation would not apply and his QBI deduction would be $180,000.

<u>Note #4: Example</u>

B carries on active real estate operations as a single member LLC, which produces a net income of $600,000, but pays no wages and has no UBIA. B’s taxable income is $700,000.

A. If B takes no further action, B' s QBI deduction will be “0” since it would be limited to 50% of wages paid (or 25% of wages plus 2.5% of UBIA).
B. B forms an S-Corporation and pays himself $150, 000 in wages. B's QBI deduction would be $75,000. The net income from B' s real estate operations is $450,000 ($600,000-$150,000 wages) which would produce a maximum deduction of $90,000 ($450, 000 x 20%). However, the deduction would be limited to $75,000 ($150,000 wages x 50%).

<u>Note #5: Example</u>

A limited liability company, L, is 100% owned by individual, X. L has QBI of $1,250,000 for the year and X has $750,000 of taxable income. L owns a building which is 50 years old, thereby not producing any UBIA and L pays no wages. If prior to year-end, L, sells the old building and acquires a new property for $10,000,000, of which $8,000,000 is attributable to the building, X, would qualify for a QBI deduction of $200,000. (QBI of $1,250,000 x 20%= $250,000 but the deduction is limited to 2.5% of UBIA of $8,000,000 or $200,000.)

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