Tax changes affecting major real estate markets in the USA

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President Donald Trump signed the Tax Cuts and Jobs Act (H.R. 1 or " TCJA") into law on December 22, 2017, making substantial changes in tax law for almost all types of taxpayers – US individuals and trusts, investors, businesses and those with international inbound and outbound operations.

As a general matter, the new law is expected to be favorable to investors of US commercial real property. Additionally, there are other factors which currently make investing in US commercial real property an attractive proposition. If we use New York City as an example, Manhattan, and more recently Brooklyn and Queens, has long been attractive to investors due to a strong, relatively stable market. At present, investing in this market may represent an even greater opportunity than usual since the market in New York City has in general softened from its frothy high in 2015, when purchasers and tenants consequently had reduced bargaining power, with better deals to be found currently across a variety of sectors. Other US markets such as the San Francisco Bay Area also remain a good investment proposition – in the case of the Bay Area, due to the extremely high demand driven by the continued tech boom and constrained inventory there.

For the real estate investor, key areas for consideration in any US real estate investment (New York City or otherwise) include:

- The use of partnerships and other pass-through entities versus the use of corporate vehicles;
- Interest deductibility on structures leveraged with internal or external debt;
- Expensing of certain asset acquisitions;
- The impact of limitations on the use of accumulated losses; and
- Exposure to the US gift and/or estate tax regimes, since there was no adjustment and therefore a lingering tax liability should a non-US investor be holding a US real estate interest directly at time of death.

For a high-level summary, the specific changes in the tax code affecting real estate businesses are:

- **21% corporate income tax rate.** A significant change – lowers the federal corporate income tax rate from 35% to 21%.
- **20% deduction for pass-through entities.** Owners of qualified pass-through entities (i.e., limited liability companies, partnerships, S Corporations, disregarded entities and trusts) will benefit from a new 20% deduction for qualified business-related income. Although such deductions are generally subject to certain wage limits and exceptions, the good news for real estate investors is that the aforementioned limits and exceptions generally should not unfavorably affect real estate businesses. This result occurs because the taxpayer can use 2.5% of "qualified property" (basically the full acquisition cost of depreciable tangible property) plus 25% of wages paid as a limit on that deduction and real estate businesses generally have higher amounts of qualified property.
- **Section 163(j) inapplicable to real estate businesses.** Real estate businesses will be exempt from certain "earnings stripping" rules, thereby allowing leverage to reduce US net basis tax if the taxpayer elects and then uses 30-year (residential) or 40-year (commercial) depreciation.
- **Carried interest: Retention of favorable capital gains treatment for carried interest.** However, the new law requires a three (3) year holding period (or, if the carried interest is sold, same must have been held for more than three (3) years) to qualify, rather than the previous one (1) year requirement. Since many real estate investors hold commercial real estate assets for more than three (3) years, the new rule may have little impact on most real estate investment managers other than those who want to flip properties in a reduced time frame.
- **Mortgage interest and SALT deductions.** Retention of a full mortgage interest deduction for commercial and residential

property landlords (by contrast, the mortgage interest deduction for personal use residential real property has been decreased via a reduction in the maximum limit for qualifying debt from $1 million to $750,000). This may expand the category of core assets available to investors by making investment in luxury multi-family developments a more attractive proposition since luxury buyers may, as a consequence of the new rule on residential mortgage interest, be discouraged from home ownership. Further, the loss of state and local income tax deductions and personal use property tax deduction on the residential side over an aggregate of $10,000 in taxes paid per year may also result in a net positive for the multi-family sector.

- **Tax deferred exchange.** Retention of "Section 1031" rules permitting tax deferred exchanges for real property held for use in a trade or business.
- **Cost recovery.** Permits full-expensing (i.e., immediate write-off) of the full cost of new equipment for qualifying taxpayers.
- **New expensing options for lodging business.** Expands deductions for certain depreciable tangible personal property used predominantly to furnish lodging or in connection with lodging.
- **Net operating losses.** If the real estate investor is active in the real estate business, any net operating losses that are generated in a given taxable year may be carried forward indefinitely as net operating losses and can be used to offset up to 80% of the taxable income. If there are excess business losses for a non-corporate taxpayer, such losses may on be used to offset up to $500,000 of non-business income.
- **Special credits.** Programs for historic rehabilitation credits and low income housing credits have been preserved. Similarly, private-activity tax exempt bonds, which are used significantly in financing the construction of low income and senior housing, have been retained.
- **Municipality grants.** Grants for real estate developers paid by municipalities will no longer be tax-deferred when paid to corporations.

Consequently, investors who have previously acquired US real estate should reevaluate their holding structures and those considering new investments will have new variables to consider. In many cases, the tax and personal risks of 2018 remain identical to those of 2017, but new 2018 tax rates and limitations may change the economics of a holding structure. In some cases, investors may benefit from reorganizing their structures so as to simplify the cash flow of their investments, without material impact to the tax economics.

For example, with the new 21% corporate income tax rate, a corporate structure may be economically equivalent to a leveraged partnership or trust structure, provided there is a clear exit strategy. However, operations must also be considered. Subject to regulatory guidance that will clarify certain ambiguous provisions of the TCJA, it appears that the tax law taking effect in 2018 could impose limitations on the use of deferred tax assets by corporations with high debt-to-equity ratios and large losses (limitations being applied to net operating loss and interest-related deductions), which could apply to real estate businesses, as outlined above.

In the commercial real estate space, beneficiaries of the new tax law include those with income from US sources and those who have paid relatively higher effective income tax rates, even after the loss of some tax deductions that have been limited or eliminated in the new tax law. As beneficiaries of the new tax law, some anticipate that new lending by banks and deployment of capital into real estate acquisitions and project expansion will follow in 2018 and thereafter. This includes retailers that pay an average effective US rate of 32.9%, banks that pay an effective US rate is 25.4%, and hotels that have historically paid an average 16% rate, according to data compiled in early 2017 by Professor Aswath Damodaran from New York University's Stern School of Business and reported recently by Laura Davison of the Bloomberg BNA.

Additionally, partnership and similar flow-through structures are more competitive as a result of the 20% deduction for partnership structures, which results in a 29.6% maximum effective rate, based on the 37% individual/trust income tax rate. This reduced rate should benefit both private joint ventures and club deals as well as REITs since they both function on a flow-through basis. This will particularly reduce the tax rates on real estate developments that generate ordinary income. In particular, US real estate businesses with large capital investments but few employees should qualify for this deduction, due to special rules that benefit real estate specifically in relation to qualified property investment US real estate investments with high payrolls, such as hotels, should benefit.

Should investors want to consider a reorganization of holdings, the fair market value of US real estate could be affected by the TCJA as well. A lower fair market value could reduce US tax on gain recognition transactions. In this regard, economists have suggested that US real property values could be impacted because the new tax law includes (i) a decrease in loans eligible for the mortgage interest deduction and (ii) a cap on deductions for state and local taxes paid by individuals owning residential real estate. This could affect US real estate investors in two ways: first, some may be inclined to expand into rental activities. This could trigger legal issues in the areas of new state filings and approvals, tax, lease agreements, and landlord-tenant disputes, among other associated issues. Second, some speculate that residential real estate property values may decline, because the market may favor renting rather than buying.

Finally, from the US estate tax perspective, a non-US investor remains subject to the limited US tax exemption of only $60,000 per person, thus making most real estate investments highly exposed to US estate tax. US Persons, however, will greatly benefit from a doubling of the lifetime exemption from gift and estate tax until 2026, which previously allowed US wealth generators to transfer $5.6 million per individual ($11.2 million for a married couple) and now allows US wealth generators to transfer $11.2 million per individual ($22.4 million for a married couple for 2018).

To sum up, now that the dust has settled, it is becoming clear that the new statute immediately improves the tax landscape for investment in US commercial real estate in a variety of ways as enumerated above, and that the next several years may represent an excellent opportunity for investors (foreign and American alike) to consider restructuring their current investments and/or acquiring, leasing, financing, constructing, developing, and/or redeveloping commercial and residential real property in vibrant US cities such as New York and San Francisco.

The foregoing is merely an introduction to the many changes that will occur in 2018. Please call your Withers tax and real estate attorneys so we can help you navigate how these many new tax rules will affect you, your family, and your real estate investments.

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