

What the Tax Bill Could Mean for Commercial Real Estate



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Will the competing tax reform bills wending their way through the House and Senate bring holiday cheer for the American taxpayer? Much remains to be worked out if a reconciled bill is to land on the President's desk before the year-end recess. While there are both gifts and proverbial "lumps of coal" for individuals and corporations in each bill, **commercial real estate is one of the few sectors that is likely to benefit under either measure.** Below, we summarize current real estate tax treatment (as well as corporate tax policy more broadly) and highlight how these measures could change under the proposed legislation from the Senate and House.

Topic	Current Situation	Senate	House
Corporate Taxes	Corporate tax rates range from 15% (up to \$50,000 in taxable income) to 35% (over \$10M), with extensive tax credits available.	Corporate tax rate drops to 20% beginning in 2019.	Corporate tax rate drops to 20% beginning in 2018 (and declines to 25% for personal services corporations .)
Corporate Alternative Minimum Tax (AMT)	Taxpayers must compute their income under the regular income tax and the alternative minimum tax (20%); their tax liability is equal to the greater of the two. In computing the AMT, only alternative minimum taxable income (AMTI) above an exemption amount is taken into account. Many business tax preferences that are allowed for regular taxable income are not allowed in determining AMTI, including accelerated depreciation. The exemption amount (\$40,000) is phased-out as income increases and is reduced by 25% of the amount by which AMTI exceeds \$150,000. Corporations receive a credit for AMT paid, which they may carry forward and claim against regular tax liability in future tax years (to the extent such liability exceeds AMT in a particular year). These credits never expire. Corporations with average gross receipts of less than \$7.5 million for the preceding three tax years are exempt from the AMT.	Retains the corporate AMT.	Repeals the corporate AMT. If a taxpayer has AMT credit carryforwards, the taxpayer would be able to claim a refund of 50% of the remaining credits (to the extent the credits exceed regular tax for the year) in tax years beginning in 2019, 2020, and 2021. Taxpayers would be able to claim a refund of all remaining credits in the tax year beginning in 2022. The provision would generally be effective for tax years beginning after 2017.

Topic	Current Situation	Senate	House
Expensing of Depreciable Assets (“Section 179”)	Businesses may immediately expense up to \$510k of the cost of any “Section 179 property” placed in service in a taxable year, with dollar-for-dollar reductions when property costs exceed \$2.03M (figures as of 2017). Section 179 property includes tangible personal property with a recovery period of 20 years or less under the modified accelerated cost recovery system (MACRS), certain off-the-shelf computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property. Broadly, qualified leasehold improvement property means any improvement to the interior a non-residential real property, excluding expenditures attributable to the enlargement of the building, any elevator or escalator, structural components benefitting a common area or the internal structural framework of the building.	Section 179 expensing limits would be increased to \$1M, with dollar-for-dollar reductions at \$2.5M. Both limits would be indexed to inflation for years beginning after 2018. “Qualified real property” is eligible, which includes any qualified improvement property as defined in Section 168(k)(3). Improvements include those to an interior portion of a building which is nonresidential real property and would add roofs, HVAC, fire protection/alarm systems and security systems effective for property acquired and placed in service after December 31, 2017.	Section 179 expensing limits would be increased to \$5M, with the phase-out amount rising to \$20M. Both limits would be indexed to inflation for years beginning after 2018 through tax years beginning before 2023. The provision would modify the definition of Section 179 property to include qualified energy efficient heating and air-conditioning property permanently, effective for property acquired and placed in service after November 2, 2017.
Expensing of Certain Business Assets (“Bonus Depreciation”)	Taxpayers may take additional depreciation in the year in which it places certain “qualified property” in service through 2019 (with an additional year for certain qualified property with a longer production period). The additional depreciation is up to 50% of the cost of the qualified property in 2017, dropping to 40% in 2018 and to 30% in 2019.. Qualified property that is eligible for this additional depreciation includes, among other items, tangible personal property with a recovery period of 20 years or less under MACRS, certain off-the-shelf computer software, and qualified improvement property. The original use of the property must begin with the taxpayer. Taxpayers may elect to accelerate the use of their AMT credits in lieu of this additional depreciation.	Taxpayers would be able to immediately expense 100% of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023 The amount would drop to 80% for property placed in service in 2023, and would decline by an additional 20% each year through 2026. Under the provision, qualified property would NOT include any property used in a real property trade or business. For a taxpayer’s first taxable year ending after September 27, 2017, the taxpayer may elect to apply a 50% allowance.	Taxpayers would be able to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain qualified property with a longer production period). The property that is eligible for immediate expensing would be expanded by repealing the requirement that the original use of the property begin with the taxpayer; property would be eligible for additional depreciation if it is the taxpayer’s first use (i.e., it may be new or used.)

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Expensing of Certain Business Assets (“Bonus Depreciation”) <i>continued</i>			Under the provision, qualified property would NOT include any property used in a real property trade or business. For a taxpayer’s first taxable year ending after September 27, 2017, the taxpayer may elect to forego the above provisions. The taxpayer’s election to accelerate AMT credits in lieu of the additional depreciation would be repealed effective for tax years beginning after 2017.
Depreciation of Real Property	Residential property is currently depreciable on a straight-line basis over a 27.5 year life; non-residential property is depreciable over 39 years.	The depreciable life for residential AND non-residential property would decline to 25 years.	No change.
1031 Exchanges	Like-kind exchange rules allow taxpayers to defer tax on the built-in gains in property by exchanging it for similar property. No gain or loss is recognized to the extent that property held for productive use in the taxpayer’s trade or business, or property held for investment purposes, is exchanged for property of a like-kind that is held for the same use. The taxpayer receives a basis in the new property equal to the taxpayer’s adjusted basis in the exchanged property. The like-kind exchange rule applies to a wide range of property from real estate to tangible personal property, but does not apply to exchanges of stock in trade or other property held primarily for sale, stocks, bonds, partnership interests, certificates of trust or beneficial interest, other securities or evidences of indebtedness or interest, or to certain exchanges involving livestock or foreign property.	Like-kind exchanges will only include real property for transfers after 2017. However, the provision would provide a transition rule to allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.	(Same) Like-kind exchanges will only include real property for transfers after 2017. However, the provision would provide a transition rule to allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

Topic	Current Situation	Senate	House
Deductibility of Interest Expense	Business interest generally is allowed as a deduction in the taxable year in which the interest is paid or accrued, subject to a number of limitations (such as interest payments between related taxpayers, interest paid in connection with tax-exempt interest, passive interest, investment interest, and qualified residence interest.) Corporations are limited in their ability to deduct disqualified interest (generally, interest paid or accrued to a related party when no Federal income tax is imposed) if two threshold tests are satisfied: - The payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio) - the payor's net interest expense exceeds 50% of its adjusted taxable income (the corporation's taxable income computed without regard to deductions for net interest expense, net operating losses, depreciation and amortization, among other items). Interest amounts disallowed under these rules can be carried forward indefinitely. Any excess limitation (i.e., the excess, if any, of 50% of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.	Every business would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income plus any business interest income. <i>Adjustable taxable income</i> would mean income computed without regard to business interest or interest income, net operating loss deductions or deductions for income from qualified production activities. The amount of any business interest not allowed as a deduction for any taxable year shall be treated as business interest paid or accrued in the succeeding taxable year (i.e., carried forward indefinitely.) The net interest expense disallowance would be determined at the tax filer level—for example, at the partnership level instead of the partner level. Special rules would apply to allow a pass-through entity's unused interest limitation for the taxable year to be used by the pass-through entity's owners and to ensure that net income from pass-through entities would not be double-counted at the partner level. (The provision requires a partner to ignore the partner's distributive share of all items of income, gain, deduction or loss of the partnership when calculating adjustable taxable income.) Additionally, the provision would not apply to certain regulated public utilities or the trade or business of performing services as an employee. Both real property trades or businesses and farming businesses may elect to be exempt from this provision on an irrevocable basis. Any taxpayer that meets the \$15 million "gross receipts test" would be exempt from this limit.	Every business would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the sum of the business's adjusted taxable income, any business interest income and floor plan financing interest for motor vehicles for the taxable year. <i>Adjustable taxable income</i> would mean taxable income computed without regard to business interest or interest income, net operating loss deductions or deductions for depreciation or amortization. Any interest amounts disallowed under the provision would be carried forward to the succeeding five taxable years and would be an attribute of the business (as opposed to its owners). The net interest expense disallowance would be determined at the tax filer level—for example, at the partnership level instead of the partner level. Special rules would apply to allow a pass-through entity's unused interest limitation for the taxable year to be used by the pass-through entity's owners and to ensure that net income from pass-through entities would not be double-counted at the partner level. (The provision requires a partner to ignore the partner's distributive share of the non-separately stated income or loss of the partnership when calculating adjustable taxable income.) Additionally, the provision would not apply to certain regulated public utilities, the trade or business of performing services as an employee, real property trades or businesses, and interest paid or accrued with respect to floor plan financing indebtedness. Any taxpayer that meets the \$25 million gross receipts test would be exempt from this limit.

Topic	Current Situation	Senate	House
Pass-Through Entities	S-corporations, sole proprietorships, partnerships, limited liability companies are taxed as “pass-through” entities subject to tax at the individual owner or shareholder level rather than the entity level. Net income is reported on individual income tax returns and is subject to ordinary income tax rates, up to the top individual marginal rate of 39.6%. Owners or shareholders that provide services to a partnership are not considered employees for Federal income tax purposes. Partnerships may distribute guaranteed payments to service-providing partners, provide a share of partnership profits, or both, as a form of compensation. In contrast, an S corporation shareholder that performs services for the S corporation is treated as an employee for Federal income tax purposes and receives wages in exchange for those services. S corporations are required to provide “reasonable compensation” to employee shareholders, and payments that fail to meet the reasonable compensation standard are subject to re-characterization as wages.	For taxable years beginning after December 31, 2017 and before January 1, 2026, pass-through entities may take as a deduction the lesser of: a) The taxpayer’s combined <i>qualified business income</i> (the lesser of 23% of the taxpayer’s business income with respect to the qualified business OR 50% of the W-2 wages paid with respect to the qualified business) PLUS 23% of the amount of qualified REIT dividends and cooperative dividends b) 23% of the excess of taxable income over net capital gains. The W-2 wage limit does not apply for taxable income below a threshold of \$250,000 for individuals (twice that amount for joint returns); this figure is indexed and is phased in for individual incomes between \$250,000 and \$300,000 in 2018 (and indexed thereafter.) A disallowance of the deduction is phased in for specified service activities above the indexed \$250,000 threshold; a specified service activity is any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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.	A portion of net income distributed by a pass-through entity to an owner or shareholder may be treated as “business income” subject to a maximum rate of 25%; the remaining portion of net business income would be treated as compensation and continue to be subject to ordinary individual income tax rates. Net income derived from a <i>passive</i> business activity would be treated entirely as business income and fully eligible for the 25% maximum rate; the percentage of business income derived from <i>active</i> business activity, including wages, would be determined by a “capital percentage.” The capital percentage would equal 30% for active activity (i.e., 30% of business income from active activity would be taxed at the 25% rate), with the remaining 70% subject to ordinary individual income tax rates. Capital percentages greater than 30% could be “proved out” for capital intensive businesses. Once made, the election of the alternative formula would be binding for a five-year period. The provision would also apply a maximum 25% rate on certain dividends from REITs (other than any portion that is a capital gain dividend or qualified dividend.) A reduced rate of 11% in lieu of the ordinary 12% rate would be phased in for small businesses with net active business income below an indexed threshold (\$75,000 for joint filers, and half this amount for individuals.) This rate would drop to 9% for taxable years beginning in 2022 and thereafter. Above taxable income levels in excess of \$150,000 for joint filers, the benefit of the 9% rate relative to the 12% rate is reduced, and it is fully phased out at \$225,000.

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Pass-Through Entities <i>continued</i>	Under current law (Section 469), certain losses are generally disallowed with respect to passive activities involving the conduct of a trade or business in which the taxpayer does not materially participate.	Qualified business income refers only to income generated from trade or business conducted in the U.S., and excludes reasonable compensation paid to the taxpayer for services rendered and any guaranteed compensation or payments.	Owners or shareholders in specified service businesses would be eligible for the preferential rate, subject to these income levels. The default capital percentage for specified service activity (defined as any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and 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) would be equal to 0%. A taxpayer in such a business would not be eligible for the 25% rate on business income, but the provision would allow the same election to owners of personal services businesses to use an alternative capital percentage based on the business's capital investments, subject to certain limitations. A special rule would apply to prevent the re-characterization of actual wages paid as business income. The capital percentage would be limited if actual wages or income treated as received in exchange for services from the pass-through entity (e.g., a guaranteed payment) exceeds the taxpayer's otherwise applicable capital percentage. Income subject to preferential rates, such as net capital gains and qualified dividend income, would be excluded from any determination of a business owner's capital percentage.

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Deduction for Residential State/Local Property Taxes	Individuals may claim an itemized deduction for state and local government income and property taxes paid. In lieu of the itemized deduction for state and local income taxes, individuals may claim an itemized deduction for state and local government sales taxes.	Individuals may itemize deductions up to \$10,000 (\$5,000 for married filing separately) for taxable years beginning after December 31, 2017, and before January 1, 2026. Individuals would <i>not</i> be allowed an itemized deduction for state and local income or sales taxes, but would continue to be entitled to a deduction for state and local income or sales taxes paid or accrued in carrying on a trade or business.	Individuals may itemize deductions for real property taxes paid up to \$10,000 (\$5,000 for married filing separately). Individuals would <i>not</i> be allowed an itemized deduction for state and local income or sales taxes, but would continue to be entitled to a deduction for state and local income or sales taxes paid or accrued in carrying on a trade or business.
Residential Housing Sales	A taxpayer may exclude from gross income up to \$500,000 for joint filers (\$250,000 for other filers) of gain on the sale of a principal residence. The property generally must have been owned and used as the taxpayer's principal residence for two out of the previous five years. A taxpayer may use this exclusion only once every two years.	For sales or exchanges after December 31, 2017 and before January 1, 2026, A taxpayer would have to own and use a home as the taxpayer's principal residence for five out of the previous eight years to qualify for the exclusion. In addition, the taxpayer would be able to use the exclusion only once every five years.	A taxpayer would have to own and use a home as the taxpayer's principal residence for five out of the previous eight years to qualify for the exclusion. In addition, the taxpayer would be able to use the exclusion only once every five years. The exclusion would be phased out by one dollar for every dollar by which a taxpayer's adjusted gross income exceeds \$500,000 (\$250,000 for single filers). The provision would be effective for sales and exchanges after 2017.
Residential Mortgage Interest and Home Equity Loan Interest	A taxpayer may claim an itemized deduction for mortgage interest paid with respect to a principal residence and one other residence of the taxpayer. Itemizers may deduct interest payments on up to \$1 million in acquisition indebtedness (for acquiring, constructing, or substantially improving a residence), and up to \$100,000 in home equity indebtedness. Under the alternative minimum tax (AMT), however, the deduction for home equity indebtedness is disallowed.	Interest on home equity indebtedness incurred after December 31, 2017 and before January 1, 2026 would not be deductible.	Interest on acquisition indebtedness pertaining to residential housing will continue, but for debt incurred after November 2, 2017, the \$1 million limitation would be reduced to \$500,000. Interest would be deductible only on a taxpayer's principal residence. Interest on home equity indebtedness incurred after November 2, 2017 would not be deductible.

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Dividends Received Deduction for Corporations	C corporations receive a deduction on dividends received from other companies whose stock they own. Ownership of less than 20% results in a dividend received deduction of 70%; ownership of 20% or greater results in a deduction of 80%. Dividends paid by a small business investment company may be eligible for a 100% deduction. REIT dividends are generally not eligible for the deduction.	80% dividends received deduction reduced to 65%; 70% dividends received deduction reduced to 50%.	80% dividends received deduction reduced to 65%; 70% dividends received deduction reduced to 50%.
Net Operating Losses	A net operating loss (NOL) is the amount by which a taxpayer's current-year business deductions exceed its current-year gross income. NOLs may not be deducted in the year generated, but may be carried back two years and carried forward 20 years to offset taxable income in such years. The alternative minimum tax (AMT) rules provide that a taxpayer's NOL deduction may not reduce the taxpayer's alternative minimum taxable income by more than 90%. Different rules apply with respect to NOLs arising in certain circumstances, such as those losses from certain bad debts of commercial banks, certain amounts related to disaster relief and excess interest losses.	Taxpayers would be able to deduct an NOL carryover or carryback only to the extent of 90% of the taxpayer's taxable income for losses after December 31, 2017 and to 80% of the taxpayer's taxable income for losses after December 31, 2022. The provision also would generally repeal all carrybacks but provide a special two-year carryback in the case of certain disaster losses incurred in business or farming. No provision for NOL carryovers.	Taxpayers would be able to deduct an NOL carryover or carryback only to the extent of 90% of the taxpayer's taxable income for losses after December 31, 2017. The provision also would generally repeal all carrybacks but provide a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses. NOLs arising in tax years beginning after 2017 that are carried forward would be increased by an interest factor to preserve its value.
Cash Method of Accounting	The cash method of accounting generally allows a business to recognize income and deduct expenses when the cash is received or paid, rather than having to accrue income and expense. Businesses structured as sole proprietorships, partnerships (without a corporate partner), and S corporations generally may use the cash method of accounting. Businesses structured as corporations and partnerships with a corporate partner may only use the cash method of accounting if its average gross receipts do not exceed \$5 million for all prior years (including the prior taxable years of any predecessor of the entity). Certain exceptions are made for farms.	The \$5 million threshold for corporations and partnerships with a corporate partner would be increased to \$15 million (and would be indexed to inflation after 2018) and the requirement that such businesses satisfy the requirement for all prior years would be repealed.	The \$5 million threshold for corporations and partnerships with a corporate partner would be increased to \$25 million (and would be indexed to inflation after 2018) and the requirement that such businesses satisfy the requirement for all prior years would be repealed. Under the provision, the average gross receipts test would be indexed to inflation.

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Recovery Periods and Leasehold Improvements	For residential rental property, the applicable recovery period for straight-line depreciation is 27.5 years and for nonresidential real property, the recovery period is 39 years. Qualified leasehold improvements (interior non-residential improvements placed in service more than 3 years after the date the building was first placed in service), qualified restaurant properties and qualified retail improvement properties are eligible for 15-year recovery periods and may be eligible for Section 179 treatment and bonus depreciation. Qualified improvement property (created under the PATH Act, effective for years from 2016 onward), is similar to a qualified leasehold improvement but does not have a 3-year rule and may be occupied by an owner, and not just a lessee. Qualified improvement property has a 39-year recovery period, and while it is eligible for bonus depreciation, is not eligible for Section 179 expensing.	For both residential rental property and nonresidential real property, the applicable recovery period is 25 years. Qualified leasehold improvements (interior nonresidential improvements), qualified restaurant properties and qualified retail improvement properties are eliminated. The recovery period for qualified improvement property drops to 10 years. Property held by an electing real property trade or business must use an alternative depreciation system.	No change.
Private Activity Bonds	Some state and local governments issue private activity bonds (PABs) to finance owner-occupied residences. In lieu of issuing such bonds, State and local governments may enable homebuyers to claim a Federal tax credit for interest on certain home mortgages by providing them with mortgage credit certificates.	Credit would be retained.	Credit would be repealed.

All information deemed to be accurate. Nothing herein should be construed as tax or financial advice.

Sources: Joint Committee on Taxation, the House Ways and Means Committee and the Senate Finance Committee.



Research Contact:

Heidi Learner | Chief Economist

hlearner@savills-studley.com

212.326.8648