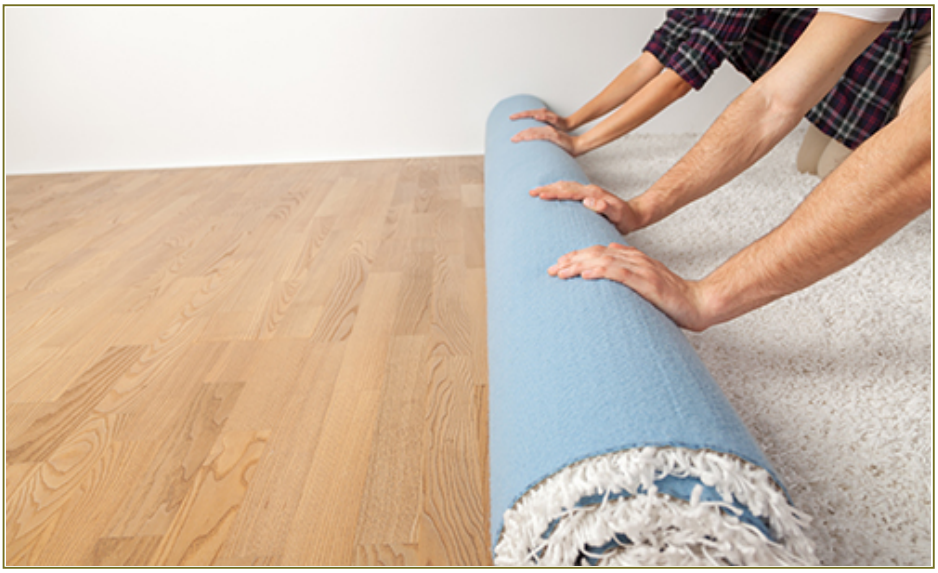
SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Cost Segregation Benefits from the Recent Tax Reform Act



Cost segregation, a technique used to reclassify building/improvement costs to personal property or land improvement property to shorter tax lives, has benefited taxpayers for decades in terms of increased cash flow and long term net present value benefits.

However, due to recent legislative changes, real property owners now have even more reason to engage in a cost segregation study (CSS).

The Tax Reform Act of 2017 (the Act) includes cost recovery provisions that open new tax planning and savings opportunities for taxpayers owning or operating real estate. Portions of this Act directly benefit cost segregation, including 100% bonus depreciation for qualifying property acquired and placed in service after September 27, 2017,

and an expansion of the definition of qualifying property to include used property (i.e., there is no longer an original use requirement).

Under the Act, taxpayers constructing or acquiring real estate–commercial or residential–can benefit from a substantial acceleration of tax deductions by reallocating purchase or construction costs to qualified property classifications through a CSS. As a result, a significant portion of the cost basis for the property can be deducted in the year placed in service.

100% Bonus Depreciation

The Act extends the bonus depreciation through 2026 for property with a recovery period of 20 years or less under MACRS and meeting the other requirements under Sec. 168(k)(2). Bonus depreciation is effective at a 100% rate for property acquired and placed in service after September 27, 2017 and before January 1, 2023, phasing down bonus to 80% for qualified property placed in service before January 1, 2024, 60% for qualified property placed in service before January 1, 2025, 40% for qualified property placed in service before January 1, 2026 and 20% for qualified property placed in service before January 1, 2027. Similar to prior law, a taxpayer can elect out of bonus depreciation for any class of property on an annual basis. For the first taxable year ending after September 27, 2017, the taxpayer can elect to apply a 50% bonus rate instead of the 100% rate.

Used Property Now Eligible

The Act also amends Sec. 168(k)(2) to extend bonus depreciation to used property, so long as it is the first use by the acquiring taxpayer and the property is acquired from an unrelated party. The legislative changes provide taxpayers with additional incentive to perform a CSS to assign property to the appropriate recovery class. Under prior law, taxpayers would benefit from a shorter recovery period, but not from bonus depreciation as the taxpayer did not meet the original use requirement. In contrast, under new law, used property is bonus-eligible. Thus, property classified to shorter lives can generally be expensed at the time placed in service. As bonus depreciation only applies to property placed in service in the United States, this will be particularly relevant for U.S.-based real property acquisitions, including both commercial and residential property.

Qualified Improvement Property May Be Eligible

The Act further amends Sec. 168 to remove references to qualified leasehold improvements, qualified retail improvement property and qualified restaurant property, categorizing them all, as well as property that was defined as qualified improvement property under the PATH Act, as qualified improvement property (QIP), for property placed in service after December 31, 2017. It appears Congress' intent was to amend Sec. 168(e)(3) to assign a 15-year recovery period (20 years alternative depreciation system) to the newly compressed class of QIP. However, there may be a technical glitch in the statute as it does not actually appear to provide a 15-year recovery period for QIP. Since Congress did not amend Sec. 168 to provide a 15-year recovery period for QIP in the new legislation and because the amended Sec. 168(k)(2) allows bonus depreciation for any property with a recovery period of 20 years or shorter, it is unclear under the current law whether QIP qualifies for the new 100% bonus depreciation and a 15-year recovery period, or whether a 39-year recovery period applies, with no bonus depreciation.

Case Study

Pre-Reform Law:

Company ABC acquires an office campus for $10,000,000 on January 15, 2017. Prior to the Act, the Company allocated $8,300,000 to building/improvements and $1,700,000 to land based on internal estimates. As a result, the Company could take $62,000 in first-year depreciation (as all property is classified as a 39-year asset). With a CSS, however, Company ABC is able to allocate $2,000,000 to shorter-lived property, accelerating first-year depreciation by an additional $325,000. Since the property is acquired and not newly constructed, the Company is not eligible for bonus depreciation.

Post Reform Law:

Assume the same costs above, except the Company acquires the property on January 15, 2018. Without a CSS, Company ABC can continue to take $62,000 in first-year depreciation. However, with a CSS, Company ABC is now eligible for 100% bonus depreciation on all qualifying CSS-reclassified assets. As a result, it can claim 100% of the reclassified asset basis of $2,000,000 as first-year depreciation.

The Takeaway

The Act benefits property owners not only by allowing 100% bonus depreciation for qualifying reclassified property, but also by extending bonus depreciation to qualifying used property. Taxpayers planning on building or acquiring commercial or residential real property should consult with their professional advisor to ensure they are maximizing their tax benefits under the new legislation.

• Edit this entry

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105
AndersenTax.com | Privacy Policy | Terms & Conditions | Disclaimer

SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

A Survey of Significant Business Credits and Incentives Developments in 2017

Federal tax reform presents major changes to income taxation in the United States.

While much attention has focused on this legislation, the federal government and various states enacted significant new laws in 2017 related to credits and incentives. This article pulls these opportunities out of the shadow of tax reform to cast light on major developments in the credits an incentives area.

Federal Income Tax Credits

Federal tax reform left major tax business credits intact. In particular, the legislation made no changes to the Work Opportunity Tax Credit or the Research and Development Tax Credit. In addition, prior to tax reform, Congress enacted tax relief measures for businesses affected by Hurricanes Harvey, Irma and Maria. One of these measures, the *Disaster Tax Relief and Airport and Airway Extension Act of 2017*, provides a new Employee Retention Tax Credit of 40% in qualified wages per employee, with a wage cap of $6,000. The maximum credit per employee is $2,400 for wages paid by a disaster-affected employer to each employee whose principal place of employment was in a hurricane disaster zone. On February 9th, 2018 the Bipartisan Budget Act of 2018, H.R. 1892 expanded the Employee Retention Credit to include taxpayers impacted by California wildfires.

Contributions to Capital

While not a change to incentives themselves, the new tax law changed the federal income tax treatment of certain state and local tax incentives as contributions to capital, as defined in Sec. 118. Under the new law, credits and incentives offered to a corporation by a governmental unit or by a civic group for the purpose of inducing the corporation to locate its business in a particular community, or for the purpose of enabling the corporation to expand its operating facilities, must be included in taxable gross income. Previously such incentives were potentially excludable.

State Credits and Incentives

More than half of the states enacted changes to tax credits and incentives focused in particular on film production, environmental clean-up and job creation. Job creation incentives had a significant number of changes including the establishment of new programs and reauthorization or modifications to others. Some of these new incentives focus on particular industries. For example, Maryland enacted the *More Jobs for Marylanders Act of 2017*, establishing incentives for new or expanding manufacturers in Maryland. These incentives offered manufacturers new to Maryland with a 10-year refundable tax credit of 5.75% of the wage per new position, state property tax exemption, sales tax refunds and waiver of all State Department of Assessment and Taxation fees. Existing manufacturers creating five to ten new jobs in specific counties will qualify for the 10-year income tax credit as well. While the incentives available vary depending on a variety of factors including location and number of new jobs created, the common goal is job creation through tax benefits.

Other job-related programs focus on redevelopment of undesirable locations. Michigan is now offering increased incentives for developers to claim the Business Tax Brownfield Credit. The new amendment to the Michigan Business Tax Act provides qualified developers that redevelop brownfield sites into mixed-use projects up to one billion dollars in tax incentives. Certain states resurrected more broad-based job incentives. Illinois for example reinstated the Illinois Economic Development for a Growing Economy (EDGE) Tax Credit through June 30, 2022. The EDGE Tax Credit is a negotiated state income tax incentive to encourage companies to locate or expand operations in Illinois. The credit can be worth as much as 50% of the incremental income tax withheld attributable to new employees plus 10% of new employee training costs.

Other states brought focus to certain segments of the workforce. Massachusetts created the New Veteran's Hire Tax Credit, which allows a $2,000 credit for each veteran hired, eligible to businesses with fewer than 100 employees. A second $2,000 credit for the next year will be available if the veteran remains employed for a second year.

Beyond job credits, many states continued to court the entertainment industry. Georgia is the first state to offer a tax credit to companies that provide post-production services. The tax credit can be worth as much as 35% of qualified, pre-approved spending by a post-production company. Louisiana amended its administrative code to

create a reservation and allocation system for its film credits. Rhode Island extended its production credit program through July 1, 2024, while eliminating video game production as a qualified activity. It should be noted that not every state liberalized incentive programs. Connecticut for example made permanent its moratorium on issuing Film and Digital Media Production Tax Credits, leaving only an exception for motion pictures that film for at least 255 days in Connecticut at facilities that receive at least $25 million in private investment.

Conclusion

The federal government was not alone enacting major legislation in 2017. State legislatures continued to use credits and incentives to entice job creation and capital investment. While we digest the major changes that come with tax reform, taxpayers should not overlook new opportunities for incentives.

• Edit this entry

SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Transfer Pricing Update: Surveying the Landscape of the New Base Erosion Rules

The Tax Reform Act of 2017 (the Act) aims to promote domestic employment using a multi-pronged approach which includes: (i) deductions to income from foreign sales tied to domestic economic activity; (ii) new taxes on income tied to intangible assets held offshore and taxed at low rates; and (iii) new taxes applied to certain types of payments made to foreign related parties.

In addition, several key concepts that were the focus of much debate in high-profile transfer pricing cases have now been formally defined. Taken together, the new law presents a mix of new opportunities and risks. Accordingly, taxpayers should make efforts to fully understand and quantify the meaning of these new changes on their tax

positions, whether in terms of their 2017 position or their positions for 2018 and beyond. This article focuses on some of the new international tax provisions and offers some key considerations in the context of transfer pricing.

New Deductions for Income on Foreign Sales from Domestic Activity

The Act introduces a new category of income: *Foreign-Derived Intangible Income* (FDII), which represents intangible income earned by a U.S. corporation from product sales (or services) income in foreign markets. FDII appears to include interest earned on income from foreign sales or services so long as the interest can be traced to the terms of the sales or services (i.e. interest charge on late payment). Note that intangible income is defined as the excess over a routine return on tangible assets (e.g., 10%). Income categorized as FDII will receive a deduction of 37.5% which, after applying the new corporate rate of 21% yields a reduced tax rate of 13.125%. This effective rate increases to 21.875% for tax years beginning on or after January 1, 2026. Provided an effective rate of 13.125% presents a tax benefit, taxpayers should revisit their transfer pricing policy to determine whether the FDII amount is being maximized. For example, if the value of outbound sales or service transactions with foreign related parties can be increased, taxpayers may be able to reduce the effective tax rate to as low as 13.125% until 2026. Increased income that qualifies for this reduction may require a change to the foreign related parties' risk profile, so care should be taken to ensure that any new transfer pricing policy is sufficiently supported by the underlying fact profile.

New Taxes for Intangible Income Earned Offshore

The Act also introduces a new category of income known as *Global Intangible Low-Taxed Income* (GILTI), which refers to foreign earnings that exceed an amount equal to a standard rate of return on tangible assets held offshore (e.g., 10%). This new tax is applied whether the foreign earnings are brought back to the U.S. or not. Until the sunsetting of this provision in 2026, a 50% deduction is applied and, after making other adjustments, the effective rate on GILTI income is 13.125%. Thus, while prior to the Act taxpayers could avoid any U.S. tax by keeping low-taxed intangible income offshore indefinitely, the new effective rate of 13.125% is significantly lower than the 35% statutory rate that would have applied had the income been distributed back to the U.S. as ordinary income. For that reason, taxpayers may still benefit from strategies that transfer intellectual property (IP) ownership to foreign jurisdictions, provided that the applicable foreign rate is no greater than the GILTI rate.

New Taxes to Discourage Base Erosion

Finally, the Act introduces a new *Base Erosion Anti-Abuse Tax* (BEAT), which is effectively an alternative minimum tax to discourage excessive earnings stripping through deductible payments of interest, royalties, and management fees to foreign affiliates. Imposed on U.S. corporations with at least $500 million in average annual gross receipts over three years, the BEAT applies a minimum tax (5% for 2018, 10% for 2019 through 2025, and 12.5% for subsequent tax years) on a taxpayer's modified taxable income. Modified taxable income is generally taxable income adjusted to exclude certain base erosion payments (as defined in the new law). The impact of the BEAT presents a challenge for U.S.-based multinational enterprises (MNEs) that implemented transfer pricing policies to optimize deductible payments of interest, royalties, and management fees to foreign affiliates. Significantly however, excluded from the BEAT tax are payments for cost of goods sold (COGS) and payments for certain types of routine services. Accordingly, MNEs should re-evaluate their transfer pricing policy to see whether royalties or services may be properly embedded in COGS. Caution must be taken however, as IRS is granted broad regulatory authority to issue regulations and other guidance to prevent the avoidance of the BEAT.

Expanded Definition of Intangibles

Layered on top of the rules described above is a new definition of intangibles. Intangible property was previously defined through a list of specific types of IP that included patents, copyrights, trademarks and so on that are *independent of the services of any individual*. Under the Act, the definition of intangibles is expanded so that if an item is not specifically defined as tangible property under the new law, it is to be considered intangible property and possibly subject to taxation. As mentioned above, the Act assigns a 10% standard return on tangible assets, so that any income in excess is to be considered intangible income, and thus subject to the GILTI and FDII provisions.

Clearly, the expanded definition of intangibles, coupled with the new base erosion provisions, is intended to make transfers of intangible property to foreign jurisdictions more expensive and thus, less beneficial from a tax standpoint.

Fundamental Change

The U.S. international tax system has been fundamentally changed. Both U.S.-based and foreign multinational businesses will find it necessary to understand and model the effects of the GILTI, FDII, and BEAT. Based on this reality, many such companies will be reevaluating the underlying economics and tax efficiency of their overall supply chain and considering modifications. As always, transfer pricing is an integral component of such analysis.

The Takeaway

The fundamentals of transfer pricing have not changed. Determining the benefits and risks, however, has become significantly more complex. Accordingly, taxpayers should expect an increase in transfer pricing disputes, especially those initiated in non-U.S. jurisdictions. It is critical that taxpayers assess these new complexities created by the Act and to identify, quantify and manage the risks and opportunities under their specific facts.

• Edit this entry

SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

The Impact of Tax Reform on the Valuation of Companies and Assets

The December passage of the Tax Reform Act of 2017 (the Act) has created an immediate impact on the calculated values of both corporations and pass-through entities.

While the long-term implications have yet to play out in terms of shifts in strategic direction, capital structure and international tax planning, one immediate result of the tax law changes is that the values of many public and private companies are increasing. While it is important to factor in the recent legislative changes, valuation professionals also must be cautious that they do not overestimate the impact of the new tax law. This article focuses on a few of the ways in which the recent legislative tax changes are having direct and indirect effects on various types of business valuations.

Effects May Vary Based on Valuation Approach

The value of a business is typically based either on a cost approach, income approach or a market approach. The effects of the tax legislation may vary depending on the approach used in the valuation. The cost approach is typically not used to value an operating business as it does not capture the going-concern nature of the entity. Therefore we will focus our discussion on the income and market approaches to value.

The income approach generally focuses on the discounted value of after tax cash flows generated by a business or asset. As such, the lower corporate tax rate, the 100% depreciation deduction for many capital expenditures through 2022 and the qualified business income deduction for certain pass-through entities are some of the changes that will generally increase the value of businesses under the income approach. A few of the changes that could offset this increase include a lower value on net operating losses (NOLs) due to the 80% annual limitation on deducting NOLs generated after 2017 and the limitation of interest deductibility. Even with the dampening impact of some of the changes, most companies using an income approach can expect to see an increase in both company and asset values in the near term.

The discount rate is another key element in the income approach and since it is primarily derived using historical inputs, it will take time to discern the true impact of the tax law changes. The tax rate itself is an input in the determination of the cost of equity and the after-tax cost of debt used in a company's cost of capital. The limitation on the amount of interest that can be deducted annually may also impact the after-tax cost of debt for many companies that utilize debt financing. Both the lower tax rate and the interest deduction limitation will increase the cost of capital, thus dampening the impact of the lower tax rate. The mechanical effect of the tax rate changes on the cost of capital will tend to have a greater impact on those companies that have relatively high levels of debt and have little to no impact on companies that primarily use equity financing. The long-term impact of the new tax laws on market returns, interest rates and capital structure will not be known until reliable historical data emerges, but valuation professionals should consider if adjustments to current historical data is appropriate.

The market approach reflects expectations about the future and, as such, valuations using this approach have included some expectation of the tax law changes since the election of 2016. It is difficult to know how much of the market appreciation has been driven by tax changes and how much is a function of other positive market factors. Due to this inherent uncertainty, the actual passage of tax reform legislation has less of an impact than might be expected. The most common fundamentals used to value companies under the market approach are earnings before interest and taxes (EBIT), earnings before interest, taxes, depreciation and amortization (EBITDA) and revenue. None of these fundamental factors reflect the positive impact of the lower tax rate. To the extent that the values are higher, that is manifested in higher multiples, provided all other factors and circumstances remain the same. Since the impact and benefits from the recent tax reform changes will not be evenly distributed to all companies, valuations derived using a market approach must carefully consider if the comparable companies used in the analysis will derive similar benefits from the tax law changes.

The Takeaway

The broader and long-term impacts of the enacted tax reform legislation will emerge slowly over time. It is likely there will continue to be a positive effect on value, although that impact will be tempered by sunsetting provisions in the legislation itself, changes in investor expectations, shifts in international operations, changes in capital structure and other as yet unidentified factors. It is clear that for the foreseeable future, tax considerations and their related assumptions will be a critical component in every valuation. It is imperative that valuations not only reflect

the obvious mechanical impacts of the tax law changes, but also consider any potential indirect effects that could enhance or offset the initial indications of increased value.

• Edit this entry

SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

Tax Reform and Its Impact on Passive Foreign Investment Companies (PFIC)

The Tax Reform Act of 2017 (the Act) brought about many significant changes in the international income tax area.

Although most of the changes have focused on the new *transition tax* for specified foreign corporations and other provisions affecting U.S. multinational businesses, the Act also includes some changes that impact passive foreign investment companies, or PFICs, where a qualified electing fund (QEF) election has not been made.

As a brief overview, a PFIC is a foreign corporation that satisfies a number of tests, including an asset and income test. The asset test is met when the average percentage of assets held that produce passive income or are held for the production of passive income is at least 50%. The income test is met when 75% or more of the gross income is

from passive activities. Passive income is defined as interest, dividends, rents, royalties, annuities and gains over losses from the sale or exchange of property that gives rise to interest, dividends, rents, royalties and annuities. If either of these tests are met, the corporation is treated as a PFIC.

If a U.S. taxpayer is an owner of a PFIC, absent a QEF election (which treats the PFIC's ordinary income and net capital gains as flowing through to the taxpayer annually similar to a partnership), no income is recognized and subject to tax unless actual distributions are made by the PFIC. However, when income distributions are made, they are generally taxed as ordinary income at the highest marginal rate regardless of the character of the income at the entity level. In addition, an interest charge is also levied on the deferred tax if there are excess distributions, which is compounded annually. As a result, U.S. taxpayers typically seek to avoid PFIC treatment.

CFC Overlap Rule

As described above, the rules for determining whether a foreign corporation is a PFIC are different than the rules for whether a U.S. person owns an interest in a controlled foreign corporation (CFC). Prior to the Act, to qualify as a U.S. shareholder of a CFC, a U.S. person must own 10% or more of the combined voting power of all classes of stock entitled to vote and, collectively, those U.S. shareholders must own more than 50% of the total combined voting power or value, whichever is greater. If a U.S. person owns less than 10% of a CFC that is also a PFIC, it will be treated as a PFIC with respect to that U.S. person.

Retroactive to January 1, 2017, a U.S. shareholder is now defined as a U.S. person owning either 10% or more of a foreign corporation's combined voting power or value, whichever is greater. Stock classes are not distinguished for this purpose.

The attribution rules to determine CFC status have also changed under the Act. Now certain stock of a foreign corporation owned by a foreign person could be attributed to a related U.S. person. The effect of these changes will likely cause more PFICs to be treated as CFCs. U.S. taxpayers should review their current ownership in PFICs to determine whether their ownership is now treated as being a U.S. shareholder in a CFC. Due to the complexity of the PFIC rules, the tax implications of an interest in a PFIC now being treated as an interest in a CFC because of the Act are beyond the scope of this article.

Insurance Exception to PFIC Rules

Prior to the Act, passive income did not include any income derived in the active conduct of an insurance business by a corporation that was predominantly engaged in an insurance business and that would be subject to tax under subchapter L (the provisions of the tax code relating to insurance companies), if it were a domestic corporation. Congress has been concerned that many hedge funds have used this exception for insurance companies to invest in assets that produce passive income without assuming the risks that are part of a traditional insurance business and thereby avoid the PFIC rules. IRS was aware of this planning technique and issued a Notice in 2003 warning that such arrangements may be challenged.

Beginning in 2018, the Act eliminates the *predominantly engaged in an insurance business test* for PFICs and instead provides that passive income does not include any income derived in the active conduct of an insurance business by a *qualifying insurance corporation*. The statute's definition of a qualifying insurance corporation will likely subject more foreign corporations to the PFIC rules that were formerly excluded because the test for qualifying as an insurance corporation are more difficult to meet. Specifically, in order to be a qualifying insurance corporation, the foreign corporation's insurance liabilities have to be more than 25% of the corporation's total

assets as reported on the company's applicable financial statements for the last year ending with or within the taxable year. Without a QEF election, U.S. investors in theses business will now be subject to the tax inefficient PFIC rules.

The Take Away

Although the Act did little to impact much of the PFIC rules, U.S. taxpayers with PFIC investments must be wary of the broadened definition of a U.S. shareholder, which could cause a PFIC to become a CFC due to the ownership attribution rules. In addition, U.S. taxpayers should review their investment in foreign corporations that claim that they are conducting an insurance business and determine whether such foreign corporations are now subject to the PFIC rules.

• Edit this entry

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105
AndersenTax.com | Privacy Policy | Terms & Conditions | Disclaimer

SPECIAL EDITION: Tax Reform Impact

NEWS YOU CAN USE FROM ANDERSEN TAX

for the RECORD

The Impact of Recent Tax Legislation on the Real Estate Business

The Tax Reform Act of 2017 (the Act) includes serval benefits for the real estate industry.

The Act provides for new tax deductions to partners, S corporation shareholders and sole proprietors investing in real estate (among other industries). In addition, provisions that aid the real estate investor were also included to eliminate the impact of new limitations on deductibility of business interest expense.

Further, although carried interest rules are modified to provide for a three-year holding period to get long-term capital gain treatment, such change likely will not impact those granted carries in many real estate partnerships. Like-kind exchanges also are still allowed for real estate and rehabilitation tax credits remain for historic properties and the low-income housing credit survives. Finally, the changes under the Act will also favorably affect foreign

investors in U.S. real estate. With respect to real estate, possibly the only negative impact of the Act for taxpayers result from changes that dampen the tax benefit of home ownership.

Favorable Qualified Business Income Deduction

For partners, S corporation shareholders and sole proprietors in certain industries (for example professional service and financial service businesses are largely excluded), the Act adds a new deduction equal to 20% of qualified business income (QBI). While the deduction is subject to a wage and property limitation, that limitation has been drafted in such a way as to not negatively impact the real estate industry. The wage and property limitation provides that the 20% deduction cannot exceed the greater of: (1) 50% of the wages paid by the partnership or (2), 25% of the wages paid by the partnership plus 2.5% of the original cost basis of depreciable tangible property placed in service in the last 10 years. A partnership's investment in depreciable real estate (but not land) can now help increase this new deduction.

Limits on Interest Deduction

The Act provides that a taxpayer's net business interest expense deduction cannot exceed 30% of its adjusted taxable income. Any interest disallowed under this rule is carried forward indefinitely, but still subject to this rule in those subsequent years. This limitation does not apply if the gross receipts from all business activities do not exceed $25 million.

However, an election can be made to eliminate application of this new limit if the taxpayer agrees to depreciate its assets under the Alternative Depreciation System (ADS). The regular recovery period for commercial real estate (e.g., an office building) is 39 years while the ADS period is a mere one year longer, 40 years. The recovery period for residential real estate is 27.5 years while the ADS period is now 30 years. The modest loss of current depreciation deductions may be worth taking if interest can then be fully deducted.

Other Changes

The Act's elimination of tax-free like-kind exchanges does not apply to real estate, leaving a major benefit for those buying and selling real property. In addition, the Act did not alter the recovery period for commercial or residential real estate. However, in what appears to be a technical error in the legislation drafting, the 15-year recovery period for leasehold improvements was inadvertently changed to 39 years.

The low-income housing tax credit remains as a valuable tool to assist construction of affordable housing. However, community development was likely hindered by elimination of the new markets tax credit. The Act allows the rehabilitation tax credit to remain, but only for historic buildings.

The grant of carried interests in a partnership has been a long-standing tax-favored way to reward sponsors, managers and other service providers by allowing some income that otherwise might be treated as ordinary income to be taxed as capital gain. The Act changes the treatment of carried interests, but in a very limited manner. With respect to a carried interest, the holding period for long-term capital gain treatment for underlying assets held by the partnership would be increased from more than one year to more than three years. However, given that real estate tends to be held for longer periods of time than financial assets, this change likely has limited impact on the real estate industry.

In years before January 1, 2018, if within a 12-month period there were sales or exchanges of a partnership interest that equal or exceed 50% of the total partnership interest in profits and capital, the partnership was deemed terminated for tax purposes. This hyper-technical rule can serve to reset the clock for depreciating the partnership's assets, which can lower the annual depreciation deduction and increase a partner's tax bill. The Act eliminates this rule.

Not all the changes under the Act positively impact real estate. Net operating losses (NOLs) can be valuable in the real estate world since depreciation and other expenses often create NOLs. The Act allows NOL carryovers to offset only 80% of a taxpayer's taxable income for taxable years beginning after December 31, 2017. While all carrybacks would generally be repealed, carryforwards would now be allowed indefinitely, with the 20-year limit under prior law repealed.

Foreign Investment in U.S. Real Estate

For many wealthy foreigners, U.S. real estate is an attractive investment. To avoid exposure to elements of the U.S. taxing system, that real estate investment is typically made through a U.S. blocker corporation. These corporate blockers can now benefit from the new 21% corporate tax rate, which slashes their tax bills nearly in half. Foreign investors who want to lend to real estate projects are still aided by the portfolio interest exemption, which allows interest paid to many foreign investors to be paid free of any U.S. tax. The Act leaves the exemption untouched.

Reduced Tax Assistance for Single Family Home Ownership

Historically, the tax law has been very supportive of single-family home purchases, with the tax deduction for real property taxes and home mortgage interest incentivizing home ownership. The Act reduces some of this incentive. The deduction for real property taxes and state and local income and sales taxes cannot exceed $10,000. In addition, the Act retains the deduction for interest on acquisition indebtedness, but only for interest on up to $750,000 of acquisition indebtedness ($375,000 for a married person filing a separate return). A grandfather rule is provided for mortgages with respect to homes that a taxpayer already owns. The Act also repeals the mortgage interest deduction on home equity loans. The impact of these changes is that home ownership is not as tax beneficial, which may make home ownership less affordable.

The Takeaway

The Act includes many potentially positive provisions for the real estate industry. However, exactly how these provisions impact individuals and their businesses must be carefully considered. For taxpayers who own and invest in real estate businesses, a detailed review of the tax impacts of the Act should be done.

• Edit this entry

PHILADELPHIA SAN FRANCISCO SEATTLE SILICON VALLEY WASHINGTON, D.C. WEST PALM BEACH
WOODLAND HILLS

Andersen Tax LLC. | 100 First Street, Suite 1600, San Francisco, CA 94105