Real Estate Taxation:

Where We Are At and Where We are Headed

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CPE 360

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Where We Are At… Legislation Timeline

- Tax Cuts & Jobs Act (TCJA) – December 22, 2017
- Families First Coronavirus Response Act (FFCRA)– March 18, 2020
- Coronavirus Aid, Relief, and Economic Security Act (CARES) – March 27, 2020
- Consolidated Appropriations Act (CAA) – December 27, 2020
- American Rescue Plan Act (ARPA) – March 11, 2021
- Infrastructure Investment and Jobs Act – November 15, 2021
- Build Back Better Act (H.R. 5376) - ???

Where We Are At:
Current Legislation

Bonus Depreciation & Sec. 179 Expense

- Property depreciated under the General Depreciation System (GDS) that has a useful life of less than 20 years qualifies for bonus depreciation.
  - Some taxpayers may choose to or be forced to used the Alternative Depreciation System (ADS), which does not qualify for bonus depreciation rates.
- The current bonus depreciation rate is 100%
  - Set to decrease to 80% in 2023, 60% in 2024, 40% in 2025 and 20% in 2026
  - Likely to be extended in future legislation.
- Section 179 expense is limited to $1,050,000 for 2021, $1,080,000 for 2022
  - Taxpayers may be able to take Sec. 179 expense on some items not eligible for bonus depreciation, such as roofs, HVAC, fire protection, alarm systems.

Qualified Improvement Property

- Qualified Improvement Property (QIP) definition:
  - Improvement made to interior portion of a nonresidential building.
  - Placed in service after the date the building was placed in service.
- The CARES act in 2020 provided QIP with a 15-year useful life under the GDS (ADS of 20 years).
  - Prior to the CARES act, the depreciable life for QIP was incorrectly omitted from the Tax Cuts & Jobs Act (TCJA). This resulted in a default 39-year life.
  - This lower life allows the property to be eligible for bonus depreciation as it is under 20 years.
  - The change in depreciable life is retroactive, effective as of the date of the TCJA.

Section 163(j) Interest Expense Limitation

- The deductible business interest expense of any taxpayer for a tax year is limited to the sum of:
  - 30% of a taxpayers Adjusted Taxable Income (ATI)
  - The taxpayer's business interest income for the year
  - The taxpayer's floor plan financing interest expense for the year.
- Adjusted Taxable Income equals taxable income with adjustments for:
  - Additions – Business interest expense, NOL deductions, 199A deductions, **depreciation, amortization**, deductions not allocable to a trade or business.
    - **For tax years beginning after 2021, the addback for depreciation and amortization is removed.**
  - Subtractions – Business interest income, income or gain not allocable to a trade or business, special adjustment for gain on sale of property.

Section 163(j) Interest Expense Limitation (cont.)

- Exclusions and exceptions to the 163(j) limitation:
  - Small Taxpayer Exception
    - The taxpayer (and any taxpayers required to be aggregated based on common ownership), must have under $25M of average gross receipts in the prior three years, indexed annually for inflation - $26M in 2020 and 2021.
    - The taxpayer may not be considered a tax shelter. This includes any taxpayer considered a “syndicate”, which is taxpayer that allocates at least 35% of losses in a tax year to limited partners or limited entrepreneurs.
  - Electing Real Property Trade or Business
    - Applies only to trade or businesses related to real property.
    - Allows for a permanent election to be excluded from the 163(j) limitation.
    - Any electing taxpayer must depreciate all real property under the ADS.
- The CARES act provided a temporary 50% ATI rate, which was only applicable for years beginning in 2019 and 2020.

Section 461(l) Business Loss Limitation

- Under the TCJA, taxpayers' ability to offset non-business income with business losses under Sec. 461(l).
  - The limitation is $250,000 for single taxpayers and $500,000 for married filing jointly taxpayers.
- Any unused business losses create or add onto the taxpayer’s Net Operating Loss (NOL) carried to the next year.
- The CARES act suspended the business loss limitation for years beginning in 2018, 2019 & 2020.
  - The limitation is effective for tax years beginning before 2027.

Net Operating Loss Limitations

- Under the TCJA, taxpayers' ability to utilize Net Operating Losses (NOLs) was restricted in two separate ways:
  - NOLs occurring in 2018 or later could only offset up to 80% of taxable income in any year it was carried forward to.
  - NOLs could no longer be carried back but could now be carried forward indefinitely.
- These limitations were suspended under the CARES act for tax years beginning in 2018, 2019 & 2020.
- ARPA extended the limitation for any taxable year beginning before January 1, 2027.

Section 1061 Carried Interest Rules

- Owners of an "applicable partnership interest" (API) have the standard 1-year holding period for Long-Term Capital Gain substituted with a 3-year holding period.
- An API is an interest obtained in connection with the performance of substantial services by the taxpayer in an "applicable trade or business"
  - An applicable trade or business includes any activity conducted which consists of:
    - Raising or returning capital, and
    - Either –
      - Investing in (or disposing of) specified assets, or
      - Developing specified assets

Section 1061 Carried Interest Rules

- Specified Assets includes:
  - Securities
  - Commodities
  - Real estate held for rental or investment
  - Cash or Cash Equivalents
  - Options or Derivative Contracts
- Section 1231 gains from sale of rental real estate are excluded from the carried interest holding period rules.
  - A sale of units or partnership interests in a partnership that holds 1231 assets is still considered capital gain and would be subject to the 3-year holding period.

Where We Are Going:

Build Back Better Act Proposed Legislation

What Is Off the Table Currently?

- Increase in individual income tax rates.
  - Including no increase in capital gains rates.
  - Exception – High income surcharge.
- Increase in corporate income tax rates.
- Removal of Sec. 1031 Like-kind exchanges.
- Expansion of carried interest rules under Sec. 1061
- No repeal of stepped-up asset basis on death.
- No changes to grantor trusts
- No restriction to Sec. 199A small business deduction.

What Is In the Current Text?

- Make Active Pass-Through Loss Limitation under 461(l) Permanent
- Change in the Interest Limitation Calculation under 163(j)
- Surcharge on High-Income Individuals
- 3.8% Net Investment Income Tax (NIIT)
- Modifications to Treatment of Certain Losses
- Increase the current State & Local Tax Deduction
- Deduction for Energy-Efficient Commercial Buildings (section 179D)
- Public EV Charging Station Credit

Proposed Section 461(l) Business Loss Limitation

- Would alter the treatment of any excess business loss carryforward.
  - Change from being treated as a NOL carryforward to specifically an excess business loss carryforward.
  - Carryforwards would then be subject to the same excess business loss rules in subsequent years, rather than being subject to standard NOL provisions.
- Depending on a taxpayers' facts, could significantly alter the affect of this provision from simply a timing difference, to something more substantial and detrimental.
- The provision would permanently disallow excess losses from being applied to portfolio or wage income. This provision is applicable for taxable years beginning after December 31, 2020.

Proposed Section 461(l) Business Loss Limitation

Single Taxpayer Facts:	2021	2022
W-2 Wages	$1,000,000	$1,100,000
Investment Income	$300,000	$100,000
Business Income/Loss	($2,000,000)	($1,500,000)
Total Income	($700,000)	($300,000)

Without 461(l)	2021	2022
Taxable Income	$-0-	$-0-
Tax (using 37%)	$-0-	$-0-
NOL C/F	$700,000	$1,000,000
Excess Loss C/F	N/A	N/A
With Old 461(l)	**2021**	**2022**
Taxable Income	$1,050,000	$190,000
Tax (using 37%)	$388,500	$70,300
NOL C/F	$1,750,000	$2,240,000
Excess Loss C/F	N/A	N/A
With New 461(l)	**2021**	**2022**
Taxable Income	$1,050,000	$950,000
Tax (using 37%)	$388,500	$351,500
NOL C/F	$-0-	$-0-
Excess Loss C/F	$1,750,000	$3,000,000

Proposed Section 163(j) Limitation

- Would move the calculation of the limitation from a partnership/S corporation level to a partner/shareholder level.
- The small taxpayer and electing real property trade or business exceptions would still apply.
- Non-excepted taxpayers would be required to furnish information to their partners or shareholders to compute the Sec. 163(j) limitation on their personal return.
- May result in either a benefit or a detriment, depending on what the facts are.
  - Will require additional reporting.

Proposed Income Tax Surcharge

- Income Tax Surcharge
  - Additional 5% tax on Modified Adjusted Gross Income in excess of:
    - $10MIL – MFJ, Single, or HoH
    - $5MIL – MFS
    - $200K – Estate and trusts
  - Additional 3% tax (total of 8% including the 5% above) on Modified Gross Income in excess of:
    - $25MIL – MFJ, Single, or HoH
    - $12.5MIL - MFS
    - $500K – Estate and trusts
  - Applicable to both ordinary income and capital gains.
  - Effective for tax years <u>beginning after</u> 2021

Other Proposed Changes

- Reduced Sec. 1202 Stock limitation for shareholders over $400k of AGI, trusts & estates.
- State and Local tax deduction cap increase from $10,000 to $72,500 and extended through 2031.
- Expansion of Net Investment Income Tax for taxpayers over $400k single/$500k MFJ to include all trade or business income.
- Modifications to Treatment of Certain Losses. This change would require a loss in a worthless partnership interest to be treated as a capital loss and deferred until the property is sold to a third party.
- Deduction for Energy-Efficient Commercial Buildings (section 179D). The deduction would be extended through 2031. The requirement for greater energy efficiency would be lowered from 50% to 25%, among other changes.
- Public EV Charging Station Credit. The alternative fuel vehicle refueling property credit would be extended through 2031. The credit would also be increased beginning in January 2022

Other Legislation to Watch

Potential Extensions

- Section 163(j) business interest expense limitation extension of depreciation and amortization addback.
  - Currently set to expire for tax years beginning after 2021.
- Extension of 100% bonus depreciation allowance.
  - Currently set to decrease starting in 2023.

Wyden Partnership Tax Proposals

- Debt to be allocated in accordance with each partner's percentage in partnership profits.
  - Would apply to both recourse and non-recourse debt.
  - Contribution of property subject to debt concerns
- Removal of pre-formation expenditure exception to disguised sale rules
  - Would deter many equity structures where a developer member incurs costs in advance of raising equity, subsequently reimbursed.
- Require remedial Sec. 704(c) allocations where built-in gain exists.
  - Creates deduction and income items to clear differences between book and tax basis.

COVID-19 Restructuring and Considerations

Payment Protection Program Loans (PPP) and Employee Retention Credit (ERC)

- PPP Loan update
  - Summary of 2nd draw process
  - Forgiveness applications
  - Ongoing concerns and issues
- ERC Update
  - Current credit utilization environment and incentive firms
  - Credit complexities
    - Reduction in deductible wages
    - PPP/ERC considerations
  - Amended payroll returns
  - 4th Quarter ERC has been retroactively repealed, except for Start up Businesses
- Deferred Payroll Taxes – 50% due by December 31, 2021

COVID-19 Lease & Debt Modifications

- Both lease & debt modifications have tax structuring options to avoid harmful tax treatments.
  - Debt modifications may be considered cancellation of debt or exchange of debt events that require income recognition.
  - Lease modifications that defer payments for tenants may not be provided the same income recognition deferral.
- Any structural changes should be reviewed by a tax advisor to avoid unintended tax consequences.

Questions?