I. The Tax Cuts and Jobs Act's Effect on Real Estate Investments

A. Introduction

At the end of 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA) taking effect for the 2018 fiscal year.[1] The bill provides the most significant tax reform in thirty years, and changes the tax calculus for many American taxpayers.[2] TCJA decreases individual and corporate tax rates, creates new deductions and increases, decreases, or altogether eliminates other deductions.[3] While these changes permeate all areas of American industry, many have a unique impact on real estate investment.[4] A new twenty percent deduction on qualified business income for non-pass-through entities is set to benefit real estate investors, who often organize business as limited liability companies (LLCs).[5] Additionally, Section 179, which aims to provide a tax break for small businesses, now extends a deduction on qualifying expenses to improve property up to a maximum of $1 million.[6] Individual homeowners, on the other hand, see a reduction in deductible mortgage interest from $1 million to $750,000, and an elimination of a $100,000 home-equity debt deduction.[7] Foreign investors in U.S. real estate are now subject to

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[1] Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017). *See* Lawrence H. Brenman et al., *Impact of the Tax Cuts and Jobs Act on Real Estate*, NAT'L L. REV. (Jan. 24, 2018), https://www.natlawreview.com/article/impact-tax-cuts-and-jobs-act-real-estate [https://perma.cc/5JER-RAAV].

[2] *See* Noel Christopher, *Unpacking The New Tax Reform: Crucial Changes for Real Estate Investors*, FORBES (July 5, 2018, 9:00 AM), https://www.forbes.com/sites/forbesrealestatecouncil/2018/07/05/unpacking-the-new-tax-reform-crucial-changes-for-real-estate-investors/#4878186574f9 [https://perma.cc/AE8R-VQUB].

[3] *See* Brenman et al., *supra* note 1.

[4] *See generally id.*

[5] Christopher, *supra* note 2.

[6] Tax Cuts and Jobs Act § 13101, 131 Stat. at 2101 (amending 26 I.R.C. § 179 (2012); *Section 179 Deduction*, SEC. 179 ORG (last visited Sept. 22, 2018), https://www.section179.org/section_179_deduction [https://perma.cc/55B8-DFFY] (stating that a goal of Section 179 is to provide a tax break for small businesses).

[7] Tax Cuts and Jobs Act § 11043, 131 Stat. at 2086 (amended 26 I.R.C. §163(h)(3)(F)(i) (2012)).

entirely new considerations when determining an investment vehicle.[8] It is yet to be seen how the tax bill will affect real estate investors. What we do know is that the new bill will at least change the calculus for many investors.

In this paper, I will outline the major tax changes for several categories of investors. Section B discusses the impact on real estate professionals. Next, Section C considers the effects on homeowners. Section D discusses how the new tax law affects foreign investors.

B. Effects on Real Estate Agents, Brokers, Investment Trusts, etc.

There are three main categories of real estate investors that the TCJA will impact, and each type of investor will be affected differently. For those heavily involved in the real estate industry, there are many provisions that may provide significant tax breaks.[9]

1. Pass-through Business Income

Businesses other than C corporations are now allowed a new twenty percent deduction on pass-through business income of a "qualified trade or business."[10] This deduction effectively reduces the maximum individual tax on qualified business income to 29.6%.[11] The deduction also applies to real estate investment trusts (REIT) dividends.[12] A "qualified trade or business" is "any trade or business other

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[8] *See* Brad Wagner & Justin Wood, *TCJA Will Affect Foreign Investments in US Real Estate*, WAGNER DUYS & WOOD, https://wagnerduys.com/resources/resource/tcja-will-affect-foreign-investments-in-us-real-estate [https://perma.cc/BW84-75GA] (outlining changes in the TCJA for foreign investors).

[9] *See* Rebecca Lake, *There's No Better Time to Be a Real Estate Investor*, U.S. NEWS & WORLD REP. (Mar. 30, 2018, 9:00 AM), https://money.usnews.com/investing/real-estate-investments/articles/2018-03-30/theres-no-better-time-to-be-a-real-estate-investor.

[10] Tax Cuts and Jobs Act § 11011, 131 Stat. at 2063; Brenman et al., *supra* note 1.

[11] ROBERT J. HAFT & PETER M. FASS, TAX-ADVANTAGED SECURITIES HANDBOOK § 9:1, Westlaw (updated Aug. 2018) ("The reduced maximum rate arises from a 20% deduction ([100% − 20%] × 37% top individual marginal rate = 29.6%.").

[12] Michele J. Alexander & Ryan Davis, *The Impact of Tax Reform on Real Estate Investment Trusts*, BRACEWELL LLP (Feb. 15, 2018),

than (i) a specified service trade or business; or (ii) the trade or business of performing services as an employee."[13] Real estate agents are not considered to be engaged in a "specified trade or business," unlike lawyers, accountants, doctors and other professionals.[14] However, if the taxpayer's taxable income is less than $157,500 (or $315,000 for those filing jointly), the "specified service trade or business" restriction does not apply, and for individuals with taxable income between $157,500 and $207,500 (or joint filers between $315,000 and $415,000) the "specified service trade or business" restriction only applies in a limited fashion.[15]

A complicated W-2 wage limitation phases in for taxpayers with taxable income greater than $157,500 for individuals (or $315,000 for joint filers) and fully kicks in for those with incomes greater than $207,500 ($415,000 for joint filers).[16] "The W-2 wage limitation is equal to the greater of (i) 50% of the taxpayer's allocable share of the entities' W-2 wages paid; or (ii) the sum of (a) 25% of the W-2 wages allocated to the taxpayer plus (b) 2.5% of the unadjusted basis (immediately after acquisition) of all qualified property."[17] This means that businesses are rewarded for paying more W-2 wages to employees, because the greater the W-2 wages paid, the greater deduction that can be taken out pursuant to section 199A.[18] This limitation does not apply to REIT dividends, however, which could affect how high-earners evaluate potential real estate investment vehicles.[19]

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https://bracewell.com/blog/impact-tax-reform-real-estate-investment-trusts [https://perma.cc/D962-KHMM].

[13] Tax Cuts and Jobs Act § 11011, 131 Stat. at 2063.

[14] John E. Girouard, *Why Real Estate May Be a Big Winner in the Tax Cuts and Jobs Act*, FORBES (Apr. 11, 2018, 4:10 PM), https://www.forbes.com/sites/investor/2018/04/11/why-real-estate-may-be-a-big-winner-in-the-tax-cuts-and-jobs-act/#15e9926967f4 [https://perma.cc/MZ7Y-JD26].

[15] *Tax Cuts and Jobs Act, Provision 11011 Section 199A—Deduction for Qualified Business Income FAQs*, INTERNAL REVENUE SERV. (last updated Sep. 22, 2018), https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs [https://perma.cc/DJX8-HT7S].

[16] HAFT & FASS, *supra* note 11, § 9:3.

[17] *Id.*

[18] *See* N.Y.C. BAR ASS'N CITY BAR CTR. FOR CONTINUING LEGAL EDUC., QBI DEDUCTION FOR RENTAL REAL ESTATE ACTIVITY (2018).

[19] Alexander & Davis, *supra* note 12.

2. *Carry-forward Net Operating Losses*

Under previous law, net operating losses (NOLs) could be used to offset 100%of taxable income for the previous two years or for the subsequent twenty years.[20] The TJCA limits the use of NOLs to offset only eighty percent of taxable income of subsequent years.[21] Additionally, NOLs cannot be used to carry back to the previous two years, but instead it carries forward indefinitely until it can be applied to a gain.[22]

This new rule puts a greater premium on consistency. Consider the hypothetical in which a real estate business realizes taxable income over a three-year period of $3 million in 2018, $7 million in 2019, and a $10 million loss in 2020. Under the previous rule, the $10 million NOL could carry back to offset 100% of the gain from 2019 and then 2018 as well.[23] After the TJCA, the taxpayer would not be able to carry back its 2020 NOL to offset gains from 2018–19.[24] It would be able to carry forward those losses indefinitely, but even then could only be used to offset eighty percent of taxable income.[25] Planning becomes even more important under the new law to provide consistent results. Specifically, delaying deductions for use in future years may prove more valuable in some instances than a current-year deduction to be carried forward and only applied to eighty percent of taxable income.[26]

3. *Business Interest Deduction Limitations*

The TCJA repealed the 163(j) earnings stripping rules, and the explanation of such rules is outside the scope of this article.[27] The new rule is that business interest expense deductions are limited to business interest income plus thirty percent of adjusted taxable income (ATI).[28]

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[20] Brenman et al., *supra* note 1.
[21] *Id.*
[22] *Id.*
[23] *Id. See* Brenman et al., *supra* note 1.
[24] Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13302, 131 Stat. 2121–26 (2017) (amending I.R.C. § 172 (2012)).
[25] *Id*.
[26] *See* HAFT & FASS, *supra* note 11, § 1A:2 (updated July 2018).
[27] *See* Wagner & Wood, *supra* note 8.
[28] Tax Cuts and Jobs Act § 13301, 131 Stat. at 2117 (amending I.R.C. § 163(j) (2012)); HAFT & FASS, *supra* note 11.

For years 2018–21, ATI will be considered to be earnings before interest, tax, depreciation and amortization, and after 2021 ATI will be equal to earnings before interest and taxes.[29] This new rule only applies to businesses with average gross receipts greater than $25 million.[30]

This limitation is particularly intriguing for real estate businesses because real property trade or businesses may elect to not be subject to this limit.[31] However, those who make this election must use the longer alternative depreciation system (ADS) and are ineligible for Section 179 first-year expensing.[32] Additionally, such an election is irrevocable.[33] For these electors, ADS involves a new 30-year depreciation period for residential real estate and a 40-year period for non-residential real estate, as opposed to a 27.5 years and 39 years respectively under the regular depreciation period.[34] Real estate businesses that rely heavily on leverage will benefit more from avoiding the thirty percent limit on interest deductions, while those with less leverage may see a greater benefit from the shorter depreciation periods and first-year expense allowances than it would from avoiding such a thirty percent limit.[35]

4. *Other Changes*

Section 179 was historically intended as a tax incentive for small businesses, allowing write-offs through depreciation on qualifying expenses up to $500,000.[36] After the TCJA, business owners can deduct up to $1 million in qualifying purchases in the first year.[37] Additionally, Section 179 now extends to rental property owners to deduct expenses on items such as appliances, furniture,

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[29] Tax Cuts and Jobs Act § 13301, 131 Stat. at 2120; Wagner & Wood, *supra* note 8.
[30] HAFT & FASS, *supra* note 11.
[31] *Id*.
[32] *Id.*; *see infra* notes 36–40 and accompanying text (describing the section 179 first-year expensing).
[33] HAFT & FASS, *supra* note 11.
[34] *Id.*
[35] *See id.* (describing some of the considerations, such as leverage, that may affect a business's determination of election or non-election).
[36] *See* Lake, *supra* note 9; *Section 179 Deduction*, *supra* note 6.
[37] *Section 179 Deduction*, *supra* note 6 (describing the new law for section 179).

heating and cooling systems, or a new roof.[38] This provides a greater incentive for rental property owners to upgrade their properties.[39] For businesses that spend more than $2.5 million on such assets or improvements, the deduction begins to be reduced, thus limiting the benefit for larger businesses.[40]

The TCJA put like-kind exchanges on the chopping block, but the new it kept the tax-deferral exchange in place for real property exchanges, only disallowing personal property exchanges from this preferential tax treatment.[41] Section 1031 allows for non-recognition of gain or loss from exchanges in kind.[42] This also allows investors to defer taxes on gains from sale of real estate if they immediately use that money to buy another property.[43]

State and local tax (SALT) on property, sales or income deductions are now capped at $10,000 by the TJCA.[44] This limitation does not apply for taxes paid in connection with a trade or business, however.[45]

C. Effects on Homeowners

The TCJA brings many changes that will also affect homeowners as real estate investors. Many of the aforementioned changes can have an effect on homeowners and should be considered in light of a homeowner's overall real estate profile. Other changes are specifically applicable to homeowners.

The 2017 tax act changed deductions for "acquisition indebtedness" and "home equity indebtedness,"[46] but these changes may not be as drastic as initially believed.[47] Under previous law,

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[38] *See* Lake, *supra* note 9.
[39] *See id.* (showing that upgrades to rental units are currently more desirable for owners).
[40] *See id.*
[41] *See* HAFT & FASS, *supra* note 11 (explaining that like-kind exchanges were kept for real property exchanges).
[42] Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13303, 131 Stat. 2123–24 (2017).
[43] Girouard, *supra* note 14.
[44] HAFT & FASS, *supra* note 11.
[45] *Id.*
[46] Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11043, 131 Stat. 2086–87 (2017).
[47] Liz L'Hommedieu & Chris Stroeer, *Insight: Home Equity Interest May Still Be Deductible*, BLOOMBERG BNA (June 26, 2018, 7:59 AM) (stating that

taxpayers were allowed a deduction for interest on acquisition debt of $1 million and home equity debt of $100,000 for mortgages that were secured by a primary residence and one other secondary residence.[48] Acquisition indebtedness includes indebtedness secured by a qualified residence that is taken out to acquire, construct, or substantially improve any qualified residence of the taxpayer.[49] Home equity indebtedness is any indebtedness secured by a qualified residence that is not acquisition indebtedness.[50] Home equity indebtedness includes items such as cars and appliances that were secured by a taxpayer residence, while acquisition indebtedness only involves buying, building, or substantially improving the qualified residence itself.[51]

Under the TCJA, the deduction is limited to $750,000 for acquisition debt and eliminated for home equity debt.[52] While this decrease is certainly a negative for applicable taxpayers, these negative effects are limited for several reasons. First, the deduction for second residences was originally thought to have been on its way out with the TCJA, but it is still allowed under the new law.[53] Further, homeowners also retained the ability to rent out a primary or secondary residence up to fourteen days a year and not pay taxes on such income.[54] Above both of these provisions is the fact that $750,000 is still a large number for mortgage interest, more than double the median house sales price.[55] However, between this mortgage deduction limitation and the SALT cap, Democrats on the House Committee on Oversight and Government Reform argued that nearly 12.5 million homeowners will not be allowed a full deduction on property taxes.[56]

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while changes were made, they may not have as large of an effect as once thought).

[48] I.R.C. 163(h)(3)(B) (2012).

[49] *Id.*

[50] 26 I.R.C. § 163(h)(3)(C) (2012).

[51] *See* L'Hommedieu & Stroeer, *supra* note 47 (differentiating between the types of indebtedness).

[52] Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11043, 131 Stat. 2086 (2017) (amending 26 I.R.C. § 163(h)(3) (2012)).

[53] Girouard, *supra* note 14.

[54] *Id.*

[55] U.S. CENSUS BUREAU, MEDIAN AND AVERAGE SALES PRICE OF HOUSES SOLD BY REGION (2017), https://www.census.gov/construction/nrs/pdf/pricerega.pdf [https://perma.cc/96Q8-69XP].

[56] See Kaustuv Basu, *Hill Briefs: Oversight Report on Tax Law Effects on Homeowners*, DAILY TAX REP. (BNA) No. 130 (July 9, 2018).

Home equity interest has a very specific definition, as outlined above, so what many people would initially consider to be a home equity loan will actually fall under "acquisition indebtedness" which will continue to be deductible.[57] In fact, the IRS responded to many questions by stating that "taxpayers can often still deduct interest on a home equity loan, home equity line of credit (HELOC) or second mortgage, regardless of how the loan is labeled."[58] The elimination of the home equity interest deduction instead prevents taxpayers from writing off a personal asset, such as a car, purchase. Thus, this elimination does not actually have much of an impact on real estate; instead, it simply prevents write-offs on other assets secured by a personal residence.

D. Effects on Foreign Investors

The TCJA includes a number of provisions that will affect foreign investors in U.S. real estate, and specifically how they utilize the blocker corporate structure.[59] However, some argue that despite the changes in consideration, there is no drastic shift for investment structure decisions as guided by the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA).[60]

Foreign investors who wish to invest in U.S. real estate have traditionally done so by utilizing a blocker corporation or partnership.[61] In choosing which structure to invest through, one must consider the estate and income tax considerations.[62] One typical investment structure is described as follows:

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[57] L'Hommedieu & Stroeer, *supra* note 47.

[58] *Interest on Home Equity Loans Often Still Deductible Under New Law*, INTERNAL REVENUE SERV. (last updated Feb. 21, 2018), https://www.irs.gov/newsroom/interest-on-home-equity-loans-often-still-deductible-under-new-law [https://perma.cc/953J-XBDD].

[59] *See* Wagner & Wood, *supra* note 8.

[60] Jonathan E. Gopman & Paul J. D'Alessandro Jr., *The More Things Change, the More They Stay the Same? Foreign Investment in U.S. Real Estate After the 2017 Tax Act*, Bloomberg BNA: Real Estate J. (June 6, 2018) (arguing that a partnership structure is still more efficient, though it carries uncertainty, but that the difference between a partnership and corporation is simply narrower).

[61] *See id.*

[62] *See id.*

> In the typical FIRPTA structure, the foreign investors contribute capital to a foreign corporation in a nontax jurisdiction such as the Cayman Islands. The foreign corporation then contributes the funds as capital or capital and debt to a wholly owned US C Corporation, known as a blocker corporation. The blocker corporation can purchase the real estate directly, but typically does so with a joint venture partner utilizing an LLC, with the LLC owning the real estate. The blocker corporation is a US taxpaying C corporation. It blocks the foreign individual investor from paying US taxes, or any filing disclosures in the U.S. Utilizing the foreign corporation as the wholly owned parent of the US blocker corporation allows the foreign investors to avoid US estate taxes.[63]

This structure utilizes a U.S. blocker corporation to ultimately protect foreign investors from estate tax liability, but it is potentially less efficient for income tax purposes than utilizing a U.S. partnership in the same way due to the double taxation nature of corporations.[64] The corporate blocker structure also provides a "filing blocker" for foreign investors—the U.S. corporation is subject to filing requirements, but the foreign entity and owners are not required to file for U.S. tax purposes.[65]

Under the TCJA, key considerations when setting up an investment structure are changed, affecting the overall evaluation of which structure to use.[66] Corporations are now taxed at a flat twenty-one percent, bringing the tax rate much closer to the twenty percent long-term capital gain rate for non-corporations.[67] The chart below outlines the general tax rates for different types of investment structures for foreign investors:

[63] Wagner & Wood, *supra* note 8.
[64] Gopman & D'Alessandro, *supra* note 60.
[65] *Id.*
[66] *See id.*
[67] *See id.*

	Corporate Structure	Flow-Through Structure	Flow-Through Structure (199A Deduction)
Tax Imposed on Gain from Sale	21%	20%	20%
Tax Imposed on Operating Earnings	44.7%	37%	29.6%

[68]

A corporate blocker structure is subject to an additional thirty percent foreign investor tax after the twenty-one percent corporate tax that is intended to mirror a dividend tax for U.S. investors.[69] However, this thirty percent rate is often fifteen percent or lower due to an income tax treaty with the corresponding country.[70] For a partnership flow-through structure, the thirty-seven percent tax rate on operating earnings is the maximum non-corporate rate that applies for such partners' flow-through earnings.[71] For partnerships that are allowed a 199A deduction, this thirty-seven percent rate is reduced to an effective 29.6%.[72]

Ultimately, a corporate blocker structure still provides estate tax protection at the expense of being less efficient for income tax purposes.[73] However, the income tax difference is narrower now than under previous law.[74] This narrowed gap, along with the estate tax security and filing blocker, may make the corporate blocker structure even more favorable.[75] However, constant tax planning will be essential for foreign investors to best structure U.S. real estate investments.[76]

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[68] *Id.*
[69] *See id.*
[70] *See id.* (explaining that many countries have income tax treaties with the U.S. which often lower the foreign investor tax rate from thirty percent to somewhere around fifteen percent or below).
[71] *See id.*
[72] *See supra* notes 10–17 and accompanying text.
[73] *See* Gopman & D'Alessandro, *supra* note 60 (describing the give-and-take of estate tax protections and income tax provisions).
[74] *See id.*
[75] *See id.* (outlining the estate tax security and tax filing blocker advantages of a corporate blocker structure); Wagner & Wood, *supra* note 8.
[76] *See* Wagner & Wood, *supra* note 8.

E. Conclusion

Ultimately, the long-term effects of the TCJA on real estate are yet to be determined. There are positive and negative provisions for all types of real estate investors, and it is impossible to fully understand the effects they will have on such investments. There do appear to be opportunities for the real estate business that will continue to make real estate ventures tax-advantaged investments. Ultimately, investment structuring and planning will be even more crucial to achieve the best tax treatment.

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