

Real Estate Tax News

How Will the Tax Cuts and Jobs Act Impact You?

As of November 7, 2017



Will Tax Reform Happen and When?



Source: The Associated Press/Evan Vucci

“The Republican House members are working hard (and late) toward the Massive Tax Cuts that they know you deserve. These will be the biggest ever.”*



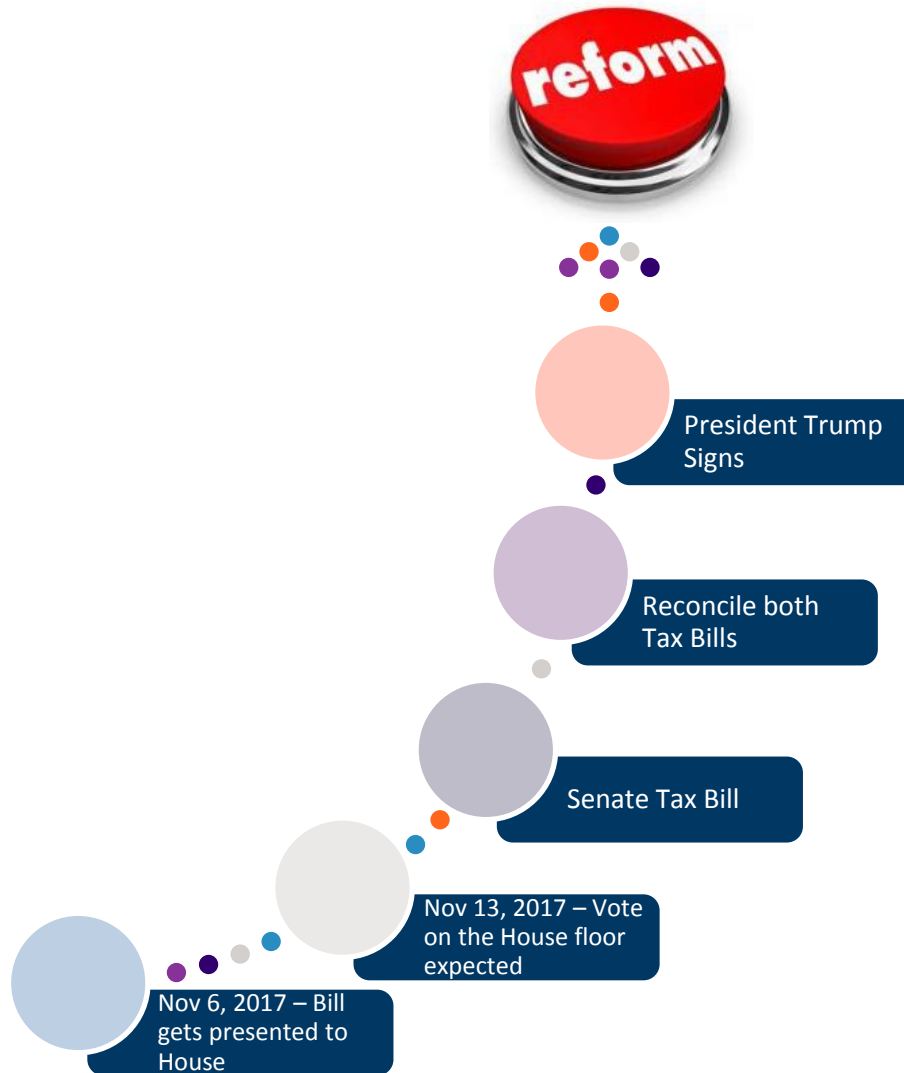
* Source: <https://twitter.com/realdonaldtrump/status/925533433597775873?lang=en>

Tax Reform Timeline



The U.S. House of Representatives Committee on Ways and Means released the **Tax Cuts and Jobs Act (TCJA)** on November 2nd.

What lies ahead in the process of tax reform?



What Upcoming Deadlines Are Motivating the Process:

1. Dec. 8th – Government Funding Deadline
2. Winter/Spring 2018 – Raise the Debt Limit
3. March, 2018 – Primary Elections begin

Analyzing the TCJA – Business Tax



- On November 2, 2017, the U.S. House of Representatives Committee on Ways and Means released the Tax Cuts and Jobs Act.
- The bill is expected to be presented to the full House of Representatives on November 6, 2017.
- Unless otherwise indicated in the remainder of this slide deck, the provisions would take place in 2018, if passed. Current law is still in effect.

Current Law & TCJA, Comparison – Business Taxes

Type of Tax	Current Law	TCJA
Corporate Tax Rate	Brackets with a maximum rate of 35%	C Corporations - 20% Personal Service Corporations – 25%
AMT	20%	Repealed A taxpayer may claim a refund of 50% of any remaining AMT credit carryforwards in tax years 2019, 2020 and 2021. All remaining AMT credits would be claimed as a refund in 2022.
Interest Expense Deductions	<ul style="list-style-type: none"> ■ Generally Not Limited ■ Except for Earnings Stripping (aka §163(j)) – Interest generally paid to a Foreign Related Party 	<ul style="list-style-type: none"> ■ Net Interest Expense limited to 30% of Adjusted Taxable Income (addback NOL, interest, depr., amort.); determined at filer level (i.e. partnership level) ■ 5 year carryover for interest disallowed ■ Repeal §163(j) ■ Limitation would not apply to real property trades or businesses or businesses with average gross receipts of \$25mm or less
NOL	Carry back 2 years; forward 20	<ul style="list-style-type: none"> ■ Carry backs are repealed; ■ NOL's can only reduce income up to 90%, similar to the to be repealed AMT rule
Carried Interest	Taxable at Capital gains rate	Amendment Proposed for 3 Year Hold Period for Cap Gains

Note that unless otherwise stated, the proposals are expected to take effect in 2018.

Current Law & TCJA – Pass-through Tax

Type of Tax	Current Law	TCJA
S-Corps & Partnerships, including LLCs	Income taxed at Investor/Owner level, max individual rate is 39.6%	<ul style="list-style-type: none"> ■ “Qualified Business Income” taxed at 25% ■ Remaining portion of net income treated as compensation to owner, subject to ordinary individual income tax rates

TCJA – 25% Pass-through Tax

Qualified Business Income

- Net income derived from passive business activity is treated entirely as business income
- Fully eligible for 25% rate

Is it Active or Passive?

- Rely on passive activity rules
- Material participation (generally based on hours spent) is active
- Use §469

Capital Percentage


- Owners actively involved in the business rely on capital % to determine passive business income
- Can elect to apply 30% capital percentage to net business income derived from active business activity
- Remaining 70% subject to ordinary income rates



TCJA – Pass-through Tax (cont.)

- Alternatively, owners may elect to apply a formula based on the facts and circumstances of their business to determine a capital percentage of greater than 30%. The formula would be based on the Federal short-term rate plus 7% multiplied by the capital investments of the business. Once made, the election to apply the alternative formula would be binding for a 5 year period.
- A special rule would apply to prevent the re-characterization of actual wages paid as passive business income. For example, if actual wages or income received in exchange for services from the pass-through entity (*e.g.*, a guaranteed payment from a partnership) exceeds the taxpayer's otherwise applicable capital percentage, then the applicable capital percentage would be limited.
- It is important to note that income currently subject to preferential rates, such as net capital gains and qualified dividends, would be excluded from an owner's capital percentage. Such income would not be re-characterized as business income for these purposes and would retain its character.
- The proposal would apply the 25% rate on certain dividends from real estate investment trusts.
- Other investment income that is subject to ordinary rates such as short-term capital gains would also not be eligible to be re-characterized as business income. However, interest income properly allocable to a trade or business would be eligible to be re-characterized as business income.

Current Law & TCJA, Comparison – Business Taxes

Type of Tax	Current Law	TCJA
Cost Recovery	<ul style="list-style-type: none"> ■ Depreciate over useful life ■ Additional 50% (40% in 2018 + 30% in 2019) depreciation on Qualified Property placed in service through 2019 ■ Property must be new 	<ul style="list-style-type: none"> ■ Fully and immediately expense 100% of the cost of Qualified Property acquired and placed in service after September 27, 2017 and before January 1, 2023 ■ Expands the property eligible by repealing the requirement that the original use of the property begin with the taxpayer ■ Favorable: Property eligible for the additional depreciation if it is the taxpayer's first use
	<p><u>TCJA: Qualified Property would not include any property used in a real property trade or business.</u></p>	
§179 Expensing	<ul style="list-style-type: none"> ■ Immediately expense up to \$500,000 per year ■ If more than \$2mm in service, reduce by amount exceeding \$2mm ■ Includes qualified leasehold improvement property, qualified restaurant property, qualified retail improvement property 	<ul style="list-style-type: none"> ■ Expense limitation increased to \$5mm ■ Phase out amount increased to \$20mm ■ Proposal effective years after 2017 and years beginning before 2023
Compensation	<ul style="list-style-type: none"> ■ Deduction for comp to covered employee limited to \$1mm, with exceptions 	<ul style="list-style-type: none"> ■ Exceptions repealed ■ Now covers CEO, CFO + 3 next highest paid
UBIT	<ul style="list-style-type: none"> ■ Many §501(a) orgs pay tax at ord. rates on UBIT 	<ul style="list-style-type: none"> ■ No exceptions; includes all §501(a)

Current Law & TCJA, Comparison – Business Taxes

Type of Tax	Current Law	TCJA
Like-Kind Exchanges (aka 1031)	No gain or loss to extent property held for investment or held for productive use in trade or business is exchanged for like-kind property	<ul style="list-style-type: none"> ■ Limit like-kind exchanges to real property transfers; Favorable to real estate industry ■ Full expensing for tangible personal property will allow for gain offsets
Partnership Terminations	Sale or exchange of 50% or more of the total interests in a partnership within a 12-month period causes a “technical” termination	Repeal technical termination rule so that assets can continue to be depreciated, restarting depreciation not required; Favorable to real estate industry
<u>Business Credits:</u> Rehabilitation Credit	Credit for expenses incurred to rehabilitate old and/or historic buildings	Repealed Transition rule allows credits made within a 24 month period no later than 180 days after January 1, 2018
New Markets Credit	Credit for investment in community development projects serving low-income communities and individuals	Repealed after 2017

Proposed Tax Reform and its Effect on REITs

Under the proposed bill, REIT shareholders will be able to use the pass-through rate similar to being a limited partner.

The TCJA includes a 20% flat tax rate for corporations.

TCJA (w/ Pass-through Rate)

C-CORPORATIONS - TCJA

Taxable Income	\$100
Corp. Tax (20%)	<u>(20)</u>
Distribution to S/H	\$80
Indiv. Tax Rate on Distribution (Qual Div: Sec 1h)	<u>20%</u>
Tax	(16)
Total Tax Paid	<u>\$36</u>
Total Cash to S/H	<u>\$64</u>

REITS - TCJA

Taxable Income	\$100
REIT Tax (0%)	<u>0</u>
Distribution	\$100
Indiv. Tax Rate on Dividend*	<u>25%</u>
Tax	(25)
Total Tax Paid	<u>\$25</u>
Total Cash to S/H	<u>\$75</u>

Current Law

REITS – Current Law

Taxable Income	\$100
REIT Tax (0%)	<u>0</u>
Distribution	\$100
Indiv. Tax Rate on REIT Dividend*	<u>39.6%</u>
Tax	(40)
Total Tax Paid	<u>\$40</u>
Total Cash to S/H	<u>\$60</u>

*There will continue to be a 20% Tax Rate on Capital Gain Dividends. The above example assumes the dividend is from operations and not capital.

Analyzing the TCJA – Individual Tax

Individual Taxes Brackets – Simplified from 7 to 4

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<u>Married, Filing Joint</u>	
10%	0-\$18,550
15%	\$18,550-\$75,300
25%	\$75,300-\$151,900
28%	\$151,900-\$231,450
33%	\$231,450-\$413,350
35%	\$413,350-\$466,950
39.6%	\$466,950 & above

<u>Single</u>	
10%	0-\$9,275
15%	\$9,275-\$37,650
25%	\$37,650-\$91,150
28%	\$91,150-\$190,150
33%	\$190,150-\$413,350
35%	\$413,350-\$415,050
39.6%	\$415,050 & above

<u>Head of Household</u>	
10%	0-\$13,250
15%	\$13,250-\$50,400
25%	\$50,400-\$130,150
28%	\$130,150-\$210,800
33%	\$210,800-\$413,350
35%	\$413,350-\$441,000
39.6%	\$441,000 & above

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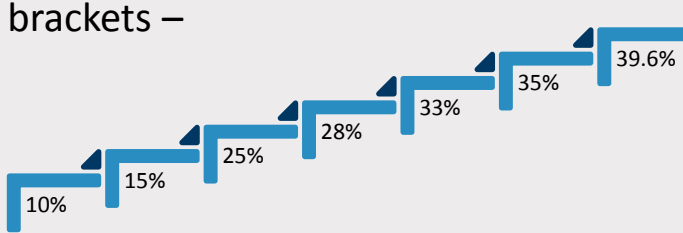
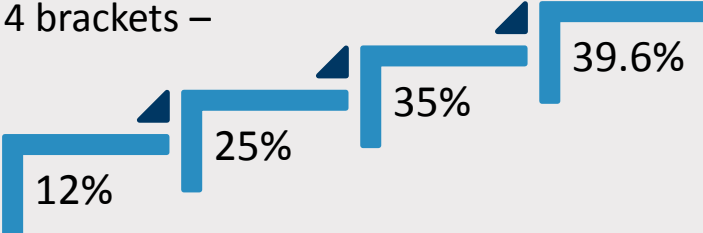
<u>Married, Filing Joint</u>	
12%	\$24,000-\$90,000
25%	\$90,000-\$260,000
35%	\$260,000-\$1 mm
39.6%	\$1 mm & above

<u>Single & Married Filing Separate</u>	
12%	\$12,000-\$45,000
25%	\$45,000-\$200,000
35%	\$200,000-\$500,000
39.6%	\$500,000 & above

<u>Head of Household</u>	
12%	\$12,000-\$67,500
25%	\$67,500-\$200,000
35%	\$200,000-\$500,000
39.6%	\$500,000 & above

Increased Standard Deduction creates 0% bracket.

Current Law & TCJA - Comparison - Individual Tax Reform

Tax Provision	Current Law	TCJA
Tax Rates*	7 brackets – 	4 brackets – 
Individuals – Capital Gains	<ul style="list-style-type: none"> 15% for Taxable Income (TI) up to \$418,400 20% if TI exceeds \$418,400 	<ul style="list-style-type: none"> 20% Capital Gain Rate Lower Thresholds are: <ul style="list-style-type: none"> 0% under the 15% bracket (\$77,200 for joint return) 15% under the 20% bracket (\$479,000 for joint return)
Standard Deduction	\$12,700 - married; \$6,350 – single	\$24,000 –married filing joint; \$18,000 – single w/ 1 child \$12,000 –single <small>*Adjusted for inflation based on chained CPI; \$24,400 for married filing joint in 2018, per TCJA language</small>
Personal Exemptions	\$4,050 for taxpayer, spouse, & dependents	Repealed
AMT	28%	Repealed A taxpayer may claim a refund of 50% of any remaining AMT credit carryforwards in tax years 2019, 2020 and 2021. All remaining AMT credits would be claimed as a refund in 2022.

*Ignores 3.8% Tax

Current Law & TCJA - Individual Tax Reform (cont.)

Type of Tax	Current Law	TCJA
Itemized Deductions	<p>Limitation</p> <ul style="list-style-type: none"> Reduced by 3% of a taxpayer's adjusted gross income exceeding a certain threshold (\$313,800 for married filing joint) 	Overall limitation repealed
- Mortgage Interest	<p>Deduct interest payments on:</p> <ul style="list-style-type: none"> \$1mm of acquisition indebtedness; \$100,000 of home equity indebtedness 	<p>Deduct interest payments on:</p> <ul style="list-style-type: none"> \$500,000 of acquisition indebtedness (debt after Nov. 2nd *); No home equity indebtedness Deductible ONLY on principal residence <p>* Mortgage loans originated (or written binding contracts to take out a mortgage entered into) prior to November 2, 2017 would not be subject to the new limitations. The refinancing of a "grandfathered" mortgage loan would also be exempt from the new limitations.</p>
- State and Local Taxes	<p>Can claim itemized deduction for state and local taxes paid:</p> <ul style="list-style-type: none"> Property Taxes ✓ Income Taxes ✓ 	<p>Can ONLY claim itemized deduction for Property Taxes up to \$10,000.</p> <ul style="list-style-type: none"> State and Local Income Taxes no longer deductible
- Charitable Contributions	Deducted up to 50% of Adjusted Gross Income	Deducted up to 60% of Adjusted Gross Income

Current Law & TCJA - Individual Tax Reform (cont.)

Type of Tax	Current Law	TCJA
Gain on Sale of Principal Residence	<p>\$500,000 exclusion (for joint filers)</p> <ul style="list-style-type: none"> Must use the property as a principal residence for 2 out of the previous 5 years 	<p>\$500,000 exclusion</p> <ul style="list-style-type: none"> Must use the property as a principal residence for 5 out of the previous 8 years Taxpayers may use the exclusion only <u>once</u> every five years Exclusion phased out by one dollar for every dollar by which a taxpayer's adjusted gross income exceeds \$500,000 (for joint filers)
Estate Tax & Generation Skipping Tax	<p>\$5.45mm exclusion</p>	<ul style="list-style-type: none"> \$5mm basic exclusion doubled to \$10mm for tax years beginning after 2017 After 2023 – Estate Tax and GST Repealed
Gift Tax	<p>Maximum rate of 40%</p>	<p>Lowered to a top rate of 35%</p>

Example: Individual Tax under the TCJA

Under TCJA:

- State income taxes are no longer deductible
- The Property Tax deduction is limited to \$10,000
- The maximum tax rate for a single person with taxable income of \$216,000 is 35%

Under the Current Law:

- State income taxes of \$21,600 are deductible
- Mortgage Interest deduction would be \$25,000
- Property Tax deduction would be \$20,000, no limitation
- Total itemized deductions: \$66,600
- Taxable income: \$184,400
- The tax rate would be 28%
- Tax = \$52,000 including \$8,400 of AMT

Suppose John Doe, who is single, has gross income of \$251,000. He lives in New Jersey and has a state tax of \$21,600. His mortgage is \$500,000 and he pays mortgage interest of \$25,000. His property taxes are \$20,000.

SIMPLE, FAIR "POSTCARD" TAX FILING

1	Wage and compensation income	1	\$251,000
2	Subtract contributions to specified savings plans	2	
3	Subtract standard deduction OR	3	
4	Subtract mortgage interest deduction	4	25,000
5	Subtract real property tax deduction	5	10,000
6	Subtract charitable contribution deduction	6	
7	Taxable income	7	216,000
8	Preliminary tax (from tax table)	8	35%
9	Add tax on investment income	9	
10	Subtract family and child credits	10	
11	Subtract earned income credit	11	
12	Subtract higher education credit	12	
13	Total tax	13	49,750
14	Subtract taxes withheld	14	
15	Refund due / taxes owed	15	49,750

Blank postcard source: fairandsimple.gov

Tax Under Current Law: \$52,000, including \$8,400 of AMT



Framework – International Tax Reform

International tax provisions in the bill include:

- Participation exemption. The proposal transitions to a territorial tax system, in which dividends and profits of foreign corporations are not subject to U.S. tax when received by U.S. shareholders that own more than 10% of the foreign corporation. Foreign tax credits on the dividends received would no longer be available. Proposal requires deemed repatriation of currently deferred foreign profits, at a rate of 12 % for cash and cash-equivalent profits and 5 % for reinvested foreign earnings (property, plant and equipment).

FTI Consulting: Real Estate & Infrastructure

FTI Consulting REIT & Tax Compliance Services Overview

Tax Structuring and Compliance Solutions to Meet Your Business Objectives

- The evolving complexities of the tax laws and regulations of the real estate industry are critical to every business decision and real estate transaction. We work globally to provide complete tax services ranging from operating as an outsourced tax compliance department for large public companies to providing transactional structuring on the most complicated real estate deals. Services we provide:

FTI Consulting Solutions		
Tax Structuring/Consulting	REIT Services	Tax Compliance
<ul style="list-style-type: none"> ■ REIT due diligence ■ Corporate and partnership structuring ■ Sale/Leasebacks ■ Section §1031 tax-free exchange transactions ■ International tax structuring ■ Tax-free reorganizations ■ Earnings & Profits (E&P) studies ■ Entity formation ■ State and local tax structuring 	<ul style="list-style-type: none"> ■ Income/Asset test compliance ■ Property Manager Questionnaires ■ Monitor dividend requirements ■ REIT qualification checklist ■ Lease review and compliance 	<ul style="list-style-type: none"> ■ Federal, state and local tax returns, including estimates and extensions ■ Corporate and REIT E&P calculation and dividend distribution amounts ■ Partnership income and liability allocations ■ Correspondence with government authorities

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Questions?



Laura Jackson

Managing Director

Roseland, NJ/
New York, NY

+1 973 852 8148

Laura.Jackson@FTIConsulting.com



Scott Drago

Senior Director

New York, NY

+1 646 632 3864

Scott.Drago@FTIConsulting.com



Philip L. Brady

Senior Managing Director

New York, NY

+1 646 632 8168

Philip.Brady@FTIConsulting.com



Scott Tannenbaum

Senior Managing Director

New York, NY

+1 973 852 8171

Scott.Tannenbaum@FTIConsulting.com



Larry Portal

Senior Managing Director

Roseland, NJ

+1 973 852 8147

Larry.Portal@FTIConsulting.com



Stephen Bertonaschi

Managing Director

Roseland, NJ

+1 973 852 8174

Stephen.Bertonaschi@FTIConsulting.com



Harvey Berenson

Managing Director

New York, NY

+1 646 632 3822

Harvey.Berenson@FTIConsulting.com



Mark Rubin

Senior Managing Director

New York, NY

+1 646 632 3836

Mark.Rubin@FTIConsulting.com



Mark Halpern

Managing Director

New York, NY

+1 646 632 3837

Mark.Halpern@FTIConsulting.com



Mark Golden

Managing Director

New York, NY

+1 646 632 3838

Mark.Golden@FTIConsulting.com

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