Flaherty Salmin CPAs
Tax Cuts and Jobs Act (TCJA) 2017
Impact on the Affordable Housing, Community Development & Real Estate Industries
January 31, 2018

Introduction:

As you know, the Tax Cuts and Jobs Act was signed into law December, 22, 2017. The new law encompasses many income tax items. We have attempted to summarize only those items that potentially affect the affordable housing (AH), community development (CD) and real estate (RE) industries. The new law impacts projects, investors, developers, owners and ultimately, the individuals in ownership. We have geared the content of this document to our Firm's client base.

Though the tax bill that became law is over 1,000 pages, additional guidance, regulation, instruction and even possible technical corrections are needed. Accordingly, much of what is presented in this document is subject to that future guidance.

While many hoped that the new tax reform would simplify our overly complex tax code, it seems to have added to the complexity. Our intent was to boil the new tax reform down to the basics that are relevant to the above mentioned industries.

The new tax law is generally effective for tax years beginning after December 31, 2017. A number of provisions will sunset after December 31, 2025.

Lastly, the green text in the following pages represents certain commentary on our part.

This document is for general information only and is not authoritative.

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1) New 21% Flat Corporate Tax Rate:

- For corporations with a fiscal year-end, a blended rate (old rate and new rate) is in effect for the tax year that began before 12/31/17.
- While it positively impacts high income corporations, it negatively impacts corporations that have less than $90,000 of taxable income.
- Increases the net value of state tax credits and other federally taxable incentives.
- Tax loss component of investor yield is reduced, which results in reduced "per credit" pricing.
- Lessens the exit tax hit for investee corporations.
- We have seen at least one project that had an adjuster provision in its operating agreement for changes in corporate tax rates. The project closed shortly after President Trump's election.
- Deferred tax assets and liabilities: Immediate financial reporting hit for pre-existing deferred tax assets and benefit for pre-existing deferred tax liabilities, since they were previously valued/calculated under the former top 35% tax rate and will now be valued with the new 21% tax rate.
- Finally, the alternative minimum tax (AMT) was repealed for corporations.

2) Enhanced Bonus Depreciation/Section 179 Expensing Deductions/Auto Depreciation Limits:

- Bonus depreciation can now be taken on used property.
- Bonus depreciation rates (generally based on PIS) are as follows:
  - 100% 9/27/17 through 12/31/22
  - 80% 1/1/23 through 12/31/23
  - 60% 1/1/24 through 12/31/24
  - 40% 1/1/25 through 12/31/25
  - 20% 1/1/26 through 12/31/26
- Section 179 does not apply to real property rental assets, but does apply to the business operations of developers and construction contractors.
- New annual limit for Section 179 immediate asset expensing is $1,000,000 (vs. previous $500,000).
- Can now use Section 179 on certain non-residential real property improvements (includes HVAC, roofs, fire alarm and security systems).

- Auto depreciation limits have increased as follows:
  - $10,000 vs. 3,160 for the 1st taxable year in the recovery period,
  - $16,000 vs. 5,100 for the 2nd taxable year in the recovery period,
  - $9,600 vs. 3,050 for the 3rd taxable year in the recovery period, and
  - $5,760 vs. 1,875 for each succeeding taxable year in the recovery period.
- Generally, the bonus depreciation maximum for automobiles remains at $8,000.
- The maximum deduction for an automobile's PIS year is $8,000 for bonus depreciation, plus $10,000 regular depreciation.

3) ADS Depreciation Life Change:

- ADS for residential rental property is now 30 years vs. 40 years, for property placed into service after December 31, 2017.
- This change from 40 years to 30 years will likely influence, in some way, the decision to make a 168(h)(6) election as well as the capital account maintenance option of using ADS vs. MACRS.

4) 20% Deduction for Qualified Business Income (QBI) /Code Sec 199A Pass-through Income Deduction:

- While on the surface, this would seem simple, we feel it will actually be quite complicated in many instances.
- Up to 20% deduction for QBI for certain partnership, S Corp or sole proprietorships (Sch C, E & F), subject to a possible wage limitation.
- Also applies to qualified REIT dividends, qualified cooperative dividends and publically traded partnerships (PTPs).
- The pass-through deduction applies to all qualified trade or businesses (which excludes specified service businesses, except for those described below).
- Generally not allowed for certain specified service businesses, however, this disallowance is not applicable (or the deduction can be phased-in) for individuals with taxable income on their Form 1040 falling within the applicable threshold limits (defined below in the wage limitation analysis).
- Specified service trade or business includes any trade or business that involves the performance of services in the fields of consulting, law, accounting, financial services, brokerage services, actuarial services, health, athletics and performing arts. Essentially it is any trade or business where the principal asset of the business is the skill or reputation of one or more of the owner(s) and/or employees. There is a specific carve out for architecture and engineering businesses from the definition of specified trade or business; however, some practitioners feel that architecture and engineering businesses could possibly be brought back into the specified service business definition by the provision that the principal asset of the business is the skill or reputation of one or more of the owner(s).
- QBI is the taxable income of the business (before the effect of the pass-through deduction) adjusted for the reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer or any guaranteed payment paid to a partner for services rendered with respect to the trade or business.

- **Reasonable compensation** of an owner(s) will need to be subtracted to arrive at QBI:
  - Reasonable compensation is currently not defined, except for previous regulations pertaining only to S Corporations. The provision will likely get some additional guidance issued.
- Wage limitation:
  - The deduction is the lesser of:
    - 20% of the business' QBI, or
    - the greater of:
      1) 50% of W-2 wages, or
      2) 25% of W-2 wages plus 2.5% of unadjusted basis of qualified property
  - The wage limitation does not apply to 1040 taxpayers, if their taxable income (before deduction) is less than:
    - $315,000 for MFJ (phase in/out to $415,000)
    - $157,500 for all others (non-MFJ) (phase in/out to $207,500)
- The above thresholds are also the thresholds used to determine if the up to 20% deduction is allowed for specified service businesses.
- The deduction cannot exceed 20% of the taxable income (without regard to the pass-through deduction, but reduced by any capital gain) of the taxpayer. If there is a net loss from all of the taxpayer's business activities in a given year, the net QBI loss will carryforward and reduce the QBI in subsequent years.
- Trusts and estates are also eligible for the deduction.

5) Limitation on Business Interest Expense Deduction:

- Business interest deduction is now limited to the sum of:
  - Business Interest Income, and
  - 30% of *adjusted taxable income*
- *Adjusted taxable income* is taxable income computed without regard to:
  - Interest expense
  - the 20% pass-through deduction
  - Depreciation, amortization and depletion, but only for tax years beginning before 1/1/22.
- Note the expiration of the depreciation/amortization add back, will result in a huge reduction to the adjusted taxable income amount for calendar years after 2021.
- For C Corps, the calculation and related possible limitation will generally end there unless the C Corp is an investee in another pass-through entity(s).
- For pass-through entities, calculations are applied first at the entity level and ultimately to the owner/investor level. We expect K-1s will include the necessary info (excess business interest & excess taxable income etc.) allocated to the owner.
- Taxpayers are exempt from the interest limitation if their average annual gross receipts of the 3 previous tax years is less than $25M.

- The aggregation rules for applying the gross receipts test have not been addressed and need further guidance. For example is it unknown whether the investor includes their percent interest in the investee/project receipts in applying the $25M exemption.
- **It appears that most real estate pass-through entities with limited/passive investors will not be eligible for the $25M gross receipts exception (due to existing "syndicate" provisions in the Code and Regulations).**
- A real property trade or business can elect out of the business interest limitation by converting the depreciable lives of real property (including qualified improvements) to ADS lives.
  - 27.5 years would convert to 30 years (assumes the new 30 year ADS life will be used for pre-enactment PIS assets as opposed to the previous 40 year ADS life)
  - 39 years would convert to 40 years
  - 15 years would convert to 20 years (subject to further guidance)
- The use of/conversion to ADS does not apply to personal property and site improvements, which make those real property related assets still eligible for MACRS depreciation and bonus depreciation.

6) Limitation on Deductible Business Losses for Taxpayers Other Than Corporations:

- Applied after the passive activity loss (PAL) limitations:
  - The maximum amount of business losses of a non-corporate taxpayer that can be used to offset non-business income (including wages) of a taxpayer is:
    - $500,000 if MFJ
    - $250,000 for all other filers
  - You are not able to carryback the excess loss. You are allowed to carry forward the excess loss (until death).
  - Note: The disallowed excess business loss is treated as a NOL and is subject to the new NOL limitation of 80% of taxable income.

7) Historic Rehabilitation Credit:

- 10% credit was repealed (was only available to non-residential buildings).
- 20% credit now reported over five years (vs. all in the placed in service (PIS) year).
  - We assume prorated equally each year at 4% per year.
- New law applies to amounts paid or incurred after 12/31/17, except for the transition provisions which allow for some projects to still claim the credit entirely in the PIS year (vs. over five years).
- Transition provisions applies to:
  - Any building owned or leased by the taxpayer at all times after 1/1/18, through the end of the 24 month (60 months under the rule for phased rehabs) period selected by the taxpayer.
  - The 24 month (possibly 60 month) period is to begin no later than 180 days from 12/22/17:
    - We calculate the date as 6/19/18 (180 days after enactment date of 12/22/17).
    - If we are using the 24 month period, then the rehab would need to be done (and PIS) by end of calendar tax year 2020.

- - There are various other considerations when reviewing applicability of the transition provisions. We will also need to wait for more guidance.

8) Solar Credit:

- No changes to PATH 2015 tax law.
- Solar ITC rate will be based on project start date:
  - 30% through 2019
  - 26% in 2020
  - 22% in 2021
- Projects must be done by 12/31/24 for the above rates to apply.
- After the above phase-down, the credit rate returns to 10%.

9) New Markets Tax Credit (NMTC):

- Our Firm does not work in the New Markets Tax Credit (NMTC) area, despite its importance as a community development tool. What we do know is that there were essentially no changes from the PATH 2015 tax law, which provided for a $3.5 billion annual allocation in each of 2018 and 2019.

10) Qualified Opportunity Funds (QOFs):

- Intended to incent investment in certain communities.
- Investors can defer, for up to 9 years, the tax on certain gain(s), if those gains are invested in a QOF(s).
- The gain is then recognized at the earlier of 12/31/26 or the date the QOF is sold.
- The gain can further be reduced by possible "step-ups in basis," if the investment in the QOF is held as follows:
  - 10% of the original gain, if QOF investment is held at least 5 years.
  - Additional 5% of the original gain, if QOF investment is held at least 7 years.
- QOFs must be certified by the U.S. Department of the Treasury.

11) Technical Termination of Partnerships Repealed:

- Technical termination (and the related depreciation restating) have been repealed.
- This will normally result in larger depreciation deductions for the acquiring partner(s).
- One other aspect of this repeal, is that any prior Section 754 elections now survive the transfer.

12) Substantial Built-in Loss Adjustments:

- A primer:
  - Partners have basis in their partnership interest as well as basis in the partnership assets.
  - If you are a transferee partner, your starting basis in the partnership is the price you paid for the interest and you initially step into the shoes of the transferor's basis in the partnership assets.

  - Section 754 elections(s) (in the partnership) allow the transferee partner(s) to adjust their basis in the partnership assets (and the resulting depreciation).
  - Under previous law, if there was no Section 754 election in place, you were not required to step down your basis on the partnership assets <u>unless</u> there was a substantial built-in loss. A substantial built-in loss, under the previous law, was if the FMV of the property was $250,000 less than the adjusted tax basis on the partnership's books at the transaction date.

- Please note that the above discussion is still in effect under the new law.
- The new law expands the definition of what constitutes a *substantial built-in loss* where there is no Section 754 election in place. The definition now includes a transfer of a partnership interest that if, hypothetically, the partnership's assets were sold for cash at FMV immediately after the transfer and resulted in a loss greater than $250,000, being allocated to the transferee partner, then the transferee partner is required to step down its basis in the partnership assets.

13) Base Erosion & Anti-Abuse Tax (BEAT):

- Our Firm does not have large multi-national corporations in our client list and accordingly, we will not touch this area directly in our work. It will however, impact the traditional investor (who has foreign affiliates) in tax credit projects and thus, impact their equity pricing.

14) Meals, Entertainment and Certain Fringes:

- Meals are still 50% deductible. Entertainment is now 0% deductible (not deductible).
- Possible unrelated business income (UBI) (and related UBIT) on certain tax free transportation (parking and transit passes) fringes to employees of a non-profit.
- Please see the chart at the end of this document for further details and comparison with the old law.

15) Employer Credit for Paid Family and Medical Leave (for 2018 & 2019 only):

- A credit is now available to eligible employers who pay family and medical leave to their employees.
- Employers must pay at least two weeks of paid leave to full-time employees and a pro-rata amount of paid leave to part-time employees, to be eligible for the credit.
- Amount of paid leave must be at least 50% of the normal wages.
- Maximum amount of paid leave to be applied to the credit is 12 weeks.
- This credit is likely not an applicable benefit to companies in New York, due to their paid family leave law, which is funded through the New York State Disability Insurance Tax.

16) Like Kind Exchanges:

- Like kind exchange tax deferral is now only available to real estate transactions.

17) Domestic Production Activities Deduction (DPAD) Repealed:

- The DPAD deduction has been repealed.

18) Cash Basis of Accounting/Uniform Capitalization Rules (UNICAP):

- The gross receipts test to be eligible to use the cash basis method of accounting and to be exempt from using the UNICAP requirements has increased to $25M. The gross receipts test is based on the average annual gross receipts over the 3 previous tax years.
- The application of the aggregation rules for the gross receipts test will need further guidance.
- The application of this new provision is considered a change in accounting method. A taxable income adjustment is required over a maximum of 4 years and the necessary tax forms need to be filed.

19) Completed Contract Method of Accounting for Long-Term Contracts:

- The completed contract method of accounting is now available, if the annual average gross receipts of the 3 previous tax years is less than $25M.
- The application of the aggregation rules for the gross receipts test will need further guidance.
- The application of the new provision is <u>not</u> considered a change in accounting method and will be applied on a cut off basis.

20) Research & Development (R&D) Expenditures:

- Certain construction contractors may be eligible to take the R&D credit.
- The new law requires that R&D expenditures be amortized over 5 years.

21) Certain Contributions from Governmental Agencies:

- Prior to enactment, corporations receiving money or property from governmental entities could exclude the receipt of the money or property from income, as a non-shareholder capital contribution. The corporation had to reduce the basis of property acquired with the related money. Additionally, the corporation's basis in any property received from the governmental entity would be zero. The new law repeals the income exclusion for corporations receiving money or property from governmental entities, previously considered non-shareholder capital contributions. Accordingly, government grants to corporations will now result in taxable income to the corporation, to the extent of actual money received or for the fair market value of property received.

22) Moving Expense Deductibility (No Longer Deductible):

- There will no longer be a deduction for the employee or exclusion from income of reimbursed moving expenses. Previously, a taxpayer was allowed a deduction from income for qualified moving expenses and an exclusion from income of qualified moving expenses that were reimbursed by the employer. This is no longer allowed, unless the taxpayer is an active duty member of the Armed Forces.

23) Limitation on the Deduction for State and Local Taxes:

- The state and local tax (income, property and sales) itemized deduction is now limited to a combined total of $10,000.

24) Limitation on Mortgage Interest Deduction:

- The new tax law limits the amount of indebtedness for the mortgage interest deduction to $750,000 of acquisition indebtedness, if incurred after December 15, 2017. The previous $1,000,000 limit is still in place for older debt and for tax years after December 31, 2025.
- Additionally, the new law eliminates the interest deduction on home equity indebtedness (including pre-enactment loans), unless used for improvements.

As always, if you have any questions on the applicability and effect of the 2017 tax law on your situation, please reach out to Flaherty Salmin CPAs.

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Certain Business Expenses Under the New Tax Reform Bill

Meals, Entertainment & Dues:

	Tax Years Beginning Before Dec 31 2017	Tax Years Beginning on/after Jan 1 2018
Client Entertainment: Expenses for recreation or amusement, i.e. event tickets, golf (excluding meals)	50% Deductible; Tickets to qualified charitable event 100% deductible	No Deduction
Client Entertainment: meals only	50% Deductible	50% Deductible
Employer provided food & beverages to employees on employer's premises	100% Deductible*	50% Deductible*
Employee meals outside the office for a business purpose (e.g. overnight travel)	Generally, 50% Deductible	50% Deductible
Office holiday parties and other expenses for recreation or social purposes primarily for the benefit of most employees	100% Deductible*	100% Deductible*
Trade Association Dues	Generally, 100% Deductible	Generally, 100% Deductible
Social, Athletic or Sporting Club Membership Dues	No Deduction	No Deduction
Membership dues for any club organized to further the taxpayer's trade or business	100% Deductible	No Deduction

Fringe Benefits:

Transportation benefits to employees including expenses in a commuter highway vehicle to and from work, transit pass and parking.	100% Deductible; excluded from employee's income (up to limits)	No Deduction to employer, remains tax free to employee (up to limits)**
Reimbursement of mileage for business travel excluding commuting expenses	100% Deductible, excluded from employee's income up to IRS mileage rate	Same as prior law
Bicycle Commuting Reimbursement	Reimbursements of up to $20 for each qualified bicycle commuting month are excludable from employee's gross income and deductible to employer	Qualified bicycle commuting reimbursements are included in the gross income of the employee and deductible to the employer
Moving Expense Reimbursement	100% exclusion to employee for qualified moving expense reimbursements provided by employer and 100% deductible to employer	Qualified moving expense reimbursements are included in the gross income of the employee and deductible to the employer***

*A *de Minimis* threshold should be applied and not exceeded, otherwise the fringe benefit can become a taxable employee benefit.

**Unless the expense is needed to ensure the safety of the employee.

***The exclusion of income is still available for active duty members of the armed forces moving pursuant to a military order.