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Tax Reform & Real Estate Businesses

On December 22, 2017, President Donald Trump signed sweeping tax reform legislation, the Tax Cuts and Jobs Act (TCJA). Following are summaries of some of the key provisions affecting the real estate industry. Commentary is in italics. All section references are to the Internal Revenue Code of 1986, as amended through the TCJA.

Overall, real estate businesses fared well in the TCJA. They should be able to claim the new 20% pass-through deduction; they can claim business interest, with some limitations; and like-kind exchanges are preserved. Their owners will be taxed at lower rates, but as a tradeoff, managers and investors may not be entitled to claim all of their net losses on their individual returns and they may not be able to enjoy the full benefits of the 100% expensing provision.

1. Income Tax Rates Lowered and Personal Deductions Limited

Beginning in 2018, the TCJA lowers the maximum federal income tax rate for individuals from 39.6% to 37%. This rate reduction (and other deduction limits discussed below for individuals) are scheduled to expire at the end of 2025 unless renewed by Congress prior to then. The maximum federal income tax rate for long-term capital gains and dividends remains at 20%. The 3.8% net investment income tax and Medicare tax above the applicable threshold also continues unchanged.

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Deductions by individuals for state and local income taxes, and *non-business* property and sales tax, are eliminated, with the following exception. Individuals may claim deductions for state and local income taxes, and state and local (non-business) property or sales taxes, up to a cap of $10,000 per year. Taxpayers may pick and choose what deductions make up the $10,000 cap.

In states such as New York and Maryland that start taxable income with federal taxable income, but that back out deductions for state income taxes, taxpayers may want to select property taxes first, as that deduction is generally recognized for state and local income tax purposes as well. For upper income taxpayers, this deduction limitation will offset much of the benefit from the lowering of the individual rates.

The cap does not apply to state and local property taxes or sales taxes paid or accrued in connection with a trade or business or income-producing activity.

The TCJA (a) limits the deduction for interest incurred on debt used to acquire, construct or improve a principal residence (or second home) to interest on up to $750,000 of debt (down from $1,000,000); and (b) eliminates the deduction for interest on home equity debt.

Under the TCJA, the maximum federal corporate tax rate is permanently reduced from 35% to 21%. In addition, the progressive rate structure is replaced with a flat tax rate of 21%. There is no special rate for personal service corporations.

The lower rates will have various ripple effects. For example, the "step up" in tax basis in an acquisition of assets has less value in negotiations with sellers, and any net operating loss carryforwards have less value than prior to the rate change.

The TCJA repeals the corporate alternative minimum tax (AMT) effective for tax years beginning after December 31, 2017. The individual AMT is retained but is much less important in light of the limitation on deduction state and local income taxes.

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2. Pass-through Business Income Deduction for Individuals

The TCJA adopts the Senate approach for reducing the taxes of the pass-through businesses. New Section 199A generally allows an individual taxpayer a deduction reducing taxable income for 20% of the individual's qualified business income from a partnership, S corporation, or sole proprietorship. Assuming the individual pays tax at the new maximum rate of 37%, the full deduction could in effect lower the individual's tax rate on such income by as much as 7.4% to 29.6%. (REIT dividends would be in effect taxed at the same rate).

The combined qualified business income amount for the taxable year is the net amount of qualified items of income, gain, deduction and loss. Qualified business income generally includes only items included in taxable income that are effectively connected with a US trade or business (including for this purpose Puerto Rico), other than specified service trades or businesses. Capital gains and losses, interest, REIT dividends, and qualified publicly traded partnership income are not taken into account.

Importantly, the deduction generally is limited to the greater of (a) 50% of the taxpayer's pro rata or allocable share of W-2 wages attributable to qualified business income paid by the partnership, S corporation, or sole proprietorship to its true common law employees; or (b) the sum of 25% of such W-2 wages plus 2.5% of the unadjusted basis, immediately after the acquisition, of all qualified property.

Partnerships or S corporations that use separate companies to hire their employees may want to restructure their operations so that they pay (or are treated as paying) the wages directly.

The new deduction could create more interest in S corporations and discourage some partnerships from issuing partnership "profits" interests, particularly to rank-and-file employees. Many service providers holding regular partnership interests or partnership "profits interests" also receive fixed, guaranteed payments, but under certain Internal Revenue Service rulings, cannot be treated as employees receiving W-2 wages. By contrast, salaries paid to S corporation shareholders are treated as W-2 wages.

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The Conference Committee, in the final bill, intending to help capital intensive and real estate businesses, adopted another way to obtain the reduced rate relying in part on investment in capital. The addition of the 2.5% value of capital assets provision will allow more real estate businesses to access the lower rate. Such businesses may have low payroll or rely on affiliated management companies.

For purposes of this second limitation, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of qualified business income during the taxable year, and for which the depreciation period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed into service by the taxpayer and ending in the year of the applicable regular recovery period under Section 168 (but in no event less than 10 years). The recovery periods for commercial real property remains at 39 years and for residential real property remains at 27.5 years.

> **Example.** Partnership holds and rents a building. The business purchased rental real property for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50% of W-2 wages (or $0); or (b) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the building immediately after its acquisition (or $2,500, 2.5% x $100,000). The partnership's deduction in 2020 is limited to $2,500. (The $2,500 amount will also apply for the next 38 years).

How the tax basis rule works with real property that has been exchanged under Section 1031 is not clear.

Gain from the sale of real property, except for depreciation recapture, is not eligible for the deduction.

A qualified business entitled to this new deduction generally is any trade or business other than a "specified service trade or business." A specified service trade or business is any trade or business activity involving the performance of services (a) in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business the

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principal asset of which is the reputation or skill of one or more of its employees; or (b) in investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

It appears that general partners and real property fund managers in management companies could be treated as engaging in a specified service trade or business and thus may not qualify for this new deduction. This would presumably apply to any of their fixed fees (but not their carried interests). Furthermore, passive investors in management entities may not qualify for the new deduction.

The catch-all provision—"any trade or business the principal asset of which is the reputation or skill of one or more of its employees"—is an ambiguous standard that is bound to create confusion and litigation. This phrase is used elsewhere in the Code only in Section 1202(e)(3)(A), dealing with the little-used exclusion for qualified small business stock, and there is nothing in the legislative history to Section 1202 or this new rule that clarifies the scope of this language. Taken to its extreme, it could have a broad application, but arguably that was not intended.

The new deduction would not apply to real estate held as an investment, and not in a trade or business.

The new pass-through income deduction is effective for tax years beginning in 2018, but is scheduled to sunset at the end of 2025, unless Congress extends it.

3. Carried Interests and Other Partnership "Profits Interests"

The TCJA's changes to carried interest and other partnership profits interests generally only affect investment funds and partnerships holding real estate for rental or investment, and not partnership "profits interests" held in partnerships that operate other types of businesses.

Under prior law, the character of any income or gain recognized by a partnership or fund flows through and retains its character at the partner level. Thus, fund managers and other holders of partnership "profits interests" are allocated their shares of the capital gain and other income when the fund or partnership sells some or all of its assets. Under prior law, if the capital gain was in respect of assets held by the fund or partnership for more than one year, the fund

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manager and profits interest holder would pay income tax at the maximum rate of 20% on such long-term capital gain. Qualified dividends from US corporations and most non-US corporations entitled to the benefit of a tax treaty with the US are also taxed at a maximum rate of 20%. In addition, such capital gains and dividends are subject to the 3.8% net investment income tax, for a combined federal maximum rate of 23.8%. Short-term capital gains and nonqualified dividends are taxed at ordinary rates (the new maximum rate is 37%), plus the 3.8% net investment income tax.

Under new Section 1061, the law described above remains the same, except that only gain from the sale of assets held by an investment fund or other applicable partnership for more than three years qualifies for long-term capital gain treatment. The three-year holding requirements apply only to "applicable partnership interests" (see discussion below). A Section 83(b) election cannot alter the above treatment. If applicable assets are sold after the one-year holding period but before the three-year holding period, the gain allocable to an applicable partnership interest is treated as short-term capital gain (and not as ordinary income).

Any transfer of an applicable partnership interest triggers short-term capital gain to the extent such gain is attributable to assets held not more than three years, if such transfer is to a family member of the transferor, or to a person who has performed services in any applicable trade or business for which the transferor performed a service within the current calendar year or the preceding three calendar years.

The new carried interest provision applies only to an "applicable partnership interest," which in effect is a "profits interest" issued to a service provider in any "applicable trade or business." An applicable trade or business is an activity that consists, in whole or in part, of (i) raising or returning capital; and (ii) either (a) investing in or disposing of "specified assets;" or (b) developing specified assets. Specified assets include securities, commodities, real estate held for rental or investment, options or derivative contracts with respect to the foregoing assets, or an interest in a partnership to the extent of the partnership's interest in the foregoing assets. Developing specified assets occurs if representations are made to investors, lenders, regulators, or others that the value, price, or yield of a

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portfolio business may be enhanced or increased in connection with the service provider's choices or actions.

Accordingly, the new carried interest provision will clearly apply to managers of private equity funds, venture capital funds, and other investment funds. Managers of hedge funds will also be affected, but some hedge funds never held their assets for more than a year in any event.

Significantly, unlike many prior carried interest proposals, the new carried interest provision applies to a manager or general partner who manages or develops a partnership investing in real estate held for rental or investment.

Most portfolio investments held in investment funds, and most real estate held in partnerships for rent or investment, are held for more than three years. Thus, new Section 1061 is not expected to have a substantial impact. But it could in circumstances where a sale is effected within the three-year holding period.

The new Section 1061 limitation will not apply to gain attributable to any asset not held for portfolio investment on behalf of third party investors, to the extent provided in Treasury regulations. *It remains to be seen how broad those regulations will be drafted. Treasury is also directed to impose new reporting requirements in this area.*

The new law does not change the normal rules for determining holding periods, including tacking on the holding period of an asset upon its tax-free contribution to the partnership. It would appear that gain allocated to an applicable partnership interest issued to a fund manager or other service partner within three years of the sale of the partnership's underlying assets could still qualify for long-term capital gain treatment, so long as the fund had held the underlying assets for more than three years. That would be the treatment under prior law. In addition, Section 1061 may apply to the sale of partnership interests within three years of their issuance, but it is not clear. However, Treasury is granted broad authority to issue regulations or other guidance to carry out the purposes of new Section 1061, and such regulations could address the circumstances addressed in this paragraph. On the last issue, Treasury could apply the provision as if the partnership sold all of its assets in a hypothetical sale immediately prior to the transfer.

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Section 1061 does not apply to a partnership interest held directly or indirectly by a corporation. On its face, the term corporation on its face includes a subchapter S corporation. *Thus, fund managers and real estate developers might be able to avoid the carried interest rule by holding their profits interests through S corporations. However, as mentioned, regulations promulgated by Treasury could address that strategy.*

If Section 1061 applies, it modifies the application of Sections 1222(3) and 1222(4) to require that capital assets be held for more than three years to obtain capital gain treatment. *However, a real estate business could generate long-term capital gain by holding for more than one year Section 1231 assets, which would appear is not covered by the language in Section 1061. But again, Treasury could address the issue.*

Section 1061 does not affect the ability of carried interests and partnership profits interests to be received tax-free.

New Section 1061 applies to taxable years beginning after December 31, 2017. There is no grandfathering.

4. Some Thoughts on Choice of Entity

Most partnerships, S corporations and other pass-through entities taxed as flow-through entities that can benefit from the pass-through deduction are probably unlikely to want to convert to a C corporation to take advantage of the new 21% maximum corporate rate.

- *Such flow-through entities will have a maximum marginal effective rate on ordinary operating income of 29.6% (plus the 3.8% Medicare or net investment income tax), while C corporations would still be subject to the dreaded double-tax—an income tax at the corporate level (maximum federal 21% rate), and another income tax on qualified dividends at the shareholder level (maximum federal 20% rate, plus the 3.8% net investment income rate). State and local income taxes would worsen the impact of the double-tax, particularly in high tax states such as California and New York.*

- *Sellers of flow-through entities can sell assets or be deemed to sell assets and pay tax on capital gains at a 23.8% rate (and can avoid the double-tax).*

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- *Buyers will still want a "stepped up" tax basis in the assets, which is not possible with a sale of stock of a C corporation owned by individuals on a stand-alone basis without the corporate double-tax applying.*

- *With a partnership, losses can still flow through to investors; they cannot flow through C corporations to their shareholders*

One type of business that might convert to a C corporation is a business that generates substantial taxable income and plans to reinvest its profits in the business, while not planning any time soon to make dividends or sell the business. This analysis could require extensive financial modeling.

C corporations that do not reinvest their earnings must be concerned about the 20% accumulated earnings tax and the personal holding company tax, a 20% penalty on undistributed passive income earned in a closely-held C corporation.

In addition, it must be kept in mind that, absent further action by Congress, individual income rates and the pass-through deduction under new Section 199A will sunset at the end of 2025. By contrast, the new 21% corporate income tax rate is permanent, but there is political risk that a new Congress and President might act to increase the rate sometime in the future.

S corporations will become more popular, since they possess a new advantage in qualifying for the pass-through deduction (relating to a W-2 wages limitation), and S corporations continue to provide self-employment tax savings in respect of net business income for shareholders who materially participate in the S corporation's business. A LLC can elect to be taxed as a S corporation effective January 1, 2018 by making the election by March 15, 2018. Its operating agreement would have to be simplified and amended.

However, it is unlikely that there will be a rush to convert partnerships and LLCs taxed as partnerships to S corporations for the following reasons:

- *Partnership "profits interests" can still be received tax-free; stock of a S corporation cannot be received tax-free, and while options can be received tax-free, they generate ordinary income on exercise not capital gain.*

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- *Partnerships are much more flexible in their economic sharing arrangements, including permitting a carry to management. S corporations are required to have only a single class of stock.*

- *In flowing through losses, partners can include in their tax basis their share of the partnership's liabilities, which cannot be done by a S corporation shareholder.*

5. 30% Limitation on Business Interest Deductibility (With an Exception for Real Estate)

Amended Section 163(j) disallows a taxpayer's deductions for business interest expense to the extent such deductions exceed 30% of the taxpayer's adjusted taxable income, plus the taxpayer's business interest income. Adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion (roughly, EBITDA) (through 2021 only), any business interest expense or income, the new pass-through business income deduction under Section 199A, or any net operating loss carryover deduction. Investment interest income and expense are not affected by amended Section 163(j). Any disallowed interest expense may be carried forward indefinitely.

Example 1. Partnership in a year before 2022 has net income 500,000 (which takes into account $500,000 in depreciation, and $500,000 in interest expense). The adjusted taxable income is $1,500,000 ($500,000 net income with the depreciation and interest expense added back), for an allowable interest deduction of $450,000 (30% x $1,500,000). This results in taxable income of $550,000 and leaves a carryover of disallowed interest expense of $50,000.

Example 2. Partnership in a year after 2021 has net income $500,000 (which takes into account $500,000 in depreciation, and $500,000 in interest expense). The adjusted taxable income is $1,000,000 ($500,000 in net income plus $500,000 of interest. This leaves an allowable interest deduction of $300,000 (30% x $1,000,000). This results in taxable income of $700,000 and a carryover of disallowed interest expense of $200,000.

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The new 30% limitation does not apply to businesses with average annual gross receipts for the three taxable years ending with the prior taxable year of *$25 million or less*.

The new limitation would have a significant effect on many highly-leveraged real estate operations, except for the fact that real property trades or business can elect out of the provision and deduct interest without regard to the limitation. Any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business may elect for the new limitation not to apply. The Conference Committee Report states that hotel and lodging facilities are real property businesses for this purpose.

However, if any such election is made, there is a trade-off: the real property trade or business is required to use the alternative depreciation system (ADS) under Section 168(g) to depreciate its nonresidential real property, residential rental property, and qualified improvement property. The ADS system has slightly longer recovery periods than the General Depreciation System (GDS) (40 years versus 39 for nonresidential real property; 30 years versus 27.5 years for residential real property; and 20 years versus 15 years for qualified improvement property).

Real estate investors may want to, where the matter is not obvious, have careful projections prepared showing projected tax results assuming the election is made and is not made. Where the investor is confident the election would be beneficial, the investor could insist on including in its partnership agreements that the partnership will make the election under Section 163(j)(7)(B) of the Code.

In the case of a partnership, the 30% limitation on business net interest expense is applied at the partnership level. As a result the interest expense passed through to the partners would not be subject to a second limitation. Any disallowed amounts may be carried forward by the partner but can only be deducted against excess taxable income attributed to the partner by the partnership's activities that gave rise to the excess business interest carryforward.

Partnerships will have added administrative requirements of reporting to their partners whether they have excess business interest (interest expense that is not able to be deducted by the

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partnership) or excess business income (the capacity to deduct additional interest expense if it were incurred). A partnership with excess income can free their partners' interest expense carryover from that partnership to that extent or from their other activities not through a partnership.

The tax basis of a partner in a partnership is reduced by the amount of excess business interest allocated to the partner, but if the partner sells or otherwise disposes of the partner's partnership interest, the basis in the partnership interest immediately before such disposition is increased by the excess of the amount of the aggregate basis reductions over the excess business interest allocated to the partner that was previously treated as business interest paid or accrued by the partner.

Similar rules, but not all of them, apply to S corporations and their shareholders.

Even businesses not subject to this limitation now could be in the future if interest rates spike or their individual circumstances or the overall economy decrease their profits.

The new limitation applies to tax years beginning after 2017. There is no grandfathering.

6. 100% Expensing of Certain Depreciable Property

All new business investment in qualified depreciable property (not including structures or intangible assets) may be fully expensed in the year of acquisition under amended Section 162(k). This bonus depreciation deduction benefit applies to property placed in service after September 27, 2017 through the end of 2022, with an additional year for certain property with a longer production period and certain aircraft. The 100% allowance is phased down 20% per calendar year for property placed in service after 2022. Thus, the allowance is 80% for property placed in service in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and none in 2027.

Qualified depreciable property includes tangible property with a recovery period of 20 years or less under the GDS. It does not include much property primarily used in a real estate trade or business, or to

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intangibles (such as goodwill or intellectual property). But real estate businesses will be able to claim bonus depreciation on qualified land improvements and tangible personal property used in a real restate business.

Through a technical error in the TCJA, the 100% expensing does not apply to qualified improvement property, which should have a 15-year recovery period. Retailers and restaurants are particularly disappointed by the oversight. Lawmakers have the fix on their list, but there are no guarantees.

The new rules apply to used property (*i.e.*, property that was not originally placed in service by the taxpayer). There is an anti-churning rule that could apply on sales between related parties.

The maximum amount a taxpayer may expense under Section 179 is increased to $1,000,000, and the phase-out threshold is increased to $2,500,000. The definition of Section 179 property is expanded to include, at the election of the taxpayer, qualified improvement property, certain tangible personal property used to furnish lodging, and certain improvements to nonresidential real property. This can become particularly relevant when full expensing ends after 2022.

7. Real Estate Cost Recovery

The recovery periods remain at 39 years for commercial real property and 27.5 years for residential real property, despite a proposal in the Senate bill to reduce them to 25 years.

A new definition of qualified improvement property substitutes for the prior definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property. Qualified improvement property has a broad definition, including any improvement to the interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service, *but is narrower than the former rule for restaurant property.* Qualified improvement property is recovered over 15 years on a straight-line basis (under amended Section 168(b)(3)(G)), as was previously the case for qualified leasehold improvement, qualified restaurant, and qualified retail improvement property.

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The alternative depreciation system (ADS) recovery period is lowered from 40 to 30 years for residential rental property and is reduced to 20 years for all qualified improvement property. *These reductions are relevant in light of the real estate business election in Section 163(j)(7)(B) described in paragraph 5 above regarding election out of the limitation on the deduction of business interest.*

8. Limits on Deductibility of Net Operating Losses

Carrying back net operating losses (NOLs) is no longer allowed, except for a one-year carryback related to certain small businesses and farms. However, NOLs can now be carried forward for an indefinite number of years (as opposed to the previous 20 year carryforward rule).

A corporation or other taxpayer may now deduct NOLs only to the extent of 80% of the taxpayer's taxable income (determined without regard to any NOL deduction). This results in an effective tax rate of 4.2% for a corporation and 7.4% for an individual (assuming the highest rate of 37% applies). The new NOL rules apply to losses arising after 2017.

Under prior law, under the corporate AMT, the use of NOL carryforwards were limited to 90% of taxable income. The new limitation has an even harsher impact. (However, pre-2018 losses should avoid the limits of both the 90% AMT and 80% regular tax limitations).

9. Active Business Losses Limited

Taxpayers have been subject to limits on using passive losses since 1987. Now active business losses are limited to the extent they exceed $500,000 for joint filers and $250,000 for other taxpayers. *Congress had a policy reason for limiting passive losses, but this new active loss limit appears to be just a revenue raiser or trade-off for lower rates.*

For taxable years beginning after December 31, 2017 and before January 1, 2026, under new Section 461(l), excess business losses of taxpayers other than C corporations are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's NOL carryforward in subsequent years. An excess business loss for the taxable year is the excess of aggregate

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deductions of the taxpayer attributable to trades or businesses of the taxpayer over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount, which is $500,000 for joint filers and $250,000 for all others.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. The provision applies after the application of the passive loss rules in Code Section 469.

New Section 461(l) has been described as addressing active losses incurred by active real property and other managers, but it appears to have a much broader scope in that it could apply to passive investors as well. Consider if an investor's passive losses have been limited by the passive loss rules, and subsequently the investor disposes of all of his partnership interest, freeing up the losses under Section 469(g). Typically, those losses could be deducted without further limitation, including against wages and salary income and such portfolio income as interest, dividends, and capital gains from the sale of stock. But it now appears that the losses would have to run the gauntlet of new Section 461(l) with its new limitation of $500,000 per year for joint filers and $250,000 for individual filers. The freed-up losses could offset any gain arising from the asset sale or other disposition event, but any surviving losses could be limited.

This new loss limitation will be a factor in determining a taxpayer's choice of entity to use a C corporation, or partnership or S corporation.

10. Technical Terminations of Partnerships Repealed

Section 708(b)(1)(B) of the Code is repealed starting in 2018. Prior to repeal, a technical termination of a partnership was triggered if, within any 12-month period, a sale or exchange of 50% or more of the interests in partnership capital and profits occurred. This required the partnership to file a new short-period final return, make new elections, and (most painfully) recover depreciation deductions over a longer period. *With the repeal, provisions in partnership agreements prohibiting a transfer of a partnership interest that would trigger a technical termination are rendered moot.*

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11. Section 1031 Cut Back to Real Estate Only

Tax-free like kind exchanges are now limited only to US real property. *While most Section 1031 exchanges involve real property, in the past Section 1031 exchanges also have been effected by operating businesses, such as newspapers or franchises, or by owners of aircraft.* There are grandfather rules for exchanges if the property disposed of was disposed of on or before December 31, 2017 (*i.e.*, in a forward exchange), or the property received by the taxpayer is received on or before such date (*i.e.*, in a reverse exchange).

Some real estate is sold containing substantial tangible personal property. The sale of such property will no longer qualify under Section 1031.

12. Contributions to Capital by Governmental Entities and Civic Groups

Section 118 is amended to provide that tax-free non-shareholder contributions generally do not include any contributions by a government entity or civic group. Such contributions are sometimes made by a local government, civic group or real estate developer as an incentive to locate business operations in the locality, but such contributions can no longer be made tax-free.

13. Estate Tax

The TCJA preserves the federal estate tax, but effective in 2018 the federal estate, gift and generation skipping transfer ("GST") tax exemptions are temporarily increased to $11,180,000 per person. The TCJA continues the portability feature that allows the estate of the first spouse to die to elect to transfer his or her unused federal estate and gift tax exemption to the surviving spouse (but as under current law, the unused GST exemption is not portable). The new rules apply to estates of people who die after December 31, 2017 and before January 1, 2026 (and also to gifts made during that time frame). *The change will reduce the number of multimillion-dollar estates that are subject to the 40 percent tax, before returning to the current exemption levels, indexed for inflation, on January 1, 2026. Heirs and legatees will continue to receive a stepped-up basis as of the date of death for purposes of any subsequent sale of inherited assets. Note that unrelated to the new law, the annual gift tax exclusion for 2018 will increase to $15,000 per donee.*

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14. Some Code Provisions Unchanged

The following tax provisions were proposed for substantial change in either or both of the House or Senate bills, but after Conference Committee deliberations, escaped entirely or largely unchanged in the final tax bill:

- Interest paid on indebtedness used to purchase a second home is untouched.
- A married couple filing jointly can exclude up to $500,000 in capital gains on the sale of their homes, as long as they have used it as a primary residence for at least two of the last five years. The House and Senate bills had proposed more strict timing rules.
- The Work Opportunity Tax Credit, Low-Income Housing Credit, and New Markets Tax Credit remain.
- While at one point proposed to be repealed, the Rehabilitation Tax Credit survived, with substantial modifications:
    - Buildings built before 1936 are now ineligible unless they are on the National Register of Historic Places or located in a Registered Historic District; and
    - Taxpayers must claim the 20% credit ratably over a 5-year period as opposed to the year the improvements are placed in service. How this rule affects basis reduction is unclear.
- The tax benefits for private activity bonds (used to fund low-income housing and other projects) remain.
- Prior versions of the House bill would have changed the self-employment tax treatment of pass-through entities, but they were not touched in the final bill.

In addition, no changes were made to the following, despite discussions they could be addressed:

- The 3.8% net investment income tax.
- Contributions to 401(k) retirement plans.

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15. Changes to Partnership Agreements

The TCJA may affect the drafting of new partnership agreements. Partners may also want to consider amending its current partnership agreement. (By partnership agreement, it includes a limited liability company operating agreement where the LLC is taxed as a partnership).

a. **Tax distributions.** With the reduction in maximum individual and corporate tax rates, the new 20% pass-through deduction for partnerships and S corporations, and the disallowance of deductions for state and local income taxes for individuals, the amounts for tax distributions in partnership agreements may be different from prior years. Many existing partnership agreements use a fixed tax rate, and others determine a hypothetical rate assuming that state and local income taxes are deductible. These provisions should be revisited.

b. **Deemed partnership terminations eliminated.** Some partnership agreements have provisions prohibiting or requiring consent if the transfer of a partner's partnership interest would trigger a deemed termination of the partnership under IRC Section 708(b)(1)(B). Such a termination, among other things, required the partnership to file a short-year-end tax return and slowed down depreciation deductions. The tax reform act has deleted Section 708(b)(1)(B). Accordingly, these transfer provisions are no longer needed in partnership agreements, and such existing provisions are rendered moot.

c. 3**0% business interest limitation.** Real estate investors with substantial stakes in a partnership, who have determined that it would be tax efficient to elect out of the business interest limitation (see item 5 above), may want to add to their partnership agreements that the partnership will make the election under Section 163(j)(7)(B) of the Code.

d. **No more tax matters partner (almost).** While not a result of the TCJA, the new partnership audit rules are now in effect. Starting January 1, 2018, the provision in partnership agreements addressing partnership tax audits should only appoint a "partnership representative" and not

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a "tax matters partner," at least for federal tax purposes. However, individuals or entities that are designated as the partnership representative should also be appointed as the tax matters partner for state or local tax law purposes for states and localities that have not yet adopted the partnership representative regime.

Note that previously the tax matters partner had to be a partner of the partnership, but that is not the case with a partnership representative.

In addition, if an entity is selected as the partnership representative, an individual representing the entity must be designated when the partnership representative is identified on the partnership's returns or else the partnership representative designation may not be respected by the IRS. It is difficult to change both the partnership representative and the designated individual.

For partnership agreements that have no partnership representative provision, since the IRS is not required to treat the partner selected as the tax matters partner as the partnership representative, the partnership should amend its partnership agreement to select the partnership representative (as well as address important elections and sharing the burden of any tax audit payments).