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A busy season debrief of 2018 real estate income tax reform

The first year administering any sweeping tax reform with hundreds of pages of new code and thousands of pages of associated guidance is never easy, nor without the devil in the details. I have outlined eight specific real estate income tax reform issues we addressed this busy season that may require special attention to take advantage of some opportunities and avoid some pitfalls.

Michael Malody
Senior tax manager, ACM

■ **Interest expense limitations on leveraged real estate syndicated partnerships.** It was more the rule than the exception that syndicated real estate partnerships fell into the expanded definition of tax shelters (allocation of more than 35% of losses to limited partners) and were subject to the new interest expense limitations under IRC Section 163(j). In the clear majority of these cases, after sensitivity analysis, it was cost beneficial to elect the qualifying real property trades or business exception under IRC Section 163(j)(7)(B). The downside of the election was that we had to adopt a 40-year recovery period on commercial real estate and qualified improvement property assets, and 30-year recovery period on residential real property (40 years for those placed in service prior to 2018), which reduced tax depreciation.

■ **The new 20% Qualified Business Income deduction.** The Treasury has explicitly targeted triple-net real estate investments in its guidance, warning that these investments may not meet the level of property owner activity to rise to the level of a trade or business and do not generate qualified business income. In order to qualify for this deduction, NNN investors may want to consider taking on an expanded role at the properties, which can be done by an agent, and build that planning into the lease administration process. In addition to qualifying the income, an appropriate level of wages or unadjusted basis (which may be a challenge for mature property investments) needs to accompany that income either directly from the partnership or in aggregation with other investments that qualify to take the deduction. The Treasury has not stated explicitly, but, in its regulation examples, indicated residential and commercial properties cannot be aggregated for these purposes, which most specifically poses a challenge for commercial properties since wages are less likely associated with these operations. We found management fees following the economics of these deals to a related S corporation management company with wages may be a means of solving the wage and basis shortfalls, while also having substance.

■ **Uncertainty of the recovery period for qualified improvement property and sales of assets with promoted interests held for less than three years.** Not including qualified improvement property in the bonus depreciation and the wording gap in the new carried interest rules under IRC Section 1061, which seemingly does not include IRC Section 1231 gains, were the most puzzling technical gaps that remained without definitive direction this season. Taking positions on these uncertain items included looking more closely at IRC Section 179 or repair regulation applications for QIP and the overall tax position of our clients potentially subject to IRC Section 1060 and the impact of a short-term capital gain redetermination.

■ **Excess business loss limitation.** In past years, real estate professionals were not limited in using net rental real estate losses to offset portfolio income or, perhaps, a spouse's W-2. The new excess business loss rules under IRC Section 461(l) limit business losses to $500,000 for married filing joint taxpayers ($250,000 for single). Real estate professionals should consider the mismatch pitfall in this rule in any projects with large amounts of self-charged interest (interest income at the individual level, business interest expense at the entity level).

■ **Qualified Opportunity Zone Funds and Qualified Opportunity Zone Businesses.** The preferred method of QOZF investments has been indirectly in QOZBs rather than direct purchases. We had to solicit several pieces of information from QOZF investors that we otherwise never needed and create some K-1 disclosures we never had to provide for QOZBs. We recommend asking for the amount of deferred gain being invested and the date that underlying gain was generated, maybe even in the subscription agreements. This information is essential in elections made at the QOZB and QOZF entities getting the tax basis correct in the QOZB. From a planning perspective, we found incentives for allocations in land and buildings to QOZB real estate deals to be different than conventional real estate deals. Also, bifurcating the return on risks taken by managers in QOZF projects rather than grouping it into carried interests should be considered, which appears to have different treatment in the regulations.

■ **New expanded partnership representative responsibilities.** In every opportunity available, we advised to opt out of the new consolidated audit regulations, which went into effect Jan. 1. For those who did not qualify for opting out and were silent on the new expanded partnership representative rules, we typically designated the partnership or the managing member entity as the partnership representative, with the existing tax matters partner as the designee within the partnership representative. We suspect more attention will be paid to these designations as we start to experience the first consolidated partnership audits, probably a year from now.

■ **Negative tax capital account reporting.** Real estate partnerships that report capital accounts on anything other than a tax basis (704(b) or book basis, for instance) and have one or more partners with a negative tax basis capital account now have an expanded disclosure requirement related to those negative capital accounts. Failure to disclose may result in a penalty. Notice 2019-20 gives some relief, provided it is addressed in the short term.

■ **Property taxes and back or home office fees.** The disallowance of state and local income and property taxes over $10,000 and the complete disallowance of investment-related fees on Schedule A should have some implications on the approach used for these expenditures. IRC Section 266 allows for capitalization of property taxes on applicable assets (investment land, for instance) and potentially can be expanded to other categories of expenses. Back office or administrative fees associated with managing real estate portfolios, which in the past may have been reported on Schedule A (probably AGI limited anyway), should be re-evaluated as unreimbursed partner or real estate business expenses.▲