Tax Cuts and Jobs Act

Issues Impacting the Real Estate Industry

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On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the "Act") into law. Not since the Tax Reform Act of 1986, more than 31 years ago, has there been such sweeping tax legislation.

Provisions of the Act will have significant impact on the real estate industry. Outlined below are some of those provisions and observations.

I. Tax Rate Changes

One of the highlights of the Act is the significant change in tax rates. The top individual tax rate is reduced from 39.6% to 37% and takes effect at $600,000 for married taxpayers filing jointly and $500,000 for single individuals, effective for taxable years beginning after December 31, 2017 and before January 1, 2026. The individual alternative minimum tax ("AMT") exemption and phase-out thresholds are increased. A substantially reduced corporate tax rate of 21% has been enacted, effective for tax years beginning after December 31, 2017. (While the Act itself does not address fiscal-year taxpayers, in general, pre-Act law would prorate on a daily basis the new rate for that part of the fiscal year after December 31, 2017.) The corporate AMT is eliminated, with limited minimum tax credits allowed from prior years. A new up-to-20% deduction on certain income applies to pass-through entities (partnerships, limited liability companies ("LLCs") taxed as partnerships, S corporations and sole proprietorships), as discussed below.

II. Cost Recovery Provisions

a. Temporary 100% Expensing for Certain Business Assets (Bonus Depreciation)

The Act allows 100% expensing for tangible property acquired and placed in service after September 27, 2017 and before January 1, 2023. The allowance phases out over five years beginning in 2023, reduced by 20 percentage points a year through 2027. Property eligible for bonus depreciation generally includes any property with a class life of 20 years or less. It is unclear from the current language of the Act if qualified improvement property (which now includes qualified restaurant property, qualified retail improvement property and qualified leasehold improvement property) will be eligible for bonus depreciation. Further clarification is necessary.

One of the Act's major changes is that used property now qualifies for bonus depreciation.

Assets that have taken bonus depreciation are subject to IRC Sec. 1245 and Sec. 1250 recapture rules when the character of the gain of the asset disposed is treated as ordinary to the extent the depreciation (including bonus) is allowed or allowable.

Taxpayers may elect 50% expensing in lieu of the 100% expensing for qualified property placed in service during the first tax year ending after September 27, 2017 and can also elect out of bonus depreciation entirely.

Observation: *With the implementation of a new provision limiting business losses for taxpayers other than corporations (see discussion below), planning regarding the timing of bonus depreciation and the election out will be important to control excessive losses in the year qualified real property is placed in service.*

Observation: *The application of bonus depreciation to used property can have a very significant impact on the acquisition of existing buildings. A cost segregation study would identify the various personal property assets and shorter life property which may now qualify for 100% bonus depreciation in the year of acquisition. This can potentially result in very significant write offs in the year of acquisition.*

b. Depreciation Deductions for Nonresidential Real Property and Residential Rental Property

Under pre-Act law, recovery periods for real property under the Modified Asset Cost Recovery System or MACRS method were 39 years for nonresidential real property, 27.5 years for residential rental property and 15 years for qualified leasehold improvements. Alternative Depreciation System or ADS method recovery periods were 40 years for nonresidential real and residential rental property and 39 years for qualified leasehold improvements. MACRS is the most commonly used of the two depreciation systems and has, relative to ADS, shorter recovery lives for depreciable assets. ADS is most often used for earnings and profits ('E&P") calculations or assets owned outside of the U.S. or by tax-exempt organizations.

The Act changes the recovery period of residential rental and qualified improvement property, if placed in service after December 31, 2017 --

- 20-year ADS recovery life and MACRS 15-year recovery life for qualified improvement property. (The MACRS recovery life, while reflected in legislative history but apparently omitted in the statutory language, may require a technical correction.)
- 30-year ADS recovery life for residential rental property.

Observation: *The decrease in the recovery life of the ADS method of depreciation most likely will not have a significant impact on taxpayers engaged in the real estate business, especially those taxpayers* *that will continue using the MACRS method of depreciation. However, real estate companies that choose to elect out of the business interest expense limitation (discussed below) will be required to use the new ADS method. This change will likely decrease E&P adjustments for corporations, including REITs. See the discussion of the interest expense limitation below.*

c. IRC Sec. 179 Expensing

Under pre-Act law, a taxpayer was required to elect, under IRC Sec. 179, to deduct the cost of qualifying property subject to limitation. The maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount was reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeded $2,000,000. The amount eligible to be expensed for a taxable year was limited to the taxable income from the active conduct of a trade or business during the year. The excess was carried forward.

The Act increases the amount the taxpayer can deduct under IRC Sec. 179 to $1,000,000 and increases the phase-out threshold to $2,500,000, these amounts to be adjusted for inflation for tax years beginning after 2018. IRC Sec. 179 properties include qualified real property, computer software and IRC Sec. 1245 property. Qualified real property includes any qualified improvement property. IRC Sec. 168(e)(6) defines qualified improvement property as any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. The following improvements do not qualify as qualified improvement property: the enlargement of a building, any elevator or escalator or the internal structural framework of the building. The Act further expands on the definition of qualified real property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging and certain improvements made to nonresidential real property, such as roofs, HVAC, fire protection and alarm systems, and security systems.

These amendments to IRC Sec. 179 expensing apply to property placed in service in taxable years beginning after December 31, 2017.

III. Provisions Relating to Sales of Real Property

a. Like-Kind Exchanges of Real Property

Previously, IRC Sec. 1031 allowed deferral of gain on like-kind exchanges for assets that included tangible and intangible personal property. Personal property can include vehicles, furniture, boats and art collectibles. The Act limits the deferral of gain on like-kind exchanges completed after December 31, 2017 to only real property not held primarily for resale. Personal property will no longer be allowed a deferral of gain.

Observation: *These new provisions should not significantly impact the real estate industry, since real property will still qualify for like-kind exchange treatment. For example, a taxpayer may still be able to exchange a commercial building for farmland -- both properties are considered real property even though the nature of the properties are different. The rules for exchanges of foreign real property remain the same in that real property located in the United States and real property located outside the United States are not property of a like-kind for exchange purposes.*

Like-kind exchanges of personal property are subject to a transition rule. The transition rule allows pre-Act law to continue to apply if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or if the property received by the taxpayer in the exchange is received on or before December 31, 2017.

b. **Tax Gain on the Sale of Partnership Interest on Look-Through Basis** (applicable to foreign investors in U.S. partnerships or LLCs)

The Act, overruling prior case law, treats a portion of the gain or loss from the sale or exchange of an interest in a partnership by a foreign person as U.S. effectively connected income ("ECI") if that partnership was engaged in a U.S. trade or business. This provision applies to sales, exchanges and dispositions on or after November 27, 2017. ECI is generally defined as income from sources within the U.S. that is connected with the conduct of a trade or business, and is generally considered U.S. taxable income. A portion of the gain or loss on the sale or exchange of such interest is treated as effectively connected to the extent that:

- such gain does not exceed the portion of the partner's distributive share of the amount of gain that would have been treated as effectively connected if the partnership had sold all of its assets at fair market value as of the date of the sale or exchange of the partnership interest (or zero, if no such deemed sale would have been effectively connected); or
- such loss does not exceed the portion of the partner's distributive share of the amount of loss on the deemed sale described above that would have been effectively connected (or zero, if no such deemed sale would have been effectively connected).

The gain or loss treated as effectively connected under this provision is reduced by the amount of gain subject to tax under FIRPTA (IRC Sec. 897). FIRPTA withholding rates had previously been increased to 15% for sales on or after February 16, 2016. Under the Act, the transferee of a partnership interest is required to withhold 10% of the amount realized on the disposition of a partnership interest if any portion of the gain (if any) would be ECI unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation, effective for sales, exchanges and dispositions after December 31, 2017.

c. Carried Interest

Certain partners in private equity firms, hedge funds and certain real estate partnerships have had the tax benefit of treating carried interests (also known as "promote" interests) as an allocable share of partnership profits. These carried interests have generally been provided to these partners in exchange for services. Since these allocations generally occur on a sale of the underlying assets, they have been primarily taxed at capital gain rates instead of the ordinary income tax rates, which are generally applicable to income from services. Under the Act, for taxable years beginning after December 31, 2017, allocations of gain to "applicable partnership interests" on the sale of partnership assets held for three years or less are treated as short-term capital gain taxed at ordinary income rates, and only gains on sale of assets held for more than three years are treated as long-term capital gain.

It is important to note: The holding period applies to any "applicable partnership interest" the managing or developing partner holds. IRC Sec. 1061(c)(1) defines an applicable partnership interest as any interest in a partnership that is transferred to or held by the taxpayer in connection with the performance of services by the taxpayer or a related person in any "applicable trade or business," even if the taxpayer made contributions to the partnership. An applicable trade or business is one whose regular business activity consists of raising or returning capital and investing in or disposing of or developing "certain assets." Certain assets may include securities, commodities, real estate held for rental or investment, cash or cash equivalents, or financial assets related to these assets. According to IRC Sec. 1061(c)(4), an applicable partnership interest does not include any interest in a partnership held by a corporation or any capital interest in the partnership that provides the taxpayer with a right to share in partnership capital based on the amount of capital contributed or on the value of the interest subject to tax under IRC Sec. 83 when the interest is received or vested. A partner will not be entitled to report gains as long-term capital gain with respect to an applicable partnership interest, unless the property being disposed of has been held for more than three years. Otherwise, the partner will have to follow the ordering rules for capital gains and losses per IRC Sec. 1222 by substituting "three years" for "one year."

The Act includes a key exception for capital interests. Capital interests are a partner's interest in partnership capital that is attributable to cash or property that is contributed into the partnership.

Observation: *In the event of a sale of the partnership's assets at fair market value, the holder* *of the capital interest would receive its share of the proceeds that were distributed upon a complete liquidation of the partnership. In an UPREIT structure, a REIT may grant the partners of the operating partnership long-term incentive plan ("LTIP') units as compensation for the partners' services. Partnership LTIP units represent a partnership interest in the REIT's operating partnership and generally vest based on terms similar to restricted stock. LTIP units are taxed upon conversion into shares of the REIT or cash with the date of such conversion as long as the units are vested and booked up. Upon the grant of the LTIP units, unitholders can choose to make an IRC Sec. 83(b) election to accelerate the recognition of income at the date of transfer, instead of having to wait for the vesting period. If the election is made, the unitholder would not have to pay tax when the LTIP units vest, only on the later sale or conversion. The new carried interest rules will not affect the holding period of this election.*

Observation: *Despite the current Administration's intention to eliminate the preferential treatment of carried interests, there have not been any significant changes to this law. The Act still allows private equity firms, hedge funds and real estate partnerships to structure in a way that allows the managers of these funds to take a share of their investor's profit at the lower, long-term capital gains rate. The Act will only require the assets held in these funds to be held more than three years to get the more favorable long-term capital gain rate. This likely will not be an issue for most private* *equity and real estate funds, since holding periods for the assets they hold are generally more than three years.*

IV. Pass-Through and Partnership Issues Provisions

a. Pass-Through Tax Treatment

The Act makes significant changes to the tax treatment of income from pass-through entities for both investment and non-investment related activities. Under pre-Act law, an individual taxpayer generally was required to apply his/her individual income tax rate, depending on his/her tax bracket, to their regular taxable income.

For taxable years beginning after December 31, 2017 and before January 1, 2026, the Act allows a deduction of 20% of a taxpayer's domestic qualified business income ("QBI") from a partnership, LLC taxed as a partnership, S corporation or sole proprietorship. The 20% deduction is also allowed for a taxpayer's qualified REIT dividends and qualified publicly traded partnership income. QBI is defined as all domestic business income other than investment income (e.g., dividends other than REIT dividends), investment interest income, short-term capital gains, long-term capital gains, commodities gains and foreign currency gains. QBI does not include reasonable compensation or guaranteed payments made to the taxpayer.

For taxpayers whose taxable income is above the limits mentioned below, the 20% deduction is not allowed if the QBI is earned from a "specified service trade or business." A specified service trade or business is defined, in part, as any trade or business (other than architecture or engineering) involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.

For specified service businesses, noted above, the deduction phases out for joint filers with taxable income between $315,000 and $415,000, and for individual filers earning between $157,500 and $207,500.

Taxpayers below this income threshold that are engaged in non-specified service businesses may deduct the 20%. Taxpayers above this income that are engaged in non-specified businesses may still deduct the 20% but are subject to a cap (the "wage limitation test"). The 20% deduction is limited to the greater of (a) 50% of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property. For this purpose, qualified property is generally defined as tangible property subject to depreciation under IRC Sec. 167, held by a "qualified trade or business" and used in the production of qualified business income (land is not included) the depreciable period for which has not ended before the close of the taxable year. The depreciable period with respect to qualified property is the period beginning on the date the property is first placed in service and ending on the later of (1) the date ten years after that date or (2) the last day of the last full year in the applicable recovery period that would apply to the property under IRC Sec. 168 without regard to IRC Sec. 168(g) (which lists applicable recovery periods under ADS). A qualified trade or business is any business other than a specified service trade or business (defined above) or the trade or business of performing services as an employee.

The 20% deduction is not allowed in computing adjusted gross income but instead is allowed as a deduction to taxable income.

Observation: *Care should be taken in making elections to expense items under the previously established tangible property regulations if bonus depreciation can be taken on the same assets.*

Observation: *The QBI deduction for REIT dividends applies without regard to the wage or property limitation which affect other forms of ownership. Certain real estate activities which would not qualify under the pass-through rules such as land leases (no payroll or depreciable property) would qualify for the QBI deduction if earned by a REIT and paid out as a dividend. This* *may result in an increase in the use of REITs in fund structures.*

b. Substantial Built-In Loss

Under pre-Act law, a partnership would not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership had made a one-time election under IRC Sec. 754 to make basis adjustments, or the partnership had a substantial built-in loss immediately after the transfer.

The Act modifies the prior law's definition of substantial built-in loss as follows:

- The partnership's adjusted basis in the partnership property exceeds the fair market of the property by more than $250,000.
- The transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

This provision applies to taxable years beginning after December 31, 2017.

c. Limitation on Losses for Taxpayers Other Than Corporations

Previously, under the passive activity loss rules contained in IRC Sec. 469, if a taxpayer had a flow-through loss from a passive activity, the passive loss could not offset earned income or ordinary income at the individual taxpayer level. The passive loss rules prevented taxpayers from using losses incurred from income-producing activities in which they were not materially involved. However, if the taxpayer is a real estate professional, the losses derived from real estate activities are not considered passive and are available to offset all categories of income, including earned income or ordinary income.

The Act amends and adds to IRC Sec. 461 an additional limitation on a taxpayer's business loss from entities other than C corporations, called an "excess business loss" limitation, effective for taxable years beginning after December 31, 2017. The Act defines an excess business loss as the excess of aggregate deductions of the taxpayer attributable to his or her trade or business over the sum of aggregate gross income or gain for the taxable year plus a threshold amount of $500,000 for married taxpayers filing jointly or $250,000 for all other taxpayers. The threshold amounts will be adjusted for inflation every year, and this limitation expires after December 31, 2025. Any residual amounts are treated as an NOL carryforward to the taxpayer in the following years in accordance with IRC Sec. 172. The Act has amended the NOL carryforward to be indefinite and limits the NOL deduction to 80% of taxable income for a given taxable year. When applying the NOL deduction in subsequent years, the taxpayer will need to follow the ordering rules per IRC Sec. 172.

Observation: *The law limits the ability of taxpayers to shelter income to $500,000 annually with pass-through losses. Consideration should be given to the new business-loss-limitation rules when taking the enhanced bonus depreciation or IRC Sec. 179 expensing deductions. The law also repeals the domestic production activities deduction for small and large businesses. That deduction was intended to provide tax incentives for businesses that produce most of their goods or work in the U.S. rather than sending that work overseas.*

d. Technical Termination of a Partnership

Previously, under IRC Sec. 708(b)(1)(B), there was a technical termination if within any 12-month period there was a sale or exchange of 50% or more of the total interests in partnership capital and profits. A technical termination generally required two separate income tax returns for the termination year: a final income tax return for the period up to the termination and an initial tax return for the period after the termination. For the return after the termination, the restarting of partnership depreciation recovery periods was required, and previous partnership-level elections ceased to apply.

The Act repeals the technical termination rules for taxable years beginning after December 31, 2017. A partnership is now treated as continuing even if 50% or more of the total capital and profit interests of the partnership are sold or exchanged. The repeal of the technical termination rule means partnerships no longer have to restart the annual depreciation deduction; existing depreciable assets within a partnership no longer have to be re-placed in service as of the effective date of the ownership change. Existing partnership elections are retained and do not have to be remade. Per the Act, a termination only exists if no part of the business continues to be carried on or if the ownership changes to a single owner.

Observation: *The Act may simplify the restructuring of an organization within a tiered partnership ownership structure, an UPREIT structure or an M&A transaction. Within the real estate industry, since most properties are held in partnerships or LLCs, it is very common for partners to transfer their interests as opposed to selling the underlying properties. The technical termination rules complicated these types of transactions. The Act should also lift the burden on compliance and reduce the professional fees incurred from filing separate tax returns and keeping separate sets of books and records.*

V.Provisions Relating to Deductions

a. Limitation on Business Interest Expense Deduction

Business interest expense is net interest paid or accrued on indebtedness related to a trade or business, but it does not include interest expense related to investments. Under pre-Act law, interest expense related to a trade or business was fully deductible. The interest deduction for interest paid to a related person that was not subject to U.S. tax might have been limited under IRC Sec. 163(j).

The Act, effective for taxable years beginning after December 31, 2017, replaces prior IRC Sec. 163(j) and limits business interest deductions for all taxpayers to 30% of the adjusted taxable income. The interest deduction limitation is applied at the partnership level. Businesses with average annual gross receipts of $25 million or less are exempt from the limitation. Taxpayers are able to carry forward the disallowed interest to future tax years.

Observation: *Since many real estate entities depend on leverage and borrowed funds for capital investments, this limitation could have a significant impact on taxable income in real estate companies. The Act does allow real estate trades and businesses to elect out of the business interest expense limitation by requiring real property to be depreciated using the alternative depreciation system. The election to use ADS only applies to* *nonresidential real property, residential real property and qualified improvement property.*

Observation: *As of this writing, there is no guidance on how to elect out of this limitation and change the depreciation method to ADS; however, the common consensus is that taxpayers will need to file Form 3115, Application for Change in Accounting Method, and true up in the basis generally over four years or less.*

b. NOL Deduction

Pre-Act law allowed corporations to take net operating loss deductions, a loss taken in a period where a taxpayer's allowable tax deductions are greater than its taxable income. NOLs could be carried back two years and carried forward 20 years. Taxpayers subject to the corporate AMT could only offset 90% of taxable income with carryover NOLs. The Act repeals the carryback provision and allows an indefinite time limit to carry forward any NOL deductions. The Act does limit the amount of NOL carryforward to any year to 80% of the taxpayer's taxable income; losses from years prior to 2018 are not subject to this limitation. The Act does not affect capital loss provisions and repeals the corporate AMT.

Observation: *This law is not likely to have a significant impact on real estate companies, since most real entities are generally formed as partnerships or limited liability companies.*

However, the Act will affect real estate investment trusts (REITs) and taxable REIT subsidiaries within the REIT structure. Since the Act will allow immediate or full expensing of certain investments, this could provide for a significant loss in the initial years, which a REIT could use to offset income in the future years. If a REIT is unable to meet its distribution requirement or has taxable income after taking the dividends paid deduction, it can rely on its NOL deductions to offset its corporate taxable income. ***However, by limiting the NOL deduction to 80% of taxable income, a REIT may still be subject to corporate income tax, since it will no longer be able to use 100% of its NOLs in a year when the dividends paid deduction does not equal its taxable income.***

c. Mortgage Interest Deduction

Previously under IRC Sec. 163(h), home mortgage interest attributable to acquisition indebtedness of up to $1,000,000 was fully deductible on the taxpayer's primary residence or a second/vacation home. For married taxpayers filing separately, this limitation was capped at $500,000. Additionally, interest attributable to home equity indebtedness of up to $100,000 was fully deductible but not to exceed the fair market value of the residence reduced by the acquisition indebtedness. For married taxpayers filing separately, this limitation was capped at $50,000. The Act reduces the indebtedness on the mortgage interest deduction limitation to $750,000 for debt incurred after December 15, 2017, and the interest is only deductible on a taxpayer's "qualified residence." A qualified residence is the taxpayer's principal residence and a second residence selected by the taxpayer to be a qualified residence. The second residence must fall within the definition of a residence under IRC Sec. 280A(d)(i). Additionally, interest on home equity lines are no longer deductible.

Observation: *The tax code has generally been favorable to single family home ownership by allowing dollar-for-dollar deduction in property taxes and mortgage interest deductions. However, the new law may negatively affect home ownership, making it less attractive by limiting these deductions. As a result of the lowered limitation on the indebtedness subject to the mortgage interest deduction and the increase of the standard deduction to $24,000, many individuals may find it more advantageous to take the larger standard deduction rather than claiming the itemized deduction. This may also impact the incentive for taxpayers to buy single-family homes, thus negatively affecting homebuilders.*

d. State and Local Tax Deduction

Under pre-Act law, IRC Sec. 164(a) allowed for a deduction of state and local property and income taxes (or sales taxes in lieu of income taxes) dollar-for-dollar (for AMT purposes this deduction was disallowed). The Act allows taxpayers to write off up to $10,000 in property taxes and income taxes (or sales taxes in lieu of income taxes), effective for tax years beginning after December 31, 2017, and before January 1, 2026.

Observation: *The Act may negatively affect individuals who own homes and have substantial deductions in state and local income taxes and property taxes that would bring them over the new standard deduction amount. This would be dependent on the market and the state in which the individuals live, along with the number of states in which the individual pays taxes. Those living in a state with higher income tax rates and where property values are assessed higher would be more negatively affected by the new laws. Since the dollar-for-dollar tax deduction will now be capped at $10,000, individuals may take the standard deduction rather than itemizing. Individuals who are close to the $24,000 may consider accelerating itemized deductions such as charitable contributions into one year and itemizing their deductions for the year and taking a standard deduction in the following year.*

VI. Other Provisions

a. Rehabilitation Tax Credit

Under pre-Act law, there was a two-tier tax credit for rehabilitation expenditures: a 20% credit for qualified rehabilitation expenditures to a certified historic structure and a 10% credit for qualified rehabilitation expenditures to a qualified rehabilitated building. A certified historic structure is any building listed in the National Register of Historic Places or located in a registered historic district. A qualified rehabilitated building generally means a building that was first placed in service before 1936 and has Department of the Interior approval for the rehabilitation.

The Act repeals the 10% credit but retains the 20% credit for qualified rehabilitation expenditures for certified historic structures. There is an additional provision that the credit be taken ratably over a five-year period at 20% of the credit per year. The effective date of the provision is for amounts paid or incurred after December 31, 2017, and a transition rule applies.

Observation: *With the corporate tax rate reduced to 21% and the loss of the 10% credit for certain qualified rehabilitation projects, there may be a significant reduction in the number of rehabilitation projects going forward.*

b. Unrelated Business Taxable Income

Previously, the tax law allowed an exempt organization that carries on more than one unrelated trade or business to calculate its unrelated business taxable income on an aggregate basis, which allowed the organization to use losses or deductions generated by one trade or business to offset income from another.

For taxable years beginning after December 31, 2017, the Act requires organizations that carry on more than one unrelated trade or business to separately calculate unrelated business taxable income for each trade or business, effectively prohibiting using losses or deductions relating to one trade or business to offset income from a separate trade or business.

Observation: *For exempt organizations investing in real estate, the Act does not specify how these aggregation rules will be implemented. Are all investments in real estate aggregated, or will the exempt organizations be required to separate each investment when calculating the tax? If all investments in real estate should be tracked separately, how are they split up -- by building, by investment type, by partnership interest, etc.?*

c. Qualified Opportunity Funds

Prior tax law has provided incentives to encourage economic growth and investment in distressed communities by providing tax benefits to business located within certain designated boundaries. The Act provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a Qualified Opportunity Fund ("QOF"), defined below, and the permanent exclusion of capital gains from the sale or exchange of an investment in the QOF, if held at least 10 years.

The Act allows for the designation of certain low-income community population census tracts as Qualified Opportunity Zones ("QOZs"). The designation of a population census tract as a QOZ remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

A QOF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in QOZ property (other than another QOF) that holds at least 90% of its assets in QOZ property. The provision intends that the certification process for a QOF will be done in a manner similar to the process for allocating the new markets tax credit. QOZ property includes any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

There are additional limitations on the provision and it is in effect from the date of enactment (December 22, 2017) but sunsets on December 31, 2026.

VII. Provisions Relating to Construction of Real Property

a. Accounting for Inventories

Under pre-Act law, a taxpayer was required to account for inventories if the production, purchase or sale of merchandise produces income for the taxpayer. When the use of inventories was necessary to clearly reflect the taxpayer's income, the accrual method of accounting was required to be used with regard to purchases and sales. An exception was provided for taxpayers with average annual gross receipts of $1 million or less during the prior three-year period, and for taxpayers in certain industries who had average annual gross receipts during the prior three-year period of $10 million or less. Taxpayers in each of these categories were considered qualified small business taxpayers and were generally permitted to account for inventories as non-incidental materials and supplies.

The Act increases the average gross receipts threshold for qualified small business taxpayers from $10 million to $25 million (indexed for inflation), regardless of industry, effective for taxable years beginning after December 31, 2017. This will expand the amount of taxpayers, including trade contractors, who will be permitted to expense non-incidental costs currently required to be capitalized as inventory.

Observation: *General contractors will likely benefit less, as they generally carry construction costs related to each contract on the balance sheet as work-in-process until profit is recognized on the contract in question, at which point the costs and revenues are moved from the balance sheet to the profit and loss statement.*

Taxpayers adopting the new provisions are required to report a change in the taxpayer's accounting method, which will require an adjustment for purposes of IRC Sec. 481.

b. Accounting for Long-Term Contracts

Under pre-Act law, construction contractors were required to generally account for long-term construction contracts (those not expected to be completed within the tax year in which the contract is entered) to use the percentage-of-completion method. Under this method, the contractor reports income based on the percentage of the contract that is completed during the tax year by multiplying the contract price by the percent of total expected contract costs incurred as of the end of the reporting period.

If the taxpayer's average annual gross receipts for the prior three years were $10 million or less, the taxpayer was exempt from using the percentage-of-completion method and used other methods, including the completed-contract method, for contracts expected to be completed within two years. Under the completed-contract method, the taxpayer recognized contract costs and revenues once the contract was completed. A contract was considered completed when one of two tests was met:

- The use and 95% test, where the contract was deemed complete upon the use of the subject matter by the customer for its intended purposes, and at least 95% of the total allocable contract costs attributable to the subject matter were incurred by the taxpayer.

- The final completion and acceptance of the subject matter of the contract, which considered all relevant facts and circumstances.

The Act increases the average annual gross receipts threshold from $10 million to $25 million (indexed for inflation) for contracts entered into after 2017. Contractors with average gross receipts for the prior three years of $25 million or less would be permitted to use the completed-contract method for long-term contracts expected to be completed within two years.

Observation: *These changes should have a significant impact on the construction industry, allowing contractors the ability, if needed, to delay the completion of projects expected to generate significant taxable income, pushing the completion of these projects to a future period. Under the provision, completion of projects generating less taxable income can be accelerated to completion and recognized in the current year.*

c. Changes to the Uniform Capitalization Rules

IRC Sec. 263A governs uniform capitalization ("UNICAP") rules that require taxpayers to capitalize direct costs and certain indirect and service costs, which are normally expensed, as part of inventory for tax purposes. The UNICAP rules generally apply to real or tangible property produced by the taxpayer and real or tangible property acquired by the taxpayer for resale. Under pre-Act law, qualified small business taxpayers with average annual gross receipts during the prior three-year period of $10 million or less were not subject to the UNICAP rules.

The Act law increases the average annual gross receipts threshold from $10 million to $25 million (indexed for inflation), effective for years after December 31, 2017.

Taxpayers adopting the new provisions are required to report a change in the taxpayer's accounting method, which will require an adjustment for purposes of IRC Sec. 481.

Observation: *These changes are consistent with other changes affecting small businesses and will give more businesses the ability to use the cash method of accounting. Many costs previously required to be capitalized will now be deductible as period costs for more taxpayers, without being required to be carried on the balance sheet in inventory.*

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