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The Tax Act at 13 Months: Where Are We?

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TODAY'S AGENDA

An Update on Opportunity Zones.

Limitation on the Deduction for Interest Expense.

The 20% Deduction for Qualified Business Income.

Questions and (Hopefully) Answers.

AN UPDATE ON OPPORTUNITY ZONES

A quick refresher of the basics.

Status update on the guidance process.

Some of the interesting things we're thinking, seeing and hearing.

Gorillas in the room: Some of the big unanswered questions.

OPPORTUNITY ZONES: A QUICK REFRESHER ON THE BASICS

3 fundamental federal tax benefits . . .

- Defer income tax on realized **capital gains**.
- A portion of that deferred gain is forgiven through a **partial basis step-up**.
- **Permanent exclusion** of the gain from the Opportunity Zone investment if held for 10 years.

OPPORTUNITY ZONES: A QUICK REFRESHER ON THE BASICS

Step 1: An investor realizes a capital gain.

Step 2: The investor generally has 180 days to invest the **gain dollars** into a Qualified Opportunity Fund (“QOF”).

Organizing the QOF: formation and certification.

QOF invests in “opportunity zone property.”

- Tangible property (real estate and personal property).
- OZ stock or partnership interests.

QOF must hold 90% of its assets in qualifying opportunity zone property on testing dates.

OPPORTUNITY ZONES: A QUICK REFRESHER ON THE BASICS

“Original use” or “substantial improvement.”

OZ property generally must meet one of 2 tests:

- **Original use** of the property starts with the QOF; or
- The QOF **substantially improves** the property.

Substantial improvement:

- Amount of improvement must exceed acquisition basis.
- QOF has 30 months to meet substantial improvement requirement.

OPPORTUNITY ZONES: A QUICK REFRESHER ON THE BASICS

“Gain dollar” investment gives investor no basis in the QOF.

Investor potentially gets 2 “free” basis step-ups.

- Investor holds QOF interest 5+ years: 10% basis increase.
- Investor holds QOF interest 7+ years: Additional 5% basis increase.

Investor has a “deemed disposition” of the QOF interest on 12/31/2026; tax due 04/15/2027.

Gain is lesser of: (a) original deferred gain; or (b) FMV of the QOF investment.

Basis step-ups generally reduce resulting gain.

Sale of QOF interest after 10+ years **permanently exempt** from tax.

OPPORTUNITY ZONES: STATUS UPDATE ON THE GUIDANCE PROCESS

Round 1 of proposed regulations issued 10/19/18.

Rev. Rul. 2018-29, issued concurrently with the proposed regulations.

Form 8996, Qualified Opportunity Fund, issued in draft; instructions issued this week.

Form 8949, Sales and Other Dispositions of Capital Assets, issued 01/14/2019.

IRS and Treasury promise additional guidance before year end.

Round 2 of proposed regulations and the government's shutdown . . .

OPPORTUNITY ZONES: SOME INTERESTING THINGS . . .

On the ground . . .

- 8,700+ Opportunity Zones, based on 2010 Census data.
- Land values and transactional volume; seller expectations.
- Will the 90/10 rule apply?

“Land”

- Revenue ruling clarifies impact on “substantial improvement” requirement.
- Basis allocation.
- Land need not separately meet “substantial improvement” test.
- 90% qualified OZ property requirement. . .

OPPORTUNITY ZONES: SOME INTERESTING THINGS . . .

Some more on the 90% qualified asset test.

- General rule: Asset cost basis (whew!).
- But, if the QOF has an “applicable financial statement,” that’s the value.
- For most funds, that likely will be GAAP.
- Impairment risk → blow the test?
- Are tax basis financial statements a better option?

OPPORTUNITY ZONES: SOME INTERESTING THINGS . . .

Inside/outside basis issues.

- Profit and loss allocations.
- Operating cash flow distributions (“ . . . Basis immediately before the distribution . . .”)
- Importance of timing – 5- and 7-year basis increases.
- Acquisition debt:
- Outside basis.
- Does not create a “mixed fund.”
- Suspended passive activity losses.
- Importance of transactional and operational modeling!

OPPORTUNITY ZONES: SOME INTERESTING THINGS . . .

Related parties: Acquisitions from related parties generally don't qualify.

- Related party rule has a very broad reach: 20% relationship under §§707(b) or 267(b).
- What's the measurement date?

Carried interests.

- Do they qualify for OZ benefits?
- Can the waterfall taint a transaction under the related party rule?

OPPORTUNITY ZONES: SOME INTERESTING THINGS . . .

Entity tiering – should it make a difference?

- Direct investment doesn't allow for the working capital safe harbor.
- Direct investment doesn't allow for the “substantially all” reduction in the 90% qualifying asset test (the “63% solution”).
- Why should this make a difference?

OPPORTUNITY ZONES: GORILLAS IN THE ROOM - UNANSWERED QUESTIONS

Debt refinancing and distributions of refinancing proceeds.

Capital recycling.

- Investor can dispose of QOF investment and reinvest in another QOF within 180 days.
- Can the QOF dispose of its investment and reinvest with continued deferral?

Ultimate disposition.

- After 10+ year hold, investor sells/exchanges **QOF interest** with no tax.
- What if the QOF holds multiple assets?
- Sale of interests versus assets.
- Bulk sale versus one-off dispositions?

OPPORTUNITY ZONES: GORILLAS IN THE ROOM - UNANSWERED QUESTIONS

Qualified Opportunity Zone Business Property.

- Among other requirements: “Original use” or “substantial improvement.”
- Definition of original use is “reserved.”
- Tax law generally defines original use as placed in service date.
- Investors concerned about development risk.
- Build-to-suit delivery just prior to certificate of occupancy?

OPPORTUNITY ZONES: GORILLAS IN THE ROOM - UNANSWERED QUESTIONS

Qualified Opportunity Zone Business.

- Among other things, a QOZB must actively conduct a trade or business.
- The rules on “active conduct of a trade or business” are “reserved.”
- What’s the appropriate definition?
- New Markets Tax Credit: “reasonably expects . . . to generate revenues within 3 years of investment.”
- Do all forms of rent qualify? What about NNN?
- Longstanding – and confusing – case law and administrative guidance.

LIMITATION ON THE DEDUCTION FOR INTEREST EXPENSE.

Prior law: Interest expense essentially deductible in full. Any limitations were manageable.

- Historic debt/equity principles.
- Limited “earnings stripping” rules.

Result: Leverage largely was a business decision, premised on:

- Availability of capital.
- Cost of capital
- Willingness to accept leverage and economic cycle risk.

Exception: Timing of deduction limited by uniform capitalization rules.

LIMITATION ON THE DEDUCTION FOR INTEREST EXPENSE

2017 Act general rule: Business interest expense limited to 30% of the sum of–

- Business interest income, plus
- “Adjusted taxable income.”
- Through 2021: Essentially EBITDA.
- After 2021: Essentially EBIT.

30% limitation does not apply to electing businesses engaged in “real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage.”

Cost of “Qualified Real Property Trade or Business” election? Mandatory ADS.

LIMITATION ON THE DEDUCTION FOR INTEREST EXPENSE

Thanksgiving gift: IRS issued proposed guidance 11/27/2018 – 439 pages . . .

Regulatory safe harbor for certain REITs – REIT level election.

Pass-thru entities: Partnership level calculation, but complex process.

Disallowed interest carries forward and retains its character in the next year.

Exemption for certain small business – average annual gross receipts < \$25 million.

Does the election make sense? Run the numbers . . .

LIMITATION ON THE DEDUCTION FOR INTEREST EXPENSE

Let's consider a (really) simple example . . .

Investment Partners is focused on multifamily rentals in their local market.

Purchase new multifamily property for \$10MM, allocated \$8MM to building, \$2MM to land.

Acquisition funded with \$4MM equity, \$6MM mortgage @ 6% interest.

Stabilized NOI anticipated @ 5%, or \$500,000.

Does Investment Partners elect QRPTB?

LIMITATION ON THE DEDUCTION FOR INTEREST EXPENSE

Line Item or Description	Election 40 Year	Elect 30 Year	No Election 27½ Year
NOI (proxy for business income)(8% of acquisition cost)(A)	\$500,000	\$500,000	\$500,000
Depreciation Expense (\$8MM basis in improvements)(B)	(200,000)	(267,000)	(291,000)
Interest Expense (Gross interest = \$6MM x 6%)(C)	<u>(360,000)</u>	<u>(360,000)</u>	<u>(240,000)</u>
Taxable Income (or loss) (D)	<u>\$(60,000)</u>	<u>\$(127,000)</u>	<u>\$(31,000)</u>
Reconciliation [Depreciation Δ (\$91,000) + Interest Δ \$120,000] [Depreciation Δ (\$24,000 + Interest Δ \$120,000)]	<u>\$(29,000)</u>	<u>\$(96,000)</u>	
Disallowed Interest Expense Carried Forward			<u>\$120,000</u>

QUALIFIED BUSINESS INCOME DEDUCTION: STATUTORY OVERVIEW

20% “bonus” deduction for “qualified business income.”

Available to taxpayers other than C corporations.

Effective maximum tax rate of 29.6% (80% x 37%).

Generally applies to income from active conduct of a trade or business.

Limitation: Greater of –

- 50% of W-2 wages from the qualified trade or business; or
- 25% of W-2 wages from the qualified trade or business +
- 2.5% of original purchase price of all “qualified property.”

QUALIFIED BUSINESS INCOME DEDUCTION: STATUTORY OVERVIEW

Alternative test of W-2 wages.

- 25% of W-2 wages from the qualified trade or business +
- 2.5% of original purchase price of all “qualified property.”

Technically, statutory wording: “unadjusted basis immediately after acquisition,” or “UBIA.”

Proposed regulations: Reduce UBIA in tax-free transactions, such as like-kind exchanges and partnership contributions.

Final regulations: No UBIA reduction for tax-free transactions.

QUALIFIED BUSINESS INCOME DEDUCTION: THE GUIDANCE TRAIL

Robust IRS and Treasury guidance, in chronological order.

Initial proposed regulations – 08/2018 (184 pages)

4-part guidance issued 01/18/2019:

- Final regulations (247 pages);
- Another round of proposed regulations (39 pages);
- Notice 2019-07; and
- Rev. Proc. 2019-11.

“That’s all nice, but what does it mean?”

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

Only a “trade or business” qualifies.

- Determined at the entity level.
- Premised on case law – inherently factual.
- Taxpayer’s motive
- “Regular, continuous and considerable.”
- Regulations explicitly reject test of taxpayer’s level of activity (like the passive activity test).
- Creates a fundamental challenge for tenancy-in-common interests.

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

Notice 2019-07: Proposed revenue procedure rental real estate safe harbor.

Similar properties can be aggregated (“enterprises”) or treated separately.

Commercial and residential real estate cannot be combined.

Rental real estate constitutes a trade or business, solely for the QBI rules, if:

- Maintain separate books and records for income/expense of each rental real estate enterprise.
- “Hours of services” test satisfied.
- Years before 2023: 250 hours/year.
- Years after 2022: 250 hours/year for any 3 of 5 consecutive years.
- Robust contemporaneous record keeping for hours of service.

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

“Rental services” includes:

- Advertising to rent or lease.
- Negotiating and executing leases.
- Tenant checks.
- Property operations, repair and maintenance.
- Real estate management.
- Purchasing of materials.
- Supervising employees or independent contractors.

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

“Rental services” excludes:

- Financing.
- Property acquisition.
- Financial or operational reviews.
- Capital improvement planning, management or construction.
- Travel time.

Who’s time counts? Owners, employees, agents and/or independent contractors.

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

Pass-thru entities can qualify for the safe harbor.

Some real estate simply excluded from the proposed revenue procedure safe harbor:

- Property used by the taxpayer as a residence for any part of the year under IRC §280A.
- Triple net-leased property.

Something new: §199A attestation statement included with the annual tax return.

- Signed by the taxpayer, under penalties of perjury.
- Signer “must have personal knowledge of the facts and circumstances related to the statement.”

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

Fall outside the proposed safe harbor?

- Rental real estate can still qualify for QBI deduction.
- Meet the definition of a “trade or business” in the regulations (Reg. §1.199A-1(b)(14)).

QUALIFIED BUSINESS INCOME DEDUCTION: HIGHLIGHTS

W-2 wages:

Rev. Proc. 2019-11 guidance.

Three alternative methods, including a simplified method.

Guaranteed payments still don't count.

Q+A