



INSIGHTS FROM THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

THE POTENTIAL IMPACTS OF TAX REFORM TO REITS AND REAL ESTATE & CONSTRUCTION COMPANIES

On December 22, President Trump signed the tax reform bill, "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," into law, marking the largest change to U.S. tax policy since the 1980s.

With most of the provisions already in effect, it's important that real estate and construction executives review the changes that occurred during the conference process to understand the impact to their companies.

To help them navigate the key provisions affecting the real estate and construction industries, we've summarized the top considerations and implications below.

PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Reduce the corporate tax rate	Reduces the top corporate tax rate from 35 to 21%. Effective date: Effective for taxable years after Dec. 31, 2017.	Industry View: Positive What's at stake: Reduced tax burden for real estate and construction companies.	Industry View: Positive What's at stake: REITs won't see direct tax relief, but REITs that have taxable REIT subsidiaries (TRS) will see a positive impact.
Lower Taxes on Pass-Through Business Income	Creates a deduction available to pass-through filers of 20% on pass-through income subject to certain limitations. This includes "qualified real estate investment dividends." Qualified REIT dividends do not include any portion of a dividend to which capital gain tax rates are applied.	Industry View: Positive What's at stake: Reduced tax burden for real estate and construction companies structured as pass-through entities. This is a big win for real estate.	Industry View: Positive What's at stake: Reduces the overall effective tax rate on REIT dividends received by individuals.

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<p>Changes to the Depreciation of Commercial Assets</p>	<p>Eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 15-year recovery period for qualified improvement property, unchanged from current law. Depreciable life of commercial assets is unchanged from current law.</p> <p>Retains the existing 40-year alternative depreciation system (ADS) cost recovery period for nonresidential real property, but would contain a reduced 30-year ADS period for residential property and a 20-year ADS period for qualified property improvement.</p> <p>Expands bonus depreciation for new qualified property investments to 100% from 50%. Applies to both new and used property.</p> <p>Effective date: Effective for property placed in service</p>	<p>Industry View: Positive-to-Neutral</p> <p>What's at stake: The impact of this provision differs based on a real estate company's cost recovery structures.</p> <p>The change is positive for real estate companies that rely on full expensing for personal property and new qualified improvement property with a 15-year recovery period and bonus depreciation.</p> <p>For real estate companies with cost recovery structures under regular depreciation, this change is neutral.</p> <p>Taxpayers that have elected to use the real property trade or business exception to the interest limitation would be required to use the longer ADS periods for depreciation.</p> <p>Additionally, if the property is depreciated under ADS, it is not eligible for a bonus.</p>	<p>Industry View: Positive-to-Neutral</p> <p>What's at stake: Since REITs are limited in the amount of tangible personal property owned, the expensing for equipment is not a huge win for REITs. Furthermore, REITs generally elect ADS for tax depreciation purposes, so it would continue to depreciate over the longer lives, with the exception of REITs that hold residential property.</p> <p>REITs that have elected to use the real property trade or business exception to the interest limitation would be required to use the longer ADS periods for depreciation and would not be eligible for the bonus.</p> <p>There is no real impact from bonus depreciation as REITs generally elect out of bonus depreciation.</p>
<p>Expansion of Section 179 deduction</p>	<p>Expands the definition of qualified real property to include improvements to nonresidential real property including roofs, heating, ventilation, air conditioning, fire protection, alarm systems, and security systems.</p> <p>Increases the amount companies can deduct in purchases from the current ceiling of \$510,000 to \$1 million and increases the phase out threshold to \$2.5 million.</p>	<p>Industry View: Positive</p> <p>What's at stake: Eases the tax burden of financing property improvements.</p>	<p>Industry View: Neutral</p> <p>There is no real impact from the increased Section 179 deduction as REITs generally do not elect Section 179 expensing.</p>

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Limitations on Interest Deductibility	<p>Revises Section 163(j) and expands its applicability to every business, including partnerships. Generally, caps deduction of interest expense to interest income plus 30% of adjusted taxable income, which is computed without regard to deductions allowable for depreciation, amortization, or depletion. Disallowed interest is carried forward indefinitely. Contains a small business exception.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Neutral</p> <p>What's at stake: Real property trades or businesses are allowed to elect out of the limitation since they do not benefit from full expensing provided to tangible personal property.</p> <p>Generally, any real property trade or business, including ones conducted by widely-held corporations and REITs, may be considered real property trades or business. Taxpayers electing to use the real property trade or business exception to the limitation on interest deductibility would be required to use ADS methods for depreciation for residential, nonresidential, and qualified improvement property.</p>	<p>Industry View: Neutral</p> <p>What's at stake: Consistent with the impact to real estate and construction companies. The limitation would not generally apply to REITs to the extent that they elect out.</p>
Eliminate ability to carryback Net Operating Losses (NOLs)	<p>Generally, eliminates taxpayers' abilities to carryback NOLs, and will limit the use of NOLs to 80% of taxable income. NOLs will no longer have an expiration period.</p> <p>Effective date: The elimination of carrybacks is effective in taxable years after Dec. 31, 2017.</p>	<p>Industry View: Negative</p> <p>What's at stake: Potential cash flow obstacle.</p>	<p>Industry View: Neutral-to-Negative</p> <p>What's at stake: REITs are not taxpaying entities and most likely would only have NOL carryforwards if they have historically been operating at a loss. For REITs that have been historically operating at a loss, this provision would have a negative impact.</p>
Limit 1031 "like-kind" exchanges to real property	<p>Eliminates the exemption for like-kind exchanges <i>except</i> for real property.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p> <p>An exception is provided if the property in the exchange is disposed of or received by the taxpayer on or before December 31, 2017.</p>	<p>Industry View: Neutral-to-Negative</p> <p>What's at stake: No material impact for straight real estate sales or replacements such as land for land. However, many transactions involve multi-asset exchanges where a taxpayer sells both real and personal property. Without the deferral for personal property, taxpayers are more likely to recognize some amount of taxable gain. This will put pressure on the allocation of purchase price to minimize potential taxable gain. Additionally, taxpayers may avoid an exchange depending on the amount of recognized taxable gain attributable to personal property.</p>	<p>Industry View: Neutral-to-Negative</p> <p>What's at stake: Same challenges with multi-asset exchanges.</p>

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Limits Mortgage & Property Tax Deductions	<p>Under current law, taxpayers can take a combined acquisition and home equity indebtedness interest expense deduction on \$1,100,000 of debt. The new legislation only permits the deduction of interest on acquisition indebtedness not exceeding \$750,000 and repeals the additional interest deduction for home equity indebtedness through 2025.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p> <p>Debt incurred on or before Dec. 15, 2017, is grandfathered into the limitations under current law. Taxpayers who entered into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchase such residence before April 1, 2018, are also eligible for the current higher limitations.</p>	<p>Industry View: Neutral-to-Positive</p> <p>What's at stake: For commercial real estate and construction companies, this could be a positive in the long term. The limited deductions could reduce the attractiveness of homeownership, which could lead to increased demand for single and multifamily rentals.</p> <p>However, homebuilders and residential land developers may see a reduction in demand.</p>	<p>Industry View: Neutral-to-Positive</p> <p>What's at stake: For REITs that hold multifamily rental properties, this could be a positive in the long term. The limited deductions could reduce the attractiveness of homeownership, which could lead to increased demand for single and multifamily rentals.</p>
Scale Back the State and Local Tax Deduction for Individuals	<p>Limits the itemized deduction for state and local taxes to \$10,000 for the aggregate sum of real property taxes, personal property taxes, and either state or local income taxes or state and local sales tax. Currently, each of those state and local taxes is a separate itemized deduction with no limitation.</p> <p>Effective date: The bill prohibits a deduction in excess of the \$10,000 limitation for 2018 state and local taxes actually paid in 2017.</p>	<p>Industry View: Neutral-to-Positive</p> <p>What's at stake: Similar to the above, could reduce the attractiveness of homeownership in high-tax states, which could lead to increased demand for single and multifamily rentals in those areas.</p> <p>However, homebuilders and residential land developers may see a reduction in demand.</p>	<p>Industry View: Neutral-to-Positive</p> <p>What's at stake: Similar to the above, could reduce the attractiveness of homeownership in high-tax states, which could lead to increased demand for single and multifamily rentals in those areas—a boon to REITs in the multifamily rental space.</p>
Carried Interest Changes	<p>Carry from investments held for under three years will be taxed at the higher ordinary income rate rather than the lower capital gains rate. Previously, the threshold was one year. The capital gains tax rate was kept as is, at a maximum of 20%.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Negative</p> <p>What's at stake: This would potentially have a negative impact for service partners of real estate investment funds that sell property that has less than a three-year holding period or service partners who sell their partnership interest without holding it more than three years.</p>	<p>Industry View: Negative-to-Neutral</p> <p>What's at stake: This would potentially have a negative impact on service partners of REIT's lower tier partnerships. However, it would likely not affect the REIT itself as corporations are not subject to this provision.</p>

PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Expansion of Cash Method of Accounting	<p>Raises the average annual gross receipts threshold from \$5 million to \$25 million for C corporations, partnerships with a C corporation partner, or a tax-exempt trust or corporation with unrelated business income, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Positive</p> <p>What's at stake: Reduced tax and recordkeeping burden for smaller real estate and construction companies.</p>	<p>Industry View: Positive</p> <p>What's at stake: This provision is unlikely to affect REITs since most REITs would still likely be over the increased threshold limits. However, smaller private REITs may see reduced tax and recordkeeping burdens from this provision.</p>
Expansion of Exemption from Percentage-of-Completion Method (PCM)	<p>Raises the average annual gross receipts threshold from \$10 million to \$25 million to exempt small construction contracts from the requirement to use the PCM. Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected to be completed within 2 years of contract commencement and (2) is performed by a taxpayer who meets the \$25 million gross receipts test.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Positive</p> <p>What's at stake: Reduced tax and recordkeeping burden for smaller real estate and construction companies. Increased ability to use completed contract method, exempt-contract percentage-of-completion method, or any other permissible method.</p>	<p>Industry View: Neutral</p> <p>What's at stake: This provision is unlikely to affect REITs, since REITs generally don't enter into long-term contracts due to restrictions on the type of income they can generate. However, REITs that have taxable REIT subsidiaries (TRS) that do enter into long-term contracts could potentially benefit from this provision.</p>
Exemption from Requirement to Keep Inventory	<p>Exempts taxpayers that meet the \$25 million average annual gross receipts threshold from the requirement to account for inventories under Section 471. Those taxpayers may use a method of accounting for inventories that either (1) treats inventories as non-incident materials and supplies or (2) conforms to the taxpayer's financial accounting treatment of inventories.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Neutral-to-Positive</p> <p>What's at stake: Most real estate companies don't generally have inventories. However, certain segments such as hospitality have limited inventories and may see reduced tax and recordkeeping burden as a result of this provision.</p>	<p>Industry View: Neutral</p> <p>What's at stake: This provision is unlikely to affect REITs since REITs generally don't carry inventory due to restrictions on the type of income they can generate. However, REITs that have taxable REIT subsidiaries (TRS) that do have inventory could potentially benefit from this provision.</p>

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Expansion of Exemption from Uniform Capitalization Rules (UNICAP)	<p>Raises the average annual gross receipts threshold from \$10 million to \$25 million for any resellers (as well as producers) to be exempted from the application of UNICAP under Section 263A.</p> <p>Effective date: Effective for taxable years after Dec. 31, 2017.</p>	<p>Industry View: Positive</p> <p>What's at stake: Reduced tax and recordkeeping burden for smaller real estate and construction companies.</p>	<p>Industry View: Neutral</p> <p>What's at stake: This provision is unlikely to affect REITs since most REITs would still likely be over the increased threshold limits. However, smaller private REITs may see reduced tax and recordkeeping burdens from this provision.</p>

TACKLING TAX REFORM: 5 INITIAL STEPS COMPANIES CAN TAKE NOW

1. **Assess impact.** Tax professionals will likely need to review the bill text manually and measure their company's specific circumstances against it to assess the impact of each provision, as well as the holistic effect on their company's bottom line.
2. **Assemble a team.** While the heaviest burden may fall on accountants, companies and their finance teams will have an important role to play to gather all the necessary data.
3. **Dig into the data.** Assessing the impact of tax reform requires a substantial amount of data to be readily available. Companies need to move from modeling the impact of tax reform to focusing on data collection and computations as soon as possible.
4. **Establish priorities.** When considering which aspects of tax reform to tackle first, focus on the areas that could have the greatest impact on your company. For REITs, real estate and construction companies, landmark provisions include: changes that could influence entity choice (reduced corporate tax rates and lower taxes on pass-through business income) and the elimination of NOL carrybacks. As a preliminary step, taxpayers operating in the real estate and construction industries should consider their overall choice of entity to minimize tax liabilities under the new law.
5. **Initiate tax reform conversations with your tax advisor.** Tax reform of this magnitude is the biggest change we've seen in a generation, and will require intense focus to understand not only how the changes apply at a federal level, but also navigate the ripple effect this is likely to have on state taxation as well.

BDO REAL ESTATE & CONSTRUCTION PRACTICE

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