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THE NEWSLETTER OF THE BDO REAL ESTATE & CONSTRUCTION PRACTICE

REAL ESTATE & CONSTRUCTION MONITOR

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.

BDO REAL ESTATE AND CONSTRUCTION PRACTICE

BDO's Real Estate and Construction practice consists of multi-disciplined professionals who are well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

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IMPACTS OF TAX REFORM

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.
Changes to the Depreciation of Commercial Assets	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. 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. Expands bonus depreciation for new qualified property investments to 100% from 50%. Applies to both new and used property. **Effective date:** Effective for property placed in service	**Industry View:** Positive-to-Neutral ***What's at stake:*** The impact of this provision differs based on a real estate company's cost recovery structures. 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. For real estate companies with cost recovery structures under regular depreciation, this change is neutral. 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. Additionally, if the property is depreciated under ADS, it is not eligible for a bonus.	**Industry View:** Positive-to-Neutral ***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. 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. There is no real impact from bonus depreciation as REITs generally elect out of bonus depreciation.
Expansion of Section 179 deduction	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. 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.	**Industry View:** Positive ***What's at stake:*** Eases the tax burden of financing property improvements.	**Industry View:** Neutral There is no real impact from the increased Section 179 deduction as REITs generally do not elect Section 179 expensing.

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PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Limitations on Interest Deductibility	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. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Neutral ***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. 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.	**Industry View:** Neutral ***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.
Eliminate ability to carryback Net Operating Losses (NOLs)	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. **Effective date:** The elimination of carrybacks is effective in taxable years after Dec. 31, 2017.	**Industry View:** Negative ***What's at stake:*** Potential cash flow obstacle.	**Industry View:** Neutral-to-Negative ***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.
Limit 1031 "like-kind" exchanges to real property	Eliminates the exemption for like-kind exchanges *except* for real property. **Effective date:** Effective for taxable years after Dec. 31, 2017. An exception is provided if the property in the exchange is disposed of or received by the taxpayer on or before December 31, 2017.	**Industry View:** Neutral-to-Negative ***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.	**Industry View:** Neutral-to-Negative ***What's at stake:*** Same challenges with multi-asset exchanges.

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PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Limits Mortgage & Property Tax Deductions	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. **Effective date:** Effective for taxable years after Dec. 31, 2017. 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.	**Industry View:** Neutral-to-Positive ***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. However, homebuilders and residential land developers may see a reduction in demand.	**Industry View:** Neutral-to-Positive ***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.
Scale Back the State and Local Tax Deduction for Individuals	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. **Effective date:** The bill prohibits a deduction in excess of the $10,000 limitation for 2018 state and local taxes actually paid in 2017.	**Industry View:** Neutral-to-Positive ***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. However, homebuilders and residential land developers may see a reduction in demand.	**Industry View:** Neutral-to-Positive ***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.
Carried Interest Changes	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%. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Negative ***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.	**Industry View:** Negative-to-Neutral ***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.

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PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Expansion of Cash Method of Accounting	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. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Positive ***What's at stake:*** Reduced tax and recordkeeping burden for smaller real estate and construction companies.	**Industry View:** Positive ***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.
Expansion of Exemption from Percentage-of-Completion Method (PCM)	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. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Positive ***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.	**Industry View:** Neutral ***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.
Exemption from Requirement to Keep Inventory	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-incidental materials and supplies or (2) conforms to the taxpayer's financial accounting treatment of inventories. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Neutral-to-Positive ***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.	**Industry View:** Neutral ***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.

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PROVISION	SUMMARY OF CHANGES	IMPLICATIONS FOR REAL ESTATE AND CONSTRUCTION COMPANIES	IMPLICATIONS FOR REITS
Expansion of Exemption from Uniform Capitalization Rules (UNICAP)	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. **Effective date:** Effective for taxable years after Dec. 31, 2017.	**Industry View:** Positive ***What's at stake:*** Reduced tax and recordkeeping burden for smaller real estate and construction companies.	**Industry View:** Neutral ***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.

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.

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ECONOMIC TURBULENCE AHEAD? GLOBAL REITS CONFIDENT THEY'LL WEATHER THE STORM

By Stuart Eisenberg

"What goes up, must come down."

That familiar refrain echoes in the back of economists' mind every time the Dow soars to new record-breaking heights, a quasi-regular occurrence last year. After more than **70 record closes** in 2017, the markets fell in early February and major indices posted their worst weekly declines in more than two years. REITs declined in tandem, with the FTSE Nareit All Equity REITs Index hitting its **lowest level** in 14 months.

Steep declines were short-lived, and the market started posting gains within the week. While indexes bucked the downturn in the immediate term, the dip is expected to usher in a period of increased volatility to an uncharacteristically calm market.

The culprit for the sudden drop? A culmination of economic factors stirred the pot with two core concerns bubbling to the surface: interest rates and inflation. Tax cuts, a plan for increased federal spending, and strong monthly wage growth in January reported by the U.S. Bureau of Labor Department stoked investors' inflation anxieties. The 10-year Treasury note—an important indicator for the market—also reached a four-year high of **2.88 percent**.

In an environment with newly-ignited market jitters, what is the overall sentiment for REITs? Data suggests that the global real estate market could be reaching the end of its upward climb as well. More than two-thirds of global REIT executives (68 percent) felt that the real estate cycle in their market was at or past its peak, according to the **BDO Global REIT Report**. The recently published report takes the pulse of the international REIT landscape, surveying 35 REIT executives at companies with a combined market capitalization of $130 billion.

Continued low yields for prime assets and interest rate concerns are likely contributing to the expectation that real estate is reaching its peak. Two-thirds of the global respondents said the movement of interest rates would have the greatest short-term impact on REITs. The U.S. Federal Reserve forecasted three gradual rate increases throughout the remainder of the year.

Interest rate increases are almost always a double-edged sword for REITs. The potential negatives include steeper financing costs and depreciation of real estate values. Rising rates can also lead investors to reallocate their shares to bonds and other assets whose returns see a bump with increased rates. In response to the market movement and expected rate increases, some publicly-traded REITs have started refinancing debt and taking other measures to reduce their exposure.

Conversely, the Federal Reserve sets interest rate programs based on the overall health of the economy and rate increases suggest renewed economic confidence. An environment of strong economic fundamentals is overwhelmingly positive for REITs, leading to increased rents and occupancy rates that could offset the negatives.

Despite a consensus that the good times can't keep rolling forever, 87 percent of REIT executives expressed confidence in their business prospects and ability to meet any challenges or market shifts head on. REITs have demonstrated steady growth over the last decade. According to NAREIT, the sector's market capitalization more than tripled in that span, reaching $1 trillion. Nearly half of the global REIT executives (46 percent) expect continued growth in the next two years.

The bottom line for the industry? Come what may, REITs are ready.

This article originally ran in Commercial Property Executive. You can access that article ***here****.*

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TAX REFORM AND PARTNERSHIPS: WHAT YOU NEED TO KNOW

By Jeffrey N. Bilsky & William J. Hodges

The new tax law contains a number of provisions that will have a significant impact on partnerships and their partners.

While businesses across many different industries are structured as partnerships, the structure is particularly common in the real estate and private equity sectors. The following discussion outlines several key partnership-related provisions and highlights several consequences these provisions may have on partners both in terms of annual operations as well as future capital transactions. The specific partnership-related tax reform provisions include:

- Deduction for Qualified Business Income of Pass-Through Entities (Section 199A);
- Recharacterization of Certain Long-Term Capital Gains (Sections 1061 and 83);
- Taxation of Gain on the Sale of Partnership Interest by a Foreign Person (Sections 864(c) and 1446);
- Repeal of Technical Termination Rules under Section 708(b)(1)(B);
- Modification of the Definition of Substantial Built-in Loss in the Case of a Transfer of a Partnership Interest (Section 743(d));
- Charitable Contributions and Foreign Taxes Taken into Account in Determining Basis Limitation (Section 704(d)); and
- Like-Kind Exchanges of Real Property under Section 1031.

DEDUCTION FOR QUALIFIED BUSINESS INCOME OF PASS-THROUGH ENTITIES (SECTION 199A)

General Rule

An individual partner's distributive share of ordinary business income is generally subject to tax at the individual's applicable income tax rate. Under the new tax law, the highest individual income tax rate is 37 percent. The law can effectively reduce the income tax rate applicable to an individual partner's distributive share of qualified trade or business income to a maximum rate of 29.6 percent. This rate reduction is achieved by providing taxpayers other than corporations a deduction for each taxable year equal to the sum of:

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1. The lesser of (A) the taxpayer's "combined qualified business income amount" or (B) 20 percent of the excess of the taxpayer's taxable income for the taxable year over any net capital gain plus the aggregate amount of qualified cooperative dividends, plus
2. The lesser of (A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year or (B) the taxpayer's taxable income (reduced by the net capital gain).

A taxpayer's combined qualified business income amount is generally equal to the sum of (A) 20 percent of the taxpayer's qualified business income (QBI) with respect to each qualified trade or business plus (B) 20 percent of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income.

Limitation Based on Wages & Capital

The portion of the deduction attributable to 20 percent of the taxpayer's QBI cannot exceed the greater of (1) 50 percent of their share of W-2 Wages paid with respect to the QBI or (2) the sum of 25 percent of their share of W-2 Wages plus 2.5 percent of the unadjusted basis of qualified property determined immediately after its acquisition of such qualified property. This limitation does not apply to taxpayers with taxable income not exceeding $315,000 (joint filers) or $157,500 (other filers). The limitation is phased-in for taxpayers with taxable income exceeding these amounts over ranges of $100,000 and $50,000, respectively.

The term W-2 Wages is defined to mean the sum of total wages subject to wage withholding, elective deferrals, and deferred compensation paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer. W-2 Wages do not include any such amount that is not properly allocable to qualified business income.

Definition of Qualified Property

The term qualified property is generally defined to mean, with respect to any qualified trade or business, tangible property of a character subject to depreciation under section 167 that is (i) held by and available for use in the qualified trade or business at the close of the taxable year, (ii) used at any point during the taxable year in the production of QBI, and (iii) the depreciable period for which has not ended before the close of the taxable year. Importantly, the new tax law defines the term "depreciable period" to mean the later of 10 years from the original placed in-service date or the last day of the last full year in the applicable recovery period determined under section 168.

Illustration of W-2 Wages & Capital Limitation

Assume a taxpayer (who files a joint tax return and has taxable income of more than $415,000) operates a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. Further, assume the taxpayer generates $20,000 of QBI resulting in a QBI deduction amount of $4,000.

The Section 199A(b)(2)(B) limitation is the greater of (a) 50 percent of W-2 wages, or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition ($100,000 * 2.5 percent = $2,500). The amount of the W-2 Wages & Capital Limitation for the year is $2,500. Therefore, the taxpayer would be entitled to a Section 199A deduction equal to $2,500 (the lesser of $4,000 or $2,500).

If the taxpayer's taxable income for the year is $375,000 (an amount above the $315,000 threshold but below $415,000), the Section 199A(b)(2)(B) limitation is subject to phase-in. The phase-in occurs over $100,000 for joint filing taxpayers, resulting in a phase-in percentage equal to 60 percent (($375,000 – $315,000)/$100,000). Under Section 199A(b)(3)(B)(iii), the taxpayer's allowable deduction is $3,100 ($4,000 – (($4,000 – $2,500) * 60 percent)).

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As a general rule, the phase-in percentage of taxpayers filing a joint return will be one percent per $1,000 of taxable income in excess of $315,000. For other taxpayers, the phase-in percentage is two percent per $1,000 of taxable income in excess of $157,500.

Definition of Qualified Business Income

QBI includes the net domestic business taxable income, gain, deduction, and loss with respect to any qualified trade or business. QBI specifically excludes the following items of income, gain, deduction, or loss: (1) Investment-type income such as dividends, investment interest income, short-term & long-term capital gains, commodities gains, foreign currency gains, and similar items; (2) Any Section 707(c) guaranteed payments paid in compensation for services performed by the partner to the partnership; (3) Section 707(a) payments for services rendered with respect to the trade or business; or (4) Qualified REIT dividends, qualified cooperative dividends, or qualified PTP income.

Carryover of Losses

The new tax law provides rules regarding the treatment of losses generated in connection with a taxpayer's qualified trades or businesses. Under these rules, if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year. In practice, this will mean that a taxpayer's net loss generated in Year 1 will be carried forward and reduce the subsequent year's section 199A deduction.

For example, assume a taxpayer generates a $1,000 loss from a qualified trade or business during the year-ended December 31, 2018. During the year-ended December 31, 2019, the taxpayer generates $1,500 of qualified business income. Under the carryover loss rule, and ignoring other limitations, the taxpayer would calculate a Section 199A deduction of $100 as follows:

Section 199A Deduction	Amount	Deduction Percentage	Allowable Deduction
Qualified Business Income	$1,500	20%	$300
Carryover Loss Amount	($1,000)	20%	($200)
Total Section 199A Deduction			**$100**

Definition of Qualified Trade or Business

A qualified trade or business includes any trade or business other than a "specified service trade or business" or the trade or business of performing services as an employee. A specified service trade or business includes any business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, 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, and investing and investment management, trade, or dealing in securities, partnership interests, or commodities. The specified service trade or business exclusion does not apply to the extent the taxpayer's taxable income does not exceed certain thresholds: $415,000 (joint filers) and $207,500 (other filers). Application of this exclusion is phased-in for income exceeding $315,000 and $157,500, respectively.

Illustration of Specified Services Exception Calculation

Assume the taxpayer has taxable income of $375,000, of which $200,000 is attributable to a specified services trade or business. Under Section 199A(d)(3), the taxpayer has an applicable percentage of 40 percent (1 – (($375,000 – $315,000) / $100,000)). Therefore, in determining includible QBI the taxpayer takes into account only $80,000 ($200,000 * 40 percent).

Special Rules for Partnerships & S Corporations

The new tax law provides that the Section 199A deduction is to be applied at the partner or shareholder level. Consequently, each partner or shareholder is required to take into account each person's allocable share of QBI. Additionally, each partner or shareholder is treated as having W-2 wages and qualified property in an amount equal to such person's allocable share of the W-2 wages and qualified property of the partnership or S Corporation.

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Comprehensive Example

Taxpayer "A" files a joint return reporting taxable income of $375,000 (determined without regard to any potential Section 199A deduction). A is allocated business income, W-2 Wages, and unadjusted basis of qualified property, respectively, from the three separate business activities summarized in Table 1:

TABLE 1 SUMMARY DATA	Activity #1	Activity #2	Activity #3
Business Income	150,000	35,000	30,000
W-2 Wages	100,000	10,000	10,000
Qualified Property	1,500,000	75,000	100,000

Activities #1 and #2 meet the definition of a qualified trade or business under Section 199A(d)(1). Activity #3, however, is a specified services business within the meaning of Section 199A(d)(2). Additionally, during the year, A received qualified REIT dividends ($25,000), qualified PTP income ($35,000), and net capital gains ($15,000). Finally, A has a net carryover qualified business loss of $100,000. Based on these facts, A will be entitled to a Section 199A deduction in the amount of $29,960. The calculation of this deduction pursuant to Section 199A(a) is illustrated in Table 2.

TABLE 2 CALCULATION OF SECTION A QUALIFIED BUSINESS INCOME DEDUCTION		Deduction Amount
Sum of:		
(1) Lesser of (A) or (B)		
(A) Combined QBI (see Table 3)	$29,960	
(B) 20% of Excess T.I. over Capital Gain plus Qual. Coop. Div.	$72,000	$29,960
(1) Lesser of (A) or (B)		
(A) 20% of Qualified Coop. Div.	$0	
(B) Taxable Income (reduced by net capital gain)	$360,000	$0
Section 199A Deduction (sum of lesser of (1) or (2))		**$29,960**

TABLE 3 COMBINED QBI AMOUNT	
Qualified trade or business amount – Activity 1	$30,000
Qualified trade or business amount – Activity 2	5,800
Qualified trade or business amount – Activity 3	2,160
Qualified trade or business amount – Carryover Loss	(20,000)
Net qualified trade or business amount (see Table 4)	$17,960
Qualified REIT dividends	5,000
Qualified PTP income	7,000
Section 199A(a) Combined QBI Amount	**$29,960**

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TABLE 4 DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS	Activity #1	Activity #2	Activity #3	Carryover QBL	Total
Net Qualified Business Income per Qualified Trade or Business	150,000	35,000	30,000	-100,000	115,000
Reduction for Specified Services Trade or Business Income*	0	0	-18,000	0	-18,000
Allowable Qualified Business Income per Qualified Trade or Business	150,000	35,000	12,000	-100,000	97,000
Deduction Percentage	20%	20%	20%	20%	20%
Qualified Trade or Business Amount (Pre-Wages and Capital Limitation)	30,000	7,000	2,400	-20,000	19,400
Limitation Based on Wages & Capital	0	-1,200	-240	0	-1,440
Qualified Trade or Business Amount	**30,000**	**5,800**	**2,160**	**-20,000**	**17,960**

**Application of the applicable percentage with respect to a specified service business is being illustrated as a reduction in QBI*

Discussion of Relevant Components in Illustrative Example

20 Percent of Qualified REIT Dividends & Qualified PTP Income

A generated $25,000 of qualified REIT dividends and $35,000 of qualified PTP income. Pursuant to Section 199A(b)(1)(B), combined QBI includes 20 percent of the aggregate amount of qualified REIT dividends and qualified PTP income of the taxpayer for the taxable year. Consequently, A's combined QBI will be increased by $12,000 (($25,000 + $35,000) * 20 percent).

Qualified Trade or Business Amount – Activity 1

A's QBI from Activity 1 is $150,000, 20 percent of which is $30,000 ($150,000 * 20 percent). A's allocable share of W-2 Wages paid with respect to Activity 1 is $100,000, 50 percent of which is $50,000 ($100,000 * 50 percent). Further, 25 percent of the W-2 Wages plus 2.5 percent of A's allocable share of the unadjusted basis in qualified property is $62,500 (($100,000 * 25 percent) + ($1,500,000 * 2.5 percent)). As A's taxable income is above the threshold amount of $315,000 but not above the $415,000 threshold amount over which the limitation would apply fully, application of the wage limitation for Activity 1 is subject to phase in. However, since the Section 199A(b)(2)(B) limitation amount of $62,500 (the greater of $50,000 or $62,500, calculated above) exceeds the QBI amount of $30,000, calculation of the phase-in amount is unnecessary. A will be entitled to include the entire $30,000 in determining his overall Section 199A(a) deduction.

Qualified Trade or Business Amount – Activity 2

A's QBI and W-2 Wages from Activity 2 are $35,000 and $10,000, respectively. 20 percent of the QBI for Activity 2 is $7,000 ($35,000 * 20 percent). 50 percent of the W-2 Wages allocated to A during the year is $5,000 ($10,000 * 50 percent); 25 percent of W-2 wages allocated to A plus 2.5 percent of A's allocable share of the unadjusted basis in qualified property is $4,375 (($10,000 * 25 percent) + ($75,000 * 2.5 percent)). As A's taxable income is above the threshold amount of $315,000, application of the wage limitation for Activity 2 is subject to phase in. Since the applicable limitation amount of $5,000 is less than the QBI amount, A's Section 199A deduction will be limited. Accordingly, the $7,000 amount is reduced by 60 percent of the difference between $7,000 and $5,000 (the greater of the wage limitation amounts calculated above), or $1,200 resulting in a deductible amount for Activity 2 of $5,800.

Qualified Trade or Business Amount – Activity 3

A's QBI and W-2 Wages from Activity 3 are $30,000 and $10,000, respectively. Because Activity 3 is a specified services business the general rule provides that no portion of A's allocable share of income is generated from a qualified trade or business. Therefore, none of the income would generally be considered QBI. However, because A's taxable income is above the threshold amount of $315,000 but below the phase out limit of $415,000, a portion of the income allocated from Activity 3 will be treated as QBI. For purposes of determining the amount of qualified business income, A has an applicable percentage of 40 percent (1 – (($375,000 – $315,000) / $100,000)) resulting in QBI of $12,000 ($30,000

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* 40 percent). 20 percent of the QBI for Activity 3 is $2,400 ($12,000 * 20 percent), representing the maximum deduction for this activity. The allowable deduction is the lesser of this amount or the greater of the amounts described in section 199A(b)(2)(B). The 50 percent wage limitation is $2,000 (($10,000 * 50 percent) * 40 percent) and the 25 percent wages plus capital limitation is $2,000 ((($10,000 * 25 percent) + ($100,000 x 2.5 percent)) * 40 percent). The taxpayer is subject to application of the wage limit due to their taxable income being in excess of the threshold amount but below the maximum phase-in amount of $415,000. As a result, the $2,400 preliminary amount must be reduced by 60 percent of the difference between $2,400 and the wage limitation of $2,000, or $240 (($2,400 – $2,000) * 60 percent). The resulting deductible amount for QBI with respect to activity 3 is $2,160 ($2,400 – $240).

Qualified Trade or Business Amount – Carryover Loss Amount

A also has a carryover qualified business loss of $100,000 that must be taken into account when calculating the current year Section 199A deduction. Accordingly, 20 percent is applied to the carryover qualified business loss which leads to a decrease in the current year eligible deduction by $20,000.

Observation: Taxpayers eligible to claim the full 20 percent deduction on QBI will incur a maximum effective rate of 29.6 percent on the QBI. While this rate reduction is beneficial, it is important to consider the decrease in corporate tax rates from 35 percent to 21 percent. This rate differential is likely to cause taxpayers to reevaluate their choice of entity decisions. There are a number of factors that need to be considered but, from a simple after-tax cash flow perspective, a key determinative factor is the likelihood of the entity distributing vs. retaining operating earnings.

Observation: While a common thought is to consider possibly incorporating an existing partnership in order to benefit from the 21 percent corporate tax rate, a corporate-to-partnership conversion should not be dismissed. When corporate tax rates were 35 percent, the tax liability imposed on gain recognized under Section 311(b) was typically prohibitive in a conversion transaction. However, with corporate rates dropping to 21 percent, consideration should now be given to the possible liquidation of a corporation and re-formation as a partnership, especially in situations where the corporation has net operating loss carryovers that could shelter the recognized Section 311(b) gain.

Observation: The determination of the combined QBI amount is dependent upon the QBI generated from each qualified trade or business activity. Further, the wages and capital-based limitations are determined with reference to wages and qualified property that is allocable to a particular qualified trade or business activity. It is not clear from the statute whether and the extent grouping rules under sections 469 may be applicable.

Observation: Properly tracking partner income and loss allocations will take on greater importance in order to accurately determine a partner's annual net business income allocations and carryover loss amounts. This importance will be further magnified as a result of the potential imputed underpayment obligations that could arise under the new partnership audit rules that went into effect for tax years beginning after December 31, 2017.

Observation: Complexities are likely to arise in situations where a partnership operates multiple activities. Maintaining adequate information and documentation will be necessary to support application of the lower rates. Consequently, partners and partnerships will need to consider the extent to which additional information will be maintained, how it will be communicated to partners, and whether any incremental administrative costs should be borne by the benefiting partners.

RECHARACTERIZATION OF CERTAIN LONG-TERM CAPITAL GAINS (SECTIONS 1061 & 83)

Under general rules, gain recognized by a partnership upon disposition of a capital asset held for at least one year was characterized as long-term capital gain. Further, the sale of a partnership interest held for at least one year generated long-term capital gain except to the extent section 751(a) applies. Under the new tax law, long-term capital gain will only be available with respect to "applicable partnership interests" to the extent the capital asset giving rise to the gain has been held for at least three years.

An applicable partnership interest is any partnership interest transferred, directly or indirectly, to a partner in connection with the performance of services by the partner, provided that the partnership is engaged in an "applicable trade or business." An applicable trade or business means any activity that is conducted

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on a regular, continuous, and substantial basis consisting of raising or returning capital and either (1) investing in, or disposing of, specified assets (or identifying specified assets for such investing or disposition) or (2) developing such specified assets. For purposes of this provision, specified assets include securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

Consistent with the intent to limit applicability of these rules, the law provides that applicable partnership interests do not include (A) a partnership interest held directly or indirectly by a corporation or (B) a capital interest in a partnership commensurate with the partner's capital contributions or the value of the interest subject to tax under Section 83 upon receipt or vesting. However, the fact that an individual may have recognized taxable income upon acquisition of an applicable partnership interest or made a Section 83(b) election with respect to such applicable partnership interest does not change the three-year holding period requirement.

The provision is applicable to taxable years beginning after December 31, 2017.

Observation: Based on the definitions of applicable partnership interests, applicable trades or businesses, and specified assets, it appears that this rule is primarily targeted at hedge funds and real estate funds with relatively short-term holding periods, i.e., more than one year but less than three years. Private equity and venture capital funds generally have a longer holding period and are unlikely to be affected to the same degree. However, care will need to be taken to ensure the holding period requirements are satisfied in all cases. Further, determination of a partner's share of capital gains "commensurate with the amount of capital contributed" will likely require detailed record-keeping and tracking of partner Section 704(b) and tax basis capital accounts. This provision is estimated to increase revenues by $1.1 billion over the 10-year period following enactment.

TAXATION OF GAIN ON THE SALE OF PARTNERSHIP INTEREST BY A FOREIGN PERSON (SECTIONS 864(C) AND 1446)

Revenue Ruling 91-32 generally provides that a foreign partner will recognize effectively connected income (ECI) on a sale of a partnership interest to the extent a sale of underlying partnership assets would give rise to an allocation of ECI to the transferor partner. The revenue ruling effectively adopts an aggregate approach to determining ECI notwithstanding the entity approach mandated by Section 741. In the recently decided case of ***Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner***, the Tax Court ruled that the taxpayer's gain on sale of its partnership interest was not ECI despite the fact that a sale of the partnership's assets would have generated ECI allocable to the partner, effectively rejecting Rev. Rul. 91-32. The Tax Court's decision applied the entity theory to the sale of a partnership interest and found the IRS' position in the revenue ruling lacked the "power to persuade".

The new tax law effectively codifies the holding in Rev. Rul. 91-32 and overturns the Tax Court's decision in *Grecian Magnesite*. In particular, the law treats the gain recognized on the sale or exchange of a partnership interest as ECI to the extent the transferor would be allocated ECI upon a sale of assets by the partnership. This provision effectively recharacterizes otherwise non-ECI capital gain from the sale of partnership interest into ECI. Additionally, the law provides that the Treasury shall issue regulations as appropriate for application of the rule in exchanges described in sections 332, 351, 354, 355, 356, or 361 and may issue regulations permitting a broker, as agent for the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition. The provision treating gain or loss on the sale of a partnership interest as ECI is effective for transactions on or after November 27, 2017, while the provision related to withholding is effective for sales or exchanges after December 31, 2017.

Observation: This proposal effectively codifies the holding Revenue Ruling 91-32 and reverse the Tax Court's decision in Grecian Magnesite. As a result of the coordination of allocable gain on a hypothetical sale of partnership assets with total ECI, accurate tracking of Section 704(c) built-in gain and losses will become significantly more important. This provision is estimated to increase revenues by $3.8 billion over the 10-year period following enactment.

REPEAL OF TECHNICAL TERMINATION RULES UNDER SECTION 708(B)(1)(B)

Under the new tax law, the technical termination rules under Section 708(b)(1)(B) is repealed for tax years beginning after 2017. No changes are made to the actual termination rules under Section 708(b)(1)(A).

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Observation: Repeal of the technical termination rule is generally a favorable development since it will eliminate the need to restart depreciation upon the sale or exchange of more than 50 percent capital and profits interest in a partnership. Additionally, the law alleviates the common occurrence of failing to properly identify transactions giving rise to technical terminations which leads to late filing of required tax returns, failure to make appropriate elections, and imposition of penalties. However, technical terminations are sometimes used to eliminate unfavorable elections, and the creation of a "new" partnership entity is oftentimes required in connection with international investments in U.S. joint ventures. While it may be possible to continue structuring transactions to achieve these objectives, the simplicity of triggering a technical termination has been eliminated. This provision is estimated to increase revenues by $1.6 billion over the 10-year period following enactment.

MODIFICATION OF THE DEFINITION OF SUBSTANTIAL BUILT-IN LOSS IN THE CASE OF A TRANSFER OF A PARTNERSHIP INTEREST (SECTION 743(D))

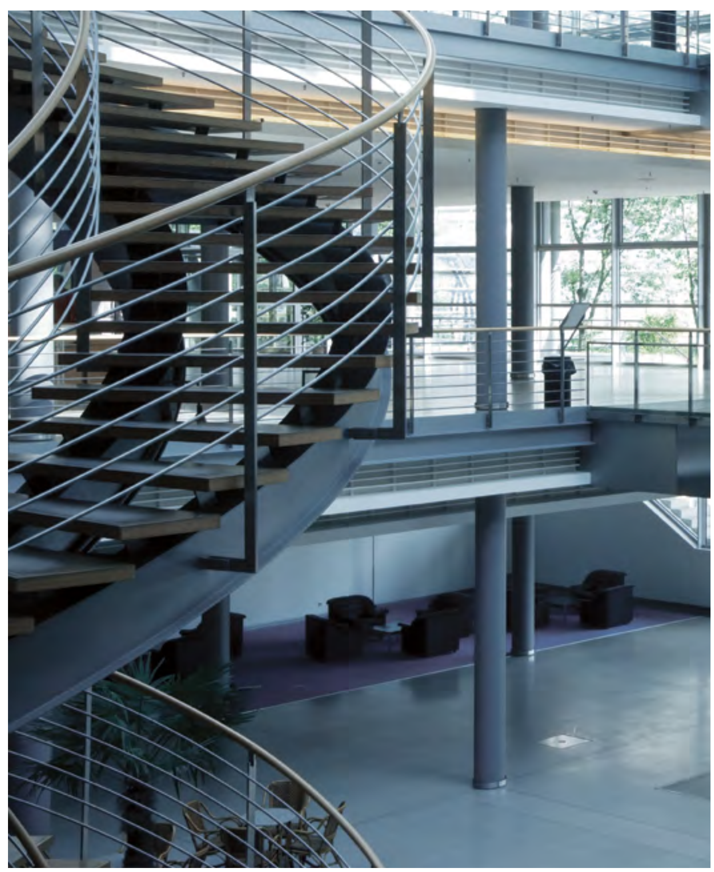
Section 743(b) provides for an adjustment to the basis of partnership property upon the sale or exchange of a partnership interest providing the partnership has a Section 754 election in effect or where the partnership has a substantial built-in loss. Section 743(d) currently provides that a partnership has a substantial built-in loss with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in all of its property exceeds the fair market value of such property by more than $250,000. Under this existing rule, it's possible that a transferee partner could acquire a partnership interest with respect to which there is a built-in loss of more than $250,000 without there being a mandatory basis adjustment because the partnership does not have an overall built-in loss meeting the threshold.

The new tax law modifies the definition of a substantial built-in loss for purposes of section 743(d). Under the law, a substantial built-in loss also exists if the transferee partner is allocated a loss in excess of $250,000 upon a hypothetical disposition by the partnership of all 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 transfers of partnership interests occurring after December 31, 2017.

Observation: It is not clear whether a relatively high number of partnership interest transfers will be captured under this rule. However, given the negative consequences of a potential downward basis adjustment it will become even more critical that partnerships properly track each partner's Section 704(b) and tax basis capital accounts. Failure to accurately track capital accounts could lead to incorrect downward adjustments resulting in increased exposure to both the transferring and non-transferring partners. This provision is estimated to increase revenues by $500 million over the 10-year period following enactment.

CHARITABLE CONTRIBUTIONS AND FOREIGN TAXES TAKEN INTO ACCOUNT IN DETERMINING BASIS LIMITATION (SECTION 704(D))

Under the general rules of Section 704(d), a partner's ability to deduct its distributive share of partnership losses is limited to the extent of the partner's outside tax basis in the partnership interest. However, this limitation does not apply to a partner's allocable share of charitable contributions or foreign tax expenditures. As a result, a partner may be able to deduct its share of a partnership's



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charitable contributions and foreign tax expenditures even to the extent they exceed the partner's basis in its partnership interest.

The new tax law modifies the section 704(d) loss limitation rule to take into account charitable contributions and foreign taxes. However, in the case of a charitable contribution of property where the fair market value exceeds the adjusted tax basis the Section 704(d) basis limitation does not apply to the extent of the partner's allocable share of this excess. This provision applies to taxable years beginning after December 31, 2017.

Observation: This rule change will increase the importance of ensuring accurate calculation of a partner's tax basis. Although partners are generally required to determine their own tax basis, it's not uncommon for partners to look to the partnership to provide relevant data including tax basis capital and liability allocations. The increased importance of outside tax basis calculations will place more pressure on partnerships to accurately track partner capital as well as determining proper liability allocations under Section 752. This provision is estimated to increase revenues by $1.2 billion over the 10-year period following enactment.

LIKE-KIND EXCHANGES OF REAL PROPERTY (SECTION 1031)

Application of Section 1031 is limited to transactions involving the exchange of real property that is not held primarily for sale. Section 1031 no longer applies to any other property including personal property that is associated with real property. This provision is effective for exchanges completed after December 31, 2017. However, if the taxpayer has started a forward or reverse deferred exchange prior to December 31, 2017, Section 1031 may still be applied to the transaction even though completed after December 31, 2017.

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BONUS DEPRECIATION TAX REFORM CHANGES MAKE COST SEGREGATION STUDIES ESSENTIAL

By Grant Keppel

With the recent passage of the bill known as the Tax Cuts and Jobs Act (TCJA), owners of commercial real estate now qualify for significant tax benefits, some of which are retroactive to the 2017 tax year.

Under the new tax regime, most owners who purchased either residential or non-residential property and closed on or after Sept. 28, 2017, can see significant tax benefits as a result of the bonus depreciation being applied to "used" property. For the first time since initial bonus depreciation provisions were passed in the Job Creation and Worker Assistance Act of 2002, owners and investors who acquire used property (property that has been used by previous owners) are now on an equal playing field as owners and investors who constructed or purchased "new" property. Under the new tax regime, qualifying assets that have a tax recovery period of 20 years or less, new and used, can now qualify for the 100-percent bonus depreciation provision in the assets' first year of service *(Note: While the term "bonus" is often misunderstood to mean an added benefit beyond the asset's depreciable tax base, it is a boost to accelerate the tax depreciation in the first year the asset is placed in service).*

The original intent of the bonus depreciation provision was to stimulate job growth and investment back into the economy. When first enacted, bonus depreciation was applied at 30 percent in the asset's first year, but only to those that were new and had a tax recovery period of 20 years or less. Since most traditional assets, such as a brick-and-mortar building, would have a tax recovery period under the Modified Accelerated Cost Recovery System (MACRS), they would be classified as either a 39-year period for non-residential real property or a 27.5-year period for residential real property. Thus, those asset classifications would not qualify for this added incentive.

Prior to the passage of federal tax reform, owners or investors in used commercial property would have had to initiate depreciation recovery at the standard 39-year MACRS period, although there may have been hidden assets with the real estate component with lower recovery periods (usually at five, seven or 15 years). Now under the TCJA, those used non-building assets that have recovery periods of 20 years or less qualify for the 100-percent bonus in the asset's first year of service (if in service after Sept. 27,

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BONUS DEPRECIATION

2017). While used qualifying assets placed in service before Sept. 28, 2017 would not qualify for the new bonus provision, there may still be assets with short tax recovery periods that will not receive the 100-percent first year bonus provision, but rather their normal MACRS depreciation rates over the five, seven and 15-year tax lives. The good news is there are many assets within the real estate component itself that can have shorter recovery periods.

In most cases where there are assets within a recently purchased used building, owners need to identify and reallocate the purchase price to take advantage of the lucrative bonus depreciation provisions. To do this, they should undertake a cost segregation study, which employs both engineering and tax professionals to assist in asset identifications. When only the lump sum cost of an asset, such as a parcel of real estate, is available at purchase, cost estimating techniques may be required to categorize individual components of the property as land, land improvements, buildings, equipment, or furniture and fixtures. Those assets traditionally allocated as land improvements, equipment, and furniture and fixtures placed in service after Sept. 27, 2017 would now qualify for the 100-percent first year bonus provision.

Take the following example: If a taxpayer acquires an existing shopping center on Sept. 27, 2017, under prior tax law, the taxpayer could allocate the purchase price via a cost segregation study to the various asset components. In this case, let's say the taxpayer allocated 20 percent of the purchase price to land (non-depreciable), 15 percent to land improvements (15-year recovery period) and 12 percent to equipment (five-year recovery period), and the balance to the building asset (39-year recovery period). Before the passage of the TCJA, by employing a cost segregation study, the taxpayer's first-year depreciation deduction would be approximately $150,000. This is opposed to an approximately $30,000 depreciation deduction if an allocation was not completed, and the taxpayer left the entire asset in the standard 39-year tax recovery period.

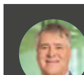
Now, using the same situation as above, if the closing date was instead Sept. 28, 2017, the land improvement and equipment assets identified in the cost segregation study would now be eligible for a 100-percent depreciation deduction. In calculating the depreciation under the new tax regime, the first-year depreciation would be approximately $1.1 million, nearly $1 million more than what the taxpayer would be entitled to prior to the bill's passage.

While this implementation of bonus depreciation can create a significant expense in the asset's first year, taxpayers must now consider if those deductions can be used to offset taxable income, to ensure there is sufficient taxable income to absorb the added deductions in the current year. The new tax law does allow for taxpayers to step down the deduction, using the prior tax provision for bonus at a 50-percent depreciation

rate. Alternatively, they can also elect out of bonus entirely and just take the traditional MACRS depreciation on the allocated assets in their respective recovery periods (i.e., without first-year bonus depreciation).

With the corporate and individual tax rates reduced by the TCJA, taxpayers also need to consider if they should use the benefits on the added depreciation in 2017 or in future years. If the taxpayer can use the depreciation deductions in 2017, it makes more sense to accelerate those deductions with a cost segregation study while the tax rates are at their highest. As most real estate is held in pass-through entities (S corporations, limited liability companies and partnerships), the income is taxed at the shareholders,' members' or partners' individual tax rates. Thus, if real estate is held in a pass-through entity and an individual is in the highest tax bracket, the benefit would be approximately 2.6 percent higher in 2017 than in 2018. For those companies that hold real estate in a C corporation, with the tax rate shifting from 35 percent to 21 percent, this one-time benefit can be as high as 14 percent in 2017.

Regardless of a taxpayer's structure, the new tax law provides a boon for any owner or investor of a used property. To maximize savings, it's critical to consider a cost segregation study to identify all qualifying assets. Savvy taxpayers will determine their ability to use the new bonus depreciation provisions and will assess when and how to implement them as a part of their overall tax strategy.



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HOW TAX REFORM WILL IMPACT CONSTRUCTION

By Maureen McGetrick

Every type of industry is impacted by the passing of the bill known as the Tax Cuts and Jobs Act (TCJA), and the construction industry was not left out of the party.

However, the precise impact will depend upon the structure of the business and the nature of its operations. For construction businesses organized as C corporations, the most significant changes are the reduction in the corporate tax rate, the 100-percent bonus depreciation deduction, the elimination of the corporate AMT, modifications of rules for use of certain accounting methods, and the limitations on interest expense deductions. A number of these items also impact construction companies organized as pass-through entities, either S corporations or Limited Liability Corporations taxed as partnerships (including General Partnerships, Limited Partnerships or Limited Liability Partnerships), but there are also considerations specific to flow-through structures, including the applicability of the deduction for qualified business income, also referred to as the Section 199A deduction. This article focuses on a high-level discussion of the important considerations construction companies should focus on in the wake of tax reform.

CHOICE OF ENTITY

Given the wide sweeping changes to both the corporate and individual tax systems brought on by the TCJA, it's an opportune time for construction businesses to reconsider the tax structure chosen for the business, especially since construction businesses tend to be closely held and therefore organized as flow-through entities. This can be a complex analysis, and would largely be driven by determining the net effective rate as a C corporation versus the rate as a pass-through entity, which will be influenced by many factors including:

- The state(s) in which the corporation does business (i.e. state effective rate);
- Whether the owners materially participate in the business;
- The level of compensation paid or required to be paid to any owners who provide services to the business to ensure reasonable amount of compensation;
- Whether the entity makes distributions or profits regularly, or whether it would prefer to accumulate profits to grow the business;
- Whether there is a planned exit from the business in the near future;
- Whether the business has any international operations; and
- Whether the business would be eligible for the 199A deduction (discussed below in more detail).

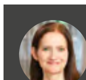
Other factors should be considered in the choice of entity analysis as well, including legal implications and the associated compliance costs of each structure.

199A DEDUCTION

The TCJA provides a 20-percent deduction for pass-through entities which generate "qualified business income," subject to certain limitations. Qualified business income is generally active income from a qualified trade or business (this definition generally excludes investment income as well as any income for personal services provided by an owner or shareholder). A qualified trade or business is typically defined as any trade or business other than a specified service business which includes the following industries: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investment management and brokerage services. There is also a broad category included in the definition of trade or business that applies to any business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Architecture and engineering were specifically excluded from the qualified trade or business definition. There is much uncertainty around these definitions, and the practitioner community has requested guidance from the IRS and Treasury on these items quickly given that these changes will apply for 2018.

While most construction businesses might seem to fall within the definition of a qualified trade or business, it is uncertain how the law will be interpreted at this point. Assuming that you get over the hurdle for a qualified trade or business, the deduction for qualified business income will be limited to the greater of either: 1) 50 percent of W-2 wages with respect to the trade or business, or 2) 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis of qualified property. Qualified business property would generally include assets held at the end of the year, used in the trade or business during the year, and for which the depreciable period has not ended. The depreciable period is the later of 10 years from the original placed in service date or the last day of the last full year in the recovery period under Section 168.

Assuming a construction business is eligible for the 199A deduction, it could reduce the top federal rate on business income from 37 to 29.6 percent, therefore making a pass-through structure an attractive alternative. However, companies must first evaluate the many planning considerations as summarized above to understand the full impact of tax reform on their business.



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MALL REIT M&A COULD ACCELERATE

By Stuart Eisenberg

On the heels of Brookfield Property Partners' acquisition of GGP, BDO USA Partner Stuart Eisenberg posits that retail REITs may have a bumpy road ahead.

The second-largest U.S. mall operator, Brookfield Property Partners, is poised to expand its portfolio with the acquisition of retail REIT GGP, pending final shareholder approval. After rejecting an earlier bid, the GGP board approved a second bid by Brookfield for a total of about $15.3 billion in a combination of cash and stock priced at $23.50 per share, Reuters reported.

Many analysts say the deal significantly undervalues GGP's assets. Markets did not appear to view the deal favorably, and mall REITs' stocks slid the day after the announcement. Widespread investor skepticism towards retail may be to blame for GGP's willingness to accept the deal. Announcement of nationwide store closings from name-brand operators and retailers may have created popular sentiment that all retailers and retail operators are suffering. For instance, after Macy's announced more than **100 store closings** last year, GGP's stock fell despite none of the closures taking place in a GGP mall.

E-commerce's rise, changing consumer tastes and the proliferation of mega-stores have contributed to malls' nationwide decline. Retailers with many brick-and-mortar locations have struggled to compete against their competitors' increased convenience and lower cost.

In 2017, a slew of major retailers including Sears, Macy's, RadioShack and Sports Authority announced nationwide store closings while more than 20 other retailers filed for bankruptcy, according to the **BDO Biannual Bankruptcy Update**. Retailers haven't fared much better in 2018. By the end of the first quarter, more than 70 million square feet of retail space was already set to shutter, according to CoStar.

WHAT'S ATTRACTING BUYERS TO RETAIL ASSETS?

Recent years have hit Class B and C malls the hardest, but even retail operators of Class A malls, like GGP, have faced their fair share of difficulties. Given the constant stream of bad news for retail, why might Brookfield and other buyers believe malls to be a viable investment, even at a bargain?

Mall owners and buyers might see an opportunity to repurpose and reposition their beleaguered mall assets to better fit current consumer tastes. This may involve adding new lifestyle amenities, such as upscale dining options and gyms, or allocating space for offices and even residential property.

The Independence Mall in North Carolina recently announced plans that take this approach towards repositioning a property. The mall will demolish the former Sears location, and among other additions, build a hotel and residential spaces. Since the mall is only 7 miles from the Atlantic Ocean, the owners believe the mall has unrealized value that the changes will unlock.

Owners may also seek to capitalize on the recent coworking boom. For example, Hudson Bay Co. recently opted to sell Lord & Taylor's flagship Fifth Avenue location to WeWork. Other property owners may follow suit or choose to convert and lease their holdings to coworking spaces, which may be a particularly popular choice in gateway markets. Alternatively, if the property is in proximity to a large population center outside an urban area, owners may choose to convert to distribution centers or other kinds of mixed-use spaces for a steady stream of income.

We'll have to wait and see which specific kinds of repositioned spaces succeed, as rapidly changing consumer tastes and technology may further disrupt mall repositioning initiatives in ways no one's even dreamed.

As the GGP deal demonstrates, the road ahead is unclear when it comes to large retail locations. Mall owners, including retail REITs, may have to accept a lower price than they might like for their assets in the current climate, or move to repurpose their properties to fit new consumer tastes.

This article originally ran in Commercial Property Executive. You can access that article here.

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TARIFFS SPARK FEARS OF RISING CONSTRUCTION COSTS: COULD INVESTMENT IN TECHNOLOGY BE THE ANSWER?

By Ian Shapiro

As U.S. trade policy decisions continue to dominate headlines, the uncertain future of high-demand import prices has business leaders and lawmakers anxious.

Earlier this year, President Trump announced a 25 percent tariff on steel imports and a 10 percent tariff on aluminum imports that took effect on March 23. While the European Union (EU), Canada, and Mexico were granted a temporary reprieve, Trump declined to extend their exemption.

China was the first to implement retaliatory tariffs on U.S. exports, such as soybeans, planes, and cars. Since then, the U.S. has been in talks with China to de-escalate the situation, but no permanent solution has been reached. After their exemption expired, Mexico announced $3 billion in tariffs against U.S. exports, including: pork, apples, potatoes, and bourbon. Canada and the EU both issued retaliatory tariffs as well.

While the stated objective of this trade policy is to "level the playing field" for American manufacturers—and many trade experts believe cheap imports have hurt the domestic steel industry—tariffs may have undesirable and unintended consequences that extend far beyond manufacturing. Many U.S. contractors rely on products comprised of foreign steel and aluminum, which are shipped in from all around the world.

Amid already rising material prices and skilled labor shortages, the tariffs could exacerbate existing unfavorable conditions in the construction sector. Despite these persistent issues, however, demand for new construction is high, as is the need to repair roads, bridges, pipelines, and other vitally important infrastructure. Addressing workforce challenges and minimizing costs is an important step for the construction sector to take full advantage of the potential offered by high demand for new projects.

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INVESTMENT IN TECHNOLOGY

PREVAILING WINDS IN CONSTRUCTION

Over the past year, costs have steadily risen steadily for contractors but haven't yet been passed along to their customers. More specifically, the producer price index for construction inputs rose 6.4 percent over the last 12 months, while the producer price index for what contractors charge has risen just 4.2 percent. Rising input costs and resulting higher prices will delay new infrastructure and development projects, as well as limit construction companies' ability to expand, hire and retain personnel, and make vital investments in new technologies and tools.

Contractors are already feeling the tariffs' effects, as their suppliers aren't sure how to hedge against the unpredictability of future prices. The outcome of renegotiated trade agreements, such as NAFTA, and other geopolitical events may also add to the uncertainty.

LABOR SHORTAGES

For years, the construction industry has warned that skilled labor shortages are hindering productivity despite an otherwise positive industry outlook. In fact, the **sector lost 2.3 million jobs** between 2006 and 2011.

While the demand for skilled craftspeople has continually increased, fewer young people are entering the industry. Potential recruits just don't see it as an attractive and viable career option, especially when other sectors are better known for being tech-savvy and offer perks that appeal to millennial workers.

Clearly, construction companies need to address the skilled-labor gap, and soon. Luckily, now is the perfect time to invest, and the two places to make these investments are clear: tech and people.

WHY TECH?

New technologies, such as 3D modeling, virtual reality, machine monitoring, big data and analytics, robotics, and artificial intelligence can provide significant value to construction sector.

The confluence of these innovations—otherwise called the fourth industrial revolution—have the potential to streamline operations and decrease costs from the blueprint to the final product.

For instance, 3D modeling and virtual reality can be deployed to ensure crystal-clear communication between architects, engineers, and project managers. Self-driving and operating machinery could allow projects to continue work overnight with limited human oversight and remove workers from otherwise dangerous jobs. There have even been **trial productions of 3D-printed homes**, which were created in just 24 hours.

The long term and practical applications of 3D printing in residential construction remain to be seen, but the possibilities are clear. Components previously imported from around the world can now be produced domestically, even on site. These printed materials might be a way to minimize the financial impact in the event future tariffs are enacted.

Such innovations could at least partially alleviate the skilled-labor and costly material woes of the sector, but technology only goes so far.

WHY PEOPLE?

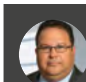
Skilled workers will always be in high-demand, but autonomous machinery can augment human labor to increase safety, speed and efficiency. Construction companies need to ensure that they match their investments in technology with investment in their own workforce. The construction industry has a workforce that skews older, so retraining initiatives will likely take first priority. The key to any digital transformation initiative is organizational buy-in. Companies need to foster cultures of continuous improvement, experimentation, and willingness to fail-fast to take full advantage of new technologies and make discoveries.

Aside from internal education and retraining, the key to a sustainable business is a strong talent pipeline. Construction companies need to make a compelling case for more people to pursue careers in the sector and demonstrating a commitment to new technology and innovation is central to attracting the next generation of workers.

WHY NOW?

With building material costs on the rise and tariffs sparking fears of further increases, contractors that harness new technology will be better positioned to take advantage of the high demand for new construction projects.

Tax reform also presents key opportunities for the sector. Companies need to undertake a thorough study of the new rules and of their own accounting and business strategies to determine what changes need to be made. Most notably, **the reduction in the corporate tax rate** will free up much-needed capital that companies should choose to invest where it counts.



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SINGLE-FAMILY RENTALS: FROM CRISIS-ERA BARGAINS TO THRIVING MARKET

By Stuart Eisenberg

Ten years removed from the financial crisis, the single-family rental (SFR) market has seen explosive growth.

With mortgages at the center of the crisis, the resulting spike in foreclosure rates and housing prices challenged homeownership as the status quo. The crash brought an outpouring of demand into the rental markets. From 2005 to 2015, more than 8 million new rental housing units were built to accommodate that demand, according to Harvard University's Joint Center for Housing Studies.

Real Estate Investment Trusts (REITs) and other institutional investors first entered the SFR arena during the heart of the crisis. The business strategy at the onset was simple: Purchase distressed assets and wait for the prices to increase, converting properties into rentals to supply the newly ignited demand in the meantime.

As the housing market recovers, demand for rental properties has not subsided. Riding the wave of that demand, SFR REITs have built a sustainable business model. Smaller landlords still outnumber corporate SFR investors by a wide margin, but REITs have carved out a small share of the market. According to *Seeking Alpha*, 130,000 of the 16 million SFR units are REIT-owned.

The SFR market comprises a small, but mighty and expanding, segment of today's overall REIT landscape. Blackstone's successful debut of Invitation Homes in 2017 granted further legitimacy to a REIT sector still in its infancy. As the fifth-listed SFR REIT, Invitation Homes raised $1.54 billion—the largest raised by a REIT across all sectors in three years. With rental demand forecasted to continue, SFR REITs are well-positioned for the future.

WHAT'S TIPPING THE SCALES FROM HOMEOWNERSHIP TO RENTALS?

Millennials are often identified as key drivers in the shift from owning to renting, and the data supports that claim: nearly two-thirds of millennials lived in rental properties in 2016. However, a strictly generational-lens obscures the full story. Many of those younger renters reside in apartments in large cities versus single-family rental homes more commonly found in markets like Atlanta, the outskirts of Los Angeles, and Phoenix.

A recent analysis published in *Seeking Alpha* reveals that the majority (58 percent) of SFR tenants are between 35-64 years old—predominantly Generation Xers. Additional research suggests income levels might be the common variable. A U.S. Census survey reveals that about half of American renters are cost-burdened—rent accounts for more than 30 percent of their income.

THE PATH FORWARD FOR SFR REITS

With just a fraction of the nation's SFR homes under institutional investors' ownership, opportunities for REITs to further expand into this space are vast. In their early years, SFR REITs prioritized growth, primarily through acquisitions of pools of foreclosed properties and consolidation. Invitation Homes became the largest SFR company following a 2017 merger with Starwood Waypoint Homes—a REIT already the product of a merger two years earlier.

While juggling the day-to-day balance of keeping vacancies low and rents competitive, some players in the SFR space are expanding their purview beyond property management. American Homes for Rent, for instance, is actively engaged in bringing new supply online through partnerships and subsidiaries with developers specialized in 'build-to-rent' properties. Overall new 'build-to-rent' properties increased by six percent between 2016 and 2017, according to the National Real Estate Investor, a gesture to market confidence in future demand.

What's next for corporate SFR investors? REITs are emerging from their growth-phase and breaking new ground to cement their place in the SFR industry.

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INVESTING IN REITS AROUND THE WORLD

By Stuart Eisenberg

Whether a U.S. REIT is courting international investors or investors are seeking acquisitions abroad, the landscape for foreign direct investment (FDI) is rapidly evolving.

STATE OF FDI IN U.S. REAL ESTATE

Within the domestic market, the most notable shift is the decline in Chinese investment, historically the largest source of FDI. Chinese investors made $54.1 billion worth of acquisitions and $5.3 billion in dispositions since 2007, according to Real Capital Analytics. While China still accounted for the largest group of foreign buyers last year, Chinese investment in U.S. commercial real estate fell 30 percent.

This year, Chinese investors became net sellers of U.S. commercial real estate, selling off $1.3 billion worth of properties, which Real Capital Analytics notes is more than any single year before. The disposition trend is partly driven by Chinese investors' financial distress, but it is also partly a consequence of China's capital control restrictions on outbound investment.

RULES OF THE ROAD FOR INTERNATIONAL INVESTORS

As U.S. commercial real estate and its investor pool continue to shift, global markets are changing just as quickly. For U.S. investors eyeing international properties, it's critical to keep in mind the diverse rules, regulations and nuances of a new market. BDO's Foreign Property Ownership report[1] offers an in-depth regulatory primer for foreign investors.

Here's a look at a few notable markets:

Canada

Canada has seen substantial activity in recent years by foreigners looking to invest in residential and commercial real estate. Canadian REITs are performing well, with the total market capitalization increasing from CAD $42.3 billion in 2012 to CAD $57.7 billion in 2017, according to S&P Dow Jones.

Canada generally encourages foreign ownership of real estate, and most provinces treat foreign purchasers of residential and commercial real estate the same as residents. Some change is likely on the horizon, however. Canada announced plans to introduce an annual speculation tax to discourage foreign and domestic speculators from removing properties from the "long-term housing stock," meaning the properties are not owner-occupied or qualifying long-term rental properties.

Singapore

DBS Group Research predicted Singapore REITs were at the start of a multi-year upturn at the end of 2017. An analyst note states, "we remain bulls in the Singapore property market as we believe that most real estate subsectors have turned the corner on the back of improving demand-supply dynamics. Supporting a more buoyant outlook for landlords (REITs) and developers is abating supply risk, which will drive prices and rentals higher as the year goes by."

With a rapidly expanding population and tight supply, the Singapore government has taken steps to control inbound investment. All foreign investors are required to apply for approval before purchasing properties.

Malaysia

In Malaysia, which adopted the REIT approach in 2005, CBRE recently noted that the pursuit of mega projects and high-value economy should continue to catalyze business activities and bring about new growth drivers and opportunities.

The country's regulatory environment is also somewhat lenient when it comes to foreign investors, as long as minimum requirements are met.

WHAT THE FUTURE HOLDS

A real estate fund's most valuable asset is their in-depth knowledge of their target real estate markets. This leads to geographic concentration in REITs' portfolios, with many specializing in certain regions and the majority staying within U.S. borders. To bridge the knowledge gap in a new market, investors often establish joint ventures with local real estate groups. As foreign real estate sectors heat up and REITs continue to search for yield, U.S. REITs are likely to adopt the joint venture model and become more active international investors.

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1 Disclaimer: Information in the publication is for reference only. Taxpayers should consult with BDO prior to making foreign investments, as several jurisdictions have tax legislation pending.

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