NATIONAL MULTIFAMILY HOUSING COUNCIL

NATIONAL APARTMENT ASSOCIATION

TAX REFORM

In December 2017, Congress enacted the *Tax Cuts and Jobs Act*, the most sweeping overhaul to the nation's tax laws in over 30 years. The Act includes numerous critical victories for the multifamily industry and keeps intact the industry's business model. The multifamily industry is now focused on ensuring that the Treasury Department implements the new law as Congress intended so that multifamily firms can continue to successfully develop and operate properties. During the tax reform debate, the industry advocated for the following priorities for tax reform:

- **Flow-Through Entities.** The multifamily industry is dominated by "flow-through" entities (e.g., LLCs, partnerships, and S Corporations) instead of publicly-held corporations. This means the company's earnings are passed through to the partners who pay taxes on their share of the earnings on their individual tax returns. **By reducing individual income tax rates and establishing a new 20 percent deduction for qualifying flow-through income, both effective through 2025, tax reform will benefit owners and operators of multifamily housing.**

- **Deduction for Business Interest**. Multifamily developers generally borrow, in many cases as much as two-thirds of total cost, to finance apartment development. Curtailing the current deduction for business interest expenses would greatly increase the cost of debt financing for projects and inhibit development activity when the nation is suffering from a shortage of apartment homes. **While tax reform generally imposes limits on the deductibility of business interest, it critically allows real estate firms to maintain a full deduction in exchange for slightly longer depreciation periods.**

- **Depreciation Rules.** During the tax reform debate, some sought to allow full expensing of multifamily properties while others proposed significantly extending the 27.5-year depreciation period applicable to such properties. Both policies would have fundamentally altered the economics of real estate transactions and disrupted the industry's business model. **Tax reform maintains the 27.5-year depreciation period. However, firms electing out of limits on interest deductibility will have to depreciate properties over 30 years. The industry is working to correct a drafting error that applies a 40-year depreciation period (instead of 30 years) for properties in existence prior to 2018. Notably, tax reform also allows full expensing of non-real property assets through 2022 and bonus depreciation through 2026.**

- **Like-Kind Exchanges**. Like-kind exchange rules enable property owners to defer capital gains tax if, instead of selling their property, they exchange it for another comparable property. These rules encourage property owners to remain invested in the real estate market. **Tax reform maintains the ability of multifamily firms to engage in like-kind exchanges with respect to real estate, including multifamily buildings.**

- **Carried Interest.** Real estate development carries considerable financial risks. In fact, one in 10 multifamily projects never breaks ground. Because of the risks involved, many real estate partnerships use "carried interest" to encourage innovation and entrepreneurship. Carried interest represents a return on an underlying, long-term capital asset, as well as risk. Developers assume responsibility for risks, including recourse debt, litigation risks and cost overruns. **While prior tax law properly treated carried interest as a capital gain for assets held at least one year, tax reform generally extends the holding period to three years. The implications for real estate, however, remain under review given that the new law does not explicitly apply to Section 1231(b) real estate assets.**

- **Low-Income Housing Tax Credit (LIHTC).** The LIHTC is the nation's major financing incentive for the development of low-income housing. **Tax reform maintains both the LIHTC and Private Activity Bonds**. Following passage of tax reform, Congress also increased LIHTC authority by 12.5 percent for 2018-2021, which will partially offset negative consequences for the program attributable to the reduction in the corporate tax rate to 21 percent.

- **Opportunity Zones. Opportunity Zones are a new incentive designed to spur investment, including in multifamily properties, in distressed communities.** Real estate developers and others may establish Opportunity Funds that will be eligible for two tax incentives: First, taxpayers may defer capital gains that are reinvested in Opportunity Funds to as late as December 31, 2026. Notably, gains deferred for five years are eligible for a 10 percent basis step up while gains deferred for seven years are eligible for an additional 5 percent basis step up. Second, post-acquisition capital gains on investments held in Opportunity Funds for at least 10 years may be permanently excluded from income.

- **Estate Tax.** Because many apartment firms are small businesses, often family owned, estate planning is a major consideration for company principals. A critical part of planning focuses on the estate tax imposed on the transfer of their assets to their heirs. **Effective through 2025, tax reform doubles the estate tax exclusion to $11.2 million ($22.4 million per couple), indexed for inflation, while maintaining stepped-up basis and a maximum 40 percent rate.**