Bloomberg Tax

Tax Management
Real Estate Journal™

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Current Legislative Considerations for Real Estate – Inflation Reduction Act and Beyond

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The real estate industry should be aware of what is and what isn't in the Inflation Reduction Act of 2022 (Act).[1] The Act is the ''short form'' of the much more comprehensive Build Back Better Act (BBBA) that almost became law at the end of 2021.[2] The key tax provisions for real estate include the 15% corporate minimum tax, a two-year extension of the §461(l)[3] active loss limitation rules, the expansion of the §179D energy efficient building deductions and the alternative energy credits, and the significant funding increase for IRS audits. The real estate industry should also be aware of provisions that didn't make it into the legislation but could come back in the future. Like the BBBA, the Act came very close to expanding the carried interest rules to lengthen holding period requirements, accelerate gain on transfers, and include gain from the direct sale of rental real estate. Further revenue raisers to be on the long-term watch include a potential expansion of the 3.8% social security tax, potential surtaxes on individuals, and the 2021 Wyden partnership tax proposals (which would introduce fundamental changes to the current state of partnership taxation). All in all, the real estate industry was spared a direct hit and can actually benefit from the energy provisions, but further torpedoes are still lurking.

INFLATION REDUCTION ACT TAX PROVISIONS

15% Corporate Minimum Tax

The Act establishes a 15% minimum tax rate on modified financial statement income for large corporations.[4] Specifically it applies to companies with more than $1 billion in financial statement income measured using a three-year average, but it excludes S corporations, regulated investment companies (RICs), real estate investment trusts (REITs), and tax-exempt organizations with less than $1 billion of unrelated business taxable income. This provision generally does not consolidate otherwise unaffiliated ''portfolio'' companies that are owned by an investment fund. U.S. companies that are owned by non-U.S. corporate entities would be subject to the tax if the adjusted financial statement income of the combined group is greater than $1 billion and the U.S. corporate group has average annual financial statement income of greater than $100 million. In a last minute favorable change for real estate and manufacturing, financial statement income is reduced by accelerated depreciation, and increased as appropriate in

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This article may be cited as Steven Schneider and Kara Altman, *Current Legislative Considerations for Real Estate – Inflation Reduction Act and Beyond*, 38 Tax Mgmt. Real Est. J. No. 8 (Aug. 17, 2022).

[1] H.R. 5376, 117th Cong. (enacted Aug. 16, 2022).

[2] For more information on the prior BBBA legislation, see Steven R. Schneider, *Duck and Cover – Preparing for Tax Increases on Real Estate*, 37 Tax Mgmt. Real Est. J. No. 10 (Oct. 20, 2021).

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[4] Act, §10101, §13904.

subsequent years. Corporations would also be eligible to claim net operating losses and tax credits against the tax (including the low income tax credit).

Although REITs are exempted from the 15% corporate minimum tax, real estate can still be affected by this new rule. Of particular interest can be the impact on global companies that own U.S. real estate through C corporation subsidiaries that could exceed the income threshold. Furthermore, Fortune 100 companies that have corporate-owned real estate and many large REITs that use C corporation taxable REIT subsidiaries (TRSs) will await more specific guidance as to legislative scope for their TRSs. Many corporations and their partners will be waiting for regulatory guidance to correlate financial statement (e.g., GAAP) and tax rules and the IRS is statutorily required to issue regulations or other guidance ''to provide for such adjustments to adjusted financial statement income as the Secretary determines necessary to carry out the purposes of this section, including adjustments — . . . [to carry out the principles of part II and III of subchapter C relating to corporate liquidations, organizations, and reorganizations and part II of subchapter K relating to partnership contributions and distributions] .''[5] While waiting for the above tax-free transaction exceptions, readers should note that there is no specific exclusion for §1031 exchanges listed for corporations subject to this minimum tax.

Section 461(l) Excess Business Loss Limitations Extended

Starting in 2018, §461(l) began denying excess business losses to be used to offset nonbusiness income over a certain threshold. The original legislation was only applicable for taxable years beginning before January 1, 2026, although was later extended one year. Under this rule, a typical real estate professional, who is otherwise able to aggregate excess real estate losses and use them against unrelated passive income, was capped on the amount such losses were usable against such passive income. As a practical matter, however, §461(l) allowed such excess losses to be carried forward as a net operating loss (NOL). This effectively meant that §461(l) created a one-year delay in using the losses since the NOL rules did not have a similar limitation on being used against passive income. The BBBA had attempted a more major change to the mechanics of such carry forward losses that would have denied the one-year delay mechanic and applied the original limitations annually to carryforward losses. The Act keeps the existing mechanics and simply extends the effective date by two years to tax years beginning before January 1, 2029.[6]

Clean Energy and Climate Change Provisions

Section 179D governs the energy efficient commercial buildings deduction. It provides a tax incentive of a deduction up to $1.80 per square foot of qualifying energy efficient systems and buildings. The Act changes the deduction to equal the product of a base rate of $0.50 and the square footage of the building, reduced by the deductions taken in the prior three years.[7] If someone other than the taxpayer reported the deduction, the three years increases to fours years. The base rate increases by $0.02, for a maximum rate of $1.00, for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by more than 25%. The base rate increases to $2.50, and the increase of $0.02 becomes $0.10, and the maximum rate becomes $5.00, if (i) the installation of the building satisfies certain prevailing wage and apprenticeship requirements, or (ii) the installation of the property begins prior to the date that is 60 days after the Secretary publishes guidance interpreting the prevailing wage and apprenticeship requirements. The Act also reduces the energy reduction standard from 50% to 25%, but eliminates the partial allowance of the deduction. The pre-existing provision reallocating deductions to the designer of a property on public land is extended to include land owned by tax-exempt entities. The Act introduces an alternative credit for qualified retrofit buildings, which a taxpayer must elect to claim.

The Act also extends and expands alternative energy credits. Of particular importance is the totally new ability of a taxpayer, including a partnership or a REIT, to sell tax credits. After December 31, 2022, taxpayers are permitted to transfer certain tax credits to an unrelated third-party taxpayer for cash. Such payment will not be counted toward income of the credit transferor (and it will rather be treated as tax-exempt income for partnerships or S corporations) and it will not be deductible by the transferee. This transfer election is available to most taxpayers for a number of credits including: (i) the §48 Investment Tax Credit (ITC); (ii) the §45 Production Tax Credit (PTC); (iii) the technology neutral ITC (§48D); and (iv) the technology neutral PTC (§45Y). In addition certain taxpayers (generally taxexempts) can receive a refundable credit from the IRS.

Of particular interest to real estate is the alternative energy credits that favor the location of facilities in

[5] Act, §10101 (adding §56A(c)(15)).

[6] Act, §13903(b).

[7] Act, §13303.

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ISSN 8755-0628

"energy communities" or "low-income communities." A bonus credit of up to 10% is offered for projects of less than five megawatts that are located in a low-income community or on Indian community land. A bonus credit of up to 20% is offered for projects of less than five megawatts that are incorporated into a qualified low-income residential building project or qualified low-income economic benefit project.[8]

IRS Funding Increase

The Act provides the IRS an additional $79.6 billion in funding, to remain available to the end of 2031. The funding is meant to increase taxpayer services and enforcement. It increases enforcement spending from $66 billion to $111.7 billion (a 69% increase), increases operations support spending from $47.6 billion to $72.9 billion (a 53% increase), increases taxpayer service spending from $33.6 billion to $36.8 billion (a 9% increase), and increases business systems modernization from $3.1 billion to $7.8 billion (a 153% increase). Enforcement appropriations will be used to hire more agents, provide more legal support, and invest in investigative technology. Operations support funding will be used to cover routine costs, such as facilities costs, and could also fund research and the IRS Oversight Board. Taxpayer services monies will go toward filing and account services, prefiling assistance, and education. The IRS must also create a task force to study the cost and feasibility of creating a free direct e-file program. Business system modernization means better cybersecurity and customer service technology.

The above funding is simply unprecedented and there is a reason it was "scored" as raising $124 billion[9] of revenue. Taxpayers need to take this seriously and immediately get their files in order. This means careful documentation of transactions, particularly related-party transactions, and careful tax analysis to support tax return filing positions. Simply asking an accountant or lawyer for a "top of the head" view of whether something "works" will not be sufficient when an auditor comes years later and asks why the partnership contribution, distribution, or like-kind exchange was tax-deferred. The standard statute of limitations for IRS audits is three years from the filing of the return but can be six years or even longer in many circumstances. Further, the IRS routinely asks (and receives) taxpayer extensions to the statute of limitations throughout the audit such that by the time the IRS makes an assessment it can be many years after the original tax return was filed. At a time of increasing interest rates the interest alone can be a sizable numbers in additional to penalties and of course the underlying tax. This IRS funding is not real estate-specific but given the large numbers of transactions in the real estate space, there is much fodder in this industry for the IRS to review.

1% Stock Buy-back Excise Tax

Although not applicable to most real estate companies because of the REIT exception, the Act imposes a 1% excise tax on the fair market value of any stock repurchased by a "covered corporation," which is a domestic corporation, the stock of which is traded on an established securities market.[10] The Congressional 10-year revenue estimate for this new tax is a very material $74 billion.[11] A "repurchase" is a redemption, including redemptions by controlled affiliate corporations or partnerships, and the Secretary is given leeway to include other economically similar transactions. The excise tax nets stock issuances and redemptions. A similar rule applies for a repurchase by a domestic corporation controlled by a foreign corporation of such foreign corporation's stock, where such stock is traded on an established securities market. The excise tax does not apply to stock that is (i) redeemed as part of a tax-free reorganization (and no gain or loss is recognized on such redemption), (ii) redeemed and contributed (or its equivalent is contributed) to an employer-sponsored retirement plan, employee stock ownership plan, or similar plan, (iii) part of a *de minimis* redemption, up to $1 million, (iv) under regulations published by the Secretary, is part of an ordinary course repurchase by a dealer in securities, (v) is part of a repurchase by a RIC or REIT, or (vi) treated as a dividend.

PROVISIONS SAVED FOR ANOTHER DAY

Section 1061 Carried Interest

In 2017, Congress passed §1061 in the Tax Cuts and Jobs Act (TCJA),[12] which generally set forth a minimum three-year holding period to obtain favorable capital gain rates for carried interest. Although real estate was included as a covered asset class, di-

[8] Act, §13103 (adding §48(e)(2)(A)).

[9] Senate Democrats, Summary: The Inflation Reduction Act of 2022 (includes top line revenue raiser estimates).

[10] Act, §10201 (adding §4501).

[11] Senate Democrats, Summary: The Inflation Reduction Act of 2022 (includes top line revenue raiser estimates).

[12] Pub. L. 115-97, tit. I, §13309 (redesignating prior §1061 to §1062).

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ISSN 8755-0628

rect sales of depreciable real estate held for at least one year continued to receive capital gain treatment as ''§1231 gains'' because the legislation was limited to extending the holding period for only traditional capital gains and not amounts ''treated as capital gain'' under provisions such as §1231 or §1256. This created preference for exiting shorter-term real estate investments through direct asset sales, rather than a sale of partnership interest by the carry partner (commonly referred to as the ''GP''). The TCJA further created tax planning opportunities for the GP to avoid selling its interest by either ''rolling over'' its investment — even if the capital partner (commonly referred to as the ''LP'') sold out — or allowing the GP to receive in-kind distributions from the partnership with a tacking of the partnership's inside holding period.

Prior to a last minute removal from the Act at the request of Sen. Sinema (D-AZ), the Act originally proposed the carried interest proposal language that was in the failed BBBA legislation. Because this has the potential to be resurrected in the future it is important to understand what this provision would have done. First, direct sales of §1231 property and other similar gains ''treated as'' capital gains would have been included (i.e., direct sales of real property held more than one year but less than three years would not be exempt). Second, the minimum holding period would be measured based on the later of (i) the date on which the taxpayer acquired substantially all of the applicable partnership interest with respect to which the amount is realized, or (ii) the date on which the partnership in which such applicable partnership interest is held acquired substantially all of the assets held by such partnership. Third, the minimum holding period to achieve long-term capital gains would have been raised from three to five years, except three years would have been retained for real property trades or businesses defined in §469(c)(7) (the same broad definition used for defining a real estate professional under the passive loss rules). Fourth, the rules would have accelerated the gain on a transfer of the partnership interest (even otherwise tax-free transfers such as to a family partnership or a gift to charity), and would provide the IRS with authority to ''prevent the avoidance of the purposes of'' §1061 through the use of partnership distributions or carry waivers.

The impact of the this proposal would be to materially and substantially increase the scope of the current carried interest limitations. The provisions that have been particularly criticized are (1) not starting the inside holding period until ''substantially all'' of the partnership capital is invested (particularly troubling for a fund that has a long investment period); and (2) making of otherwise non-taxable transfers of interests taxable events. While there were significant comments from the real estate industry and related discussions to try to improve these problematic mechanics,[13] the concern is that since the text was simply removed and not modified, these same issues and need for last minute clean up could come up again in the future.

Surtax on High-Income Individuals

The BBBA had included a high-income surtax that was considered for inclusion in Act but ultimately was not. The surtax would have applied to all types of income at a rate of 5% for incomes over $10 million and an additional 3% for incomes over $25 million. It is possible that this concept could live to see another day.

Expansion of 3.8% Self-Employment Tax

Like the surtax, the expansion of the scope of the existing 3.8% tax is a provision that could arise again in the future. This tax is currently found in §1401 and §1411 and has some well-known exceptions for many real estate professionals and S corporation owners. Expanding the scope to essentially all non-salary income is expected to come up again in the future even if it escaped the Act.

Wyden Partnership Provisions

On September 10, 2021, Sen. Wyden (D-OR) released a laundry list of over 15 additional technical provisions relating to partnership taxation with the headline that he was closing ''loopholes'' that allow the wealthy and large corporations to ''avoid paying their fair share of taxes.''[14] This has been the topic of multiple panel discussions with government officials since introduction where it is clear that the government is actively considering wholesale changes to limit otherwise tax-deferred transactions that are commonplace in the real estate world. Although some of the original proposals such as the ones relating to §704(b) seem to be stalled, there are active discussions relating to debt allocations, built-in gain rules, and disguised sales that the industry should focus and provide comment on. Each of these three items is discussed below.

[13] For a detailed discussion of these issues, see the real estate industry comment letter*Support Economic Mobility, Entrepreneurial Risk-Taking, and America's Real Estate* (Aug. 3, 2022).

[14] *See* Chairman's News | Newsroom | The United States Senate Committee on Finance. Although many of this proposals are new and unvetted others are a repeat of a series of 2014 legislative proposals commonly known as the ''Camp'' proposals.

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ISSN 8755-0628

Section 752 Debt Allocations With Profit Percentages

The debt allocations proposal would require partnership debt to be allocated based on partnership profits as opposed to the current system that allocates nonrecourse debt first to the partners who need it to avoid taxing deemed cash distributions in excess of tax basis. The same profit-based sharing would also apply to recourse debt, even if fully guaranteed by a partner. The net effect is a tax on partnership formations imposed on a partner who contributes a historical property subject to debt in excess of the partner's tax basis in the property. This provision would impact both existing and new partnerships and materially overrule the current rules for tax-deferred contributions to partnerships for property that has existing debt in excess of tax basis.

Section 704(c) Built-In Gains and Mandatory Remedial Allocations

Under §704(c), if a partner contributes appreciated property to a partnership, there are three generally prescribed methods to minimize the shifting of such built-in gain to the other partners. The baseline "Traditional" method forces tax deductions to the noncontributing partner first (up to their share) and recognized built-in gain to the contributing partner. The second "Curative" method then allows the partnership to shift other available tax items of a matching character to make up or "cure" any tax shortfalls under the Traditional method. Finally the "Remedial" method creates notional items to cure any shortfalls if there are otherwise insufficient existing tax items to cure with. The Treasury regulations have always made clear that the Remedial method is optional, presumably recognizing that sometimes this method can have draconian effects.[15] However this proposal would mandate the Remedial method in all events. The impact of the Remedial method on an otherwise tax-deferred contribution to a partnership is two-fold. First, it is akin to a partial deemed taxable installment sale to the partnership over the amortizable life of the contributed asset. Second, it has the effect of converting the gain on the deemed installment sale above to ordinary income instead of capital gain. For example, if "Partner" contributed a 10-year depreciable asset with zero basis and $100 of value to "Partnership" for a 10% interest, Partner would have annual remedial allocations of $9 of ordinary income over the 10-year depreciable life of the asset for a total of $90 of ordinary income.

Disguised Sale Treatment for Reimbursements of Pre-Contribution Expenses

It is common for a developer to be required to front the costs of permitting and other pre-development costs before the capital partner joins. When the capital partner joins, the developer is reimbursed for the capital partner's share of these expenses. Subject to various limitations, the current tax rules allow such reimbursements to generally be tax-free returns of tax basis, even if the underlying property has appreciated.[16] Instead, the proposal would treat this reimbursement as sale proceeds, requiring the developer to pay taxes on a deemed partial sale of the property to the partnership. The legislation appears to be concerned about certain fact patterns where the current regulatory exceptions apply to the contribution of appreciated property purchased in the two-year period before contribution, but the reimbursement exception's primary scope relates to reimbursements for property improvements and not original acquisition costs.

CONCLUSION

The tax law relating to real estate continues to evolve with the Act. However, with the failure to adopt carried interest changes and changes to the imposition of the 3.8% tax, when coupled with the favorable expansion of energy credits, the real estate industry will likely view the Act with a sense of relief. The largest impact of the Act may be less about the statutory changes and more the potential for future long and complex IRS audits and the need for detailed contemporaneous documentation. While these audits may cause taxpayers to beef up their tax files, it's important not to also lose sight of the potential for future legislation. Although §1031 like-kind exchanges seem safe for the foreseeable future, fundamental changes to partnership taxation could be on the horizon and the proposals need serious vetting. Staying abreast of developments and involved in real estate trade associations is important.

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[15] Reg. §1.704-3(d)(5)(ii).

[16] For details and limitations on this exception, see Reg. §1.707-4(d).

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ISSN 8755-0628