Applegate & Thorne-Thomsen
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BREAKING NEWS BULLETIN

RE: Initial Thoughts on Tax Reform as Enacted

DATE: January 12, 2018

Below is a summary of our initial review of important aspects of the Public Law No: 115-97 (formerly known as the Tax Cuts and Jobs Act of 2017, H.R. 1) (the "Act") and the potential impact on low-income housing, historic and new markets transactions. The law was signed and became law on December 22, 2017. The 1,000+ page proposed legislation is very complex and additional observations may be made after further study. Our initial conclusions are below.

1. **Interest Deductions** – Partnerships will need to elect to be an Electing Real Property Trade or Business in order to avoid the 30% cap on interest deductions.
    - Note that there is a potential issue as to whether bridge loan interest at a fund/syndicator level would be subject to the 30% cap because the funds may not be considered to qualify as an Electing Real Property Trade or Business. This won't impact lower-tier partnership opinions, but it could impact syndicators and their funds. So far there is not clear guidance on this.

2. **Depreciation** – Because the partnership will be an Electing Real Property Trade or Business, alternative depreciation has to be used for the real property.
    - Residential Rental Buildings – 27.5 year depreciation → 30-year depreciation
        - The reduction of the Alternative Depreciation Schedule period for residential rental property from 40 years to 30 years may make it harder to prevent capital account problems for projects with relatively low amounts of capital (bond deals, mixed income deals with large amounts of market

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units, and projects with large amounts of commercial space which don't break the 80/20 rule).

- Non-Residential Rental Buildings – 39-year non-residential property → 40-year depreciation.

- Qualified Improvement Property – (nonresidential interior property excluding expansions, elevators/escalators and internal structure framework) also slows down. For some reason, it is hard to track the charts in the bill, but the Joint Explanation says it gets 15 year MACRS. This needs further study.

3. **Bonus Depreciation** – changes to 100% bonus depreciation for property placed in service before January 1, 2023. Starting on January 1, 2023 bonus depreciation begins phasing down 20% a year.

   - Available or Unavailable for Electing Real Property Trade or Business? There have been questions as to whether bonus depreciation is available for an Electing Real Property Trade or Business. Based on our initial review of the Act, bonus depreciation should be available, but we continue to monitor the issue.

   - Used Property - Bonus Depreciation also applies to used property that is acquired from unrelated parties.

     - Note that this may spur cost segregation studies on purchases of existing buildings to try and get bonus depreciation on acquired personal property and site improvements that is not replaced in the year of acquisition. This may lead to questions as to how much acquired personal property can be worth if it is going to be replaced.

4. **Historic Credits** –

   - 5-Year Credit - For rehabilitation work performed after 2017 on buildings which were not owned by the taxpayer on or prior to January 1, 2018, the 20% historic credit is made available over a 5-year period.

     - Note that in any tax year, the taxpayer only gets the allocable share. Unfortunately the new law does not provide any clear guidance on how the credit is allocated over the 5-year period. There are a number of ways that ratable share could be calculated: by the number of days of the 5-year period in each taxable year, by the number of months, or just ratably over the number of taxable years in the 5-year period (and there would usually be 6 taxable years over which the 5-year period occur). We are making efforts to get guidance from the IRS on this issue.

        - For example, an allocation based on months would look like the following. Assume a building were placed in service on March 1. The taxpayer would get 10 months of credits in that first year, 12 months of credits each year for the next 4 years, and 2 months of credits in the 6th taxable year.
    - Work in Process – for projects that commenced work in 2017, technically the Effective Date language provides that it is effective for costs incurred after 12/31/17. So the implication would be that any QREs incurred in 2017 would still get the 20% credit on the day of PIS even if the Project otherwise did not meet the transition rule requirements below (e.g. fail to meet the transition rule 24-month requirement or "taxpayer" definition is defined narrowly so that the admission of an investor in 2018 is deemed a different taxpayer). This has not yet been subject to any discussion and there could be additional nuances, but that is our current interpretation.

    - Transition Rules –

        - Technical Terminations Eliminated – A primary cause for concern was that if a partnership acquired property in 2017, but admitted an investor next year or had an upper-tier investor admitted next year, that would trigger a technical termination. That raised an issue of whether the "old partnership" was a different taxpayer than the "new partnership." Fortunately, the bill eliminates Technical Terminations, so that issue has been eliminated.

        - Who is the Taxpayer? – The transition rule says that the taxpayer needs to own a property starting on 1/1/18. There is not a consensus on whether "taxpayer" means the partnership or the ultimate user of the credits or the level of opinion that could be given on the issue. Thus the admission of an investor in 2018 could create an issue as to whether the transition rule is satisfied. There was a helpful statement on the floor of the Senate by Senator Cassidy on this point. There are hopes for helpful legislative history or future guidance, but whether anything will develop is unknown.

            - Practice Point – if trying to establish ownership in 2017 in order to syndicate the historic tax credit, it is important that a partnership or limited liability company have at least 2 members that are not disregarded into each other.

5. **New Markets Tax Credits** – The bill maintains the credit's authorization for 2018 and 2019, as was agreed to in the bipartisan PATH Act that Congress passed in December 2015.

6. **Base Erosion** – Only 80% of LIHTC may be used against base erosion. Also, 80% of Section 45(a) renewable energy credit and Section 48 energy credits may be used against base erosion. HTC and NMTC are not usable against base erosion.

7. **Taxable Year of Inclusion** – The new rule is that an accrual basis taxpayer cannot take an item into income for tax purposes later than they take it into income for financial statement purposes. It is not clear yet how this impacts transactions and if it would impact tax credit transactions materially, although OID and prepayments issues are discussed in the Joint Explanation section of the Conference Report. We have not yet seen any discussion on this point. Our guess is that tax opinions would likely state that they assume that financial statements will not report income earlier than shown in the Projections.

8. **Nonshareholder Contributions to Capital** – Nonshareholder capital contribution treatment is disallowed for grants to corporations from governmental entities. This won't directly impact lower-tier tax credit opinions because nonshareholder contributions to capital are not structured directly to partnerships due to an IRS position that such a structure does not work. To the extent that a taxable sponsor used to obtain grants and treat them as a nonshareholder contribution to capital and loan 100% of the proceeds to a tax credit partnership, that structure will no longer work. Such grants would be taxed at the 20% corporate rate and only the remaining 80% could be loaned in. This may require restructuring of transactions to get soft governmental loans rather than grants, if that is possible given the governmental entity and the program involved.

9. **Technical Termination Elimination** – As mentioned above, the Act eliminates technical terminations due to a sale or exchange of more than 50% of the interests in a partnership within a 12-month period. This means that the transfer of a 99% interest in a fund to a limited partner will no longer trigger a technical termination.

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