Kentucky Commercial Real Estate Conference

Commercial Real Estate Income Tax Update

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Your Guide Forward

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Topics We Will Cover

- Taxmageddon - 1/1/2026
  - Where we are now and how we got here
  - What will happen if Congress doesn't act
- Solar Tax Credits
- Other Tax Planning Strategies

Taxmageddon – 1/1/2026

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Where We Are Now and How We Got Here

The Tax Cuts and Jobs Act (passed in 2017, generally effective beginning in tax year 2018) reduced the corporate tax rate to the present 21% rate (down from 35% max rate for years prior to 2018)

Post 2020 net operating losses –
no carryback and unlimited carryforward
(80% of taxable limitation)

Section 163(j) business interest limitation – business interest expense deduction limited to 30% of adjusted taxable income

Where We Are Now and How We Got Here

- Note that the TCJA changes presented on the previous slide, which primarily impact corporations, were enacted **permanent** changes to the federal tax code
- Many of the other TCJA tax cuts were instead temporary in nature and eventually sunset; a few in fact have already expired (i.e.“Big Three” business tax incentives)
- Several key provisions sunset after 2025, and therefore as a result many taxpayers will see a significant increase in their federal income tax burden if Congress doesn’t act first to prevent this from happening

Taxmageddon 2024, 2025 – Business Interest Limitation (“Big Three” #1)

- As previously mentioned, TCJA added Section 163(j) to the tax code, which applies a 30% of adjusted taxable income (“ATI”) limitation to the deduction for business interest expense
- Interest expense and net operating losses are added back in the calculation of ATI
- In the initial implementation years, taxpayers were also entitled to add back tax depreciation and amortization expense in the calculation of ATI
- Beginning with the 2022 tax year, the add back for tax depreciation and amortization was removed, resulting in lower ATI and further limiting the deduction for business interest expense (unfavorable, increases taxable income)

Taxmageddon 2024, 2025 – Bonus Depreciation Phase Down (“Big Three” #2)

- First year bonus depreciation allows businesses to immediately deduct the cost of eligible depreciable property placed in service during the tax year
- TCJA restored 100% first year bonus depreciation for eligible assets acquired and placed in service after 9/27/17 and before 1/1/23

100% bonus depreciation has begun to phase down beginning with the 2023 tax year. The phase-out schedule is as follows:

- **2023 – 80%**
- **2024 – 60%**
- **2025 – 40%**
- **2026 – 20%**
- **2027 – 0%**

Taxmageddon 2025 – R&D Expense Capitalization (“Big Three” #3)

(Not Applicable Commercial Real Estate)

- Prior to the 2022 tax year taxpayers have generally been permitted to deduct research and development expense in the year it is incurred
- TCJA requires businesses to capitalize Section 174 research and development expenses (including software development costs)
- Capitalized R&D costs are recovered as amortization expense over a period of at least 5 years (15 years for foreign research)

TAX PLANNING NOTE:
Certain qualifying Section 174 research and development expenses may be eligible for the R&D tax credit, a permanent tax savings opportunity (versus capitalization which an unfavorable timing difference)

Taxmageddon 2024, 2025 & Enhanced Child Tax Credits

TCJA raised the child tax credit from $1k to $2k for the 2018 tax year

- Eligibility requires earned income (credit phases in 15% for earned income in excess of $2.5k annually)
- $1.6k of the $2k is refundable
- Phase-out of the credit beginning with $200k in income ($400k MFJ)
- Pandemic-era policy (American Rescue Plan Act) raised the credit to $3.6k for children under age 6 and $3k for children under age 18, but only for the 2021 tax year

Tax Relief for American Families and Workers Act

- 1/16/2024 – Senate Finance Chairman Ron Wyden (D-Ore.) and House Ways & Means Chairman Jason Smith (R-Mo.) announced a tax deal which the House ultimately passed by a large margin later the same month
- The House Bill addressed (temporarily at least) all of the previously referenced Big Three business tax incentives while also enhancing the refundability of the child tax credit
- Limited GOP support prevented the bill from advancing in the Senate

"I remained concerned the CTC provisions undermine the work requirement and…transform the CTC from primarily working family tax relief into a government subsidy."
- Senate Finance Committee Ranking Member Mike Crapo (R-Idaho)

Taxmageddon 1/1/2026 – QBI Deduction

- TCJA created Section 199A - Qualified Business Income (“QBI”) deduction for individual taxpayers
- 20% deduction for QBI from pass-through entities (excludes specified service business income)
- Top federal rate of 37% less 20% = 29.6% top rate for QBI income

If Congress doesn’t act, the QBI deduction will go away after 2025

Taxmageddon 1/1/2026 – Individual Tax Rates

TCJA lowered the marginal tax brackets to
10%,
12%,
22%,
24%,
32%,
35% and
37% (top rate)

These tax rates are set to sunset after 2025 and the top rate will return to 39.6%

Coupled with sunset of the QBI deduction, the effective top rate on pass-through business income would increase from 29.6% to 39.6% (33% increase)

Currently the maximum tax rate on long-term capital gains and qualified dividend income is 20% (plus the 3.8% net investment income tax if applicable) –
note this rate is not impacted by any TCJA sunset

Taxmageddon 1/1/206 – Standard & Itemized Deductions

- TCJA nearly doubled the standard deduction for all filing statuses ($14.6k for single, $29.2 MFJ for 2024)
- The itemized deduction for state and local tax (SALT) was capped at $10k annually
- TCJA suspended the home equity loan interest deduction and limited the home mortgage interest deduction to the first $750k of debt (down from $1M)
- TCJA eliminated most miscellaneous itemized deductions

If Congress doesn't act all of those noted will revert to pre-TCJA amounts and thresholds beginning in 2026

Taxmageddon 1/1/2026 – Estate and Gift Tax

TCJA effectively doubled the estate and gift tax basic exclusion from $5.5M in 2017 to $11M (this amount is adjusted for inflation each year and was $13.6M for 2024, or $27.2M for a married couple)

- At the end of 2025 this provision will sunset, cutting the exclusion roughly in half
- Taxpayers who die with a taxable estate greater than the exclusion can be subject to a federal estate tax rate of up to 40% on the taxable portion of their estate

Potential Outcomes

Substantial federal tax legislation is on the horizon

Need to address the sunset of TCJA

When and what form - outcome of the election; which party takes control of Congress

The wide range of potential outcomes makes it very difficult to do tax planning in the current environment

Taxpayers should plan to huddle with their advisors post-election to reevaluate their game plan

Solar Tax Credits

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Inflation Reduction Act (IRA)

The IRA introduced new and expanded several other tax credits related to clean energy

The IRA is focused on providing incentives for renewable and sustainable energy technology infrastructure development. These technologies include:

- Solar
- Wind
- Geothermal
- Combined Heat & Power
- Zero-Emissions nuclear power facilities
- Carbon Capture
- Hydrogen

Energy Tax Credits & Incentives

Section 48 – Investment Tax Credit

- Provides a tax credit for investment in renewable energy projects
- The base credit is 6% of the basis of the qualified energy property
- Credit may be increased to 30% if project meets prevailing wage and apprenticeship requirements
- In addition to the respective 6% and 30% base credit rates there are several stackable bonuses potentially available to increase the credit rate (domestically sourced materials and geography)

Energy Tax Credits & Incentives

Section 48 – Investment Tax Credit

- Provides for a credit against federal tax liability in the year the eligible property is placed into service
- Subject to a recapture period of five years from when the property is placed into service
- Subject to general business credit limitations and restrictions (carryback and carryforward rules)
- Technologies: wind, storage (now standalone too), biomass, geothermal, solar, small irrigation, landfill, hydro…

Credit Rate Increase

IRA implemented provisions that can increase base credit rate

Credit Increases	Requirements
5 times the base credit	Projects meeting prevailing wage and registered apprenticeship requirements (“PWA”)
10%	Facility meets domestic content requirements
10%	Placed in service in an energy community
10%	Solar and wind facilities with a maximum net output of less than five megawatt (a/c) if located in a low-income community
20%	Project is part of a qualified low-income residential building project or a qualified low-income economic benefit project

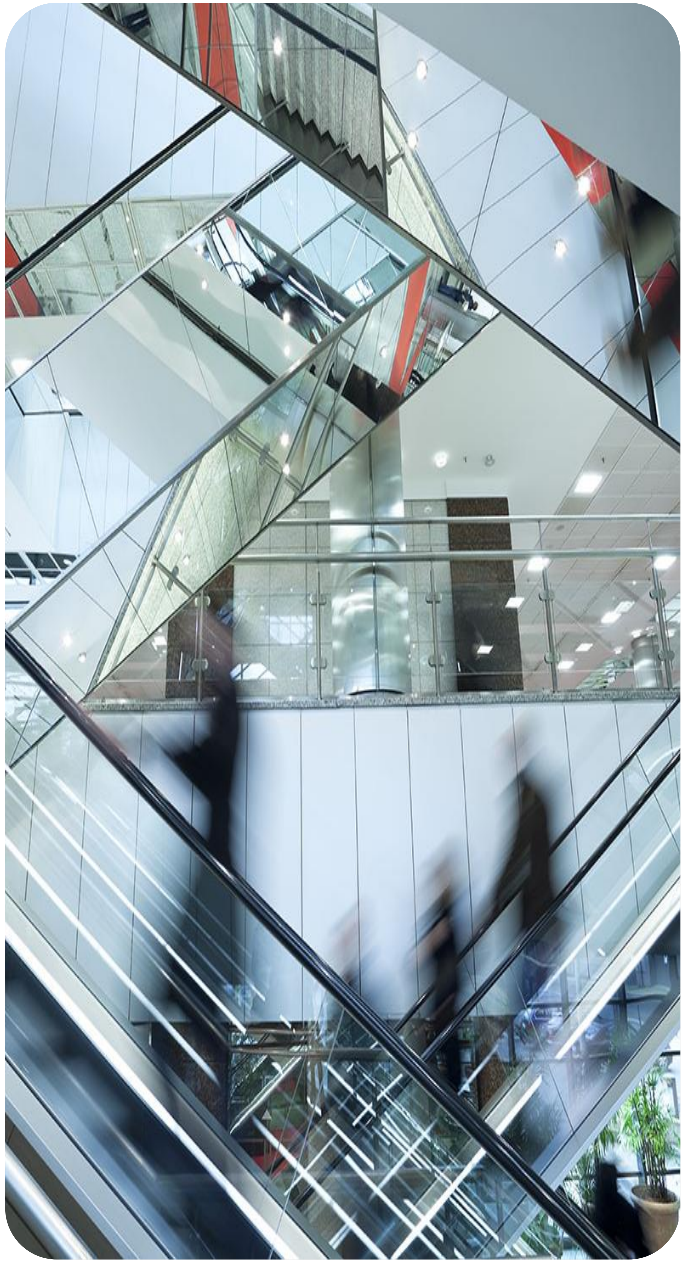
Credit Enhancement Requirements

Prevailing Wage Requirements

- Any laborers or mechanics employed on a project must be paid prevailing wages for the location of the project
- The prevailing wage rate is determined by the Department of Labor

Apprenticeship Requirements

- Percentage of total labor hours for construction, repair or alteration of an energy facility performed by apprentices
- Participating in a registered apprenticeship program



Transferability

- The IRA created new mechanisms for which the tax credits can be utilized:
  - Elective Pay (also referred to as Direct Pay)
  - Transferability
- Section 6418 allows entities not eligible to use elective pay to transfer all or a portion of an eligible credit to an unrelated transferee taxpayer for cash

Transferability

Any consideration the transferee pays for the credit must be in cash

- Under proposed regulations, the transfer election must be made for a specified portion on the basis of a single eligible credit property
- As a condition of any credit being transferred, the eligible taxpayer must complete a pre-filing registration process and obtain a registration number for each eligible credit property covered by the election
- The eligible taxpayer must make the election on a timely filed original return for the tax year for which the credit is determined

Transferability

- Any cash consideration paid by the transferee taxpayer is not included in the eligible taxpayer’s gross income, and it is not deductible by the transferee taxpayer
- The transferee taxpayer cannot re-transfer the credit
- Once made, the election is irrevocable

Benefits of Transferability and Buy-Side Opportunities

Arbitrage Opportunity

- Clean energy tax credits are purchased at less than a 1:1 ratio, creating permanent financial and cash savings for companies
- For instance, a tax liability of $1 million settled through the cash purchase of $1 million of clean energy credits at discounted pricing

Cash Benefit

Cash Payment Deferral

- There are no federal quarterly estimated payments if there is no federal tax liability is anticipated
- Cash outlays can be timed for the end of year or the beginning of the subsequent tax year.
- These credits can be carried back up to 3 years so there is an ability to receive on the arbitrage on prior year liabilities

Buy-Side Example

Credit Utilization & Carryback	
75% of Projected Current Year (CY) Tax Liability	$5.3 million
Tax Credits Purchased	$7.8 million
Excess Tax Credit Generated	$2.5 million
Previous Three Years Tax Liability (Carryback)	$2.5 million
Total Tax Credit Used	$7.8 million
New Federal Tax Liability CY + Last Three Years	$0

Transferability	
Tax Credits Purchased	$7.8 million
Cost of Tax Credits (at rate of $0.87)	$6.8 million
Permanent Savings	$1 million
Quarterly Estimated Payment Deferral (7%)	$0.3 million
Total Benefit (Saving + Deferral)	$1.3 million

Sell-Side Example

ABC, Inc.'s projected tax liability is less then the amount of credit generated

Carryback/carryforward	
75% of Projected Tax liability	**$5.3M**
Tax Credit Generated	**$7.8M**
Excess Tax Credit Generated	**$2.5M**
1 previous year tax liability (Carryback	$0
20-year projected tax liability (Carryforward)	$1.1M
Remaining Credit	**$1.4M**
Credit not expected to be used	**$1.4M**

Transferability	
Remaining Tax Credit	**$1.4M**
Discount Factor on Transfer	**10%-15%**
Cash received upon transfer 12% Discount	$1.23M
Cash Excluded from Gross Income	**$1.23M**

Additional Considerations

- The passive loss rules apply to the transferee
- IRS stated "transferee taxpayer subject to Section 469 would be required to treat the credits making up the specified credit portion as passive activity credits"
- Individuals and closely held C corporations may have certain specified passive income that can be offset with the credits
- Marketplaces facilitate these transactions between buyers and sellers

Transfer Process

Marketplaces list credits that are eligible to be transferred where buyers can review credits being sold

Entities bid on credits if an offer is accepted, they will discuss deal terms to see if an agreement can be reached

If both parties agree on deal terms and enter into a non-binding agreement the buyer will then conduct diligence

After diligence, the transaction will close adhering to the deal terms. Buyer claims credit on their return & seller receives cash

Navigating Challenges

- The ability to buy and sell federal clean energy credits is a new opportunity which brings with it challenges that we have seen in the market

- Some challenges we have seen so far:
  - Recapture concerns
  - Insufficient documentation for the credits
  - Properly registering the credits to be transferred
  - Lack of technical expertise on the rules governing these credits
  - Sourcing desired credit amount

Recapture Considerations

ITC is subject to recapture for the five-year compliance period following the placed in-service date of the asset generating the credit

Events that can trigger recapture include a casualty loss event or a change in ownership of the asset as the result of sale once the asset has been placed in service

The entity who claims the credit which is the buyer in a transfer is ultimately responsible if recapture occurs

Recapture Considerations

To combat recapture concerns insurance products are available to mitigate buyer's risk

Generally only credits being sold in excess of $5M are being offered with insurance by the seller

Credits that are insured typically transact at a premium limiting the arbitrage benefit

Sellers may offer guarantees & indemnities for smaller credits to address recapture concerns of a buyer

Due Diligence

- While recapture is one concern for buyers there are additional things to consider when conducting diligence:
  - Whether the entity transferring the credit is a qualified transferor
  - Reviewing technical specifications of the asset generating the credit with respect to its eligibility as qualified energy property
  - Whether tax credit amount is being properly calculated
  - Establishing when the project was placed in service
  - If applicable whether prevailing wage and apprenticeship has been met

Credit Pricing

Current market conditions see credits trading in the range of 87 cents to 92 cents on the dollar

There are several factors that can contribute to the credit price:

Size of the credit (smaller transaction to trade at greater discount)	Whether a credit is insured	Type of technology generating the credit being purchased	Credit type - ITC vs PTC	Additional factors

Other Tax Planning Strategies

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Extended Energy Tax Credits & Incentives

Section 45L – Energy Efficient Home Construction Credit

- Expanded and extended through 2032
- Maximum credit is increased to $5,000 from $2,000

Section 179D – Energy Efficient Commercial Building Deduction

- Modified formula to determine eligibility for new construction
- Added new deduction for retrofit property to existing buildings
- Deduction is permanent
- Increased deduction from $1.80 per square foot to maximum available deduction of $5.00 per square foot

Pass-Through Entity Tax

- 30+ states have passed legislation
- State taxes paid at entity level
- Requires election to be filed
- Workaround to federal $10k cap on individual SALT deductions

Pass-Through Entity Tax (PTET)

- Taxes paid at State level to receive federal deduction
- Consider paying by year end to take current year deduction
- Individuals take a credit for taxes paid by entity
- Reduce/eliminate state estimated payments at individual level

Opportunity Zone – Reminder

Gains from OZ Deferrals Due 12/31/26

Character of gain deferred will drive tax rate owed

- Short term – taxed at ordinary rate
- Long term – tax at capital gains rates (currently 20%)

Selling Real Estate – Asset vs Membership Interest

Asset Sale

- Seller will be taxed on gain
  - Depreciation recapture ~ different tax rates

- Buyer’s basis reset to purchase price for property taxes

Membership Sale

- Tax treatment for the seller is same as selling building
  - State tax advantages
  - No local taxes on sale (certain circumstances)

- Tax treatment for buyer
  - Step into shoes of exiting investor – basis step up
  - No change entity so property tax values are not reset with PVA.
  - Undisclosed liabilities risk

Questions

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