Navigating Uncharted Waters: Understanding the Impact of Tax Reform on Real Estate.

April 19th, 2018

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Highlights for Today

- 1040 Changes
- C-Corporations
- Capital Contributions
- Carried Interest
- Rehabilitation & Other Tax Credits
- Excess Business Losses & NOLs
- Methods of Accounting
- Interest Expenses
- Taxation of Pass-through Income

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1040 Highlights - Itemized Deductions

- Temporarily increases the standard deduction to $12,000 for individuals and $24,000 for married filed jointly taxpayers

- Retains the deduction for mortgage interest expense, but in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may deduct the interest on no more than $750,000 of acquisition indebtedness. In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is $1 million

- Temporarily limits the aggregate deduction for nonbusiness state and local income tax, sales tax, and property tax deductions to $10,000 ($5,000 for married taxpayers filing separately).

- Temporarily repeals the 3% AGI limitation on itemized deductions, also known as the "Pease limitation."
- Misc Itemized deductions repealed going forward

1040 Highlights

- Increases both the exemption amount and the phase-out thresholds for the individual alternative minimum tax (AMT)
- Eliminates the deduction for alimony payments under divorce or separation agreements entered into or modified after December 31, 2018. Payments will not be treated as income for the recipient ex-spouse.
- Eliminates the Section 199 (DPAD) manufacturing deduction.
- Temporarily increases the child tax credit to $2,000 (partially refundable) per qualifying child and $500 nonrefundable credit for qualifying dependents other than qualifying children. Phase-out at certain adjusted gross income (AGI) levels applies
- Suspends the deductions for personal exemptions until tax years beginning after December 31, 2025.

1040 Highlights

- Repeals the special rule allowing the recharacterization rule to be utilized to unwind a Roth IRA conversion but retains the ability to contribute to an IRA and convert to a Roth.
- Residential Energy-Efficient Property Credit Extended Through 2021

C-Corporations

- C-corporation income will now be taxed at a flat rate of 21%.
- AMT Tax is repealed
- Fiscal year tax payers can utilize blended rates through out the two split years
- Dividends received deduction percentage is reduced to
  - 65% - If they own at least 20% of the corporation
  - 50% - All other dividends

Contributions to Capital

- Previously, a C or S corporation could receive amounts from a governmental entity or civic group on a tax-free basis often to close their financing gap. These are now taxable unless pursuit to master development plan that was approved by the governmental entity *prior* to the law’s enactment date.
  - Examples:
    - Tax Increment Financing (TIF) funds
    - Bargain purchase of land
    - Incentive grants.

Interest Expense

- New limitation to interest expense
  - The deduction of business interest expense is limited to 30% of the taxpayer's adjusted taxable income (ATI)
  - Business income computed without the deduction of depreciation and amortization for tax years 2017-2021
    - After 2021, business income is reduced by depreciation and amortization
- Exemption
  - Taxpayers with average annual gross receipts less than $25 million
- Elect-out out interest expense limitation
  - There is an option to elect out of the interest expense treatment but there are consequences:
    - Must Depreciate Non-Residential Property using 40-year life
    - Must Depreciate Residential Property using 30-year life
    - Qualified Improvements will be depreciated over 20-years

Carried Interest

- To qualify for long-term capital gain on the sale of a partnership interest received in exchange for services, the taxpayer must now hold that partnership interest for a three-year period.

Rehabilitation & Other Tax Credits

- For rehabilitation expenditures paid or incurred after December 31, 2017, the 10% credit for pre-1936 buildings is repealed, but the 20% credit for certified historic structures remains.
- The credit must now be claimed ratably over a five-year period rather than being claimed in the year the rehabilitated building is placed in service
- A transition rule applies to rehabilitation expenditures for either a pre-1936 building or a certified historic structure that are paid or incurred after December 31, 2017, as long as the building is owned by the “taxpayer” at all times on and after January 1, 2018 and the 24-month (or 60-month) period begins no later than 180 days after the date of the law’s enactment.

Excess Business Losses

- Excess business losses will no longer be deductible in the current tax year
  - Only non-corporate taxpayers
    - Current interpretations say that congress only meant C-corporations and not S-corporations
    - Applies to the aggregate income and deductions from all of a taxpayer's trades or businesses.

What is an excess business loss?

- the excess of the taxpayer’s total trade or business deductions and losses over the sum of
  - (a) their total income and gains and
  - (b) $250,000 (single) or $500,000 (joint)

Excess Business Losses

Excess business losses example:

- Bob, a single taxpayer, has deductions of $500,000 from a business. Bob's gross income from the business is $200,000.
- Bob's excess business loss is $50,000 ($500,000 – ($200,000 + $250,000)).
- The $50,000 excess business loss is treated as part of the taxpayer's net operating loss (NOL) carryforward in later years.

Net Operating Losses

- After 2017 Net Operating losses can offset only 80% of taxable income, rather than the current 100% offset

- Excess business losses are carried *forward* and treated as part of the taxpayer's NOL carryforward in later tax years.

Methods of Accounting

- More taxpayers will be eligible for cash method:
    - The current $5 million average gross receipts threshold for corporations and partnerships with corporate partners that cannot use the cash method is increased to $25 million.
    - The current $1 million average gross receipts threshold ($10 million for certain industries) for businesses with inventories that cannot use the cash method is increased to $25 million.

- Small construction contracts entered into after December 31, 2017, and that are completed within two years are exempt from the required use of the percentage-of-completion method if the taxpayer meets the $25 million average gross receipts test for the year the contract commences.



Energy Credit

- 179D deduction is extended to property placed in service until the end of 12/31/2017



Taxation of Pass-Through Business Income

- Owners of pass-through entities and sole proprietors will be able to claim a below-the-line deduction for 20% of their net *qualified business income.* Qualified business income does not include S-corporation wages, guaranteed payments for services, or investment income from a pass-through entity.



Taxation of Pass-Through Business Income

- For taxpayers with income above $315,000 joint ($157,500 single), the 20% deduction is subject to the phase-in of two limitations:
  - Under the first limitation, the deduction would be limited to the greater of (a) 50% of the entity’s W-2 wages or (b) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of the entity’s qualified property .
    - Since option (a) is often $0 for rental properties because most of them have few if any W-2 employees, the last-minute addition of option (b) will be beneficial for the real estate industry.
  - The deduction relating to “specified service trade or business” income will phase out to zero for any taxpayer with taxable income in excess of $207,500 ($415,000 for married filing jointly).
    - Specified service trade or business” means any business engaged in performing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business for which the principal asset of the business is the reputation or skill of one or more of its employees or owners, or a business that involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities

Taxation of Pass-Through Business Income

Passthrough Income Deduction

Taxable Income	415,000
Filing Status	MFJ
Specified Service[2]	No
Wages	70,000
Qualified Property	30,000

Passthrough	
Qualfied Business Income (QBI)[1]	100,000
Special Business Deduction[3]	(20,000)
Add-back Limitation on QBI	-
Business Taxable Income	**80,000**
Income Tax	26,050
Business Income	100,000
Less Income Tax	(26,050)
Net Cash	**73,950**
Federal Blended Tax Rate	**26.05%**

C-Corp	
Business Income	100,000
Corporate Tax	(21,000)
State Taxes	(9,800)
Business Taxable Income	**69,200**
Dividend	69,200
Tax on Dividend	(13,840)
Net Cash	**55,360**
Federal Blended Tax Rate	**34.84%**

Taxation of Pass-Through Business Income

Passthrough Income Deduction

Taxable Income	415,000
Filing Status	MFJ
Specified Service[2]	Yes
Wages	70,000
Qualified Property	30,000

Passthrough	
Qualfied Business Income (QBI)[1]	100,000
Special Business Deduction[3]	-
Add-back Limitation on QBI	-
Business Taxable Income	**100,000**
Income Tax	32,450
Business Income	100,000
Less Income Tax	(32,450)
Net Cash	**67,550**
Federal Blended Tax Rate	**32.45%**

C-Corp	
Business Income	100,000
Corporate Tax	(21,000)
State Taxes	(9,800)
Business Taxable Income	**69,200**
Dividend	69,200
Tax on Dividend	(13,840)
Net Cash	**55,360**
	34.84%

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Other Items

- § 1031 exchanges are repealed for personal property
- For tax years beginning after Dec. 31, 2017, the DPAD is repealed
- 50% Entertainment expenses is repealed
- R &D Credit is retained, but after 2021 the credit must be capitalized and amortized over 5 years

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