Gettry Marcus CPA, P.C.

2017 TAX LEGISLATION

Q & A: Major Provisions Affecting Real Estate

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INTRODUCTION

The 2017 Tax Cuts and Jobs Act provides for the most significant changes to the Internal Revenue Code in decades that will affect almost every taxpayer. At the same time, it presents challenges in its interpretation and implementation, having been enacted only ten days before most of its changes took effect after a very short legislative process. While many of its provisions are straightforward, there are several areas that are marked by ambiguity and which will require technical guidance from the Treasury Department.

This guide is an overview of the most significant topics affecting the Real Estate business in question-and-answer format. As the aforementioned technical guidance becomes available, we will provide relevant updates. Please feel free to contact your Gettry Marcus professional for more information, and to learn how these changes affect you and your business.

1. QBI DEDUCTION FOR RENTAL REAL ESTATE ACTIVITY

Q: How would the new 20% deduction for pass-through income benefit the owners of a profitable rental property?

A: Assuming that a rental real estate activity is considered a trade or business (this is believed to be the case for most rental activities), the owners (other than C corporations) can deduct 20% of the net profit in arriving at taxable income. However, there is a limitation based on 50% of W-2 wages paid to employees or, if larger, 25% of wages plus 2.5% of the unadjusted basis of depreciable property at the end of the year. For this purpose, depreciable property that has been held at least 10 years and beyond the asset's regular depreciation period is not included. Furthermore, the percentage of wages and property limitations do not apply to taxpayers whose taxable income (before the QBI deduction) is under a threshold amount — $157,500 ($315,000 for joint filers).

Example #1: Joe owns a 50% membership interest in PJ LLC, which is taxed as a partnership; there are no special allocations. For the year 2018, PJ has net rental income of $1,200,000. The property is managed by a real estate management company, so PJ has no W-2 wages other than $60,000 paid to a superintendent. The building was acquired in 2004 for $7 million and has a MACRS life of 27.5 years. There is $40,000 of equipment that was acquired in 2007 and is fully depreciated and $30,000 of equipment acquired in 2010 that is also fully depreciated. Joe files a joint return and his tentative taxable income from all sources is $700,000.

Joe's QBI deduction is calculated as follows:

Maximum amount = $600,000 share of net income X 20% = $120,000
50% W-2 wages limit = $30,000 share of wages X 50% = $15,000
Or

25% of $30,000 = $7,500; plus share of building basis ($3,500,000) plus share of equipment held less than 10 years ($15,000) = $3,515,000 X 2.5% = $87,875
$7,500 + $87,875 = $95,375.

Joe's deduction is limited to $95,375, which will reduce his taxable income to $604,625.

Example #2: Same as above, except the property is self-managed by the LLC so W-2 wages are $400,000, and Joe's share is $200,000. His 50% of wages limitation is $100,000; wages plus basis limitation is ($200,000 X 25%) = $50,000 plus $87,875 = $137,875. His deduction is the maximum amount of $120,000.

Example #3: Same as #1, but due to losses and deductions from other sources, Joe's tentative joint taxable income is only $310,000. Joe can take the maximum $120,000 deduction without regard to the wages/property basis limitations.

2. CHANGES TO TAX DEPRECIATION RULES

Q: What changes were made with respect to depreciation and cost recovery under the 2017 Tax Cuts and Jobs Act?

A: Several changes were made that will result in acceleration of depreciation deductions

SECTION 179 EXPENSE

Under prior law, a taxpayer's annually allowable Code Sec. 179 expense couldn't exceed $500,000 as adjusted for inflation. In addition, there was a phasedown of the allowable amount when the cost of section eligible property placed in service by the taxpayer during the tax year exceeded 2,000,000, adjusted for inflation. At the election of the taxpayer, qualified leasehold improvements, qualified restaurant property and qualified retail improvement property (see below) were eligible for expensing.

Effective for property placed in service *in years beginning* after 2017, the above-referenced amounts are each increased by $500,000, to $1,000,000 and $2,500,000, respectively. They will continue to be adjusted for inflation.

Furthermore, the type of property eligible for Section 179 expensing is expanded to include all qualified improvement property, as well as personal property used in connection with lodging facilities that previously did not qualify.

BONUS DEPRECIATION

Under prior law, newly acquired depreciable property was eligible for additional first-year ("bonus") depreciation of 50% of the basis. This was set to phase down and completely expire after 2019. In addition, the original use of qualified property had to begin with the taxpayer.

Effective for property *acquired and placed in service after September 27, 2017* (unless subject to a written binding contract to acquire before September 28, 2017), property is eligible for 100% bonus depreciation. There is a scheduled phase-down to 80% starting in 2023 and ending at 20% in 2026, after which the provision is set to expire. In addition, used property now qualifies if it was not previously used by the taxpayer or a related party.

QUALIFIED IMPROVEMENT PROPERTY

The separate categories for qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property are combined into one category, qualified improvement property. However, due to a drafting error, this category is not currently eligible for bonus depreciation and has a 39-year life. A technical correction could be required to resolve this.

3. NEW LIMITATIONS ON BUSINESS LOSSES

Q: What new limitations on the tax benefits of net losses from businesses were created by the 2017 Tax Cuts and Jobs Act?

A: There are three major changes affecting taxpayers:

EXCESS BUSINESS LOSS DISALLOWANCE

Under prior law, net losses from business incurred by noncorporate taxpayers (after applying passive activity limitations, etc.) could be deducted and offset all other sources of income in the loss year without limitation.

Effective for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, a taxpayer's "excess business loss" (EBL) is disallowed. EBL is equal to the pre-limitation aggregate deductions for the tax year that are attributable to the taxpayer's trades or businesses over gross income or gain from said businesses plus $250,000 ($500,00 for a joint return). Any disallowed EBL is treated as an NOL carryover to the following tax year (subject to the 80% limitation discussed below).

For partnerships and S corporations, EBL rules are determined at the partner/shareholder level.

Example 1: Susie Green receives a K-1 from CYE, LLC reflecting a business loss of $300,000 for 2018. The loss is non-passive and there is no basis or at-risk limitation, and Susie has no other trade or business income. Her EBL is $50,000 ($300,000 –$250,000). The $50,000 excess business loss is treated as part of the Susie's NOL carryforward in later years.

Example 2: Same as above, except Susie files a joint return with her husband, Jeff. She doesn't have an excess business loss because the business loss ($300,000) doesn't exceed the $500,000 threshold for joint filers.

For years beginning after 2018, the $250,000/$500,000 thresholds will be indexed for inflation.

ELIMINATION OF NET OPERATING LOSS (NOL) CARRYBACKS

Under prior law, an NOL incurred by a C corporation, individual, estate or trust for any tax year was generally carried back two years, and then carried forward 20 years. An election to waive the carryback and carry the entire NOL forward could be made with the return of the loss year.

Effective for losses incurred in years ending after 2017, NOL's may no longer be carried back. However, these losses may now be carried forward indefinitely.

TAXABLE INCOME LIMITATION

Under prior law, the NOL deduction wasn't subject to a limitation based on taxable income for regular tax purposes.

Effective for losses incurred in years beginning after 2017, the NOL deduction is limited to 80% of taxable income, determined without regard to the NOL deduction itself. Carryovers to other years are adjusted to take account of the 80% limitation.

Example: In 2018, XYZ Inc., a calendar-year C corporation, has a $90,000 NOL and no other NOL carryovers. XYZ's loss is carried to 2019, when it has tentative taxable income of $100,000. The 2019 NOL deduction is limited to 80% of $100,000, or $80,000. The remaining $10,000 can't be deducted in 2019, but can be carried forward indefinitely.

4. BUSINESS TAX INTEREST EXPENSE LIMITATION

Q: What are the changes in business interest deductions pursuant to the Tax Cuts and Jobs Act of 2017?

A: Unlike under prior law, business interest deductions for taxpayers with more than $25 million average gross receipts (including attribution from commonly owned businesses) are now subject to a limit, generally 30% of income (but subject to modifications discussed below).

BUSINESS INTEREST EXPENSE LIMITATION

Business interest was not limited under pre-2018 law. The new law limits the business interest deduction to the sum of:

- Business interest income; plus
- 30% of adjusted taxable income (but not below zero); plus

The limitation applies at the partnership level, such that the partnership's ordinary income or loss includes the allowable deduction for business interest. To prevent double counting and potentially increasing the allowable limit for business interest, the adjusted taxable income for a partner does not include the pass-through income from the partnership. However, if the partnership has not met the limit – in other words, if it has not deducted interest up to the maximum amount of 30% of adjusted taxable income – the unused portion, called excess taxable income, may be used by the partners to compute their adjusted taxable income.

Adjusted taxable income is taxable income computed without regard to:

- Non-business income, gain, deduction or loss;
- Business interest;
- NOL; and
- Pass-through deduction (under new Code §199A);

- For the years between 2018 and 2021, adjusted taxable income is also computed without regard to depreciation, amortization, or depletion.

Interest over the limit is carried forward indefinitely. If there is a change in control of a corporation that would trigger a limitation on NOL carryover under Code §381, the business interest carryover is treated, and limited, just as an NOL carryover would be.

Exclusions from the limitation

The limit does not apply to small taxpayers, defined by reference to the same threshold that determines which taxpayers may use the cash method, i.e. average gross receipts of $25 million. However, pass-through entities that allocate 35% or more of losses to investors who are not active in the business are subject to the limitation.

A real property trade or business may make an irrevocable election to be exempt from the limitation, if they use the slower "ADS" method of depreciation for real property which increases the recovery periods.

STATE IMPACT

Numerous states have not adopted various aspects of the above changes. It is imperative that a well-thought-out plan is implemented to reduce both federal and state/local taxes.

DISCLAIMER

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