Tax Cut and Jobs Act
for
Real Estate

What Real Estate Owner Need to Know for 2018 & Beyond

By

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Meet The Speaker

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Chuck Thornton, CPA specializes in tax planning, compliance and tax representation before governmental authorities. Chuck has lectured locally and nationally on topics such as tax law, management, business valuations and strategic tax planning. Both the American Institute of Certified Public Accountants and the Arizona Society of Certified Public Accountants have honored Chuck as the Speaker of the Year.

Email your questions to Chuck. If they are not answered at the end of the presentation, we will get back to you via email.

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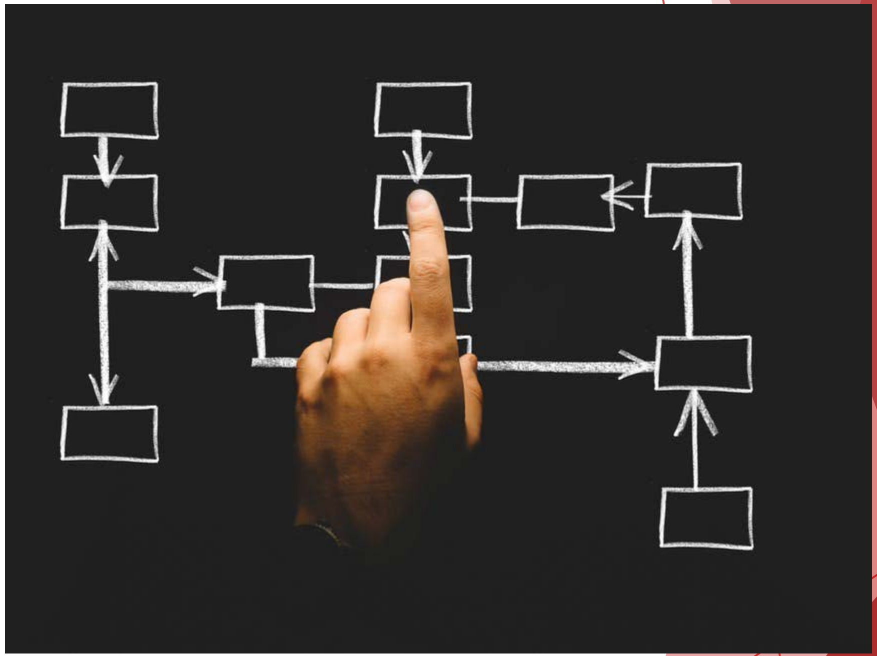
Major Points We Will Discuss

- New 20% Pass Through Deduction (Section 199A)
- Considering Cost Segregation
- Interest Paid Limitations
- Depreciation Changes
- Limitation on Losses



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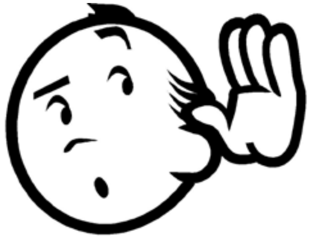
The 20% Pass Through Deduction for Qualified Business Income of Pass-thru entities

- This is the big one, and the one we will spend some time on
- Basically, with various exceptions and limitations
  - You get a deduction of Qualified Income. That is somewhat your K-1 profit
  - So as a starter if your qualified business income is $100,000, you get a deduction against that for 20% and hence a $20,000 deduction
  - And if your tax bracket is your tax savings is $6,600
  - Sound interesting?



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So while you're thinking of what to do with the savings, lets start with definitions.

- Qualified Business Income (QBI)(Section 199A) a new term in the code!
- QBI means income from any trade or business other than
  - A specified service trade or business, or
  - A trade or business if performing services as employee (ie W-2, so if you work for someone, Section 199A has no application to your wages.)
- What components are not part of QBI?
  - Must be associated with conduct of trade or business
  - Does not include effectively investment income
  - Reasonable Compensation paid to tax payer
  - Guaranteed Payments from a Partnership

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So while you’re thinking of what to do with the savings, lets start with definitions (continued)

- What is a specified service trade or business
  - Specifically excludes engineers and architects
  - Performance of services in the field of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial service broker services or any other trade or business is the reputation of skill of 1 or more employees
  - This presentation is not for the folks doing qualified services, BUT you might be renting your own building to your practice—if so stay tuned!!!
  - But, This will not apply under certain income ranges (discuss more on this later in another webinar)

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Is Investment in Real Estate a Trade or Business?

- The statue neither specifically includes or excludes real estate
- So the criteria applicable to defining a “trade or business” is the same
- This term is used throughout numerous sections in the Internal Revenue Code
- This criteria is usually to deny losses, particularly hobby losses.—not the case in our discussion, since losses would never yield a QBI deduction
- General definitions include consideration for the time, energy, continuity and involvement of the business (or in the case real estate operations).
- <u>Most commentators seem to agree, so far, that triple net leases for a particular real estate, probably would not be a trade or business</u>

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Real Estate Trade or Business Issues and Strategies

- Change triple net leases into more operating type leases where owner takes care of maintenance, taxes, insurance etc.
- If renting to your business, consider reducing rent—thereby increasing business income

Note: Any of these ideas are, at this point, untested. In the presenters opinion you would need to tie in some economic purpose for these changes.

For businesses over $25,000,000 in gross receipts, you might actually want to have a triple net lease in years 2022 and beyond (more coming up).

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Certain Principles Apply

- QBI starts with Taxable Income
- Excludes Investment type Income
- Deduction of 20% of Domestic Qualified Income
- Once your total taxable income exceeds $415,000 the deduction is further limited to the greater of
  - 50% of W-2 wages, or
  - 2.5% of unadjusted basis plus 25% of wages

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Example

Jack files MFS. He has a Schedule C sole proprietorship and has taxable income from that business of $150,000. His other income is $50,000 which is not QBI income.

- His taxable income, taking the standard deduction is $176,000.
- Compute 20% times QBI income of $150,000 = $30,000 (tentative)
- Limit 20% of taxable income x $176,000 = $35,200
- Result $30,000 Deduction

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Example Taxable Income over $415,000

- In the prior example, QBI income is $1,000,000 (ie. from proprietorship)
- No other QBI and taxable income is $700,000
- Has W-2 wages of $250,000—employees and even his own
- Assets with unadjusted cost of $100,000
- Tentative deduction $1,000,000 x 20%= $200,000
- Limit is now NOT based on taxable income, but is based on
  - Greater of 50% wages $250,000 x 50% = $125,000, or
  - 25% of W-2 wages Plus 2.5% of unadjusted basis of assets

    $250,000 x 0.25 = $62,500 plus 2.5% x 100,000 = $2,500 for total of $65,000

Result: QBI deduction is $125,000

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Some Other Concepts

- 20% QBI from all sources is added to become "Combined Qualified Income"
- This can be from your share of interest in entities, as well as proprietorship
- Wage return requirement—allocable to business and for which returns filed with SSN are done before 60 days after the due date including extensions—you will probably not have wages in a real estate rental business.

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Some Other Concepts, Continued

- Qualified Property
  - Depreciation tangible property use to produce income subject to QBI
  - Depreciable period cannot end before close of tax year.
  - Depreciable Period
    - Begins when property is placed in service
    - Period Ends the latter of
      - The date ending 10 years after property placed in service, or
      - the last day of the last full year in the applicable recovery period that would apply under Modified Accelerated Cost Recovery System (MACRS) depreciation without regard to the alternative depreciation system
  - Cost placed in service is criteria, not the net amount after depreciation

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Examples

- Residential property subject to depreciation life 27.5 years. The cost can not be taken into consideration in year 30.
- Non-residential property subject to depreciation life of 39 years. The cost can not be taken into consideration in year 42.
- Caveats
  - Cost Segregation may reduce otherwise longer life portions of your property—by claiming a shorter life than otherwise that which is normal in real estate
  - Other treatments such as Qualified restaurant property, Qualified retail improvement may do the same.

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Bringing This Together for the Real estate owner

- If your real estate is separate from operating entity
  - Consider if a triple net lease - a triple net lease probably does not work
  - You will probably have no W-2 wages, unless your operations are extensive. If so, wages would help in trade or business definition. Consider common paymaster
  - Lets assume no wages. The only remaining limitation creator is 2.5% of the unadjusted basis, and assuming you have not exceeded the time period.

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Example

- Assume that your QBI for rentals is $200,000 and without any limitation you have a $40,000 QBI deduction (20%)
- You have no wages, but the building cost (not including land) 3,000,000 about 10 years ago. The limit is (2.5% x $3,000,000 or $75,000. Your limit is $75,000.
- Question?
  - What would happen if you reduced rent and what caveats should you consider?
  - What about simply keeping the lease the same, but simply not paying the rent (i.e. accrue it) until after 2025—what would happen?
  - Is your lease a triple net lease, what might you do?

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What Happens to Excess Losses of QBI

- Carry forward to next period to offset next years QBI
- For regular taxes, and if not passive, deduct but limitations on NOL

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Cost Segregation Study Strategies for 2017

- Seriously Consider Cost Segregation Study (called Cost Seg)
- Breaks components into shorter lives (consider caveat in prior slides)
- Remember the 199A rules begin in tax year 2018.
- Normally a Cost Seg study reduces taxable income significantly in the year the study is done. IF that creates a loss, you do not want that in 2018, so 2017 would be ideal.
- It is still possible to do a Cost Seg study for 2017 as long as it is done before you file your tax returns (which could be on extensions)

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Other Issues

- Many issues to be considered (and technical, so bear with me)
- Basis Issues
- At Risk Issues
- Passive Issues
- Loss Limitation Issue
- Use of Aggregation Election

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Cost Recovery under Bonus Depreciation

- Prior to 1/1/17 to 9/27/17 50%
- Acquired 9/27/2017 to 2022 100%
- Acquired 2023 80%
- Acquired 2014 60%
- Acquired 2025 40%
- Acquired 2026 20%

- Now for used or new property (tangible personal property)

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179 Depreciation

- Amount of Eligible Property Increase from $500,000 to $1,000,000
- Phase out if more than $2,500,000 of 179 property acquired
- Applies to new or used property

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179 Definition Expansion

- Qualified tangible personal property and qualified real property
  - Improvements to non-residential real property placed in service which is
    - Roofs
    - Heating, Ventilation and Air Conditioning
    - Fire Protection and Alarm Systems
    - Security Systems

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Business Interest Deduction

- Applies only to group of businesses where gross receipts exceed $25 Million
- Disallows interest to extent it exceeds 30% of adjusted taxable income (effectively EBITDA) before interest and depreciation
- Carryforward okay
- EBITDA concept good until January 1, 2022. After that depreciation is deducted effectively creating a EBITA concept

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Business Interest Deduction to Watch for 2022 and Beyond—for individual subject to this issue

- At that time, depreciation is used to reduce taxable income thereby reducing the allowance of interest deduction.
- This is on an affiliate basis. So the test of this of this could include rental and operating income.
- Considerations
  - Start thinking about capital structures, related party loans, bank provisions on loans, and specific loan agreements
  - This applies to "trade or businesses"
    - For this should be consider triple net leases—what a quagmire!

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Net Operating Loss Carryforward

- Current law NOL's carry back 2 years and forward 20 years
- Current limits income offset to 80% of future year income.
- Elimination of carryback
- But NOL's can be carried indefinitely
- Reduced amount if income is over $500,000 in carryforward year

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The Moral on This

- Do not wait until October or November to start thinking about this
- Planning starts now for 2018 and beyond, so you can have your solutions to enhance the opportunities
- Robust software is needed to work through all of these issues
- For our clients
  - We will be identifying their opportunities, after our last seminar, and we will be approaching during and shortly after tax season.
  - For others, not our clients—you should start the discussion now, with your advisor.

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And Another Reminder!

Don’t Wait!!!

Start resolving these issues early in the year!!

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Questions?

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