Anchin Alert

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Tax Cuts and Jobs Act Offers Favorable Tax Breaks for Real Estate Owners

The Tax Cuts and Jobs Act (TCJA), which was signed into law on December 22, offers the real estate industry a treasure trove of tax breaks. Overall, most Real Estate companies and owners will come out ahead under the new tax law, but there are a number of tax breaks that were eliminated. Here are the most important changes in the new law that will impact the real estate industry.

New deduction for pass-through businesses

Under prior law, net taxable income from pass-through business entities (such as sole proprietorships, partnerships, S corporations and LLCs) was simply passed through to owners. It was then taxed at the owners' tax rates. In other words, no special treatment applied to pass-through income recognized by business owners.

For tax years beginning in 2018, the TCJA establishes a new deduction based on a noncorporate owner's qualified business income (QBI). This new tax break is available to individuals, estates and trusts that own interests in pass-through business entities. The deduction generally equals 20% of QBI, subject to restrictions that can apply at higher income levels.

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss from any qualified business of the noncorporate owner. For this purpose, qualified items are income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business. QBI does not include certain investment items, reasonable compensation paid to an owner for services rendered to the business or any guaranteed payments to a partner or LLC member treated as a partner for services rendered to the partnership or LLC.

The QBI deduction is not allowed in calculating the noncorporate owner's adjusted gross income (AGI), but it reduces taxable income. In effect, it's treated the same as an allowable itemized deduction.

W-2 wage limitation.
For pass-through entities, the QBI deduction generally cannot exceed the greater of the noncorporate owner's share of:
- 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Qualified property is the depreciable tangible property (including real estate) owned by a qualified business as of year end and used by the business at any point during the tax year for the production of qualified business income.

Under an exception, the W-2 wage limitation does not apply until an individual owner's taxable income exceeds $157,500 ($315,000 for joint filers). Above those income levels, the W-2 wage limitation is phased in over a $50,000 range ($100,000 range for joint filers).

Service business limitation.
Finally, the QBI deduction generally isn't available for income from specified service businesses (such as most professional practices other than engineering and architecture). Under an exception, the service business limitation doesn't apply until an individual owner's taxable income exceeds $157,500 ($315,000 for joint filers). Above those income levels, the service business limitation is phased in over a $50,000 phase-in range ($100,000 range for joint filers).

The W-2 wage limitation and the service business limitation do not apply as long as taxable income is under the applicable threshold. In that case, the taxpayer should qualify for the full 20% QBI deduction.

Section 179 deduction

Beginning in 2018 the amount a business may claim as an immediate deduction under Section 179 will increase from $500,000 to $1 million. The limit on property eligible for the Section 179 deduction is increased to $2.5 million. The TCJA also expanded the definition of Section 179 property to possibly include roofs, HVAC property, fire protection and alarm systems, and security systems if these improvements are made to nonresidential real property.

Accelerated depreciation

The TCJA increased the amount a business or taxpayer may expense under bonus depreciation from 50% to 100% for property placed in service after September 27, 2017 and before January 1, 2023. The amount allowed as bonus depreciation after 2022 will be reduced by 20% until it is fully phased out in 2027. Property purchased prior to September 28, 2017 and placed in service will still be eligible for the 50% bonus deprecation.

The definitions for qualified leasehold improvement property, qualified restaurant property, and qualified retail property have been eliminated and are now included in the new definition of qualified improvement property. Qualified improvement property is depreciable over 15 years using half year conventions. Qualified improvement property no longer needs to be subject to a lease or placed in service three years after the date the building was placed in service.

Like-kind exchanges – Section 1031

Section 1031 rules that allow tax-deferred exchanges of appreciated like-kind property were modified to allow for exchanges of only real estate after December 31, 2017. Beginning in 2018, there are no more like-kind exchanges for personal property assets. However, the prior-law rules still apply if one leg of an exchange has been completed as of December 31, 2017, but one leg remains open on that date.

New limits on business interest deductions

Subject to some restrictions and exceptions, prior law stated that interest paid or accrued by a business generally is fully deductible. Under the TCJA, affected corporate and noncorporate businesses generally cannot deduct interest expense in excess of 30% of "adjusted taxable income," starting with tax years in and after 2018. Entities and individuals that own real estate can make an election to use a slower depreciation method for their real property and deduct 100% of their interest expense. This election could limit the amount of bonus depreciation the taxpayer may be eligible for in the future. Careful planning should be done prior to making this election.

For S corporations, partnerships and LLCs that are treated as partnerships for tax purposes, this limit is applied at the entity level rather than at the owner level.

For tax years beginning in 2018 through 2021, adjusted taxable income is calculated by adding back allowable deductions for depreciation, amortization and depletion. After 2021, these amounts aren't added back in calculating adjusted taxable income.

Business interest expense that's disallowed under this limitation is treated as business interest arising in the following taxable year. Amounts that cannot be deducted in the current year can generally be carried forward indefinitely.

Taxpayers (other than tax shelters) with average annual gross receipts of $25 million or less for the three previous tax years are exempt from the interest deduction limitation. Certain other taxpayers are also exempt.

Excess Loss Limitation

A new limitation applies to deductions for "excess business losses" incurred by noncorporate taxpayers. The TCJA defines an Excess Loss as an amount in excess of $250,000 or $500,000 for a married taxpayer filing joint. Losses that are disallowed under this rule are carried forward to later tax years and can then be deducted under the rules that apply to NOLs. This new limit kicks in after applying the passive activity loss rules. However, it applies to an individual taxpayer only if the excess business loss exceeds the applicable threshold. Unlike the business interest limitation this limit is calculated at the taxpayer level and not the entity level.

Net Operating Losses

For Net Operating Losses (NOLs) that arise in tax years ending after December 31, 2017, the maximum amount of taxable income that can be offset with NOL deductions is generally reduced from 100% to 80%. In addition, NOLs incurred in those years can no longer be carried back to an earlier tax year (except for certain farming losses). Affected NOLs can be carried forward indefinitely under the TCJA as opposed to a limit of 20 years under the prior law.

Reduced or eliminated employer deductions for business-related meals and entertainment

Prior to the TCJA, taxpayers generally could deduct 50% of expenses for business-related meals and entertainment. Meals provided to an employee for the convenience of the employer on the employer's business premises were 100% deductible by the employer and tax-free to the recipient employee. Various other employer-provided fringe benefits were also deductible by the employer and tax-free to the recipient employee.

Under the new law, for amounts paid or incurred after December 31, 2017, deductions for business-related entertainment expenses are disallowed. Meal expenses incurred while traveling on business are still 50% deductible, but the 50% disallowance rule will now also apply to meals provided via an on-premises cafeteria or otherwise on the employer's premises for the convenience of the employer. After 2025, the cost of meals provided through an on-premises cafeteria or otherwise on the employer's premises will be nondeductible.

Carried Interest

The long awaited carried interest legislation was part of the TCJA. The allocation of income that a partner receives for services performed to a partnership will now be subject to a three year holding period on capital gain property instead of the normal one year holding period.

Estate Tax

The estate and gift tax exemptions were increased from $5.0 million to $10 million dollars per individual. The exemption is indexed for inflation so an individual can shelter approximately $11.2 million of assets from the estate and gift tax. After 2025 the exemptions will revert back to a $5 million dollar base.

Changes to some employee fringe benefits

The new law disallows employer deductions for the cost of providing commuting transportation to an employee (such as hiring a car service), unless the transportation is necessary for the employee's safety.

It also eliminates employer deductions for the cost of providing qualified employee transportation fringe benefits (for example, parking allowances, mass transit passes and van pooling), but those benefits are still tax-free to recipient employees.

What's Next?

The TCJA is the largest overhaul of the tax code in more than 30 years, and we've covered only the highlights of the real estate-related tax provisions here. If you would like to discuss these changes, planning opportunities or have any specific questions, contact your Anchin Relationship Partner, or consider joining us for one of our two webinar sessions titled "Tax Reform Discussion – How Will the Bill Affect You? Get the Answers; Not Just the Facts."

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