Abbott, Stringham & Lynch

Tax Group

Tax Reform and the Impact on Real Estate

Presented by:

Mike Eichenbaum, CPA

February 6, 2018

Abbott, Stringham & Lynch

CERTIFIED PUBLIC ACCOUNTANTS & BUSINESS ADVISORS

Upcoming Webinar
12:00-1:00 PST

- Wednesday, February 7, 2018 –
  at 12:00-1:00 PST
  Tax Reform for Pass-Through Entities

Introduction

- Mike Eichenbaum, CPA
  - Tax Manager
  - 10 years of real estate / partnership experience
    - Like-kind exchanges
    - Residential and commercial rentals
    - Real estate development

    - Panel
      - Ivette Carrasco and Erika Garcia
      - ASL Tax Staff

Topics

- The Brand New Pass-Through Entity Deduction (Section 199A)
- Changes to the Like-Kind Exchange Rules
- Vastly Enhanced Business Asset Expensing
- Changes to Individual Mortgage and Property Tax Deductions
- Limitations on Pass-Through/Net Operating Losses

Pass-Through Entity Deduction

- In general – business returns not filing as a C-Corp (partnership, LLC, Schedule C, Schedule E) are eligible for a 20% deduction on pass-through net income (subject to qualified business income)
    - Example – a 50/50 real estate partnership incurs $10,000 taxable income. $5,000 flows to each investor on their K-1. Each investor gets to deduct an additional $1,000 each on their individual tax returns
    - Note – no cash payment requirement to receive this deduction

Pass-Through Entity Deduction (continued)

- Qualified Business Income
  - All income reported on a tax return with the exception of capital gains and interest income

- Limitations
  - If an individual is reporting taxable income in excess of $415,000 (married filing joint), the deduction is now limited to individual's allocation of 25% of wages paid from the entity plus 2.5% of depreciable property (referred to as the "Corker Kickback").

Pass-Through Entity Deduction (continued)

- Example – individual reports $500,000 of taxable income. Of that income $200,000 is income from pass-through of a 10% owned real estate investment. Depreciable property (original cost) is $5,000,000.

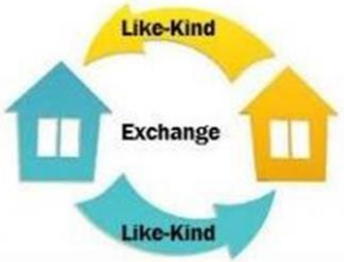
- Breakdown
  - $200,000 X 20% = $40,000 deduction (assuming no limitation)
    - Since this individual exceeded the taxable income threshold, we must calculate the reduced amount based on the calculation set forth by the joint committee

  - $5,000,000 X 2.5% = $12,500 + $-0- wages = $12,500

Pass-Through Entity Deduction (continued)

- More to note:
  - If Qualified Business Income exceeds taxable income, use 20% of taxable income
  - Guaranteed payments do not count as qualified business income
  - If you are considered a specified service trade or business (healthcare, broker, accounting professional, lawyer…) no business deduction allowed in excess of $415,000 threshold.
  - If you have one pass-through with net income and another with net loss that exceeds the net income of the former, no current year 20% deduction allowed for the entity with income (carries forward)
  - Still waiting on IRS for technical corrections, Notices, Rev Procs, Regulations
  - Deduction will expire in 2025

Like-Kind Exchanges



- Prior law – non recognition of gain for any property held in business or investment if "like-kind" property is purchased within the exchange rules
- New law – non recognition of gain for real property exchanges only
- Issues arise for lump sum sale of real estate and personal property sales (residential real estate with appliances…hotels) although it may apply to commercial real estate sale as well.
- Cost segregation considerations
- Still waiting on further IRS guidance

New Business Asset Expensing Rules

- New Bonus Depreciation Expensing Rules for 2018
  - 100% expensing on qualified assets. (generally most fixed assets except real estate) through 2022, then % phases down yearly 80/60/40/20 through 2025. Prior law was 50% bonus depreciation deduction.
    - Note – includes assets placed in service after September 27, 2017 so this could impact your 2017 filing.
    - Includes new and used property (prior law deduction was for new property only)

New Business Asset Expensing Rules (continued)

- Section 179 expensing
  - Applies to nonresidential real estate only
  - Prior law – expense allowed for all tangible fixed assets with the exception of land and real estate (allowed expense for tenant improvements)
  - Current law – expands 100% deductions for roofing, HVAC, fire protection, and security systems
  - Expands tax year deduction from $500,000 to $1,000,000

Changes to Individual Mortgage and Property Tax Deductions

- Mortgage interest – personal residence
  - Prior law – deduction for mortgage interest on up to $1,000,000 mortgage (interest deduction limited if mortgage exceeds limitation)
  - Current law – up to $750,000 mortgage until 2025 then reverts back to $1M
  - Homes purchased prior to December 15, 2017 are grandfathered in to prior law
  - No mortgage interest deduction for HELOCs (prior law allowed this on HELOCs up to $100,000)

Changes to Individual Mortgage and Property Tax Deductions (continued)

- Property taxes
  - Prior law - unlimited in the amount of property tax deduction on residence, second home…
  - Current law – limited to $10,000 per year through 2025
  - Combines limitation with state taxes
  - Updates – California is attempting to pass a state bill as a work around to allow a deduction for state taxes – stay tuned

Limitations on Business Losses (non C-Corporation)

- If the aggregate of all business losses on an individual return exceeds the aggregate of business income by over $500,000 if MFJ or $250,000 single, your loss is limited to $500,000 or $250,000, respectively.
    - Basically if the sum of all your K-1s, Schedule C and Schedule E rentals exceeds a $500,000 loss, you are limited to a $500,000 loss in total during that tax year
- Losses not deducted on the tax return converts to an NOL to be applied to the following year
- Limitation expires after 2025

Limitations on Business Losses (non C-Corporation) (continued)

Example 1:

- Tom is a single taxpayer and has net losses of $300,000 from his sole-proprietor business (assume no other 1040 activity)

- Tom will have $50,000 as an excess business loss ($300,000 – $250,000)
  - Tom will have a $50,000 NOL to be utilized in subsequent years

Partnerships and S Corporations

Excess business loss limitation rules apply at the partner or shareholder level.

Example 2:

- John and Mary start a Real Estate business as equal partners.
- John is single and invests $500,000
- Mary is married and invests $500,000
- In 2018, the partnership reports a net loss of $700,000
- Each has $350,000 partnership loss on Schedule E

Partnerships and S Corporations (continued)

Example 2 (continued):

- John has an excess business loss of $100,000 ($350,000 – $250,000)
- Mary has no excess business loss ($350,000 less than $500,000)
- Mary’s $350,000 loss is from a passive activity

- Code Section 461(l) applies after the application of the passive loss rules of Code Section 469.

Changes to the Net Operating Loss (NOL)

- In general, NOLs are generated if in one tax year you incur business losses that exceed taxable income.

- Prior law – no limit on the amount of NOL deduction in that you could effectively deduct all current year income with an NOL carryover from a prior year.

  - Ex – taxable income in 2018 is $300,000
  - NOL carryover from 2017 business losses is $400,000
  - Current year taxable income is $-0- with a $100,000 NOL carryover to 2019.

Changes to the Net Operating Loss (NOL) (continued)

- Current law – NOL deductions are limited to 80% of taxable income
  - Ex – taxable income in 2018 is $300,000
  - NOL carryover from 2017 business losses is $400,000
  - Current year taxable income is $60,000 ($300,000 – $240,000 ($300,000 X 80%)) with a $160,000 NOL carryover to 2019.
- Prior law – NOLs expire after 20 years
- Current law – NOLs carry over indefinitely
- Prior law – choice to carryback NOL 2 years or carryover current year generated NOL
- Current law – must carryover current year generated NOLs

Other Topics

- Carried Interest
  - 3 year holding period

- Business interest expense limitations
  - Limits business interest expense on properties that average over $25 million over the last 3 tax years

  - Limited to 30% of adjusted taxable income

  - Real estate businesses are generally exempt if election is made at the entity level (ADS depreciation method must be used)

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- Questions?