Boulder Investment Group

Tax Implications of Real Estate Investing After the Tax Cuts & Jobs Act (TCJA) of 2018

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Real Estate Tax Changes from Tax Cuts & Jobs Act Starting 2018

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Issue	Previous law (2017)	TCJA (2018)
Tax rates - A business where the 20% Qualified Business Income (QBI) deduction would apply	39.6% + 3.8% net investment income tax – 43.4%	29.6% (37% marginal rate with 20% QBI deduction) + 3.8% net investment income tax – 33.4%
Tax rates - A business where the 20% QBI deduction would <u>not</u> apply (excluding self-employment tax)	39.6% + 3.8% net investment income tax – 43.4%	37% + 3.8% net investment income tax – 40.8%
Interest expense – IRC §163(j)	Generally, fully deductible	A Real Property Trade or Business (RPTB) can elect out of 30% of EBITDA/EBIT interest limitations and fully deduct. Limited interest expense deductions can be generally carried forward indefinitely. All other business interest is subject to this limitation (except farming).
Depreciation expense	27.5 years for residential real property, 39 years for nonresidential real property	Same as previous law unless electing out of 30% interest limitation – depreciable lives would then be 30 years for residential and 40 years for nonresidential real property acquired after 2017 (pre-2018 property changed to a 40-year life for residential and nonresidential property).

Real Estate Tax Changes from Tax Cuts & Jobs Act Starting 2018 (Continued)

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Issue	Previous law (2017)	TCJA (2018)
Bonus depreciation	50% deduction allowed for most "original use" assets besides building	100% for certain assets, including used property. Thus, cost segregation studies become more valuable.
Highest marginal capital gain tax rate on real estate sale income (unchanged)	20% + 3.8% net investment income tax	20% + 3.8% net investment income tax
Carried interest (for distributive items of long-term capital gain)	20% + 3.8% net investment income tax (1 year hold required)	20% + 3.8% net investment income tax (potential 3-year hold period required)
Corporate tax rate on all real estate related income	35%	21% (starting in 2018). Distributions not deductible, thus still subject to two layers of tax – corporate and shareholder levels.
Net operating losses (NOL) carryforwards	100% (90% for AMT)	80% and indefinite carryforward (no carrybacks allowed); corporate AMT repealed
Active loss limitations offsetting other income items (EBL)	No limitations	Single taxpayers limited to $250,000, married filing joint taxpayers limited to $500,000 and carried forward
1031 Like-kind exchanges	Real and personal property allowed for like kind exchanges	Only real property allowed for like kind exchanges. Gain on personal property mitigated by new bonus depreciation rules.

Example: Real Estate Cash Flow Investment

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Cap Rate	6.0%	20,000,000	Property acquisition cost		
Cash-on-cash return	10.0%				
Debt	70.0%	14,000,000	16,000,000	80.0%	Building
Equity investment	30.0%	6,000,000	4,000,000	20.0%	Land
Total cost	100.0%	20,000,000	20,000,000	100.0%	
Net operating income (NOI)		1,195,000			
Annual debt service - 4.25% IO		(595,000)	Limited to 30% of NOI, or $358,500		
Annual cash flow **(A)**		600,000			
Annual depreciation - 30 year		(533,333)	Previously was 27.5 year, or $581,818		
Adjusted Gross Income		66,667			
Standard deduction		(24,000)			
QBI deduction - 20%		(8,533)	New for 2018		
Taxable income		34,133			
Federal tax		3,714			
Colorado tax		1,581			
Total tax **(B)**		5,295			
Cash tax rate **(B) / (A)**		0.88%			

These metrics for Cap Rate and Cash-on-Cash return are typical of the current real estate market for multi-family housing.

New law changes result in: reduced interest deduction of $236,500 ($595,000 - $358,500) and reduced depreciation expense of $48,485 ($581,818 - $533,000).

Accordingly, we recommend a Real Property Trade or Business (RPTB) election is made to deduct the interest without limitation (may not be necessary, depending on facts). The tradeoff is annual depreciation reduced by $48,485.

Example: Tax Differential on Types of Income

Annual net cash flow	600,000	600,000	600,000	600,000
Income Type	Rental Real Estate (Previous Slide)	Qualified Dividends or Capital Gains	Interest Income & NonQualified Dividends	Self Employed Attorney
Adjusted Gross Income (AGI)	66,667	600,000	600,000	584,004
Standard deduction	(24,000)	(24,000)	(24,000)	(24,000)
QBI deduction - 20%	(8,533)	0	0	0
Taxable income	34,133	576,000	576,000	560,004
Federal tax	3,714	79,670	152,979	147,380
Self-employment tax - 15.3%	0	0	0	31,991
Net investment tax - 3.8%	0	13,300	13,300	2,737
Colorado tax	1,581	26,669	26,669	25,928
Total tax	5,295	119,639	192,948	208,036
Cash tax rate	0.88%	19.94%	32.16%	34.67%

This example isolates $600,000 of income solely to distinguish the difference in rates. Obviously, taxpayers could have different combinations of each income type above. This example is meant to clarify how valuable depreciation is in sheltering tax, especially when used in conjunction with the proper amount of debt. Tax minimization is a powerful wealth management tool, and would be more pronounced without graduated rate tables.

The Limitations on Real Estate Losses – Applied at Investor Level

- Losses from real estate can be limited by:
  - Basis limitations – different rules apply for each type of legal entity utilized. Basis is generally equal to 1) contributions to the entity, 2) increased/decreased by profit/loss, and 3) decreased by distributions. LLC's permit losses and distributions to be passed through to investors, and with greater flexibility. Other entities generally encounter limitations when funds are borrowed from third parties. For example, debt in an S Corporation increases basis only if the shareholder actually loans money to the corporation.
  - At Risk limitations – IRC Section 465 limits the losses generated by various business and investment activity to the amount the investor is "at risk" in the venture. Qualified nonrecourse financing (QNF) – although investors are not liable for debts of an LLC, they have basis and are considered "at risk" if the QNF is secured by real property [IRC §465(b)(6)].
  - Excess business loss limitations (EBL) – new for 2018. Limits a taxpayer's ability to offset nonbusiness income with an overall loss from business, even if the taxpayer materially participates in the business. EBL limitation is applied after PAL, and limits business losses to $500,000 annually. We're not seeing much impact to real estate from this new provision – mostly on start up companies.

The Limitations on Real Estate Losses – Applied at Investor Level (Continued)

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- Utilization of Passive activity loss limitations (PAL) involves a netting process – rental activities are passive regardless if the taxpayer materially participates. An exception exists for a "Real Estate Professional" [IRC §469(c)(7)]. Such passive losses cannot offset nonpassive income from:
  - Business in which the taxpayer materially participates,
  - Salaries and wages, and
  - Portfolio income (generally interest, dividends, and gains from the sale of investment property that produces portfolio income).
- Example – strategic disposition of passive activity with suspended PAL's from previous years are allowed without limitation [See IRC §469(g)(1)(A)]:
  - Johnny (not a real estate professional) has $12,000 of suspended PAL's from two limited partnerships and an additional $4,000 suspended PAL from a rental property. In 20X1, Johnny disposed of several speculative stocks (portfolio) that resulted in a capital loss on that year's return of $17,000, which was carried forward to 20X2. In 20X2, the three passive activities produce net losses of $2,000. Thus, losses carried forward to 20X2 are $35,000 ($12K + $4K + $17K + $2K).
  - In 20X2, Johnny sells the rental property, recognizing a long-term capital gain of $20,000 (<u>key here is this is PAL source</u>). Result: The $20,000 capital gain allows 1) full use of the $17,000 capital loss carryover, 2) $16,000 of suspended PAL's and the $2,000 current year PAL. CPA's refer to this as a triggering event to "free up" suspended losses, thereby offsetting other sources of nonpassive income.

Guidelines for Real Estate Dispositions

- Allen sold a rental building that he owned for many years. His original cost of the building was $500,000 and he has taken straight-line depreciation deductions of $200,000, leaving an adjusted basis of $300,000. His basis in the land is $100,000. He sells the property for $850,000.

	Building	Land	Total	
Selling price	650,000	200,000	850,000	
Adjusted basis	(300,000)	(100,000)	(400,000)	
Gain from sale	350,000	100,000	450,000	
		Gain	Tax	Rate
§1250 depreciation recapture		200,000	50,000	25.00%
§1231 gain (capital)		250,000	50,000	20.00%
Totals		450,000	100,000	22.22%

Upon the disposition of most property on which depreciation was taken, taxpayers must recognize ordinary income (or *recapture*) an amount equal to all or a portion of the gain realized on the disposition. Depreciation recapture is subject to tax using the following rates: 1) at the taxpayer's highest marginal tax rate in the case of personal property, and 2) a flat 25% in the case of depreciation taken on buildings and structural components.

<u>When to use a Like-Kind exchange</u>:

- Taxpayer has nondepreciable, nonincome-producing property and can exchange it for depreciable, income-producing property,
- Taxpayer can convert actively managed real property for investment property (e.g. triple net lease) or vice-versa,
- Significant appreciation in value that would result in a large tax liability. General rule is once you do a §1031, you should continue on that path. If held until death, beneficiaries may receive a permanent deferral and step-up of basis under IRC §1014.

<u>When not to use a Like-Kind exchange</u>:

- When the gain is passive income that can be used against current or suspended PAL's, and the 3.8% net investment income tax can be avoided (ie, AGI < $250,000).
- If the taxpayer has a wide disparity between capital gains and ordinary tax rates. For example, taxpayer may be better off after-tax if sale of raw land taxed as capital gain is replaced with cash flow property with significant depreciation.

Additional Real Estate Considerations

- New centralized Partnership audit regime. Starting 2018, IRS will conduct audits and make adjustments at Partnership level. Small Partnerships (less than 100 partners), should not assume they can elect out of these new rules.
- Uncertainty of new Qualified Business Income (QBI) 20% deduction for real estate. An activity normally qualifies if the primary purpose is for profit and the taxpayer is involved with continuity and regularity. For example, a triple-net lease (NNN) would not qualify for the QBI deduction. IRS Notice 2019-07 provides a Safe-Harbor election to treat a rental real estate operation as a qualified activity.
  - A Specified Service Trade or Business (SSTB) does not qualify.
  - SSTB includes the performance of services in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, or brokerage services.
  - Its principal asset is the reputation or skill of one of its owners or employees.
- The JCJA significantly expanded IRC §179(f) to expense certain qualifying property. Such property may now be eligible for full expensing in the year placed in service.
  - Certain qualified improvement property (QIP) to the interior of a nonresidential building.
  - Other nonresidential improvements such as roofs, HVAC, fire protection, and security.

Additional Real Estate Considerations (Continued)

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- The TCJA reduced qualified residence interest on acquisition indebtedness to $750,000 for new loans taken out after 12/31/2017. Loans before that are grandfathered up to $1.0 million. Interest on home equity indebtedness up to $100,000 is suspended until 2025.
- State and local tax itemized deductions capped at $10,000. We're seeing fewer clients with AMT problems as a result.
- The Alternative Minimum Tax (AMT) exemption amount increased to $109,400 for married couples filing jointly
- Qualified Opportunity Fund (QOF).
  - May permit capital gain deferral that otherwise would be included in income before 2027. May include gains from real estate (and §1250 recapture), stocks, bonds, art, land, and other qualified investments.
  - A QOF will require substantial improvements to property – ie doubling of acquisition cost in a 30-month period.
  - Allows temporary deferral of gain if proceeds are invested in a QOF during the 180 day period following sale. The deferred gain may be reduced permanently by 10% if the QOF is held at least five years, or 15% if the QOF is held at least seven years.
- The TCJA raised the applicable lifetime exclusion amount to $11,400,000 for 2019. The annual gift exclusion is $15,000 per donee for 2019
  - For a surviving spouse, any unused exclusion can be transferred (*portability*). Portability is only available if the executor of the predeceased spouse's estate elects on a timely filed Form 706 estate tax return.
  - Remember to seek discounts of LLC interests for gift and estate purposes (minority discounts, lack of control and transfer restrictions)

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