Key federal income tax considerations for real estate owners - by Marc Finer

June 08, 2018 - Financial Digest

Marc Finer
Murtha Cullina LLP

The recently enacted Tax Cuts and Jobs Act (the TCJA) made several significant federal income tax changes that impact personal and professional real estate owners. Notably, a number of the changes will sunset after a certain number of years. Key provisions of the TCJA that effect real estate owners include:

• Limitation on Deduction for State and Local Property Tax: The annual itemized nonbusiness deductions for income, sales and state and local property taxes are limited to $10,000 in the aggregate.

• Reduction in Mortgage Interest Deduction: Mortgage interest on new mortgages obtained after December 14, 2017 is deductible only on the first $750,000 of mortgage debt (previous limit was $1 million). The limit applies to the combined amount of mortgage loans on a primary and second (i.e., vacation) home. Interest on home equity loans continues to be deductible, but only if the loan proceeds are used to buy, build or improve a home. Qualifying home equity loans count towards the $750,000 cap.

Deduction limits for property taxes and mortgage/home equity loan interest may make primary or vacation home ownership more difficult and/or less desirable and produce a positive effect on the rental real estate market. Vacation home owners should consider renting their homes and/or transferring them in to business entities to potentially avoid these limitations.

• 20% Qualified Business Income ("QBI") Deduction: Real estate dealers and investors who are sole proprietors or equity owners in pass-through entities (e.g., partnerships, S corporations, LLCs) may deduct 20% of their share of QBI in determining their personal income tax liability. The deduction becomes limited based on a percentage of W-2 wages and qualified property (e.g., real estate) once taxable income exceeds $157,500 (single filer) or $315,000 (joint filers). Qualified REIT dividends are not subject to this limitation.

The QBI deduction potentially decreases the effective tax rate on business income from 37% to 29.6%. The “qualified property” limitation makes the deduction more available to owners of rental real estate businesses which often pay fees to a property management company rather than W-2 wages. To maximize the deduction, real estate businesses should be structured to create QBI and REIT investments should be considered.

• 100% Bonus Depreciation: The TCJA increases first-year bonus depreciation from 50% to 100% for new and used eligible property placed into service between September 17, 2017 and December 31, 2022.

• IRC Section 179 Deduction: The TCJA increases the maximum amount a taxpayer can expense under Internal Revenue Code (“IRC”) Section 179 to $1 million and the phase-out threshold to $2.5 million (from $510,000 and $2,030,000, respectively, in 2017). The TCJA also expands the definition of qualifying property to include certain improvements to nonresidential buildings (e.g., HVAC system, roofs and alarm and security systems).

The increased availability of 100% bonus depreciation and IRC Section 179 deductions provides a meaningful tax benefit for real estate owners. Cost segregation studies will become critical to identify immediately deductible repairs and improvements and the availability of the deductions for property that did not previously qualify.

• Business Interest Limitation: The TCJA limits the business interest deduction for certain large businesses to the sum of business interest income plus 30% of a adjusted taxable income. Real estate businesses have the option to elect out of this limitation but the trade-off is that 100% bonus depreciation is not available and longer depreciation lives apply to certain real estate assets.

The inability to fully deduct business interest could dramatically effect debt-financed real estate businesses which may now face a substantial increase in taxable income. Also, existing debt is not grandfathered so owners of leveraged real estate should consider re-evaluating their capital structure and whether electing out of the limitation makes financial sense. The reduction in tax rates may mitigate the impact of this limitation.

• Like-Kind Exchanges: The TCJA limits IRC Section 1031 tax deferral to like-kind exchanges of qualifying real estate.

Cost segregation studies will play an important role in determining the portion of a building that is not considered real estate. The ability to fully expense the purchase of personal property through 100% bonus depreciation and the IRC Section 179 deduction may reduce the negative impact caused by this limitation.

States have responded to changes made by the TCJA in a variety of ways. For example, the Connecticut legislature recently passed the “Act Concerning Connecticut’s Response to Federal Tax Reform” (the “Act”) in response to the TCJA. If signed into law as expected, the Act will require businesses to add back the 100% bonus depreciation deduction and the IRC Section 179 deduction and take the deductions over four years and five years, respectively. In addition, the Act does not adopt the 30% business interest limitation. To mitigate the SALT cap, the Act permits municipalities to offer a property tax credit to eligible taxpayers who make voluntary contributions to a designated charitable organization that supports public services (e.g., public education).

Marc Finer is partner at Murtha Cullina LLP, Hartford, Conn.