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Tax Reform Act provisions impacting the real estate investor

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The most substantial tax law changes in 30 years were enacted by the US Congress in December 2017. The Tax Cuts and Jobs Act (TCJA) significantly changes how US entities are taxed.

Tax rate changes

Many foreign investors have held their ownership stake in real estate through a corporation. The corporate structure allows them to limit their estate tax exposure and they are not required to file an individual US income tax return, so it provides some confidentiality. As opposed to a flow through entity, a US corporation owned by a foreign owner 'blocks' the tax obligation at the corporate level. This means that the corporation, not the foreign owner, is subject to US tax. Historically, with this corporate ownership structure for real estate, sale of the property was taxed at 34 percent, whereas, had that real estate been owned through a flow through entity, the sale could have been subject to a more preferential capital gain rate of 20 percent. Under the prior law, some investors were willing to pay the 14 percent difference

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in tax because of the benefits the blocker structure offered. With the enactment of the recent Tax Act, the corporate tax rate has been lowered to 21 percent, which is only slightly higher than the individual rate of 20 percent. Therefore, we expect to see many more foreign owners hold their US real estate interests in a corporate form.

US residents usually invest in real estate directly or through a partnership and, therefore, are taxed on income from the property as an individual. Under the TCJA, the individual tax brackets have been expanded and tax rates reduced in each bracket, meaning more of a taxpayer's income will be taxed at a lower rate. The top tax rate on ordinary income, for individuals, was changed from 39.6 percent to 37 percent, and if the income qualifies for the new 20 percent deduction their top tax rate on trade or business rental income becomes 29.6 percent. This 25 percent reduction of tax is substantial and smart entrepreneurial owners will find ways to maximise their savings. The QBI deduction provides taxpayers the opportunity to make operating, legal and accounting changes to their businesses in an effort to maximise the deduction.

Cost recovery

One of the most favourable taxpayer aspects of the TCJA are the cost recovery changes. The expansion of bonus depreciation and section 179 expensing allows owners to recover the cost of their capital investments much faster. Section 179 can now be used to deduct building systems in non-residential property. Many non-residential real estate owners can now fully deduct the replacement cost of their new roofs, HVAC systems and fire protection and alarm systems compared to depreciating them over 39 years under the prior law.

Bonus depreciation has been substantially expanded as well. Under the TCJA, new and used property with a 20 year or less recovery period now qualifies for 100 percent bonus depreciation. This expansion of bonus depreciation, to include used property, allows property owners the opportunity to substantially increase their write offs in the year of purchase. Cost segregation studies should be performed to document that the assets qualify for bonus depreciation.

For non-residential property, there is a class of property which was created prior to the TCJA called Qualified Improvement Property (QIP). QIP is any improvement, after the property has been placed in service, to the interior of a non-residential building, except for improvements related to structural framework of the building, elevators and escalators, or expansion of the building. Before the TCJA, QIP was treated as a 39 year asset and was eligible for bonus depreciation. The TCJA changed the language in the statute and Congress intended to reduce the depreciable recovery period from 39 years to a 15 year life. However, final language in the statute did not reflect this change. This oversight means QIP property is not currently eligible for bonus depreciation. It is anticipated that this will be addressed in a technical corrections bill which presumably will be made retroactive to 1 January 2018. However, until the change is made, or more guidance is issued, the significant benefit taxpayers would receive from being able to take a bonus on QIP is in question and taxpayers should await further guidance before determining if they will take bonus depreciation on QIP for 2018.

Deductions and limitations

An individual taxpayer may receive a 20 percent deduction for Qualified Business Income (QBI) – the net amount of items of income, gain, loss and deductions relating to a qualifying business. The new deduction is not available to a corporation. Real estate owners should review the level of activity within their rental property to make sure their operations qualify as a rental real estate trade or business. While the Department of Treasury has yet to provide guidance on what types of rental activity will qualify as a trade or business, current law suggests you need to have regular, continuous and substantial activity to be considered in a rental property trade or business. Owners might want to consider taking back some of the management responsibility of the property by assuming activities and expenditures such as insurance, taxes, maintenance and cleaning for the rental property.

In addition to having a qualified business, limitations apply to high income individuals and most rental real estate owners will have to meet a wage and capital test to qualify for the deduction. The deduction is limited to the lessor of 20 percent of their qualified business income or 25 percent of employee wages paid by the rental property, plus 2.5 percent of the unadjusted basis of qualified assets used in the rental trade or business. The unadjusted basis test does not include land cost, and buildings and their components are included in the unadjusted basis amount to the extent they are still within their depreciation recovery period (27 and a half years for residential property and 39 years for nonresidential property). Owners of older properties that have been in service for longer than their recovery period may want to purchase new assets or pay more wages before year end to maximise their deduction.

Prior to 2018, taxpayers could generally deduct 100 percent of their business interest expense. Starting in 2018, a taxpayer's interest deduction is limited to 30 percent of adjusted taxable income, plus business interest income for the year. Any disallowed interest expense is carried forward indefinitely. The new business interest limitation rules can apply to leveraged real estate entities if the entity's average gross receipts over three years is more than $25m.

Many property owners will not exceed the $25m gross receipt threshold on a single property, and if they are invested in just one property these rules will likely not apply to them. However, those entities which have institutional investors in their ownership structure, or owners who have investments in multiple properties, could be subject to the business interest limitation. The limitation requires investors to aggregate the gross receipts they have within an affiliated group to determine if they meet the $25m gross receipts threshold. With an institutional investor you might be required to include income from other entities in the gross receipts test, and it could pull a smaller real estate property into the limitation.

Real estate businesses may choose to elect out of the limitation. The election out is irrevocable and it comes with a cost to the entity. The election requires the taxpayer to change their tax depreciation on residential property, non-residential property and qualified improvement property to the ADS method of depreciation, which could substantially slow down their current depreciation deduction. The Department of the Treasury is expected to issue guidance on how this method change will be accomplished, which is important to determine the full impact of this election. It is important to note that a change to the ADS system will eliminate the use of bonus depreciation for some of the assets that might have otherwise qualified. Thus, computations of this impact need to be considered before a decision to elect out of the interest limitation rules can be made. For example, residential properties in service before 31 December 2017 might have their recovery period extended from 27 and a half years to 40 years, under current law. For non-residential property, switching to ADS life will only extend the recovery period from 39 to 40 years, so the impact is not nearly as great. Taxpayers need to be aware of the new rules and perform some analysis to determine the tax cost of the reduced depreciation expense compared to the tax cost on the interest expense limitation. An alternative might be to consider making additional capital contributions to pay down debt and avoid the interest deduction limitation.

Planning considerations

Decreased tax rates, along with accelerated cost recovery provisions, make future investments in real estate more attractive. Start reviewing your rental property business practices to determine if, by changing any of your operating, legal or accounting practices, you can improve your chance to qualify as a real estate trade or business.

Plan for the timing, amount and character of capital improvements to your property. When acquiring additional properties, consider obtaining a cost segregation report to maximise your current depreciation deductions.

Review the new business interest limitation rules to determine if you are subject to the limitations. If you are, start planning today to minimise the impact and determine if you are eligible to elect out of those rules.

Take the time to learn and understand how the new tax law applies to your situation. Start planning now in order to fully maximise those benefits for 2018. ■