New Tax Law and How It Affects the Real Estate Industry

WAGNER KIRKMAN BLAINE
KLOMPARENS & YOUMANS LLP
ATTORNEYS AT LAW

March 9, 2018

Cameron L. Hess, CPA, Esq.
Wagner Kirkman Blaine
Klomparens & Youmans LLP

10640 Mather Blvd Mather, CA 95655 (916) 920-5286	1350 Treat Blvd., Suite 400 Walnut Creek, CA 94597 (925) 478-7308

chess@wkblaw.com

I. **Overview**.

The Tax Cuts and Jobs Act (ACT) has produced probably the greatest tax law changes in 30-years. In fact there are so many changes, it is difficult to make generalizations that are true for most everyone as to whether they will have more or less tax, without grouping people into categories. Before getting into home ownership, a few of the changes should be discussed:

A. Selection of Individual Changes

1. Tax Brackets. There have been significant changes in personal income tax brackets. While clearly beneficial for married couples, single individuals earning from about $300,000 - $425,000 will have only small tax reductions given that the hitting them with a 35% tax bracket on earnings above $200,000 is intentionally meant to shrink down their tax savings.

TABLE 1

How Will Your Tax Bracket Change in 2018?

SINGLE

Old Rates	Old Bracket	New Rates	New Brackets
10%	$0–$9,525	10%	$0–$9,525
15%	$9,526–$38,700	12%	$9,526–$38,700
25%	$38,701–$93,700	22%	$38,701–$82,500
28%	$93,701–$195,450	24%	$82,501–$157,500
33%	$195,451–$424,950	32%	$157,501–$200,000
35%	$424,951–$426,700	35%	$200,001–$500,000
39.6%	$426,701+	37%	$500,001+

MARRIED, JOINT FILER

Old Rates	Old Bracket	New Rates	New Brackets
10%	$0–$19,050	10%	$0–$19,050
15%	$19,051–$77,400	12%	$19,051–$77,400
25%	$77,401–$156,150	22%	$77,401–$165,000
28%	$156,151–$237,950	24%	$165,001–$315,000
33%	$237,951–$424,950	32%	$315,001–$400,000
35%	$424,951–$480,050	35%	$400,001–$600,000
39.6%	$480,051+	37%	$600,001+

SOURCES: Heritage Foundation research and Tax Cuts and Jobs Act, H.R. 1, 115th Congress, 1st Session. IB4800 heritage.org

2. Head of Household Disincentive. Those claiming head of household, while receiving lower taxes to the extent their taxable income is below $82,500 will be placed, as to greater earnings, within in the same tax bracket as single individuals. This change represented

a compromise to address those Republicans opposed to giving tax benefits to unmarried persons with dependents.

3. Marriage Penalty? Congress reduced the "marriage penalty" built into the tax brackets both by having the brackets for married persons broadened and reducing bracket ranges for single individuals earning more than $200,000. The effect is that married persons will save more under the ACT.

4. Standard Deduction. Lessening the tax advantages somewhat for home ownership is the doubling of the standard deduction. The ACT provides for a standard deduction of $12,000 (single) or $24,000 (married filing jointly) from 2018 through 2025. On the other hand, as outlined below, higher income taxpayers, while subject to hurdles, may still benefit from claiming itemized deductions over the standard deduction. Also, several of these provisions are only in place from 2018 through 2025-years, meaning that home owners have a greater likelihood of having tax benefits in the future, as some provisions expire.

5. Loss of Personal Exemptions. The deduction for personal exemptions has been removed for the eight (8) tax years covering from 2018 through 2025. In purchasing a home in anticipation of children, the birth of children will itself not provide a tax benefit through 2025. And, those with 5 or more children will find that the prior law granted more with the lower deduction and personal exemptions.

6. Other Itemized Deductions. Individuals also lost or had limited a number of other itemized deductions from 2018 through 2025. These include:

a. Qualified Moving Expense Deduction

b. Losses from Wagering Losses

c. Miscellaneous Itemized Deductions.

7. Alimony Deduction. Beginning with marital dissolutions after 2018, there will no longer be allowed a deduction for alimony. This is a permanent change.

8. California Tax Law. California law has not yet conformed and it is not expected that these provisions will likely be adopted, except for conformity with the Alimony Deduction provision to avoid confusion for married persons intending to divorce.

Impacts of the Tax Cuts and Jobs Act

	James	Jason	Amber	Kavya and Nick	Sophie and Chad	Soren and Linnea	Laura and Seth	Joe and Ethan
Ordinary Income	$30,000	$52,000	$75,000	$85,000	$165,000	$325,000	$2,000,000	$48,000
Marital Status	Single	Single	Single	Married	Married	Married	Married	Married
Earners	1 earner	1 earner	1 earner	1 earner	2 earners	2 earners	1 earner	Retired
Children	No kids	2 kids	No kids	2 kids	2 kids	3 kids	2 kids	n/a
Tax-Deferred Retirement Contributions	$2,600	$4,000	$5,500	$5,500	$20,000	$37,000	$18,500	$0
Itemization	Std. Ded.	Std. Ded.	Std. Ded.	Std. Ded.	Itemizing	Itemizing	Itemizing	Std. Ded.
Current Law	$4,331	$5,198	$16,104	$11,035	$29,345	$71,629	$713,234	$3,497
Proposed	$3,953	$3,306	$14,327	$8,782	$27,122	$62,012	$694,330	$3,227
Tax Liability Change	-$379	-$1,892	-$1,777	-$2,254	-$2,224	-$9,617	-$18,904	-$270
% Tax Liability Change	-9%	-36%	-11%	-20%	-8%	-13%	-3%	-8%
% Change in After Tax Earnings	1.26%	3.64%	2.37%	2.65%	1.35%	2.96%	0.95%	0.56%

Note: Tax burden figures do not include employer-side payroll taxes. These results are for 2018, and do not reflect the expiration of many individual provisions.
Source: Tax Foundation calculations.

TAX FOUNDATION @TaxFoundation

II. 20% Qualified Business Income (Pass-Though) Deduction (Section 199A)

A. Background. This is a substantial expansion of former Section 199, domestic production deduction, limited previously to manufacturers. If you don't know the old section, you won't understand several nuances of new section. It is not limited to pass-through entities and includes Schedule C filers.

B. Home Builders/Developers. Section 199A is available practically to the same extent as the former Section 199 Domestic Production Deduction.

C. Limited Availability on Income As Real Estate Agent/Broker Services.

1. Why? Except for the small business owner – under $157,500/$315,000, the term "Qualified Trade or Business, excludes – except for architects/engineers – professional services as defined under Code Section 1202(e)(A)(3) – which consists of

> *any trade or business involving the performance of services in the fields of health, law, ~~engineering, architecture~~, accounting, actuarial science, performing arts, consulting, athletics, financial services, **brokerage services**, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.*

2. Property Management. The same limitations will likely apply to property management service income. To the extent that there is a separate pass-through entity that is a revenue center providing property management, there will be the dilemma if it should be treated as part of an affiliated enterprise. However, in California, if not the owner, property management services must be provided by an attorney or real estate broker, and therefore property management services may not qualify.

D. Does Income from Rental/Commercial Property Investments Qualify? It depends. The IRS has struggled historically to decide what level of rental activities represents a trade or business, and not an investment. Triple net leases and ground lease income may fail. The Service's position is generally that if management services are provided by a third party, the owners hold an investment, not a trade or business. However, older case law says otherwise.

E. Computation. The computation is complicated. First it is NOT a simple 20% deduction against qualified business income. "Simplified" – The general measure is the lesser of 100% of qualified business income or 20% of the net of taxable income – less capital gains. And, there are further limits – based on income, wages, wages + capital and taxable income. There pare provisions for REITs and Coops. Further guidance with the IRS is needed. For more on this issue, go to http://www.wkblaw.com/articles-news

III. Doing Business - C Corporation vs "Other Choice?

A. 2017 Tax and Jobs Act. The Act eliminated tiered corporate rates and adopted a flat 21% corporate tax rate. It also eliminated corporate alternative minimum tax. A question arises as to whether business should be conducted through a C Corporation.

Where a C Corporation is used wherein profits are intended to be retained and not principally distributed to the key owners, a C Corporation may be more beneficial as retained earnings are only taxed at a 21% federal income tax rate. However, if there is any intention to have a majority of profits distributed, then an S Corporation, partnership or "nothing" may still, however, be a better option tax wise than doing business as a C Corporation (taxable corporation.) In that situation, the 21% tax rate probably should **never** be the reason to choose to be a C Corporation due to the impact of double taxation on distribution of profits by way of dividends/distributions (other than as wages.) Namely:

Entity	Federal	Result
C Corporation	36.8% - 39%* 20-23.8% Dividends + 21% Corporate Rate *Combined Effective Rate	Higher
S Corporation	10-37% *Individual Income Tax Rate	Lower

Plus, for California – Dividends are double taxed on a C Corporation.

B. Other Reasons to Choose to be a C Corporation (rather than an S Corporation)

1. Earnings. Most earnings may have to be distributed as wages.

2. Group Term Life Insurance. Only C Corporations exclude premiums paid to cover up to $50,000 of employee group-term life insurance coverage.

3. Medical Reimbursement Plan. A reimbursement plan for medical expenses still deductible, but a non-reportable benefit for C Corporation shareholders. Few taxpayers will have enough to itemize. It may save *some* taxes.

C. Choice of Entity if not a C Corporation.

1. LLC? An LLC is not available to operate as a licensed broker/agent. There are no provisions in the Business and Professions Code (B&P) which authorize a limited liability company to become licensed as a real estate broker. (RE 218 (Rev 6/16)). Acting under an LLC may result in unauthorized practice and disciplinary action.

2. Partnership? 10 CCR 2728. Allowed as long as every partner is a licensed broker.

IV. Deductions for Realtors & Real Estate

A. Deductions as a Sales Agent. Most sales agents are independent contractors, and should already be deducting business deductions on Schedule C. The elimination of miscellaneous itemized deductions – including employee business expenses should not affect those who are independent contractors with respect to business expenses.

B. "Luxury" Vehicle Limits. The loss of 1031 exchange rules won't hurt sales of vehicles for business use because the annual depreciation limit for passenger automobiles (including trucks and vans) [that are not exempt as heavy vehicles] placed in service after December 31, 2017 were increased as follows (indexed after 2018-year):

- $10,000 – 1st year placed in service,
- $16,000 – 2nd year,
- $ 9,600 – 3rd year,
- $ 5,760 – each succeeding year.

These are substantial increases as compared to what was allowable in prior years. Vehicles may also qualify for first-year bonus depreciation. See below.

C. First Year Write-Off (Section 179 Expensing.) Section 179 first-year write-off election has been increased to $1 million. The phase-out threshold for the $1 million has increased to $2.5 million from 2018 through 2025. Beginning January 1, 2018, residential rental property personal property now qualifies – carpets, drapes, furnishings. However, now eligible is ***qualified improvement property*** (excluding restaurant buildings and some restaurant improvements) – which represents nonresidential interior improvements and roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems. Required as to both is that they be installed in nonresidential real property after the date the real property was first placed in service.

Heavy vehicles ("SUVs") are not subject to the luxury vehicle limits but are subject in 2018 through 2025 to a $25,000 first year deduction limit.

D. Bonus Depreciation. 100% first-year depreciation deduction ("Bonus" depreciation) aka "Additional First Year Depreciation" is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (or January 1, 2024 for certain long-production-period property and aircraft). The Act also expands qualified property to include used property; and certain qualified film, television, and live theatrical productions. Excluded from qualified property is certain public utility property and vehicle dealer property.

After 2022, the rate of bonus depreciation decreases over the next four (4) years:

- 80% for property placed in service in 2023
- 60% for property placed in service in 2024
- 40% for property placed in service in 2025
- 20% for property placed in service in 2026

The Act also extended the $8,000 additional bonus depreciation amount for qualified passenger automobiles, trucks, and vans. **Combining the extended $8,000 bonus depreciation with the revised depreciation limits on luxury autos, a new luxury auto placed in service in 2018 can receive up to $18,000 in first year depreciation**

E. Missing Legislation. The Act was *supposed to* consolidate the 15-year depreciation for 15-year leasehold improvement property, 15-year retail improvement and 15-year restaurant improvements. However, in defining these as qualified improvements, the Act forgot to include the provision for a 15-year write-off, but eliminated each of the three existing deductions.

V. Like-Kind Exchanges

The Tax Cuts and Jobs Act retains the current Section 1031 Like Kind Exchange rules for real property. It repeals the use of Section 1031 for personal property, such as art work, auto fleets, heavy equipment, etc.

VI. Meals & Entertainment.

The rules for deduction of meals and entertainment have changed. Take your clients to lunch, not sporting events. The Act provides that no deduction is allowed with respect to entertainment, amusement, or recreation activities. This includes membership dues with respect to any club organized for business, pleasure, recreation or other social purpose, or a facility or portion of a facility used in connection with the above items. The following chart provides a quick summary of these and other changes:

	2017 Expenses (Old Rules)	2018 Expenses (New Rules)
Office Holiday Parties Summer Office Picnic	100% deductible	100% deductible
Entertaining Clients	50% deductible	Meals – 50% deductible
	Event tickets, 50% deductible for face value of ticket; anything above face value is non-deductible	No deduction for entertainment expenses
	Tickets to qualified charitable events are 100% deductible	
Employee Travel Meals	50% deductible	50% deductible
Meals Provided for Convenience of Employer	100% deductible provided they are excludible from employees' gross income as de minimis fringe benefits; otherwise, 50% deductible	50% deductible (nondeductible after 2025)
Fringe Benefits	Businesses could deduct the cost of employee parking, transit passes and bike commuting reimbursements, and employees could exclude the benefit from income. Employee achievement awards could consist of anything within a dollar limit of $400 per award and $1,600 for all awards to the employee for the year.	Businesses can no longer deduct the cost of employee parking and transit passes (bike commuting reimbursements are still deductible), but employees can still exclude the benefit from income, except bike commuting reimbursements. Employee achievement awards must be tangible personal property and not cash, gift cards, coupons or certificates, nor tickets, meals, vacations, lodging or stocks and bonds. The dollar limits remain unchanged.

VII. Alternative Minimum Tax. (Individuals)

A. From 2018 through 2025, most individuals with income under $500,000 ($1 million married filing joint) will no longer have or will have very little Alternative Minimum Tax. However, for individuals with substantial income, AMT can remain an issue.

> During the 2017-year, Marta Washington, an investment property owner, single, had taxable income of about $410,000 for the 2017-year, from interest, dividends, capital gains and rental property income. Her taxes included $18,700 in AMT and $8,000 in net investment income tax. **For 2018-year, assuming no change, she will owe zero alternative minimum tax.**
>
> Marta will still owe about $8,000 in net investment income tax. **<u>She does not</u>** have a significant tax savings from the new tax brackets, because tax rates from 2018 through 2025 for income above $200,000 (and below $500,00) were raised and will wipe out tax reductions from lower income brackets.

VIII. Net Operating Loss Deduction

Many builders may still have unused net operating losses or may incur new net operating losses. Under the Act, there is no longer a carryback of net operating losses. In addition, the deduction of net operating losses for future years will be split into two groups. Those prior to the 2018-year may be deducted in full. Those losses incurred after 2017 will be limited to 80% of taxable income when applied to later years. However the 20-year limit is eliminated.

IX. Home Ownership

A. Overview. The Tax Cuts and Jobs Act (ACT) placed renters and home-owners on *nearly* the same playing field for itemized deductions. The tax benefit of interest deductions and taxes for federal income tax purposes might not be enough alone to itemize. It may help those with large donations to continue to itemize.

1. Deduction for Taxes. The deduction for both income taxes and property taxes on Schedule A is now capped to $10,000 per year as an itemized deduction, whether single or married.

Example 1. Marti Baker reports for the 2018-year expects California taxable income will be $100,000. Her 2018-year California taxes liability is expected to be roughly $6,600 – which she will have paid in during the year. If she purchases a home, the most she can deduct for property taxes paid will be $3,400 ($10,000 - $6,600). Any excess property taxes paid will not be deductible as an itemized deduction for federal income tax purposes because as cap on state tax deductions will be reached.

a. Marriage Incentive or Penalty? The $10,000 limit applies regardless of whether one is single or married. This may seem to create a possible marriage penalty, wherein unmarried couples are each allowed $10,000 and can double up if they do not gate married. On the other hand, married or single higher income individuals in California having more than about $160,000 in reportable taxable income will probably have already tapped out on state income tax itemized deductions. For them a home purchase may not gain a greater federal itemized deduction for state taxes paid.

On the other hand, because property taxes remain an itemized deduction for California income tax purposes, a home purchase will continue to provide a tax benefit on California tax returns.

2. Deduction for Interest. For new loans, the mortgage interest deduction will be limited to interest charges in connection with not more than $750,000 of acquisition debt. This is a permanent change and will apply for 2018 and all future years.

a. Existing Loans – Postponement of Rules. Existing loans, under the old rules will temporarily be exempted and under the old rules, including refinances – to the extent that the principal amount of indebtedness is not increased. However after the 2025-year, even the old loans will be subject to the new rules. And, refinances may be subject to the new rules faster, effective the earlier of the date that the original loan. However, if the original loan was for interest only, the effective date is 30-years after the 1st refinancing or the expiration of the term of the 1st refinancing.

Example 2. During the 2018-year, Jacob and Mary Abrams sells their old home in Gold River and purchases a new home in Granite Bay for $1.8 million, but subject to a loan of $1.1 million with 5% interest. They pay during the year total interest of $52,000.

Had the loan closed during the 2017-year, all of the $52,000 interest expense would have qualified as an interest expense itemized deduction for federal and California income tax purposes. (The 2017-year limit is $1 million + $100,000 line of credit amount.)

Under the ACT only $35,455 of the interest expense is a federal itemized deduction. $16,545 of the interest would not be deductible for Federal income tax purposes; however the entire $52,000 remains an itemized deduction for itemizing for California income taxes.

Note in this example, the Abrams couple, married, will still qualify to itemize deductions. However the itemized deduction for state taxes will be severely limited. While this would seemingly cause higher taxes, the tax rates from 2018 to 2025 will be lower. Whether their taxes increase or decrease, they will still be better off as homeowners than as renters for tax purposes.

Marriage Penalty. Again here, there the limitation on deduction for interest has reached a point wherein there is a significant marriage penalty. Were the Abrams couple unmarried, the limit of $750,000 each would mean that the entire interest amount – if split 50/50, would qualify. In this respect, there is a monetary incentive to "shack up" where the loan will exceed $750,000.

3. Suspension of Personal Casualty Loss Deduction. For the 2018-year through the 2025-year, a personal casualty loss, such as the loss of a home due to fire or flood not covered by insurance, is no longer qualified as a casualty loss, except where the loss is in a presidentially declared disaster area.

4. Sale of Principal Residence Exclusion Unchanged. While heavily discussed, no change was made to current provisions providing the right to exclude $250,000 per

person ($500,000 married, filing jointly) of gain recognized with respect to sales of homes that were used as a principal residence during two of the five years immediately preceding the sale of the residence.

X. **Selection of Business Changes Important for Real Estate.**

Certain changes while not particular to real estate professionals are of interest to them.

A. $250,000 Business Loss Limitation (Noncorporate Taxpayers). Real Estate Professionals and other business owners will be limited as to the losses that they may take from their business activities. Losses will be limited to $250,000 ($500,000 if married filing jointly) against nonbusiness income. The remaining portion realized in any year will be subject to net operating loss limitations (now limited to 90% of taxable income for regular tax purposes.)

B. Interest Expense Limitation (Large Accrual Taxpayers Only.) Leveraged real estate acquisitions may be limited in claiming interest deductions to 30% of income, unless an election is made to take depreciation over a period of 40 years. This requirement does not apply to small businesses – any cash basis taxpayer other than a tax shelter, with not more than $25 million in average gross receipts.

C. Accounting Methods. The allowance of the cash method of accounting has been simplified. The various provisions under Section 448 have been consolidated to allow the cash method of accounting for small businesses, defined as taxpayers other than a tax shelter with not more than $25 million in average gross receipts. This is an across-the-board replacement that covers personal service corporations, farming businesses and other enterprises. Historically, guidance indicated that the limitation is to be computed on a company-by-company basis among related corporations.

XI. **Estate Planning Changes**

A. Doubled Exclusion. The Act doubled the unified credit amount allowable for spouses dying and gifts made after December 31, 2017 and before January 1, 2026. The exclusion amounts are now roughly $10.9 million per person ($20.8 million between spouses jointly.) Given this change, the focus of trusts will primarily be on probate avoidance. However, the use of a marital trust, and portability, remains advantageous, not because of estate taxes, but because of the opportunity for a double step-up in tax basis wherein assets held in a marital trust may qualify to be restated to fair market value at the surviving spouse's death.

B. <u>General Estate Planning</u>. Now that trusts are commonly used, the changes should not discourage use of trusts for probate avoidance. Furthermore, even if there is no estate tax, there are substantial reasons, including, asset protection planning, at the death of the first death to form a marital or credit trust, even though estate taxes are unlikely.

C. <u>Real Estate Tax Planning</u>. In California, real estate seems to have a funny way of appreciating, wherein for those in investment real estate eventually there are estate taxes. The new rules end after 2025 and therefore, if estate taxes applied under the old rules, expect that the old rules may come back and cause taxation after the 2025-year.

D. <u>Warning to Your Clients</u>. Good estate planning is always critical. And, it is easy to get screwed up. The higher limits may cause more to think they should save money and do "poor man's planning" without legal counsel. This includes taking the advice of bankers and friends to use "pay on death" designations, joint tenancy, and other provisions on bank accounts, real estate – TOD Deeds. In fact, with surprising frequency, they may/will in fact in California completely invalidate later good estate planning. And they are difficult to detect and correct. The result is very costly. It can have the wholly unintended effect of leaving intended beneficiaries completely out and in the cold and destroy decades of later planning.