2018 Tax Law

Impact of the 2018 Tax Law on Real Estate Owners

1031
Knowledge

Congress has approved sweeping tax cuts and tax reform that have not been tackled by the federal government in over 30 years (since the Tax Reform Act of 1986.). The tax law, formally referred to as "The Tax Cuts and Jobs Act," will go into effect January 1, 2018. This article has the most up-to-date information along with a summary of how the tax law provisions will affect homeowners and real estate investors who own all types of investment property. Although this article generally does not delve into tax issues not associated with real estate, there are many new tax provisions and this is essential information for anyone that owns real estate to understand.

PRIMARY RESIDENCE HOMEOWNERS

As a result of doubling the standard deduction to $12,000 for single filers and $24,000 for married filing jointly, according to Moody's Analytics, as many as 38 million Americans who would otherwise itemize may instead choose the higher standard deduction under the new tax plan. The doubling of the standard interest deduction, in essence, removes a previous tax incentive of moving from renting a residence to home ownership. A likely unintended outcome will be fewer Americans choosing to become homeowners versus renting a residence solely for the tax advantages.

Any home mortgage interest debt incurred before December 15, 2017, will continue to be eligible for the home mortgage interest deduction up to $1,000,000. Any home mortgage interest debt incurred after this date will be limited to no more than $750,000 qualifying for the home mortgage interest deduction. Beginning 2018, the deduction for interest paid on a home equity line of credit ("HELOC") will no longer be eligible for the home mortgage interest deduction. However, the tax law preserves the deduction of mortgage debt used to acquire a second home. This should have a positive impact on supporting property values in resort and vacation destinations.

State and local taxes (referred to collectively as "SALT") can be deducted, but will no longer be unlimited as under previous tax law. The 2018 tax law will allow homeowners to deduct property taxes and either income or sales taxes with a combined limit on these deductions being limited to no more than $10,000. Top earners who live in a state with higher taxes like California, Connecticut, Oregon, Massachusetts, New Jersey, New York will be negatively affected the most by no longer having the previous full federal deduction available. There is the potential for home values in high state tax areas on both the West Coast and East Coast to see a reduction in property values partially due to the new capped SALT deduction at $10,000 and partially due to the new maximum $750,000 home mortgage deduction. A National Association of REALTORS™ study found there could be a drop in

Compliments of:

<FirstName LastName>
<Title>
<Company>
<XXX.XXX.XXXX> | <XXX.XXX.XXXX>
<Email> | <Website>

ASSET PRESERVATION®
INCORPORATED

HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com

home prices up to 10 percent in these and other high state tax areas as a result of limitations in the tax law that won't be as favorable as prior law for some property owners.

Both the House and Senate tax bills had originally proposed increasing the length of time a homeowner would need to live in a primary residence (from five out of eight years versus the current requirement to live in a primary residence two out of five years to qualify for the Section 121 tax exclusion). This proposed change did not become a part of the 2018 tax law. Homeowners will continue to only need to live in their primary residence 24 months in a 60 month time period to be eligible for tax exclusion up to $250,000 if filing single and up to $500,000 if married filing jointly. Property owners will still have the ability to convert a residence into a rental property or convert a rental property into a residence and qualify for tax exclusion benefits under both the primary residence Section 121 rules and also potentially qualify for tax deferral on the rental property under the Section 1031 exchange rules.

INVESTMENT PROPERTY OWNERS

Investment property owners will continue to be able to defer capital gains taxes using 1031 tax-deferred exchanges which have been in the tax code since 1921. No new restrictions on 1031 exchanges of real property were made in the new tax law. However, the tax law repeals 1031 exchanges for all other types of property that are not real property. This means 1031 exchanges of personal property, collectibles, aircraft, franchise rights, rental cars, trucks, heavy equipment and machinery, etc will no longer be permitted beginning in 2018. There were no changes made to the capital gain tax rates. An investment property owner selling an investment property can potentially owe up to four different taxes: (1) Deprecation recapture at a rate of 25% (2) federal capital gain taxed at either 20% or 15% depending on taxable income (3) 3.8% net investment income tax ("NIIT") when applicable and (4) the applicable state tax rate (as high as an additional 13.3% in California.)

Some investors and private equity firms will not have to reclassify "carried interest" compensation from the lower-taxed capital gains tax rate to the higher ordinary income tax rates. However, to qualify for the lower capital gains tax rate on "carried interest," investors will now have to hold these assets for three years instead of the former one -year holding period.

Some property owners, such as farmers and ranchers and other business owners, will receive a new tax advantage with the ability to immediately write off the cost of new investments in personal property, more commonly referred

Compliments of:

<FirstName LastName>
<Title>
<Company>
<XXX.XXX.XXXX> | <XXX.XXX.XXXX>
<Email> | <Website>

ASSET PRESERVATION®
INCORPORATED

HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com

to as full or immediate expensing. This new provision is part of the tax law for five years and then begins to taper off. There are significant concerns these business and property owners will face a “tax cliff” and higher taxes once the immediate expensing provision expires.

Investment property owners can continue to deduct net interest expense, but investment property owners must elect out of the new interest disallowance tax rules. The new interest limit is effective 2018 and applies to existing debt. The interest limit, and the real estate election, applies at the entity level.

The tax law continues the current depreciation rules for real estate. However, property owners opting to use the real estate exception to the interest limit must depreciate real property under slightly longer recovery periods of 40 years for nonresidential property, 30 years for residential rental property, and 20 years for qualified interior improvements. Longer depreciation schedules can have a negative impact on the return on investment (“ROI”). Property owners will need to take into account the longer depreciation schedules if they elect to use the real estate exception to the interest limit.

The tax law creates a new tax deduction of 20% for pass-through businesses. For taxpayers with incomes above certain thresholds, the 20% deduction is limited to the greater of: 50% of the W-2 wages paid by the business or 25% of the W-2 wages paid by the business, plus 2.5% of the unadjusted basis, immediately after acquisition, of depreciable property (which includes structures, but not land). Estates and trusts are eligible for the pass-through benefit. The 20% pass-through deduction begins to phase-out beginning at $315,000 for married couples filing jointly.

The tax law restricts taxpayers from deducting losses incurred in an active trade or business from wage income or portfolio income. This will apply to existing investments and becomes effective 2018.

State and local taxes paid in respect to carrying on a trade or business, or in an activity related to the production of income, continue to remain deductible. Accordingly, a rental property owner can deduct property taxes associated with a business asset, such as any type of rental property.

This article is only intended to provide a brief overview of some of the tax law changes, which will affect any taxpayer who owns real estate and is not intended to provide an in-depth overview of all the tax law provisions. Every taxpayer should review their specific situation with their own tax advisor.

Compliments of:

<FirstName LastName>
<Title>
<Company>
<XXX.XXX.XXXX> | <XXX.XXX.XXXX>
<Email> | <Website>

ASSET PRESERVATION INCORPORATED

HQ 800.282.1031 | NY 866.394.1031
apiexchange.com | info@apiexchange.com