Impact of the 2018 tax laws on real estate owners (Part 1) - by Pamela Michaels

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This is part 1 of an overview of the new tax law, formally referred to as "The Tax Cuts and Jobs Act," and the impact on both residential property owners as well as investment property owners. The scope of this overview focuses on real estate-related tax law changes and generally does not delve into tax issues not associated with real estate. Part 2 will focus on changes affecting primary residences and residential property owners. Part 1 focuses on changes affecting investment property owners.

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 new 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 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 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 new 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. 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 new 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 new tax law provisions. Every taxpayer should review their specific situation with their own tax advisor.

Part 2 of this article will appear in the February 6th edition of the New York Real Estate Journal

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