

## **Published Articles**

# The New Tax Law's Impact on Real Estate

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Greenbaum, Rowe, Smith & Davis LLP 2018 Real Estate Update: Trending Issues & Topics of Interest

## February 2018

The New Year brings with it a new tax law - the Tax Cuts and Jobs Act - that impacts the owners of real estate in many ways. This article presents an overview of those changes.

### **Limitation on Mortgage Interest Deductions**

For taxpayers who purchase new homes, interest will be deductible only on up to \$750,000 of "acquisition indebtedness." This is debt to acquire, or make substantial improvements to, a personal residence. Under the prior law, interest was deductible on up to \$1 million of debt. The prior law, with its \$1 million limit, will continue to apply to any mortgages that were taken out before December 15, 2017, as well as any debt that is refinanced after this date provided the refinancing does not exceed the amount of the refinanced debt.

Interest on home equity loans and home equity lines of credit (HELOCs) are no longer tax deductible, unless the proceeds are used to make substantial improvements AND when combined with any other acquisition indebtedness, does not exceed the \$750,000 limit. The loss of the deduction for home equity loans includes both new and existing home equity loans and lines of credit.

#### Limitation on State and Local Tax (SALT) Deduction

In addition to the limitation on deducting home mortgage interest, there is now a limit on the deduction for state and local taxes - only allowing for a maximum deduction of \$10,000 (\$5,000 if married and filing separately) for all state and local income taxes combined (i.e. property, sales, and income taxes).

#### Section 1031 - Like-Kind Exchanges

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As a result of the new law, only real estate will qualify for Section 1031 like-kind exchanges. Taxpayers will no longer have the ability to do a like-kind exchange of personal property, such as artwork, airplanes, trucks, machinery and equipment.

## Partnerships, Limited Liability Companies and Sole Proprietors

Since corporate taxpayers saw their income tax rate drop from 35% to 21%, the new tax law also provides a benefit to owners of pass-through entities (i.e. partnerships, limited liability companies, S corporations, and sole proprietorships). Generally, the owners of these entities are entitled to a 20% deduction on their share of the passed-through income. However, this benefit is subject to various limitations:

- Only income from a trade or business is subject to the deduction. Interest, dividends, and capital gains
  that are passed through are not eligible for the deduction.
- An owner of a trade or business that primarily involves the performance of services (other than
  engineering and architecture) will not be entitled to the deduction. This exclusion, however, does not
  apply if the owner's total taxable income (from all sources) does not exceed \$157,500 (\$315,000 for
  joint filers). The exclusion applies in part to owners with taxable income between \$157,500 and
  \$207,500 (between \$315,000 and \$415,000 for joint filers).
- An owner of a non-service trade or business whose total taxable income exceeds \$157,500 (\$315,000) will be subject to the "wage limitation." This means that the 20% deduction will only be available to the extent of the greater of: (1) 50% of the owner's percent of the entity's total wages as reported on its W-2 tax forms; or (2) a formula using both wages and the entity's capital investment (i.e. the owner's share of 25% of wages + 2.5% of the entity's unadjusted basis in its depreciable property).

The availability of this deduction expires after 2025.

#### **Business Interest Deduction**

The new law provides that taxpayers will not be able to deduct business interest expenses above 30% of EBITDA (earnings before interest, taxes, depreciation and amortization) until the end of 2021, and limits the interest expense to 30% of EBIT (earnings before interest and taxes) starting in 2022. However, investors in real estate (both pass-through entities and REITs) are permitted to elect out of the 30% limitation rule. If they opt out, however, they will face a longer cost recovery period for depreciation on their property.

#### **REITs**

REITs will continue to be a popular vehicle for real estate investment, as they have received favorable treatment under the new law. Investors in REITs will enjoy the same 20% deduction for business income enjoyed by pass-through business owners for ordinary REIT dividends. The deduction will not apply to capital gains and qualified dividend income, which will continue to be taxed at the same favorable rates as before. Furthermore, while interest income received from a mortgage investment is not subject to the 20% business income deduction, the ordinary dividends received from a Mortgage REIT do qualify for the



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deduction.

#### **Depreciation**

The new law provides for a 15 year recovery period for qualified improvements, eliminating the separate definitions of qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. It also extends and modifies bonus depreciation by allowing businesses to deduct 100% of the cost of eligible property in the year it is placed in service, as long as it is before 2022. After that, the amount of allowable bonus depreciation will be phased out over four years - 80% for property placed in service in 2024, 40% for property placed in service in 2025, and 20% for property placed in service in 2026. The new law also doubles the limitation on the amount that can be expensed under Section 179 (rather than capitalized) each year from \$500,000 to \$1 million, and expands the classification of qualified property.

While the Senate version of the new law would have decreased the recovery period for real estate, the final version did not enact any changes to the MACRS recovery periods of 39 and 27.5 years for nonresidential and residential rental property, respectively. It did, however, reduce the ADS recovery period for residential rental property from 40 years to 30 years for property placed in service after 2017.

Finally, the new law contains a provision in Section 168(g)(3)(B) that was intended to give qualified improvement property (other than leaseholds, restaurants and retail) a 20 year ADS recovery period instead of 40 years. However, the provision intended to accomplish such, Section 168(e)(3)(D)(v), was not included in the final version of the law, thereby leaving us with what Tony Nitti in Forbes described as "a stairway to nowhere."

Owners of real estate are advised to consult with an experienced tax attorney or other tax professional to ascertain the specific impact of the new law on their circumstances.