2018 Tax Reform - What's Changing?

FINAL VERSION

Tax Cuts and Jobs Act

Don't brave the tax changes alone. Join our newsletter.

How this document works

This document attempts to identify sections of the FINAL Tax Cuts and Jobs Act. Each relevant section listed in this document are those we feel real estate investors should be aware of.

Link to the FINAL bill (a short read of 1,097 pages)

Legal Stuff

This document and all text contained herein is not meant to render tax advice nor create a client relationship with you, the reader. This document is for informational purposes only and should not be used to render advice or to substantiate tax positions. Further, this document is not a complete analysis of the House or Senate bills and should not be construed as such.

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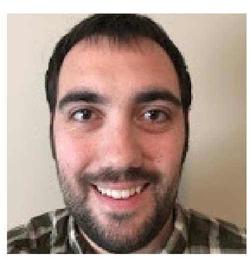


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Summary and Key Takeaways

Effective Date of proposed changes (In General): December 31, 2017

This means the majority of these changes will apply beginning in the 2018 tax year. However, almost ALL of the changes **expire** in 2025.

Key Takeaways

The House and Senate have reconciled their bills. Because their bills will add less than $1.5 Trillion (this bill adds $1.456 Trillion) to the deficit over the next decade, they only need a majority to pass the bill, which they currently have. Expect the bill to be signed into law within the next few weeks.

- Itemized deductions have been reduced and simplified.
    - Mortgage interest deductible on $750,000 of new acquisition debt.
    - State and local income and sales taxes, as well as property taxes, are limited to an aggregate $10,000 annual deduction.
    - Misc. itemized deductions have been eliminated.
    - Medical expense floor reduced from 10% to 7.5% of AGI.
- Standard deduction increases to $12,000 for single and $24,000 for MFJ.
- Personal exemptions eliminated.
- Qualified income from sole proprietorships, LLCs, and S-Corps can potentially qualify for a 20% deduction.
    - Deduction is subject to a limitation of 50% of W-2 wages, **or** 25% of W-2 wages plus 2.5% of basis from qualified property.
        - This is an added bonus for real estate investors.
        - <u>Example:</u> You purchase rental property worth $1MM. Assuming you don't pay W-2 wages, you will qualify for a $25,000 (2.5% x $1MM) deduction that was not previously available.
    - Wage limitation does not apply for single and MFJ taxpayers earning less than $157,500 and $315,000 respectively.
    - Service businesses do not qualify unless they meet the above earnings thresholds.
- No change to the Section 121 exclusion (gain on primary residence).
- Alternative Minimum Tax still exists, but higher exemptions before AMT is triggered.
- Bonus Depreciation is now 100% (previously 50%) for qualifying property.
- C-Corporation Tax Rates reduced to 21%.
- Lifetime exclusion (estates, gifts, etc) has increased to $10,000,000 from $5,000,000.
- 529 plan funds can now be used to pay for public, private, and religious elementary and secondary education.
- Penalty from Obamacare individual mandate has been eliminated.
- Rehabilitation tax credit reduced in scope.
- Domestic Production Activity Credit (DPAD) eliminated.

Winners and Losers

Winners

- President Trump due to the 2.5% deduction for capital assets based on basis.
- Owners of C-Corporations earnings in excess of $50,000 net income annually.
- Taxpayers with estates of $22MM as they can now gift them tax-free to heirs.
- High income earners who will see their top tax rate drop to 37%.
- Real estate investors who own rentals or stakes in passthrough companies.
- Healthy young people who do not want to buy insurance.
- Low income taxpayers (even better if families with children) due to the increase in the standard deduction and refundable child tax credits.
- Creative tax accountants who will find tons of loopholes in this rushed bill (our mouths are frothing).

Losers

- Middle class individuals (proportionately) - even though you will likely see a reduction in your tax liability, the majority of cuts are going to businesses. Additionally, the top marginal rate moved from 39.6% to 37%. Why wasn't more done for the middle class?
- Democrats - assuming they regain control, they are facing billions of dollars of expiring tax reductions in 2025.
- Families with multiple children, who are in the 22% marginal tax bracket or above, due to the elimination of personal exemptions (though child tax credits can potentially offset or reduce this loss).
- High income earners that are married filing joint due to the marriage penalty related to marginal tax brackets.
- Everyone who is not a healthy young person and wants/needs health insurance due to increased premiums from the exodus of people not required to buy health plans.

Regardless of your political affiliation...

This was the largest tax reform since the Tax Reform Act of 1986. The Act was enacted on October 22, 1986. The first proposal for revision was presented by the Treasury on November 27, 1984. As you can see, it took a little under two years to pass the massive 1986 Act.

The politicians voting on this bill are not tax experts. Yet in a little less than six weeks, they were able to assemble and pass a bill that will add $1.456 Trillion to the deficit over the next ten years. We're sure you've seen the state of the Senate's original proposal that was passed with the handy handwritten text in the margins and complete sections crossed out.

One thing is for certain - if you own or invest in a business or real estate, hire a smart tax strategist immediately. There will be tons of loopholes to exploit, and smart tax strategists are going to have a field day with this bill.

Individual Income Tax Rates

Sec. 11001. Modification of rates (pg. 1)

- Tax Brackets (amounts to be adjusted for inflation):
  - 10% Tax Bracket
    - MFJ: $0 - $19,050
    - Single: $0 - $9,525
  - 12% Tax Bracket
    - MFJ: $19,051 - $77,400
    - Single: $9,526 - $38,700
  - 22% Tax Bracket
    - MFJ: $77,401 - $165,000
    - Single: $38,701 - $82,500
  - 24% Tax Bracket
    - MFJ: $165,001 - $315,000
    - Single: $82,501 - $157,500
  - 32% Tax Bracket
    - MFJ: $315,001 - $400,000
    - Single: $157,501 - $200,000
  - 35% Tax Bracket
    - MFJ: $400,001 - $600,000
    - Single: $200,001 - $500,000
  - 37% Tax Bracket
    - MFJ: $600,000+
    - Single: $500,000+

- Capital Gains Brackets (amounts to be adjusted for inflation):
  - 0% Tax Rate
    - MFJ: $0 - $77,200
    - Single: $0 - $38,600
  - 15% Tax Rate
    - MFJ: $77,201 - $479,000
    - Single: $38,601 - $425,800
  - 20% Tax Rate
    - MFJ: $479,001+
    - Single: $425,801+

Standard Deduction

Sec. 11021. Increase in standard deduction. (pg. 49)

- MFJ increase to $24,000.
- Single increase to $12,000.

Personal Exemptions

Sec. 11041. Suspension of deduction for personal exemptions. (pg. 76)

- The personal exemption for every taxpayer, spouse and dependent is repealed.
- Definition of dependent is retained.

Pass-Through Business Income

Sec. 11011. Deduction for Qualified Business Income. (pg. 23)

- Deduction for sole proprietors, LLCs, and S-Corps equal to the sum of:
    - The lesser of:
        - Combined Qualified Business Income, or
        - 20% of the excess of: the taxable income divided by the sum of any net capital gain.
    - The lesser of:
        - 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer, or
        - taxable income reduced by the net capital gain.
- Combined Qualified Business Income Amount (in general) is the lesser of:
    - 20% of the qualified business income with respect to the qualified trade or business, or
    - The greater of:
        - 50% of the W-2 wages with respect to the qualified trade or business, or
        - The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.
- Qualified property is:
    - Property which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
    - Property which is used at any point during the taxable year in the production of qualified business income, and
    - The depreciable period for which has not ended before the close of the taxable year.
- W-2 limitations for Qualified Business Income does not apply if:
    - Taxable income for the taxpayer is less than:
        - $157,500 if single.
        - $315,000 if MFJ.
- Service businesses, except for engineering and architecture, are not eligible for this deduction unless:
    - Taxable income for the taxpayer is less than:
        - $157,500 if single.
        - $315,000 if MFJ.

Child Tax Credit

Sec. 11022. Increase in and modification of child tax credit (pg. 51)

- The Child Tax Credit will increase from $1,000 to $2,000 per qualifying child. The refundable credit amount will be limited to $1,400.
- For each dependent who is not a qualifying child, a $500 credit applies.
- Phase Out:
    - MFJ: $400,000.
    - Single: $200,000.

529 Plans

Sec. 11032. Account Funding for Elementary and Secondary Education. (pg. 75)

- Up to $10,000 per year can be used from 529 plans to pay for:
    - Public, private, and religious elementary and secondary schools.
    - Home school students.

American Opportunity and Lifetime Learning Credits

No changes.

Limit to Itemized Deductions

Sec. 11042-11045. Limitation on itemized deductions. (pg. 86)

- Aggregate amount of state and local tax income and sales tax, as well as property tax, is capped at $10,000 per year.
    - Cannot pre-pay 2018 taxes **income** taxes.
- Interest deduction allowed on up to $750,000 on new acquisition debt.
    - If you have a binding contract on or before Dec. 15, 2017, allowance is $1MM.
    - Deduction for interest on home equity debt (HELOCs and Refis not related to improving your home) is eliminated.
- Misc. Itemized deductions eliminated.
- Medical expense floor moves from 10% to 7.5% of AGI.
    - Retroactive to 2017.

Charitable Contributions

Sec. 11023. Charitable contributions. (pg 54)

- Increased limitation for cash contributions to 60%.

Alimony Payments

Sec. 11051. Repeal of deduction for alimony payments. (pg. 96)

- Deduction for alimony payments eliminated and alimony received will no longer be included in income.
    - Begins in 2019.

Moving Expenses

Sec. 11048. Suspension of exclusion for qualified moving expenses. (pg. 94)

- Deduction for moving expenses is eliminated.
    - Exception for armed forces.

Gain on Sale of Primary Residence (Section 121 Exclusion)

No changes.

Estate and Gift Tax Exemption

Sec. 11061. Increase in estate and gift tax exemption. (pg. 101)

- Increased the $5,000,000 lifetime exclusion amount per person to $10,000,000.

Alternative Minimum Tax

G. Alternative Minimum Tax. (pg. 668 of 1,097 per pdf page counter)

- Increases exemption amount.
    - Increased to $109,400 for MFJ.
    - Increased to $70,300 for all other taxpayers.
- Increases phase out.
    - Increased to $1MM for MFJ
    - Increased to $500,000 for all other taxpayers.

Obamacare Individual Mandate

Sec. 11081. Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimum Essential Coverage. (pg. 103)

- Eliminates penalty associated with not having health care.
    - Begins in 2019.

Corporate Tax Rate

Sec. 13001. 21 Percent Corporate Tax Rate. (pg. 115)

- Reducing corporate tax rate to 21%.

100% Expensing for Certain Business Assets

Sec. 13201. Temporary 100-Percent expensing for certain business assets. (pg. 139)

- Qualified property with a recovery period of less than 20 years can now be 100% expensed (previously 50%). This is referred to as “bonus” depreciation.
    - Start date is 9/27/2017
- 100% expensing allowed through year 2023, after which it begins to phase out through 2027.

Section 179 Expensing

Sec. 13101. Modification of rules for expensing depreciable business assets. (pg. 129)

- Increases the maximum aggregate cost amount able to be expensed to $1,000,000 from $500,000.
- Increases the threshold to begin the phaseout of Sec 179 expensing to begin at $2,500,000 rather than $2,000,000 beginning.
- Allows for use of Sec. 179 expensing for the following improvements to non-residential real property:
    - Roofs.
    - Heating, ventilation, and air-conditioning property.
    - Fire protection and alarm systems.
    - Security systems.

1031 Exchanges

Sec. 13303. Like-kind exchanges of real property. (pg. 190)

- Modified to put emphasis on **real property.**

Depreciation of Rental Property

No changes.

Domestic Production Activity Deduction (DPAD)

Sec. 13305. Repeal of deduction for income attributable to domestic production activities. (pg. 198)

- Sec. 199 - The deduction for income attributable to domestic production activities has been repealed.

Rehabilitation Tax Credit

Sec.13402. Rehabilitation credit limited to certain historic structures. (pg. 218)

- Repeals the 10% credit for pre-1936 buildings.
- 20% credit is retained for certified historic structures.
- Transition rule is in place.