Tax Reform
&
Your Bottom Line

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Tax Reform – Policy Changes and Impacts

- Economic impacts
  - GDP
    - Marked up 2018 forecast to 2.6% (from 2.5%)
    - Dynamic scoring model suggests 0.8% ($300B) more GDP after 10 years
  - Business investment
    - 1.1% higher after ten years
  - Labor supply and employment
    - 0.6% higher
      - 0.9 million more workers in labor force
  - Reduced home price growth to a positive 2.9% growth rate in 2018

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20% Pass-Thru Deduction

Final Law:

- Individuals may generally deduct 20% of qualified business income (QBI), based on wages or on wages plus a capital element

- Final pass-thru deduction represents tax savings of $415 billion

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Business Interest Deduction (BID)

Final Law:

- Deduction limited to 30% of earnings without regard to depreciation, amortization, and depletion

HOWEVER…

- <u>Real estate businesses can keep the full deduction</u>, with tradeoffs

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Depreciation of MF Structures

FINAL LAW = PRIOR LAW

27.5 YEARS

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1031 Like Kind Exchanges

Earlier proposals: Repealed

- Represented a $20 billion tax hike for real estate over 10 years

House: Retained for Real Estate

Senate: Retained for Real Estate

Final Law: Retained for Real Estate

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Mortgage Interest Deduction

Final Law: Cap reduced to $750k; retained second homes; eliminated HELOC deduction

- Home owner tax savings of $220 billion relative to the House bill

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Home Equity Lines of Credit

Home owners may still deduct HELOC interest, so long as:

- The loan was used to make a “substantial” home improvement, and
- Total mortgage debt does not exceed the new $750K cap

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SALT

Final Law

Itemizers may deduct property taxes plus state and local income <u>OR</u> sales taxes, up to combined amount of $10,000

- Final Tax Savings for Home Owners:
  - $310 billion due to $10,000 deduction for property and sales/income taxes

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AMT to the Rescue?

Final Law: Substantially reduces the number of taxpayers subject to the AMT by:

- Raising the income phase-out thresholds
- Increasing the exemption amounts

RESULT

The number of AMT payers projected to fall from 5.4 million only 200,000 taxpayers

- More than 5 million taxpayers who could not claim the SALT deduction may now be eligible.

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AMT Relief

- Represents a **$637 billion tax cut**
  - Particularly beneficial for owners of small businesses in and residents of high-cost areas

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Capital Gains Exclusion

Allows homeowners to avoid capital gains tax on up to $250k (singles) or $500k (couples) in profits from sale of primary residence

(provided they reside in the home for a set period of time)

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Capital Gains Exclusion

Final Law = Current Law

- No tax increase
- Saved home sellers $22 billion relative to the House bill

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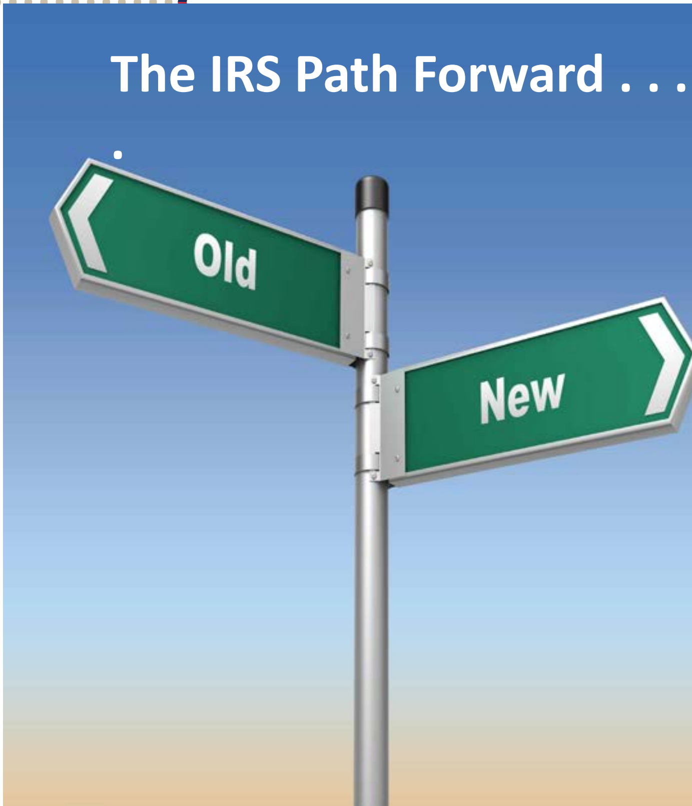
The IRS Path Forward . . . . .



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20% Pass-Thru Deduction

Who can generally take the full 20% deduction?

- Taxpayers with less than $157,500 (singles)/$315k (couples) in taxable income

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Qualified Business Income Defined

The law defines QBI as pass-thru income minus "net capital gains"

Net capital gains = (long-term capital gains) – (short-term capital losses)

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Calculating QBI

Pass-thru income: $120,000

Long-term capital gains: $25,000

Short-term capital losses: $5,000

Qualified Business Income

$120,000 – ($25,000 - $5,000)

=

$120,000 - $20,000 = $100,000

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How To Calculate 20% Deduction

<u>If under those income thresholds</u>

- Taxpayer receives a deduction equal to the **<u>lesser</u>** of:

  - 20% of their qualified business income (QBI)

  OR

  - 20% of taxable income

The “Lesser of” Rule

Example:

A married, independent contractor earns $100,000 and claims the $24,000 standard deduction, reducing taxable income to $76,000.

The pass-thru deduction is worth $15,200 ($76,000 x 20%)

Why isn’t the deduction worth $20,000--20% of their $100,000 in income?

The rule says that the deduction is the lesser of 20% of QBI or 20% of taxable income.

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How to Calculate the Deduction: Income Above the Threshold

Example

- Qualified business income: $600,000
- Filing status: Married filing jointly
- Ideal deduction: $120,000 = ($600,000 x 20%)

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How to Calculate the Deduction: Income Above the Threshold

Option #1: Use W-2 Wages Paid

Deduction is calculated based on 50% of W-2 wages paid.

W-2 wages paid: $200,000

1. Multiply by 50%
2. Maximum possible deduction is $100,000.

Taxable income is reduced by $100,000.

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How to Calculate the Deduction: Income Above the Threshold

Option #2: W-2 Wages + Depreciable Assets

Deduction is equals 25% of W-2 wages paid plus 2.5% of unadjusted basis of all qualified property.

W-2 wages paid: $200,000 **Qualified property**: $1 million

1. Multiply W-2 wages by 25%: $50,000
2. Multiply $1M in qualified property by 2.5%: $25,000
3. Maximum deduction is $50,000 plus $25,000, or $75,000

Taxable income is reduced by $75,000.

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Business Interest Deduction

New limitation

- Limited to 30% of EBIT through 2022
- After that, the deduction is limited to 30% of EBITDA

However…

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Business Interest Deduction

Any real property trade or business can elect to keep their deduction, with potential tradeoffs.

The definition of "real property trade or business" is VERY broad and covers:

"…any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

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Changes to Sec. 179 Depreciation

	Prior Law	New Law	Difference
Maximum deduction	$500K	$1 million	+ $500K
Phase-out threshold	$2 million	$2.5 million	+ $500K
Fully phased out at	$2.5 million	$3.5 million	+ $1 million
Permanent	No	YES	

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Full Expensing

Prior Law

Generally, any purchase had to be depreciated over an extended period.

New Law

100% of the cost of any purchases (except for real property) made through 2022 may be deducted in the first year.

This decreases to 80% in 2023, 60% in 2024, and so on until it fully phases out by tax year 2027.

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The BID Choice

All real estate businesses HAVE A CHOICE

- May elect out of the new limitation to the business interest expense deduction
  - Benefit:
    - Can deduct 100% of business interest expenses
  - Drawback:
    - Cannot take advantage of full expensing
- Whatever the ultimate decision, the taxpayer is locked into their choice for three years, **SO…**

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Net Operating Losses (NOLs)

- Carrybacks no longer allowed
- May carry NOLs forward indefinitely, rather than only 20 years
- NOLs may be used to offset only 80% of business income in a tax year

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Active Loss Limitations

- **If you own a business in which you "materially participate"** (i.e. you generate "active" business income):
  - You may no longer use unlimited losses to offset income elsewhere cap has been placed on losses that can be used to offset other income.
  - Deductible losses are limited to $250,000 (single) / $500,000 (married filing jointly)
  - These "active losses" may no longer offset passive income
  - Accumulated passive losses will be treated as active losses in the year of disposition of a business interest

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Example: Active loss limitations

Joe (single) leaves his job to pursue his dream of owning his own business

Seed money invested by:

- Joe: $500,000
- Mary: $500,000

Business net income/(loss) in the 1st year: ($700,000)

Joe and Mary's active loss: $350,000 apiece

Joe's excess loss = $350,000 - $250,000 (limit for single filers) = $100,000

Must carry the loss forward

Mary's excess loss = $0, can immediately use toward a refund

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Important Under-the-Radar Changes

- Fringe benefits
  - Transit benefits, in particular
    - Employer contributions no longer deductible from pre-tax business income
- Contributions in aid of construction (CIACs)
  - Watch for increased PILTs from water and sewage utilities

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