Tax Reform & Your Bottom Line
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
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
Final Law:

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

HOWEVER...

- Real estate businesses can keep the full deduction, with tradeoffs
Depreciation of MF Structures

FINAL LAW = PRIOR LAW

27.5 YEARS
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Earlier proposals: Repealed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
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
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
Final Law

Itemizers may deduct property taxes plus state and local income OR 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
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.
AMT Relief

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

Final Law = Current Law

- No tax increase
- Saved home sellers $22 billion relative to the House bill
The IRS Path Forward . . . .
Who can generally take the full 20% deduction?

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

Pass-thru income: $120,000
Long-term capital gains: $25,000
Short-term capital losses: $5,000

Qualified Business Income

\[ \text{Qualified Business Income} = \$120,000 - (\$25,000 - \$5,000) \]

\[ = \$120,000 - \$20,000 = \$100,000 \]
How To Calculate 20% Deduction

If under those income thresholds

- Taxpayer receives a deduction equal to the \textit{lesser} of:

  - 20% of their qualified business income (QBI)
  - 20% of taxable income

\textbf{NAHB}

National Association of Home Builders
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.
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 \times 20\%)
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.**
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.
Business Interest Deduction

New limitation

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

However...
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.”
## Changes to Sec. 179 Depreciation

<table>
<thead>
<tr>
<th></th>
<th>Prior Law</th>
<th>New Law</th>
<th>Difference</th>
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<tbody>
<tr>
<td><strong>Maximum deduction</strong></td>
<td>$500K</td>
<td>$1 million</td>
<td>+ $500K</td>
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<tr>
<td><strong>Phase-out threshold</strong></td>
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<td><strong>Fully phased out at</strong></td>
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<tr>
<td><strong>Permanent</strong></td>
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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.
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...
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
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. A 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.
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
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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