



Tax Considerations for Owning and Investing in Real Estate

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INTRODUCTION

Introduction

- Tax reform is an ongoing process
 - The Tax Cuts and Jobs Act (TCJA) was released at the end of 2017
 - Various regulations, notices, and other guidance has been released and continues to be released
 - The 2018 election resulted in a purple Congress = not much is happening
 - The 2020 election may result in adjustments to the TCJA, or a complete overhaul
 - “Permanent” is never permanent

Introduction

- Congress returned from recess this week, and they are expected to focus on:
 - Temporary tax breaks (extenders)
 - Technical corrections to TCJA (some have bipartisan support)
 - Retirement plan changes (the SECURE Act will make significant changes to how retirement plans are paid out, among other things, if it passes)
 - The \$10,000 SALT deduction limitation



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CHOICE OF ENTITY – GENERAL TAX CONSIDERATIONS

List of Tax Entities

- Partnership
- C corporation
- S corporation
- Trust (Grantor, Non-Grantor)

Partnership

- Income taxed at partner level
- Flexible allocations, allows for differing levels of investment
- Negative capital allowed so long as there is basis through recourse or qualified non-recourse debt
- Distributions of property generally do not result in taxable income

C Corporation

- Income taxed at corporate level at 21%
- Dividends paid to shareholders based on ownership, taxed to shareholders (generally at long-term capital gains rates of 0% - 23.8%)
- Multiple types of shares with varying interests allowed (e.g. common shares, voting shares)
- Distribution of appreciated property will result in gain, some of which may be treated as ordinary income due to depreciation recapture

Income Allocations & Taxation

- S corporation:
 - Income taxed at shareholder level
 - Distributions must be equal, based on ownership
 - Only one type of stock allowed, but can have voting and non-voting shares
 - Shareholders have debt basis for loans made by the shareholder to the S corporation only
 - Type of shareholder is limited
 - Distributions of appreciated property will result in gain, some of which may be treated as ordinary income due to depreciation recapture

Income Allocations & Taxation

- Trust – Grantor:
 - All activity of the trust is taxed to the Grantor (or beneficiary, if the beneficiary is treated as the grantor) even if distributions are not made
 - Distributions are not taxed when they are made
- Trust – Non-Grantor:
 - All activity of the trust is taxed to the trust *unless* distributions are made to the beneficiary
 - Distributions carry out taxable income, but generally not taxable capital gains unless some exception applies
 - Distributions in excess of taxable income during the year are not taxable



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SPECIFIC TAX PROVISIONS TO CONSIDER

Passive Activity Loss Limitations

- Rental real estate activities are generally considered passive activities – i.e. losses in excess of passive income will be carried forward until they can offset additional passive income, or the activity is disposed of
- Common Exceptions:
 - Real Estate Professionals
 - Short term rentals treated as a trade or business (e.g. a hotel)
 - Significant personal services provided with rental treated as a trade or business
 - Rental to a trade or business that is also owned by the taxpayer (self-rental)
- Material participation rules must be met for rentals that are treated as a trade or business!

Real Estate Professional Treatment

- Determined each tax year – requirements:
 - More than 50% of personal services performed by taxpayer in all trades or businesses must be performed in real property trades or businesses in which the taxpayer materially participates
 - Development, construction, acquisition, conversion, rental, operation, management, leasing, brokerage, etc.
 - Taxpayer must perform more than 750 hours of service in such real property trades or businesses
- Result – rental activities that the Real Estate Professional materially participates in will be treated as non-passive

Qualified Business Income Deduction

- New deduction introduced with 2017 Tax Reform (Tax Cuts & Jobs Act) taken on an individual's personal income tax return (or a trust/estate return)
- Deduction equal to 20% of Qualified Business Income (QBI), subject to wage and property basis limitations
- Activity must be considered a “trade or business” to have QBI
 - A rental activity can be considered a trade or business for QBI purposes, but still considered passive for the passive activity loss limitation rules!
 - Favorable court cases suggest that most rental activities, with the exception of triple net leases, can be considered trades or businesses
- Losses that are allowed for Federal tax purposes will factor into the QBI calculation

Cost Recovery Provisions

- The TCJA changed the depreciation provisions to allow a taxpayer to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. Property can be either new or used.
- After December 31, 2022, the bonus depreciation percentage slowly decreases until it is phased out after December 31, 2026.
 - 2023 – 80%; 2024 - 60%; 2025 – 40%; 2026 – 20%

Cost Recovery Provisions

- TCJA increased the Section 179 limitation to \$1 million (2018), and increased the phase-out amount to \$2.5 million (2019)
- These amounts are now indexed for inflation – 2019 amounts:
 - Limitation - \$1,020,000
 - Phase-Out - \$2,550,000
- Expanded the definition of eligible 179 property to include the following improvements to nonresidential real property:
 - Roofs
 - Heating, ventilation, and air-conditioning property
 - Fire protection and alarm systems
 - Security systems

Cost Recovery Provisions

- TCJA consolidated the categories of “qualified leasehold improvements,” “qualified restaurant property,” and “qualified retail improvement property” into one category: Qualified Improvement Property
 - Eligible for Section 179 expense
 - 39 year life (due to a drafting error) and NOT subject to bonus depreciation

Business Interest Limitations

- Businesses with gross receipts in excess of \$25 million, looked at each year, will be subject to a limitation on the deduction for business interest. The deduction is limited to the sum of:
 - The business interest income for the year;
 - 30% of the taxpayer's adjusted taxable income for the year; and
 - The taxpayer's floor plan financing interest expense for the year
- An exception applies for real property trades or businesses that make an election to be an excepted trade or business. However, making the election will mean that the business will be required to depreciate real property and qualified improvement property using the alternative depreciation system (ADS)

Excess Business Loss Limitation

- Business losses in excess of \$500,000 Joint / \$250,000 Single will not be allowed and will instead carry forward as a Net Operating Loss (NOL)
- Applied after other loss deferral provisions (i.e. passive activity losses, basis and at-risk limitations, etc.)
- Loss limitation calculated on Form 461
- Only proposed regulations have been issued, but questions still remain:
 - Whether or not wages are considered business income for the calculation (it appears the answer is yes)
 - Whether or not gain from the sale of S corporation stock should be considered business income (there appears to be a look-through approach to determine the portion of the gain related to the business vs. investment)

Qualified Opportunity Zone Investments

- Eligible taxpayers can elect to defer recognition of some or all capital gains, to the extent that the taxpayer invests in an eligible interest in a Qualified Opportunity Zone
 - Deferral of up to 10 years, but will be recognized if QOF interest is sold or transferred prior to
 - Must invest gains within 180 days of gain recognition (exception for Sections 1256 and 1231 capital gain, and gains from pass-through entities where 180 days begins on the last day of the taxable year)
 - Gains recognized from a sale of the interest in the QOF may be excluded if the investment is held for 10 year



Questions?



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