Tax Reform and Planning Opportunities for *Real Estate & Construction Companies*

RDG+ Partners
ACCOUNTING & CPA SERVICES

On December 22, President Trump signed the tax reform bill known as the "Tax Cuts and Jobs Act of 2017" into law. This is the most sweeping update to the U.S. tax code in more than 30 years and there are several opportunities for significant tax savings.

With most of the provisions already in effect, it's imperative that real estate and construction owners review these changes and understand the potential impact to their companies. At ***RDG+Partners***, we have spent significant time reviewing and analyzing the impact of this new tax law. Below are some of the key tax reform changes and planning opportunities for your consideration.

TAX REFORM CHANGES + PLANNING OPPORTUNITIES

- ***Reduces the corporate tax rate***

  The corporate tax rate is reduced from **35 to 21%** effective for taxable years after December 31, 2017.

- This reduces the overall tax liability for real estate and construction companies that file as a C-Corporation.

- ***Lowers taxes on pass-through business income***

  A **20% qualified business deduction** is available to pass-through filers on qualified pass-through income, subject to certain limitations. This includes "qualified real estate investment dividends." Qualified REIT dividends do not include any portion of a dividend to which capital gain tax rates are applied.

- This may reduce the overall tax liability for owners of real estate and construction companies that are structured as pass-through entities. It is imperative to be mindful of the limitations to the qualified business deduction. **There are various tax strategies** that can be examined on a case-to-case basis to ensure one is taking advantage of the new laws. ***RDG+Partners*** offers tax modeling services to analyze the impact of these changes and make recommendations to maximize the benefits to you and your business.

TAX REFORM CHANGES + PLANNING OPPORTUNITIES

Changes to the depreciation of commercial assets

Separate definitions of qualified leasehold improvements, qualified restaurant, and qualified retail improvement property has been eliminated. This provides a general 15-year recovery period for qualified improvement property, unchanged from current law for nonresidential property only. It does not apply to residential rental. Depreciable life of commercial assets is also unchanged from current law.

40-year alternative depreciation system (ADS) cost recovery period for nonresidential real property remains but contains a reduced 30-year ADS period for residential property and a 20-year ADS period for qualified property improvement.

Bonus depreciation for new qualified investments is now 100%, up from 50%. This applies to both new and used property. This change was effective for property placed in service after September 27, 2017.

- This change allows for personal property to be fully expensed in the year of purchase for nonresidential rental property. The application of 100% bonus on new and used property is also beneficial. It may be advantageous to consider performing a cost-segregation study to maximize potential depreciation, and ***RDG+Partners*** can assist with the implementation of this tax reduction strategy.
- Real estate and construction companies should keep in mind state conformity to bonus depreciation.

Expansion of Section 179 deduction

The definition of qualified real property includes improvements to nonresidential real property including roofs, heating, ventilation, air conditioning, fire protection, alarm systems, and security systems.

The amount companies can deduct in purchases increases from the current ceiling of $510,000 to **$1 million** and increases the phase out threshold to $2.5 million.

- Real estate and construction companies should keep the newly expanded definition of qualified real property in mind as a tax savings strategy. Deducting Section 179 expense up to $1 million eases the tax burden of improving property. **Companies should keep in mind that Section 179 is only allowed to the extent of taxable income.**

Limitations on interest deductibility

Section 163(j) is revised and expands its applicability to every business, including partnerships. Generally, it **caps the deduction of interest expense to interest income plus 30% of adjusted taxable income, which is computed without regard to deductions allowable for depreciation, amortization, or depletion.** Disallowed interest is carried forward indefinitely. This limitation generally will not apply to taxpayers with average gross receipts that do not exceed $25 million for the three-taxable-year period ending with the prior taxable year. The $25 million threshold applies in the aggregate to certain related taxpayers.

- **Real property trades or businesses are allowed to elect out of the limitation** since they do not benefit from full expensing provided to tangible personal property. Taxpayers electing to use the real property trade or business exception to the limitation on interest deductibility would be **required to use ADS** methods for depreciation for residential, nonresidential, and qualified improvement property

Eliminates net operating loss (NOLs) carrybacks

Net Operating Loss Carrybacks has been eliminated effective in taxable years after December 31, 2017. The use of NOLs carried-forward will be limited to 80% of taxable income. NOLs will no longer have an expiration period.

- Real estate and construction companies may consider carrying back any losses generated in 2017 to prior years where the corporate tax rate is higher.

TAX REFORM CHANGES + PLANNING OPPORTUNITIES

- ***Limits 1031 "like- kind" exchanges to real property***

  Effective for taxable years after December 31, 2017, like-kind exchanges are only available on **real property**.

- Straight real estate sales or replacement transactions will have no material impact from this change. However, many transactions involve multi-asset exchanges where a taxpayer is selling both real and personal property. Taxpayer's may now recognize more taxable gain on the personal property transactions. It will be especially important to correctly allocate the purchase price between real and personal property. ***RDG+Partners*** can help structure the sale and allocation appropriately to minimize income taxes.

- ***Limitations on mortgage interest deductions***

  Effective for tax years beginning after December 31, 2017, only the deduction of interest on acquisition indebtedness not exceeding $750,000 is permitted. The previously allowed interest deduction for home equity indebtedness is repealed through 2025.

  Debt incurred on or before December 15, 2017 is grandfathered into the limitations under current law. Taxpayers who entered into a written binding contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who actually purchase such residence before April 1, 2018, are also eligible for the pre-tax-reform higher limitations.

- The limitation on mortgage interest deductions could reduce the attractiveness of homeownership. This could lead to increased demand for single and multifamily rentals. However, homebuilders and residential land developers may see a reduction in demand for the same reason.
- Real estate companies are still allowed the full deduction. The limitation only applies to individuals.

- ***Reduction in the state and local tax deduction for individuals***

  The itemized deductions for state and local taxes are limited to $10,000 for the aggregate sum of real property taxes, personal property taxes, and either state or local income taxes or state and local sales tax. Currently, each of those state and local taxes is a separate itemized deduction with no limitation.

- Homebuilders and residential land developers may see a reduction in demand, as fewer individuals will be able to itemize their deductions with the limitation on state and local tax deductions. However, rental properties, especially in higher state tax states, could see an increase in demand as homeownership won't be as attractive.
- Real estate companies are still allowed the full deduction. The limitation only applies to individuals.

- ***Expansion of cash method of accounting***

  Effective for taxable years after December 31, 2017, the average **annual gross receipts threshold is increased from $5 million to $25 million** for C corporations, partnerships with a C corporation partner, or a tax-exempt trust or corporation with unrelated business income, regardless of whether the purchase, production, or sale of merchandise is an income- producing factor.

- The expansion of the cash method of accounting can reduce tax and the recordkeeping burden for the small real estate and construction companies. It may be advantageous to file a change in accounting method. ***RDG+Partners*** offers services to analyze how changing to a cash method of accounting may impact your business.

✛ ***Expansion of exemption from percentage-of-completion method (PCM)***

The average annual gross receipts threshold is increased from $10 million up to $25 million. This **exempts small construction contracts from the requirement to use the PCM.** Contracts within this exception are those contracts for the construction or improvement of real property if the contract is (1) expected to be completed within 2 years of contract commencement and (2) is performed by a taxpayer who meets the $25 million gross receipts test.

✛ **The expansion of the exemption from the percentage of completion method may reduce tax and the recordkeeping burden for the small real estate and construction companies**. It may be advantageous to file a change in accounting method. ***RDG+Partners*** offers services to analyze how this change may impact your business.

✛ ***Exemption from requirement to keep inventory***

Taxpayers that meet the $25 million average annual gross receipts threshold are exempt from the requirement to account for inventories under Section 471.

Those taxpayers may use a method of accounting for inventories that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting treatment of inventories.

✛ Many real estate companies don't have inventory; however, some may have limited inventories. This exemption may lead to a reduced tax liability as well as less of a recordkeeping burden.

✛ ***Expansion of exemption from uniform capitalization rules (UNICAP)***

The average annual gross receipts threshold is increased from $10 million to $25 million for any resellers (as well as producers) to be exempt from the application of UNICAP under Section 263A.

✛ The expansion of the exemption from the UNICAP rules may reduce tax and the recordkeeping burden for the small real estate and construction companies.

What Now?

✛ Initiate a tax reform conversation with your *RDG+Partners* professional. Be proactive & plan ahead.

Tax reform of this magnitude is the biggest change we've seen in over 30 years and it will require intense focus to understand how the changes apply not only at the federal level, but also the potential impact for state taxation as well.

Contact your RDG+Partners tax professional today

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