

# New 2018 Tax Law for Real Estate Investors

**REHAB**  
VALUATOR



Daniil Kleyman

[www.IRALawyer.com](http://www.IRALawyer.com)



John M. Hyre III

# New 2018 Tax Law for Real Estate Investors

By Attorney John Hyre

[Iralawyer.com](http://Iralawyer.com)

[Realestatetaxlaw.com](http://Realestatetaxlaw.com)

(614) 207-2441

[johnhyre@realestatetaxlaw.com](mailto:johnhyre@realestatetaxlaw.com)

# My Qualifications

- ▶ Attorney, Accountant, REI
- ▶ I've assisted thousands of REI clients nationwide - and still do
- ▶ REI clients range from brand newbies to large commercial operations
- ▶ We see lots of “odd” deals
  - ▶ Lease options, subject-to's, assignments, discounted note purchases, etc.

# My Qualifications

- ▶ Very few CPA's or attorneys are well versed in RE or SDIRA's
- ▶ I know of none who have been through IRA audits, and few who have been through RE audits
- ▶ I know of none who have beaten the IRS on SDIRA's in Tax Court
- ▶ I have done both - on multiple occasions

# Section 199A: Pass-Thru Deduction BASICS

- ▶ Deduction of up to 20% of income from “Trade or Business”
- ▶ But not greater than 20% of Taxable Income
- ▶ Sole-proprietor, partnership, limited partnership, S-Corporation, most LLC’s (not those taxed as C-Corporations)
- ▶ Taken on Form 1040 after all other deductions, but before credits
- ▶ US Trade or Business - “Trade or Business” is *essential*
- ▶ Automatic for most “small” pass-thru businesses
- ▶ Rules get more complex once taxpayer’s income is \$315,000 (Married Filing Joint) or \$157,500 (Single)
  - ▶ Certain “Naughty” Services Excluded above the threshold
  - ▶ Extra Limits Based on W-2 wages paid and depreciable assets in service
- ▶ Requires meticulous & current planning
  - ▶ Very good records
  - ▶ No co-mingling

# “Trade or Business”

- ▶ Term of art, defined mostly in the case law, different definitions depending on which Code section is in play
- ▶ Mere “Income Producing Activity” is usually very passive - collecting interest & dividends, holding stock or land for appreciation, etc.
  - ▶ If the activity generates tax-favored income (e.g. - capital gains, dividends), then it is probably not part of a Trade or Business
- ▶ Trade or Business involves “regular & continuous” activity
  - ▶ Not the same as a “Dealer” which involves a greater degree of activity....all “Dealers” have a T/B, but not all “buy-sell” activities rise to the level of a “Dealer”
  - ▶ AirBNB always = T/B (Hotel, not rentals)
- ▶ Allows for more deductions than mere “income producing activity”
  - ▶ Seminars & Education
  - ▶ Section 1231 Property
  - ▶ Home Office
  - ▶ Travel
  - ▶ Start-Up Costs

# Small Rental Example

- ▶ “Small” = Taxable Income < \$315,000 MFJ/\$157,500 Single
- ▶ Net Income from Rental T/B = \$100,000
- ▶ Taxable Income = \$80,000 (“small”)
- ▶ Deduction = \$16,000 (lesser of 20% of \$100k from T/B or 20% of \$80k Taxable Income)
  
- ▶ Net Income from Rental T/B = \$70,000
- ▶ Taxable Income = \$100,000
- ▶ Deduction = \$14,000
  
- ▶ May have more than one “Rental Trade or Business”
  - ▶ IRS considers rentals in different states a different T/B
  - ▶ I’d break out properties that do not qualify from those that do qualify
    - ▶ Otherwise go for “all or nothing” but may not like the result!

# Big Rental Example (No phase-out)

- ▶ “Big & No Phase-Out” = Taxable Income > \$415,000 MFJ/\$207,500 Single
- ▶ Once “Big”, a new limit on the deduction applies
- ▶ Greater of
  - ▶ 50% of W2 Wages; or
  - ▶ (25% of W2 Wages) + (2.5% of purchase of depreciable property used in T/B)
- ▶ Net Income from Rental T/B = \$100,000
- ▶ Taxable Income = \$500,000 (“Big”)
- ▶ \$0 Wages, \$700,000 Depreciable real estate + \$200,000 Non-Depreciable Land
- ▶ Deduction = \$17,500, that is the lesser of
  - ▶ 20% of \$100k from T/B (\$20,000);
  - ▶ 20% of \$500,000 Taxable Income (\$100,000); or
  - ▶ [25% of W-2 wages] + [2.5% of Depreciable Property used in T/B] (\$17,500)



# Qualifying Depreciable Property

- ▶ Depreciable Property (e.g. - not land)
- ▶ Tangible - can touch it (e.g. - not loan costs)
- ▶ Held by & available for use in the T/B by year-end
- ▶ Used at any point in taxable year for production of QBI (i.e. - “in service”)
- ▶ Depreciable period has not ended before year-end
  - ▶ Last Full Year of Depreciable Period; or
  - ▶ Ten Years, whichever is longer
  - ▶ Means property will “run out” at some point in time
- ▶ Rental Real Estate - yes, except land and loan costs
- ▶ Notes - no, they do not depreciate
- ▶ Inventory held for sale (e.g. - rehab & retail) - no, does not depreciate
- ▶ Automobiles (owned by company), equipment - yes, even if “written off” in first year

# W-2 Wages

- ▶ Must be “properly included” in a return filed with the Social Security Administration on or before 60 days after the due date
- ▶ This is a problem for many businesses - they procrastinate
- ▶ The return must be correct - that is, W-2 wages must be “properly included” on it
- ▶ Wages must be “properly allocable” to the T/B
- ▶ Many, many, many REI have multiple companies and file their W-2’s through one company only. **I would not assume that the IRS will accept such an arrangement.**
- ▶ Ditto the use of “management companies” and “employee leasing”
- ▶ May have an incentive to put certain contractors on W-2 to meet this threshold
- ▶ Paying yourself via W-2 may or may not be respected by the IRS (“substance over form”). Further: While ups your W-2 threshold, it reduces your QBI. To even attempt to track these numbers requires detailed, timely, and accurate books - which many of you lack.

# Naughty Services

- ▶ “Rich” taxpayers who also provide Naughty Services lose the benefit of the Pass-Thru Deduction
- ▶ Naughty Services include:
  - ▶ Health (e.g. - doctors & dentists)
  - ▶ Law
  - ▶ Accounting
  - ▶ Actuarial Sciences
  - ▶ Performing Arts
  - ▶ Athletics
  - ▶ Financial Services
  - ▶ Brokerage (probably includes RE brokers & agents, not clear)

# More Naughty Services

## ▶ “Consulting”

- ▶ Conference Report: “... the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services.”
- ▶ If I am advising you (“coaching”) how to buy a property, I am consulting. If I am listing the property or actively managing it, I am brokering (probably still naughty) or managing (probably not naughty even if a broker’s license is required).
- ▶ I’d separate Naughty Service businesses (e.g. - my law practice) from Approved businesses (e.g. - my book sales)

# Naughty Services Overkill

- ▶ “any trade or business where the principal asset is the reputation or skill of 1 or more employees or owners”
  - ▶ Uh-oh.
  - ▶ That describes A LOT of small businesses
  - ▶ Not an issue if you are “small” - remember, Naughty Services are only an issue for Medium’s & Big’s
  - ▶ The key word is “the” - if it were “a”
    - ▶ Are there other assets that make “reputation or skill” NOT the principal asset?
  - ▶ Rehab & Retail - argue that capital & work crew are each “more primary” as assets
  - ▶ Assigning contracts or options - I think you are hosed
  - ▶ Rentals - the buildings are the primary asset, no brainer here
  - ▶ Lending - the money is the primary asset, no brainer

# Naughty Services Overkill (cont.)

- ▶ “any trade or business where the principal asset is the reputation or skill of 1 or more employees or owners”
- ▶ RE broker or agent - that’s going to be a tough sell for small operations. Shouldn’t an issue for larger ones with systems & staff. Can argue that the name (e.g. “KW”) is the real asset - weak.
- ▶ Any services-based business where you are the sole employee, or where the employees are few/part-time/low skilled

**NOW BACK TO OUR EXAMPLES**

# Private Lenders

- ▶ “Trade or Business” is a big issue with lenders
- ▶ Very little case law, most of it on the extremes (e.g. - mobster)
- ▶ One Revenue Ruling with very little weight or analysis that has lenders on a hair-trigger for “T/B” status. This can work to our advantage: RR = “I can” instead of “I must”
- ▶ We normally argue that small lenders are NOT a T/B to avoid imposition of Self-Employment (aka Social Security) taxes
- ▶ We now have an incentive to treat lenders as a T/B (20% tax break!) and a legal reason to do so (Revenue Ruling 58-195) while protecting ourselves from SE/SS taxes (S-Corporation)

# Private Lenders & T/B

- ▶ Revenue Ruling 58-195
- ▶ “In the instant case, A has been employed on a full-time basis by the city of M for a number of years. During such time and separate and apart from his work as a city employee, A has regularly made loans to individuals at interest as a side line activity. These loans are generally secured by real estate and chattel mortgages. A does not advertise as being in the business of lending money and does not have a business address as such. Most of A's clients come to him on the recommendations of realtors, accountants, banks, and former clients. He receives all payments on loans directly, makes all necessary disbursements, determines whether the taxes, insurance, etc., are currently paid and inspects any property involved for proper maintenance.”
- ▶ ENTIRE Analysis by IRS: “In the instant case, since A personally makes and services the loans as a regular sideline activity from which he earns a part of his livelihood, it is held that such activities carried on under the circumstances described constitute a trade or business”
- ▶ AS DISTINCT FROM: “For example, an individual who merely lends money and holds the mortgage until maturity may not include the interest in computing his net earnings from self-employment, since this is an investment rather than a trade or business.”



# Small Private Lenders

- ▶ If you are a “small” (\$315k MFJ/\$157.5k Single) lender, form an LLC taxed as an S-Corporation
- ▶ Based on Revenue Ruling 58-195, treat the activity as a “T/B”
- ▶ TRACK YOUR HOURS to justify a low “reasonable salary”
- ▶ Pay yourself a low W-2 wage based on your hours
- ▶ Most of the income from lending will come out of the S-Corporation as non-SE/SS-taxable distributions, so being a “T/B” does little harm
- ▶ The T/B status will allow you take the Pass-Thru Deduction
- ▶ You will also get extra write-offs (e.g. meals, travel, etc.)

# Big Private Lender

- ▶ “Big & No Phase-Out” = Taxable Income > \$415,000 MFJ/\$207,500 Single
- ▶ Unlikely to be a Naughty Service
- ▶ Once “Big”, a new limit on the deduction applies, greater of:
  - ▶ 50% of W2 Wages; or (25% of W2 Wages) + (2.5% of purchase of depreciable property used in T/B)
  - ▶ Unlikely to be much depreciable property - Computer? Office equipment? If I were buying office equipment one of several T/B, I’d put it here.
  - ▶ Could pay yourself a W-2
    - ▶ Track time, “substance over form” & “reasonable salary” issues
    - ▶ Balance Pass-Thru Deduction against Payroll Tax Cost (and pension contribution eligibility)

# Rehab & Retail Example: Dealer?

- ▶ Assumes “Dealer” status
- ▶ Remember, T/B is not the same as “Dealer” - all Dealers are a T/B, not all Buy-Sell T/B are “Dealers”
- ▶ If haven’t done “too many” deals, then can argue that buy-sell deals are not “inventory” and you are not a “Dealer”
- ▶ Upside: You pay ordinary income tax rates WITHOUT SE/SS Tax
- ▶ Downside: Does not qualify for 199A Deduction
- ▶ If SE/SS Tax exposure is low OR using S-Corp to control exposure, then treat as T/B or “Dealer”

# Rehab & Retail

- ▶ If you are a “small” (\$315k MFJ/\$157.5k Single) rehabber, then no problem - take 20% of QBI or 20% of Taxable Income, whichever is less
- ▶ This assumes you have a T/B and are not reporting gains on Schedule D as “capital gains”
- ▶ If you are large....it gets complicated. Your deduction is limited to 50% of W-2's OR [(25% of W-2's) + (2.5% of depreciable property)]
  - ▶ Probably need to jack up W-2's early on in the year. These types of businesses do not tend to have much DEPRECIABLE property - your inventory does not count!
  - ▶ Greater incentive to run this as an S-Corporation: Pay yourself W-2. Reduces QBI but jacks up W-2 threshold

# Assignor

- ▶ If you are a “small” (\$315k MFJ/\$157.5k Single), then no problem - take 20% of QBI or 20% of Taxable Income, whichever is less. Sound familiar?
- ▶ If “large”....you’ve got a problem with Naughty Services Overkill:
  - ▶ “any trade or business where the principal asset is the reputation or skill of 1 or more employees or owners”
  - ▶ Time to mix in some rehabs (you are making enough to do so) and get some W-2’s paid....the rehabs allow you to argue that your “skill or reputation” is not “THE primary asset” and the W-2’s help get past the extra limit for being “Big”

# Depreciation

- ▶ #1: \$2,500 Expensing Election
  - ▶ NOT improvements to real property
  - ▶ Tangible personal property; or
  - ▶ Supplies for repairs & maintenance
  - ▶ Cabinets, Washers & Dryers, Carpets, Window Parts “Yes”
  - ▶ Furnaces, Roofs, Anything Going Into a Rehab “No”
- ▶ In place by December 31<sup>st</sup> of prior year AND on tax return for that year
- ▶ MUST expense same items on financials
- ▶ “Substance over form” & “anti-abuse” rules apply

# Depreciation

- ▶ #2: “Bonus” Depreciation
  - ▶ Taken in first year - basically a write off
  - ▶ On Tangible personal property
  - ▶ 20 year or less depreciation schedule
    - ▶ Land Improvements
    - ▶ Usual personal property - carpets, appliances, etc.
  - ▶ “Used” property now permitted - means buying a rental property can result in “break outs” that are deducted NOW
    - ▶ Cannot buy from “you” no matter how cleverly done

# Depreciation

## ▶ #3: Section 179

- ▶ Old Law: Can deduct personal property used in RE business IF it is not part of a place that provides “lodging” (i.e. - computer in your office “good”, computer in a furnished rental “bad”)
- ▶ Old Law: Can deduct personal property in a place that provides “lodging” IF “transient” - hotel, AirBNB
- ▶ NEW Law: Personal property in residential real estate now can be deducted via Section 179 - use this when over \$2,500 (cannot expense) and not qualified for “Bonus” depreciation.
- ▶ Bottom line: Personal property in rentals is now deductible 3 different ways.



# Depreciation

- ▶ #4: Regular Depreciation
  - ▶ Residential real estate still gets depreciated over 27.5 years & non-residential commercial property over 39
  - ▶ Cars now depreciate faster
  - ▶ Faster depreciation for farm equipment (5 years instead of 7)

# Depreciation

- ▶ #5: Qualified Property
- ▶ Replaced Qualified Restaurant, Retail, and Leasehold Property
- ▶ Definition: Improvement is made
  - ▶ To the interior of a building that is non-residential real property; and
  - ▶ The improvement is placed in service after the building was first placed in service
- ▶ Supposed to Depreciate over 15 years - they forgot to include it, oops!
- ▶ Therefore does not qualify for Bonus Depreciation either
- ▶ Hopefully they get in a “technical correction”

# New C-Corporation Rates

- ▶ US had the highest corporate tax rate in the industrialized world
  - ▶ Dear Democrats: And yes, the effective rate was actually higher, your imaginary “loopholes” did not lower the effective rate to competitive levels
  - ▶ Unlike other countries, we tax corporate income earned outside of the US - and at high rates. It was malpractice for US-based corporations to NOT invert.
  - ▶ Should result in repatriation of up to 2 trillion USD
  - ▶ Looking at a far less biased source, the European think tanks are very concerned that new competitive US corporate tax rate will result in a drain of capital from Europe to US
  - ▶ This change was long overdue. Republicans did the right thing. Democrats will of course demagogue the issue.

# C-Corp Tax Arbitrage

- ▶ Look at a C-Corp as a “Diluted SDIRA”
  - ▶ 21% bracket instead of \$0
  - ▶ More flexible withdrawal options - but still with a price (e.g. - double tax)
  - ▶ Works best if you keep money growing inside. Withdrawal likely kills most of the tax benefit due to 2<sup>nd</sup>-tier tax on dividends
  - ▶ Complex rules & admin hassle come into play - need to weigh such intangible costs against benefits
  - ▶ Unlike SDIRA can do business with family members, partners, etc.
  - ▶ Can also be used for your own personal benefit
  - ▶ Less savings than a SDIRA, but more flexibility

# When does it make sense?

- ▶ Net Investment Income Tax (“Obamacare Tax” or “NIIT”) of 3.8% applies to investment income (most net rental income, interest, dividends, capital gains, etc.) to the extent taxpayer has Adjusted Gross Income of > \$250k MFJ or \$200k Single. NIIT should be factored into arbitrage decisions.
- ▶ For example:
  - ▶ You file MFJ and make \$300,000 taxable income and will pay NIIT on \$50,000 of that income. Your bracket = 24% (\$165,001 to \$315,000) + NIIT of 3.8% = 27.8% bracket. Is it worth the hassle of moving (for example) \$50,000 of income into a C-Corporation to be taxed at 21% for a savings of \$3,400? Most clients would say “no”

# When does it make sense?

- ▶ Another example:

- ▶ You file MFJ, make \$800,000 taxable income and are in a 37% bracket (\$600k+ MFJ/\$500k Single) with no NIIT-taxable income. Is it worth the hassle of moving (for example) \$200,000 of income into a C-Corporation to be taxed at 21% for a savings of \$32,000? Most clients would say “yes”. Size matters.
- ▶ Sometimes two identical (on paper) clients choose differently based on purely subjective matters. For example, some clients hate admin/paperwork/moving parts and will not create more of it, even for 5-figure sums.

# How to Move Business To C-Corp

- ▶ Just pay the C-Corporation a consulting fee or management fee from your high-earning business. Done!
  - ▶ Um, *NO*. Such transactions completely lack “economic substance”. The IRS usually wins in court on these.
  - ▶ See for example:
    - ▶ *ASAT, Inc. v. Commissioner*, 108 T.C. 147
    - ▶ *Weekend Warrior Trailers, Inc. v. Commissioner*, T.C. Memo. 2011-105
    - ▶ *Fuhrman v. Commissioner*, T.C. Memo. 2011-236
  - ▶ We see this approach frequently with supposed “rental management companies” and “billing companies” for MD’s.
  - ▶ It is “doable” if the C-Corp looks & acts like an actual rental management company, billing company, etc. Getting to that point takes time & effort that should be factored into the cost-benefit decision.

# Better Way: Segment Business

- ▶ I have a tax law practice (big bread winner), a course/seminars business (good money) and a small real estate/notes portfolio (cash flows OK, gets reinvested). Given my bracket and numbers, putting the seminar business in a C-Corp might make sense.
- ▶ For REI with flipping (either rehab & retail or assignment) businesses, part of that business can be run through a C-Corporation....run “x” number of deals through the C to get to the “right” number. This approach should work with other “fungible” businesses. Perhaps an AirBNB business that runs the short-term rentals but does not own the buildings? Think about it.
- ▶ You can often find a way to segment a business. For example, I could split the tax law practice into three categories: SDIRA/401k, real estate, and all other. Each portion could have separate employees (e.g. - different lawyers based on specialty, etc.). The narrative (“non-tax business purpose”) matters.



# Old Tricks, Old Traps

## Personal Holding Company Tax

- ▶ (IRC Sections 541, 542, and 543):
- ▶ More than 50% of value of stock is held, directly or indirectly, by 5 or fewer people AND 60%+ of its gross income is “passive” (dividends, interest, rents, annuities, mineral rights, etc.)
- ▶ Triggers “Personal Holding Company Tax” of 20% - basically the downside of the dividend distribution without the upside
- ▶ Designed to keep taxpayer from sheltering passive income from personal tax rates
- ▶ How to avoid it:
  - ▶ Distribute. This is an especially important strategy with SDIRA’s and avoidance of UBIT.
  - ▶ Reduce amount of passive income/increase active income

# Old Tricks, Old Traps

## Personal Services Corporation

- ▶ Most of the stock is held by professionals in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (over-simplified definition for the sake of time).
- ▶ Flat 35% tax bracket instead of regular 21% corporate bracket - and that's is before 2<sup>nd</sup> layer of taxation on dividends
- ▶ Recommendation: Avoid it
- ▶ There will be opportunities to game it, beyond the scope of this overview. For example, the list of “professions” is narrower than those listed for purposes of the Pass-Thru Deduction

# Old Tricks, Old Traps

## Accumulated Earnings Tax

- ▶ 20% tax on “excessive” retained earnings
- ▶ Have specific plans for future use of earnings
  - ▶ Anticipated cash flow crunches, equipment purchases, etc.
  - ▶ A new line of business - hard money lending that qualifies as a “trade or business” and does not produce “passive interest income” and therefore avoids Personal Holding Company Issues?
  - ▶ A periodic rehab & retail that requires capital reserves?
- ▶ No need to justify 1<sup>st</sup> \$250,000 retained (\$150k for Personal Service Corporations)
- ▶ Document, document, document

# The Death of UBIT?

- ▶ 37% tax (for the most part, small \$12.5k bracket to get to top rate)
- ▶ UBIT is caused by 3 things. When an IRA, 401k or similar account:
  - ▶ Regularly carries on a “trade or business”; or
  - ▶ Borrows
  - ▶ Rents out personal property (e.g. - cars, machinery)
- ▶ C-Corp buffer means SDIRA pays at 21% corporate rate instead of 37% UBIT rate
- ▶ There is no double tax because SDIRA’s generally do not pay tax on corporate dividend distributions
- ▶ Such entities are “one shot” and “disposable”
- ▶ **COUNSEL & SPECIAL DRAFTING BY KNOWLEDGEABLE PEOPLE MANDATORY!**

# The Death of UBIT: Example

- ▶ SDIRA wants to invest in Dairy Queen franchise which would qualify as “T/B that is regularly carried on”
- ▶ The income from such a T/B would normally be subject to 37% UBIT rates
- ▶ The SDIRA forms a 100%-owned C-Corporation and makes a ONE TIME contribution of capital
- ▶ C-Corp invests in the DQ and brings in the income which is taxed at 21% - a bit more than half the UBIT rate
- ▶ C-Corp makes distributions if & when desired to the SDIRA tax-free.
- ▶ C-Corp can retain its earnings and invest in other UBIT-generating businesses

# The Death of UBIT: Debt Example

- ▶ Mind Your Math!
- ▶ SDIRA invests in LLC that owns leveraged rental RE
- ▶ The income attributable to debt would normally be subject to 37% UBIT rates - but only on portion of gain attributable to debt
- ▶ Is it better to pay UBIT on “x”% of rental income or corporate rate on 100% of income? Depends on “x”, run the math.
  - ▶ If leverage = 10%, then effective rate on SDIRA = 37% UBIT rate x 10% = 3.7% effective rate. In that case, C-Corporation at 21% would be counterproductive.
  - ▶ If leverage = 90%, then effective rate on SDIA = 37% UBIT rate x 90% = 33.3%, so corporate rate of 21% is “better enough” to justify the extra moving parts

# The Death of UBIT: PHC Issues

- ▶ When IRA invests in “passive” activity that is debt leveraged (e.g. non-AirBNB rentals) PHC is an issue if passive income = 60%+ of corporate gross income
- ▶ In such cases, be sure to distribute proceeds at least equal to net income or pay the PHC tax.
- ▶ Issue: Phantom Income. If the company in which the C-Corp invests has income, especially if large (e.g. - sale of a large leveraged property) and does not distribute enough cash by the end of the year, then C-Corporation either cannot distribute (and will get stuck paying PHC Tax) or needs to come up with cash to make a distribution (e.g. - loan from a friendly, non-disqualified person)
- ▶ Example: Company in which C-Corp invested sells a rental property (passive for PHC purposes) on December 31<sup>st</sup> and send a check to C-Corp January 1<sup>st</sup>. Issue: Unless C-Corp came up with money and made distribution in “right amount on 12/31, it’ll need to pay the PHC tax.

# Net Operating Losses: Unintended Benefit

- ▶ 2-Year Carry-Back Eliminated (Farmers still get 1-year)
- ▶ 15-Year Carry-Forward made infinite
- ▶ NOL applies up to 80% of taxable income.
- ▶ Congress viewed this as a “smack”. For many of you it is a bonus because NOL’s would often reduce business income to zero - so you’d “lose” your personal deductions. This way there’s still some income to “soak up” your personal deductions
- ▶ Requires planning - which means current & accurate financials. For example, why “write off” depreciable assets if it will make your income “too low” to take personal deductions?



# Cash Method Expansion

For most taxpayers, “cash method” beats “accrual method” of accounting for two reasons:

- ▶ Much, much simpler & easier as far as bookkeeping & admin goes
- ▶ Accrual method tends to accelerate income and defer deductions
- ▶ Ask your CPA if EACH of your entities *and* EACH of your businesses
  - ▶ Is on “cash” or “accrual” method of accounting
  - ▶ Needs to maintain “inventory” (only applies to businesses that sell things)
  - ▶ Is subject to 263A “Unicap” rules (usually applies to large builders/rehabbers)

# Cash Method Expansion

- ▶ New Threshold = average annual gross receipts for last 3 years of less than \$25 Million and you are exempt from
  - ▶ Being forced into accrual method of accounting
  - ▶ Unicap/263A Accounting Rules
  - ▶ Keeping inventories
  - ▶ Completion-of-Contract Method for Construction Contracts
- ▶ Changing from any of the above (except completion-of-contract method) is a “Change of Accounting Method”
  - ▶ Presently unclear whether such changes will be automatic or require IRS consent
  - ▶ No consent required going forward for new businesses

# Business Interest Deduction Rules

- ▶ Does not apply to most of you
  - ▶ Exempt if < \$25M in average annual gross receipts for past 3 years
  - ▶ Applies at entity level
  - ▶ Even if over \$25M figure, most RE-related businesses can elect out for a price: Considerably longer depreciation schedule

# 1031's

- ▶ Exist for real estate only, repealed for “all other”
- ▶ Will wreak havoc with airlines, rental car companies, etc.
- ▶ Means that when you trade your old business car in for a new one there will probably be taxable gain
- ▶ For landlords who engage in cost segregation, 1031'ing a property may now show some gain on “sale” of stoves, carpets, refrigerators, etc.

# More Misc.

- ▶ No more entertainment deductions
- ▶ Meal deductions are pretty much all 50%
- ▶ Employee Achievement Awards Must be Tangible Personal Property
- ▶ Section 199 Repeal

# Still Standing

- ▶ Coverdell Educational Savings Accounts
- ▶ Section 121 Exclusion for Sale of Personal Residence remains unchanged
- ▶ \$250 “Educator” Deduction Retained
- ▶ Deduction for Student Loan Interest Retained
- ▶ Grad Students Not Taxed on Free Tuition
  - ▶ Given how much they tend to like socialism, one would think they’d be happy to help fund it

# Personal

- ▶ Estate Tax Exemptions Doubled to \$10M per person, indexed
- ▶ Old top rate was 39.4%. Now 37%
- ▶ All brackets have been dropped, many have been lengthened.
- ▶ Personal exemptions repealed
- ▶ Standard Deduction increased from \$12,000 MFJ to \$24,000 (From \$6,000 to \$12,000 if Single)
- ▶ Child tax credit increased to \$2,000 (\$1,400 handout limit) and income threshold increased to \$400k for MFJ (was circa \$130k)
  - ▶ Net Effect: 30% of taxpayers itemize now. Number will drop to 10%. Will help “just barely” itemizers. Will hurt those who have kids & itemize, especially kids over 18.

# Personal

- ▶ Old top rate was 39.4%. Now 37%
- ▶ All brackets have been dropped, many have been lengthened.
- ▶ Personal exemptions repealed
- ▶ Standard Deduction increased from \$12,000 MFJ to \$24,000 (From \$6,000 to \$12,000 if Single)
- ▶ Child tax credit increased to \$2,000 (\$1,400 handout limit) and income threshold increased to \$400k for MFJ (was circa \$130k)
- ▶ \$10,000 limit on deduction for state personal income taxes & property taxes on personal residence
  - ▶ Does not limit deduction for property taxes on rentals
  - ▶ AMT had already limited these deductions in an indirect way
  - ▶ Certain (“blue”, ahem) states lose subsidy on high taxes



# Personal

- ▶ \$750k limit on loan amount (not acquisition amount) eligible for interest deduction on personal residence
  - ▶ Prospective only, \$1M limit still applies for pre-2018 acquisitions
- ▶ Repeal of personal casualty & theft loss deduction, except in presidentially declared disaster areas
- ▶ Increase in AMT exemption amount - will help a bit
- ▶ **Alimony reversed as of agreements entered into before 12/31/18**
- ▶ Penalty for not buying health insurance is gone
  - ▶ Per the media “Mandate repealed”. I guess the way you put it matters.
- ▶ Medical expense deduction floor temporarily back down to 7.5% of AGI from 10%
  - ▶ Note: This is an inferior means of deducting medical expenses.
- ▶ Moving expense deduction gone except for military

# More Personal

- ▶ Increased contributions to ABLE Accounts
- ▶ Saver's credit applies to ABLE Accounts
- ▶ Can Roll \$\$\$ from 529 Accounts to ABLE Accounts
- ▶ 529 Plans can distribute up to \$10,000 per person per year for K-12
- ▶ Roth IRA Re-Characterizations gone after 2017
  - ▶ 2017 Conversions: Old rules still apply even in 2018

# Itemized Deductions Repeal #1

- ▶ Makes having a “Trade or Business” even more important for what were “investment” activities such as lending
- ▶ Here’s a list to review later:
- ▶ Appraisal fees for a casualty loss or charitable contribution;
- ▶ Casualty and theft losses from property used in performing services as an employee;
- ▶ Clerical help and office rent in caring for investments (“investments” mean activities that do not rise to the level of a “trade or business”);
- ▶ Depreciation on home computers used for investments;
- ▶ Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust;
- ▶ Fees to collect interest and dividends;
- ▶ Hobby expenses, but generally not more than hobby income;
- ▶ Indirect miscellaneous deductions from pass-through entities;

# Itemized Deductions Repeal #2

- ▶ Investment fees and expenses;
- ▶ Loss on deposits in an insolvent or bankrupt financial institution;
- ▶ Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
- ▶ Repayments of income;
- ▶ Safe deposit box rental fees, except for storing jewelry and other personal effects;
- ▶ Service charges on dividend reinvestment plans; and
- ▶ **Trustee's fees for an IRA, if separately billed and paid.**
- ▶ **Tax prep (personal return only and only the non-business portions of it)**
- ▶ Employee expenses
- ▶ Business bad debt of an employee;
- ▶ Business liability insurance premiums;
- ▶ Damages paid to a former employer for breach of an employment contract;
- ▶ Depreciation on a computer a taxpayer's employer requires him to use in his W2 job;

# Itemized Deductions Repeal #3

- ▶ Dues to a chamber of commerce if membership helps the taxpayer perform his W2 job;
- ▶ Dues to professional societies;
- ▶ Educator expenses;
- ▶ Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work;
- ▶ Job search expenses in the taxpayer's present occupation;
- ▶ Laboratory breakage fees;
- ▶ Legal fees related to the taxpayer's W2 job;
- ▶ Licenses and regulatory fees;
- ▶ Malpractice insurance premiums;
- ▶ Medical examinations required by an employer;
- ▶ Occupational taxes;
- ▶ Passport fees for a business trip;
- ▶ Repayment of an income aid payment received under an employer's plan;

# Itemized Deductions Repeal #4

- ▶ Research expenses of a college professor;
- ▶ Rural mail carriers' vehicle expenses;
- ▶ Subscriptions to professional journals and trade magazines related to the taxpayer's W2 job;
- ▶ Tools and supplies used in the taxpayer's W2 job;
- ▶ Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's W2 job;
- ▶ Union dues and expenses;
- ▶ Work clothes and uniforms if required and not suitable for everyday use; and
- ▶ W2 job-related education.
- ▶ Repayments of income received under a claim of right (only subject to the two percent floor if less than \$3,000);
- ▶ Repayments of Social Security benefits; and
- ▶ The share of deductible investment expenses from pass-through entities.

# Net Effect On Personal Side

- ▶ 95% of taxpayers get a cut
  - ▶ Sorry to the 5%
  - ▶ If you do not pay taxes, you do not get a cut, so sorry
  - ▶ VERY business-friendly
- ▶ Lots of simplification that the press did not cover
  - ▶ Accounting thresholds of \$25M
  - ▶ Way fewer itemizers
- ▶ Have 18+ Kids File Own Return - and pay them wages
- ▶ Some charitable giving via C-Corporations (up to 10% of Corp income)