STESSA

How New Tax Laws Impact Your **Rental Property Investments**

2019 EDITION

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Summary of Key Changes

Tax Cuts & Jobs Act

The TCJA revises many key regulations affecting rental property owners, including:

- Bonus depreciation is increased from 50% to 100% for some kinds of personal property and land improvements.
- Personal property is no longer eligible for 1031 exchanges, which are now limited to real property only.
- Some real estate professionals are now eligible for a new 20% QBI deduction.
- The amount of excess business losses that can be used to offset other income is now capped at $500K (married) / 250K (single) instead of unlimited.
- Mortgage interest and property taxes remain fully deductible on all types of investment property.

The Tax Cuts and Jobs Act (TCJA) of 2017 is the most substantial tax reform bill signed into law since the Tax Reform Act Of 1986.

General Tax Law

Many rental property owners are also likely to be affected by other more general tax law changes under the TCJA:

- [Tax brackets] for individuals are reduced and widened.
- The standard deduction is increased to $12,000 for single taxpayers and $24,000 for those married and filing jointly, while personal exemptions are eliminated.
- The deduction for state and local taxes, including property tax on personal residences is now capped at $10,000 for those who use itemized deductions.
- The Alternative Minimum Tax (AMT) exemption amounts have increased to $109,400 for couples filing jointly and $70,300 for all other taxpayers. AMT phaseout thresholds are increased to $1,000,000 for married taxpayers filing a joint return, and $500,000 for all other taxpayers. These phaseouts are now also indexed for inflation.
- The lifetime gift exclusion is increased to $5.6 million for individuals and $11.2 million for married couples.

100% Bonus Depreciation

The Tax Cuts and Jobs Act (TCJA) increased bonus depreciation from 50% to 100% for personal property and land improvements with a useful life of less than 20 years until 2023. Bonus depreciation is then quickly phased down to 20% in 2026, where it will remain indefinitely.

This is arguably the most important change in The Tax Cuts and Jobs Act for real estate investors. 20-30% of residential investment property can typically be reclassified as 5, 7, or 15-year property using a cost segregation study. These amounts are then depreciated in full during the first year of ownership using 100% bonus depreciation.

Let's say you purchase a property for $500,000, and conservatively value the land at 20%, resulting in an aggregate improvement basis of $400,000. Straight line depreciation over 27.5 years would result in annual depreciation of $14,545.

PRO TIP

The Bonus Depreciation increase is arguably the most important change for real estate investors. Bonus depreciation has increased from 50% to 100% for personal property and land improvements with a useful life of less than 20 years until 2023 and can deliver significant tax savings for those who qualify.

EXAMPLE: 100% BONUS DEPRECIATION

Pursuing a cost segregation study and 100% bonus depreciation will likely result in the following benefits:

	NO COST SEG	100% BONUS
Structure	$400,000	$320,000
15-Year Property	$0	$20,000
7-Year Property	$0	$0
5-Year Property	$0	$60,000
Annual Depreciation	$14,545	$11,636
1st Year Bonus Depreciation	$0	$20,000
Total First Year Depreciation	$14,545	$91,636
First Year Tax Savings*	$3,491	$21,993
Annual Dep Years 2+	$14,545	$11,636
Annual Tax Savings Years 2+*	$3,491	$2,727

**24% tax bracket used for illustrative purposes.*

As you can see from the chart, the cost segregation approach and 100% bonus depreciation deliver significant year one tax savings.

This strategy will likely have the biggest impact on investors that qualify as real estate professionals for tax purposes since you'll need significant other income in order to utilize the full amount of bonus depreciation. That said, cost segregation can still be beneficial to other investors, especially during years in which you expect to have large capital gains tax liabilities from the sale of a property.

Changes to Section 1031 “Like-Kind” Exchanges

The Tax Cuts and Jobs Act (TCJA) limits the type of property eligible for a like-kind exchange to real property only. While most real estate investors can breathe a sigh of relief that this tried and true tax deferment strategy remains available, a cloud lurks behind every silver lining.

You can indeed still use like-kind exchanges to defer the capital gains and depreciation from the sale of real property. That said, if you use a cost segregation study, some of the property’s value will be reclassified as personal (e.g. 5-year property). This portion will then be ineligible for a 1031 exchange and will be subject to capital gains and depreciation recapture.

There are of course ways this can be mitigated by using capital losses and/or passive losses to offset the gain upon sale. Also, because used personal property may have little value left at the time of sale, the seller may try to allocate a smaller portion of the sales price to personal property to reduce the taxable capital gains or depreciation recapture. In practice, this may not prove as easy as it sounds because the buyer usually wants the opposite.

EXAMPLE: “LIKE-KIND” EXCHANGES

Continuing with the cost segregation example, if $60,000 of a property’s value is reclassified as 5-year personal property and entirely depreciated during the time of ownership, this will result in $60,000 worth of taxable capital gains (or depreciation recapture) upon sale even when the investor pursues an otherwise fully compliant like-kind exchange.

20% QBI Pass-Through Deduction (199A)

In parallel with the corporate tax rate being reduced from 35% to 21%, the Tax Cuts & Jobs Act (TCJA) of 2017 introduced a new 20% pass-through deduction. This provision allows certain business owners to deduct 20% of qualified business income when your taxable income is below $157,500 (single) or $315,000 (married). Should your taxable income be above these thresholds, a complicated calculation will be used to determine the amount of this deduction. Luckily your tax professional or tax software will handle that for you.

PRO TIP

The new 20% pass-through deduction allows certain business owners to deduct 20% of qualified business income.

Landlords may qualify for the 20% pass-through deduction under the safe harbor if all conditions are met.

Safe Harbor for Landlords

If you still have taxable income from your rental properties after following the strategies explored in Stessa's Rental Property Tax Guide, you may qualify for the 20% pass-through deduction under the following safe harbor, which requires that ALL conditions are met:

- ☑ The property is held directly by the individual or held through a disregarded entity by the individual or passthrough entity seeking the deduction. For example, a person who owns a single-member LLC that holds a rental property would meet this test.
- ☑ Commercial and residential real estate may not be part of the same enterprise.
- ☑ Separate books and records must be maintained to reflect income and expenses for each rental real estate activity or enterprise. A separate real estate enterprise may constitute multiple properties as long as it is all commercial or all residential.
- ☑ 250+ hours of rental services must be performed for the enterprise within the calendar year, inclusive of hours provided by non-owners (see detail below).
- ☑ Contemporaneous records are required, including time reports or similar documents, regarding: a) hours of all services performed, b) description of all services performed, c) dates on which such services are performed, and d) who performed the services.

Qualifying rental services include advertising to rent, negotiating and executing leases, verifying tenant applications, collection of rent, daily operation and maintenance, management of the real estate, purchase of materials, and supervision of employees and independent contractors. Services performed by owners or employees, agents, or contractors all count toward the 250 hours.

Note that even if your rentals don't meet the criteria for the above safe harbor, that doesn't necessarily mean your business entity won't qualify for the 20% pass-through deduction. There are other possible avenues available to qualify for this deduction. Regardless of whether your activity qualifies for the described safe harbor, if you plan on taking this deduction, you will have to issue Form 1099s to all independent contractors to which you paid over $600 during the year.

It's worth clarifying here that rental property owners are generally not required to file or send Form 1099s to independent contractors unless you plan to take the 20% pass-through deduction, provide substantial services to guests, or qualify as a real estate professional for tax purposes.

Excess Business Limits & NOLs

The Tax Cuts and Jobs Act adds a new provision to the tax code limiting the amount of "excess business losses" taxpayers (with the exception of C-Corps) can use to offset their other income to $250,000 for individuals and $500,000 for married couples. The remainder will be carried forward as a net operating loss (NOL).

To clarify "excess business losses" are the amount of deductible expenses in excess of income generated from that business. For example, if your business generated $1,000,000 in income and has expenses of $1,780,000, your business loss is $780,000.

The rules for deducting NOLs were also changed under TCJA. In previous years taxpayers could use NOLs to completely wipe out their taxable income, however this is now limited to 80% of taxable income. In previous years, taxpayers could carry back a NOL two years and carry it forward up to 20 years. Under TCJA, the carryback is eliminated but NOLs can be carried forward indefinitely.

For most rental property investors, this will only affect you if you qualify as a real estate professional for tax purposes, which makes other income eligible for offset by passive NOLs. As discussed above, the NOLs can be substantial if you're using cost segregation and taking advantage of 100% bonus depreciation.

EXAMPLE: EXCESS BUSINESS LOSSES & NOLS

Let's say your business generates an excess business loss of $780,000. You're married so you can use up to $500,000 of those losses against your other income, while the remaining $280,000 is carried forward as a NOL. In previous years, you would have been able to use the entire $780,000 loss to offset other income, should you have been fortunate enough to have at least that amount of other income available.

Changes in the Deductibility of Mortgage & Home Equity Interest

As you're probably aware, the Tax Cuts and Jobs Act limits the amount of mortgage interest you can deduct on your primary and secondary residences to a combined total of $750,000 in principal, while keeping the prior $1,000,000 cap in place for mortgages originated before 12/14/17. The key point here is that there remains no limit on the amount of mortgage and loan interest you can deduct on properties held for investment purposes.

Interest on up to $100,000 of home equity debt, secured by a personal residence, was tax deductible prior to the TCJA regardless of how the proceeds were used. Under the TCJA, interest on home equity debt, secured by a personal residence, is only tax deductible if the proceeds are used to substantially improve the residence.

However, you can choose to treat any debt secured by a residence, as not secured by your residence (yup, sounds weird but that's the IRS for ya). This allows you to use the interest tracing rules to classify the interest on home equity debt, secured by your residence, as passive activity interest and deduct the interest on Schedule E of your tax return.

There's no limit on the amount of mortgage and loan interest you can deduct on properties held for investment purposes.

When it comes to pure rental properties, the interest on lines of credit and cash-out refinances need to be used in your rental business (or another business) to be tax deductible.

When renting your home on a short-term basis, you will prorate your mortgage interest, and other expenses that relate to your entire home (e.g. property tax), based on both how long the home was rented, and the square footage ratio of the room to the entire home. Of course if you rented the entire home, these expenses would simply be prorated based on days rented (days rented/personal use + days rented).

Renting a room, or your entire home, on a short-term basis can help homeowners, with mortgage principal over the thresholds mentioned above, deduct more interest because part of the mortgage interest can be classified as business interest, which is not subject to the mortgage limits.

PRO TIP

For pure rental properties, interest on lines of credit and cash-out refinances need to be used in your rental business to be tax deductible.

Opportunity Zones & Funds

Opportunity Zones were introduced by the Investing in Opportunity Act, part of The Tax Cuts & Jobs Act passed in late 2017. They are economically-distressed communities nominated by the state governments and certified by the Secretary of the U.S. Treasury. A full list of current Opportunity Zones can be found on the CDFI Fund website.

Opportunity Funds are investment vehicles organized as a corporation or a partnership to invest in Opportunity Zones, and hold 90% or more of its assets in Opportunity Zone assets. The assets must be acquired after December 31, 2017.

These funds allow investors to pool their capital together and help revitalize Opportunity Zones through new business and projects. In exchange, investors receive favorable capital gains tax treatment on the sale of their capital assets.

PRO TIP

Investors only need to invest the capital gains portion from the proceeds of the sale in an Qualified Opportunity Fund whereas they would need to invest their entire proceeds of the sale (basis + capital gains) for a 1031 exchange.

Tax Benefits of Investing in Qualified Opportunity Funds

Investing in a Qualified Opportunity Fund provides investors with flexibility and several tax benefits.

Investors only need to invest the capital gain portion from the proceeds of the sale of their current assets in a Qualified Opportunity Fund in order benefit. This allows investors to receive their basis upon liquidation of an asset while only rolling their capital gain into the opportunity fund. Compare that to a 1031 exchange where you must generally roll all of your proceeds from the sale of an asset into the replacement asset.

Similar to a 1031 exchange, the capital gain portion of the proceeds from the sale of an asset must be reinvested into an Qualified Opportunity Fund within 180 days of the sale.

Basis Step-Up: Investors who invest in Qualified Opportunity funds will receive a step-up in their investment basis if they hold the investment for a certain number of years. Initially, the basis step-up is zero. But if the investor holds for five years, they will receive a basis step-up of 10%. If the investor holds for seven years, they will receive an additional 5% of basis step-up. As a result, if an investor holds a Qualified Opportunity Fund investment for a period of seven years or more, they will reduce the originally taxable portion of their capital gain by 15%.

EXAMPLE: TAX BENEFITS OF INVESTING IN QUALIFIED OPPORTUNITY FUNDS OVER TIME

Length of Investment	Tax Benefits
5 years or less	**Deferral of capital gains tax until the interest in the fund is liquidated.**
5-7 years	**Basis of investment is increases by 10%**
7-10 years	**Basis of investment is increases by another 5% for a total of a 15% increase.** **Payment of capital gains is deferred until 12/31/26 or the date the fund is sold or exchanged, whichever comes first.**
10+ years	**In addition to the benefits above, the capital gains tax on the Opportunity Fund investment will be eliminated.**

Note: Most pure rental properties will not qualify for Opportunity Funds. In order to qualify for an Opportunity Fund, the buildings use must originate with the fund (i.e. development) or an existing building must be substantially improved by the fund. Substantial improved is defined as adding enough capital improvements to the property to at least double the building's basis.

EXAMPLE: QUALIFIED OPPORTUNITY FUNDS AND TAXES OVER DIFFERENT TIME HORIZONS

An investor purchased $100,000 of XYZ Co. stock in 2010. In 2018 they sell the stock for $250,000, generating a capital gain of $150,000.

Within 180 days they invest the $150,000 gain in a Qualified Opportunity Fund, deferring the capital gains tax.

In five years, the basis of the capital gain invested into a Qualified Opportunity Fund increase by 10%. Because $150,000 was invested into the Qualified Opportunity Fund, the investor's basis in the fund will be $15,000. This means if the investor sold after a five year hold, they would pay capital gain taxes on $135,000 ($150,000 - $15,000).

If the investor held for seven years, the basis receives an additional 5% step-up, or $7,500 in our example. The investor's basis in their $150,000 capital gain invested is now $22,500. If the investor then sold, they would pay capital gain tax on $127,500 ($150,000 - $22,500) of their original investment.

If the investor holds for eight years (year 2026), the capital gain tax on the $127,500 (85% of $150,000) of deferred capital gain will be due, assuming the fair market value of the Qualified Opportunity Fund interest is higher than the deferred gain.

If the investor continues to hold their investment for 10 years, and during this time, the original $150,000 investment in the Opportunity Fund appreciates to $325,000, the investor would not owe tax on the additional appreciation of $175,000. The capital gain tax on post-acquisition appreciation would be eliminated.

This guide should equip most rental property owners with basic tax strategies needed to minimize next year's tax bill. It's also a great source of ideas and possible scenarios to explore with your CPA. This is not an exhaustive list of all available real estate tax strategies and there may be additional actions you can take to further reduce your tax liability.

For more information on how the strategies discussed in this guide might apply to your specific situation, and tax compliance in general, we recommend consulting directly with your CPA. Also see the official guidance provided by the IRS, other tax content developed by Stessa, and further resources available via The Real Estate CPA.

While reasonable efforts were taken to furnish accurate and up-to-date information, we do not warrant that the information contained in and made available through this guide is 100% accurate, complete, and error-free. We assume no liability or responsibility for any errors or omissions in this guide.

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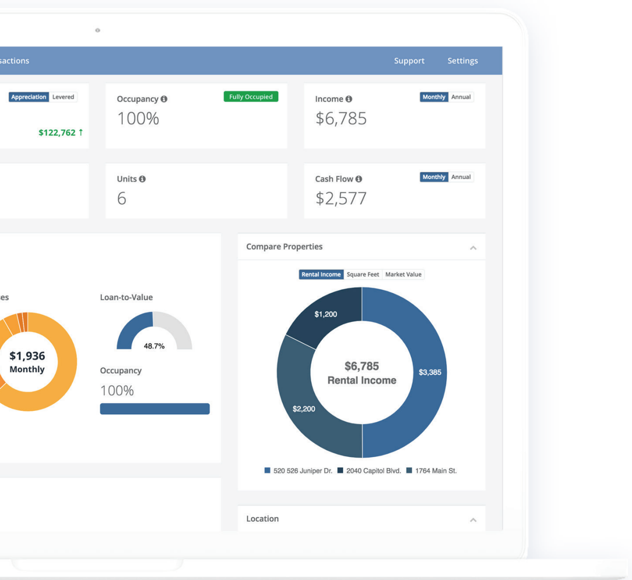

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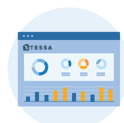

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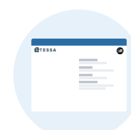

Built by rental investors for rental investors

Stessa was built from the ground up with rental investors in mind. We take care of all the tedious tracking and reporting details so you don't have to.

Stessa gives the millions of real estate investors with single-family rentals and multifamily buildings a powerful new way to track, manage, and communicate the performance of their real estate assets. Tracking rental property finances and monitoring performance used to be time-consuming and tedious. Now, Stessa's smart income and expense tracking technology makes it effortless, automating the busy work and saving property owners valuable time. Get a current view of how your portfolio is performing, and get the insights you need to make decisions without the manual spreadsheet updates.

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THE REAL ESTATE CPA

This content was created by Stessa in partnership with The Real Estate CPA.

Thomas Castelli, CPA is a Tax Strategist and real estate investor who helps other real estate investors keep more of their hard-earned dollars in their pockets, and out of the government's.

The Real Estate CPA is a 100% virtual accounting firm that helps individual real estate investors, syndicates, and private equity funds save thousands in taxes and grow their business with outsourced accounting and CFO services. While traditional CPAs will take on clients across numerous industries and become "generalists," we only service real estate investors or business owners in the real estate industry. We eat, breathe, and live real estate!

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