Tax Cuts and Jobs Act

Provisions Impacting the Construction and Real Estate Industry

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On Friday, December 15, Congressional Republicans released the details of their Tax Cuts and Jobs Act legislation. It now appears it will be sent to the President's desk for signature by Christmas. Click here for Wipfli's recently issued summary of the sweeping tax changes made by the bill.

The following is a more detailed discussion of those provisions in the proposed law that will most impact businesses in the construction and/or real estate industry. Unless otherwise noted, the changes would be effective for tax years beginning after 2017. Upon federal enactment, one can expect additional complications at the state level because some states automatically adopt federal changes and others may adopt them in part or in whole at a future time.

Taxation of C-Corporation Income

- C-corporation income will now be taxed at a flat rate of 21%. If the legislation is enacted before year-end, corporations will need to adjust their deferred tax assets/liabilities shown on their 2017 financial statements. Since most construction contractors have a net deferred tax liability, the result will be recognition of additional book income and a detailed footnote explaining that income to their bonding company.
- Fiscal year taxpayers are likely able to utilize a blended tax rate for tax years that include January 1, 2018, rather than having to wait until their first fiscal year beginning in 2018.
- The corporate alternative minimum tax is repealed, eliminating the significant swings in tax liability that can result from the use of the completed-contract method for regular tax and the percentage-completion method for AMT purposes.

Taxation of Pass-Through Business Income

Owners of pass-through entities and sole proprietors will be able to claim a below-the-line deduction for 20% of their net *qualified business income.* Qualified business income does not include S-corporation wages, guaranteed payments for services, or investment income from a pass-through entity.

For taxpayers with income above $315,000 joint ($157,500 single), the 20% deduction is subject to the phase-in of two limitations:

- Under the first limitation, the deduction would be limited to the greater of (a) 50% of the entity's W-2 wages or (b) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of the entity's qualified property. Since option (a) is often $0 for rental properties because most of them have few if any W-2 employees, the last-minute addition of option (b) will be beneficial for the real estate industry.
- Under the second limitation, the 20% deduction would not apply to pass-through income from certain specified service businesses or any business whose principal asset is the reputation or skill of one or more of its employees or owners, with a special exception for architectural and engineering firms. (In other words, architectural and engineering firms are ***not*** subject to the specified service business limitations).

Excess Business Losses

Under current tax law, non-corporate taxpayers' ability to deduct from a business activity is limited by their tax basis, their amount at risk, and the passive loss rules. Taxpayers who overcome these hurdles will now be confronted with a surprising fourth limitation.
For tax years through 2025, *excess business losses* will no longer be deductible in the current tax year. Instead, those losses must be carried forward and treated as part of the taxpayer's net operating loss in the subsequent tax year. An excess business loss is the excess of the taxpayer's total trade or business deductions and losses over the sum of (a) their total income and gains and (b) $250,000 (single) or $500,000 (joint). Given that net operating losses generated after 2017 can offset only 80% of taxable income, rather than the current 100% offset, this new treatment is even worse than it initially appears.

Methods of Accounting

The number of taxpayers that can use the cash method of accounting for income tax purposes, rather than being forced to use the accrual method, is significantly increased.

- The current $5 million average gross receipts threshold for corporations and partnerships with corporate partners that cannot use the cash method is increased to $25 million.
- The current $1 million average gross receipts threshold ($10 million for certain industries) for businesses with inventories that cannot use the cash method is increased to $25 million.

In addition:

- Any producer or reseller that meets the $25 million average gross receipts test is exempt from the use of the uniform capitalization rules.
- Small construction contracts entered into after December 31, 2017, and that are completed within two years are exempt from the required use of the percentage-of-completion method if the taxpayer meets the $25 million average gross receipts test for the year the contract commences.
- The bill does not appear to directly address the Alternative Minimum Tax adjustment for long-term contracts (other than a home construction contract) for non-C corporations.

Depreciation Lives – Real Property

While the depreciable lives for nonresidential real property and residential rental property remain at 39 and 27.5 years respectively, *qualified improvement property* will now be eligible for a 15-year life. The current favorable depreciation rules for leasehold improvement property, restaurant property, and retail improvement property are eliminated, and these previously separate categories are now consolidated under the singular "qualified improvement property" definition noted above.

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the building was first placed in service. Qualified improvement property does not include any improvement that relates to the enlargement of the building, an elevator or escalator, or the building's internal structural framework.

Bonus Depreciation and Section 179

Bonus depreciation allows a taxpayer to immediately deduct a percentage of the cost of qualifying property in the year the property is acquired, rather than depreciating it over a period of years. For qualified property acquired and placed in service between September 28, 2017, and December 31, 2022, the bonus is 100%. Beginning in 2023, that bonus will decrease by 20% each year. In addition to increasing the bonus depreciation percentage, the definition of qualifying property was expanded to include used property, a significant benefit for taxpayers purchasing existing buildings.

Section 179 allows a taxpayer to immediately deduct a certain amount of the cost of qualifying property in the year the property is acquired rather than capitalizing that cost and depreciating it over a period of years. The maximum amount that can be expensed is increased to $1 million. This $1 million amount is reduced by the amount that the taxpayer's total qualifying assets placed in service in the taxable year exceed $2.5 million. The definition of qualifying property is also expanded to include roofs, HVAC property, fire protection and alarm systems, and security systems in nonresidential buildings that are placed in service after the building is placed in service.

Interest Expense

The deduction of business interest expense is limited to 30% of the taxpayer's adjusted taxable income. ATI is business income computed without the deduction of depreciation and amortization for tax years 2017-2021. After 2021, business income is reduced by depreciation and amortization. Taxpayers with average annual gross receipts that do not exceed $25 million are, fortunately, exempt from this limitation. Special computations of this interest expense limitation apply in the case of partnerships (not S corporations). Any disallowed interest is carried forward indefinitely.

Taxpayers may elect to not have this limitation apply to any business involving real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. However, the taxpayers are then required to depreciate their nonresidential property using a 40-year life, residential rental real property using a 30-year life, and qualified improvements using a 20-year life (the new ADS lives for these properties).

Contributions to Capital

Previously, a C or S corporation (but not a partnership or an LLC) could receive amounts from a governmental entity or civic group on a tax-free basis, often using such amounts to close their financing gap. Common examples of such tax-free amounts were tax increment financing (TIF) funds, a bargain purchase of land, and incentive grants. However, beginning with the date that this new law is enacted, such amounts will now be taxable unless they are made pursuant to a master development plan that was approved by the governmental entity prior to the law's enactment date.

Like-Kind Exchanges

The current provision allowing the nonrecognition of gain in the case of a like-kind exchange of property held for productive use in a trade or business or for investment is modified to limit its application to only real property that is not held primarily for sale. Thus, personal property is no longer eligible for tax-free exchange. This new limitation applies to exchanges completed after December 31, 2017, unless the disposition of the old property or receipt of the new property has already occurred by December 31, 2017.

Carried Interest

To qualify for long-term capital gain on the sale of a partnership interest received in exchange for services, the taxpayer must now hold that partnership interest for a three-year period. The fact that an individual may have included an amount in taxable income upon their acquisition of the partnership interest or made a Section 83(b) election with respect to the partnership interest is irrelevant. Developers who build and sell after a year or two will need to grant their carried interests as soon as possible in the development process and then take this new holding period into consideration when calculating the after-tax economics of a sale of the property.

Rehabilitation and Other Tax Credits

For rehabilitation expenditures paid or incurred after December 31, 2017, the 10% credit for pre-1936 buildings is repealed, but the 20% credit for certified historic structures remains. In addition, the credit must now be claimed ratably over a five-year period rather than being claimed in the year the rehabilitated building is placed in service. A transition rule applies to rehabilitation expenditures for either a pre-1936 building or a certified historic structure that are paid or incurred after December 31, 2017, as long as the building is owned by the "taxpayer" at all times on and after January 1, 2018 and the 24-month (or 60-month) period begins no later than 180 days after the date of the law's enactment. This transition rule gives taxpayers a very limited opportunity to get the necessary property ownership in place by December 31, 2017.

The following other tax credits of interest to the construction and real estate industry are retained: Research and Development Tax Credit, Work Opportunity Credit, Low Income Housing Credit, and New Markets Tax Credit.

Stay tuned for future tax alerts and planning ideas in the coming days and weeks as Wipfli tax experts from across the country continue to examine and analyze the ramifications of the Tax Cuts and Jobs Act. If you have questions, please contact your Wipfli relationship executive.