Revisiting Key Aspects of the Tax Cuts and Jobs Act and Important 2019 Guidance from the IRS that Affect The Real Estate Industry

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It is the middle of the tax season and it important to highlight some of the major provisions of the Tax Cuts and Jobs Act ("TCJA") (*see* http://bit.ly/2jZX47p) passed in December, 2017, affecting the real estate industry. The TCJA includes many new provisions, and retained some previous provisions, with both positive and negative effects on the real estate industry and real estate professionals in particular. As indicated in a previous article (*see* https://bit.ly/2G6txCj), there will continue to be a debate as to what effect the Tax Cuts Act will have on the general real estate market and the economy overall.

Positive Changes

The TCJA does include specific provisions, namely the Qualified Business Income ("QBI") deduction, that will have positive tax implications on real estate agents and brokers, which, thanks, in part, to the efforts of the National Association of Realtors ("NAR"), were specifically exempt and which would have restricted real estate agents and firms from benefitting from this deduction. Moreover, the recently issued IRS regulations and revenue procedures provide much needed clarification on whether individuals and businesses owning real estate rental properties could take advantage of the QBI deduction.

The TCJA also maintained the existing capital gains exclusion amounts (i.e., $250,000 for a single person and $500,000 for a married couple) relating to the sale of a taxpayer's principal residence, provided the taxpayer(s) lived in the home for 2 years out of the last 5 years. There was a push by Congress to repeal this provision entirely. Again, strong lobbying efforts by NAR and others resulted in this provision remaining and keeping the 2-out-of-5-year threshold. Congress also attempted to change the requisite time frame to 5 years out of the last 8 years, which would have certainly had a negative impact on the real estate market.

Negative Changes to the Tax Law

In contrast, there are many provisions such as the $10,000 cap on "SALT" (state and local tax) deductions; the reduction on the principal amount (from $1,000,000 to $750,000) on which mortgage interest can be deducted, and added limitations in the mortgage interest deductions for principal and home equity loans, the repeal of the casualty loss deduction (which allowed homeowners to include a deduction on their tax return for losses not covered by insurance), and the repeal of the moving expenses deduction for everyone but those in the Armed Forces, which will impact the real estate market.

One item of note that was not addressed at all by Congress was the extension of the Mortgage Forgiveness Debt Relief Act (the "Debt Relief Act") which expired at the end of 2017 and which provided much needed relief to those individuals who were involved in a short sale or foreclosure. The Debt Relief Act allowed individuals to not have to declare as income the amount of the loan that was forgiven by the lender. Previously, individuals were required to include the

amount forgiven as income and pay income tax thereon. The Tax Extension Act of 2017 was never passed, and therefore, those individuals would now be required to include any amount that was forgiven on their tax return and pay income tax on the "phantom" income. NAR is currently in discussions to try to get this provision extended for 2018 and 2019, but to date, there is no word on whether it will be done in time for the April 15th filing deadline.

An Overview of the TCJA and the Section 199A QBI Deduction

Under the TCJA all eligible taxpayers making less than $157,500 for single filers, and less than $315,000 for joint filers, may take a deduction equal to 20% of the taxpayers' qualified business income on their personal tax return. However, once a single filer exceeds the $157,000 threshold by up to $50,000 (i.e., $207,000), or joint filers exceed the $315,000 by up to $100,000 (i.e., $415,000), the deduction will be allowed but will phase out on a pro-rata basis once they exceed the above amounts. The IRS provides helpful FAQs relating to the Section 199A QBI deduction on its website. (*See* https://bit.ly/2RbxOtc).

Once the above threshold levels have been reached, then any "specified service trade or business" will ***not*** be permitted to take this deduction at all. Section 1202(e)(3)(A) of the Internal Revenue Code ("IRC") specifically defines a "specified service trade or business" as "…any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees…."

It is important to note that while the term "brokerage services" is included in the definition above, the newly issued regulation explains that "brokerage services" includes "…services provided by stock brokers and other similar professionals, but does not include services provided by real estate agents and brokers, or insurance agents and brokers." (*See IRS Regulation 107892-18*, page 223, at https://bit.ly/2RWdJLk).

Other "qualified trades or businesses," similarly may claim the full 20% deduction subject to the specified threshold levels. However, after the threshold levels have been met, "qualified trades or businesses" are able to continue to claim the deduction but they would be subject to the "wage and capital limit exception."

This "wage and capital limit exception" allows a continued deduction that is the greater of: "(i) 50% of the W-2 wages paid by the business, or (ii) the total of 25% of the W-2 wages paid by the business plus 2.5% of the cost basis of the tangible depreciable property of the business at the end of the year." The recently issued IRS Revenue Procedure 2019-11 provides additional clarification and methods for calculating W-2 wages as defined in Section 199A. (*See* https://bit.ly/2R5IBog). It is imperative that taxpayers seek the advice of their accounting professionals when it comes to calculating the applicable deduction.

One crucial area that was not addressed clearly was whether individuals or businesses which owned real estate investment property could qualify for the QBI deduction. The IRS finally addressed this and issued important guidance in January.

Critical Guidance and Regulations Issued by the IRS in 2019

On January 18, 2019, the Internal Revenue Service ("IRS") issued much awaited and needed guidance, new regulations and an important notice containing a revenue procedure clarifying many of the ambiguities existing in the TCJA. (*See IRS Press Release*, IR 2019-04, Jan. 18, 2019, at https://bit.ly/2CwSfLg). The IRS explains that "[t]he new QBI deduction, created by the [TCJA] allows many owners of sole proprietorships, partnerships, S corporations, trusts, or estates to deduct up to 20 percent of their qualified business income." The TCJA also allows taxpayers to deduct 20% of "qualified real estate investment trust (REIT) dividends and publicly traded partnership income." It is important to note that this QBI deduction is *not* available for W-2 employees or for business income earned by a C corporation.

Safe Harbor for "Rental Real Estate Enterprises"

One important clarification provided by the IRS appeared in Notice 2019-07 which contained a revenue procedure ("Revenue Procedure") providing a "safe harbor" dealing with a "Rental Real Estate Enterprise" that would permit the QBI deduction. (*See* IRS Notice 2019-07 at https://bit.ly/2R1nenN). In order to qualify for the "safe harbor", a taxpayer must satisfy the following requirements: (a) maintain separate books and records showing all income and expenses; (b) perform 250 hours of "rental services"; and (c) maintain[ ] contemporaneous records, including time reports, logs, or similar documents, regarding the following: (i) hours of all services performed; (ii) description of all services performed; (iii) dates on which such services were performed; and (iv) who performed the services. Such records are to be made available for inspection at the request of the IRS." The third requirement will not be required for 2018.

Basically, an individual or business entity engaged in a rental estate enterprise must meet the above requirements before being allowed to take advantage of this safe harbor. NAR provides an informative video explaining the requirements of the new IRS Revenue Procedure. (*See "What Realtors Need to Know About the New Tax Law,"* NAR Video, at https://bit.ly/2PWpfSz).

The IRS requires those individuals or entities engaging in a "rental real estate enterprise" which would like to take advantage of the QBI deduction safe harbor to show that they spent 250 hours or more providing "rental services." The Revenue Procedure defines "rental services" as services that "…include: (i) advertising to rent or lease the real estate; (ii) negotiating and executing leases; (iii) verifying information contained in prospective tenant applications; (iv) collection of rent; (v) daily operation, maintenance, and repair of the property; (vi) management of the real estate; (vii) purchase of materials; and (viii) supervision of employees and independent contractors. Rental services may be performed by owners or by employees, agents, and/or independent contractors of the owners." The Revenue Procedure specifically *excludes* the following from "rental services":

- financial or investment management activities, such as arranging financing;
- procuring property;
- studying and reviewing financial statements or reports on operations;
- planning, managing, or constructing long-term capital improvements; or

- hours spent traveling to and from the real estate.

Owners and operators of a "rental real estate enterprise" must keep contemporaneous time records and must be sure *not* to include any of the above excluded items in said records. The time incurred by "employees, agents and independent contractors of owners" can be taken into account when calculating the 250 hours. The time spent by the real estate brokers, agents and attorneys in connection with the preparation and negotiation of lease would also be included when calculating the 250 hours. It is important for owners to keep track of time and ensure that their agents, employees and independent contractors provide detailed time records.

There are also two important and common "real estate arrangements" that will disqualify an owner from this safe harbor. If the rental real estate enterprise involves a "triple net lease" or if the rental real estate is used by the owner as a residence for any part of the year (as described under IRC Section 280A), then the owner will not qualify for the above safe harbor. This does not mean that this type of enterprise would be disqualified from claiming the QBI deduction altogether, it simply means that the owner would not qualify for this specific safe harbor but it can try to establish that it is a "qualified trade or business" under other sections of the IRC. It is very common for commercial real property owners to enter into "triple net leases," so this safe harbor would not be available to those individuals or enterprises.

Another important requirement is that the owner of the rental real estate enterprise must, under penalty of perjury, submit a statement to the IRS along with the tax return. The revenue procedure provides as follows:

> "The statement must be signed by the taxpayer, … which states: 'Under penalties of perjury, I (we) declare that I (we) have examined the statement, and, to the best of my (our) knowledge and belief, the statement contains all the relevant facts relating to the revenue procedure, and such facts are true, correct, and complete.' The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the statement."

While this revenue procedure is not a formal regulation, it provides that taxpayers may rely on it until final regulations have been issued by the IRS. Real estate professionals should have familiarity with these provisions so that they may highlight them and advise their clients to seek the advice of an accounting professional.

Tax Impacts and The Real Estate Industry

It is important for real estate brokers, agents, attorneys, mortgage brokers and others, to be aware of the key aspects of the TCJA and the new tax regulations so that they may alert their clients to the issues concerning real property ownership as well as knowing how the tax changes affect them personally when purchasing real property. Whether an individual is purchasing a primary residence or purchasing commercial real estate for investment purposes, that individual needs to know about the tax consequences and the incentives or disincentives of real property ownership.

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