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Musings Under New Code Section 199A
- The Focus of Most Small Business and Real Estate Investors -

One of the more controversial provisions of the Tax Cuts and Job's Act of 2017 ("TCJ Act") given last minute changes, is new Code Section 199A. It is a boon to private business investment and the real estate industry and is a focus of much commentary. Its aim is to foster investment in real estate and small businesses and, when coupled with certain other tax benefits offered for new investment, it does so in a unique way that differs from historic methods of cost recovery type tax incentive. For example, under the Economic Recovery Tax Reform Act of 1981, Reagan's incentives offered accelerated depreciation that promoted the purchase and development of real estate based upon economics that were driven by the present benefit of tax loss tax savings. Proformas generating losses under the laws that then existed illustrated how those losses would offset a taxpayer's other taxable income, thus producing a favorable economic result. This lead to a real estate bubble driven by the purchase of properties that didn't generate positive economics on their own, with some arguing this lead to the S & L crisis from 1986- 1995. Uniquely, Code Section 199A permits a deduction of 20% of qualified business "income," encouraging positive economics.

Unlike typical expenses or accelerated write-offs, once an expense or cost is deducted that amount is no longer susceptible to future write-offs. A last minute change to the TCJ Act added a significant philosophical change in tax law aimed at fostering real estate investment, whether passive or otherwise. Under this rule, taxpayers over a given level of taxable income ($157,500 single or $315,000 joint filer) are subject to limitations on their ability to deduct 20% of their qualified business income. In general, if subject to the limitation, the deduction cannot exceed the lesser of (1) 50% of the allocable share of the taxpayers share of the business's W-2 wages or (2) 25% of the W-2 wages plus 2.5% of the "unadjusted basis" of "qualified property." For a joint filer, application of this limitation means approximately a 1% loss for every $1,000 over the threshold and 2% for a single filer. Qualified property includes most depreciable property and whether or not it has been written-off as an expense under Code Section 179 or is depreciated. This last minute change provides real estate investors a significant benefit, because the so called "wage limitation" doesn't mean the absence of a deduction if nominal or no wages are paid, provided qualified property exists. What's more, qualified property remains unadjusted for not less than 10 years, even if the asset is fully depreciated or expensed beforehand.

Additionally, this rule is expanded by permitting it to extend to REITs and publicly traded

partnerships investing in real estate, unaffected by the above described limitation. Thus, taxpayers are permitted to deduct (without itemized deduction limitation) not only a portion of their qualified business income, but also 20% of their income from REITs or publicly traded real estate partnerships. In essence, 20% of real estate investment in publicly traded partnerships is now tax free.

Because these measures are aimed at investment that makes economic sense, the production of income is important and the generation of loss is discouraged. This is because a loss from a qualified business will decrease the deduction and any excess will be carried forward to reduce the deduction in future years. Qualified business income is a “net” amount, with income reduced by deductions and losses. As such, in some circumstances certain expenses producing deductions that are elective should not be taken. For example, under Code Section 179, the election to expense capital assets is not mandatory and though generally desirable a study should be undertaken on the impact under Code Section 199A.

With tax planning in general, analysis of a taxpayer’s particular circumstances is necessary to produce optimum results. Not much got simpler under the TCJ Act, but opportunities do abound. For most individuals, significant opportunities exist to enhance estate, business, and investment plans. We are presently digesting the TCJ Act and will be writing more as developments unfold. Our next comprehensive Client Update will be released in mid-January. For more on the TCJ Act, see http://www.jckempe.com/wp-content/uploads/2017/12/Using-Tax-Reform-to-Your-Advantage-1.pdf

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Our Office Locations:

941 N Highway A1A

Jupiter, FL 33477

561-747-7300

1101 East Ocean Boulevard

Stuart, FL 34994

772-223-0700