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TAX REFORM AND THE IMPACT ON THE REAL ESTATE INDUSTRY

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The Republican tax plan, now signed into law by President Donald J. Trump, is the first major reform of the U.S. tax code since 1986. To identify key takeaways for corporations and individuals, the Washington Business Journal recently partnered with Abraham "Abe" Leitner, a Tax Director at Goulston & Storrs. Abe has significant experience planning numerous cross-border transactions for U.S. and foreign individuals and corporations. He advises high net worth individuals, foreign governments, insurance companies, hedge funds, real estate developers, REITs, assisted living providers and manufacturers. Abe structures international joint ventures involving real estate investments in the United States and abroad and has advised multinational corporations on cross-border mergers and acquisitions.

What are the three most significant changes for corporations in the tax reform bill?

In addition to the change to the corporate tax rate, the most significant changes to the corporate tax landscape include the shift to a territorial system of international taxation in the form of a new dividends received deduction and a new 20% deduction, equivalent to a 16.8% effective tax rate, for foreign derived intangible income (FDII). This category--much broader than its name implies--includes most sales of goods or services to foreign customers. In truth, the new 30% limitation on deducting business interest expense will probably have a broader effect on corporations than the FDII deduction, but the 30% limitation also applies to non-corporate businesses.

How will the reduced federal tax rate impact the deferred tax assets and liabilities for financial statement reporting purposes?

The reduction in federal tax rates will generally shrink the value of deferred tax assets and liabilities. For companies whose deferred tax assets exceed their deferred tax liabilities, there will be a net negative effect on the balance sheet. On the other hand, for companies whose deferred tax liabilities exceed their deferred tax assets, there will be a net positive effect. The impact of the enacted law changes will have a broad impact on the four assertions of financial statements: recognition, measurement, presentation, and disclosure.

What are the main issues and opportunities a business owner should consider when choosing between continuing to operate as a flow-through entity (such as an S Corp, LLC or Partnership) as opposed to converting to a regular C corporation due to the lower 21% corporate tax rate?

A shareholder of a C corporation still faces a second level of tax on dividends distributed from the corporation, but, since the federal tax rate on dividend income is lower than the rate on other ordinary income (dividends are generally taxed at the 20-percent rate that applies to long-term capital gains), the combined rate on income subject to such double taxation is 36.8%, which is slightly lower than the 37% maximum rate on income earned through a flowthrough entity. However, dividends are also subject to an additional Medicare net investment income tax of 3.8% Also, corporations may be subject to a second level of state and local taxation. Accordingly, a flowthrough entity probably makes more sense for most small businesses that distribute the bulk of their income to their owners currently. C corporations may be more attractive to businesses that reinvest a lot of their earnings and can benefit from deferring the second level of shareholder tax. C corporations may also be attractive for businesses with international operations due to the special benefits for foreign income in the recent Code changes.

The international provisions in the tax reform bill contain huge benefits for corporations that are not available to individuals. Can you comment on some of those and explain why they are so important?

One of the new major benefits for corporations in the tax reform bill is a new 100% dividends received deduction for dividends from foreign subsidiaries. It allows earnings from offshore operations to be repatriated to the United States tax-free. Individuals are not eligible for this deduction. In addition, while there is a new rule requiring all U.S. shareholders of controlled foreign corporations (CFCs) to include the global intangible low-taxed income (GILTI) of the foreign corporation in the shareholder's income in the year it is earned by the CFC, corporations are eligible for a 50% deduction against their GILTI inclusion along with a foreign tax credit, which effectively reduces the federal tax rate on such low-taxed foreign earnings to somewhere between zero and 10.5%. Individuals are not eligible for this deduction and face a 37% federal tax rate on any such low-taxed income of their CFCs. Finally, individuals are not eligible for the new FDII deduction applicable to income from sales and services to foreign customers.

What are the repatriation tax rates applicable to individuals, partnerships and LLCs?

The repatriation tax rates are determined by a formula that applies a deduction designed to reduce the rate on such income in the hands of a corporation to 15.5% for earnings invested in "cash positions" (which include marketable securities) and 8% for earnings invested in other business assets. For individuals, the same deductions translate into tax rates of 17.5% for earnings invested in cash positions and 9.05% for earnings invested in other business assets.

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How is the 20% "pass through" deduction calculated?

For taxpayers with income below the $157,500 threshold ($315,000 for joint filers) the calculation is pretty straightforward since such taxpayers can simply deduct 20% of their business income. For taxpayers above that threshold, they need to determine whether their business qualifies for the deduction at all since many services business (such as businesses providing legal, accounting and certain other professional services) don't qualify for the deduction. In addition, the deduction for such higher income taxpayers is limited to the greater of (i) 50% of the W-2 wages paid by the business or (ii) the sum of 25% of the W-2 wages plus 2.5% of the business's depreciable tangible property.

Will I be able to deduct the interest I pay on my business loan to the bank?

The Act limits the deductibility of interest for every business, regardless of its form, to 30% percent of adjusted taxable income (defined similarly to "EBITDA" by adding back to taxable income interest, any NOL or pass-thru business deduction, and (until 2022 only) depreciation). This limitation does not apply to: (1) taxpayers with less than $25 million of gross receipts; and (2) real property trades or businesses that elect out of the limitation. Real property trades or businesses include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (including management and operation of lodging facilities). Interest in excess of 30% is carried forward indefinitely.

Will the state allow me to claim the 20% qualified business income deduction?

For most states, the starting point for determining tax liability is federal adjusted gross income. Since the qualified business income deduction reduces federal adjusted gross income, the deduction will generally apply for state purposes as well in those states. However, some states do not automatically follow changes to the federal rules determining adjusted gross income, so you need to check with your accountant on the rules in your state.

Service trades or businesses (over certain income thresholds) are excluded from the new partnership qualified business income deduction. How does the definition of service trade or business differ from the qualified small business stock definition?

The qualified small business income deduction is in many respects broader than the qualified small business stock exclusion. Unlike the latter, the qualified business income deduction is available for engineering and architectural services, banking, insurance, financing, leasing, or similar businesses, farming business, businesses involving the extraction of natural resources and for hotels and restaurants.

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