2018 Recap: Tax Changes Affecting the Real Estate and Construction Industries

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The Tax Cuts and Jobs Act of 2017 (TCJA) had great impact for those engaged in the real estate and construction industries at the business and individual level. As we close out 2018, we review the most significant changes that will affect tax planning for 2018 and beyond.

Tax Rates
As has been well documented, personal tax brackets have changed across the board. For businesses operating as a C corporation, tax rates were reduced to a flat 21 percent rate for taxable years after Jan. 1, 2018. The top individual rates for owners of pass-through entities and sole proprietorships were decreased from 39.6 percent to 37 percent. However, the changes in individual rates are set to expire after 2025.

20 Percent Deduction for Pass-Through Entities
The new 20 percent deduction based on qualified business income (QBI) for pass-through entities is great news for many construction firms that operate as a form of that entity. The bill limits this deduction to "non-personal service businesses." A personal service business is defined as performing in the following fields: athletics, brokerage services (not real estate), consulting, financial services, health and law "where the main asset of the business is reputation or skill of one or more of the employees or owners."

Business Interest Deduction
For all business entities, business interest deductions are limited to the sum of interest income plus 30 percent of adjusted taxable income. However, businesses with average gross receipts for the prior three years of $25 million or less are exempt from this limitation. Keep in mind that adjusted taxable income is equal to taxable income that is computed without regard to deductions for interest, depreciation, depletion, amortization and net operating losses.

Alternative Minimum Tax (AMT)
The AMT was eliminated for C corporations, but remains in place for owners of pass-through entities. However, the exemptions and phase-out limits were substantially increased to $70,300 (single) and $109,400 (married filing jointly). Contractors should note that the AMT provisions require that small contractors calculate their long-term contracts under the percentage of completion method for AMT purposes.

Long-Term Contracts Exception
Another piece of good news for contractors in the TCJA is that it increased the gross receipts limit to qualify for the small construction contract exception to the percentage of completion method (PCM) by $15 million. Under the PCM method, taxpayers must include in gross income for the tax year an amount equal to the product of the gross contract price, and the percentage of the contract completed during the year. Before the tax reform package was enacted, construction companies with average gross receipts of $10 million or less in the preceding three years were entitled to an exception from the requirement to use the PCM method for long-term contracts

as long as they met certain requirements. The Tax Cuts and Jobs Act increased the amount of gross receipts from $10 million or less to $25 million or less.

Bonus Depreciation Doubled to 100 Percent…For Now

As one of the most significant changes to the tax law, investing in new capital is much more attractive now that 50 percent expensing was increased to 100 percent for most property, including property placed in service after Sept. 27, 2017. The new bonus depreciation increase is set to expire Jan. 1, 2023, and then will be phased down 20 percent each year until it totally phases out in 2027.

Section 179 Deduction

The annual limit for Section 179 deductions was increased to $1 million and will begin to phase out once qualifying purchases exceed the increased amount of $2.5 million. Starting in 2018, inflation will index these amounts moving forward. While the 100 percent bonus depreciation makes the 179 provision irrelevant, it is still significant for certain real property improvement that is not eligible for the bonus depreciation, such as certain structural components to commercial buildings, including roofs, security systems and HVAC.

Qualified Opportunity Zones

Finishing on an exciting note, one of the most promising provisions in the TCJA is an incentive to spur economic activity by investment in low-income neighborhoods in exchange for deferred capital gains. Qualified opportunity zones (QOZ) are commanding much of the headlines in the real estate industry. The program creates qualified opportunity funds, which are partnerships or corporations formed specifically to invest in QOZs. QOZ funds can be an attractive investment for individuals looking to defer capital gains. Investors who have capital gains can participate by investing their gains into these funds and, as long as the gain is held within the fund, they can defer it until 2026. Based on all the aforementioned tax advantages available to investors, developers should be clamoring at the opportunity to get their hands on property within the designated QOZ.

See related blog: Investors: Highway to the Opportunity Zone.

As you see, changes in the TCJA offer significant benefits to the real estate and construction industries at both the business and personal levels, and many provide immediate benefit in 2018. As 2018 comes to a close, there is still time to complete 2018 tax planning and take advantage of tax benefits.

Do you have questions about these changes? Contact Roger T. Gingerich, CPA/ABV, CVA, CCA, the partner-in-charge of the Skoda Minotti Real Estate & Construction Group, at 440-449-6800 or email Roger.