FREE INVESTOR GUIDE

How Does the New 2018 Tax Law Benefit Real Estate Investors?

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Summary: In this article, you will learn how real estate investors/ rental and investment property owners benefit from the new 2018 tax law, both this year, in 2019 and beyond. There are significant changes to tax deduction rates with income and business expenses. Read on to learn how the new tax law will benefit you!

Introduction

With the new tax law real estate investors have the opportunity to expand their real estate holdings. One of the reasons that investors are acquiring additional properties, is due to the new 2018 rental property tax deductions. As you will learn in the following post, the new tax law for rental property owners can be used in conjunction with 2018 standard deductions to create additional opportunities for positive monthly cash flows.

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3 Advantages of the 2018 Tax Cuts for Everyone

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act. At their core, these 2018 tax cuts result in lower taxes for individuals and businesses throughout the United States. The lower tax rates create the opportunity for individuals to invest in high yield rental properties, as well as standard investment properties. The three main advantages for Trump's new tax plan are reduced tax rates, the addition of several tax deductions, and the lowering of the corporate tax rate from 35 percent to 21 percent.

Advantage #1 – Reduced Tax Rate

The 2018 income tax bracket will reflect an approximate two percent decrease in taxes per income bracket. For example, the lowest tax bracket drops from 15 percent to 12 percent, while the highest taxable bracket drops from 39.6 percent to 37 percent. For higher income families, i.e. the top top earning 20 percent of individuals, the after tax income will increase by an estimated 2.9 percent. However, approximately 90 – 95 percent of individuals will still receive a 2.2 percent increase in their after tax incomes.

Advantage #2 – More Tax Deductions Available

It’s important to note that the Act introduces additional tax deductions. The standard deduction changes from $6,350 for an individual to $12,000. Additionally, the joint filing increases from $12,700 to $24,000 in deductions. However, it is important to note that the Act does eliminate the previous $4,150 deduction from income for each individual claimed on a tax form. This means that some families might end up paying additional taxes, even with the Act’s increased deductions. For the average family, however, the standard deductions are financially beneficial.

The list of available deductions is quite lengthy, however it includes:

- **Medical Expense Tax Deduction.** — This deduction allows taxpayers to deduct approved medical expenses that are 7.5 percent or more of their listed income. Previously, only Seniors had the opportunity to deduct 7.5 percent.
- **Property Tax Reduction.** — With the new tax law investment property taxes can be deducted up to $10,000. It is important to note that taxpayers must choose either property taxes or income / sales tax for their $10,000 deduction on state and local taxes.
- **Home Mortgage Interest with Greater Tax Deduction.** — The Act does limit the deductions on mortgage interest to the first $750,000 of a loan. Additionally, the interest on home equity lines of credit are no longer allowed to be deducted. However, it is important to note that current mortgage holders are not affected by the new list of deductions.
- **Increased Charitable Donations Tax Deduction Limit.** — The incentive to make charitable contributions, however they increased the amount of charitable contributions that can be written off from 50 percent to 60 percent. Individuals who

have higher annual income that they want to lower can use this deduction to write off a significant portion of their income and thus enjoy a lower tax bracket.

Advantage #3 – C Corporation Tax Rate now at 21%

For businesses, the corporate tax rate has been cut from 35 percent to a flat 21 percent. It is important to note that this percentage applies to all tax brackets. Additionally, unlike the individual changes which are set to expire at the end of 2025, the corporate cuts are permanent.

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4 Ways Real Estate Investors Can Take Advantage of the New Tax Act of 2018

The qualified business income deduction with buy and hold real estate, is now listed at a 20 percent tax deduction on taxable income. In theory, these deductions will allow real estate investors to deduct portions of their real estate investment properties. For example, the passive income earned from rental properties should result in deductions, which can lead to more money earned and saved.

1 – New 199A: Pass-through Deduction to Qualify for the 20% Deduction

The new 20 percent deduction on pass-through income for sole proprietors, LLCs, and S-corporations allows the company to avoid paying taxes. Instead, the taxes are passed through to the owner. For any real estate investor, who has secured investments via LLCs, this new pass-through provision has the opportunity to create significant savings.

2 – 20% Deduction on Taxable Income

If you can keep your taxable income at or less than $157,500 as single individual, or $315,00 when filing as a married / joint return, then you will qualify for the 20 percent deduction. To help you control your income, you can transfer income through to a C Corporation (and thus enjoy the benefits of the 21 percent flat tax rate). You can also use charitable donations to lower your income. Finally, you can direct portions of your income into retirement accounts, such as your self-directed IRA.

3 – 100% Bonus Depreciation

The “100% bonus depreciation,” essentially means that something that depreciates in less than 20 years can be entirely written off within the first year. For example, you could write off the carpet inside of a rental home within the first year, which means that you don’t have to depreciate it. For real estate investors, this means that many of the small home improvement projects that they complete each time a new tenant moves into a property can be written off on their yearly taxes. As a direct result of the latter action, real estate investors have the opportunity to enjoy additional savings as well as the potential for increased earnings (since they will now have the extra funds needed to complete those small home improvement projects that result in higher monthly rents). Finally, it’s important to note that the “100% bonus depreciation” is a temporary rule whereby the rate is set to reduce to 80% in 2023 and is projected to be lowered even further in the following years.

4 – Avoid Real Estate Tax with Section 121 together with 1031 Exchange

You can use the [1031 exchange] when selling a profitable residence to defer some of the taxes that you would have otherwise paid. For example, if you lived in the home for 2 out of the 5 years, then you can use the Section 121 to only pay a portion of the taxes on the sale. You can then use the 1031 Exchange to purchase a rental property with some of the monies earned, and thus avoid tax on the sale of the original residence. This tactic is especially important for property owners in high real estate markets, such as the Bay Area where homes are constantly increasing in price.

How Can Rental Property Landlords Benefit from 199A?

As previously mentioned within this post, property landlords can benefit from the new pass-through deductions, also known as 199A. This new rule states that rental activity can qualify as a business. Since it is considered a business, you might be eligible to deduct up to 20 percent of your net rental income. The latter deduction, coupled with the other deductions (such as those outlined in the 100% bonus depreciation), ensure that you will be effectively taxed on approximately 80 percent of your rental income.

S Corporation vs Sole Proprietor Tax

It's important to note that you only qualify for an income tax deduction of up to 20 percent of the net rental income if you meet the following criteria.

- You operate the rental business as an LLC owner, S corporation shareholder, partner in a partnership, or sole proprietor.
- Your total taxable income (after deductions) is less than $157,500 as a single or $315,000 as a married couple filing a join tax form.

With the above information in mind, let’s say that you are a single individuals who owns a duplex that earns a total profit of $20,000. As the sole proprietor you would report your rental income, as well as the property’s expenses on an IRS Schedule E. You would add the $20,000 rental profit to your other income; however, with the new Act, you would now be able to deduct $4,000 from your net rental income of $20,000. Let’s also say that your total taxable income was $100,000. With the 20 percent deduction you would save $960 in income tax for the year.

Benefits of a C Corporation Tax Status

The largest benefit of a C Corporation is that it can help to control Income. As seen in the above example, if you want to reduce your income levels, so that you can enjoy 20 percent rental income deductions, then you might use a C Corporation to transfer income and thus meet the income levels needed to enjoy certain deductions. C Corporations also help landlords avoid self employment taxes, which is especially beneficial to real estate investors who are trying to enter into a lower tax bracket for the year (without compromising on the opportunity for additional financial gains). In this vein, it is important to note that any landlords who don’t provide substantial personal services to tenants can still remain exempt form paying

Medicare or Social Security taxes on their listed rental incomes.

Major 2018 Tax Takeaways for Real Estate Investors

It’s no secret that the new Act is a bit confusing. However, the good news is that it offers numerous opportunities for real estate investors to capitalize on the number and type of deductions available. With this in mind, as 2018 rapidly comes to a lose, it is important that real estate investors and active landlords take the following three steps:

1. Plan your Schedule A.
2. Control income via charitable donations, using retirement accounts, and leverage C Corporations to control income so that you qualify for the 20 percent deduction.
3. Explore the potential benefits of C Corporations vs. Sole Proprietor vs. LLC vs. S Corporation.

If you complete the above three steps, then you can qualify for huge deductions on your 2018 taxes. With this in mind, it is important to remember that some of the tax benefits are set to expire at the end of 2025, which means that you need to act now if you want to take full advantage of the potential to save additional funds, while simultaneously expanding your real estate investment portfolio.

Investor FAQ

Planning ahead is the key to taking advantage of Trump's new tax plan. With this in mind, the new 2018 tax laws are a bit confusing, which is why we've answered some of the most common questions below. If you'd like to learn more about how you can take advantage of the new tax laws, please contact your investing consultant.

1- Does the 199A also apply to income in an IRA or in a PPM from a syndication?

199A is for individuals for certain individuals and trusts. Conversely, an IRA isn't typically paying tax, which is why it doesn't need the deduction. With this in mind, the 199A doesn't apply to an IRA or C Corporations. However, if you are a completely passive investor in a PPM, then it is more likely that the taxes will occur on the income within the syndication. As such, you would have to look at your taxable income vs. the qualified income coming out of the PPM (dependent on what the syndication is actually doing, i.e. is it building a property or is it already receiving rental income) to determine if it qualifies for the 199A. Speaking with your tax advisor can help you to determine more accurately if the 199A could apply in a PPM from a syndication.

2- If all of my investments are in my self directed IRA, is there any way to use any of these new tax write offs?

The self directed IRA remains a tax free bubble. The beautiful part about the new tax write offs, is that if you are forced to take the minimum distribution amount of money each year, then you can instead give that money to a charity and thus enjoy a 100 percent deduction.

3- Is there any advantage to taking a dividend instead of a wage?

Yes, absolutely there is an advantage to taking a dividend instead of a wage from a C Corporation. In the latter instance, you are enjoying the benefits of a long term capital gain vs. paying taxes on the higher wage. Remember that with many of the deductions, you want to ensure that your income isn’t too high. C Corporations, and subsequently dividends, are ways to avoid the latter issue, especially if you qualify for the first few tax brackets where the dividends are taxed at a zero percent. In an S Corporation it is still better to take a dividend instead of a wage, because you save money on the self employment tax.

4- How to avoid the mandatory state tax for LLCs?

The short answer, is that you would take all of the subject LLCs and make them owned by an outside entity. You would have an active management entity, as well as a franchise entity, the properties themselves are owned as trusts, and the beneficiary LLC is owned out of state. This sounds quite complicated, however your investor consultant will be able to explain the nuances of this strategy, so that you can ideally avoid the mandatory state taxes.

5- With the right LLC set up can a private lending qualify for the new 20% tax savings?

The short answer is yes, but it will depend on the type of business that you set up to do it.

6- Can you take the 20% tax savings for your rental property if it is managed by a property manager?

The way that it appears now (without additional regulations or guidance from the IRS), the short answer is yes. The only area that would be a “no,” is for triple net leases. However, it is important to note that this is a grey area, so time will tell if you can still take the 20 percent tax savings even when the property is managed by another person.

7- What would be the most tax efficient structure for passive income LLC treated as a C-Corp?

For passive income, you want it to flow under your return. In layman’s terms, if you have several properties, then you want to have them taxed as a partnership, so that you don’t have all of the properties listed on your first page of your Schedule E. If you are getting any loans on any of the properties, then you can make your life a lot easier from a tax perspective.

Conclusion

While the long-term implications of the new Act are still to be determined, many of the changes do offer immediate and direct benefits to real estate investors. Landlords and real estate investors who purchase properties under LLCs are especially able to take advantage of the new rules, so that they can purchase homes, enjoy higher passive income, and greatly reduce their annual taxes. In this vein, it is important to remember that many of the changes are set to expire at the end of 2025, which is why you should consult with your investor consultant and tax advisor to take full advantage of a lower tax bill and strategically structured real estate portfolio.

ABOUT JESSICA CONFLITTI

Jessica manages content creation, PPC and SEO for Real Wealth Network. She joined our team part-time in August of 2015 and quickly moved to a full-time position to write for the blog and to oversee our independent researchers and analysts that help keep RWN on the cutting edge of investor education. In her free time, Jessica enjoys writing music, baking, meditating, and spending time with her friends and family.
