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Federal tax law brings numerous changes for commercial property owners

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The Tax Cuts and Jobs Act is the most sweeping change to the U.S. federal income tax laws in over three decades, and it will have an effect on every U.S. taxpayer, but none more so than taxpayers engaged in the real estate business.

Let's focus on some of the significantly impacted financial aspects of commercial real estate.

Section 179 property

The tax law increases the maximum amount of assets a taxpayer may expense under section 179 to $1 million.

The law expands the definition of section 179 property to include the following improvements to nonresidential property: roofs, heating, ventilation and air-conditioning property, fire protection, and alarm systems and security systems, as long as improvements are placed in service after the date the building was first opened.

This was not available to real estate entities in the past.

Opportunity zones

Recently, there has been a national rush to acquire Opportunity Zone assets under a new program that aims to draw long-term investments in low-income communities by providing a federal tax incentive for investors.

In April, Gov. Dannel P. Malloy nominated 72 low-income zones in 27 municipalities across Connecticut as Opportunity Zones.

The new law and regulations allow investors to roll their gains into new projects in these zones throughout the country.

By investing a gain into a qualified Opportunity Zone project, investors can achieve substantial deferrals for payment of the tax on the gain. In addition, if held for 10 years, the investment will receive a "free" step-up in basis, thus making it virtually free.

1031 exchanges

1031 real estate exchanges, which allow investors to sell a property and reinvest the proceeds in a new property while also deferring capital gains taxes, survived the new tax law.

But personal property no longer qualifies for the tax-deferred exchange. Thus, real estate owners that have had a cost segregation study to accelerate depreciation, by assigning shorter useful life to personal property, may have a harder time deferring depreciation recapture.

Interest expense limitation

The deduction for net business interest expense is limited to 30 percent of the taxpayer's adjusted taxable income. Adjusted taxable income is roughly EBITDA (earnings before interest, tax, depreciation and amortization) before 2022 and roughly EBIT thereafter. The interest deduction limitations do not apply to certain small businesses.

Typically, businesses that have on average no more than $25 million of gross receipts over the prior three years are eligible for what is now known as the small business exemption.

Unfortunately, many real estate entities will not be allowed the small-business exemption, as they may qualify as a "tax shelter."

Real estate entities may take a 100 percent interest expense deduction. However, if this deduction is made, the entity must use the alternative depreciation system for nonresidential real property, residential real property and qualified improvement property. The alternative depreciation system does not allow for the use of "bonus" depreciation and has longer recovery periods than typical tax depreciation.

Depreciation

Businesses may take 100 percent bonus depreciation on qualified property both acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. Full bonus depreciation is phased down by 20 percent each year for property placed in service after Dec. 31, 2022, and before Jan. 1, 2027.

So what is qualified property? Under the Tax Cuts and Jobs Act, qualified property is defined as tangible personal property with a recovery period of 20 years or less. The tax law eliminates the requirement that the original use of the qualified property begin with the taxpayer. This "new to you" rule for the inclusion of used property is a significant and favorable change from previous bonus depreciation rules.

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