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Tax implications on commercial real estate - by Mark Zink

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The Tax Cuts and Jobs Act, the country's largest tax overhaul since 1986, has forced business owners and investors across sectors to re-evaluate their business models and portfolios. While it's too early to understand the full impact of the tax reform, analysts all agree that the commercial real estate sector should benefit from certain provisions.

One of the larger benefits of the tax overhaul is the new deduction for investors that hold their property in pass-through entities. Instead of paying a direct corporate tax, these companies "pass-through" their gains and losses to the individual members of the partnership or limited liability company. Investors are currently able to deduct 20% of dividend income, with the remainder of the income taxed at the investor's marginal rate. This deduction, which is set to expire on Dec. 31, 2025, will have the effect of reducing the tax rate on pass-through income to less than 30% in many cases.

Many investors were relieved to learn that 1031 exchanges were preserved in the new act, allowing them to keep exchanging property of a like kind, generally without paying tax. However, this type of exchange no longer applies to personal property, such as furniture or equipment. While this may have little effect on multi-family investments, it's likely to have a negative impact on properties that possess a significant amount of personal property, such as restaurants with value tied up in kitchen equipment and furniture.

Finally, under the new bonus depreciation rules, investors can enjoy more tax benefits in the year they make property improvements. Property owners will be able to expense 100% of qualified improvement property (QIP) expenditures up to $1 million,which were, or will be, acquired and placed in service between Sept. 27, 2017 and December 31, 2022. The QIP expenditure is scheduled to decrease by 20% every year between 2023 and 2027, when that rule expires. The Tax Cuts and Jobs Act also expands the types of new and used real property that qualify for the allowance, including HVAC equipment, fire protection and alarm systems, and security systems.

Overall, the Tax Cuts and Jobs Act is expected to increase the rate of return on commercial real estate and encourage investment. While the new act motivates current CRE investors to re-evaluate their portfolios, new investors are encouraged to consider commercial real estate with the potential of higher after-tax yields than other investment options. Regardless, it is imperative for investors to work closely with a tax advisor to fully understand the implications of the new act on their assets, allowing them to maximize these benefits.

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