Alert | Tax

December 2017

How Will the New Tax Law Impact the Homebuilding Industry?

The Tax Cuts and Jobs Act will have an impact on the greater homebuilding industry - builders, bankers, and brokers. Some unfavorable provisions which were in the original House bill have been modified in a compromise with the more favorable Senate bill. Furthermore, some homebuilders will be helped by the 20 percent deduction for pass-through income, but a detail of that tax break will limit this benefit for many homebuilders. Here is the breakdown.

Doubling of Standard Deduction: The standard deduction for a married couple will nearly double to $24,000. This means that the tax advantage of buying a home instead of renting, due to the ability to deduct mortgage interest and property taxes will disappear for many entry level purchasers. This is because a purchaser would need to have more than $24,000 in mortgage interest and property taxes (and other itemized deductions) before there would be a tax benefit of buying rather than renting their home, potentially suppressing sales for this market segment because some prospective customers may decide that they might as well rent if there is no tax savings to buying. Entry level homebuilders might need to add amenities in order to entice prospective customers to purchase their product. There is a potential silver lining here. It is possible that REIT's might be formed to specialize in renting single family homes, and this might become a market for entry level homebuilders who could build entire subdivisions of homes to sell to REIT customers, who would then rent the homes.

Home Mortgage Interest Deduction Limitation: The home mortgage interest deduction will be limited to the interest paid on $750,000 of debt, down from $1 million under the prior law. This will impact the upper-end home market, as well as mid-level markets in areas with higher home values, as customers may not wish to make a home purchase that would require financing more than $750,000. This was a compromise between the House bill's limit of $500,000, and the Senate bill which would have preserved the $1 million limit. This $750,000 indebtedness limitation will be effective for homes purchased under a contract that is dated after Dec. 14, 2017, so it will not be possible to entice customers to purchase a home now to get in under the deadline, because this deadline has already passed. However, this effective date might encourage customers under a binding contract prior to December 15 to close on their transaction in order to be grandfathered in under the existing $1 million limit.

Mortgage Interest on Second Home: The new law leaves in place the existing rule allowing mortgage interest to be deducted on a first and second home – subject to the $750,000 total debt limitation (interest is deductible on the first $750,000 of aggregate debt on both homes). This is beneficial for homebuilders in vacation home markets, because the original House bill would have eliminated the deduction of mortgage interest on a second home.

Home Equity Line of Credit: The new law eliminates the deduction for interest on a second mortgage securing a home equity line of credit up to $100,000, making it less desirable for some prospective customers to purchase rather than rent their homes since they will not be able to tap their equity with deductible interest payments.

$500,000 Gain Exclusion on Sale of Principal Residence: Under prior law, a married couple can exclude up to $500,000 in long-term capital gain ($250,000 for a single taxpayer) on the sale of home that has been their principal residence for at least two years. Both the original House and Senate bills would have increased this two year requirement to five years, which would have diminished the value of purchasing a home for many prospective customers who intend to flip after two years. Furthermore, the original House bill would have phased this benefit out for taxpayers with income over a certain amount. The new law does not contain either of these limitations, thereby preserving this existing tax benefit of home ownership.

Deductibility of Property Taxes: The new law limits the deduction for state and local taxes to an aggregate amount of $10,000 for both property taxes and either state income taxes or sales taxes. This will go into the calculation of whether it pays to buy rather than rent a home. Homebuilders in states with no state personal income tax, like Florida, Texas, and Nevada, may be in a better position because this entire $10,000 deduction amount would be allocated by these customers to property taxes and sales taxes, since they would not be paying state income taxes there. However, prospective customers in states with a personal income tax might figure that if their entire state income tax amount is over $10,000, then there would be no benefit for deduction of property taxes, and this might result in a decision to rent rather than purchase their home. This limitation on deduction for property taxes puts homebuilders in states without a personal income tax in a better position than homebuilders in states with a personal income tax. The limitation on property taxes only applies to homes that are used for the owner's personal use, this limitation does not apply to a home that is rented out to third parties. As a result, a prospective purchaser that is planning to rent the home to others would be able to deduct the property taxes without this limitation.

20 Percent Deduction for Business Owners: Homebuilders who are structured as a sole proprietorship or pass-through entity (partnership, LLC or Subchapter S Corporation) would be eligible to deduct up to 20 percent of their income from their business. For example, assume the owner of a homebuilding business has a profit of $500,000, the owner (subject to limitations) would be able to deduct up to $100,000, and pay tax on only $400,000 in profits. However, there are two important limitations that would reduce this benefit for many owners of a homebuilding business. The first limitation is that income attributable to the reasonable compensation of the owner is not eligible for this deduction, so let's assume that the owner's reasonable compensation should be $100,000, then only $400,000 of his profit from the business is eligible for the 20 percent deduction. The other limitation says that the deduction is limited to the greater of: (1) 50 percent of W-2 wages paid by the business; or, (2) 25 percent of W-2 wages plus 2.5 percent of the business's depreciable assets. For example, if the owner has $500,000 in profits, the company would have to pay $1,000,000 in W-2 wages or own substantial capital assets, like construction equipment or its own building in order to be able to take full advantage of the 20 percent deduction. Compensation paid to workers on a form 1099 and equipment that is leased would not help with this limitation. Owners who have a total taxable income of less than $315,000 (married filing jointly) or $157,500 (single filers) will not be subject to this limitation, but this benefit phases out quickly as taxable income increases over these thresholds.

21 percent Tax Rate for Corporations: Homebuilding businesses structured as a regular "C" corporation (a corporation that is not a Subchapter S corporation) will be taxed at a maximum tax rate of 21 percent, a major rate reduction from the prior law. Homebuilding businesses that are currently structured as a pass-through entity or sole proprietorship might be tempted to convert to a C corporation, but there are disadvantages. Foremost is that the profits of a C corporation are taxed twice, once at the corporate level on its taxable income, and again when the shareholders of the corporation receive dividends. This double tax problem would hit a homebuilding business especially hard when the sale of the business occurs. In addition, the conversion of an existing business to a C corporation might trigger taxes. The decision to convert to a C corporation must be carefully thought out with the total tax costs modeled by the business's tax advisors. Once a company is converted to a C corporation, there is almost always a significant tax cost to going back to a pass-through entity.

Limitation on Deduction of Interest: Under the new law, the deduction of interest expense incurred by most businesses will be limited to the sum of business interest income plus 30 percent adjusted taxable income. However, this business interest deduction limitation will not apply to electing businesses involved in the development, construction, or reconstruction of real property. As a result, most homebuilders should not be affected by this interest deduction limitation.

Author

This was prepared by **Marvin A. Kirsner**. Questions about this information can be directed to:

- Marvin A. Kirsner | +1 561.955.7630 | kirsnerm@gtlaw.com

- Or your Greenberg Traurig attorney

GT GreenbergTraurig

Albany. Amsterdam. Atlanta. Austin. Boca Raton. Boston. Chicago. Dallas. Delaware. Denver. Fort Lauderdale. Germany.¬ Houston. Las Vegas. London.* Los Angeles. Mexico City.+ Miami. New Jersey. New York. Northern Virginia. Orange County. Orlando. Philadelphia. Phoenix. Sacramento. San Francisco. Seoul.∞ Shanghai. Silicon Valley. Tallahassee. Tampa. Tel Aviv.^ Tokyo.¤ Warsaw.~ Washington, D.C.. West Palm Beach. Westchester County.