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Potential Impact of Tax Reform on the Construction and Real Estate Industries

Since the very beginning of Donald Trump's campaign to become President of the United States, he has emphasized the need for individual and business tax reform. The last time major tax reform occurred in the United States was over 30 years ago, in the more collegial Reagan-era atmosphere that brought us the Tax Reform Act of 1986. Despite the various tax proposals introduced by the Trump Administration and Congressional leaders, the timing and certainty surrounding passage of tax legislation in 2017 remains unclear. The political battles being waged between Republican and Democratic members of Congress make bipartisan support for a tax bill highly unlikely. Similarly, the in-fighting amongst members of the Freedom Caucus and moderate Republicans within the House of Representatives casts doubt on whether the controlling party can reach consensus on any legislation, as exhibited by their initial failure to repeal and replace The Affordable Care Act ("Obamacare"). Notwithstanding the current political theater in Washington, DC, many proposals warrant serious consideration as they represent a drastic change to current U.S. Federal income tax law. This tax insight begins with an overview of several of the proposals relevant to taxpayers in the real estate and construction industries and then discusses a few of the tax planning considerations associated with the proposals.

Tax Planning Considerations Related to the Tax Reform Proposals

We recommend that taxpayers begin positioning themselves now to respond to the opportunities and challenges that tax reform will present. Below is a list of items to consider prior to the passage of tax reform legislation:

1.Consider the implications of tax reform on financial projections – Tax reform proposals generally lower tax rates and broaden the tax base by reducing or eliminating several tax breaks. Taxpayers should not assume that the reduction in tax rates will result in lower taxes, since the benefit of reduced tax rates may not fully compensate for the loss of deductions repealed as part of base broadening. Taxpayers may want to model the impact of tax reform on their tax liability and consider the impact of tax reform on their financial projections. Taxpayers should also consider the potential impact of federal tax reform on their state tax liabilities (e.g., will states where they operate conform to federal base broadening measures without reducing state tax rates, thus increasing state tax bills?).

2. Consider the implications of a potential change in rates on tax accounting methods – Taxpayers subject to today's top rates would benefit from accelerating deductions and deferring income this year if tax reform results in lower tax rates next year. Now would be an ideal time to develop a strategy to take advantage of a change in tax rates, particularly because many tax reduction strategies need to be implemented well in advance of year-end.

3. Consider the implications of tax reform on asset acquisitions – Businesses planning to acquire fixed

Tax Reform Proposals at a Glance

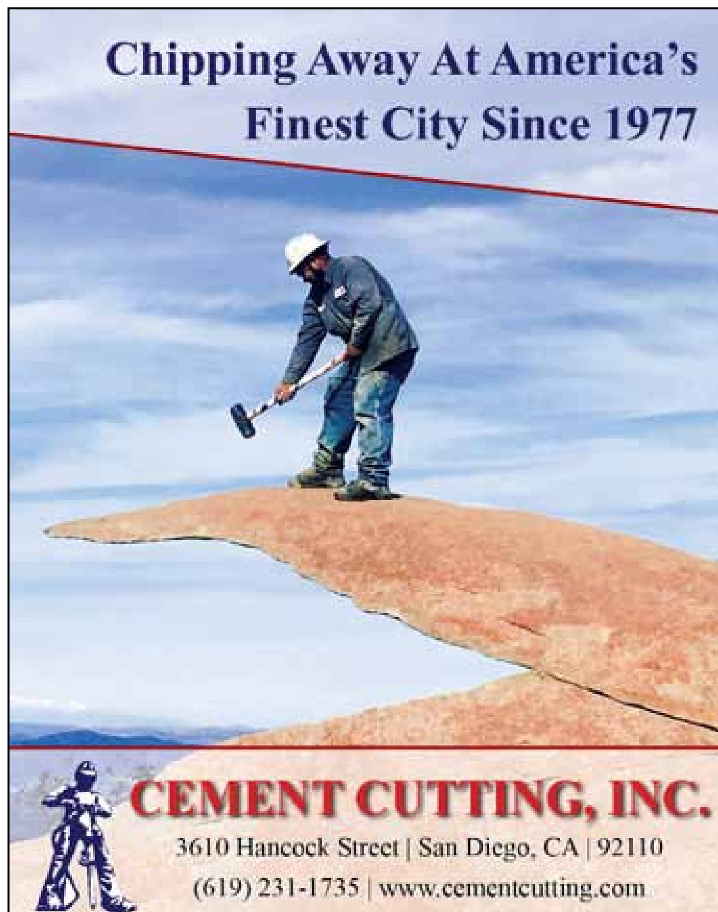
The following table compares selected aspects of current tax law to the tax reform proposals advanced by both President Trump and House Republicans.

	Current Law	President Trump' Proposals	House Republican Tax Reform Blueprint
Personal Tax Rates	Seven tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%	Three tax brackets: 10%, 25%, 35%	Three tax brackets: 10%, 25%, 35%
Personal long-term capital gains tax rates	Up to 23.8%	Up to 20%	Ordinary rates with a 50% exclusion (i.e. 6%, 12.5%, 16.5%)
Maximum pass-through tax rate	39.6%	15%	25% for "active business income" 33% for other ordinary income
Maximum corporate	35%	15%	20%
Personal Standard Reduction	Married filing jointly: $12,700 Head of Household: $9,350 / Single $6,350	Married filing jointly: $25,400 Single $12,700	Married filing jointly: $24,000 Single with a child: $18,000 / Single $12,000
Depreciation	Fixed assets are generally capitalized and depreciated with section 179 immediate expensing available in some cases	U.S. manufacturers (possibly including construction contractors) can elect to expense cost of fixed assets in year of purchase	Cost of tangible and intangible property, including buildings (but not land), is immediately expensed
Interest Expense Deductability	Generally Deductible	U.S. manufacturers lose deductibility of interest expense when full expensing of fixed assets is elected	Deductible only to the extent of interest income
Carried Interest (Capital Gains allocated to the holder of a partnership profits iinterest)	Taxed at Capital Gains Rates	Taxed at Ordinary Income Rates	Taxed at Capital Gains Rates
Domestic Production Activities Deduction	Construction contractors eligible for a deduction equal to 9% of their construction income	Not specifically addressed but plan generally involves limiting tax deductions	Repealed
Border Adjustment Tax (20% tax on imported goods and services)	No	No	Yes
Alternative Mininum Tax (AMT)	Potentially imposed on both corporations and individuals	Repeal	Repeal
Gift And Estate Tax	Tax of up to 40% imposed on gifts and estates, subject to a $5.45 million lifetime exemption per spouse	Repeal estate tax (replaced by income tax in Campaign proposal); proposal is unclear regarding gift tax	Repeal estate tax; proposal is unclear regarding gift tax

assets in the near future may want to consider whether they would be better off acquiring the assets before or after tax reform legislation is enacted and time their asset acquisitions accordingly. Many taxpayers will find that they are better off acquiring fixed assets in 2017, using the depreciation deductions (including bonus depreciation and section 179 expensing) to offset income otherwise subject to marginal federal tax rates of up to 43.4%. Some taxpayers—particularly those acquiring buildings and other assets with long useful lives that are not eligible for bonus depreciation under current law—may find they would be better off if they were able to expense the cost of fixed assets in the year of purchase, even if the deduction offsets income subject to lower tax rates. Businesses that are evaluating whether to lease or purchase an asset should consider the potential impact that a change in tax rates would have on their cash flow projections.

4. Consider the implications of a border adjustment tax – Tax reform could include a 20% border adjustment tax on the cost of imported goods and services. Contractors may want to structure their contracts so that the customer is responsible for any additional costs incurred to procure foreign goods and services as a result of the border adjustment tax, if enacted (for example, by stipulating that the customer provide the imported materials or including a price adjustment mechanism). In addition, contractors may want to consider the impact of a border adjustment tax on their supply chain by thinking of ways to obtain goods and services domestically.

5. Consider like-kind exchange implications – The most recent tax proposals advanced by President Trump and House Republicans do not address like-kind exchanges. Legislation introduced in 2014 would have repealed section 1031 and some believe that proposals to repeal section 1031 will resurface as the tax reform process unfolds. Note that the proposals permitting the immediate expensing of buildings would not fully replace section 1031, if repealed, since the proposals would not permit land to be expensed. Further, federal accelerated expensing may not be adopted by some states. Taxpayer's considering possible real estate transactions should stay abreast of developments with Section 1031 since some exchanges may yield more favorable tax results under current law than after reform occurs.



6. Consider the implications to capital structure of limitations on deductibility of interest - If limitations are imposed on the deductibility of interest, then the after-tax cost of debt financing would increase relative to the cost of equity financing, potentially influencing the amount of leverage that businesses use in their capital structures. While the proposals do not specify how interest on existing debt would be treated, clients obtaining financing may want to opt for longer-term debt (preferably without prepayment penalty) since a grandfather provision may permit interest on existing debt to be deducted.

7. Consider the implications on the organizational structure – The tax structure that makes most sense for a business under current law will not necessarily make the most sense in the event that tax reform legislation is enacted. New businesses may want to select an organizational structure that provides flexibility to adapt to whatever changes tax reform may bring. The income tax status of a limited liability company can be changed by merely filing an IRS election and without making any changes to the entity from a legal perspective. This makes LLCs a versatile business entity and one well suited for a changing tax environment. Existing businesses that are contemplating a change to their organizational structure should consider the impact that tax reform might have on their proposed structure or wait until there is greater certainty regarding tax reform before moving forward with significant changes.

CLA's Take

Even the most casual observer of Washington politics can appreciate the animosity harbored by the various political factions and the resulting challenges to tax reform. Whether the issue is healthcare, environmental, or tax law reform, while one side of the aisle is committed to dismantling the Obama administration's legacy, the other appears intent on defending it at all costs. These practical challenges justify skepticism that monumental, once-in-a-generation tax law changes will occur in 2017. Instead, the odds seem to favor passage of a scaled-back tax reform package.

Current timelines call for tax reform to proceed in the fall, but the window of opportunity is narrow. If reform does not occur before early 2018, we expect to see declining enthusiasm in Congress for tax law changes, which is a common occurrence in the face of midterm elections. In the meantime, it is important for taxpayers to understand the implications of potential tax law changes.