TRAINING TIP OF THE WEEK

Are You Ready for Tax Season?

Real Estate Pros will find a lot to like in the new tax law, but need to stay on top of the changes.

Don McGlynn, associate broker with Maury Real Estate in Bethesda, Md., followed the news closely in 2017 when Congress passed the Tax Cuts and Jobs Act that brought a 20 percent business income deduction. The provision offered him the promise of a big tax savings, as it allows independent contractors and owners of pass-through businesses (S corporations, limited liability companies, and partnerships) to deduct 20 percent from their net business income before they calculate their tax. But for his 2018 quarterly estimated payments, McGlynn opted to pay the same tax that he did in 2017, expecting that he'll sort everything out in early 2019, when it comes time to file his actual 2018 tax return.

"I met with my tax guy last year; he ran a scenario on the new tax law and said I would save almost a full quarter of payment," says McGlynn, a 20-year veteran agent. "Even so, I didn't change my quarterlies. The IRS hadn't yet come out with its rules, so we just opted to pay what we've been paying and work it out later."

That's a sound strategy for applying the new deduction, known as the 199A deduction, for this first go-around, says certified public accountant Peter Baker of Business Planning Group in Washington, D.C. Baker says you can't go wrong paying the same estimated tax you paid your previous year because that creates a safe harbor for you until it comes time to reconcile your estimated payments with your actual tax liability.

"As long as you pay estimated taxes based on last year's tax liability, even if you end up owing more tax come April 2019, you won't be penalized or face interest charges for underpayment," says Baker.

A Host of Changes

The 20 percent business income deduction is just one provision in the tax law that's important to real estate professionals. The law also lowers tax rates, increases the standard deduction, eliminates personal exemptions, lowers the cap on the mortgage interest deduction, and imposes a cap on state and local tax deductions.

The lower tax rates are expected to be a win for taxpayers generally, because the law makes across-the-board reductions in the tax brackets. The new standard deduction is expected to greatly reduce the number of people who itemize their deductions, thereby saving people time and in many cases money. But it also blurs the distinction between owning and renting for tax purposes, and that ultimately might work against homeownership. And the caps on the MID and state and local deductions could reduce people's incentive to buy more expensive homes, particularly in high property-tax states like California, Illinois, and New Jersey.

These are all important changes, and real estate professionals can provide a service to their customers and clients by being familiar with them, although any questions people have about how those changes apply should be referred to a qualified accountant or tax attorney, says Evan Liddiard, NAR's director of tax policy.

From the standpoint of real estate professionals' business interests, though, the 20 percent pass-through deduction is probably the most consequential, because it's expected to result in significantly reduced tax liability.

Like McGlynn, Lise Howe, broker-associate at Keller Williams Capital Properties in Washington and Maryland, chose to base her 2018 quarterly estimated tax payments on her 2017 payments to ensure she didn't run afoul of the IRS before its rules came out.

"I was concerned about underestimating, so I'm paying on my old schedule and figured that once the IRS comes out with the rules, if I can get money back, that'll be great," says Howe.

Clarity Needed

The final rules pertaining to the tax law, along with new or modified tax forms to accommodate them, should be ready for tax season, which starts in late January. Among other things, they're expected to provide clarity on the kinds of income that qualify for the 20 percent deduction. While commission income earned by real estate professionals is covered, the law is ambiguous on other forms, including rental income. It says the deduction applies to rental income if that activity constitutes a trade or business. What has been unclear is whether real estate professionals and others who own relatively small rental properties that do not require extensive management would be able to claim the deduction against the rental income.

On this point, your best bet is to assume you cannot take the deduction until after the IRS resolves the ambiguity, says Baker. "We just don't know yet how the income and related losses will be treated." (NAR is seeking clarification on this point.)

One pertinent change on which the IRS has already issued a temporary rule concerns the deductibility of meals as part of business entertainment. The law eliminated the 50 percent deduction for business-related entertainment, like a baseball game, show, or party, but kept in place the partial deduction for business meals. There was ambiguity, however, over how the IRS would treat business meals that were paid for as part of an entertainment activity. The IRS clarified this question in October by saying meals as a part of business entertainment remain partially deductible, but the costs need to be accounted for separately.

"I advise my clients to take the 50 percent deduction for any food they purchase for business meetings or receptions or open houses where clients are present, if there's proper substantiation," says Baker.

McGlynn, the Bethesda agent, says the elimination of the entertainment deduction won't change his business spending. "I take clients out for dinner or drinks as a thank-you," he says. "So, it won't have any effect on me."