

## How the Tax Cuts and Jobs Act Affects Landlords

The new tax law has some major changes in store for landlords.

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The Tax Cuts and Jobs Act (H.R. 1, "TCJA") has been passed by Congress. Landlords are among the biggest winners under the new law. Virtually all landlords will save money--many, to quote our President, will save "bigly." Enjoy it while you can.

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The main provisions of the TCJA affecting landlords are discussed below. Except where otherwise noted, all of these provisions take effect on January 1, 2018, so they will not affect your 2017 taxes.

### New Pass-Through Tax Deduction

For landlords, the most stunningly good provision of the TCJA is a new tax deduction for owners of pass-through businesses. This includes the vast majority of residential landlords who own their rental property as sole proprietors (who individually own their properties), limited liability companies (LLCs), and partnerships. With these entities, any profit earned from the rental activity is "passed through" to the owner or owners' individual tax returns and they pay tax on it at their individual income tax rates.

Example: Alice, a single person, owns a duplex she rents out. In 2018, she earns a total profit of \$20,000. Alice is a sole proprietor. She reports her rental income and expenses on IRS Schedule E. She adds her \$20,000 rental profit to her other income and pays tax on it at her individual tax rates. In 2018, her top tax rate is 24%, so she pays \$4,800 in income tax on her rental profit.

The TCJA creates a brand new tax deduction for individuals who earn income through pass-through entities (new IRC Sec. 199A). If your rental activity qualifies as a business for tax purposes, as most do, you may be eligible to deduct an amount equal to 20% of your net rental income. This is in addition to all your other rental-related deductions. If you qualify for this deduction, you'll effectively be taxed on only 80% of your rental income. Thus, the effective rate for taxpayers in the top 37% tax bracket is 29.5%.

This extremely complex deduction goes into effect in 2018 and is scheduled to end on January 1, 2026. All the ins and outs of the deduction have yet to be made clear by the IRS; however, it basically works as follows:

Taxable Income Below \$315,000 (\$157,500 for Singles)  
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You qualify for an income tax deduction equal to 20% of your rental income if:

you operate your rental business as a sole proprietor, LLC owner, partner in a partnership, or S corporation shareholder, and  
your total taxable income for the year from all sources after deductions is below \$315,000 if you're married filing jointly, or \$157,500 if you're single.

Example: Assume that Alice from the above example had \$100,000 in taxable income in 2018. Since she was a sole proprietor, she may take a pass-through income deduction of 20% x \$20,000 rental income = \$4,000. This saves her \$960 in income tax.

This deduction is phased out if your income exceeds the \$315,000/\$157,500 limits. It disappears entirely for marrieds filing jointly whose income exceeds \$415,000 and for singles whose income exceeds \$207,500.

This is a personal deduction you can take on your return whether or not you itemize. However, it is not an "above the line" deduction that reduces your adjusted gross income (AGI).

Income Above \$415,000 (\$207,500 for Singles)

If your annual taxable income is over \$415,000 if you're married filing jointly, or \$207,500 if you're single, you are still entitled to a pass-through deduction of up to 20% of your rental activity income. However, your deduction cannot exceed:

50% of your applicable share of the W-2 employee wages paid by your rental business,  
or

25% of your share of the W-2 wages paid by your business, PLUS 2.5% of the original purchase price of the depreciable long-term property used in the production of income—for example, the real property you rent.

Since most residential landlords have no employees, the 25% plus 2.5% deduction will be of most benefit to them.

Example: Assume that Alice from the above examples earned \$250,000 in total taxable income during 2018. She has no employees in her rental business. Thus, her pass-through deduction is limited to 2.5% of the purchase price of the long-term property she uses in her rental activity. This consists of her duplex, which she purchased five years ago. Her depreciable

basis in the duplex (purchase price minus value of the land) is \$100,000. Her pass-through deduction is limited to  $2.5\% \times \$100,000 = \$2,500$ .

The 2.5% deduction can be taken during the entire depreciation period for the property, which is 27.5 years for residential property. However, it can be no shorter than 10 years.

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### Increased and Expanded Section 179 Expensing

A provision of the tax code called Section 179 enables rental business owners to deduct in one year the cost of personal property used in a rental business, such as furniture and appliances. During 2017, the maximum amount that can be deducted under Section 179 is \$500,000. Starting in 2018, the Section 179 maximum is increased to \$1 million. The \$1,000,000 amount is reduced (but not below zero) by the amount by which the cost of property placed in service during the year exceeds \$2,500,000.

One significant limitation on Section 179 is that it has never been available for rental property owners to use to deduct the cost of personal property used in residential rental units. In a major victory for landlords, the TCJA eliminates this restriction starting in 2018.

### 100% Bonus Depreciation Through 2022

Currently, business owners may deduct in a single year up to 50% of the cost of personal property they purchase for their business. The TCJA increases this amount to 100% for property acquired and placed into service from September 27, 2017 through December 31, 2022. Moreover, 100% bonus depreciation would apply for the first time to both new and used property, instead of new property only. The bonus depreciation amount will be phased down in 2023 and later years as follows:

- 80% for property placed in service during 2023
- 60% for property placed in service after during 2024
- 40% for property placed in service during 2025
- 20% for property placed in service during 2026
- 0% for 2027 and later.

Bonus depreciation may not be used for real property, except for real property improvements such as landscaping or grading, and other components that have a depreciation period of 20 years or less. Thus, landlords may not use it to deduct the cost of their rental buildings or major building components. However, landlords can use bonus depreciation to fully deduct in one year the cost of personal property they use in their rental activity, such as appliances, laundry equipment, gardening equipment, and furniture. But landlords can often do this already under existing provisions in the tax law—for example, the de minimis safe harbor enables landlords to fully deduct in one year any personal property that costs \$2,500 or less. Section 179 can also now be used.

Listed property must be used over 50% of the time for business to qualify for bonus depreciation. Listed property includes cars, and entertainment property like televisions and cameras. Computers were classified as listed property as well, but the TCJA removes them from this classification starting in 2018. Thus, bonus depreciation may be used to deduct computers used less than 50% of the time for a rental business.

## Landlords Will Not Be Required to Pay Self-Employment Taxes

As you probably know, people who own their own businesses are required to pay Social Security and Medicare taxes on their net business income, as well as income taxes. These taxes are commonly referred to as self-employment taxes. One of the nice things about owning rental property is that rental income is ordinarily not subject to self-employment tax, only income tax. However, there is one exception for landlords who provide substantial personal services to their tenants and are effectively running a bed and breakfast business or hotel, not a normal rental operation.

The House version of the TCJA contained a provision that removed the rental income exemption from self-employment taxation. However, as many tax experts expected, this was dropped from the final version of the bill. Thus, landlords who do not provide substantial personal services to their tenants remain exempt from having to pay Social Security and Medicare tax on their rental income.

#### Lower Individual Tax Rates

As mentioned above, almost all residential landlords pay income tax on their rental profits at their individual tax rates. The TCJA reduces these individual rates. Starting 2018, the individual tax rates are as follows:

Rate

Married Filing Jointly

Individual Return

10%

\$0 - \$19,050

\$0 - \$9,525

12%

\$19,050- \$77,400

\$9,525 - \$38,700

22%

\$77,400 - \$165,000

\$38,700 - \$82,500

24%

\$165,000 - \$315,000

\$82,500 - \$157,500

32%

\$315,000 - \$400,000

\$157,500 - \$200,000

35%

\$400,000 - \$600,000

\$200,000 - \$500,000

37%

over \$600,000

over \$500,000

These rates are scheduled to expire after 2025.

#### No Deductions for Not-For-Profit Rental Activities

The vast majority of rental activities qualify as businesses or investment activities. However, rentals that are not profit-motivated must be classified as not-for-profit activities, also called hobbies. Under prior law, expenses from a hobby could be deducted as a personal itemized deduction on IRS Schedule A to the extent they exceeded 2% of the taxpayer's adjusted gross income. However, such deductible hobby expenses could not exceed hobby income. The TCJA completely removes the personal deduction for hobby expenses. This means that while the income from a rental activity classified as a hobby must be reported and tax paid, no expenses may be deducted.