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# Tax Reform May Contain Some Nasty Surprises for Rental Property Owners

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Until recently, business losses were heavily favored by the tax code. As long as they were not considered to be passive losses, business losses could be used to offset any type of income, including business income, wages, and portfolio income. P.L. 115-97 (commonly known as the Tax Cuts and Jobs Act, the "TCJA"), which was signed into law on December 22, 2017, introduced a new concept under which business losses cannot be used to offset certain types of income. This change has significant consequences for many owners of rental real estate.

**Background**

Even prior to the enactment of the TCJA, the passive loss rules of Internal Revenue Code section 469 provided a limitation on the ability of a taxpayer to use losses from a passive activity to offset non-passive income (e.g., salary or portfolio income). However, although rental real estate is generally a per se passive activity, an owner of rental real estate generally can avoid the passive loss limitations if he qualifies as a real estate professional (i.e., at least half of his business activities are performed in real estate businesses in which he materially participates, and such services amount to at least 750 hours per year). Prior to the TCJA, losses from rental real estate could be used to offset other types of income if not subject to the passive loss limitations.

**New Limitation on Deduction of Business Losses**

P.L. 115-97 added section 461(*l*) to the Internal Revenue Code, which applies beginning in 2018 and is set to expire at the end of 2025. The new law did not make any changes to the passive loss rules of section 469.

Section 461(*l*) provides that a taxpayer may use deductions that are attributable to trades or businesses of the taxpayer to offset only (1) income attributable to trades or business and (2) $250,000 of other income for singles and $500,000 of other income for married couples filing jointly (with such amounts to be adjusted for inflation in subsequent years). Any deductions attributable to trades or businesses in excess of these amounts (referred to as "excess business losses") are disallowed and are treated as a net operating loss carryover to the following taxable year. In the case of a partnership or S corporation, the limitations of section 461(*l*) are applied at the partner or shareholder level.

Unfortunately, if excess business losses are treated as a net operating loss under section 461(*l*), they become subject to another taxpayer-unfriendly provision of the TCJA. The TCJA also changed the rules relating to the deduction for net operating losses, so if disallowed excess business losses under section 461(*l*) are carried over to future years, they are subject to additional limitations. Specifically, net operating losses now can only be used to offset up to 80% of the taxpayer's taxable income and cannot be carried back to previous years, two limitations that did not exist before the TCJA. (However, net operating losses can now be carried forward indefinitely, rather than limited to 20 years.)

**Analysis**

Many family offices own rental real estate that generates losses, and use those losses to offset portfolio income. Until section 461(*l*) was enacted, this arrangement enabled them in many cases to pay little or no income tax on their portfolio income. Under the TCJA, however, passive income such as interest, dividends, and capital gains can no longer be sheltered by such business losses. This is true even if the taxpayer qualifies as a real estate professional under section 469 (and thus is not subject to the passive loss limitations). As a result, the owners of such family offices may face a significant income tax liability in 2018 for the first time.

Another way that taxpayers have historically been able to take advantage of real estate losses is by using those losses to offset wage income from other sources. Thankfully, it appears that section 461(*l*) still allows a taxpayer to use business losses to offset wage income. Thus, while the owners of a family office with rental real estate may no longer be able to use their real estate losses to offset portfolio income, it appears that they can still use those losses to offset salary

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income (whether or not related to the real estate business).

It is noteworthy that section 461(*l*) does not apply to C corporations. This, along with the reduction in the corporate tax rate from 35% to 21%, may lead some taxpayers to consider organizing their businesses for tax purposes as C corporations as opposed to partnerships or S corporations. For example, the family office described above may be able to avoid the recognition of any material tax liability by transferring both the real estate business and the portfolio investments to a C corporation. (However, they would want to carefully consider a number of downsides to owning property through a C corporation in making this determination.)

**Conclusion**

The impact of section 461(*l*) may come as an unpleasant surprise to taxpayers that are accustomed to using real estate losses to offset portfolio income. Since this change went into effect on January 1, 2018, it is important for owners of real estate businesses to consider restructuring their businesses sooner rather than later in light of this and other significant changes enacted by the new tax law.