5 Ways The CARES ACT Will Allow Real Estate Investors to Pay Your Expenses, Keep Your Employees and Put Money Back in Your Pocket

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// Paycheck Protection Program //

What is it?

The Paycheck Protection Program is a 100% Federally Guaranteed loan established to help employers pay for essential overhead items such as payroll, health insurance, interest, rent and utilities. To qualify for the loan employers must be an "eligible recipient" as defined below…

Eligible Recipient:

- Small business, non-profit organization, or other groups who have 500 employees or less (full-time, part time or other basis)
- Sole proprietorships, independent contractors and eligible self-employed individuals

Certain other industries as defined in Section 1102

...and they have experienced:

- Supply chain disruptions
- Staffing challenges
- Decrease in gross receipts or customers
- A closure

How is the loan determined?

The loan is determined by taking your average payroll for the one-year period before the loan was made and multiplying it by 2.5. The maximum amount of the loan is $10,000,000. Your average payroll is calculated by taking all eligible payroll expenses and dividing that number by 12.

- Eligible payroll expenses include:
- Salaries, wages, commissions, tips, separation or other comp
- Payments for vacation, parental, family, medical or sick leave
- Health Insurance
- Retirement
- State and local taxes assessed on compensation

Sum of payments of any compensation to sole proprietors or independent contractors that is not than $100,000 in 1 year prorated to the covered period

- Eligible payroll does not include:
- Any compensation in excess of annual salary of $100,000 prorated to covered first period
- Qualified sick or family leave for which credit is allowed under Families First Act
- Payroll Taxes

How is the loan forgiven?

The loan may be forgiven if employers maintain an equivalent number of full-time employees (determined by the calculation below) and spend the proceeds on qualified expenses over the 8 weeks following the loan origination.

Multiply the potential exclusion amount noted (i.e. spent on eligible uses) by:

- Average Full time equivalent (FTE) per month during covered period (8 weeks after origination)

divided by either (at borrower discretion):

1. Average monthly FTE from 2/15/19-6/30/19 or
2. Average FTE from 1/1/20 - 2/29/20

Qualified expenses include:

- Payroll Costs
- Interest on Covered Mortgage Obligations Incurred before 2/15/20.
- Rent under lease in force before 2/15/20
- Utilities for which service began before 2/15/20

Actions To Take:

- Reach out with your banking relationships and ask for information they have to get started.
- Get your books and records up to date now.
- Start pulling your payroll reports that support the eligible payroll expense discussed above
- Most recent mortgage statements
- Most recent utility bills (Electric, Gas, Telephone, Water, Internet, Etc.)
- Current Lease agreement (if applicable)
- Complete previous forms the SBA has historically requested (may waive)
    - Form 1919 – Borrower Information Form
    - Form 912 – Statement of Personal History
    - Form 413D – Personal Financial Statement

Observation:

Obviously this is the cornerstone legislation for which small businesses have been waiting. When the final guidance is released, we foresee a rush to obtain these funds that could potentially overwhelm the system. Hopefully the infrastructure can support it. Furthermore, the timing of receipt is of great interest to many small businesses who are struggling to keep the lights on. Many indicate it will be several weeks as of the date of this analysis (March 28th) before these funds will be available, and we are advising our clients to continue to manage their cash as if they were not available. One final note, while $350 billion is a considerable sum, the ultimate question is it enough? Will these funds become exhausted well in advance of the 6/30/20 sunset of this program or will there be enough to go around? If they run out, will the fed allow more funds to be allocated? Those are all crystal ball questions for which no one knows the answer. Bottom line in our opinion is to be proactive and be prepared. Have your ducks in a row so when you are ready to apply the process is as streamlined as possible.

What Is A Net Operating Loss?

A Net Operating Loss (NOL) is when a business has deductions in excess of income. This is common in the real estate industry as depreciation deductions often cause deductions in excess of income received. This is not to be confused with passive activity losses and suspended losses. Net Operating Losses are determined at the taxpayer level.

Old Law:

Net Operating Losses can only be carried forward and be used against 80% of the taxpayer's taxable income. Under the current law, NOLs cannot offset 100% of income

New Law:

The CARES Act removes the 80% rule and allows taxpayers to offset 100% of income through the use of NOLs. The Act also allows taxpayers to use NOLs created after December 31, 2018 to be carried back 5 years.

Timeline:

The CARES Act temporarily establishes the new law for 2018, 2019, and 2020.

Observation:

This is a massive opportunity for real estate investors. The ability to create Net Operating Losses through significant depreciation deductions creates opportunity to generate refunds from prior years. It is our opinion that the real estate market will turn back to a buyers market allowing investors to create wealth through the purchase of real estate assets. If you are a real estate professional with active participation in your rental portfolio you will have the opportunity to build wealth while benefiting from significant tax benefits.

// Excess Business Loss Rules //

What are excess business losses?

Excess business losses are the total amount of business losses stemmed from noncorporate trades or businesses plus $250,000 ($500,000 MFJ)

Old Law:

Excess business losses are only allowed to offset nonbusiness income up to $250,000 ($500,000 MFJ). Excess business losses are treated as an NOL and carried forward.

New Law:

The CARES Act removes the excess business loss limitation allowing taxpayers to use excess business losses against their nonbusiness income.

Nonbusiness Income Defined:

Nonbusiness income is income derived from investment and other activities not created in the ordinary course of business. Examples of this are interest, dividends, royalties, gains, and some W2 income.

Timeline:

The CARES Act temporarily establishes the new law for 2018, 2019, and 2020.

Example:

Jim is a single taxpayer with $400,000 of interest income and $600,000 loss from his real estate business. Under the old law, Jim would only be able to take $250,000 of his $600,000 loss against his $400,000 of interest income. Thus Jim would have taxable income of $150,000 ($400,000-$250,000) and a NOL carry forward of $350,000 ($600,000-$250,000). Due to the changes in The CARES Act Jim will now be able to use his entire business loss against his interest income and then carry the excess back 5 years (See NOL rules above)

Observation:

This part of The CARES Act has caused significant confusion for many investors. While this temporary modification may provide high income real estate investors with great opportunity to fully offset their income, it is unlikely to provide benefit to passive investors. Investors that have been affected by the excess business loss rules in 2018 and 2019 can amend their return and request a refund.

// Payroll Tax Deferral //

What is it?

Employers (as well as self-employed individuals) can defer the employer's share of the 6.2% social security tax that would otherwise be due through 12/31/20.

The deferral must paid be as follows

- 50% by 12/31/2021
- 50% by 12/31/2022

The Caveat

Unfortunately with good news there is bad news. If you receive a loan from the Paycheck Protection Program (discussed above) and it is forgiven, you do not have the ability to defer the payroll taxes.

Observation:

Certainly, the Paycheck Protection Program discussed above is a more favorable provision. That being said, the competition for the Paycheck Protection Program will be enormous and could leave several real estate investors without the stimulus. The payroll tax deferral should be used as a last resort, and could help with cash flow during lean times. Understand the liability remains, and has to be repaid over the 2 years noted above. Generally, payroll taxes are NOT something you want to get behind on, so be sure to follow through.

// Business Interest Expense Limitation //

What is it?

The business interest expense limitation is a limitation on the amount of interest certain businesses can deduct. This limitation was enacted for businesses with average gross receipts over a 3 year period of $25 Million Dollars. It also includes businesses that are considered tax shelters. In the real estate industry, most syndications are considered tax shelters and are subjected to the business interest expense limitation.

Old Law:

Business interest expense is limited to 30% of adjusted taxable income.

New Law:

Business interest expense is limited to 50% of adjustable taxable income.

Timeline:

Generally, the business interest expense limitation is for tax years 2019 and 2020. There are special rules for partners in partnerships which only allow the increase in the business interest expense limitation for 2020 (see below for more details).

The Caveat:

Businesses can elect out of the business interest expense limitation by subjecting their assets to the ADS method of depreciation. This is a less favorable depreciation method as the depreciable lives increase and the total depreciation for the asset will decrease.

Partners In a Partnership:

For partners in a partnership that do not elect out of the business interest expense limitation beginning in 2019 and are allocated excess business interest the allocation will be treated as follows:

- 50% of the excess business interest will be treated as paid or accrued by the partner's first tax year beginning in 2020 and isn't subject to any limits in 2020.
- 50% of the excess business interest will be subject to the limitations in the same manner as any other excess business interest that is allocated.

Observation:

This is a very fluid piece of The CARES Act. Additional analysis, consideration, and guidance over the coming weeks are necessary to ensure proper planning. We recommend meeting with your tax advisors to ensure you are making the appropriate decisions when it comes to the business interest expense limitation.

Retirement Plans

Taxpayers may now take up to $100,000 in distributions from retirement plans without a 10% early withdrawal period.

Available to:

- A taxpayer (or their spouse) who has been diagnosed with COVID-19;
- Experienced adverse financial consequences from being laid off, furloughed, quarantined, hours reduced or unable to work due to childcare.

While you will avoid the 10% penalty, the distributions will be taxable unless you repay the distributions back to the plan within 3 years. If not repaid, the Act does allow you to spread the income over a 3-year period beginning in 2020.

Required minimum distributions from retirement plans are waived for 2020.

Federal Student Loans

Taxpayers now have the ability to pause the payments on your federal student loans for six months until September 30, 2020.

- Interest shall not accrue during the suspension period.
- These 6 months will count for purposes of any student loan forgiveness program

Employers can pay up to $5,250 of your student loans tax free to the employee.

Employer Rentention Credit

There is a one-year credit against the 6.2% share of the employer's payroll tax for businesses that continue to pay their employees during the following situations:

- The operation was fully or partially shut down during any calendar quarter in 2020 (due to COVID-19 orders from governmental authorities).
- The operation remained open; but during any quarter the gross receipts for that quarter were less than 50% of what they were for the same quarter in 2019. Eligible until a quarter in which gross receipts rebound to 80% of same quarter in prior year.

Credits are equal to 50% of qualified wages for each employee (up to $100,000) and are refundable.

No credit will be available if you receive the Payroll Protection Program.

Duckett Ladd is a CPA firm that specializes in working with the top real estate investors in the country. The DL Process creates a systems whereby we partner with real estate investors to reduced taxes, generate cash flow, and create legacy wealth for themselves and their families.

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