Iowa State University

Center for Agricultural Law & Taxation

Tax Cuts & Jobs Act

Key Provisions Impacting Agricultural Producers and Small Businesses

June 12, 2018

Contact Information

- Kristine Tidgren, ktidgren@iastate.edu
- www.calt.iastate.edu
- @CALT_IowaState

Today

- Limited to two hours.
- Will hit the highlights for small businesses, particularly agricultural producers.
- *Entity Planning in the Wake of the Tax Cuts & Jobs Act*, offered July 12-13 in Ames, will go under the hood much deeper.
  - Sounds like we *may* have some guidance by then.

Paul Ryan
@SpeakerRyan

Follow

America's music tastes have changed since 1986, but our tax code hasn't. It's time. spkrryan.us/2jv3bCT

A Lot Can Change in a Year

Tax Cuts & Jobs Act

- Signed into law on December 22, 2017.
- Biggest changes to the tax code since 1986.
- Passed strictly on a party-line vote.
- *Lots of guidance* needed for interpretation.
- A number of technical corrections are needed to have law conform to Congressional intent.
- Uncertain times for some clients.
  - But, new law should *generally* result in lower tax liability for most agricultural producers and small businesses through 2025.

Limitations

- To allow law to be passed on a party-line vote, it was passed as part of budget reconciliation act.
  - Many strings attached.
- Law had to comply with Byrd rule.
  - This means that it could not be blocked by a filibuster and could get through with a bare majority in the Senate.
  - Also means law could not significantly impact federal deficit beyond 10 years or include extraneous provisions that do not impact revenue or outlays.
    - This is why individual provisions are temporary.

Even Title Had to Change

- Parliamentarian said that name “Tax Cuts & Jobs Act” violated the Byrd rule, thus it was changed to, “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”

When Will We Receive Guidance?

- May 9 Priority Guidance Plan said still aiming for June 30 for "Computational, definitional, and anti-avoidance guidance under new §199A," "Guidance adopting new small business accounting method changes under §§263A, 448, 460, and 471," and "Guidance on new §168(k)."
- IRS acting Commissioner recently said initial 199A guidance should issue in a couple of weeks!

Individual Issues Most Impacting Small Businesses

Lowered Individual Tax Rates

- Most agricultural businesses operate as sole proprietor or pass-through business.
- **From 2018 through 2025**, the Act lowers individual tax rates across the board.

Old Law	TCJA
Seven brackets at 10, 15, 25, 28, 33, 35, and 39.6% Single filer rate schedule: 10% >$0 15% >$9,525 25% >$38,700 28% >$93,700 33% >$195,450 35% >$424,950 39.6% >$426,700	Maintains seven brackets at 10, 12, 22, 24, 32, 35, and 37%; expires after 2025 Single filer rate schedule: 10% >$0 12% >$9,525 22% >$38,700 24% >$82,500 32% >$157,500 35% >$200,000 37% >$500,000

Capital Gains & Qualified Dividends

- TCJA generally retained the maximum rates and breakpoints.
- Indexed for inflation each year

15 percent breakpoint = $77,200 for MFJ and $38,600 for singles

20 percent breakpoint = $479,400 for MFJ and $425,800 for singles

Increased Standard Deduction

- Of the roughly 143 million tax filers in the U.S., about 48 million itemized deductions in 2017.
  - The Act will *significantly* decrease that number by eliminating many itemized deductions and increasing standard deduction.
  - For 2018 through 2025, the Act increases the standard deduction to $24,000 for married filing jointly, $12,000 for single taxpayers, and $18,000 for head of household.
  - The additional standard deduction for the aged or blind continues at $1,300 in 2018.

Suspends Many Itemized Deductions

All Miscellaneous Itemized Deductions Subject to the 2% Floor, including:

- *Unreimbursed* ***employee*** expenses (including, home office expenses, uniform expenses, travel expenses, meals & entertainment expenses, license fees, tools used for work, and job search expenses)
- Tax preparation expenses
- Safe deposit box rental
- Hobby expenses
- Investment fees and expenses

Unreimbursed Employee Expenses

- Hits certain types of employees hard:
  - Truckers
  - Salespeople
  - Employees with a home office

- Businesses may need to reexamine their reimbursement policies so employees are not hit so hard.

Forest Expenses

- Both corporate and non-corporate timber owners generally have been able to deduct management costs relating to timber held as an investment against income from any source.
  - Non-corporate owners were limited to Schedule A itemized deduction subject to 2 percent floor.
    - These expenses must now be capitalized as a carrying charge.

State & Local Taxes

- Individual taxpayers can now claim as an itemized deduction **only an amount up to $10,000** ($5,000 for married filing separately) per year for state and local income taxes and/or property taxes paid during tax years 2018 through 2025 (Schedule A).
  - ***But property taxes incurred in a trade or business continue to be fully deductible on a Schedule C, Schedule E, or Schedule F.***

Charitable Contributions

- Largely unchanged, but with increase in standard deduction and loss of many itemized deductions, many charitable contributions will no longer result in a tax deduction.
  - The Act does *not change* the ability of those over 70 1/2 to make qualified charitable distributions from an IRA, without including those distributions in income.
  - **The Act does not change the ability of farmers to make a charitable contribution of commodities without including those distributions in income.**

Healthcare Mandate

- The Act sets the Individual Shared Responsibility Payment to $0, beginning in 2019, meaning that individuals who do not have health insurance in 2019 and later will not be liable for the penalty.
- The penalty remains in place for tax years 2017 and 2018.
  - *Watch for new types of health plan options, including association health plans.*

Kiddie Tax

- *Old law*: Earned income of children taxed at individual rates and unearned income (exceeding $2,100) was taxed at parent's rate if that rate was higher.
- *New law*: Unearned income (exceeding $2,100) is now subject to *trust and estate rates*.

2018 Trust Tax Brackets and Rates on Ordinary Income	%
$0 to $2,550	10
$2,551 to $9,150	24
$9,151 to $12,500	35
over $12,500	37

2018 Trust Tax Rates On Capital Gains & Qualified Dividends	%
$0 to $2,599	0
$2,600 to $12,699	15
$12,700 and over	20

Kiddie Tax

- Applies to full-time students under the age of 24 or to any children through age 18.
  - Applies only if *earned* income does not exceed 50 percent of support.
    - Scholarships don't count.

Implications

- Gifting grain to child to have child sell has been a strategy to avoid SE tax.
  - If child not in the business of selling grain
- However, must now compare parent's tax rate to that of child's under trust tax rates and weigh decision carefully.

Individual AMT

- Individual AMT retained, but significantly increased exemption amounts and phase-out thresholds.
- 2018 exemption is $109,400 for MFJ (up from $84,500 in 2017).
  - $70,300 for singles (up from $54,300 in 2017).
- Phase-out thresholds are increased to $1,000,000 for MFJ (up from $160,900), and $500,000 for all other taxpayers (other than estates and trusts)(up from $120,700).
  - These amounts are indexed for inflation.

Ag Businesses with Employees

Meals & Entertainment

- Tax Cuts and Jobs Act disallows business deduction for *entertainment* expenses.
  - Prior to act, there was 50 percent deduction if such an expense was directly related to business.
  - How that applies to meals is unclear. Guidance is needed.
- Meals consumed while on business travel continue to be 50 percent deductible.

What do we know?

Expense	Pre-TCJA	2018
Client-Related Business Meals	• 50%	• ? (0 or 50)
Employer-Provided Business Meeting Meals	• 50%	• 50%
Employer-Provided Coffee, Tea, snacks, etc.	• 100%	• Probably 50%
Employee Holiday parties	• 100%	• Probably 100%
Work-Travel Meals	• 50%	• 50%

Meals for Convenience of Employer

- Meals for the convenience of employer are now 50 percent deductible and will be 0% deductible after 2025.
  - This is a big deal for many agricultural businesses.
- Should continue to be excluded from employee's income under IRC § 119(a) if Treas. Reg. § 1.119-1(a)(2)(ii) conditions are met.
- Note that if the meals are not excludable from income, expense is deductible as compensation.

Estate, Gift, and Generation Skipping Tax

Estate Tax Provisions

- TCJA Doubled the basic exclusion to $11,180,000 per person for estate and gift and generation skipping tax.
- $15,000 annual exclusion retained.
- Portability Retained
- Basis Adjustment Retained
- **Basic exclusion amounts reset to pre-Act levels in 2026.**

Estate Tax & Generation Skipping Tax

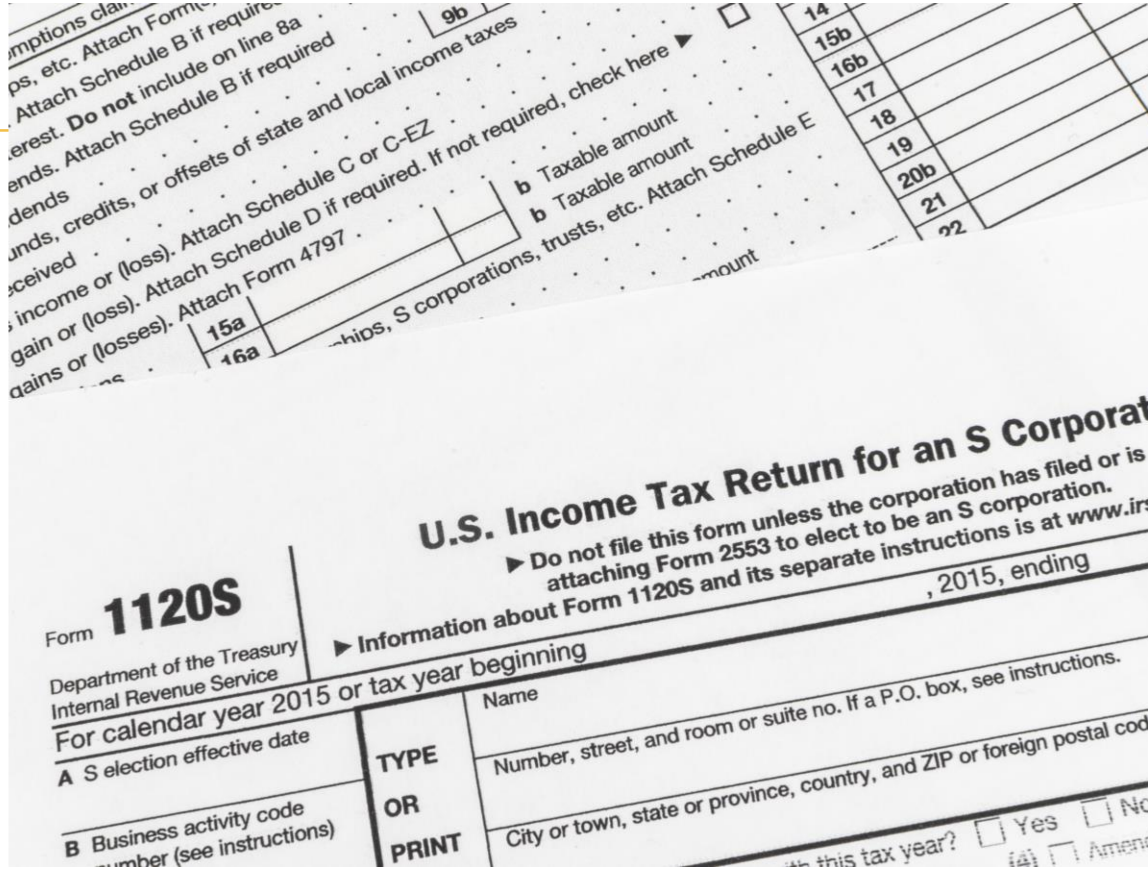
- In 2016, there were 5,219 estate tax returns filed for **taxable** estates.
    - Only 682 taxable estates had any farm property in 2016 **(2% of total taxable assets)**
- *Now estimated that number will be around 1,800.*
- Big need to plan for disability, farm transition, capital gain tax, etc. *And increased exclusion is not permanent*.
    - GST planning necessary

What about a clawback?

- If gift is given during lifetime while higher exclusion amount is in place, but giver dies when exclusion is lower, is there a clawback?
  - Appears that Congress did not intend a clawback, but IRS is tasked with writing regulations to define how process would work.
    - Computation of estate and gift taxes to reflect changes in basic exclusion amount is on list for priority guidance.

What about portability?

- Existing regulations would apply DSUE in place at time of first spouse to die.
- This perhaps makes portability election more, not less, important. Would (in the absence of contrary guidance) lock in the higher amount of exclusion for future years, even if exclusion decreases.



Key Business Provisions

Corporate Income Tax Rate

- *Permanently* lowers the maximum corporate tax rate from 35% to 21%, beginning in 2018.
- Fiscal year C corps apply a blended rate (between old rate and new rate), based upon IRC §15.
  - Confirmed by IRS Notice 2018-38 (4/16/2018)

Example

- Blended Corp. has a June 30 taxable year. For tax year ending June 30, 2018, it had taxable income of $1,000,000. Given these facts, Blended Corp.'s tax rate is calculated under IRC § 15(a) as follows (next slide).

Example

- Blended Corp.'s tax calculated based upon pre-TCJA rates:
$ 340,000
- Number of days in taxable year before TCJA effective date:
184
- Proportionate tax for pre-TCJA rates:
(340,000 * 184/365) = $171,397
- Blended Corp.'s tax calculated based upon post-TCJA rates:
$ 210,000
- Number of days in taxable year after TCJA effective date:
181
- Proportionate tax for post-TCJA rates:
(210,000 * 181/365) = $104,137
- Total Tax for Blended Corp's taxable year ending June 30, 2018 = $171,397 + $104,137 = **$275,534**

Corporate Tax Rate – Now a Flat Rate

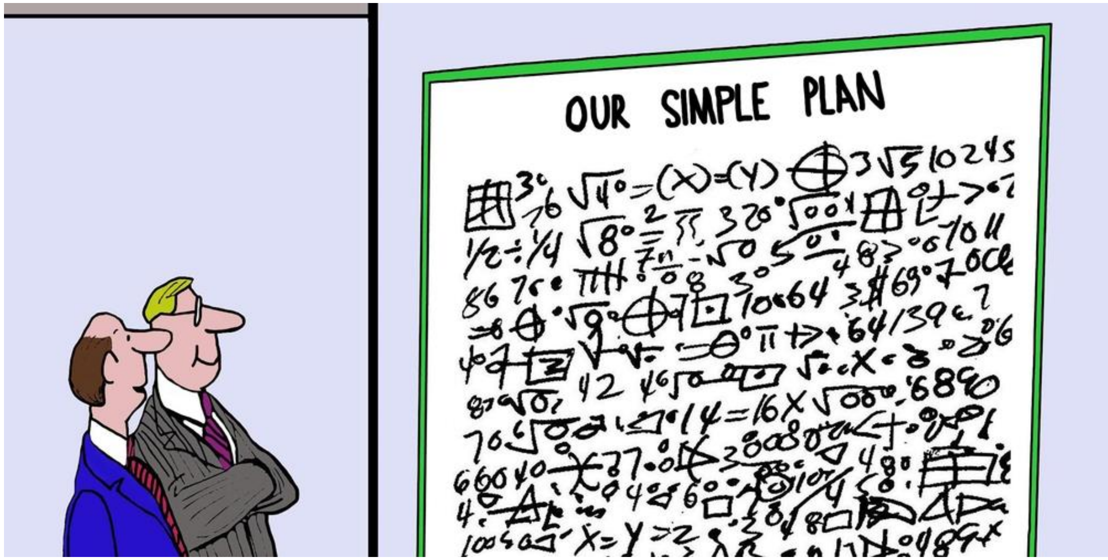
- Small corporations may consider conversion to S Corporation in light of new law.
  - Old Rates:

Taxable Income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

- $50,000 taxable income = $7,500 in 2017, but $10,500 in 2018.
- $80,000 taxable income = $15,450 tax in 2017, but $16,800 in 2018.

Corporate AMT

- The corporate AMT was repealed for tax years beginning after 2017.



NEW IRC § 199A DEDUCTION

New IRC § 199A Deduction

20 percent deduction (subject to many limitations)

- Applies to "**qualified business income**" received by an individual from a pass-through business:
  - LLC (not taxed as a C corporation)
  - S Corporation
  - Partnership
  - Sole Proprietorship
  - **ALSO APPLIES TO TRUSTS**
- Tries to even the playing field for pass-throughs, making the **highest effective rate 29.6%.**

New IRC § 199A Deduction

- Unlike corporate tax rate provision, IRC § 199A deduction is in effect **only from 2018 through 2025**.

Qualified Business Income

- The **net** amount of qualified items of income, gain, deduction, and loss with respect to **any qualified trade or business** of the taxpayer.
- QBI **does not include** wages, reasonable compensation, guaranteed payments, non-business interest income, non-business annuity income, dividend income, or capital gain. IRC § 199A(e)(4).
  - To extent provided in regs, any IRC §707(a) payment to a partner outside of his partner capacity for services rendered.

Qualified Business Income

- Must be effectively connected with a **U.S.** trade or business.
- There is a separate calculation for each "qualified trade or business."
  - Calculated at entity level or activity level? Grouping elections apply?
    - **GUIDANCE NEEDED**

Qualified Business Income

- What about IRC §1231 gain?
  - Committee report says, "any item *taken into account* in determining net long-term capital gain..."
  - Need guidance, but most likely *not* QBI

Qualified Business Income Generally = Net Income – Capital Gain

Appears to equal:

- Net Schedule F income
  - Form 4797 recapture – appears to be gain that fits the definition, but guidance must confirm
- Net Schedule C Income
- Net Schedule E Income (need guidance to confirm)
- Capital Gain is *excluded*

Additional Questions

- What about:
  - SEHD under IRC § 161(l)
  - ½ SE Tax Deduction
  - Retirement plan contributions for partners and sole proprietors.

- Are these “deductions” that must be allocated to QBI?

Rental Income

- Seems to fit within Congressional intent for QBI, but NEED GUIDANCE.
- No legislative requirement for *active* or *material* participation (see how IRS interprets).
  - *Note*: House proposal specifically included income from passive business activities in its definition of “qualified business income”
    - Said that activity would have same meaning as IRC §469 passive loss rules.
- Code excludes specified categories of *investment* income but does not exclude rental income or passive income in general (limited partner, etc).

Rental Income

- Likely must rise to the level of ***trade or business***.
  - *Commissioner v. Groetzinger*, *480 U.S. 23* (1987)(conducted for income or profit *and* engaged in with some regularity or continuity)
- "***Trade or business***" not well defined.
  - Seems to be differently applied based upon provision in which it's used.
  - *Note*: Trade or business of renting property is DIFFERENT from trade or business of *farming*.
  - Trade or business income can be *passive (see IRC* § 469(c)).

Cash Rental Income

Trade or business of *renting* property:

- Landlord sells a *single* house at a loss. *Not* a capital asset because he was in trade or business of renting property. *Hazard*, 7 TC 372 (1946).
- *Good v. Commissioner*, 16 TC 906 (1951) (pasture rental was trade or business of the taxpayer; not a capital asset)
- IRC §212 and IRC §162 overlap, they are not redundant or mutually exclusive. *Curphey v. Commissioner*, 73 TC 766 (1980).
  - But, 80-acre rental not a trade or business for IRC §280A (home office deduction). *Anderson*, TC Memo 1982-576.
  - *Durbin v. Birmingham*, 92 F. Supp. 938 (S.D. *Iowa* 1950)(farm lease not trade or business…sharecropper leased Colorado land).
- *Meinhardt v. Commissioner*, (8th Cir. 2014) (farmhouse separate from **leased farmland, which was "admittedly a business activity**" for which couple entitled to deduct "**ordinary and necessary expenses.")**

Rental Income as QBI?

- Most specified investment income excluded from QBI is already entitled to a preferential rate.
- 199A deduction seems designed to reward capital, not labor, because employment income (and reasonable compensation/guaranteed payments/specified services business) is excluded from QBI.
  - This supports conclusion that ***passive rental income should be considered QBI***.
  - Self-rental should be QBI as well.
- **BUT LOTS OF DIFFERENT OPINIONS AND WE NEED GUIDANCE.**

Calculating the QBI Deduction

- If your taxable income is below $315,000 for MFJ or $157,500 for singles, **you qualify with no limitations**:
  - the new 199A deduction for QBI is the **LESSER** of:
    - 20 percent of QBI OR
    - 20 percent of (taxable income – capital gain)

Income Below Threshold

- James, single
- Taxable income = $100,000 ($44,000 wages, $68,000 in QBI from farming operation, minus $12,000 standard deduction)

199A Deduction =

- Lesser of:
  - .20 * $68,000 = $13,600 OR
  - <u>.20 * $100,000 = $20,000</u>

= **$13,600**

James' taxable income will be $86,400.

Wages/Capital Limitation

- Taxpayers with taxable income (not counting the new 199A deduction) exceeding $157,500 (single) or $315,000 (married filing jointly) are subject to a **W-2 wages/capital limitation**.
  - Above those income amounts, the deduction phases out over the next $50,000/$100,000 of income if W-2 wages/capital limitation restricts deduction.

W-2 Wages/Capital Limitation

If income is above the threshold/phase-out, deduction is limited to larger of:

- 50 percent of W-2 wages for the trade or business **OR**
- the sum of (25 percent of W-2 wages PLUS 2.5 percent of the **unadjusted basis** immediately after acquisition of all qualified property)]

Capital Limitation

- *Qualified property* generally includes that property depreciable under IRC § 167.
- *Questions regarding whether property for which 179 has been taken is eligible and whether bonus is subtracted in calculating "unadjusted basis" (need guidance).*
- Applies for recovery period *or* 10 years, whichever is **longer**.
    - Property **must still be in service**.

What are W-2 Wages?

- “The amounts described in [IRC § 6051(a)(3), (8)] paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.”
  - Does not include commodity wages.
  - Does not includes wages paid to children under 18 years old.
  - Does not include guaranteed payments.

Income *Above* Threshold

Marion, single taxpayer (**no** W-2 wages or depreciable property)

- Taxable income = $210,000 ($222,000 in QBI minus $12,000 standard deduction)

199A Deduction = ***Lesser*** of:

  - 20 percent of the taxpayer's QBI OR
  - the LARGER of: [50 percent of W-2 wages for the trade or business OR the sum of (25 percent of W-2 wages PLUS 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property)]

- **No Deduction** because no W-2 wages or qualified property (tangible and depreciable)

Income Within Phase-out Range

Marion, single taxpayer (K-1 income), **no** W-2 wages or qualified property)

- Taxable income = $168,000 ($180,000 in QBI minus $12,000 standard deduction)

199A Deduction = ***Lesser*** of:

  - 20 percent of the taxpayer's QBI (**$36,000**) OR
  - the LARGER of: [50 percent of W-2 wages OR (25 percent of W-2 wages PLUS 2.5 percent of unadjusted basis …)]

- **ABOVE THRESHOLD, but only 21% of the way into $50K phase-out, so <u>Marion can take 79% of deduction or $28,440</u>. (less than 20 percent of taxable income)**

"Specified service trade or business"

- *services in the fields of health, law, ~~engineering~~, ~~architecture~~, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or **any trade or business where the principal asset of such trade or business is the reputation or skill of*** **the owner** ***or 1 or more of its employees****….*IRC § 1202(e)(3)(A)
- Plus: investing and investment management, trading, or dealing in securities …, partnership interests, or commodities…

- **No Deduction** unless income below income threshold (with phase-out) ($157,500, single and $315,000, MFJ) (phased out over next $50K or $100K)

“Specified service trade or business”

- Need guidance
- Any trade or business where the principal asset of such trade or business is the reputation or skill of the owner or 1 or more of its employees.
- Income limitation is all that matters if taxpayer falls within this definition.

DPAD

- Implemented in 2005, the IRC § 199 deduction climbed to 9 percent for tax years 2010 and later.
- Deduction was lesser of:
  - 9 percent of taxable income from qualified production activities income (QPAI) or
  - 50 percent of W-2 wages or
  - 9 percent of taxable income
- Corporations and individuals qualified for DPAD.

DPAD and Cooperatives

- Beginning with some favorable private letter rulings in 2008, coops began characterizing patrons' sales as per unit retains paid in money (PURPIM).
- Patron would get a 1099-PATR reporting the sale.
- Cooperatives could include PURPIM in calculating its own DPAD and choose to pass through whatever percentage it chose.
  - Helpful for farmers without wages
  - Many cooperatives passed through

DPAD Repealed

- IRC § 199 was permanently repealed beginning in 2018.
- Congress said it was no longer needed in light of lower corporate tax rates and new 199A deduction.

Qualified Cooperative Dividends

- Cooperatives were not happy and their lobbyists went to work.
- Special provision was added into the law at the last hour.

Qualified Cooperative Dividend

- As written, significantly favored sales to cooperatives by members over sales to non-coops or sales by non-patrons. (20 percent of gross, rather than 20 percent of net).
  - Extent of discrepancy was *unintentional*.
  - Lack of understanding.

Qualified Cooperative Dividends

Non Coop

- $200K sales
- $150K expenses

$50K net income

Deduction is lesser of:

20 percent of $50K = $10K OR (2) 20 percent of $50K-$12K = $38K *.20 = **$7,600**

Final Taxable Income = $30,400

Coop Sale by Member

- $200K sales
- $150K expenses

$50K net income

Deduction is lesser of:

20 percent of $200K = $40K OR

100 percent of taxable income = **$38K**

Final Taxable Income = $0

Consolidated Appropriations Act, 2018 Provided Fix

- Those not selling to cooperatives continue to calculate 20% QBI deduction (net income)(limited to 20 percent of taxable income minus capital gain).

DPAD is Reintroduced (Without the Name)

- Patrons selling to cooperatives must calculate 20% QBI deduction, then subtract **lesser** of:
  - 9% of net income attributable to coop sale or
  - 50 percent W-2 wages attributable to sale
    - *Note if they pay no wages, there is no reduction (20% QBI deduction)*
    - *Those who pay wages typically get only an 11% QBI deduction*

    - ***BUT ALSO…***

Coops Can Take "New DPAD"

- IRC § 199A(g) reintroduces DPAD, although it's not called that.
- This allows coops to take a deduction equal to 9 percent of qualified production activities income (income-expenses). This deduction, however, is limited to 50 percent of W-2 wages paid.

“New DPAD”

- Cooperative can choose to pass some or all of their deduction through to patrons (just like old DPAD).
- This 199A(g) deduction for patrons is limited by 100% of taxable income (not subtracting capital gain).
- If cooperative passes through deduction (may be up to 9% of QPAI), some farmers will get greater than 20 percent 199A deduction.
    - If not, some will be stuck with 11%.

Big Decision

- Boards have big decision:
  - If they don’t pass through the deduction, larger patrons that pay wages will see *lesser* deduction than if selling to private.
  - If they do pass through deduction, not all patrons will be able to use it (and cooperative won’t be able to use it).
    - C corporations can’t use it
    - Farmers must have income to take advantage of deduction
    - Farmers with high capital gain may benefit

Example – No Wages Paid

- $50,000 QBI ($250K grain sales – $200K expenses)
- Farmer has $75,000 in taxable income because of off-farm job.
- Farmer's final 199A deduction for 2018 is $10,000 (QBI) (no reduction because no W-2 wages)
- + $2,500 (199(g)) =
- **$12,500**

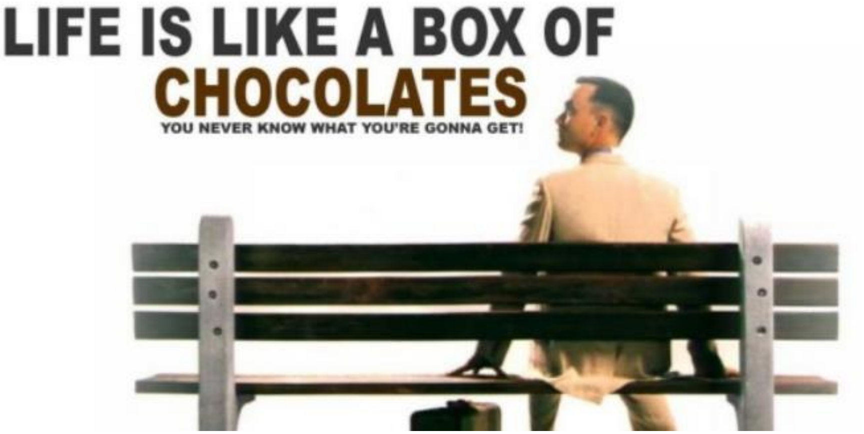
(This farmer receives a 199A deduction = 25 percent of QBI)

Wages Paid

- Same facts, except farmer pays $25,000 in wages.
- Farmer must subtract $4,500 (9% of QBI) from $10,000 tentative deduction for a final QBI deduction of $5,500.
- Farmer thus gets only an 11 percent QBI deduction in this example. However, farmer also gets to take his $2,500 199A(g) pass-through deduction from Coop, for a **final 199A deduction of $8,000 (16 percent of QBI).**

Bottom Line

Overall deduction may be less, more or the same if you sell to a cooperative as opposed to a non-cooperative, depending upon your individual situation. (Intended to be a bit unclear so as not to excessively influence marketing decisions).



Corporate Patrons

- The 199A deduction, including the new 199A(g) does not apply to taxpayers that are C Corporations.
- Section199A(g)(A) deduction is now restricted to "eligible taxpayers," which are taxpayers "other than a corporation." 199A(g)(2)(D).
- Likewise, 199A(g)(2)(C) limits the cooperatives' own deduction only by qualified payments attributed to “eligible taxpayers.”
    - What will happen with allocation?

DPAD Transition Rules

- Applies to farmers who receive a cooperative payment in 2018 attributable to QPAI for which the old DPAD was applicable.
  - Any QPAI attributable to a cooperative tax year *beginning before 2018*.
- These farmers (including corporations) can still take an actual DPAD deduction on their 2018 return.
  - No 199A deduction will be allowed for such payments.

199A & Fiscal Year Entities

- Effective date of 199A is taxable years beginning after 12/31/2017. Applies to owners, not entities.
- It appears that taxpayer receiving a K-1 from an entity with a tax year ending in 2018 should get to take 199A deduction for all income for 2018 tax year.
  - Guidance needed.

QBI Loss

- If a taxpayer’s QBI is a negative amount, the law provides that the taxpayer must **carryover a QBI loss to the following tax year for purposes of calculating that year’s QBI deduction (but won’t take it below zero)**.

Example

QBI in 2018

- $20,000 for business A and negative $50,000 for business B = No QBI deduction and $30,000 carryforward QBI Loss

QBI in 2019

- $20,000 for business A and $50,000 for business B.
- .20 * $70,000 = $14,000 – (.20 * $30,000 = $6,000) = **$8,000 QBI deduction**.

QBI Loss

- How do wages limitations, etc. apply to this?
- Need guidance on the mechanics of the loss calculation.

TCJA Partnership Change

- Partnerships will no longer "terminate" when there is a sale or exchange of > 50 percent of interests in the partnership. IRC § 708(b)(1).
  - Effective for tax years beginning after 2017.

REIT Dividends and PTP

- 20 percent deduction applies to qualified real estate investment dividends and qualified publicly traded partnership income.
  - Not subject to wages/capital limitation
  - Is limited to 20 percent of (taxable income – capital gain)

COST RECOVERY

Bonus Depreciation

- 100 percent bonus depreciation through 2022, beginning with:
  - Qualifying property acquired *and* placed into service after September 27, 2017
  - Taxpayers could elect to use 50 percent bonus for 2017 purchases.
    - Also, can elect no bonus (elections cannot be revoked without IRS consent)
- Act provides that additional first-year depreciation (bonus) will apply to *used*, as well as new property.

Bonus Depreciation

- Phase-out is as follows:
  - 2023: 80 percent bonus,
  - 2024: 60 percent bonus,
  - 2025: 40 percent bonus, and
  - 2026: 20 percent bonus.
  - After that time, bonus depreciation ends.
- Property acquired before September 28, 2017, but placed in service on or *after* that date, is subject to pre-Act phase-down limits (i.e. 40 percent in 2018).

Bonus Depreciation - Used

- Can’t use the property at any time before acquiring it.
- Can’t acquire the property from a related party.
- Can’t acquire the property from a component member of a controlled group of corporations.
- Basis of the used property is not figured in whole or in part by reference to the adjusted basis of the property in the hands of the seller or transferor.
- The taxpayer’s basis of the used property is not figured under the provision for deciding basis of property acquired from a decedent.

Section 179

- Beginning in 2018, the Act expanded Section 179 to provide an immediate $1 million deduction (up from $510,000 in 2017) with a $2.5 million phase-out threshold (up from $2,030,000 in 2017).
- These amounts are indexed for inflation beginning in 2019.
- They are permanent.

Section 179

- Must be acquired by purchase for use in the active conduct of a trade or business.
- Must be tangible property that is both:
  - Eligible for MACRS depreciation AND
  - IRC §1245 property
- Now includes "Qualified Improvement Property" at the election of the taxpayer (discussed later) and
  - Roofs, HVAC property, fire-protection and alarms and security systems for non-residential real property (placed in service after real property)

Like-Kind Exchange

- The Act retained IRC § 1031 like-kind exchange treatment for real property, but eliminated it for personal property, beginning with exchanges occurring after December 31, 2017.
- Elimination of like-kind exchange for personal property is permanent.
- While increased expensing and depreciation options offset impact, there are significant distinctions.

Old Law

- Old law, like kind exchange treatment was mandatory for a trade:
- In 2017, John traded a tractor with a FMV of $75,000 and an adjusted basis of $0 for a tractor with a fair market value of $125,000, plus $50,000 in cash.
  - IRC § 1245 recapture was deferred, and the basis in John's replacement tractor was $50,000 ($0 basis in relinquished tractor, plus boot paid). John could generally use IRC §179 to immediately expense $50,000, the amount of boot paid in the transaction.

New Law Example

- In 2018, John “trades” a tractor with a FMV of $75,000 and an adjusted basis of $0, plus $50,000 cash, for a tractor with a fair market value of $125,000.
- This transaction is a sale and a purchase. John must now recognize $75,000 in § 1245 recapture.
  - John’s basis in his new tractor is $125,000, the full purchase price of the tractor.
  - John can likely use federal IRC § 179 to expense that amount in 2018. If Section 179 is not available, he can use 100 percent bonus.

What difference does it make?

Same net income in examples, BUT:

- Choosing to apply higher amounts of IRC §179 or bonus depreciation to offset the recognized § 1245 gain will result in lower net Schedule F income, thereby reducing SE income.
  - Planning consideration for retirement
- The sale/purchase treatment (as opposed to the like-kind exchange treatment), may be useful in some cases to create ordinary income to offset a net operating loss carryforward.

What difference does it make?

- An accurate trade-in value will now be important.
  - Watching to see if IRS issues regulations governing the reporting of exchanges in light of new law.
- A state’s treatment of Section 179 and Bonus matters!

Real Property Issues

- “Real” property still proper subject for IRC § 1031 exchange.
    - Generally, the definition of real property under section 1031 is determined by state law.
        - 1245 property that was real property under state law should still be real property (but consider fully expensed single purpose ag building!)

Vehicle Depreciation (No Bonus)

The amount of the depreciation deduction for passenger cars and light duty trucks and vans shall not exceed (for 2018)—

- $10,000 for the 1st taxable year in the recovery period,
- $16,000 for the 2nd taxable year in the recovery period,
- $9,600 for the 3rd taxable year in the recovery period, and
- $5,760 for each succeeding taxable year in the recovery period.

Vehicle Depreciation

- For 2018, the Section 280F(a) depreciation amount for passenger cars and vans and trucks <=6,000 lbs. are the same because adjustments for inflation do not begin until 2019.
  - IRS will again likely apply different inflation adjustment to truck chassis autos.

Bonus and Passenger Vehicles

- The Act *retains the $8,000* limit for additional first-year depreciation for passenger vehicles. But, the law changes bonus to also apply to ***used*** vehicles.
  - So in first year, taxpayer can deduct $18,000 from passenger auto in 2018.
  - However, further deprecation deductions are not straightforward when bonus is in play.

    -Need guidance

SUVs and Trucks > 6,000 lbs.

- ***100 percent bonus applies to new or used SUVs and trucks***, for those vehicles purchased and placed in service **after September 27, 2017**.
- $25,000 Section 179 SUV cap is retained, but with 100% bonus in play, it's not as impactful.
  - Must be > 50 percent business use. Allocated above that amount between business and personal.

Example One

James acquired and placed into service an SUV in February of 2017 (bought for $45,000) as his primary farming vehicle. He is able to document 100 percent business use through travel logs. The SUV has a GVW of 8,000 lbs.

- In 2017, James could expense $25,000 under IRC § 179 and then apply 50 percent bonus depreciation ($10,000). He could then use MACRS to begin depreciating the balance.

Example Two

- James acquired and placed into service the same 8,000 pound SUV in October of 2017. He was now able to depreciate the entire amount in 2017 using 100 percent bonus depreciation. This would now be true even if the SUV were not new property.

Example Three

- Libby acquired and placed into service a used light-duty pickup truck for 100 percent business use in March of 2017 for $16,000. In this case, her 2017 first year deduction was limited to $3,560 because used vehicles were not eligible for bonus depreciation.

Example Four

- Now suppose Libby acquired and placed into service her used light-duty pickup truck for $16,000 in January 2018. In this case, her purchase is eligible for bonus depreciation, and Libby is able to deduct her entire purchase since the 2018 IRC § 280F first-year limitation is $18,000, more than her purchase.
  - Note that if Libby chose to expense with IRC §179 instead, she would be limited to a $10,000 expense deduction.

NEW DEPRECIATION PROVISION

Farm Depreciation

- Beginning in 2018, the Act allows ***new*** farm equipment to be depreciated over a period of **five** years, instead of seven years.
- It also removes the requirement that farm property is depreciated using the 150 percent declining balance method (except for 15 or 20-year property).
  - Farmers can use 200 percent declining balance method (placed in service =>2018 and taxable years ending after such date)
- These provisions apply to property placed in service after December 31, 2017.

Qualified Improvement Property

- Eliminates separate categories and includes:
  - Leasehold Improvement Property
  - Restaurant Improvement Property
  - Retail Improvement Property

New *expanded* definition: any improvement to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service (no three-year rule).

Qualified Improvement Property

Does not include:

- the enlargement of the building,
- any elevator or escalator, or
- the internal structural framework of the building.

Qualified Improvement Property

- MACRS recovery periods of 39 and 27.5 years for nonresidential real and residential rental property, respectively was retained.
- Committee report shows that Congress intended to provide a general 15-year MACRS recovery period for qualified improvement property.
  - However, that provision was mistakenly not added to the code.

Qualified Improvement Property

- **Result**: Current law does not allow 15-year recovery period AND does not allow bonus for qualified improvement property
  - It is not "qualified property" by virtue of 15-year recovery period and not added as separate category of qualified property.

- Technical correction proposed. Time will tell.

Section 179 Does Apply to Qualified Improvement Property

Includes roofs, HVAC, fire protection systems, alarm systems and security systems.

OTHER PROVISIONS

Net Operating Losses

- Beginning in 2018, the Act eliminates the two-year carryback of net operating losses (five-years for farming businesses), but allows a **two-year carryback** of net operating losses in the case of losses incurred in the trade or business of farming.
- It also limits the net operating loss deduction to 80 percent of taxable income for **losses incurred after December 31, 2017.**
- Unlimited carryforward.
- Pre-2018 losses should carry forward under old rules.

Net Operating Loss Issue

- The current statutory language provides that the changes to NOL carryforwards and carrybacks are effective for "taxable years **ending after December 31, 2017**, " while the conference committee provided an effective date for tax years "**beginning after December 31, 2017**."
  - Current language would prejudice fiscal year taxpayers with respect to 2017 losses.
  - **Admitted error. Technical correction proposed.**

Excess Business Loss Disallowance

- The TCJA implements an excess business loss rule that replaces (and expands upon) the excess farm loss rule (***through 2025***).
  - Old rule: non-corporate farmers' losses (if they received an applicable subsidy) were limited to a threshold amount of $300,000 ($150,000 for married filing separately).
- **Now**: *Non-corporate* excess business loss exceeds $500,000 (MFJ)/$250,000 (single)
  - Excess is treated as NOL.

Business Interest Limitation

- Although the Act restricts business interest deductions generally to 30 percent of adjusted gross income (beginning in 2018), those restrictions do not apply to businesses with cash receipts below $25 million.
- The Act also allows a farming business (as defined in IRC § 263A(e)(4)) and agricultural cooperatives to elect not to be subject to the business interest limitation. Such farming businesses, however, are then be required to use ADS for assets with recovery period of 10 years or more.

Cash Accounting

- TCJA has significantly expanded the availability of cash accounting to farming and other C corporations and partnerships with a C corporation partner.
- Beginning in 2018, these entities may use cash accounting if they meet the gross receipts test of IRC § 448(c).
  - $25 million or less using a three-year averaging rule (3 *prior* years).
- S Corps, partnerships, and proprietors continue to be eligible for cash accounting, regardless of receipts.

Trees & Vines

Trees & Vines

UNICAP Rules

- Under IRC 263A, all-sized farmers have been required to capitalize the costs of **pre-productive period** if the plant has pre-productive period > 2 years (*after planted and before "placed in service": **produce a crop with value > cost of harvesting it***)
- Most farmers **could** elect out:
  - But, then farmer was required to use **ADS** on property used predominantly in farming and **so generally could not use bonus depreciation**

Trees & Vines

- The Tax Cuts & Jobs Act, IRC 263A(i) provides an exemption from the UNICAP rules for businesses that meet the gross receipts test of IRC § 448(c).
  - Less than or equal to $25 million in the three prior tax years

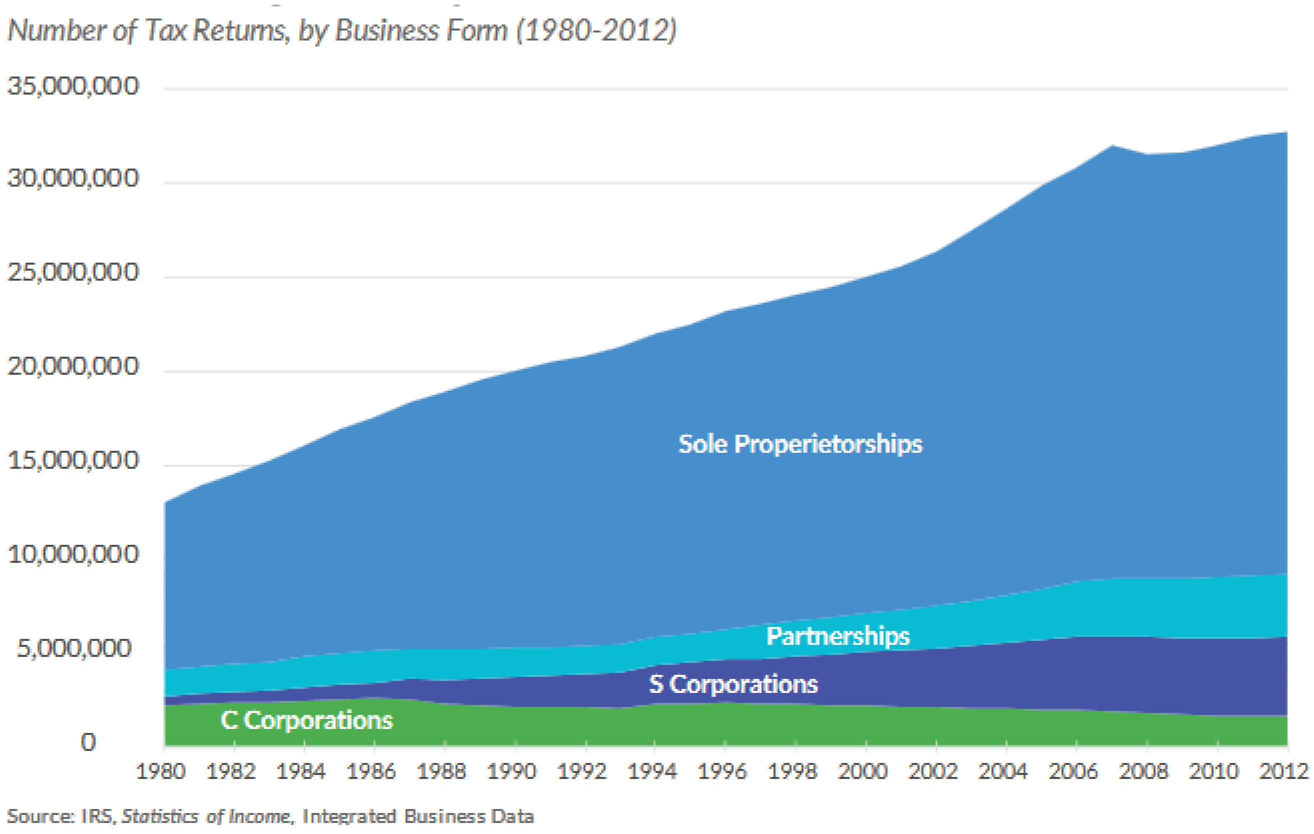
- This means that farmers in this category are now *exempt* from the UNICAP rules and **may deduct costs incurred during the pre-productive period**.

Question

- What about those farmers who have already opted out of UNICAP?
  - Will regulations provide a simplified method for undoing that election in light of the new law?
  - Law says that any change of accounting will be treated as initiated by taxpayer and made with IRS consent.
  - Will a Form 3115 be all that is needed? Will automatic consent be granted?
    - Lots of questions. Watching for guidance.

Entity Considerations

Will the TCJA reverse the trend?



Not Likely for *Most*

- Top rate for corporation is now 21 percent, but remember it's a flat rate on all income
  - C-corporations are subject to double taxation: shareholders pay up to 20 percent on dividends (This income is also subject to NIIT for high-income earners).
  - Highest combined rate for C corps (not considering NIIT) is 38.6 percent.
- Highest individual tax rate is 37 percent and it's a graduated system (makes a big difference for lower earnings)
  - Highest marginal rate for QBI is 29.6 percent

Factors Favoring C corporation

- Higher the income, closer the call (for some).
  - C corps continue to deduct state and local *income* taxes
  - Specified services businesses above threshold or businesses without wages/capital above the threshold not entitled to QBI deduction
  - Start-up business with lots of income and reinvested within business, not paying dividends
  - C corp tax cut is permanent

Factors Favoring Pass-Throughs

- Single level of taxation.
- C corporations face potential 20 percent accumulated earnings tax.
- C corporations can face personal holding company tax.
- Difficult to get out of a C corporation.
- Uncertainty of future legislation.
- Graduated rate for individuals:

Married Individuals Filing Joint Returns and Surviving Spouses

If Taxable Income Is Between:	The Tax Due Is:
0 - $19,050	10% of taxable income
$19,051 - $77,400	$1,905 + 12% of the amount over $19,050
$77,401 - $165,000	$8,907 + 22% of the amount over $77,400
$165,001 - $315,000	$28,179 + 24% of the amount over $165,000
$315,001 - $400,000	$64,179 + 32% of the amount over $315,000
$400,001 - $600,000	$91,379 + 35% of the amount over $400,000
$600,001 +	$161,379 + 37% of the amount over $600,000

Erb

Other Factors

- State treatment of entity and income
- Type of income

Entity rate comparison
FEDERAL top rate comparison by entity

Type of business income	2018 Top rate
Pass-through: Active	29.6%*/**
Pass-through: Passive	33.4%*/**
C corporation: Distribute all earnings	39.8%*
C corporation: Distribute ½ of earnings	30.4%*
C corporation: Retain all earnings	21%

*Includes 3.8% Medicare tax on investment income, but not FICA or SE tax on earned income. Also assumes AAA has been used after conversion to C.
**Assumes 20% deduction not otherwise limited

Source: Grant Thornton

First Consideration = Income

- For business with low/no wages or a specified services business, key is to try to get taxable income below threshold ($157,500 / $315,000).
  - Contribute to retirement accounts, look at other deductions.
  - Could be beneficial to file separate returns, but make sure!
  - QBI deduction phases out above that threshold (50K/100K)

If Income Below the Threshold

- Partnership may be more favorable than S corporation for some.
  - Must weigh self-employment tax savings against QBI.
  - No requirement for guaranteed payments and IRS representative suggested in May there is no plan for that.

  - **Key**: If already paying S corporation salary close to $128K limit, switch to partnership may be good move.

Watch Lowering S Corp Wage

- IRS will likely scrutinize such changes very closely in light of the new incentive to minimize reasonable compensation for S corporation shareholders to maximize the QBI deduction.

If Income Above Threshold

- S Corp may be better because of the W-2 wage you can pay yourself to allow for QBI deduction (50 percent of wages).
  - Some have suggested 28.5 % (of business income) guideline for W-2 wage maximization.

Stay Tuned!

- We will post updates as soon as any guidance is issued!

Tax Cuts & Jobs Act Resources

Join us July 12-13

- Entity Planning in the Wake of the Tax Cuts & Jobs Act (Ames and online)
  - Kari Apel
  - Bob Jamison
  - Kristy Maitre
  - Kristine Tidgren


Thank
You !