DEAN MEAD
ATTORNEYS AT LAW

INCOME TAX CONSEQUENCES OF THE TAX CUTS AND JOBS ACT

By:
Dean Mead P.A.
Jane D. Callahan, Esq.
Christopher R. D'Amico, Esq.
Charles H. Egerton, Esq.
Brad Gould, Esq.
Stephen R. Looney, Esq.
Edward A. Waters, Esq.

TABLE OF CONTENTS

DEAN MEAD
ATTORNEYS AT LAW

I. Background Information

Tax Cuts and Jobs Act (the "Act"), enacted December 22, 2017.

II. Changes Primarily Affecting Individual Taxpayers

1. Tax Rates

a. Ordinary Income Tax Rates – Code § 1(i); Act § 11001

i. The Act retains seven rate brackets, but changes five of the rates, including the top rate. Furthermore, the Act changes the thresholds for each bracket. The new rates are below.

2017	Act
10%	10%
15%	12%
25%	22%
28%	24%
33%	32%
35%	35%
39.6%	37%

ii. The top marginal rate applies to taxable income above $500,000 (up from $418,400) for single taxpayers and head of household filers and $600,000 (up from $470,700) for married individuals filing joint returns and surviving spouses.

b. Capital Gain Tax Rates – Code § 1(j)(5)(A); Act § 11001(a)

i. The capital gains tax rates of 0%, 15%, and 20% remain unchanged. However, the income levels at which the different rates apply are now indexed using Chained CPI-U, which is discussed in detail below.

c. Kiddie Tax – Code § 1(j)(4); Act § 11001(a)

i. The "kiddie tax" provisions continue to apply to a child if: (1) the child has not reached the age of 19 by the close of the tax year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time; (2) the child's unearned income exceeds $2,100; and (3) the child does not file a joint return..

ii. The Act simplifies the kiddie tax by applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child without consideration of the child's parents or other siblings. As was the situation prior to the Act, earned income continues to be taxed according to an unmarried taxpayers' brackets and rates. However, net unearned income is taxed according to the tax schedule for trusts and estates.

d. AMT – Code § 55(d)(4); Act § 12003(a)

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act increases the AMT exemption and exemption phase-out amounts for individuals as follows:

	2017		**Act**	
	Exemption	**Phase-out**	**Exemption**	**Phase-out**
Single	$54,300	$120,700	$70,300	$500,000
MFJ & SS	84,500	160,900	109,400	1,000,000
MFS	42,250	80,450	54,700	500,000

ii. All of these amounts will be indexed for inflation after 2018 under the Chained CPI method.

2. Deductions/Exemptions

a. Standard Deduction – Code § 63(c)(7); Act § 11021(a)

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years beginning after 2018. No changes are made to the current-law additional standard deduction for the elderly and blind.

ii. All of these amounts will be indexed for inflation after 2018 under the Chained CPI method.

b. Personal Exemption – Code § 151(d); Act § 11041(a)

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the deduction for personal exemptions is reduced to zero.

c. Home Mortgage Interest and Home Equity Loan Interest – Code § 163(h)(3)(F); Act § 11043(a)

i. Prior to the Act, qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations. Qualified residence interest is interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence.

ii. Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which is secured by such residence. The maximum amount treated as acquisition indebtedness is $1 million ($500,000 in the case of a married person filing a separate return). Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness.

iii. Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence. The amount of home equity indebtedness may not exceed $100,000 ($50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

iv. Thus, the aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

v. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, Code § 163(h)(3) reduces the limits on qualifying acquisition debt to $750,000 ($375,000 for a married taxpayer filing separately). However, for acquisition debt incurred before Dec. 15, 2017, the prior limit applies. The higher prior limit also applies to debt arising from refinancing acquisition debt incurred prior to Dec. 15, 2017, to the extent the debt resulting from the refinancing does not exceed the original debt amount.

vi. The Act eliminates the deduction for interest on home equity debt. Code § 163(h)(3)(F)(i)(I).

vii. There is an exception to the Dec. 15, 2017 date, the binding contract exception, which provides that a taxpayer who entered into a binding written contract prior to Dec. 15, 2017 that was to close on the purchase of a principal residence before Jan. 1, 2018, and who actually purchases such residence before Apr. 1, 2018, shall be considered to incur acquisition indebtedness prior to Dec. 15, 2017.

d. State and Local Tax Deduction – Code § 164(b)(6); Act § 11042

i. Prior to the Act, individuals were permitted a deduction under Code § 164 for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes include:

a) State and local real and foreign, real property taxes

b) State and local personal property taxes; and

c) State, local, and foreign income, war profits, and excess profits taxes.

ii. At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.

iii. Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.

iv. For tax years beginning after Dec. 31, 2017 and ending before Jan. 1, 2026, Code § 164 is modified to limit the amount of such taxes that an individual may deduct. Taxpayers may no longer deduct foreign real property taxes. In addition, the remaining taxes may be deducted in an amount up to $10,000 ($5,000 in the case of a married person filing a separate return).

v. These limitations do not apply to amounts paid or accrued in carrying on a trade or business described in Code § 212.

e. Miscellaneous Itemized Deductions – Code § 67(g); Act § 11045

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act suspends all miscellaneous itemized deductions subject to the two-percent floor. A non-exhaustive list of such deductions includes:

a) Business bad debt of an employee;

b) Business liability insurance premiums;

c) Damages paid to a former employer for breach of an employment contract;

d) Depreciation on a computer a taxpayer's employer requires him to use in his work;

e) Dues to a chamber of commerce if membership helps the taxpayer perform his job;

f) Dues to professional societies;

g) Educator expenses – excluding the above the line deduction;

h) Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work;

i) Job search expenses in the taxpayer's present occupation;

j) Laboratory breakage fees;

k) Legal fees related to the taxpayer's job;

l) Licenses and regulatory fees;

m) Malpractice insurance premiums;

n) Medical examinations required by an employer;

o) Occupational taxes;

p) Passport fees for a business trip;

q) Repayment of an income aid payment received under an employer's plan;

r) Research expenses of a college professor;

s) Rural mail carriers' vehicle expenses;

t) Subscriptions to professional journals and trade magazines related to the taxpayer's work;

u) Tools and supplies used in the taxpayer's work;

v) Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work;

w) Union dues and expenses;

x) Work clothes and uniforms if required and not suitable for everyday use; and

y) Work-related education.

f. <u>Medical Expenses – Code § 213(f); Act § 11027(a)</u>

i. For tax years beginning after Dec. 31, 2016 and ending before Jan. 1, 2019, the threshold for deducting medical expenses shall be 7.5-percent for all taxpayers. Thereafter, the threshold will be 10 percent.

g. <u>Casualty and Theft Losses – Code § 165(h)(5); Act § 11044</u>

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, new Code § 165(h)(5) suspends the itemized deduction for casualty and theft losses except for losses attributable to a federally declared disaster. However, where a taxpayer has personal casualty gains, the loss suspension doesn't apply to the extent that such loss doesn't exceed the gain.

h. <u>Moving Expenses – Code §§ 132(g), 3401(a)(15), 3121(a)(11), 3306(b)(9) and 217; Act §§11048 and 11049</u>

i. <u>Exclusion</u>. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Code § 132(g) exclusion for qualified moving expense reimbursements is suspended, except for certain military personnel.

ii. <u>Deduction</u>. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Code § 217 deduction for moving expenses is suspended, except for certain military personnel.

i. <u>Charitable Contributions – Code §§ 170(b)(1)(G) and 170(l); Act §§ 11023, 13705, and 13704</u>

i. <u>Contribution limits.</u> For contributions made in tax years beginning after Dec. 31, 2017, the 50% limitation under Code § 170(b) for cash contributions to public charities and certain private foundations (Code § 170(b)(1)(A) organizations) is increased to 60%. Contributions exceeding the 60% limitation are carried forward and deducted for five (5) years.

ii. <u>College Sports Seating Rights.</u> The Act modifies Code § 170(l) for contributions made in tax years beginning after Dec. 31, 2017, by denying a charitable deduction for any payment to an institution of higher education and the tax payer receives, directly or indirectly) the right to purchase tickets or seating at an athletic event.

j. <u>Overall Limitation on Itemized Deductions – Code § 68(f); Act § 11046</u>

i. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act suspends the Code § 68 overall limitation on itemized deductions that applied to taxpayers whose adjusted gross income exceeded specified thresholds. The itemized deductions of such taxpayers were reduced by

3% of the amount by which AGI exceeded the applicable threshold, but the reduction could not exceed 80% of the total itemized deductions, and certain items were exempt from the limitation.

k. Gambling Losses – Code § 165(d); Act § 11050

i. Prior to the Act, Code § 165(d) provided that "losses from wagering transaction" were allowed as a deduction only to the extent of the gains during the taxable year from such transactions. Case law permitted taxpayers to deduct amounts connected to wagering (*e.g*., transportation, admission fees) regardless of wagering winnings.

ii. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the limitation on wagering losses under Code § 165(d) is modified to provide that "losses from wagering transactions" includes any deduction otherwise allowable that is incurred in carrying on and wagering transaction. Wagering losses and expenses thus will be limited to wagering winnings.

l. Alimony – Code §§ 61(a)(8), 71(a) and 215(a); Act § 11051

i. Prior to the Act, alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse. Child support payments are not treated as alimony.

ii. The Act strikes Code § 215 thereby eliminating the deduction for alimony for the payer under agreements. Furthermore, the Act eliminates Code § 61(a)(8) which causes alimony to not be considered income to the recipient.

iii. The Act, but not the Code, provides that the current rules continue to apply to already-existing divorces and separations, as well as divorces and separations that are executed by Dec. 31, 2018. However, taxpayers have the option to have the new rules under the Act apply to modifications of agreements that are entered into after Dec. 31, 2018 if the modification expressly provides that the Act rules are to apply.

3. Child and Family Tax Credit – Code § 24(h); Act § 11022(1)

a. For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act increases the child tax credit to $2,000 per qualifying child. The credit is further modified to temporarily provide for a $500 nonrefundable credit for qualifying dependents other than qualifying children. The maximum amount refundable may not exceed $1,400 per qualifying child.

b. The Act modifies the adjusted gross income phase-out thresholds. The credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (in the case of married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phase-out thresholds are not indexed for inflation.

4. Repeal of Affordable Care Act Individual Mandate – Code § 5000A(c); Act § 11081

    a. For months beginning after Dec. 31, 2018, the amount of the individual shared responsibility payment is reduced to zero.

5. Income

    a. Discharged Student Loans – Code § 108(f); Act § 11031

        i. Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.

        ii. The Act expands the exception for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, for certain student loans that are discharged on account of death or total and permanent disability of the student. Loans eligible for the exclusion under the provision are loans made by:

            a) the United States (or an instrumentality or agency thereof),

            b) a state (or any political subdivision thereof),

            c) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law,

            d) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation, or

            e) private education loans (as defined in § 140(7) of the Consumer Protection Act).

        iii. Additionally, the provision modifies the gross income exclusion for amounts received under the National Health Service Corps loan repayment program.

    b. Deferral Election for Qualified Equity Grants – Code § 83(i); Act § 13603(a)

        i. Code § 83 provides specific rules that apply to property, including employer stock, transferred to an employee in connection with the performance of services. These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction. Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture.

ii. These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value. Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee.

iii. Code § 83(b) election is generally not available to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, a Code § 83(b) election may be available.

iv. The Act created Code § 83(i) which permits a "qualified employee" to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to "qualified stock" transferred to the employee by the employer. An election to defer income inclusion ("Code § 83(i) election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

v. If an employee makes a Code § 83(i) election, the income must be included in the employee's income for the taxable year that includes the earliest of:

a) the first date the qualified stock becomes transferable;

b) the date the employee first becomes an "excluded employee";

c) the first date on which any stock of the employer becomes readily tradable on an established securities market;

d) the date five years after the first date the employee's right to the stock becomes substantially vested; or

e) the date on which the employee revokes the Code §83(i) deferral election.

vi. A Code § 83(i) election is made in a manner similar to the manner a Code § 83(b) election.

vii. Code § 83(i) does not apply to income with respect to nonvested stock that is includible as a result of a Code §83(b) election. Furthermore, Code § 83(i) expressly states that restricted stock units (RSUs) are not eligible for Code § 83(b) elections. Absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

viii. Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the Code § 83(i) election, to meet the requirements necessary to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock are met.

ix. An excluded employee with respect to a corporation is any individual

a) who was a one-percent owner of the corporation at any time during the ten (10) preceding calendar years;

b) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity,

c) who is a family member of an individual described in (1) or (2), or

d) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years.

x. Qualified stock is any stock of a corporation if

a) an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and

b) the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an "eligible corporation".

xi. Qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

xii. A corporation is an eligible corporation with respect to a calendar year if

a) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and

b) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units ("RSUs"), with the same rights and privileges to receive qualified stock.

xiii. For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules. However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.

xiv. For purposes of the provision, corporations that are members of the same controlled group are treated as one corporation.

6. Miscellaneous

a. Inflation Calculation – Code § 1(f); Act § 11002(a)

i. For tax years beginning after Dec. 31, 2017, dollar amounts that were previously indexed using Consumer Price Index for All Urban Consumers (CPI-U) will instead be indexed using Chained Consumer Price Index for All Urban Consumers (C-CPI-U).

ii. Indexed parameters in the Code switch from CPI-U indexing to CCPI-U indexing going forward in taxable years beginning after December 31, 2017. Therefore, in the case of any existing tax parameters that are not reset for 2018, the provision indexes parameters as if CPI-U applies through 2017 and C-CPI-U applies for years thereafter.

b. ABLE Accounts – Code §§ 25B, 529 and 529A; Act §§ 11024 and 11025

i. A qualified ABLE program is a tax-favored savings program established pursuant to Code § 529A to benefit disabled individuals and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations. Several changes were made to ABLE programs by the Act.

ii. The Act permits amounts from qualified tuition programs (also known as 529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year. Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by Code § 72.

iii. The Act also increased the ABLE account contribution limits for tax years ending before January 1, 2026. Although the general overall limitation on contributions (the per-donee annual gift tax exclusion ($14,000 for 2017)) remains the same, the limitation is temporarily increased with respect to contributions made by the designated beneficiary of the ABLE account. Code § 529A(b)(2)(B) provides that after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year. Additionally, the provision temporarily allows a designated beneficiary of an ABLE account to claim the saver's credit provided in Code § 25B for contributions made to their own ABLE account.

c. <u>Section 529 Plans – Code §529(c)(7); Act § 11032(a)</u>

i. For distributions made after Dec. 31, 2017, the definition of "qualified higher education expense" is expanded by new Code § 529(c)(7) to include tuition at an elementary or secondary public, private, or religious school, up to a $10,000 limit per tax year.

III. <u>Changes Affecting Businesses</u>

1. <u>Reductions in Corporate Tax Rates</u>.

a. Effective for all tax years of a C corporation beginning after 12/31/17, all corporate taxable income will be subject to tax at a flat 21% rate.

b. Previously, under Code § 11(b), corporations were taxed at a rate of (i) 15% on taxable income between $0 - $50,000; (ii) 25% on taxable income between

$50,001 - $75,000; (iii) 34% on taxable income between $75,001 - $10,000,000; and (iv) 35% on taxable income in excess of $10,000,000.

c. Unlike most of the other changes under the Act, this change is permanent.

2. Other Changes Applicable to C Corporations.

a. Reduction in Dividends Received Deductions. The dividends received deduction for C corporations will be reduced from current levels of 80% and 70% to 65% and 50%.

b. Repeal of Corporate AMT. The new Act repeals the corporate alternative minimum tax.

c. Impact of NOL Limitations. The new NOL limitations imposed under the Act (discussed below) will prevent NOLs arising in tax years beginning after 12/31/17 from being carried back to prior years when C corporation marginal rates were as high as 35%, but may now be carried forward indefinitely.

3. QBI Deduction; Choice of Entity. Effective January 1, 2018, the Tax Act enacts new Code § 199A which generally provides a deduction of 20% of the "Qualified Business Income" ("QBI") from an S corporation, partnership, LLC (taxed as a partnership) or a sole proprietorship. Although new Code § 199A also provides rules for dividends from qualified real estate investment trusts, dividends from qualified cooperatives and income from publicly traded partnerships, this outline will focus on the deduction applicable for owners of S corporations, partnerships, LLCs and sole proprietorships.

a. The Deduction in General. For taxable years beginning after December 31, 2017 and before January 1, 2026, taxpayers (including estates and trusts) other than corporations generally may deduct 20% of the QBI of an S corporation, partnership, LLC or a sole proprietorship **allocable** to such shareholder, partner, member or sole proprietor.

In order to obtain the full benefit of the deduction without being subject to the wage and capital limitations discussed below, the taxable income of the shareholder, partner, member or sole proprietor must be less than $157,500 or less than $315,000 in the case of a married taxpayer filing jointly (the "Threshold Amounts"). Consequently, a taxpayer receiving the full benefit of the deduction would see a reduction in such taxpayer's top marginal tax rate on QBI to 29.6% (37% top marginal individual tax rate x 20% = 7.4% deduction; 37% - 7.4% = 29.6%).

Example #1: Sole Proprietor (Single-Member LLC) In a Qualified Trade or Business with Taxable Income Less than Threshold Amount. Assume A is the sole owner of a qualified trade or business through a single-member disregarded LLC. The business has no employees and no substantial fixed assets. The QBI from the business is $200,000 and A's wife has taxable income of $100,000 so that their combined taxable income is $300,000.

Because the taxable income of the taxpayer is below the Threshold Amount of $315,000 for married individuals filing jointly, A's deduction will be equal to $40,000 (20% x $200,000 of QBI).

b. Qualified Business Income. The term "QBI" generally means the net amount of "qualified items of income, gain, deduction and loss" with respect to any "qualified trade or business" of the taxpayer. Qualified items of income, gain, deduction and loss mean items of income, gain, deduction and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States. In other words, QBI only includes domestic income and not foreign income. However, in the case of a taxpayer who otherwise has QBI from sources within the commonwealth of Puerto Rico, provided all of the income is taxable, the taxpayer's income from Puerto Rico will be included in determining the individual's QBI.

i. Definition of "Trade or Business" Code § 199A leaves open what constitutes a "trade or business" for purposes of determining the deduction. There are a number of different interpretations of what constitutes a trade or business under the Code, with the highest standard being that of a Code § 162 trade or business. In order for an activity to achieve that standard, the business must be regular, continuous and substantial. Hopefully, there will be further guidance on what constitutes a "trade or business" for purposes of the new Code § 199A deduction, or be prepared for substantial litigation over this issue. For example, would the ownership of a single piece of commercial real estate rented out on a triple net lease basis qualify as a "trade or business" for purposes of the Code § 199A QBI deduction?

ii. Investment Related Income Excluded from QBI. Qualified items also do not include investment-related income, deductions or loss. Specifically, qualified items do not include, among other things, short-term capital gain or loss, long-term capital gain or loss, dividend income or interest income.

iii. Reasonable Compensation and Guaranteed Payments Excluded from QBI Additionally, QBI does not include any amount paid by an S corporation that is treated as reasonable compensation to the taxpayer, nor does it include any guaranteed payments made by a partnership to a partner for services rendered with respect to the trade or business or any other amounts paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

a) Where a qualifying trade or business does not have depreciable property or any wages other than those paid to the owner or owners of the business, a determination should be made on the amount of Form W-2 compensation to be paid to the owner so that the W-2 limit is not zero, while at the same time leaving some QBI on which to apply the 20% since any reasonable compensation will reduce QBI.

b) The formula for obtaining the maximum deduction is 20% (y - x) equal to 50% of x, where y is the income prior to the payment of wages and x is the amount of W-2 wages. Consequently, approximately 28.57% of income should be paid as wages in order to maximize the deduction. For example, assume $1,000,000 of QBI, with the same taxable income and no wages paid to employees other than shareholders (and no significant qualified property). If the qualifying trade or business is formed as an S corporation and wages are paid to the taxpayer, approximately 28.57% of the QBI should be paid as income to the shareholder in order to maximize the deduction, as this would result in a deduction of approximately $142,850 ($1,000,000 of QBI minus $285,700 W-2 wages to S corporation shareholder results in $714,300 of QBI x 20% = $142,860, while the W-2 wage limitation would be equal to 50% of $285,700, or $142,850). <u>Keep in mind that this formula is applicable only to an S corporation that has no employees other than the Shareholders</u>.

iv. <u>Qualified Trade or Business</u>. As will be discussed in more detail below, a qualified trade or business means a trade or business <u>other than</u> a "specified service trade or business" and <u>other than</u> the trade or business of being an employee.

v. <u>Mechanics of Deduction</u>. The deduction reduces a taxpayer's taxable income but not his or her adjusted gross income (i.e., it is a "below the line" deduction). However, the deduction is available whether you itemize deductions or take the standard deduction.

vi. <u>Carryover of Loss to Reduce QBI in Subsequent Taxable Year</u>. Under Code § 199A(c)(2), if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount will be treated as a loss from a qualified trade or business in the succeeding taxable year. Consequently, it appears that even if such loss is used in computing taxable income in Year 1, when you get to Year 2, that QBI loss carries over and reduces the QBI for Year 2 solely for purposes of computing the 20% of QBI deduction. Additionally, under Code § 172(d)(8), if a taxpayer has a Code § 199A deduction in a year in which such taxpayer has a net operating loss, the taxpayer's net operating loss does <u>not</u> include the Code § 199A deduction.

c. <u>Limitation(s) Based on W-2 Wages and Capital</u>. For businesses other than a "specified service trade or business" (which will be discussed below), and for which the taxpayer's taxable income exceeds $207,500 ($157,500 + $50,000 phase-in amount), or $415,000 ($315,000 + $100,000 phase-in amount) if married filing jointly, the deducible amount for <u>each</u> qualified trade or business carried on by the S corporation, partnership, LLC or sole proprietorship is the **lesser of** (1) 20% of the taxpayer's allocable share of QBI with respect to the qualified trade or business; or (2) the **greater of** (a) the taxpayer's allocable share of 50% of the W-2 wages with respect to the qualified trade or business, or (b) the taxpayer's allocable share of the sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all "qualified property" (the "wage and capital limitations").

i. <u>W-2 Wages</u>. W-2 wages are wages paid to an employee, including any elective deferrals into a Code § 401(k)-type vehicle or other deferred compensation. W-2 wages do not include, however, things like payments to an independent contractor or management fees. This definition raises issues for employees employed by an affiliated management company that leases the employees to an operating business or businesses. The question is whether wages paid by the management company can be taken into account with respect to each qualified trade or business even though it is operated in a separate taxable entity (such as the grouping of activities permitted under the passive activity loss rules of Code § 469). Additionally, because a partner is not an "employee" of the partnership under Rev. Rul. 69-184, 1969-1 C.B. 256, and a sole proprietor is not an "employee" of the sole proprietorship, neither guaranteed payments made to a partner nor any other payments made to a partner or a sole proprietor appear to qualify as W-2 wages (which can either be advantageous or disadvantageous depending upon the circumstances).

a) Code § 199A(b)(4) specifically defines W-2 wages by reference to Code §§ 6051(a)(3) and (8). This mirrors, in part, the language in Code § 199(b) as it existed prior to the Tax Act relating to the Domestic Production Activities Deduction. Guidance on wage issues had been issued under prior Code § 199 in Rev. Proc. 2006-22, 2006-1 C.B. 1033 and in the Code § 199 Regulations. Revenue Procedure 2006-22 provided three safe harbors for determining the definition of wages for purposes of old Code § 199: (1) the "Modified Box Method" which uses the lesser of Box 1 or Box 5 of the Form W-2; (2) the "Modified Box 1 Method" which adds a modified Box 1 amount subtracting amounts not subject to federal income tax withholding, added to the deferrals reported in Box 12; and (3) the "Tracking Method" where the amounts subject to federal income tax withholding are tracked, deferrals are added, and other modifications made. Again, however, Revenue Procedure 2006-22 and the prior regulations issued under Code § 199 are not direct authority for Code § 199A, but may provide some insight as to how similar wage determination issues will be interpreted.

b) Code § 199A wages do not include any amount which is not properly included in a return filed with the Social Security Administration on or before the sixtieth (60^{th}) day after the due date, including extensions, for such return. Consequently, good compliance with reporting rules is necessary to get credit for the maximum amount of W-2 wages.

ii. Allocable Share. If there is more than one owner of the pass-through entity, it must be kept in mind that the owners are only entitled to their "allocable share" of QBI, W-2 wages and unadjusted basis of qualified property. For an S corporation, a shareholder's allocable share will be equal to his or her percentage ownership of the stock of the S corporation. For partnerships, where special allocations may be made under Code § 704(b), a partner's allocable share of QBI and of W-2 wages will be equal to the amount of ordinary income of the qualifying trade or business allocated to such partner by the partnership.

iii. Qualified Property. For purposes of Code § 199A, "qualified property" means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, which is used in the production of QBI sometime during the taxable year, and for which the depreciable period has not expired before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the **later** of (a) the date ten years after such date; or (b) the last day of the full year in the asset's normal depreciation period. Again, with respect to a shareholder of an S corporation, such shareholder's "allocable share" of the unadjusted basis of qualified property will be equal to his or her percentage ownership in the stock of the S corporation. However, with respect to partners of a partnership (including LLCs taxed as partnerships), the partner's allocable share of the unadjusted basis of qualified property will be equal to the percentage of depreciation allocated to such partner by the partnership.

Example #2. LLC Taxed as a Partnership in a Qualified Trade or Business with Income in Excess of Threshold Amount Plus Phase-In Amounts. A is a 30% owner of an LLC which has QBI of $3,000,000. The LLC paid wages of $1,000,000 and the LLC's unadjusted basis in qualified property is $200,000.

A's deduction will be equal to the lesser of:

1.	*Total QBI*	*Allocable Share (30%)*	*20% Deduction*
	$3,000,000	*$900,000*	*$180,000*
	and the greater of:		
2(a)	*Total W-2 Wages*	*Allocable Share (30%)*	*50% Limitation*
	$1,000,000	*$300,000*	*$150,000*
	or		
2(b)	*Total W-2 Wages*	*Allocable Share (30%)*	*25% Limitation*
	$1,000,000	*$300,000*	*$75,000*
	plus		
	Unadjusted Basis	*Allocable Share (30%)*	*2.5% Limitation*
	$200,000	*$60,000*	*$1,500*
	TOTAL		*$76,500*

Thus, A is entitled to a deduction of $150,000.

d. Phase-In of Wage and Capital Limitations. For taxpayers having taxable income between $157,500 and $207,500 ($157,500 plus $50,000), or with respect to married individuals filing jointly having taxable income between $315,000 and $415,000 ($315,000 plus $100,000), the wage and capital limitations are phased in. Specifically, if the wage and capital limit is less than 20% of the taxpayer's QBI with respect to the qualified trade or business, the taxpayer's deductible amount is determined by reducing 20% of QBI by the same proportion of the difference between 20% of the QBI and the wage and capital limit as the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return). Once the taxpayer has $207,500 of taxable income, or $415,000 of taxable income in the case of a married individual filing a joint return, the wage and capital limitations apply fully to the taxpayer.

Example #3: S Corporation In a Qualified Trade or Business with Taxable Income Within the Phase-In Range.

A and B are married. A's allocable share of the QBI of an S corporation is $300,000. A's allocable share of the W-2 wages paid by the S corporation is $40,000. A's allocable share of the unadjusted basis of the qualified property is $100,000. B earns wages from her job of $85,000 so that their taxable income is $385,000.

Step 1: Determine what would A's deduction have been if the wage and labor limitation did not apply. 20% of $300,000 = $60,000.

Step 2: Determine A's "Excess Amount" by looking at the difference between $60,000 and the amount which would be deductible if wage and capital limitations applied in full. Greater of:

1. *50% of $40,000 = $20,000; or*

2. *(25% of $40,000) plus (2.5% of $100,000) = $12,500.*

A's Excess Benefit is $40,000 ($60,000 - $20,000).

Step 3: Figure Percentage of Taxable Income of A over Threshold Amount:

$385,000
<$315,000>

$70,000 /$100,000 = 70%

Step 4: A loses 70% of $40,000 Excess Benefit or $28,000

A is therefore entitled to a deduction of:

20% of QBI	*$60,000*
Reduction of $40,000 Benefit	*<$28,000>*
	$32,000

e. Specified Service Trade or Business. Code § 199A defines a "specified service trade or business" as any trade or business involving the performance of services in the fields of health, law, 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 one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. It should be noted that engineering and architecture services are specifically excluded from the definition of a specified service trade or business. Because a specified service trade or business includes both "consulting" and "any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners," there will be a great deal of uncertainty as to whether certain businesses are a specified service trade or business, and thus expect a substantial amount of litigation to ensue on this issue.

i. Deduction Allowed for Specified Service Trade or Business if Taxable Income Less than Threshold Amounts. Even though a specified service trade or business is not a qualified trade or business, such business will nevertheless be eligible for the 20% of QBI deduction provided that the taxpayer's taxable income is less than the Threshold Amounts of $315,000 in the case of married individuals filing joint returns and $157,500 for all other taxpayers.

<u>Example #4: Specified Service Trade or Business with Taxable Income Below Threshold Amount</u>.

A is a partner in a law firm. A is married and has total taxable income of $300,000 with his wife. A's allocable share of the QBI of the law firm is $250,000, his allocable share of W-2 wages of the law firm is $60,000 and his allocable share of the unadjusted basis of the qualified property of the law firm is $40,000.

Even though A derives his income form a specified service trade or business, he will receive a deduction of $50,000 ($250,000 x 20%). Because A's taxable income is below the Threshold Amount of $315,000, the wage and labor limitation won't apply (the <u>greater</u> of $30,000 (50% of $60,000) or $16,000 (25% of $60,000 plus 2.5% of $40,000).

ii. <u>Phase-Out of Deduction For Specified Service Trades or Businesses</u>. The ability to take the deduction for 20% of QBI for a specified service trade or business is phased out for a taxpayer having taxable income between $315,000 and $415,000 in the case of married individuals filing joint returns, and between $157,500 and $207,500 for all other taxpayers. Specifically, for a taxpayer with taxable income within the phase-out range, the taxpayer takes into account only the "applicable percentage" of qualified items of income, gain, deduction or loss, and of allowable W-2 wages. The "applicable percentage" with respect to any taxable year is 100% reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 (or $100,000 in the case of a joint return).

<u>Example #5</u>: <u>Specified Service Trade or Business with Taxable Income Within the Phase-In (or Phase-Out) Range</u>. A (a lawyer) and B are married. A's allocable share of the QBI of the law firm (an S corporation) is $300,000. A's allocable share of wages paid by the law firm is $40,000. A's allocable share of the unadjusted basis of the law firm's qualified property is $100,000. B earns wages of $85,000 so that their taxable income is $385,000.

<u>Step 1</u>: Determine what would A's deduction have been if the wage and labor limitation did not apply at all. 20% of $300,000 = $60,000.

Step 2: Determine how much of A's $100,000 "phase-in" threshold has been exceeded:

$385,000
<$315,000>

$70,000 /$100,000 = 70%

Step 3: Determine A's "Applicable Percentage" by subtracting 70% from 100% = 30%.

QBI	*Applicable Percentage (30%)*
$300,000	*$90,000*
W-2 Wages	*Applicable Percentage (30%)*
$40,000	*$12,000*
Unadjusted Basis	*Applicable Percentage (30%)*
$100,000	*$30,000*

Step 4: Determine A's deduction using the "Applicable Percentage" numbers: equal to the lesser of:

1. *20% of QBI of $90,000 = $18,000; or*

2. *the greater of:*

   (a) 50% of $12,000 = $6,000; or

   (b) 25% of $12,000 plus 2.5% of $30,000 = $3,750.

Step 5: Determine the excess of the deduction allowed to A if W-2 limitation did not apply over amount deductible if wage limitation fully phased-in: $18,000 - $6,000 = $12,000.

Step 6: Determine Percentage of Taxable Income of A over Threshold Amount:

$385,000
<$315,000>

$70,000 /$100,000 = 70%

Step 7: A loses 70% of $12,000 benefit or $8,400:

A is therefore entitled to a deduction of:

20% of QBI	*$18,000*
Reduction of $12,000 Benefit	*<8,400>*
Total Deduction	*$9,600*

iii. No Deduction Allowed if Specified Service Trade or Business and Taxable Income Exceeds Threshold Amount Plus Phase-In. The deduction for 20% of QBI is not available at all for shareholders, partners, members or sole proprietors of a specified service trade or business whose taxable income is $207,500 or above, or in the case of married individuals filing a joint return, $415,000 or above.

Example #6: Specified Trade or Business with Taxable Income over Threshold Plus Phase-In (Phase-Out) Range.

A is a partner in a law firm. A is married and has taxable income of $1,000,000. A's allocable share of income of the law firm is $700,000, his allocable share of the W-2 wages of the law firm is $200,000 and his share of the unadjusted basis of qualified property is $100,000.

A is entitled to no deduction at all because the law firm is a specified service trade or business and A's taxable income exceeds $415,000. A is completely "phased-out" of any deduction.

If, on the other hand, the business had been a qualified trade or business, A's deduction would be equal to the lesser of:

1. *20% of $700,000 = $140,000; or*

2. *the greater of:*

   (a) 50% x $200,000 = $100,000, or

   (b) 25% x $200,000 plus 2.5% x $100,000 = $52,500.

A would therefore be entitled to a deduction of $100,000 if the business had not been a specified service trade or business.

f. Overall Limitation**.** In addition to the other limitations described above, the maximum amount of deduction available under new Code § 199A (for all of a taxpayer's qualified trades or businesses) cannot exceed 20% of the excess of the taxpayer's taxable income less any capital gain for the taxable year.

Example #7: *Taxable Income Limitation Applies*. *A is married and has $100,000 of QBI. A has $200,000 of long-term capital gains, $30,000 of wages, and $50,000 of itemized deductions, resulting in taxable income of $280,000. A's deduction is limited to the lesser of:*

1. *20% of QBI of $100,000 = $20,000; or*

2. *20% of ($280,000 taxable income less $200,000 of capital gain) = $16,000.*

g. Recap of Rules for Qualified Trades or Businesses. In the case of a qualified trade or business other than a specified service trade or business, if the shareholder's, partner's, member's or sole proprietor's taxable income is less than the threshold amount ($157,500 or $315,000), such owner will generally be entitled to deduct 20% of his allocable share of the QBI from an S corporation, partnership, LLC or sole proprietorship. In the event that the taxable income of such shareholder, partner, member or sole proprietor is over the full phased-in amount ($207,500 or $415,000), the deduction is equal to the **lesser of** (1) 20% of the taxpayer's allocable share of QBI from the S corporation, partnership, LLC or sole proprietorship; or (2) the **greater of** (a) the taxpayer's allocable share of 50% of the W-2 wages of the qualified trade or business; or (b) the taxpayer's allocable share of 25% of the W-2 wages of the qualified trade or business plus 2.5% of the unadjusted basis of the qualified property used in such trade or business.

h. Recap of Rules for Specified Trades or Businesses. In the case of a specified service trade or business, provided the taxable income of the shareholder, partner, member or sole proprietor is less than the threshold amounts ($157,500 or $315,000), his or her deduction should be equal to 20% of such taxpayer's allocable share of the QBI of the S corporation, partnership, LLC or sole proprietorship. However, in the event that the taxable income of the shareholder, partner, member or sole proprietor is over $415,000 for married individuals filing joint returns, or $207,500 for all other taxpayers, no deduction will be allowed for such taxpayer.

i. Observations. Clearly, the rules for the new deduction available to owners of S corporations, partnerships, LLCs and sole proprietorships are extremely complex (and certainly did not simplify the Code), especially where the taxpayer's taxable income exceeds the threshold amounts ($157,500 or $315,000) discussed above. These new rules can result in different (and presumably unintended) results between S corporations, partnerships and sole proprietorships having the same amount of income, and thus may affect the taxpayer's choice of entity decisions. These different results are the result of two factors.

j. S Corporations and Unreasonably Low Compensation. In Rev. Rul. 59-221, 1959-1 C.B. 225, the IRS found that an S corporation's income does not constitute earnings for purposes of the self-employment tax. Additionally, Code § 1402(a)(2) specifically excludes from the definition of net earnings from self-employment dividends on shares of stock issued by corporation. Consequently, neither a shareholder's distributive share of income passed through from the S corporation under Code § 1366 nor any S corporation distributions actually received by the shareholder from the S corporation constitute net earnings from self-employment subject to the self-employment tax.

Because wages paid to shareholder-employees of an S corporation are subject to social security taxes while S corporation distributions are not, shareholder-employees have an opportunity for significant tax savings by withdrawing funds from the S corporation in the form of distributions rather than wages. As a result of this strategy, the IRS has been successful in re-characterizing S corporation distributions as wages subject to social security taxes where it determines that unreasonably low compensation has been paid to the shareholder-employee of the S corporation. See the following:

a) Rev. Rul. 74-44, 1974-1 C.B. 287, Rev. Rul. 71-86, 1971-1 C.B. 285 and Rev. Rul. 73-361, 1973-2 C.B. 331.

b) Radtke v. United States, 895 F.2d 1196 (7th Cir. 1990).

c) Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).

d) Esser, PC v. United States, 750 F. Supp. 421(D. Ariz. 1990).

e) Cave v. Commissioner, 476 F. App'x 424 (5th Cir. 2012), *aff'g* per *curiam*, T.C. Memo 2011-48.

f) Watson P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), a*ff'g* 757 F. Supp. 2d 877 (S.D. Iowa 2010).

g) Herbert v. Commissioner, T.C. Summ. Op. 2012-124.

h) Scan McClary Ltd., Inc. v. Commissioner, T.C. Summ. Op. 2013-62.

i) Glass Blocks Unlimited v. Commissioner, T.C. Memo 2013-180.

j) IRS Fact Sheet FS-2008-25.

This reclassification risk applicable to S corporations, does not apply, however, to partnerships or sole proprietorships (at least under current law).

k. W-2 Wages Cannot be Paid to Partners of a Partnership or Sole Proprietors. As discussed above, unlike S corporations which pay W-2 wages to their shareholder-employees, W-2 wages cannot be paid to a partner of a partnership or to a sole proprietor, which can lead to the wage limitation being equal to zero where the qualified trade or business has no outside employees.

Example #8: *High Income Qualified Trade or Business with No Outside Employees. Assume that a qualified trade or business generates $600,000 of QBI and that the $600,000 is also A's taxable income.*

1. *Sole Proprietorship. Because a sole proprietor cannot pay himself a salary, and because A's taxable income is over the Threshold Amount as fully phased-in, the W-2 limitation will apply and A's deduction will be equal to 50% of zero W-2 wages, or zero.*

2. *Partnership. Even if A pays himself a guaranteed payment of $150,000, that amount presumably will still not qualify as W-2 wages, so again the amount of the deduction would be equal to 50% of zero W-2 wages, or zero.*

3. *S Corporation. Since S corporation shareholders are required to pay themselves "reasonable compensation", assume A pays himself $150,000. In such case, A's deduction would be equal to the lesser of:*

   (a) 20% of $450,000 of QBI ($600,000 QBI - $150,000 salary) or $90,000.

   (b) 50% of $150,000 W-2 wages, or $75,000.

Example #9: *Low Income Qualified Trade or Business With No Outside Employees.*

Assume that A's business only generates $300,000 of QBI and that the $300,000 is also A's taxable income.

1. *Sole Proprietorship. Because A's taxable income is below $315,000, A will be entitled to a deduction of 20% of $300,000, or $60,000, because the wage limitations will not apply.*

2. *Partnership. Assuming no guaranteed payments are made by the partnership to A, A will likewise be entitled to a deduction equal to 20% of $300,000 or $60,000.*

3. *S Corporation. A still has to pay himself "reasonable compensation", so assume A pays himself $100,000. That will reduce A's share of QBI from $300,000 to $200,000, so that in this situation A's deduction would only be $40,000 (20% of $200,0000).*

It is doubtful that Congress actually intended to have the Code § 199A deduction be different depending on the type of entity the taxpayer is using where such entities are producing identical income. It is possible that a "reasonable compensation" standard could be applied to partnerships and sole proprietorships the same as for S corporations (with such amounts being treated as W-2 wages) so that businesses having the same income would receive the same deduction under Code § 199A. However, until further guidance is issued in the form of a technical corrections bill or possibly guidance from the IRS, the plain language of new Code § 199A seems to create these anomalous results.

A possible "work around" for this issue in the case of a partnership would be to form a tiered partnership structure, so that the lower-tiered partnership would be owned by an upper-tiered partnership, and the lower-tiered partnership could then pay wages to partners of the upper-tiered partnership. While such a structure may work, the IRS has expressed doubt to a similar type arrangement utilizing a disregarded entity to enable a partner to be treated as an employee for withholding purposes. Under the purported structure, a partnership creates a wholly-owned entity that is disregarded for federal income tax purposes, and has the partners of the partnership become employees of the disregarded entity, which for employment tax purposes, is treated as the employer having its own employer identification number and subject to W-2 withholding. On June 13, 2014, Curtis Wilson, IRS Associate Chief Counsel (Pass-Throughs and Special Industries) stated that the IRS is looking at this issue but that if use of the disregarded entity works, "it makes it pretty easy to get around what would otherwise be the general rule, and so … we think it's a stretch."

l. Effect of Tax Act on Choice of Entity**.** As a result of the reduced corporate tax rate for C corporations to a flat 21%, as well as the deduction for 20% of QBI of pass-through entities and sole proprietorships, choice of entity and structuring considerations may be affected, especially where the entity is not planning on distributing available cash to its owners.

m. Double Tax Imposed on C Corporations. Although C corporations will continue to be subject to the so-called "double-tax" on their earnings, once at the corporate level and again at the shareholder level when the earnings of the corporation are distributed to its shareholders, the maximum combined double-tax rate will be reduced significantly from 48% (or 50.47% if the Net Investment Income tax is applicable), to 36.8% (or 39.8% if the Net Investment Income Tax is applicable). Additionally, in states like Florida which impose a corporate income tax (5.5%) on C corporations but not on S corporations, partnerships, LLCs or sole proprietorships, the maximum marginal tax rate on distributed earnings will be even higher than 39.8% (e.g., approximately 43.11% in Florida). This should be contrasted to a top marginal tax rate of 37% on the income of a pass-through entity or sole proprietorship even if the taxpayer derives no benefit whatsoever from the deduction available under Code § 199A, or a top marginal tax rate of 29.6% on the QBI of a pass-through entity or sole proprietorship where the taxpayer receives the full benefit of Code § 199A without being subject to the wage and capital limitations. To the extent that a C corporation is not distributing its earnings, however, consideration also must be given to the possible application of reasonable compensation arguments, the accumulated earning tax under Code § 531 or the personal holding company tax under Code § 541.

i. Reasonable Compensation. Although traditionally unreasonable compensation arguments have been applied in the C corporation context to re-characterize unreasonably high compensation paid to shareholder-employees as dividends subject to double tax, it is possible that the IRS will apply unreasonably low compensation arguments (that have been applied in the S corporation area) to C corporations where the C corporation is retaining earnings taxed at the 21% flat tax rate and not paying any (or unreasonably low) compensation to its shareholder-employees, which would be taxed at a maximum marginal tax rate of 37% and also be subject to FICA taxes.

ii. Accumulated Earnings Tax. S corporations and other pass-through entities are not subject to the Accumulated Earnings Tax imposed under Code § 531.

a) General. The accumulated earnings tax is a penalty tax imposed upon C corporations that accumulate earnings in excess of the reasonable needs of the business, rather than pay them out to shareholders, with the purpose of avoiding taxes at the shareholders level.

b) Tax Base. The accumulated earnings tax applies to accumulated taxable income at a tax rate of 20%. Accumulated taxable income is the corporation's taxable income, subject to certain adjustments (as provided in Code § 535(b)), reduced by: (A) the dividends-paid deduction, if any, and (B) the accumulated earnings credit.[1] The adjustments, as provided in Code § 535(b), include: (A) income taxes accrued to the corporation for the year; (B) corporate charitable contributions over the 10% deduction limit under Code § 170(b)(2); (C) the corporation's capital losses disallowed under Section 1211; and (D) the corporation's net capital gain for the year. The accumulated earnings credit is an amount that starts at $250,000 but could be higher if justified by the reasonable business needs of the corporation. In other words, the accumulated earnings credit is designed to allow corporations to retain at least $250,000 and as much of earnings as is supported by the reasonable needs of the

[1] Code § 531(a).

business.[2] The minimum accumulated earnings credit is determined annually as the excess of $250,000 over the corporation's accumulated earnings at the end of the preceding tax year.[3] Thus, if a corporation had no prior years' accumulated earnings, the current year's minimum accumulated earnings credit would be $250,000. If the corporation's prior year accumulated earnings were $100,000, however, the minimum credit would be $150,000 ($250,000 minus $100,000). Note that corporations performing services in the field of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting may claim a minimum accumulated earnings credit of only the excess of $150,000 over accumulated earnings at the end of the preceding tax year.

c) Reasonable Business Needs. As mentioned above, there are two basic elements that must be present in order for the accumulated earnings tax to apply. First, there must be an accumulation of earnings beyond the reasonable needs of the business. Second, the earnings had to have been accumulated for the purpose of avoiding shareholder level taxes. Thus, a corporation is generally able to avoid the accumulated earnings tax if it can demonstrate that it retained the earnings for its reasonable business needs. Whether particular grounds indicate that earnings have been accumulated for reasonable business needs or beyond depends on the specific circumstances.[4] Generally, an accumulation of earnings is excessive if it is more than what "a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business."[5] In addition, the retained earnings must be directly connected with the needs of the corporation and must be for bona fide business purposes. The "business" of a corporation includes not only that which it has previously carried on but also any line of business it may undertake.[6]

d) Tax Avoidance Purpose. Even if a corporation has accumulated earnings beyond its reasonable needs, the earnings must have been retained for the purpose of avoiding taxes at the shareholder level in order for the

---

2 Code § 535(c).
3 Code § 535(c)(2).
4 Treas. Reg. § 1.537-2(a).
5 Treas. Reg. § 1.537-1(a).
6 Treas. Reg. § 1.537-3(a). *See also* Treas. Reg. § 1.537-2(b) for examples of specific grounds for accumulations most frequently encountered in reasonable business needs cases.

accumulated earnings tax to apply. Note, however, that unreasonable accumulations create a presumption of a tax-avoidance purpose, rebuttable by the corporation.[7] Tax avoidance needs only be one of the purposes, not the sole or dominating purpose, of the accumulation.[8] Although the Code does not specify the person or persons whose purpose is relevant in determining liability for the accumulated earnings tax, it is presumably the purpose of those who control the corporation, through stock ownership or otherwise, that is key. The following factors are among those considered in determining whether a corporation's retention of earnings was motivated by a tax-avoidance purpose:

(i) Dealings between the corporation and its shareholders, including loans and advances to shareholders and expenditures of corporate funds for the shareholders' personal benefit (rather than paying dividends).[9]

(ii) Investing undistributed earnings in assets having no reasonable connection to the corporation's business.[10]

(iii) A dividend history demonstrating that shareholder taxes were avoided by the corporation's failure to make distributions.[11]

(iv) Corporate loans to friends or relatives of shareholders, as well as to other corporations owned directly or indirectly by the shareholders.[12]

e) <u>Exceptions</u>. The accumulated earnings tax imposed under Code § 531 does not apply to a personal holding company within the meaning of Code § 542, a foreign personal holding company within the meaning of Code § 552, a corporation exempt from tax under Subchapter F, and a passive foreign investment company within the meaning of Code § 1296.[13]

---

7 Code § 533(a).
8 *U.S. v. Donruss Co.***,** 393 US 297 (1969).
9 *See* Internal Revenue Manual 4.10.13.2.2 (03/16/2015).
10 <u>Id.</u>
11 <u>Id.</u>
12 Treas. Reg. § 1.537-2(c).
13 Code § 532(b).

iii. Personal Holding Company Tax. S corporations and other pass-through entities are not subject to the Personal Holding Company Tax imposed under Code § 541.

a) General. A closely held corporation whose income is largely of investment character may be a personal holding company (PHC), in which case a penalty tax is imposed on the "personal holding company income" if not distributed. The personal holding company tax is designed to prevent corporations from accumulating earnings rather than distributing the earnings as taxable dividends. The personal holding company tax is equal to 20% of the undistributed personal holding company income.

b) Definition. A corporation is a personal holding company if: (i) at least 60% of its adjusted ordinary gross income (as defined in Code § 543(b)(2)) for a taxable year is personal holding company income, and (ii) at any time during the last half of the taxable year, more than 50% in value of the corporation's stock is owned, directly or indirectly, by or for not more than five individuals.[14]

c) PHC Income. Personal holding company income generally includes dividends, interest, royalties (including mineral, oil and gas royalties and copyright royalties), annuities, rents, produced film rents, compensation for use of corporate property by shareholders, personal service contract income, and income from estates and trusts.[15] In general, undistributed personal holding company income means "taxable income" (as adjusted by the items set forth in Code § 545(b)), less the dividends paid deduction (as defined in Code § 561).[16] Adjustments to taxable income generally include negative adjustments for federal income taxes, certain net operating losses, and net capital gains less the attributable taxes.

n. Taxation of Gain Upon Sale of Assets of Corporation. The maximum marginal combined rate for a C corporation selling its assets is the same as the maximum double tax on earnings of a C corporation which are distributed to its shareholders (36.8% or 39.8% if the 3.8% Net Investment Tax is applicable). Again, in some states such as Florida, a corporate income tax (5.5% in Florida) is imposed on C corporations but not on S Corporations, partnerships, LLCs or sole proprietorships, which will increase the maximum marginal double tax on the sale

[14] Code § 542(a).
[15] Code § 543(a).
[16] Code § 545(a).

of assets (e.g., to approximately 43.11% in Florida). This should be contrasted with the sale of assets by an S corporation, partnership or LLC taxed as a partnership, or a sole proprietorship, where typically the bulk of the sales price is allocated to capital assets (such as goodwill), so that the maximum marginal rate to which the gain on the sale of the assets will be subject will either be 20% (the maximum capital gains tax), or, if the taxpayer does not materially participate in the trade or business carried on by the entity, 23.8% with the addition of the Net Investment Tax.

o. <u>The Cost of "Escaping" C Corporation Status</u>. There has already been substantial discussion that a number of S corporations, LLCs and sole proprietorships may convert to C corporation status as a result of the flat 21% tax rate imposed on C corporations. However, the owners of C corporations may not be able to "escape" the shareholder-level tax because of reasonable compensation arguments, the accumulated earnings tax or the personal holding company tax, as discussed above. Additionally, in the event Congress subsequently raises the corporate tax rate (although deemed a "permanent change"), taxpayers may find themselves "trapped" in C status. Once in the C corporation regime, there are number of "prohibitions" and "toll charges" on entities that want to convert back from a C corporation to a pass through entity or sole proprietorship.

If a C corporation converts to a partnership or a sole proprietorship, the conversion will be treated as a taxable liquidation. Where an S corporation has revoked its S election to become a C corporation, Code § 1362(g) generally prohibits the corporation from reelecting S status for a period of five years. Even where a C corporation is allowed to convert to S corporation status, a number of unfavorable rules may apply to the S corporation which has converted from C corporation status, including the application of the LIFO recapture tax under Code § 1363(d), the imposition of the tax on excess passive investment income imposed under Code § 1375 for S corporations having subchapter C earnings and profits, the possible termination of the corporation's S election (where it has excess passive investment income and subchapter C earnings and profits for three consecutive taxable years) under Code § 1362(d), the less favorable distribution rules applicable to S corporations having subchapter C earnings and profits versus S corporations having no subchapter C corporation earnings and profits and the possible loss of net operating losses under Code § 172. Most importantly, the so-called built in gains tax under Code § 1374 is imposed on C corporations which have converted to S corporation status (which effectively imposes a double tax to the extent of any built-in gain of such corporation at the time of conversation), if the assets of the corporation are sold or otherwise disposed of within the five (5) year period following the corporation's conversion to S status. This can be especially disadvantageous for a cash-basis taxpayer having accounts receivable converting from C to S status where the collection of such accounts receivable following conversion to S status will be treated as built-in gain subject to the built-in gains tax.

p. Conclusion. As discussed above, the rules applicable to the 20% of QBI Deduction for pass-throughs and sole proprietorships are complex and should be carefully considered in the selection of the type of entity to use, as well as whether employees versus independent contractors should be used in the business and whether employees can be in a separate management company.

Also, a great deal of thought should be given before a business decides to convert from a pass-through entity to a C corporation due to the difficulty in getting out of "C" corporation status, and the "toll charges" imposed on converting from "C" corporation status.

Unless you have a crystal ball predicting future changes to the law, revenues, payroll, equipment purchases and the timing of the sale of the business, it is going to be very hard to recommend that a business convert to "C" corporation status. Obviously, one of the biggest factors as to whether a "C" corporation makes sense at all is how much of the earnings you are planning to distribute to the shareholders. If you frequently take profits out of your business or believe you may sell your business in the foreseeable future, it makes the most sense to stay a pass-through entity or sole proprietorship.

Don't act impulsively. Just take a deep breath, relax and carefully review your options with your accountant and tax attorney.

4. Modification of Interest Expense Deductions.

a. The Act limits the deduction for net interest expenses for every business (whether corporate or other) in a taxable year to (i) the business interest income of such business for such taxable year; (ii) 30% of adjusted taxable income of such business for such taxable year; plus (iii) the taxpayer's floor plan financing interest for such taxable year. Taxpayers whose average annual gross receipts for the preceding three taxable years are less than $25,000,000 are exempt from this limitation.

i. Adjusted taxable income is defined as the taxable income of a taxpayer –

a) Computed without regard to:

(i) Any item of income, gain, deduction or loss which is not properly allocable to a trade or business;

(ii) Any business interest or business interest income;

(iii) The amount of any net operating loss under Code § 172;

(iv) The amount of any deduction allowed under Code § 199A; and

(v) In the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

b) Computed with such other adjustments as provided by the Secretary.

ii. Business interest means any interest paid or accrued or indebtedness properly allocable to a trade or business, but does not include investment interest under Code § 163(d)(3).

iii. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business, but does not include investment interest under Code § 163(d)(3).

b. The amount of business interest not allowed as a deduction as a result of the aforementioned limitation is treated as business interest paid or accrued in the following tax year, and may be carried forward indefinitely.

c. The general carryforward rule (above) does not apply to partnerships.

i. The amount of any business interest not allowed as a deduction to a partnership as a result of the 30% limitation is not treated as business interest paid or accrued by the partnership in the succeeding taxable year. Rather, it is treated as excess business interest which is allocated to each partner in the same manner as the non-separately stated taxable income or loss of the partnership.

ii. If a partner is allocated any excess business interest from a partnership in any taxable year, such excess business interest is treated as business interest paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership, but only to the extent of such excess taxable income. Any portion of such excess business interest remaining after the application of the rule in the preceding sentence shall, subject to the limitations of the rule in the preceding sentence, be treated as business interest paid or accrued in succeeding taxable years.

iii. Excess taxable income is the amount that bears the same ratio to the partnership's adjusted taxable income as (i) the excess of (1) 30% of the partnership's adjusted taxable income over (2) the amount by which the partnership's business interest, reduced by any floor plan financing interest, exceeds its business interest income of the partnership, bears to (ii) 30% of the partnership's adjusted taxable income.

d. <u>Special Rules for Partnerships and S Corporations</u>.

i. Each partner's adjusted taxable income is determined without regard to such partner's distributive share of any of the partnership's items of income, gain, deduction or loss.

ii. Each partner's adjusted taxable income is increased by the partner's distributive share of the partnership's excess taxable income.

iii. A partner's distributive share of partnership excess taxable income is determined in the same manner as the partner's distributive share of the partnership's non-separately stated taxable income or loss.

iv. Rule similar to these apply to S corporations and their shareholders.

e. In the case of a taxpayer that is a corporation or other form of entity, this limitation is applied at the entity level.

f. Certain types of trades or businesses, including, among others, the trade or business of performing services as an employee, an electing real property trade or business and an electing farming business, are excluded from the definition of a trade or business for purposes of Code § 163(j).

5. <u>Modification of Bonus Depreciation</u>.

a. The Act allows 100% bonus depreciation under Code § 168(k) for qualified property placed in service between 9/27/17 and before 1/1/23. This bonus depreciation will be reduced to 80% if the qualified property is placed in service between 1/1/23 and 12/31/23; 60% if placed in service between 1/1/24 and 12/31/24; 40% if placed in service between 1/1/25 and 12/31/25; and 20% if placed in service between 1/1/26 and 12/31/26.

i. Prior to the Act, property (other than certain types of property having a longer production period and certain types of aircraft) had to be placed in service prior to January 1, 2020. Now, property (other than certain types of property having a longer production period and certain types of aircraft) must be placed in service prior to January 1, 2027.

b. The Act also modified the requirement that, in order to qualify for bonus depreciation, the original use of the property must begin with the taxpayer. Now, under Code § 168(k)(2)(A)(ii), property whose original use does not begin with the taxpayer (used property) may constitute qualified property subject to bonus depreciation if such property:

i. Was not used by the taxpayer at any time prior to acquisition;

ii. Was not acquired from certain related persons;

iii. Was not acquired from another component member of a controlled group; and

iv. Was not acquired in a transaction in which the basis of such property was determined by reference to the adjusted basis of such property in the hands of the person from whom it was acquired or under Code Section 1014.

6. Modification of Expensing.

a. Code § 179 allows a taxpayer to treat the cost of any Code § 179 property as an expense which is not chargeable to capital account, allowing such cost to be deducted for the taxable year in which such Code § 179 property is placed in service.

b. Prior to the Act, the aggregate cost which could be taken into account under Code § 179 was $500,000. The Act increased this limitation to $1,000,000.

c. Prior to the Act, the $500,000 limitation (which is now a $1,000,000 limitation) was reduced (not below zero) dollar for dollar by the amount by which the cost of Code § 179 property placed in service during such taxable year exceeded $2,000,000. The Act increased the $2,000,000 threshold to $2,500,000.

d. For taxable years beginning after 2018, the $500,000 limitation and $2,500,000 threshold are increased by multiplying such amounts by the cost-of-living adjustment under Code § 1(f)(3).

e. The Act also expanded the types of real property that qualify as Code § 179 property ("qualified real property").

i. Prior to the Act, in order to constitute qualified real property, such real property had to constitute qualified (i) leasehold improvement property, (ii) qualified restaurant property or (iii) qualified retail improvement property.

ii. Qualified real property under Code § 179 adopts the concept of "qualified improvement property," which completely replaces the three categories above.

a) Qualified improvement property is defined as any improvement to an interior portion of a building (subject to certain exceptions below) which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Qualified improvement property is a significant expansion of the types of property that qualify, as compared to qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property.

b) However, qualified improvement property does not include improvements for which the expenditure is attributable to:

(vi) The enlargement of the building;

(vii) Any elevator or escalator; or

(viii) The internal structural framework of the building.

iii. The Act further expanded the definition of qualified real property by including the following improvements to nonresidential real property placed in service after the date such property was first placed in service:

a) Roofs;

b) Heating, ventilation and air-conditioning property;

c) Fire protection and alarm systems; and

d) Security systems.

7. <u>Modification of Net Operating Loss ("NOL") Deduction</u>.

a. Prior to the Act, an NOL was generally first carried back two years and then carried forward twenty years. Under the Act, any NOL arising for tax years beginning after 12/31/17 may be carried forward indefinitely but, in most cases, may not be carried back.

b. Prior to the Act, NOLs were not subject to a limitation based on taxable income. Under the Act, the amount of taxable income a taxpayer can offset with an NOL carry-forward in any taxable year will be limited to 80% of taxable income (determined before deducting the NOL) to the extent the losses comprising such NOL arose in taxable years beginning after 12/31/17.

8. <u>Limitation on Excess Business Losses</u>.

a. For taxable years beginning after 12/31/17 and before 1/1/26, the Act added new Code § 461(*l*), which limits excess business losses of non-corporate taxpayers. Excess business losses are defined as the excess of –

i. The aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer; over

a) The sum of –

(i) The aggregate gross income or gain of such taxpayer for the taxable year which is attributable to such trades or businesses; plus

(ii) $250,000 (or $500,000 in the case of taxpayers filing a joint return).

b. For taxable years beginning after 2018, the $250,000 (or $500,000, in the case of taxpayers filing a joint return) amount above is increased by multiplying such amount by the cost-of-living adjustment under Code § 1(f)(3).

c. For partnerships and S corporations, this limitation is applied at the partner or shareholder level.

d. Losses which are disallowed under Code § 461(*l*) are treated as NOLs and are carried forward indefinitely.

e. Code § 461(*l*) is applied after the application of Code § 469, relating to passive activity losses.

9. New Restrictions Imposed on Section 1031 Exchanges. Code § 1031 and its predecessor provisions under the Internal Revenue Codes of 1939 and 1954, as well as various Revenue Acts dating back to 1921, enabled a taxpayer who transferred qualifying property held by him for productive use in a trade or business or for investment in exchange for qualifying replacement property to be held by him for such purposes, to defer all or a portion of his gain on the exchange. Although the dollar volume of these exchanges each year has been primarily attributable to real property exchanges, Code § 1031 was also widely used for exchanges of many types of both tangible and some intangible personal properties such as fleets of leased vehicles, aircraft and business equipment.

The Act amended Code § 1031 to limit its applicability solely to real property. Although this change is relatively straight-forward, there are still questions with respect to the scope of its applicability. For example, if a taxpayer holds real property with respect to which it has previously done a cost segregation study and has identified a variety of items as tangible personal properties eligible for a more rapid write-off for depreciation purposes, will these items, most of which are treated as “real property” under applicable state law, be eligible for deferral under newly amended Code §1031?

The changes to Code § 1031 will apply to exchanges completed after 12/31/17, subject to certain transition rules for exchanges commenced but not completed prior to that date.

10. Changes Under the Act to Partnerships and LLCs Treated as Partnerships. The Act made a number of changes affecting entities that are treated as partnerships for federal income tax purposes, including LLCs (other than LLCs that filed elections to be treated as corporations). The most important of these changes relates to the pass-through of the deduction for qualified business income discussed in Part III. 1. above. This portion of the outline will discuss additional changes affecting tax partnerships not addressed in other parts of this outline.

a. Carried Interests. Carried interests, which are also known as profits interests, are partnership interests issued to a person in exchange for services. These interests have been used for many years to recognize and reward "sweat equity". If structured properly in compliance with existing IRS guidance (Rev. Proc. 93-27 and Rev. Proc. 2001-43), the issuance of a profits interest is not taxable to the recipient partner and, as the corollary to that rule, the issuing partnership will be precluded from claiming a deduction with respect to the grant of such interest to the service partner. The rules governing the initial issuance of a profits interest were not affected by the Act.

In recent years, private equity funds and hedge funds that often manage millions of dollars of portfolio investments for investors have utilized these carried interests as a means of compensating fund managers. Since these funds manage assets, most of which are capital assets, these fund managers effectively receive compensation taxed at long term capital gains rates for their services. This has raised the ire of many politicians and others in recent years.

The Act has added new Code § 1061 which provides that any gains recognized by the holder of certain types of carried interests that would otherwise be treated as long term capital gains, will instead be treated as short term capital gains taxed at rates applicable to ordinary income unless the assets that generated such gains were held in excess of three years (as contrasted with the normal one year plus one day minimum holding period for eligibility for long term capital gain treatment).

The language set forth in new Code § 1061 limits its applicability primarily to carried interests issued by partnerships that manage portfolio assets, which include stock and securities, commodities, real estate held for rental or for investment purposes, and cash or cash equivalents.

New Code § 1061 specifically exempts certain otherwise includible carried interests from its provisions. The primary exemption is for a carried interest that is held by a "corporation". Query: does the term "corporation" include an S corporation? An S corporation is a corporation under state law and is otherwise treated under the Code as a corporation except to the extent otherwise provided in Subchapter S of the Code. Unfortunately, this issue cannot be resolved until further guidance becomes available.

b. Repeal of Technical Termination Rule. Under prior law, if sales or exchanges of partnership interests representing 50% or more of the total interests in both partnership capital and partnership profits were completed within any 12-month period, the partnership was deemed to have terminated under Code § 708(b)(1)(B). The results of such a termination included: (i) the taxable year of the partnership closed, usually resulting in a short taxable year that required the filing of an additional return; (ii) any partnership elections that were in place prior to the termination ceased to apply to the partnership; and (iii) all partnership depreciation recovery periods were restarted.

The Act has repealed Code § 708(b)(1)(B), effective for all transfers of partnership interests that take place after 12/31/17. As a result of this repeal, the only event that can cause the termination of a partnership for federal income tax purposes is if "…no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership…" Code §708(b)(1)(A).

c. <u>New Rules Applicable to Mandatory Basis Adjustments Upon Sales or Exchanges of Partnership Interests</u>. Code § 743(a) provides that no change will be made to the tax basis of partnership property upon a sale or exchange of a partnership interest, or upon a transfer of a partnership interest by reason of the death of a partner, unless either: (i) the partnership had an election in place under Code § 754 for the partnership taxable year in which the transfer occurred, or (ii) the partnership had a substantial built-in loss immediately after the transfer. The existence of a substantial built-in loss resulted in a mandatory write sown of the partnership's tax basis in those assets with the built-in loss. Needless to say, a mandatory write-down of the tax basis of partnership assets caused by the existence of a substantial built-in loss is never popular with a partnership or its partners.

Under prior law, a partnership would be deemed to have a "substantial built-in loss" only if the partnership's cumulative tax basis in all of its properties exceeded the cumulative fair market value of all of its properties by more than $250,000. The Act has expanded the circumstances in which the partnership will be deemed to have a substantial built-in loss to also include a situation in which the transferee partner would be allocated a loss of more than $250,000 if the partnership sold all of its assets (in a hypothetical sale) for their current fair market values immediately following the transfer of such partnership interest to the transferee partner.

<u>Example</u>: Partnership ABC, which has 3 partners, A, B and C, owns two assets as of 06/30/18: Asset #1 has a built-in gain of $1,000,000 and Asset #2 has a built-in loss of $900,000. Partnership ABC does not have a Code § 754 election in effect. Under ABC's partnership agreement, if Asset #1 is sold by the partnership, all of the gain attributable to Asset #1 must be allocated to partner A, and all profits or losses attributable to a sale of Asset #2 will be equally allocated (33 1/3% to each partner) among all of the partners. Under prior law, partnership ABC would not be treated as having a built-in loss if a partnership interest was sold because it had a net built-in <u>gain</u> of $100,000. However, under Code § 743(d), as amended by the Act, if partner B sells his entire partnership interest to a unrelated third party on 06/30/18 for its net fair market value of $33,333 the new transferee partner would be allocated a net loss of $300,000 if the partnership engaged in the hypothetical sale of all of its assets for their fair market values and allocated the profits and losses therefrom in accordance with ABC's partnership agreement because all of the gain on Asset #1 would be allocated solely to partner A, and of each of partners A, C and the new transferee partner would be allocated $300,000 of loss from this hypothetical sale of Asset #2. Thus, under Code §§

743(a) and 743(d), as amended by the Act, partnership ABC will be required to write-down the tax basis of Asset #2 to its current fair market value as of 06/30/18.

d. <u>New Rule for Pass Through of Partnership Charitable Contribution Deductions</u>. As a general rule, a partner may only claim his or her allocable share of partnership losses and deductions to the extent of such partner's tax basis in his or her partnership interest under Code § 704(d). Under prior law, an exception to this outside basis limitation rule was available for a partner's allocable share of the partnership's charitable contribution deductions. Thus, if partner A had a tax basis in his or her partnership interest that had been reduced to $0.00 by previous allocations to partner A of partnership losses and/or by reason of partnership distributions, and if partner A is then allocated partnership charitable contribution deductions of $100, partner A would still have been able to claim the full $100 charitable contribution deduction because the basis limitation rules of Code § 704(d) did not apply.

The Act has now modified Code § 704(d) to provide that no charitable contribution deductions may be passed through to a partner if the partner does not have sufficient tax basis in his or her partnership interest to facilitate the pass through. This modification of Code § 704(d) by the Act is applicable to all taxable years of the partnership beginning after 12/31/17.

e. <u>New Partnership Audit Rules are Now in Effect</u>. Although not related to the Act, the new partnership audit rules enacted as part of the Bipartisan Budget Act of 2015 became effective for all partnerships for their taxable years beginning after 12/31/17. These new rules, which will generally govern all tax audits and tax controversies are dramatically different than the prior rules relating to partnership audits. These new partnership audit rules provide for an audit at the partnership level and the general rule is that once a partnership adjustment has been proposed by the IRS, any tax increases will be collected <u>from the partnership</u> and not from the partners. A new position that is referred to as a "partnership representative" has been created under these new partnership audit rules. The partnership representative will effectively become a "tax czar" with complete authority to bind the partnership to any and all settlement agreements with the IRS and will also have the sole authority to contest any proposed tax adjustments in court or otherwise. The new rules provide the opportunity to elect out of these new partnership audit provisions under certain circumstances and also provide for alternate methods of pushing partnership adjustments out to the partners.

Every partnership and LLC taxed as a partnership should have specially designed provisions included in its partnership agreement or operating agreement designed to comply with these new rules, including imposing restrictions on the party that is designated as the "partnership representative" to ensure that any decisions made by the partnership representative will have been approved in advance by either all or a majority in interest of the partners.

IV. Changes Affecting Tax-Exempt Organizations

1. Donors

   a. Impact of Change in Standard Deduction – Code § 63(c); Act § 11021

      Consider the potential impact on charitable giving that may result based on the increase in the standard deduction.

      i. Charitable contributions remain deductible as itemized deductions.

      ii. The increases in the standard deduction from 2017 levels are from $12,700 to $24,000 for married filing joint, from $9,350 to $18,000 for head of household, and from $6,350 to $12,000 for individuals.

      iii. Also, consider impacts of lower top marginal rate, suspension of limitation on itemized deductions, increase in estate tax exemption.

   b. Charitable Contribution Deduction Limitation – Code § 170(b)(1); Act § 11023

      i. The deduction for contributions to a public charity (or the other organizations listed in Code § 170(b)(1)(A)), is limited to 50 percent of adjusted gross income (without regard to any NOL carryback) (AGI).

      ii. This percentage limitation is increased to 60 percent of AGI for cash contributions to such organizations, with a five-year carryover.

   c. "Contribution" for Athletic Seating Event Rights – Code § 170(l); Act § 13704

      i. The partial deduction (80%) for amounts paid in exchange for college athletic event seating rights is repealed.

      ii. In 2017, 80% was deductible. In 2018, no deduction for seating rights.

2. Exempt Organizations

   a. Unrelated Trade or Business Income – Code § 512(a)(6) (new); Act § 13702

      i. Exempt organizations must compute unrelated business taxable income separately for each unrelated trade or business.

      ii. The new 21% corporate tax rate does not have any graduated rates, so net tax will be higher on lower taxable incomes. For example, if the unrelated business taxable income is $50,000, the graduated tax rates (15%) would have resulted in a tax of $7,500, whereas the flat tax rate of 21% results in a tax of $10,500.

iii. Net operating losses from prior years may be used to offset all unrelated business taxable income; net operating losses starting in 2018 shall apply only to the separate business that generated the loss.

b. <u>Contemporaneous Written Acknowledgement by Donee Organization – Former Code § 170(f)(8)(D) (deleted); Act § 13705</u>

i. Required in order to deduct contributions of $250 or more.

ii. The ability to substantiate based on the done organization's Form 990 has been eliminated.

c. <u>Excise Tax on Large Endowments at Private Schools – Code § 4968 (new); Act § 13701</u>

i. A 1.4% excise tax is imposed on net investment income of private college or university with at least 500 students (and more than 50% of the students in the United States), with investment assets of at least $500,000 per full time student.

ii. Net investment income is calculated using the regular rules for private foundations to determine the 2% (or 1%) excise tax on investment income of Section 4940(c).

iii. Exempt use assets are not included in the calculation.

iv. Net investment assets of related organizations (such as supporting organizations) are combined with the assets of the college or university.

d. <u>Executive Compensation – Code § 4960 (new); Act § 13602</u>

i. A 21% excise tax (based on the new corporate tax rate) is imposed on compensation paid by tax-exempt organizations in excess of $1,000,000 for a "covered employee."

ii. "Covered employee": five highest paid employees (current and prior years).

Excludes: amounts paid to licensed medical professionals (including veterinarians) for the performance of medical (or veterinary) services by such professional.

iii. Include compensation paid to the employee by a related organization (such as a supporting organization); reasonableness of the amount of compensation is not relevant.

iv. An "excess parachute payment" (defined as more than three times the employee's average salary for the prior five years, paid upon separation from employment) to a covered employee is also subject to the 21% excise tax.

e. Proposals NOT Adopted

i. Flat 1.4% excise tax on investment income of private foundations; the current 2% (or 1%) excise tax remains in effect.

ii. Johnson Amendment – remains in Section 501(c)(3); exempt organizations may not participate or intervene in a political campaign on behalf of (or in opposition to) a candidate for public office.

iii. Tax on royalty income from licensing trademarks; not adopted.

iv. Exception from private foundation excess business holdings tax for certain wholly-owned philanthropic businesses; not adopted.

v. Donor advised funds, additional reporting requirements; not adopted.

V. Special Agricultural Provisions

1. Depreciation

a. Act § 13203: Machinery or equipment, other than grain bins, cotton ginning assets, fences, or other land improvements, the original use of which commences after December 31, 2017, shall be treated as 5-year property.

b. Act § 13205: Any property held by an electing farming business with a recovery period of ten (10) years or more can use the alternate depreciation system provided under Code § 168(g).

i. An affirmative election is necessary to take advantage of this provision, but the method for making this election is to be dictated by the Secretary in regulations to do not yet exist.

ii. Election is irrevocable.

iii. Making this election will also exempt the electing farming business from the limitations on the deductibility of business interest under Code § 163(j), as amended by Act § 13301.

c. Act § 13207: For the past two (2) legislative sessions, the Florida delegation (and others) have advocated for an amendment to Code § 263A to provide relief for the citrus industry under the name of the Emergency Citrus Disease Response Act. The substance of those efforts is contained here.

i. Code § 263A allows for expensing the costs of replanting, instead of capitalizing, where the original trees were lost or damaged due to freeze, disease, drought, pests, or casualty. This benefit, however, was previously limited to the taxpayer who experienced the loss.

ii. The Act adds a provision to Code § 263A(d)(2) which allows for bringing in new investors and still reaping the expensing benefit, provided that the original taxpayer retains an equity interest not less than 50% in the replanted citrus in the year the amounts were paid.

iii. In the alternate, the expensing benefit is available to a new taxpayer who has purchased the entirety of the original taxpayer's interest in the affected land to the extent the replanting is on that land.

iv. These benefits are available until December 22, 2027.

d. Note: All depreciation provisions currently have limited relevance due to unlimited, immediate expensing allowed by the Act under Code § 168(k) for property placed in service prior to January 1, 2023.

2. <u>Act § 13312: Code § 118 Nonshareholder Contributions to Capital</u>

a. Code § 118 exempts any "contribution to capital of the taxpayer" by a nonshareholder from inclusion in gross income of the taxpayer.

b. Case law provides guidance as to what qualifies as a nonshareholder contribution to capital as follows: (1) the contribution must become a permanent part of working capital; (2) the contribution must not be compensation for specific quantifiable services; (3) the contribution must be bargained for; (4) the contribution must foreseeably benefit the corporation in an amount commensurate with its value; and (5) the contribution must ordinarily be employed to generate additional income.

c. Act § 13312, however, amends Code § 118 by specifically excluding from the meaning of "contribution to capital of the taxpayer" both contributions in aid of construction or any other contribution as a customer or potential customer and contributions by any governmental entity or civic group.

d. The amendment is to be effective for contributions made after December 22, 2017.

e. The Act provides an exception for contributions made after the effective date by a governmental entity which are made pursuant to a "<u>master development plan</u>" approved by the governmental entity prior to the effective date, however the meaning of this term is murky as it is not defined in the Act.

f. While this provision does not specifically apply to agriculture, many agricultural landowners consider entering into contracts with government entities that would be affected by this provision. Funds received under existing contracts with government entities (for example, a water management district) are now taxable where they were not previously so. This affects existing contracts and the willingness of taxpayers to enter into such contracts in the future.

3. Act § 11011: New Cooperative Advantages

a. New Code § 199A(g) provides for a deduction allowable to "specified agricultural or horticultural cooperative[s]" in the amount of the lesser of (i) 20% of the excess of the gross income of the cooperative less the qualified cooperative dividends paid during the taxable year for the taxable year or (ii) the greater of 50% of the W-2 wages of the cooperative with respect to its trade or business or the sum of 25% of the W-2 wages of the cooperative with respect to its trade or business plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of the cooperative.

b. The deduction under new Code § 199A(a) is also calculated in a manner that takes qualified cooperative dividends into account.

i. Because cooperative dividends are generally going to be equal to the farmer's share of the cooperative's gross income, a farmer selling entirely to a cooperative can take a 20% deduction out of a much bigger number, with the only limit being taxable income.

ii. This is an additional benefit that makes sales to cooperatives advantaged, although the precise calculus is complex and nuanced.

iii. The advantage to cooperatives over other farming companies has been the topic of much discussion and is reportedly set to be corrected in a glitch bill. That said, there are no specifics of what the fix might be at this time and any fix is miles of negotiation and procedure away.