

# **Tax Consequences of the Tax Cuts and Jobs Act**

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## QBI DEDUCTION

20% of the QBI

S Corporation

Partnership

Sole Proprietorship

Allocable to the owner

Top marginal tax rate on QBI potentially **29.6%**.

## QBI DEDUCTION

### Simple Example

S Corp Net Income	\$150,000
Shareholder Salary	<u>(\$50,000)</u>
S Corp Net Taxable Income	\$100,000
<b>Shareholder QBI Deduction</b>	<b>(\$20,000)</b>
Shareholder Taxable Income	\$130,000
	[\$50,000 + \$100,000 - \$20,000]

**QBI DEDUCTION**

First Phase in Thresholds

\$315,000 – Married Filing Jointly

\$157,500 – Everyone Else

All Businesses Good

## **QBI DEDUCTION**

### Slightly Less Simple Example

A is the sole proprietor of a qualified trade or business run through a single-member LLC. The business has no employees and no substantial fixed assets.

The QBI from the business is \$200,000 and A's spouse has taxable income of \$100,000 so that their combined taxable income is \$300,000.

A's deduction will be equal to \$40,000 (20% x \$200,000 of QBI).

## QBI DEDUCTION

If below **threshold amounts**, get full 20% deduction whether a qualified trade or business or a specified service trade or business.

## QBI DEDUCTION

“Overall limitation” applies even if below threshold amounts:

Taxable Income less Net Capital Gain.

## **QBI DEDUCTION**

Second Phase in Thresholds

\$415,000 – Married Filing Jointly

\$207,500 – Everyone Else

Qualified Trade or Business: Wage & Capital Limits

Specified Service Trade or Business: No Deduction



## **QBI DEDUCTION**

Phase In of Wage and Capital Limitations For  
Qualified Trade or Business

Phase Out of QBI Deduction For Specified Service  
Trade or Business

\$315,000 to \$415,000 – Married Filing Jointly

\$157,500 To \$207,500 – Everyone Else

## **QBI DEDUCTION**

Wage and Capital Limits:

20% QBI deduction limited to:

The greater of:

- 50% of the W-2 wages
- 25% of the W-2 wages plus 2.5% of the unadjusted basis of all qualified property

## **QBI DEDUCTION**

### What Is A Qualified Trade Or Business?

Excludes Specified Service Trade or Business

Excludes Trade or Business of Being an Employee

### Definition of a “Trade or Business”

Section 162

**Real Estate Businesses**

Separate Entities and Grouping

## **QBI DEDUCTION**

What is QBI?

Foreign Income Excluded

Investment-Related Income Excluded

Reasonable Compensation and Guaranteed  
Payments Excluded

## **QBI DEDUCTION**

Carryover of Loss to Reduce QBI in Subsequent Taxable Year

Mechanics of Deduction

Modification of Substantial Understatement Penalty for 199A: 5% Vs. 10%

## **QBI DEDUCTION**

What Are W-2 Wages?

Independent Contractors

Management Fees

What is Qualified Property?

Allocable Share

**QBI DEDUCTION**

Specified Service Trade or Business

Definition

Consulting Business

Reputation or Skill

**QBI DEDUCTION**

Engineers and Architects Specifically Excluded

Deduction Still Allowed If Below Threshold amount

Phase Out of Deduction

No Deduction If Over fully Phased In Amount



**QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$600,000 of QBI which all of the taxpayer's Taxable Income

**Sole Proprietorship**

A sole proprietor cannot pay themselves a salary

A's taxable income exceeds the Threshold Amount

W-2 Limitation Applies

A's Deduction = 50% Of Zero W-2 Wages = \$0 deduction

**QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$600,000 of QBI which all of the taxpayer's Taxable Income

**Partnership**

Partnership pays each partner a Guaranteed Payment of \$150,000  
Not W-2 Wages

A's taxable income exceeds the Threshold Amount

W-2 Limitation Applies

A's Deduction = 50% Of Zero W-2 Wages = \$0 deduction

**QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$600,000 of QBI which all of the taxpayer's Taxable Income

**S Corporation**

Company pays A a \$150,000 salary

A's taxable income exceeds the Threshold Amount

W-2 Limitation Applies

20% Of \$450,000 of QBI ( $\$600,000$  QBI -  $\$150,000$  salary) =  $\$90,000$

50% Of  $\$150,000$  W-2 Wages =  $\$75,000$

## **QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$300,000 of QBI which all of the taxpayer's Taxable Income

### **Sole Proprietorship**

A sole proprietor cannot pay themselves a salary

A's taxable income does not exceed the Threshold Amount

A's Deduction = 20% Of QBI = \$60,000 deduction

## **QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$300,000 of QBI which all of the taxpayer's Taxable Income

### **Partnership**

Partnership pays no Guaranteed Payments

A's taxable income does not exceed the Threshold Amount

A's Deduction = 20% Of QBI = \$60,000 deduction

**QBI DEDUCTION**

High Income Qualified Trade or Business with no Outside Employees  
\$300,000 of QBI which all of the taxpayer's Taxable Income

**S Corporation**

Company pays A a \$100,000 salary

A's taxable income does not exceed the Threshold Amount

20% Of \$200,000 of QBI ( $\$300,000 \text{ QBI} - \$100,000 \text{ salary}$ ) = \$40,000

**QBI DEDUCTION**

Effect of Tax Act on Choice of Entity

Double Tax on C Corporation Earnings

36.8% or 39.8% with Net Investment Income Tax

5.5% Florida Income Tax on C Corporations

**QBI DEDUCTION**

Arguments IRS Can Use Against Corporations  
Retaining Earnings:

Reasonable Compensation

Accumulated Earnings Tax

Personal Holding Company Tax



**QBI DEDUCTION**

Double Tax on Sale of Assets of C Corporation

39.8% vs. 20% Capital Gain Rate on Pass-Throughs

5.5% Florida Income Tax on “C” Corporations

**QBI DEDUCTION**

Trapped In C Status:

Tax Rates Could Be Increased (Permanent Is NOT Permanent)

Prohibitions on Converting Back To S Status

“Toll” Charges

**QBI DEDUCTION**

Taxable Liquidation to Convert to Partnership

Built-In Gains Tax

LIFO Recapture Tax

Tax on Excess Passive Investment Income &  
Possible Termination of S Status

Distribution Rules

Loss of NOLs

## **Interest on Business Loans**

§ 163(j)

Capped at

Business interest income

+ 30% of adjusted taxable income

+ Floor plan financing interest

## **Interest on Business Loans**

Example:

- Adjusted taxable income - \$20,000
- Business interest income - \$2,000
- Business interest expense - \$10,000
- Deduction limited to  $\$2,000 + (30\% \times \$20,000 = \$6,000) = \$8,000$
- \$2,000 carried forward

## **Interest on Business Loans**

\$25 million gross receipts threshold

Special Partnership Rule

Special Real Estate Election

Notice 2018-28

## **New Restrictions Imposed on Section 1031 Exchanges**

The Act amended Code § 1031 to limit its applicability solely to real property.

## Carried Interests

- TCJA added new Code § 1061 which changes the holding period required to obtain long-term capital gain treatment from in excess of one year to in excess of three years for applicable partnership interests.
- A carried interest, which is sometimes referred to as a profits interest, is an interest in a partnership (or an LLC treated as a partnership for tax purposes) that is received solely in exchange for services rendered to or on behalf of the partnership.
- The three plus year holding period will be applied to all sales of capital assets by the applicable partnership.
- Although not entirely clear, the three plus year holding period requirement will probably also apply to a sale of the partnership interest by the service partner.
- New Section 1061 apparently does not apply to Code § 1231 assets (trade of business assets).



## Carried Interests Cont'd

- An “applicable partnership interest” to which Section 1061 applies is defined in Section 1061 as “any interest in a partnership which, directly or indirectly, is transferred to (or is held by) the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, to in any applicable trade or business.
- An “applicable trade or business” is defined as any activity conducted on a regular, continuous, and substantial basis which...consists in whole or in part, of (1) raising or returning capital and (2) either: (i) investing in (or disposing of) “specified assets” ...or (ii) developing specified assets.
- A “specified asset” means securities (including stocks), commodities, real estate held for rental or for investment, cash or cash equivalents, options or similar passive investment assets.

## Carried Interests Cont'd

- Two types of partnership interests that are excluded from the application of Section 1061.
  - An applicable partnership interest will not include a partnership interest that is held by a corporation.
    - Not clear whether a “corporation” is intended to be limited to C corporations or whether it may also include S corporations. Treasury and the IRS have announced their intention to issue regulations that will limit this exception to C corporations, but it is not altogether clear that they have the authority to apply this limitation.
  - The second exception is any capital interest in a partnership which provides the taxpayer with the right to share in partnership capital commensurate with either (i) the amount of capital contributed or (ii) the value of a partnership interest that the taxpayer was required to include in income upon receipt under Code § 83.

## §263 A(d)(2): Prior to the Act

Edible crops lost or damaged by reason of disease, drought, pests, or casualty – immediate expensing available for costs of replanting.

- Same crop (with variation in variety)
- On same land or any other U.S. land
- Can take place with a higher density

No timing restriction (separate from possible USDA rules)

Opportunity for Investors – New partners could participate as long as the original taxpayer retained a greater than 50% equity interest in replanted property and the new investors materially participated.

## §263 A(d)(2): After the Act

General rule still applies BUT a special rule was added for citrus plants

Liberalizes provisions for new investors setting the threshold at not less than 50% retained by the taxpayer OR the entirely new owner of the land on which the casualty occurred

Applies until December 22, 2027

## Prior to the Act

Code §118 excluded amounts received by a corporation from a governmental entity to undertake environmental restoration projects from income as nonshareholder “contributions to capital.” These types of projects primarily benefit the public, but are constructed on privately owned land.

## After the Act

Amounts received by a corporation from a governmental entity like those described above are taxable income to the corporation unless the payments are made pursuant to a “master development plan” approved by the governmental entity before December 22, 2017 (“Grandfather Clause”). The term “master development plan” is not defined.

## Impact

C corporation formed under the laws of Florida  
Federal Tax 21% + State Tax 5.5% = effective tax of 26.5%

Shareholders of Florida S corporation  
Possible rates as high as 37%

**Costs passed on to government agencies in order to make public minded taxpayers whole...**

**Does this Policy make sense? Impact on public-private partnerships?**

## Grandfather Clause

The Act amendments do not apply to contributions made after December 22, 2017 from a government entity made pursuant to a master development plan approved prior to December 22, 2017.



## Immediate Action Steps Taken

This past Legislative Session, the State of Florida adopted an inclusive state definition of “master development plan” that includes regional environmental restoration and water projects (such as Basin Management Action Plans, Regional Water Supply Plans etc.) in an effort to avoid penalizing existing projects with unexpected tax consequences that could jeopardize those projects. House Bill 1151.

## Now Focus Turns to Federal Effort

While not dispositive of the issue, federal tax law often defers to state law regarding real property rights and interests, therefore a state definition in its real property statutes should have significant persuasive value. *See, e.g.,* Rev. Rul. 66-40, 1966-1 C.B. 227 (using New York state law to determine if a cooperative apartment was considered real property for the purpose of interpreting federal tax law).

IRS to issue regulations for new Section 118.

## What About Updates?

Clarification that updates or modifications of existing master development plans won't lose grandfathered status.

## Long-Term Effort

Restore Code Section 118 exclusion for payments from governmental entities to corporate taxpayers utilized for capital improvements needed to undertake environmental restoration projects that primarily benefit the public but are constructed on private lands.

## Section 199A—Super Coop Deduction As reported in Tax Notes:

### Farm Fix Talks Continuing

Finance Committee Chair Orrin G. Hatch, R-Utah, complained that the TCJA's new section 199A passthrough business income deduction has been having **unintended effects in agricultural markets** because of its treatment of qualifying cooperative dividends.

“The current statutory language [in the Tax Cuts and Jobs Act] does not maintain the previous competitive balance between cooperatives, other agricultural businesses, and the farmers who sell their crops to them, which existed prior to the...tax reform bill,” Hatch said.

Hatch said he and Sens. Chuck Grassley, R-Iowa, John Thune, R-S.D., and Pat Roberts, R-Kan., are taking a leading role in identifying a solution “**that does not pick winners and losers, and is fair to everyone involved.**”

## **Omnibus Bill Enacted March 23, 2018**

Modifies Section 199A to more closely mimic Section 199 prior to its repeal by TCJA.

**Thank you!**