Tax Cuts and Jobs Act of 2017 Overview and Planning for Individuals and Businesses

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The Tax Cuts and Jobs Act of 2017

- Signed into law on December 22nd
- Most provisions will only apply to tax years **2018 through 2025**, after which time the old laws will apply (unless something changes)
- Some provisions result in permanent changes

INDIVIDUAL TAX CHANGES

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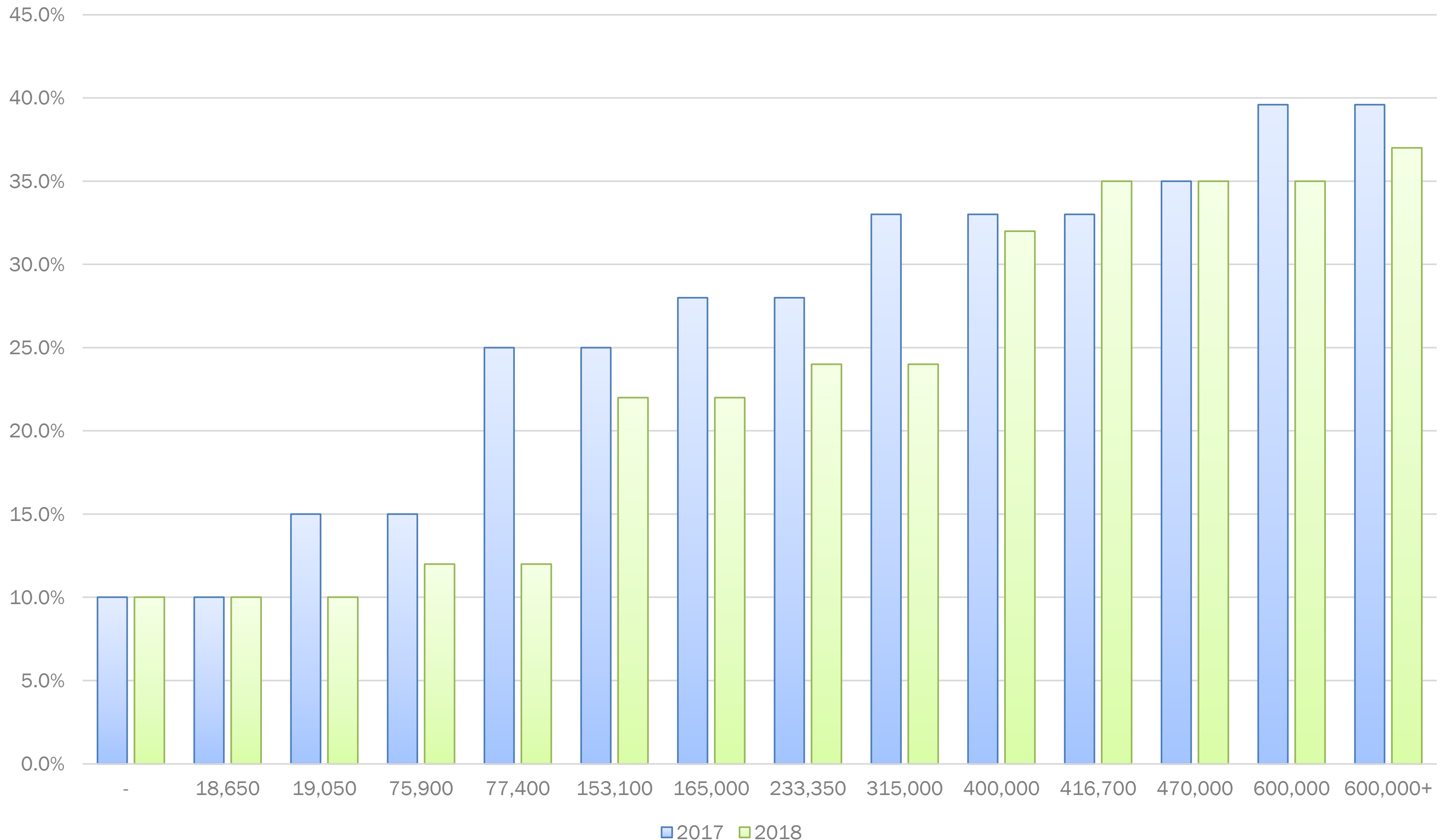
TAX RATES & WITHHOLDING

2018 Income Tax Brackets

Current Law	Single Filers	Married Joint Filers
10%	$0 to $9,524	$0 to $19,049
12%	$9,525 to $38,699	$19,050 to $77,399
22%	$38,700 to $82,499	$77,400 to $164,999
24%	$82,500 to $157,499	$165,000 to $314,999
32%	$157,500 to $199,999	$315,000 to $399,999
35%	$200,000 to $499,999	$400,000 to $599,999
37%	$500,000+	$600,000+

Comparison of Tax Rates: Married Filing Jointly



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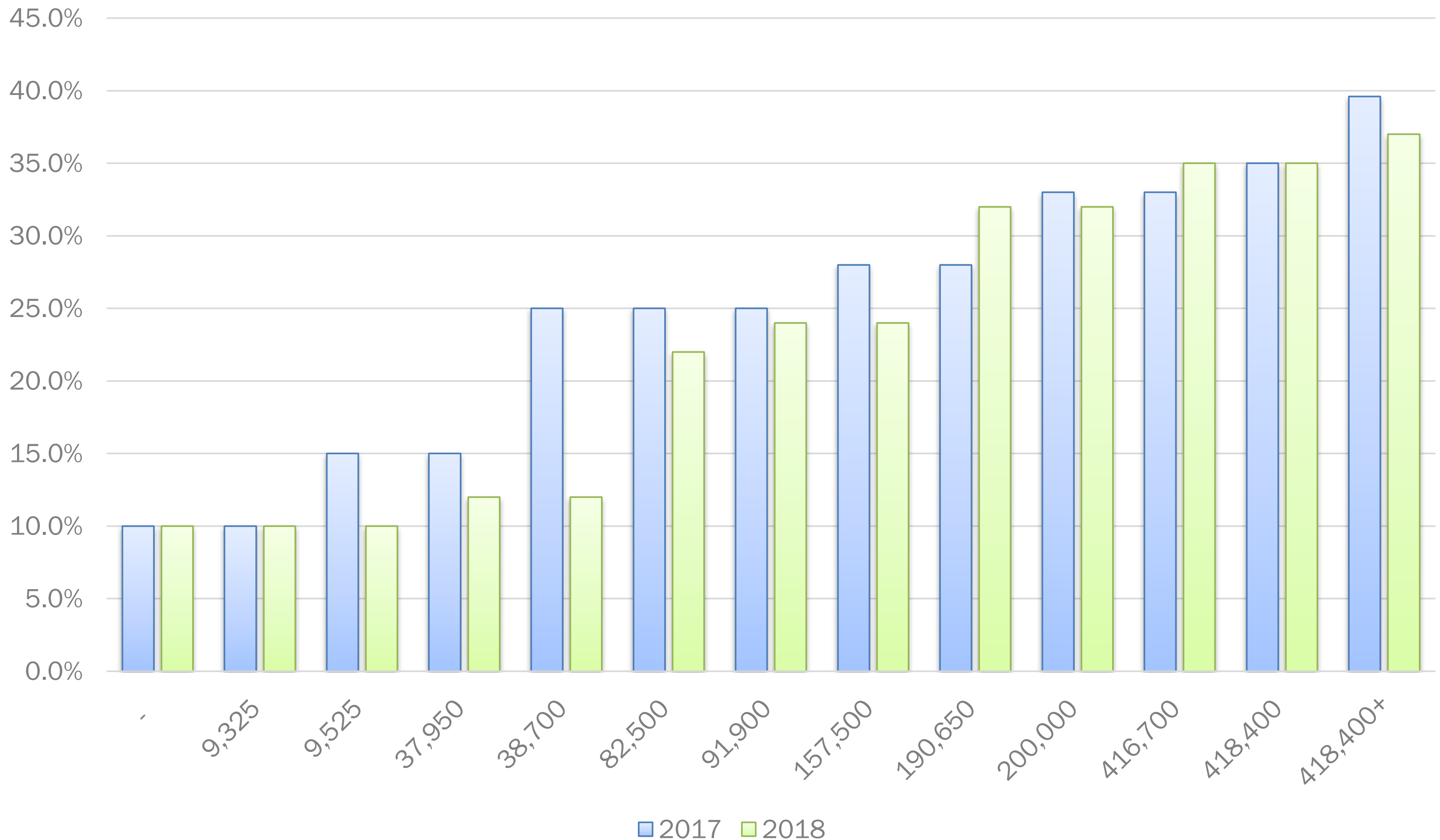
Comparison of Tax Rates: Single



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Capital Gain and Dividend Tax Rates

- Tax bracket break points are retained

Rate	Joint Filers	Single Filers
0%	$0 to $77,200	$0 to $38,600
15%	$77,200 to $479,000	$38,600 to $425,800
20%	$479,000 +	$425,800 +

SECTION 199A - NEW 20% DEDUCTION

Section 199A – In General

- The provision expires in tax year 2026.
- The provision is actually comprised of *three separate deductions*.
  - **"20% pass-through deduction"**
  - 20% of taxpayer's qualified REIT dividends and PTP income
  - Overall limitation (20% * (TI – net capital gains, dividends, 1250 recapture)
- Final Regulations released January 18, 2019.

Final Regulations

- Real estate, especially on the Commercial side, probably most impacted by final regulations
- Two key steps to understand and apply 199A within real estate
  1. Determine if each venture rises to the level of a Section 162 trade or business
  2. For each Section 162 trade or business, compute qualified business income (QBI).

Step 1: The Section 162 Trade or Business Requirement

- Final regulations establish a prerequisite whereby a business must first rise to the level of a "Section 162 trade or business" before it is capable of producing income eligible for the 20% deduction. Unfortunately, as the preamble to the regulations concedes, the statute has never defined what it means to be a Section 162 trade or business.
  - In *Groetzinger*, the Supreme Court stated that to rise to the level of a Section 162 trade or business, "the taxpayer must be involved in the activity with continuity and regularity. . . . A sporadic activity, a hobby, or an amusement diversion does not qualify."

Step 1: The Section 162 Trade or Business Requirement

- Other court examples:
- *Example 1:* Taxpayer owns eight buildings on eight separate parcels of land. Taxpayer does not directly conduct maintenance or management functions, but hires an agent to carry out these functions. This activity was considered a trade or business because the activity of the agent is considered involvement by the Taxpayer.

Step 1: The Section 162 Trade or Business Requirement

- *Example 2:* Taxpayer purchased and rented out two properties. Taxpayer had researched the locations and determined that they were the best locations to earn a profit. Taxpayer did not perform any activities, but hired an agent to advertise and rent out the property. The agent was responsible for registration, housekeeping, and general maintenance on the property. This activity was considered a trade or business because the activity of the agent is considered involvement by the Taxpayer.

Step 1: The Section 162 Trade or Business Requirement

- *Example 3:* Taxpayer inherited a home that was leased to a tenant. The tenant continued to occupy the home and pay rent until the house was sold 14 years later. The taxpayer paid for upkeep and repairs during that time, typically after receiving estimates provided by the tenant. Since this activity did not require regular and continuous activity to manage (the tenant was managing the property), this was not considered a trade or business.

Step 1: The Section 162 Trade or Business Requirement

- *Example 4:* Taxpayer (a decedent) rented out a property but had no obligations to maintain or repair the property, or pay the taxes or other assessments. He had nothing to do, directly or indirectly, with the management or operation of the property. This was not considered a trade or business.

Step 1: The Section 162 Trade or Business Requirement

- The Section 162 standard remains problematic, for rental real estate — or more accurately, for a specific *type* of rental real estate.
  - Target #1 – Commercial NNN leases

Step 1: The Section 162 Trade or Business Requirement

- In Notice 2019-7, the IRS offered a safe harbor providing that a rental activity (or multiple rentals if the taxpayer chooses to treat them as a combined enterprise, with the understanding that commercial properties cannot be grouped with residential properties) will rise to the level of a Section 162 trade or business if: - **Under Penalties of Perjury**
  - separate books and records are maintained for each rental activity (or the combined enterprise if grouped together),
  - 250 hours or more of "rental services" are performed per year for the activity (or combined enterprise), and
  - the taxpayer maintains contemporaneous records, including time reports or similar documents, regarding
    - hours of all services performed,
    - description of all services performed,
    - dates on which such services are performed, and
    - who performed the services.

Step 1: The Section 162 Trade or Business Requirement

- For these purposes, rental services include advertising to rent, negotiating and executing leases, verifying tenant applications, collection of rent, daily operation and maintenance, management of the real estate, purchase of materials, and supervision of employees and independent contractors.

Step 1: The Section 162 Trade or Business Requirement

- A taxpayer can't use the safe harbor for any property rented on a *triple net basis*.
  - Because the building owner bears little of the responsibility of operating the building, the IRS has viewed the ownership of real estate rented on a triple-net basis as akin to holding stock, and it has treated the property as an investment rather than a Section 162 trade or business (See *Neill* and *Rev. Rul. 73-522).*

Step 1: The Section 162 Trade or Business Requirement

- Consider the following:
  - *A owns 20 large commercial properties through 20 separate limited liability companies. A also owns a management company that oversees all 20 properties, and he works full time seeking tenants, negotiating leases, and handling the various needs of the buildings' occupants. Each building, however, is rented to its tenants on a triple net basis. The buildings generate $5 million in net rental income annually, and A spends over 2,000 hours each year managing his combined rental business.*
- A is in the trade or business of owning and managing rental real estate. A's activity is regular and continuous and clearly entered into for profit.

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Step 1: The Section 162 Trade or Business Requirement

- The regulations require the Section 162 trade or business standard to be met for each *separate activity* of the taxpayer. A business cannot be aggregated unless it first satisfies the Section 162 standard.
- This creates a problem for A. When viewed globally, it is clear that managing 20 large commercial properties is a trade or business and would surely be treated as such if they were conducted through a single entity. Under Section 199A, however, A's properties must be evaluated separately, and when they are, the triple net nature of each lease may preclude A from treating *any* of the rentals as a Section 162 trade or business, and in turn, any of the rental income as eligible for the Section 199A deduction.

Step 1: The Section 162 Trade or Business Requirement

- The final regulations make clear that just because property rented on a triple net basis can't use the safe harbor, it doesn't necessarily prevent the taxpayer from arguing that the rental rises to the level of a Section 162 trade or business based on the facts and circumstances.

Step 1: The Section 162 Trade or Business Requirement - Self-Rentals

- The final regulations do provide one exception to the trade or business requirement for rentals:
  - A rental activity will be treated as a Section 162 trade or business if it is rented to a "commonly controlled" trade or business owned by the taxpayer.
  - Owner occupied or “self-rental” is granted de facto Section 162 status, even if the activity might not have otherwise satisfied that standard.
- To be "commonly controlled," the property must be rented to an individual or pass-through (no C corporation), and the same owner -- or group of owners -- must own 50% or more of both the property and business.
  - For these purposes, the 50% standard is measured by using the attribution rules of Sections 707 and 267, which is a departure from the proposed regulations.

Step 1: The Section 162 Trade or Business Requirement - 1099 Filings

- If you're going to argue that your rental is a trade or business, you'll have to *treat it like a trade or business.*
  - This means filing Forms 1099 and accepting that any mortgage interest is now "business interest," and is therefore subject to the new interest limitation rules of Section 163(j).

Step 2: Determine Qualified Business Income

- Once a taxpayer met Section 162 trade or business threshold, the taxpayer must determine the "qualified business income (QBI)" for each **separate** qualified trade or business.
- QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business that is effectively connected with the conduct of a business within the United States.
  - Think of QBI as the normal, operating income the business was designed to generate.

Step 2: Determine Qualified Business Income

- As a result, QBI does not include certain investment-related income, including the following:
  - Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, or any item *treated as capital gain or loss.* This last clause is important, because it means that a business owner's net Section 1231 gain -- which is generally taxed as capital gain under the chameleon rules of that section -- will NOT be included in QBI. However, if you have a net Section 1231 *loss*, the loss is treated as an ordinary deduction, and thus *will* reduce QBI.

199A- Who Can Take It?

- Individuals can take the deduction on their personal return for certain business income reported on their personal return
  - Most individuals who operate as a P.A., LLC, or Sole Proprietor should qualify
- If an individual's overall taxable income does not exceed $315,000 (married filing jointly) or $157,500 (single), then the deduction applies to ANY type of business
- If overall taxable income exceeds these thresholds, then the deduction is completely phased out for **specified service businesses** once taxable reaches $415,000 or $207,500

Specified Service Business

- Definition: A service trade or business is one involving the performance of services in the fields of health, law, **engineering, architecture**, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or **any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees**
  - Note: legislation carved out a special exception for engineering and architectural businesses so they will not be subject to the same limitations

Specified Service Business

- What is not SSTB:
  - Real estate brokers & agents
  - Real estate management
  - "Catch-all" resulted in VERY narrow definition
    - Basically limited to income received for endorsements; appearances; licensing or use of your personal image, likeness, name, signature, voice, trademark, or any other symbols of your identity

Services or Property Provided to a Specified Service Trade or Business

- The moment the statute was finalized, tax lawyers and CPAs scrambled to find ways to strip income OUT of a specified service business and into a business that was eligible for the 20% deduction.
  - "Cracking" involved removing a qualified business from an SSTB and having it charge a fee to the SSTB; for example, the owners of a law firm would purchase a building in a separate LLC and rent the building to the law firm. This would reduce the income in the law firm -- which isn't eligible for a 20% deduction anyway -- and move it to a rental activity, where it would be treated as QBI.

Services or Property Provided to a Specified Service Trade or Business

- The final regulations put a big damper on cracking, by providing that if a business rents property or provides services to a commonly controlled SSTB, the rental income or service income generated from the SSTB is treated as SSTB income as well.

Services or Property Provided to a Specified Service Trade or Business

- *Example*
  - *A and B own law firm AB. A and B purchase a building in AB LLC, and rents 70% of the building to the law firm. The building is the only asset the LLC owns. Even though the rental of real property is generally not treated as an SSTB, because the building is rented to a commonly-controlled SSTB (the law firm), 70% of the rental income is treated as being earned in an SSTB, and is not eligible for the 20% deduction.*

Services or Property Provided to a Specified Service Trade or Business

- In the proposed regulations, if a business rented more than 80% of its property or provided more than 80% of its services to a commonly-controlled SSTB, ALL of the income was converted into SSTB income, even if some of the income was generated from unrelated parties. The final regulations found that provision to be unduly harsh, and removed the 80% standard.

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How Does The Deduction Work?

- Taxpayers with overall taxable income of $315,000/$157,500 or less will qualify for the deduction
- Taxpayers with overall taxable income in excess of $415,000/$207,500 will qualify for the deduction if they do not have a specified service business, subject to other deduction limitations
- Taxpayers with overall taxable income between these limits will qualify for a deduction, but it may not be the entire 20% if they have a specified service business, and it may be subject to the other deduction limitations

How Does The Deduction Work?

- Where overall taxable income is $315,000/$157,500 or less, the deduction *per business* is equal to 20% of a business's QBI
- A net loss will carry forward and reduce qualified business income in future years

How Does The Deduction Work?

- Where overall taxable income is greater than those thresholds *and the business is not a specified service business*, then the deduction *per business* is equal to the **lesser of**:
  - 20% of QBI, OR
  - The **greater of**:
    - 50% of the W-2 wages of the business, OR
    - The sum of 25% of the W-2 wages PLUS 2.5% of the unadjusted basis immediately after acquisition of all qualified property
      - Qualified property = tangible property subject to depreciation that is used in the qualified trade or business at the close of the taxable year for which the "depreciable period" has not ended. This period is the later of 10 years after the property was first placed in service, or the last day of the last full year in the applicable recovery period that would apply to the property under § 168.

Example #1

- **Taxpayer organized as a sole proprietor (files a Schedule C) or LLC with less than $315,000 of overall taxable income, married filing jointly**
  - Assume the following:
    - Qualified Business Income of $200,000
    - Net Capital Gains of $25,000
    - Overall Taxable Income of $300,000
  - The deduction is the **lesser of**:
    - 20% of QBI ($200,000 x 20% = $40,000) OR
    - 20% of taxable income in excess of net capital gains ($300,000 - $25,000 = $275,000 x 20% = $55,000)
  - Result = **$40,000 deduction**

Example #2

- **Taxpayer organized as an S corporation with less than $315,000 of overall taxable income, married filing jointly**
  - Assume the following:
    - Business income of $200,000, with $50,000 of this income paid out in wages to the sole shareholder
    - Net Capital Gains of $25,000
    - Overall Taxable Income of $300,000
  - Qualified Business Income = $150,000 because wages do not qualify
  - The deduction is the **lesser of**:
    - 20% of QBI ($150,000 x 20% = $30,000) OR
    - 20% of taxable income in excess of net capital gains ($300,000 - $25,000 = $275,000 x 20% = $55,000)
  - Result = **$30,000 deduction**

Example #3

- **Non-specified service business where taxable income is over $415,000, married filing jointly**
- Assume the following:
  - Qualified Business Income of $450,000
  - W-2 wages of $125,000
  - Net Capital Gains of $50,000
  - Qualified Property Basis of $2,000,000
  - Taxable Income of $600,000

Example #3

- Step 1: 20% of qualified business income - $450,000 x 20% = $90,000
- Step 2: 50% of W-2 wages - $125,000 x 50% = $62,500
- Step 3: 25% of W-2 wages [$125,000 x 25% = $31,250] plus 2.5% of qualified property basis [$2,000,000 x 2.5% = $50,000] = $81,250
- Step 4: Greater of Step 2 or Step 3 = $81,250 (Step 3)
- Step 5: Lesser of Step 1 or Step 4 = $81,250 (Step 4)
- Step 6: 20% of taxable income reduced by net capital gain - $600,000 - $50,000 = $550,000 x 20% = $110,000
- Step 7: Lesser of Step 5 or Step 6 = $81,250
- **The allowable deduction is $81,250**

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PLANNING FOR THE QUALIFIED BUSINESS INCOME DEDUCTION

Choice of Entity

- Consider using sole proprietorships (or SMLLCs) and partnerships to maximize the deduction if TI under $315K
  - Corporations are required to pay reasonable compensation
  - Owners' wages and guaranteed payments are not eligible for the deduction
  - Owner's of sole proprietorships/SMLLCs do not take a wage and there are no reasonable guaranteed payment rules

Aggregation of Commonly Controlled Businesses

- Aggregation under Section 199A can only be done when the following requirements are met:
  - Each business to be aggregated rises to the level of a Section 162 trade or business.
  - The same person or group of persons, directly or indirectly, own 50% or more of each business to be aggregated.
    - For S corporations, the ownership is measured by reference to the outstanding stock;
    - For partnerships, it is measured by reference to the interest in capital or profits in the partnership.
  - The attribution rules of Sections 267 and 707 apply for these purposes.
  - The final regulations make clear that to be considered part of a "group" of owners, the same people do not need to own an interest in EACH entity being considered for aggregation.

Aggregation of Commonly Controlled Businesses

- Requirements cont'd
  - The "control test" is met for the "majority" of the tax year, which MUST INCLUDE THE LAST DAY OF THE TAX YEAR.
  - The businesses share the same tax year.
  - None of the businesses may be SSTBs.
  - The businesses to be aggregated must satisfy two of the following three factors:
    - They must provide products, services, or property that are the same or customarily offered together;
    - They must share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; or
    - The businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group.

Aggregation of Commonly Controlled Businesses

- If you elect to aggregate, you determine your share of QBI, W-2 wages, and UBIA for the aggregated businesses before computing the deduction.

Aggregation of Commonly Controlled Businesses

- A taxpayer may elect to group some activities while leaving others alone. As a result, this aggregation regime more closely resembles the "slice and dice" grouping rules of Section 1.469-4, as opposed to the "all or nothing" grouping regime for real estate professionals.

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BUSINESS TAX CHANGES

Depreciation and Cost Recovery

- The Act allows taxpayers to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 instead of 50% bonus depreciation
- Eligible property includes **new and used property**, repealing the current requirement that the original use of the property begin with the taxpayer

Depreciation and Cost Recovery

- After 2022 a phased-out bonus depreciation percentage is allowed over the next five years:
  - 80% for property placed in service after Dec. 31, 2022 and before Jan. 1, 2024
  - 60% for property placed in service after Dec. 31, 2023 and before Jan. 1, 2025
  - 40% for property placed in service after Dec. 31, 2024 and before Jan. 1, 2026
  - 20% for property placed in service after Dec. 31, 2025 and before Jan. 1, 2027

Section 179 Expensing

- The 179 limitation on the amount that could be expensed is increased for eligible property placed in service for tax years beginning after December 31, 2017 to $1 million.
- The phase-out amount is increased from $2 million to $2.5 million
- Both amounts are indexed for inflation after 2018

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Section 179 Expensing

- New and used property qualifies as before
- The definition of eligible 179 property is expanded to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service:
  - Roofs
  - Heating, ventilation, and air-conditioning property
  - Fire protection and alarm systems
  - Security systems

Qualified Improvement Property

- The Act consolidates what was qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property
  - Eligible for Section 179
  - Possibly 15 year and bonus depreciation

Entertainment Expenses

- No deduction after 2017 is allowed with respect to:
  - An activity generally considered to be entertainment, amusement or recreation,
  - Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or
  - A facility or portion thereof used in connection with any of the above items
- Cost of meals incurred related to entertainment are also not deductible

Entertainment Expenses

- Entertainment includes any activity of a type that is generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs and sporting events, and on hunting, fishing, vacation, and similar trips
- The exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions) is repealed

Entertainment Expenses Still Deductible

- Entertainment expenses that are treated as compensation to an employee-recipient
- Expenses for recreational, social, or similar activities and related facilities primarily for the benefit of employees who are not highly compensated employees including
  - Christmas party
  - Annual picnic
  - Summer outing

Business Meals

- Meals paid for on business travel remains 50% deductible
- Business meals continue to be 50% deductible for meetings with customers and clients, provided the venue is not considered entertainment
- For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the provision expands the 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer
  - After 2025 these on-site meals will not be deductible

Employee Parking

- Employers have provided employees with parking at the workplace for many years without a tax cost. It has been considered a non-taxable fringe benefit and rightly so.
- **Under recent IRS guidance in Notice 2018-99 (released December 10, 2018), most every employer, including tax-exempt organizations, will have tax consequences to consider related to providing employee parking.**

Employee Parking

- When TCJA changed the law related to employee parking, most thought this would be an issue if an employer was paying a third party for employee parking.
- Under the new law, a for-profit employer is not allowed to deduct expenses related to providing employee parking and tax-exempt organization employers must treat the amount paid for employee parking expenses as unrelated business taxable income (UBTI) and will pay an income tax if the amount of employee parking expenses exceeds $1,000.

Employee Parking

- There are two notable exceptions to the disallowance rule.
  - First, is if the parking benefit is included in the taxable wages of the employees.
  - Second, is if that parking is primarily (greater than 50%) for the general public and not primarily for employees.

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QUESTIONS?

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