



Hertzbach & Company, P.A.

Tax Reform Update and Q&A Session

October 18, 2018

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This presentation has been prepared for informational purposes only, and is not intended to or should be relied upon for tax, legal and accounting advice. Readers should consult their tax advisors concerning the application of tax laws to their particular situations.

Objectives and Agenda

- Refresher on Tax Reform 2018 and beyond
- Discuss current status of Tax Reform and guidance trends
- Review recent guidance related to meals and entertainment
- Discuss changes in accounting methods affecting contractors
- Discuss new guidance affecting depreciation and new pass-through entity deduction
- Discuss several action items affecting pass-through businesses
- Questions and hopefully answers

Tax Reform Refresher

- Tax Cuts and Jobs Act passed December 22, 2017
- Sweeping Changes to Individual and Business tax changes
 - Elimination of deductions (business and non-business)
 - Reduction in marginal tax rates
 - New limitations (interest/taxes) and some new deductions (20% deduction)
- Majority of modifications and new provisions effective 1/1/18 (special rules for FYE taxpayers)
- Most, if not all, **C corporation** provisions made permanent
- Most, if not all, **Individual** tax provisions subject to phase out (2026)

Tax Professionals and Taxpayers alike left with many questions

Tax Reform Comparison at a Glance

Issue	Previous law (2017)	TJCA of 2018
Business Income -- pass-through deduction	39.6% + possible 3.8% NIIT	29.6% percent (at highest individual rate of 37%) + possible 3.8% NIIT
Business Income – no pass-through deduction	39.6% + possible 3.8% NIIT	37% + possible 3.8% NIIT
Interest expense	Fully deductible	Generally, limited to 30% EBITDA/EBIT. C/F of limited deductions. Possible exceptions and election out (with cost)

Tax Reform Comparison at a Glance

Issue	Previous law (2017)	TJCA of 2018
Methods of accounting (long-term and non-long term contracts)	Accrual - \$5 mil or less C corps (\$10 mil for others) POC - \$10 mil or less (non-LTCs)	Increased to \$25 mil or less for most businesses
Depreciation expense	27.5 years for residential real property, 39 years for nonresidential real property	Same, unless electing out of 30% interest limitation; Election = ADS life (30 vs. 27.5 yrs or 40 vs. 39 yrs)
Bonus depreciation	50% allowed for most original use assets besides buildings	100% for certain assets; including used. Sept 27, 2017 effective
Highest marginal capital gain tax rate	20% + 3.8% NIIT	20% + 3.8% NIIT

Tax Reform Comparison at a Glance

Issue	Previous law (2017)	TJCA of 2018
Carried interest (for distributive items of long-term capital gain)	20% + 3.8% NIIT (1-year hold required)	20% + 3.8% NIIT (potential 3-year hold would be required)
Corporate tax rate	35%; 20% AMT	21% (starting in 2018); no AMT
Active loss limitations offsetting other income items	No limitations	Single taxpayers limited to \$250,000, MFJ taxpayers limited to \$500,000 with C/F
1031 exchanges	Real and personal property allowed for like kind exchanges	Only real property allowed for like kind exchange

IRS Issues Guidance – Slow and Steady Wins the Race

Issue Date	Reference	Guidance Summary
3/1/18	Notice 2018-18	Related to Partnership Interests Held in Connection with Performance of Services. Specifically, exception for “corporations” does not include S corporations
4/2/18	Notice 2018-28	Initial Guidance under Section 163(j) for Tax Years Beginning After December 31, 2017 (interest limit)
4/12/18	Notice 2018-35	Changes in Accounting Periods and Method of Accounting (Transitional Guidance for Section 451 Advance Payments)

IRS Issues Guidance – Slow and Steady Wins the Race

Issue Date	Reference	Guidance Summary
4/16/18	Notice 2018-38	2018 Fiscal Year Blended Tax Rates for Corporations
6/20/18	Notice 2018-48	Designated Qualified Opportunity Zones under IRC 1400Z-2
5/23/18	Notice 2018-54	Guidance on Certain Payments Made in Exchange for State and Local Tax Credits

IRS Issues Guidance – Slow and Steady Wins the Race

Issue Date	Reference	Guidance Summary
8/8/18	Notice 2018-64	Notice 2018-64 – Methods for Calculating W-2 Wages for Purposes of Section 199A (20 Percent Pass-Through Deduction)
8/9/18	Prop Reg IRC 965	Transition Tax under Section 965
8/8/18	Prop Reg IRC 168	Additional First Year Depreciation Deduction
8/16/18	Prop Reg IRC 199A	Qualified Business Income Deduction

IRS Issues Guidance – Slow and Steady Wins the Race

Issue Date	Reference	Guidance Summary
8/27/18	Prop Reg IRC 170	Contributions in Exchange for State and Local Tax Credits
9/24/18	Notice 2018-71	Employer Credit for Paid Family and Medical Leave
10/3/18	Notice 2018-76	Expenses for Business Meals

Still Waiting for IRC 163(j) Business Interest Guidance...So What Do We Know?

- Limitation does not apply to any trade or business with average annual gross receipts of \$25 million or less
 - Test is based on control group testing under IRC 52(a) and (b) – commonly owned/controlled businesses treated as one
 - No specific definition of what a trade or business is
 - Application on a year by year basis
- Limitation initially applied at entity level; but provision takes effect at owner level
 - Interest suspended at partner/owner level
 - Distributive share is subject to double counting restriction
 - Excess Business Income calculation and allocation

Still Waiting for IRC 163(j) Business Interest Guidance...So What Do We Know?

- Election out for real estate trades or businesses, with consequence
 - Election applies to current and future years until revoked
 - Likely will require mid-life change in asset depreciation to ADS
- IRS Guidance – Current and Planned
 - Regulations to apply new rules: Aggregation, disclosure, carry over/forward rules, examples and computations, basis adjustments
 - Notice clarifies partners cannot double count certain items at owner level (business interest income to extent exceeds partnership expense; only excess business taxable income from partnership)
 - DISCLOSURE, DISCLOSURE, DISCLOSURE

Expenses for Meals and Entertainment

Entertainment Expenses

- No deduction allowed for:
 - Any activity considered entertainment, amusement, or recreation
 - Membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes
 - Facility or portion thereof used in connection with any of the above items
- Exceptions (deduction allowed):
 - Expenses includible as compensation to payee
 - Office / holiday parties

Expenses for Meals and Entertainment

- Welcome Clarification – Notice 2018-76
 - Most business meals still eligible for 50% deduction
 - Between employee and employer
 - Taxpayer and customer, business associate, prospective customer, etc.
 - Requirements
 - Ordinary and necessary incurred in trade or business
 - Not Lavish or extravagant
 - Taxpayer/employee of must be present
 - Current/Potential customer, client, consultant, or similar
 - Separate purchase from an entertainment activity

Accounting Method Changes for Contractors

- Increased average annual gross receipts (three prior tax years) threshold to \$25 million for the following accounting methods:
 - **Cash method**
 - **Accounting for long-term contracts**
 - Accounting for inventories
 - UNICAP 263A

Accounting Method Changes for Contractors

- \$25 Million Gross Receipts Test
 - Three year averaging (as of 1st day of current tax year)
 - Required use of Accrual/POC -- Increased from \$10 million (\$5 million for C Corps)
 - Long-Term Contracts – applied on a cut-off basis for most
 - Aggregation rules of related businesses still apply
- Long-Term Contracts – Documentation
 - Contract by contract analysis
 - What is/was my exempt contract method?
 - What is an exempt contract?
 - When was a contract entered into?

Depreciation Changes and New Guidance

1. Changes in Bonus Depreciation effective September 27, 2017
2. New Rules ADS lives for Residential and Non-residential property
3. Modifications to Qualified Improvement Property (QIP)– 15 year life (maybe)
4. Expanded expensing of certain Real Property under Section 179 Rules

- 100% AFYD property PIS after 9/27/18; now including used property
- New ADS lives – 20 yr, 30 yr, 40yr for QIP, residential and non-residential property
- IRS Clarification of QIP bonus eligibility (limited)
- Increased \$1 million expensing limit

Depreciation Changes and New Guidance

- 100% bonus depreciation 2018-2022; 2023-2026 phase out 20% each year
- Technical correction still needed for 15 yr life related to Qualified Improvement Property
- Senate Republicans wrote to Treasury clarifying intention that QIP should have a 15 year life
- Election out of 100% bonus depreciation
- Clarification of Used Property
- Partnership Specific Provisions

Depreciation Changes and New Guidance

- Partnership Specific Provisions

- Not Eligible

- IRC 734(b) basis adjustments – not partner specific property
 - Remedial allocations under IRC 704(c)
 - Contributed property with zero adjusted tax basis
 - Property distributed to partner under IRC 732

- Eligible

- IRC 743(b) basis adjustments – partner specific property
 - Assets contributed in same year originally acquired/PIS

Depreciation Changes and New Guidance

- Electing Real Property Trades or Businesses
 - ADS and effect on bonus
 - Non-QIP assets still eligible for bonus depreciation
 - 20% Pass-Through Deduction planning opportunity???
- Real Estate
 - Acquisition of “new” properties (5, 7, 15 year assets)
 - Cost segregation studies
 - Acquisition of operating businesses

20 Percent Pass-Through Deduction

- Generally a deduction of 20% of qualified domestic business income from a sole proprietorship, partnership, or S corporation
- Deduction reduces taxable income but not AGI (potential state implications)
- 3 Applicable Limitations can apply
 - Qualified Business Income
 - Wages or wages plus certain property
 - Overall Taxable Income (with adjustment)
- Reminder: Watch out for Specified Service Businesses (SSTB)

20 Percent Pass-Through Deduction

- Overall Calculation
- First must determine for each business separately, lesser of:
 - 20% of QBI of a taxpayer's qualified business; or
 - Wage/Property Limitation (when over TI thresholds)
 - 50% of W-2 Wages with respect of the trade or business or
 - 25% of W-2 Wages plus 2.5% of unadjusted basis immediately after acquisition of qualified property (UBIA)
- Then, combine the computed QBI amounts above
- Finally, deduct the lesser of:
 - Combined QBI; or
 - 20% of Taxable (with adjustments)

20% Deduction – What did we Learn/Receive from IRS Regulations?

- The calculation really is as complicated as we thought it was
- Questions in Calculating Qualified Business Income:

Question	Answer
Do suspended losses prior to 2018 reduce QBI?	No
Does a FYE taxpayer with FYE in 2018, have QBI for its entire 2018 FYE?	Yes
Are Guaranteed Payments paid to a partner included as QBI?	No, but will reduce it
What about Net Operating Losses incurred before 2018? Do they reduce QBI?	No

20% Deduction– What did we Learn/Receive from IRS Regulations?

More Questions	Answer
Are pre-2018 IRC 481(a) adjustments included in QBI? What about post 2018 IRC 481(a) adjustments?	No Maybe
Can taxpayers aggregate two trades or business when determining QBI?	In certain cases
What about IRC 751 gains/losses, do they count toward QBI?	Generally, yes
Does the deduction reduce a shareholder/partner's basis in interest?	No
Can wages from one business be used to calculate QBI of another?	Generally, no, but can depend
Do losses of one business negatively affect QBI of another?	It can

20% Deduction– What did we Learn/Receive from IRS Regulations?

Even More Questions	Answer
Was clarification provided as to what is a Specified Service Business? <i>Comment: some good news here!!!</i>	In general, yes
Did the IRS provide clarification regarding the IRC 707(a)(1) statement and exclusion from QBI?	Yes, but there are still open questions
Any special rules to be aware of for calculating unadjusted basis immediately after acquisition of qualifying property (UBIA)?	Yes
Any there any particular rules pass-through entities should be concerned about?	Of Course

20% Deduction – Specified Service Trade or Business

- What is a Specified Service Trade or business?
 - ...any trade or business involving the performance of services in one or more of the following fields: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, dealing in securities, 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.
- General contractors, subcontractors/trades and construction management trades or businesses are not SSTBs

20% Deduction – Disclosure, Disclosure, Disclosure

If nothing else is taken away today

...RPEs must determine and report to their owners and IRS, QBI, W-2 wages, the UBIA of qualified property for each trade or business directly engaged in, and whether any of its trades or businesses are specified service trades or businesses (SSTBs). RPEs must also determine and report qualified REIT dividends and qualified PTP income received directly by the RPE. Each RPE must report this information on or with the Schedules K-1 issued to the owners...

Note: this is a requirement on all flow-through returns, regardless if SSTB or if wage or property limits apply.

20% Deduction – Disclosure, Disclosure, Disclosure

- Why is disclosure so important?
 - IRS added a statement in the regulations – presumption of Zero
- Format of Disclosure – not known at this point but hoping IRS will replace old IRC 199 codes with new IRC 199A codes
- What do we need tell our owners?
- Anything else?

20% Deduction – Unadjusted Basis Immediately after Acquisition

- Again, No disclosure by a RPE = Presumption is UBIA of qualified property is zero
- What is qualifying property?
- What did we get from Prop. Regs.?
 - Disclosure, Disclosure, Disclosure of UBIA of each trade or business
 - Cost of property is determined under IRC 1012 (carryover basis under IRC 721 and IRC 351 transactions apply)
 - IRC 743(b) or 734(b) basis adjustments do not count
 - Later additions/improvements treated as separate property (consistent with IRC 168 asset disposition rules)
 - Anti-abuse rules apply to avoid basis creation transactions
 - Disclosure is based on each item of qualified property; no current clarification of an aggregation approach

20% Deduction – Unadjusted Basis Immediately after Acquisition

- Anything else?
 - UBIA for partnerships
 - Fully depreciated assets but still qualified property
 - Affect of Section 179 expense and bonus depreciation
 - Assets of 1031 exchanges or 1033 conversions
 - What about pre-2018 technical terminations?

20% Deduction – Aggregation of Businesses

- Individuals may aggregate qualifying trades or businesses and treat them as a single business
- Requirements to aggregate
 - Same person or group of persons, directly or indirectly, owns 50% or more of each trade or business (considers certain family relationships)
 - 50% ownership requirement is met for a majority of the tax year
 - All items of each business are reported on returns with the same tax year,
 - No specific service businesses; and
 - Trade or businesses must satisfy at least two of the following three factors to demonstrate integration
 - Provide products and services that are the same or customarily offered together (e.g., a gas station and a car wash);
 - Share facilities or significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources; and/or
 - Operate in coordination with, or reliance upon, one or more of the businesses within the group

20% Deduction – Aggregation of Businesses

Question	Answer
Can entities aggregate or just individuals/trusts?	Individuals/Trusts only, IRS has requested comments for entities
Can taxpayers use same groupings used for IRC 469 purposes?	No, 199A rules are different
Can groupings change from year to year?	No, unless there is change if facts and circumstances
Must groupings be disclosed?	Yes and disclosure is annual.
Does the taxpayer have to own 50% of each trade or business?	No, same person or <u>group</u> of persons must. IRS does not mandate disclosure. Minority owner may ask entity.

20% Deduction – W-2 Wages

- General Rule

The W-2 wage limitation is applied separately for each trade or business, meaning each business must have wages to generate a deduction on QBI

- What does this mean?

- Separate employees
- Separate payroll filings
- Separate W-2 filings

- What about commonly controlled businesses?

20% Deduction – W-2 Wages

- Three Step Process
 - Calculate wages
 - Allocate wages to each business
 - Allocate wages to QBI
- Calculate wages - IRS Provided 3 Methods in Notice 2018-64
 - Unmodified Box Method
 - Modified Box 1 Method
 - Tracking Wages Method

20% Deduction – W-2 Wages

- Allocating wages to each business
 - ...the portion of the W-2 wages allocable to each trade or business is determined in the same manner as the expenses associated with those wages are allocated among the trades or businesses under §1.199A-3(b)(5)...
- Based on a reasonable method that is consistently applied from year to year
 - Information readily available
 - Allocation used in internal records
 - Ratable apportionment
 - IRS prescribed simplified methods??

What to Watch Out For

- Additional Tax Reform Guidance
 - Comments and Final Regulations
 - Proposed Regulations related to Business Interest and Excess Loss rules
- The Protecting Family and Small Business Tax Cuts Act of 2018 (House passed in Sept 2018)
- The Family Savings Act of 2018
- New Forms, Schedules, Instructions, etc.

Thank you for your time.

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