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The 2017 Tax Reform Act: What Lawyers Should Know

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Agenda

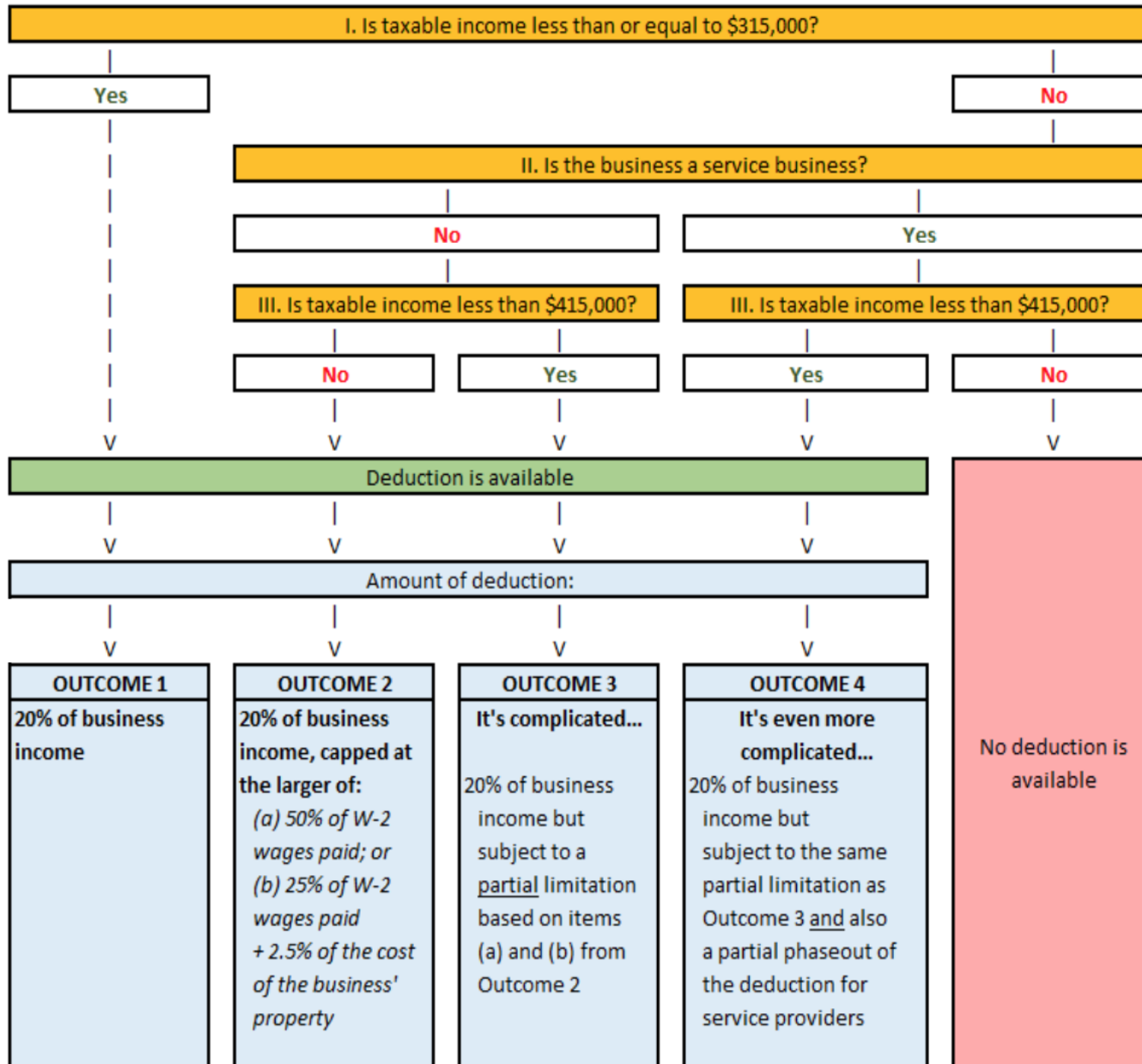
- I. 20% deduction under Sec. 199A
- II. Depreciation / like-kind exchange rule changes
- III. New rules for M&E expenses
- IV. Qualified Opportunity Zones
- V. Other observations
 - Non-deductibility of legal expenses
 - Estate clawback
 - New centralized partnership audit regime (from 2015 act)

I. 20% deduction under Sec. 199A

Overview of the Pass-Through Deduction of § 199A

- The Tax Cuts and Jobs Act (“TCJA”) created a 20% deduction from income for businesses operating as “pass-through” entities
 - These include businesses operated as sole proprietorships, partnerships, S corporations, and limited liability companies taxed as partnerships
 - *Not* C corps
- **The heart of planning is managing: (1) Taxable Income; and (2) the Wage and Capital Limitation for Qualified Trades or Businesses**
- **Attorneys don’t qualify... UNLESS THEY DO.**
(and your taxable income is the key)

Section 199A Deduction Summary



2019 (MFJ): \$321,400 – \$421,400

What is a Qualified Trade or Business?

- **Reg. § 1.199A-1(b)(14):**
 - a trade or business under section 162 other than the trade or business of performing services as an employee
 - In addition, rental or licensing of tangible or intangible property (rental activity) that does not rise to the level of a section 162 trade or business is nevertheless treated as a trade or business for purposes of section 199A, if the property is rented or licensed to a trade or business conducted by the individual or an RPE which is commonly controlled under §1.199A-4(b)(1)(i) (The same person or group of persons, directly or indirectly, owns 50 percent or more of each trade or business)

Specified Service Trade or Business

- Health
- **Law**
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Investing and investment management
- Trading in securities, commodities, or partnership interests
- Dealing in securities, partnership interests or commodities
- 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

“Reputation/Skill” Narrowly Defined

- Preamble to the final 199A regs:
 - “The final regulations retain the proposed rule limiting the meaning of the reputation or skill clause to fact patterns in which an individual or RPE is engaged in the trade or business of receiving income from **endorsements, the licensing of an individual’s likeness or features, and appearance fees.**”

§ 199A Deduction – Simple Examples

- Chris (unmarried) is a solo practitioner earning net fees of \$100k from the practice
- After allowable deductions not relating to the business, Chris' TI = \$81k
 - His taxable income is below \$315k so *we don't care that he is an attorney*
- Chris' 199A deduction = \$16,200 → the lesser of:
 - i. 20% of Chris' QBI from the business ($\$100,000 \times 20\% = \$20,000$); and
 - ii. 20% of Chris' TI for the taxable year ($\$81,000 \times 20\% = \$16,200$).
- Fed tax paid with no 199A deduction = **\$13,760**
- Fed tax paid with 199A deduction of \$16,200 = **\$10,196**
- Total tax savings = **\$3,564**

| Individual Tax Brackets under TCJA – Single filers | |
|--|-----------------------|
| 10% | \$0 - \$9,525 |
| 12% | \$9,526 - \$38,700 |
| 22% | \$38,701 - \$82,500 |
| 24% | \$82,501 - \$157,500 |
| 32% | \$157,501 - \$200,000 |
| 35% | \$200,001 - \$500,000 |
| 37% | \$500,001 + |

§ 199A Deduction – Simple Examples

- For Qualified T or B's with TI in excess of \$415,000 (MFJ), the deduction is limited to the greater of:
 - i. 50% of W-2 wages;
 - ii. 25% of W-2 wages + 2.5% of UBIA

...and it is **NOT** available for SSTBs like you

| Individual Tax Brackets under TCJA – Joint filers | |
|---|-----------------------|
| 10% | \$0 - \$19,050 |
| 12% | \$19,051 - \$77,400 |
| 22% | \$77,401 - \$165,000 |
| 24% | \$165,001 - \$315,000 |
| 32% | \$315,001 - \$400,000 |
| 35% | \$400,001 - \$600,000 |
| 37% | \$600,001 + |

§ 199A Deduction – Simple Examples

- **Ex1:** Mark (married) owns several duplexes in, I Regret Buying Rentals in a College Town, LLC
 - The LLC generates \$500k of QBI
 - Some of the duplexes have fully depreciated
 - The total UBI for all the duplexes = \$500k
 - Mark has 2 employees that manage the duplexes; W-2 wages = \$60,000
 - Mark's QBI deduction = **\$30,000**
 - Lesser of (a) \$100,000 ($\$500k \times 20\%$); OR (b) greater of: (i) \$30k ($\$60k \times 50\%$) or (ii) \$27,500 ($(\$60k \times 25\%) + (\$500k \times 2.5\%)$)
 - Fed tax paid with no 199A deduction = **\$126,378**
 - Fed tax paid with 199A deduction of \$30,000 = **\$115,878**
 - Total tax savings = **\$10,500**

SSTB Income

- Reg. § 1.199A-5(c)(2): if a T or B has 50 percent or more common ownership with an SSTB, to the extent that the T or B provides property or services to the commonly-owned SSTB, the portion of the property or services provided to the SSTB will be treated as an SSTB (meaning the income will be treated as income from an SSTB)
- **Ex:** Susan, a lawyer, owns a practice and also owns the office building. Susan rents half the building to the law practice and half the building to unrelated persons. The renting of half of the building to the law practice will be treated as an SSTB, but the other half is not.

Pooled Real Estate Opportunities for Service Providers

- **Ex1:** Mark & Chris, LLC; Law Practice; 50/50 interests;
 - Buy building that costs \$1mm and hold it in Mark & Chris Building, LLC
 - Lease building to Mark & Chris, LLC for \$100k per year
 - mirrored ownership in Mark & Chris Building, LLC (50/50)
 - All income from Mark & Chris Building, LLC is SSTB income
 - If Taxable Income \leq \$315,000 (MFJ) → We do not care
 - If Taxable Income $>$ \$315,000 (MFJ) → We do care

SSTB Income

- **Ex2:** Same as Ex1. Furthermore, Nathan & Sam, LLC are in the exact same situation as Mark & Chris, LLC. Also, Bill & Sara, LLC are in the exact same situation (SSTBs, 50/50 interests, etc.)
 - Each LLC bought a building that costs \$1mm and hold it in a separate LLC from their service practice and lease their buildings to their service practices for \$100k per year each
 - If all three entities that hold the buildings join forces and combine their buildings into 1 LLC as opposed to 3 separate LLCs, then none of the rental income will be SSTB income (common ownership is 33% < 50%)

Renewed Importance of Reviewing Reasonable Compensation

- S-Corp shareholders are not subject to self employment taxes on S-corp earnings (different from pass-through entities taxed as partnerships)
- IRS requires a reasonable salary be taken with the balance of earnings escaping self-employment taxation
- Many methods and factors to consider when determining reasonable compensation, no IRS safe-harbors exist
- In the advent of a new 20% pass-through deduction, the incentive to understate owners salary is potentially increased

Before the TCJA

| | <u>Tax Return</u> | <u>Market Value</u> |
|-------------------------------------|-------------------|---------------------|
| Sales | \$500,000 | \$500,000 |
| Cost of Goods Sold | (250,000) | (250,000) |
| Owners Salary | (30,000) | (100,000) |
| Taxable Net Income | <u>\$220,000</u> | <u>\$150,000</u> |
| Self Employment Tax Base Difference | 70,000 | |
| Self Employment Tax Rate | 15.30% | |
| Self Employment Taxes Saved | <u>10,710</u> | |

After the TCJA

| | Tax Return | Market Value |
|---|------------|--------------|
| Sales | \$500,000 | \$500,000 |
| Cost of Goods Sold | (250,000) | (250,000) |
| Owners Salary | (30,000) | (100,000) |
| Taxable Net Income | \$220,000 | \$150,000 |
| | | |
| Self Employment Tax Base Difference | 70,000 | |
| Self Employment Tax Rate | 15.30% | |
| Self Employment Taxes Saved | 10,710 | |
| | | |
| Additional "Profit" from a Qualified Business | 70,000 | |
| 199A Deduction | 20.00% | |
| Reduction in Taxable Income | 14,000 | |
| Marginal Tax Rate | 24% | |
| Additional Income Tax Savings | 3,360 | |

Words of Caution and Planning Opportunities

- There are rumors that the IRS intends to make reasonable compensation an area of increased focus in 2019.
- Threshold for applying penalties for understatement of tax with a 199A deduction reduced.
 - Substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - i) ~~10%~~ **5%** of the tax required to be shown on the return for the taxable year, or
 - ii) \$5,000.

Guaranteed Payments are BAD

- A guaranteed payment is a payment made by a partnership to a partner for services and that is determined without regard to the *net* income of the partnership
- Under I.R.C. § 199A(c)(4)(B), qualified business income does not include any guaranteed payment described in § 707(c) paid to a partner for *services rendered* with respect to the T or B
- A guaranteed payment paid by a lower-tier partnership to an upper-tier partnership retains its character as a guaranteed payment and is not included in QBI of a partner of the upper-tier partnership regardless of whether it is guaranteed to the ultimate recipient

Guaranteed Payments

- Partners who receive guaranteed payments from a partnership that generates QBI → increase their distributive share of QBI from that partnership by *foregoing their guaranteed payments in exchange for a priority allocation of partnership profits in the form of a preferred return*

 **Needs to be drafted in the operating agreement**

- Although this approach does not have the same economic result of a guaranteed payment (which is payable regardless of the partnership's income), in most cases, it should achieve a very similar economic result

Guaranteed Payments

- **Ex1:** A, B, and C (all single) are equal 1/3 partners in a law practice, ABC Law, LLC
 - ABC Law generates \$450k income
 - In exchange for services, each partner is paid a \$100k guaranteed payment → reduces ABC Law's TI to \$150k
 - Each partner receives a 20% deduction on \$50k → \$10k deduction under § 199A
 - Pay tax on \$140k (\$100k guaranteed payment + \$40k net income)
 - **Total tax savings under § 199A = \$2,400**

Guaranteed Payments

- **Ex2:** Same as Ex1 except that ABC Law amends its operating agreement to entitle each partner to 1/3 of the profits as opposed to a guaranteed payment
 - Each partner receives a 20% deduction on \$150k → \$30k deduction
 - Each partner pays tax on \$120k
 - **Total tax savings under § 199A = \$7,200**
 - **Additional tax savings of \$4,800**

II. Depreciation & like-kind exchange rule changes

Like-kind exchanges are for...REAL ESTATE ONLY

- Facts:
 - Bob trades his 2015 Chevy Suburban *used in his business* + \$30k cash for the 2019 Suburban
 - Bob has depreciated the 2015 vehicle to \$0 but it's still worth \$45K.
- Old rules: Like-kind exchange → no recognized gain on the trade. Bob depreciates the \$30K cash paid for the 2019 vehicle.
- New rules: Taxable sale. Bob realizes a \$45K gain on the sale of his 2015 vehicle. He depreciates the \$75K new vehicle.
- Bad result, but fear not...

Enter bonus depreciation

- 100% bonus depreciation available to Bob (so he can write off the \$75K vehicle to offset the \$45K gain he realizes)
- 100% bonus available through 2022, at which point it is scheduled to scale back for most assets:
 - 2023: 80%
 - 2024: 60%
 - 2025: 40%
 - 2026: 20%
- Used assets are now eligible

Also, enhanced Sec. 179 is available

- Bonus is applied to all assets placed in service within an IRS class life (i.e., it's a class-by-class determination)
- Sec. 179 is an asset-by-asset determination, which helps us to “fine-tune” taxable income
- Sec. 179 now available for components of *commercial* buildings
- Sec. 179 now available for equipment used in *residential* buildings (e.g., refrigerators, garage door openers, etc.)

WWWK

III. New Rules for M&E Expenses

I.R.C. § 274(a)(1)(A)

“In general no deduction otherwise allowable under this chapter shall be allowed for... an activity which is of a type generally considered to constitute entertainment, amusement, or recreation...”

General Requirements

50% Business Meals

Notice 2018-76 (October 3, 2018)

1. Ordinary and necessary business expense
2. Must not be lavish or extravagant
3. Taxpayer or employee of taxpayer must be present
4. Food provided to a current or potential customer, client, consultant, contact, etc.
5. If provided during an entertainment activity, value of meal must be clearly identifiable (purchased separately, or separately stated on bill)

M&E Under TCJA

Employee Meals Changes

| Expense Type | 2017 Expenses (Old Rules) | 2018 Expenses (New Rules) |
|---|-------------------------------|---|
| <p><i>Employee snacks and beverages treated as a de minimis fringe (non-taxable to employee)</i></p> <p><i>Example: Coffee, juice, bagels, donuts, provided in the breakroom</i></p> | <p><i>100% deductible</i></p> | <p><i>50% deductible 2018 - 2025</i></p> <p><i>Nondeductible after 2025</i></p> |
| <p><i>Employee meals provided for convenience of the employer</i></p> <p><i>Example: Lunch is provided to employees working on a Saturday or staying late to finish a project</i></p> | <p><i>100% deductible</i></p> | <p><i>50% deductible 2018 - 2025</i></p> <p><i>Nondeductible after 2025</i></p> |

M&E Under TCJA

What Hasn't Changed

| Expense Type | 2017 Expenses (Old Rules) | 2018 Expenses (New Rules) |
|---|-------------------------------|-------------------------------|
| <p><i>Meals and/or entertainment provided to employees and included in wages as a taxable fringe benefit</i></p> <p><i>Example: All expenses paid vacation w/ meals & entertainment package</i></p> | <p><i>100% deductible</i></p> | <p><i>100% deductible</i></p> |
| <p><i>Employee travel or other business meals</i></p> <p><i>Example: meals at an industry conference, training, or local chamber of commerce meeting</i></p> | <p><i>50% deductible</i></p> | <p><i>50% deductible</i></p> |
| <p><i>Office parties for Employees (not clients or prospects)</i></p> <p><i>Example: Holiday parties, annual picnics, etc.</i></p> | <p><i>100% deductible</i></p> | <p><i>100% deductible</i></p> |

Action Items and Key Takeaways

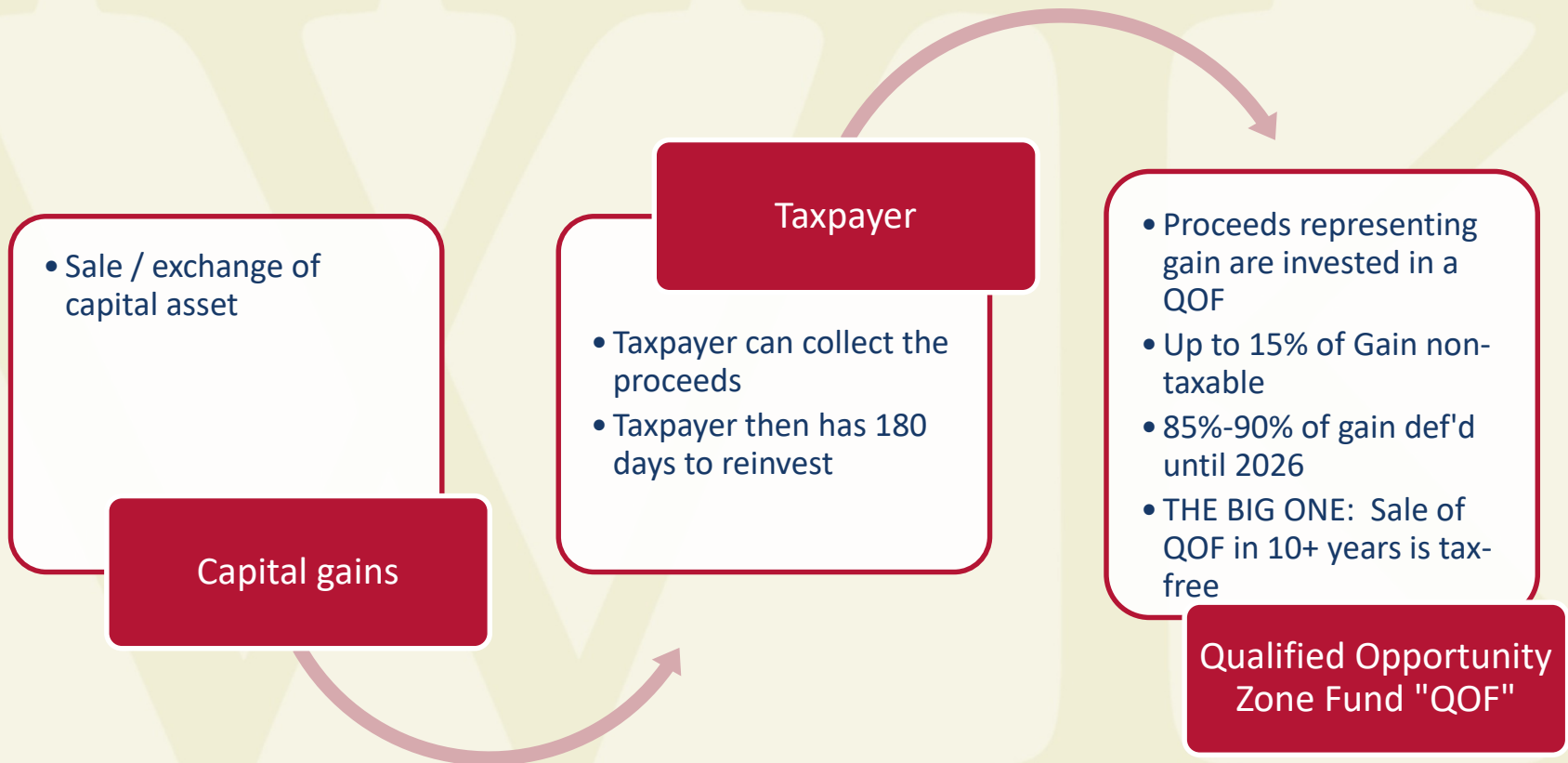
- Entertainment is no longer deductible; a separate account should be set up to specifically track entertainment type activities.
- Client/contact meals are still meals (and not entertainment) provided they meet the criteria for deductibility
- Be mindful of de-minimis fringe benefits and “convenience meals” as the deductibility has changed
- Throw more company-wide parties
(Not tax advice)

IV. Qualified Opportunity Zones

Overview

- Code Section 1400Z
- Provides four new tax incentives for reinvesting capital gains in designated QOZs
- Designed to promote investment in low-income communities primarily through real estate development and improvement

QOZ 101



BUT FIRST! SOME ACRONYMS!

- Qualified Opportunity Zone (QOZ)
- Qualified Opportunity Fund (QOF)
 - Qualified Opportunity Zone Property (QOZP)
 - Qualified Opportunity Zone Business (QOZB)
or
 - Qualified Opportunity Zone Business Property (QOZBP)

“So just to clear up the confusion, a QOF must invest in QOZP by either owning QOZBP directly or investing in a QOZB that owns QOZBP.”

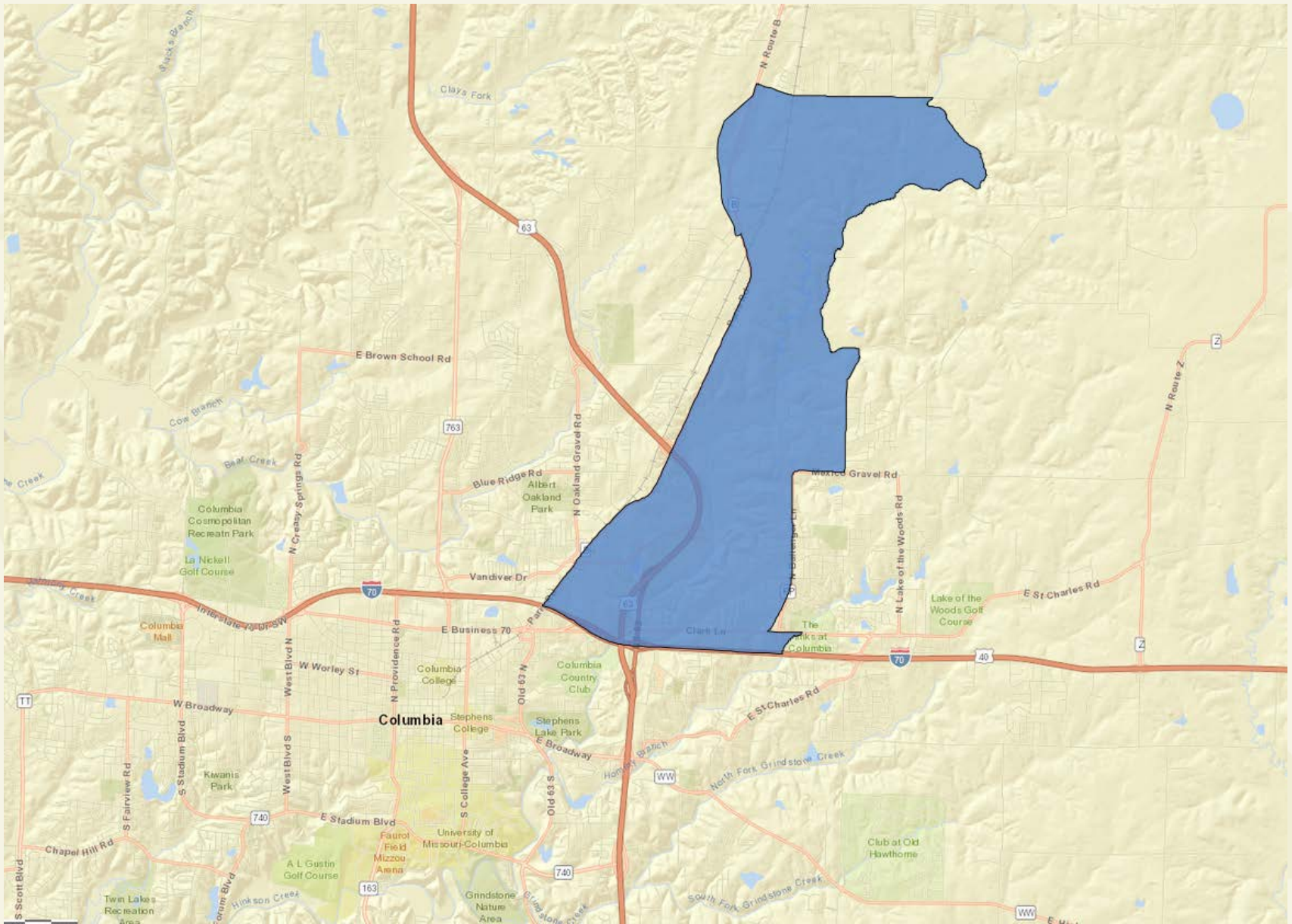
-Tony Nitti, Forbes

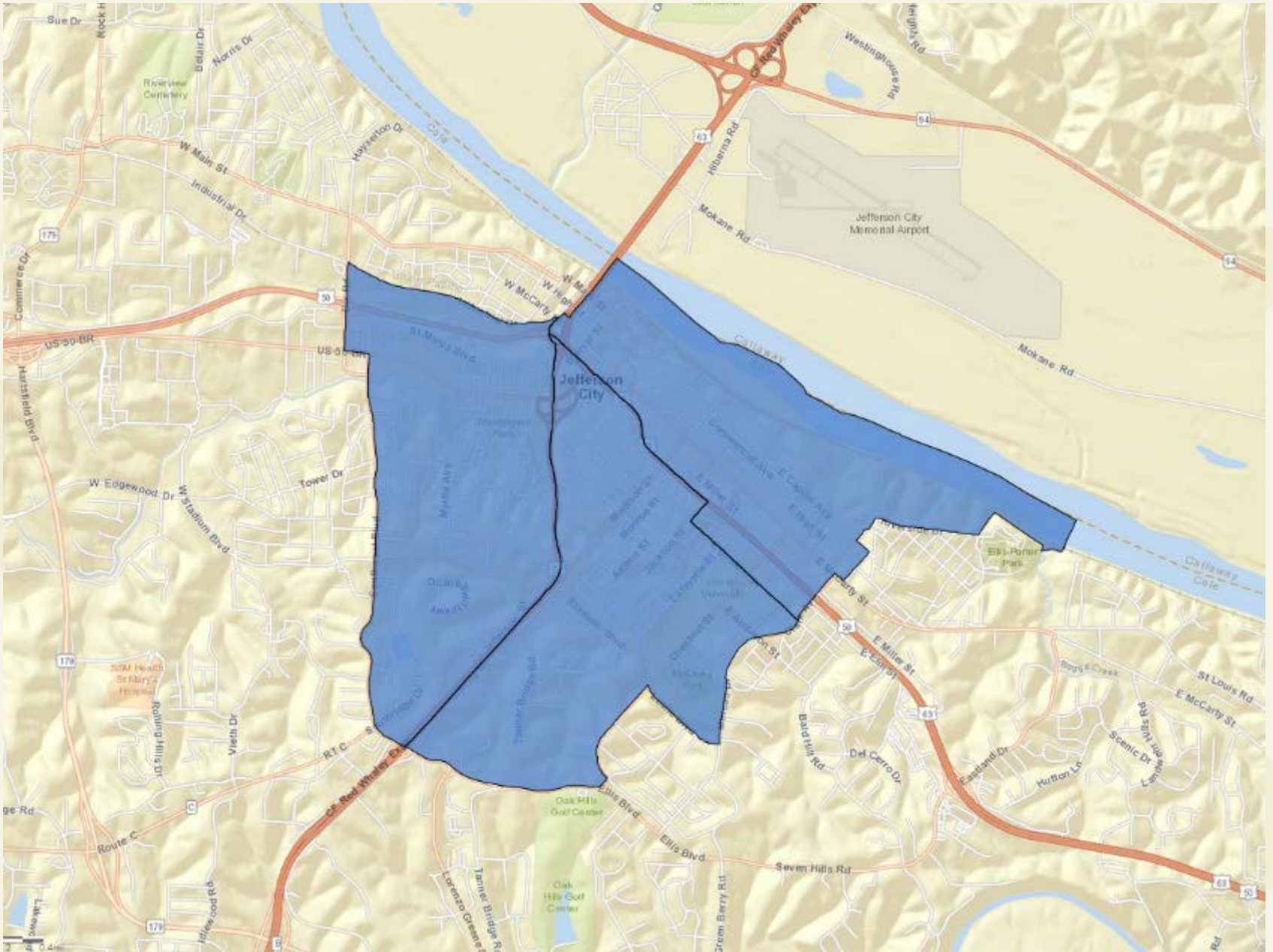
Order/Mechanics of Investment

1. Only equity investments made from capital gains qualify
2. Qualified Opportunity Fund (QOF) is formed and must be either a partnership or c-corporation (no S corporations)
3. Entity will self certify as a QOF (Form 8996)
4. Taxpayer invests capital gains in QOF in exchange for ownership (order of steps 1-3 is very important) within 180 days of realization.
Election to defer gain is made on individual tax return
5. QOF makes investment into QOZBP improvement (directly or indirectly) within 30 months
6. Many rules and open questions still exist

Benefits of Investing in an O-Zone

1. Deferral of the original gain recognized on the original sale of up to 8 years (all gains trigger on December 31, 2026, or earlier if sold)
2. Permanent exclusion of 10% of the original gain if held 5 years prior to December 31, 2026 (invest by December 31, 2021)
3. Permanent exclusion of an additional 5% of the original gain if held 7 years prior to December 31, 2026 (invest by December 31, 2019)
4. Permanent exclusion from gain of 100% of the investment's appreciation if held for 10 years or more (invest by June 30, 2027)





Example:

On December 1, 2018, Jeremy E. Taxpayer (JET) realizes \$500,000 of gain from the sale of mutual funds. JET is looking to diversify his investment income and forms ABC Partnership for the purpose of investing in a QO Zone. ABC self-certifies with the IRS. JET and another investment partner (FRED) then invest \$500,000 each to construct a \$1,000,000 commercial building in downtown Jefferson City with the intention of leasing the space to a bank or other professional service practice. The building is leased for a period of 15 years at which point, ABC Partnership is sold for \$2,500,000.

FRED invests capital not derived from capital gains, so QOZ tax benefits are not available to him. JET however will experience the following tax benefits if he holds the investment at least 10 years:

Example Continued

- \$0 taxes paid on the 2018 Form 1040
- Year 5 – Permanent exclusion 10% of gain (\$50,000)
- Year 7 – Permanent exclusion of another 5% of gain (\$25,000)
- Year 8 – Taxes paid on 85% of original gain (\$425,000)
- Year 10 and beyond permanent exclusion of appreciation in building investment (must be sold before 2047)
- Year 15 JET's share of the \$2,500,000 or \$1,250,000 is completely tax free

Current Strategies and Takeaways

- Extending 2018 Form 1040s will provide additional time to report or defer the gains if a taxpayer is not sure if they want to invest in a QOF
- However, the 180 day rule still applies (note: special rule for owners of flow-through entities)
- Full benefits only available for investments made by December 31, 2019.
(Potential loss of 5% benefit)
- Proceed with caution, and good advisors

WWWK

V. Other observations

Non-Deductibility of Legal Expenses

- Most plaintiffs are now taxed on their gross recoveries, with no deduction for attorney fees
- *Commissioner v. Banks*, 543 U.S. 426 (2005)
 - U.S. Supreme Court held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries
- EX: settle for \$1,000,000 and pay \$400,000 to attorney
 - Taxed on \$1,000,000
 - Until TCJA, plaintiffs could deduct the \$400,000 below the line
 - A miscellaneous itemized deduction was limited, but it was still a deduction (e.g., only fees greater than 2 percent of AGI could be deducted)

Non-Deductibility of Legal Expenses

- Still an above-the-line deduction for employment claims and some whistleblower claims
- **Plaintiffs have an incentive to settle cases and allocate as much of the proceeds to personal physical injuries or physical sickness**
 - See I.R.C. § 104(a)(2)
 - Emotional distress
 - by itself → taxable
 - Personal physical injury/sickness causes emotional distress → Not taxable

Non-Deductibility of Legal Expenses

Harvey Weinstein – sexual harassment

- I.R.C. § 162(q): No deduction for:
 - (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or
 - (2) attorney's fees related to such a settlement or payment.
- Applies to tax years after 2017
- 162(q) disallows above-the-line deductions for employment claims
- Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018 → Bill has not passed yet
 - Clarifies that the limitation on the deductibility of attorney's fees applies only to the taxpayer who is prohibited from deducting the cost of the payment or settlement and not the taxpayer who is receiving the payment or settlement

Estate tax changes (No clawback)

- Exemption is \$11mm+ (\$22mm+ married), inflation indexed
- Exemption is scheduled to cut in half in 2026
- If the reduction seems imminent, taxable gifts can be made before 2026 to use up the vanishing 2026 exemption without fear of “clawback,” the possibility future estate taxes could be higher as a result of the prior taxable gifts

New partnership audit regime

- IRS can now make adjustments and assess tax at the partnership level at the highest tax rates
- Only certain partnerships can elect out
 - Requires INDIVIDUAL ownership
 - Not revocable trusts
 - Not single-member LLCs
- New name for the coordinator of any audit activity
 - Old TEFRA: “tax matters partner”
 - Required to be a partner / member
 - New centralized regime: “partnership representative”
 - Not required to be a partner / member

Thank You



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