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# One Year In: Lessons Learned on Tax Reform

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# Tax Reform Overview

- Tax Cuts and Jobs Act signed into law on December 22, 2017
- Largest change to U.S. tax law since the 1980s
- Generally effective after 12/31/2017
- Impacts all companies, regardless of size, industry, or ownership structure
- Most changes are temporary
  - Sunset after 2025

# Depreciation of Improvements - The Correction that Never Came

- ▶ Immediately prior to passage of the Tax Cuts and Jobs Act, “Qualified Improvement Property” was specifically identified in IRC Sec. 168 as qualifying for bonus depreciation treatment, regardless of its depreciable life. This allowed immediate expensing of most internal improvements of nonresidential buildings, rather than depreciating over 15 or 39 years.
- ▶ In an effort to simplify the rules, TCJA modified the rules for bonus depreciation to apply to any depreciable property with a recovery period of 20 years or less.
- ▶ In re-writing and expanding the definition of “Qualified Improvement Property,” no indication was made that QIP was 15-year property, thus disqualifying from both bonus depreciation eligibility and shorter depreciable life.

# Depreciation of Improvements - The Correction that Never Came

- ▶ Writers of the bill indicated that this exclusion was an error and not the intended treatment.
- ▶ Restoring Investment in Improvements Act, a one-page bill to add QIP to the list of property qualifying for a 15-year life (and thus qualifying it for bonus depreciation), introduced on March 26, 2019 with bipartisan support and referred to the Ways and Means Committee.
- ▶ Has not made it out of committee.

# Bigger Contractors are Small Contractors

- ▶ IRC 460 generally requires that income from most long-term construction contracts be reported using the cost-to-cost percentage-of-completion method.
- ▶ 460(e) provides exceptions for certain contracts, including those of small contractors (who estimate that the contract will be completed within 2 years).
- ▶ Pre-TCJA, the definition of a small contractor was one whose average annual gross receipts over the prior three years was \$10 million or less. This had been the metric since 1986.
- ▶ TCJA increased this threshold to \$25 million and adjusts it for inflation going forward (to increase in increments of \$1 million).
- ▶ The accounting change is automatic within the new threshold.
- ▶ This provided an instant tax-planning opportunity for contractors that have historically been in the \$10 million-to-\$25 million range, to explore using other methods of accounting, such as the completed contract method, for tax purposes.

# Rate and Loss Planning - A Balancing Act

- ▶ With potential deduction acceleration (i.e. bonus depreciation) and income deferral (i.e. PCM exemptions), taxable income (or losses) may become more volatile.
- ▶ With new tax rates and loss limitations, keeping income as low as possible may not always be the best choice.
  - ▶ 2017 top individual tax bracket was 39.6% on income exceeding \$470K for MFJ and \$418,400 for single
  - ▶ 2018 top individual tax bracket was 37% on income exceeding \$600K for MFJ and \$500K for single
  - ▶ \$250K of taxable income would put a joint filer in the 33% bracket in 2017, but 24% bracket in 2018.
  - ▶ Loss carrybacks have been repealed.
  - ▶ Loss carryforwards can only be used to offset 80% of taxable income in future years
  - ▶ Excess business losses (\$500K MFJ/\$250K single) must be carried forward

# 199A - A New Layer to Shareholder Compensation Planning

- ▶ The new Qualified Business Income deduction (199A) allows up to 20% of net business income to be excluded from taxable income, but is limited to 50% of the company's W-2 wages paid if certain income thresholds are exceeded.
  - ▶ Contract Labor, not included in W-2 wages, is not included in the 199A deduction.
- ▶ Historically S corp shareholders have been incentivized to keep their salaries low (but reasonable) to avoid overpaying payroll taxes.
- ▶ Depending on the company's profitability and size of the company's workforce, shareholder comp planning may be beneficial... large bonuses could result in a larger deduction (which will more than offset the resulting increase in payroll tax).
- ▶ Entities taxed as partnerships may want to re-analyze their structure, as guaranteed payments do not qualify as QBI, nor do they count as W-2 wages paid.



# Are Rental Activities Trades or Businesses?

- ▶ The phrase “trade or business” is used frequently in the tax code but is never actually defined.
- ▶ *Com. V. Groetzinger* (1987) defines a trade or business as one that is considerable, regular, and continuous, and whose primary purpose for engaging is for income or profit.
- ▶ Prior to 199A, many considered rental of real estate to NOT be a trade or business, because such treatment was largely inconsequential. 199A made this determination quite important, as only income from trades or businesses are eligible for the QBI deduction.
- ▶ IRS Notice 2019-07 provides a Safe Harbor for treatment of rental real estate as a trade or business for purposes of 199A:
  - ▶ Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise
  - ▶ 250 or more hours of rental services are performed per year with respect to the rental enterprise (does NOT include arranging financing; procuring property; studying and reviewing of financial statements or reports on operations; planning, managing, or constructing long-term capital improvements; or travel time to and from the real estate)
  - ▶ Contemporaneous records are maintained regarding hours, descriptions, and dates of services performed, and who performed the services
  - ▶ Does not include triple net leases or real estate used by the taxpayer as a residence for any part of the year

# The Rebirth of C Corporations?

- ▶ On first glance the new flat 21% tax rate for C corporations (down from a top rate of 35%) seems attractive compared to the top individual rate of 37%.
- ▶ C corporations are still subject to double-taxation, as distribution of profits are taxable dividends, taxable at rates up to 23.8% depending on income.
- ▶ C corporations do not qualify for 199A.
- ▶ If 199A is being maximized, the effective top rate for an individual would be 29.6% ( $37\% \times 80\%$ ).
- ▶ Even if dividends are taxed at 15%, a C corp that distributes all of its profits to its shareholders would effectively be taxed at 32.9% ( $21\% + 15\%$  of 79%).
- ▶ Still may be a good fit in the right circumstances, but not as much as some originally thought.

# Other Changes / Surprises

- ▶ New nondeductible expenses -
  - ▶ Entertainment (previously 50% deductible)
  - ▶ Nondeductible “club dues” was re-defined as “membership dues for a club organized for business, pleasure, recreation, or other social purposes” - previously was generally limited to country clubs
  - ▶ Unreimbursed employee expenses
  - ▶ More meals are only 50% deductible - previously some meals provided to employees were fully deductible.
    - ▶ Exception for “expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of employees” - e.g. Christmas parties and company picnics
    - ▶ Exception for goods, services, and facilities made available to the general public
- ▶ Interest limitations for highly leveraged companies - 163(j)
  - ▶ For companies whose average gross receipts exceed \$25 million, interest expense is limited to 30% of EBITDA.
  - ▶ Certain real property trades or businesses may elect out of this limitation in exchange for giving up accelerated depreciation benefits.
- ▶ Like-kind exchanges are now limited to real property
  - ▶ Trade-in of vehicles could result in taxable gain.

# Individual's Changes

- ▶ Sch A Tax Limitation
  - ▶ Deduction for state and local income taxes, along with property taxes, is now limited to a deduction of \$10,000 for MFJ and \$5,000 for MFS.
- ▶ Mortgage Interest Limitation
  - ▶ For debt secured after Dec. 15, 2017, the limit is \$750,000 for MFJ and \$375,000 for MFS.
- ▶ SALT Credit Limitation for Federal Benefit
  - ▶ No longer a double benefit as all charitable deductions must be reduced dollar-for-dollar by the credit amount in excess of 15% of the contributions value.
  - ▶ Credits below 15% of the contributions value are still 100% deductible.

Questions?

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# Thank You



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