THE TAX CUTS AND JOBS ACT & AGRICULTURAL PRODUCERS

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AALA Annual Educational Symposium
October 26, 2018
Portland, Oregon

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I. INTRODUCTION

The Tax Cuts and Jobs Act (TCJA) ushered in the most significant changes to our tax code in more than 30 years. On December 22, 2017, President Trump signed the TCJA into law. Although most changes went into effect January 1, 2018, meaning that they will impact tax returns filed in 2019, most agricultural clients need to understand how the law is impacting them early in 2018 so they can make good business decisions in the months ahead.

II. KEY CHANGES

Below is an overview of key changes implemented by the new law and how they may impact agricultural producers.

A. Modifying Individual Income Tax Brackets

Most farm businesses are taxed as sole proprietorships, partnerships, or S Corporations. This means that business income is passed through to the owners, who pay taxes based upon individual income tax rates. From 2018 to 2025, the TCJA lowers individual income tax rates across the board. IRC § 1(j). The graduated rates that apply to ordinary income are 10%, 12% (down from 15%), 22% (down from 25%), 24% (down from 28%), 32% (down from 33%), 35%, and 37% (down from 39.6%). IRC § 1(j)(2). The TCJA leaves the maximum rates on net capital gains and qualified dividends and the income breakpoints largely unchanged.

B. Increasing the Standard Deduction

Taxpayers only itemize deductions if the amount they can deduct on 1040, Schedule A, is more than their standard deduction. The TCJA will significantly decrease the number of taxpayers who itemize deductions. Beginning in 2018, the TCJA increases the standard deduction from $13,000 to $24,000 for married filing jointly taxpayers and from $6,500 to $12,000 for single taxpayers. IRC § 63(c)(7)(A). The increased standard deduction is in place through 2025.

C. Suspending the Personal Exemption

In 2017, taxpayers could generally take a personal exemption of $4,050 for themselves, their spouse, and each of their dependents. In conjunction with increasing the standard deduction and lowering individual income tax rates, the TCJA suspends the personal exemption from 2018 through 2025. IRC §151(d)(5)(A).

D. Eliminating Many Deductions

The TCJA eliminates or modifies a number of individual itemized deductions for tax years 2018 through 2025.

1. <u>State and Local Tax Deduction</u>

For tax years 2018 through 2025, the TCJA limits the amount of combined state and local income and property taxes taxpayers can claim as an itemized deduction to $10,000 ($5,000 for married filing separately*)*. IRC § 164(b)(6)(B). Property taxes incurred in a trade or business, however, continue to be fully deductible on a Schedule C, Schedule E, or Schedule F. IRC §§ 162, 212.

2. <u>Charitable Contributions</u>

The TCJA generally leaves in place current law regarding the deductibility of charitable contributions. With many fewer taxpayers itemizing deductions, however, many charitable contributions will no longer result in a tax benefit. The TCJA does not change the ability of those over 70 1/2 to exclude from income qualified charitable distributions from an IRA. IRC 408(d)(8). Nor does it impact the ability of farmers to exclude charitable gifts of grain or other commodities from income. Rev. Rul. 55-138; Rev. Rul. 55-531. These forms of charitable contributions can provide qualified donors with a tax benefit even if they do not itemize.

3. <u>Home Mortgage Interest Deduction</u>

Through 2025, the TCJA lowers the home mortgage interest deduction from $1 million ($500,000 married filing separately) to $750,000 ($375,000 married filing separately). IRC 163(h)(3)(F). The TCJA also suspends the deduction for interest paid on a home equity loan, unless that loan is used to buy, build, or substantially improve the taxpayer's home that secures the loan. IRC 163(h)(3)(B).

4. Miscellaneous Itemized Deductions Subject to the 2 Percent Floor

For tax years 2018 through 2025, the TCJA suspends all miscellaneous itemized deductions subject to the two percent floor, including, for example, unreimbursed employee expenses, hobby expenses, and investment fees. IRC § 67(g).

5. Medical Expenses Deduction

The TCJA retains the current itemized deduction for medical expenses exceeding 10 percent of the taxpayer's adjusted gross income. For tax years 2017 and 2018, however, the TCJA decreases this AGI threshold for everyone (not just those 65 and older) to 7.5 percent. IRC § 213(f)(2).

E. Increasing the Child Tax Credit and Creating a New Dependent Credit

The TCJA raises the child tax credit from $1,000 to $2,000 per qualifying child for tax years 2018 through 2025. IRC § 24(h)(2). Of this credit, $1,400 per child is refundable. The TCJA also provides a new $500 nonrefundable credit for each dependent who does not qualify for the child tax credit, including those over the age of 16. IRC § 24(h)(4). In addition to receiving a larger child tax credit, more families will qualify for the child tax credit under the TCJA because the phase-out of the credit does not begin until a married filing jointly couple reaches adjusted gross income of $400,000 or a single taxpayer reaches an adjusted gross income of $200,000. Under prior law, the $1,000 credit per child began to phase out when the married filing jointly couple had modified adjusted gross income above $110,000 and the single taxpayer had modified adjusted gross income above $75,000.

F. Estate, Gift, and Generation Skipping Tax

The TCJA did not eliminate the estate or gift tax, but it did double the basic exclusion amount for tax years 2018 through 2025. IRC § 2010(c)(3)(C). Consequently a person can die with an estate worth $11,180,000 (adjusted for inflation) in 2018, and the estate will owe no estate tax. Rev. Proc. 2018-10. Basis adjustment (often a "step up") continues at death for all estates, whether taxable or non-taxable. IRC § 1014(a)(1).

Although many fewer estates will be subject to estate tax through 2025, the TCJA does not eliminate the need for estate or transition planning. In many cases, however, the focus may turn even more toward planning to avoid the capital gains tax and planning for disability and transitioning the business.

G. Corporate Tax Rate

The TCJA permanently lowers the maximum corporate tax rate from 35 percent to 21 percent, beginning in 2018. IRC § 11(b). C corporations with a fiscal year beginning in 2017 will apply a blended rate incorporating 2017 and 2018 rates, as directed by IRC §15. IRS Notice 2018-38. Because the law transforms the corporate tax structure to a flat rate for all income, small C corporations with income below $50,000 will see an increase in their corporate income tax rate from 15 percent to 21 percent. Such entities may consider electing S corporation status. S corporations subject to the built-in gains tax will see a new rate of 21 percent instead of 35 percent.

H. Deduction for Pass-Through Business Income

From 2018 through 2025, the TCJA allows most individuals receiving income from a sole proprietorship or a pass through business—including an S corporation or a partnership—to take a new "Section 199A" deduction. IRC § 199A. This provision was intended to ensure that pass-through businesses also receive a tax rate reduction under the TCJA. Because these businesses are taxed at the owner level, however, this tax break is provided through a deduction instead of a general rate reduction. The 199A deduction is arguably the most complex portion of the new tax law. It is also a provision for which much IRS guidance is needed. On August 8, 2018, IRS and Treasury issued initial guidance through proposed regulations, REG-107892-18. This section provides a general overview of the new 199A deduction and initial IRS guidance.

1. Qualified Business Income

IRC § 199A generally allows a 20 percent deduction for "qualified business income" (QBI), defined as the "*net amount* of qualified items of income, gain, deduction, and loss with respect to any "qualified trade or business" of the taxpayer. Such term shall not include any qualified REIT dividends or qualified publicly traded partnership income. IRC § 199A(c). Qualified businesses income must be "effectively connected with the conduct of a trade or business within the United States." IRC § 199A(c)(3)(A). The law specifically excepts from the definition of "qualified business income” (QBI) capital gain, dividends, interest income not allocable to a trade or business, non-business annuity income, and any losses or deductions allocable to those items. IRC § 199A(c)(3)(B). Qualified business income also does not include reasonable compensation received by an S corporation shareholder, or guaranteed payments received by a partner in a partnership. IRC § 199A(c)(4).

Section 199A requires that qualified business income eligible for the 199A deduction must come from a “qualified trade or business.” The proposed regulations state that for purposes of 199A, IRC § 162(a) provides the most appropriate definition of “trade or business.” IRS notes that the definition is “derived from a large body of existing case law and administrative guidance interpreting the meaning of trade or business in the context of a broad range of industries.” Yet there is no bright-line definition of what types of rental activities constitute trades or businesses for purposes of IRC § 162. The courts make trade or business determinations on a case-by-case basis after a highly factual inquiry. The best “definition” for an IRC § 162 “trade or business” is the most recent guideline from the U.S. Supreme Court: To be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity. *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987). A sporadic activity, a hobby, or an amusement diversion does not qualify. *Id*. For more information on this issue, see https://www.calt.iastate.edu/blogpost/despite-guidance-lots-questions-remain-regarding-rental-income.

Solely for purposes of IRC § 199A, the regulations do provide that the rental of property to a related trade or business is automatically treated as a trade or business if the rental and the other trade or business are commonly controlled (regardless of whether the rental activity and the trade or business are otherwise eligible to be aggregated under § 1.199A-4(b)(1)). But for all other rentals, a fact-based determination must be made as to whether the rental is a "trade or business" before the 199A deduction may be claimed.

2. <u>Calculating the Deduction</u>

A taxpayer’s Section 199A deduction generally may not exceed 20 percent of his or her taxable income, reduced by net capital gain. IRC § 199A(a)(1). The § 199A deduction reduces taxable income, not adjusted gross income. IRC § 63(b). As such, limitations based upon AGI (such as payment limitations for farm programs) are not impacted by the new IRC §199A deduction. Taxpayers are not required to itemize to claim the Section 199A deduction.

3. <u>Wages/Capital Limitation</u>

The 199A deduction for qualified business income is generally subject to a wages/capital limitation; however, the phased-in limitation only applies to individuals with taxable income greater than $315,000 (MFJ) or $157,500 for singles. IRC § 199A(b)(2). Once these income levels are reached, the limitation is phased in for the next $100,000 of income (MFJ) or $50,000 for singles. IRC § 199A(b)(3).

The wages/capital limitation, which begins with the wages limitation from the repealed DPAD, also incorporates an alternative capital component. IRC § 199A(b)(2). The limitation is the *greater* of the following:

- 50 percent of the W-2 wages paid with respect to the qualified trade or business, or
- The sum of 25 of percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

4. <u>Income from Sales to Agricultural Cooperatives</u>

Originally, IRC § 199A provided a separate 20 percent deduction for “qualified cooperative dividends.” This provision, which was hastily written and not well vetted, would have allowed many farmers selling commodities to cooperatives a 20 percent deduction for their *gross sales* to the cooperative. This was because the definition of “qualified cooperative dividend” encompassed per-unit retains paid in money (PURPIM), as well as traditional patronage dividends. IRC § 199A(e)(4). The payments made by agricultural cooperatives to their patrons for their gross sales are often characterized as PURPIM. Thus, this provision would have, in many cases, meant tax free income to the cooperative patron (expenses are often 80 percent of gross sales). A fix to this provision was included in the Consolidated Appropriations Act, 2018, H.R. 1625, signed by the President on March 23, 2018.

Instead of the 20-percent deduction calculated based upon gross sales, the cooperative patron is now subject to a new bifurcated calculation and a hybrid 199A deduction. Essentially, the fix gives the cooperative patron a deduction that blends the new 199A deduction with the old 199 DPAD deduction (all within the new 199A). Depending upon their individual situations, cooperative patrons may be advantaged, disadvantaged, or essentially treated the same by selling to a cooperative rather than selling to a non-cooperative. While the significant advantage is gone, the complexity certainly is not.

First, patrons calculate the 20 percent 199A(a) QBI deduction that would apply if they had sold the commodity to a non-cooperative. The patron must then, pursuant to 199A(b)(7), subtract from that tentative 199A(a) deduction amount the lesser of the following to reach the final QBI deduction:

- 9 percent of net income attributable to cooperative sale(s) OR
- 50 percent of W-2 wages they paid to earn that income from the cooperative

Note that if the patron does not pay W-2 wages to any employees, *no reduction is required*. Under the revised IRC §199A(g), cooperative patrons get to take an *additional* “DPAD-like” deduction (if any) passed through to them by the agricultural cooperative. The determination of the amount of this new “DPAD-like” deduction, will depend upon the amount of the cooperative's qualified production activities income (QPAI) attributable to that patron's commodity. The cooperative generally receives a 199(g) deduction equal to nine percent of its QPAI. The final amount passed through to the patron is at the discretion of the cooperative. It is governed by language copied directly from the old DPAD provision. In any event, the overall amount a cooperative can choose to pass through to its members cannot exceed 50 percent of the value of the wages the cooperative pays to its employees. The patron’s 199A(g) deduction cannot exceed taxable income (subtracting the 20 percent QBI deduction detailed above, but not subtracting capital gain).

a. Example One

Pat Patron, a single taxpayer, is a member patron of Big Coop. In 2018, he sells all of his grain through Big Coop. Pat receives $250,000 from Big Coop in 2018 for his grain sales. He receives $230,000 of this as a per unit retain paid in money (PURPIM) and $20,000 as an end-of-year patronage dividend. Pat also has $200,000 in expenses, which does not include any W-2 wages in 2018. Pat has no capital gain income in 2018, but he receives wages from an outside job, leaving him with taxable income of $75,000 (after the $12,000 standard deduction is subtracted). Pat’s 2018 qualified business income (QBI) is $50,000, which equals his net income from his grain marketing activities. Under 199A(a), Pat calculates a tentative QBI deduction of $10,000, which is .20 of his QBI. Because Pat’s taxable income is below $157,500, his QBI deduction is not limited by the wages / capital limitation.

Because all of Pat’s tentative QBI deduction is attributable to qualified payments he received from Big Coop, Pat must determine what portion of that deduction must be reduced under 199A(b)(7). He must reduce his QBI deduction by the lesser of:

- 9 percent of QBI allocable to qualified payments from cooperative ($50,000 * .09 = OR $4,500) OR
- 50 percent of W-2 wages attributable to Pat’s coop payments ($0)

Because Pat paid no wages for his grain business, he is not required to reduce his QBI deduction at all. He is therefore entitled to the full 20 percent 199A(b) deduction. Assume that in 2018, Big Coop also allocates a $2,500 199A(g)(2)(A) deduction to Pat for his portion of the Coop’s QPAI. This deduction is limited only by Pat’s taxable income (after subtracting his QBI deduction). Pat’s final 199A deduction for 2018 is $10,000 (QBI) + $2,500 (199(g)) = $12,500 (25 percent of QBI). Pat’s final taxable income in 2018 is therefore $75,000 - $12,500 = $62,500.

b. Example Two

We will now change only one fact from Example One. Here, we assume that $25,000 of Pat’s $200,000 in expenses were W-2 wages that he paid to an employee. Here, Pat’s tentative 199A(a) QBI deduction will remain $10,000 (20 percent of QBI). However, he must now reduce his QBI deduction by the lesser of the following:

- 9 percent of QBI allocable to qualified payments from cooperative ($50,000 * .09 = OR $4,500) OR
- 50 percent of W-2 wages attributable to Pat’s coop payments ($25,000 * .5 = $12,500)

Here, Pat must subtract $4,500 from his $10,000 tentative deduction for a final QBI deduction of $5,500. Pat thus gets only an 11 percent QBI deduction in this example. However, Pat also get to take his $2,500 199A(g) deduction from Big Coop, for a final 199A deduction of $8,000 (16 percent of QBI). Pat’s final taxable income in this example is $67,000.

c. Deduction for Agricultural Cooperatives

The fix also significantly changes the deduction allowed to agricultural cooperatives themselves. Under the original 199A, the cooperative would have received its own 20-percent deduction, calculated based upon gross income minus qualified cooperative dividends paid. This deduction was also limited by a wages/capital restriction.

Under the fix, this approach is replaced by the "DPAD-like" regime discussed above. The cooperative can take a new 199A(g) deduction in an amount equal to 9 percent of "QPAI" (which includes PURPIM), limited by taxable income and 50 percent of W-2 wages paid. If the cooperative passes the 199A(g) deduction through to its patrons, it must reduce, in a corresponding amount, the deductions it could normally take for its payments to the patrons.

d. Corporate Patrons

The 199A deduction, including the new 199A(g) does not apply to patrons that are C Corporations. Specifically, the 199A(g)(A) deduction, although modeled after the old DPAD, is now restricted to "eligible taxpayers," which are taxpayers "other than a corporation." 199A(g)(2)(D). Likewise, 199A(g)(2)(C) limits the cooperatives' own deduction only by qualified payments attributed to "eligible taxpayers." This is because the new 199A(g) can only be passed through to non-corporate taxpayers (including shareholders of S Corporations).

e. Transition Rule

The new law also includes a transition rule for patrons who receive a cooperative payment in 2018 that is attributable to QPAI for which the old DPAD deduction was applicable. This will include any QPAI attributable to a cooperative tax year beginning before 2018. See Section 101(c)(2). With the original DPAD gone in 2018, taxpayers were left to wonder how to report such DPAD allocations. The law clarifies that such farmers will still be able to take the old DPAD deduction in 2018, as long as it is attributable to QPAI which was allowed to the cooperative for a tax year beginning before 2018. No 199A deduction will be allowed for such payments.

5. <u>Service Trade or Businesses</u>

Specified service trade or businesses are generally excluded from taking the Section 199A deduction because they are excluded from the definition of a "qualified trade or business." IRC § 199A(d)(1)(A). Like the W-2 wages/capital limitation, however, this restriction is phased in, based upon taxable income. The services business limitation begins to apply to taxpayers with taxable income greater than $315,000 (MFJ) or $157,500 for singles. Once these income levels are reached, the limitation phases in over the next $100,000 of income for MFJ or $50,000 for singles. IRC § 199A(d)(3)(A). A specified service trade or business is defined as follows:

> 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 the owner or 1 or more of its employees….

IRC § 199A(d)(2)(A)(citing IRC § 1202(e)(3)(A)). Additionally, the law states that investment management, trading or dealing in securities would be a specified service trade or business. The proposed regulations significantly limit the reach of the SSTB definition. Proposed §1.199A-5. Farm property managers, real estate agents, and insurance brokers are not in a SSTB. Veterinarians, however, are providing services in the field of health and are in an SSTB.

I. Bonus Depreciation

The TCJA allows 100 percent bonus depreciation through 2022 for qualifying property acquired and placed into service after September 27, 2017. IRC § 168(k)(6)(A). The percentage then phases down over the next four years, in increments of 20. IRC § 168(k)(A). This phase-out is as follows:

- 2023: 80 percent bonus,
- 2024: 60 percent bonus,
- 2025: 40 percent bonus, and
- 2026: 20 percent bonus.

After 2026, bonus depreciation ends. Property acquired before September 28, 2017, but placed in service on or after that date, is subject to pre-Act phase-down limits (i.e. 40 percent in 2018). Notably, the TCJA extended bonus depreciation to **used** property, as well as new property, by removing the requirement that the first use of the property originate with the taxpayer. IRC § 168(k)(2)(A)(ii). For qualifying property, additional first-year depreciation is automatic. Taxpayers must affirmatively elect out of the deduction for any class of property to which they do not want bonus depreciation to apply. IRC § 168(k)(7). During the first tax year ending after September 27, 2017, taxpayers could choose to elect 50 percent bonus, instead of 100 percent bonus. IRC § 168(k)(10)(A). Once these elections are made, they cannot be changed without IRS consent.

J. Section 179

Beginning in 2018, the TCJA permanently expands Section 179 to provide an immediate $1 million deduction (up from $510,000 in 2017) with a $2.5 million phase-out threshold (up from $2,030,000 in 2017). IRC § 179(b)(1), (2). This amount will be indexed for inflation beginning in 2019. IRC § 179(b)(6). Unlike bonus depreciation, the Section 179 expense deduction must be affirmatively elected each year. Taxpayers may make an election or revoke an election on an amended return. This is a useful provision for many agricultural producers who cannot always predict their income and the usefulness of the election long-term.

K. Vehicle Depreciation

1. 2018 Limits for "Passenger Automobiles"

For passenger automobiles placed into service after December 31, 2017, section 13202 of the TCJA significantly increases the dollar limitations on depreciation and expensing for passenger automobiles. For 2018, the amount of the depreciation and expensing deduction for a passenger car or light duty truck or van shall not exceed—

- $10,000 for the 1st taxable year in the recovery period,
- $16,000 for the 2nd taxable year in the recovery period,
- $9,600 for the 3rd taxable year in the recovery period, and
- $5,760 for each succeeding taxable year in the recovery period.

These numbers shall be adjusted for inflation after 2018. As such, for 2018, the limits for light-duty trucks, vans, and passenger cars are the same. The TCJA retained the $8,000 limit for additional first-year depreciation for passenger automobiles. So in 2018, the maximum amount a taxpayer can deduct for a passenger automobile in the first year is $18,000.

2. The Unusual Interplay of 100 Percent Bonus and IRC § 280F

Taxpayers who purchase a passenger automobile subject to the IRC § 280F limitations must consider the impact of taking bonus depreciation on future depreciation deductions. The last time we had 100 percent bonus, Rev Proc. 2011-26 stated that If the unadjusted depreciable basis of a passenger automobile exceeded the first-year limitation amount under § 280F(a)(1)(A)(i), the excess amount was the unrecovered basis of the passenger automobile for purposes of § 280F(a)(1)(B)(i) and, therefore, not deductible until the first taxable year succeeding the end of the recovery period. And then it was subject to the limitation under § 280F(a)(1)(B)(ii). In other words, under this interpretation, if a taxpayer buys a $45,000 car in 2018, he or she can immediately depreciate $18,000, but the remaining $27,000 would not be depreciable until year 2024.

Rev. Proc. 2011-26 provided a safe harbor work around for this problem in 2011. For years after the first-year deduction, the guidance generally allowed taxpayers to determine the unrecovered basis of the passenger automobile for its placed-in-service year as though the taxpayer claimed 50-percent, instead of the 100-percent, bonus depreciation. This was a complex “solution” and until IRS guidance issues further guidance, we won’t be sure how it will handle the current issue.

3. Larger Vehicles

SUVs with a gross vehicle weight rating above 6,000 lbs. are not subject to depreciation limits. They are, however, limited to a $25,000 IRC §179 deduction. IRC § 179(b)(5)(A). No depreciation or §179 limits apply to SUVs with a GVW more than 14,000 lbs. Trucks and vans with a GVW rating above 6,000 lbs. but not more than 14,000 lbs. generally have the same limits: no depreciation limitation, but a $25,000 IRC §179 deduction. These vehicles, however, are not subject to the §179 $25,000 limit if any of the following exceptions apply:

- The vehicle is designed to have a seating capacity of more than nine persons behind the driver's seat;
- The vehicle is equipped with a cargo area at least 6 feet in interior length that is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or
- The vehicle has an integral enclosure, fully enclosing the driver compartment and load-carrying device, does not have seating behind the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Although SUVs purchased after September 27, 2017, remain subject to the $25,000 IRC § 179 limit, they are eligible for 100% bonus depreciation if they are above 6,000 lbs. This is true for both new and used vehicles. For a taxpayer's first taxable year ending after Sept. 27, 2017, taxpayers may elect to apply a 50 percent allowance instead of the 100 percent allowance. To make the election, they must attach a statement to a timely filed return (including extensions) indicating they are electing to claim a 50% special depreciation allowance for all qualified property. Once made, the election cannot be revoked without IRS consent. As noted above, taxpayers may also elect out of bonus entirely for any class of property by filing an election on a timely filed return. Once filed, such an election cannot be revoked without IRS consent.

L. Farm Equipment Depreciation

Beginning in 2018, *new* farm machinery or equipment is depreciated over a period of five years, instead of seven. IRC § 168(e)(3)(B)(vii). This change does not apply to grain bins, cotton ginning assets, fences, or other land improvements. The TCJA provides that farmers will use the 200 percent declining balance method of MACRS depreciation for many farming assets placed into service in 2018 or later. IRC § 168(b)(2). Before this change, most farming property was depreciated using the 150 percent declining balance method. This change does not generally apply to (1) buildings and trees or vines bearing fruits or nuts, (2) property for which the taxpayer elects either the straight-line method or 150% declining balance method, (3) 15 or 20-year MACRS property that must be depreciated under the 150% declining balance method, or (4) property to which the alternative depreciation system applies. Farmers can elect to use 150 percent declining balance method.

M. Cash Accounting

IRC § 448(b)(1) excepts a "farming business" from its general requirement that C corporations and partnerships with a C corporation partner use the accrual method of accounting. For this purpose, "farming business" means the trade or business of farming within the meaning of Code Sec. 263A(e)(4). IRC § 448(d)(1)(A). IRC § 447(a), however, generally requires that taxable income arising from the trade or business of farming for a C corporation or a partnership with a C corporation partner is to be computed using the accrual method.

For purposes of this sub-section, the "trade or business of farming" does not include operating a nursery or sod farm or raising or harvesting of trees (other than fruit and nut trees). Prior to the TCJA, §447 also removed from its accrual accounting requirement (1) farming corporations with $1 million or less in gross receipts in any tax year beginning after 1975 and (2) "family corporations" with gross receipts of $25 million or less.

The TCJA has significantly expanded the availability of the cash method of accounting to farming C corporations and partnerships with a C corporation partner. Beginning in 2018, the IRC § 447 accrual accounting requirement does not apply to any farming corporation that meets the gross receipts test of IRC § 448(c), which is $25 million or less in 2018. The gross receipts test is applied using three-year averaging rules. For purposes of the IRC § 447(a) accrual accounting requirement, a C corporation that meets the gross receipts test for any taxable year is not treated as a corporation at all for that taxable year. IRC § 447(c)(2). This means that partnerships with such C corporations as partners are also not required to use the accrual method of accounting. Farming S Corporations continue to be wholly excluded from an accrual accounting requirement, regardless of gross receipts. IRC § 447(c)(2).

N. Net Operating Losses

The TCJA reduces the five-year carryback of net operating losses for a farming business to two years. IRC § 172(b)(1)(B). It also limits the net operating loss deduction to 80 percent of taxable income for losses incurred after December 31, 2017. IRC § 172(a)(2). The new law, however, allows indefinite carryovers, instead of the 20-year carryover allowed under prior law. IRC § 172(b)(1)(A)(ii). Net operating losses incurred prior to 2018 are still allowed to be deducted against 100 percent of taxable income.

O. Excess Business Loss Disallowance

The TCJA also implements an excess business loss rule that replaces (and expands upon) the excess farm loss rule. The excess farm loss rule applied to non-corporate farmers who received an applicable subsidy. Under this rule, these non-corporate farmers' losses were limited to a threshold amount of $300,000 ($150,000 for married filing separately). Excess farm losses could be carried over to future years. The TCJA suspends the excess farm loss rule for years 2018 through 2025, and replaces it with an excess business loss rule (which also expires in 2026). The new excess business loss rule applies to all non-corporate taxpayers, not just those involved in farming and not just those farmers receiving an applicable subsidy. IRC § 461(l). Under IRC § 461(l)(3)(A), an "excess business loss" is one that exceeds $500,000 (married filing jointly) or $250,000 (single). These limit amounts will be indexed for inflation after 2018. Any loss disallowed by this rule will be treated as a net operating loss, but apparently only subject to a carryforward.

P. Like-Kind Exchange

The TCJA retained IRC §1031 like-kind exchange gain recognition deferral for real property, but eliminated it for *personal* property, such as farm equipment or livestock. IRC § 1031(a)(1).

1. Prior Law

Under 2017 law, IRC § 1031 non-recognition treatment was mandatory for a qualifying exchange of personal property. Those who did not want to apply §1031 like-kind exchange rules to a trade typically had to structure the transaction as a clear sale and purchase to avoid being automatically deemed a like-kind exchange by IRS and the courts. Taxpayers could generally accomplish this by selling the old asset to a different party than the one from whom the new asset was purchased.

With a §1031 exchange, gains or losses on the exchange of like-kind personal property used in a trade or business were generally deferred. This meant that if a farmer traded a fully depreciated piece of equipment for a newer model, the like-kind exchange rules applied, and recognition of IRC § 1245 recapture was deferred. If a farmer traded several raised breeding heifers for some like-kind cows, § 1231 gain would be deferred on that transaction as well. In a like-kind exchange, the basis of the relinquished property was carried over to the basis of the replacement property, and gain recognition was rolled ahead until such time as the replacement property was sold. Specifically, the basis of the replacement property was equal to:

Basis of the relinquished property - Boot received + Boot paid + Gain recognized - Loss recognized

a. Example

Gain (but not loss) was recognized only to the extent that the boot received exceeded the gain realized. A loss was recognized only if property given was not like-kind and the adjusted basis exceeded its FMV. A basic example illustrates this formula:

> In 2017, John traded a tractor with a FMV of $75,000 and an adjusted basis of $0 for a tractor with a fair market value of $125,000, plus $50,000 in cash.
>
> Under old law, applying automatic like-kind exchange treatment, IRC § 1245 recapture was deferred, and the basis in John's replacement tractor was $50,000 ($0 basis in relinquished tractor, plus boot paid). John reported the transaction on Form 8824, and could generally use IRC § 179 to immediately expense $50,000, the amount of boot paid in the transaction.

2. Current Law

The Tax Cuts and Jobs Act, H.R.1, amended IRC § 1031 by striking the word "property" and replacing it with "real property." This means that like-kind exchange treatment is still available for real property, but it is gone *permanently* for personal property, beginning in 2018.

A transition rule provides that a qualifying personal property exchange where either the property was disposed of or received by the taxpayer on or before December 31, 2017, is still subject to like-kind exchange treatment. With no § 1031 treatment available to personal property in 2018, equipment or livestock "trades" will be treated as taxable events, with the taxpayer computing gain or loss based upon the difference between the amount realized on the sale of the relinquished asset and the party's adjusted basis in the asset. "Amount realized" includes any money, as well as the fair market value of property (other than money) received in the transaction. IRC §1001(b). There will be no tax deferral for §1231 gains or §1245 recapture. There will also be no deferral for a loss.

a. Largely Offset by Increased Expensing and Depreciation Options

Increased expensing and bonus depreciation options must be considered in assessing the overall impact of the loss of the 1031 exchange for personal property. The Act generally allows just over five years of 100 percent bonus depreciation for qualifying property acquired and placed into service after September 27, 2017 (taxpayers can elect to use 50 percent bonus for 2017 purchases). Beginning in 2023, the Act would then allow one year of 80 percent bonus, one year (2024) of 60 percent bonus, one year (2025) of 40 percent bonus, and one year (2026) of 20 percent bonus. After that time, bonus depreciation will end. Important for this purpose, the Act provides that the enhanced first-year additional depreciation property provisions apply to used property, as well as new property (beginning with property acquired and placed into service after September 27, 2017).

Beginning in 2018, the Act also expanded Section 179 to provide an immediate $1 million deduction (up from $510,000 in 2017) with a $2.5 million phase-out threshold (up from $2,030,000 in 2017). These amounts will be indexed for inflation beginning in 2019. These provisions are not set to expire.

b. Example of "Trade" under New Law

The following example illustrates 2018 tax treatment of an equipment "trade" in light of the new law:

> In 2018, John "trades" a tractor with a FMV of $75,000 and an adjusted basis of $0, plus $50,000 cash for a tractor with a fair market value of $125,000.
>
> In 2018, this transaction will be treated as a sale and a purchase. John must now recognize $75,000 in § 1245 recapture (the difference between the FMV of the traded tractor ($75,000) and its adjusted basis ($0)). This transaction will be reported on Part III of Form 4797 and taxed as ordinary income (no self-employment tax). John uses the proceeds of the sale, plus an extra $50,000 in cash, to purchase the new tractor. Thus, John's basis in his new tractor will be $125,000, the full purchase price of the new tractor. John can likely use IRC § 179 to expense this amount in 2018. If Section 179 is not available, he can use 100 percent bonus to capitalize and depreciate the full amount in 2018.

3. <u>Other Considerations</u>

In 2017 and 2018, John from our above examples will have the same total income on his Form 1040. However, the difference between a § 1031 exchange and a sale and purchase is not one without distinction.

a. Self-Employment Tax Considerations

Choosing to apply higher amounts of IRC §179 or bonus depreciation to offset the recognized § 1245 gain will result in lower net Schedule F income, thereby reducing SE income. While this means less SE tax, it also means less retirement income down the road. This is an important planning consideration. In the 2017 example above, assume John otherwise had $125,000 in net Schedule F income. With like-kind exchange treatment, John deferred $75,000 in § 1245 gain, and expensed $50,000 (the cash boot paid). This meant that John's Schedule F income was reduced to $75,000. This income is subject to SE tax. In 2018, also assume John otherwise has $125,000 in net Schedule F income. Now he must recognize the $75,000 in recapture income, which is not reported on Schedule F, but on Form 4797, Part III. But John can now expense (or depreciate using bonus depreciation) the full amount of his $125,000 purchase on Schedule F. This will result in $0 in Schedule F income and no SE tax liability.

b. New 199A Deduction Considerations

The new IRC § 199A creates a new deduction for "qualified business income." This deduction can generally be taken in an amount up to 20 percent of "qualified business income." IRC § 1245 recapture reported as gain on Form 4797 should qualify as a component of qualified business income. QBI is defined as the "net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, or qualified publicly traded partnership income." IRC § 199A(c)(1). The law also excludes wages, reasonable compensation, guaranteed payments, interest income, dividend income, and capital gain from the definition of QBI. IRC § 199A(c)(3)(B). Proposed regulations also clarify that IRC § 1231 gain or loss is excluded from the definition of QBI to the extent that it is treated as a capital gain or loss. In other words, such capital gain or loss is excluded from the definition of QBI whether or not it arises from the sale or exchange of a capital asset. Specifically, QBI does not include any item taken into account in determining net long-term capital gain or net long-term capital loss.

c. Loss Considerations

The sale/purchase treatment (as opposed to the like-kind exchange treatment), may be useful in some cases to create ordinary income to offset a net operating loss carryforward. Careful planning is necessary to properly handle expensing and depreciation elections in light of other income.

d. Reporting of the Sales Price

In the past, the adjusted basis of the relinquished property was reported on Form 8824 and carried forward to the replacement property. That number was readily available from depreciation schedules. Now, the gross sales price of the property must be reported on Form 4797, in addition to the adjusted basis. Under IRC § 1001(b), the sales price should equate to the fair market value of the relinquished property. In other words, an accurate trade-in value will be important. IRS may issue regulations governing the reporting of exchanges in light of the new law.

e. Permanent v. Temporary

The elimination of like-kind exchange treatment for personal property is permanent, as is the enhanced IRC § 179 deduction. 100 percent bonus depreciation, however, is available only through 2022 before it begins to taper down. It will be eliminated fully in 2027. In any event, permanent or temporary only means until the next Congress changes its mind.

f. Exchanges Occurring Between September 28, 2017, and December 31, 2017

As noted above, 100 percent additional first year depreciation is available to qualifying property acquired and placed into service after September 27, 2017. This includes used property. Consequently, there is a three-month window (for individual calendar year taxpayers) where 100 percent bonus depreciation and IRC §1031 treatment for like-kind personal property coexist. The new law allows 100 percent bonus to apply only to the boot paid in such like-kind exchanges. This is because IRC § 168(k)(2)(E)(ii) states that property qualifying for bonus depreciation must meet the requirements of IRC § 179(d)(3), which states that "the cost of property does not include so much of the basis of such property as is determined by reference to the basis of other property held at any time by the person acquiring such property." This is true whether the taxpayer elects to take 100 percent bonus or 50 percent bonus, as is available during the first tax year ending after September 27, 2017, under IRC § 168(k)(10).

> Note: For assets purchased before September 28, 2017, 50 percent bonus would apply to both the boot and the adjusted basis of the relinquished property, although section 179 could only be used to expense the amount of the boot paid.

g. Impact of State Taxation

How states choose to respond to the new federal tax laws will have large implications for taxpayers.

Q. Domestic Production Activities Deduction

The TCJA eliminates the DPAD deduction, which was frequently used by agricultural producers and cooperatives. (repealed IRC § 199).

R. Business Interest Deduction Limitation

Although the TCJA has restricted business interest deductions generally to 30 percent of adjusted gross income (beginning in 2018), those restrictions do not apply to taxpayers that meet the $25 million gross receipts test of IRC § 448(c). IRC § 163(j)(3). The TCJA also allows a "farming business" (as defined in IRC § 263A(e)(4)), as well as a specified agricultural or horticultural cooperative to elect not to be subject to the business interest limitation. An electing farm business isn't a "trade or business" for purposes of the business interest limitation. IRC §163(j)(7)(A)(iii). An electing businesses, however, is required to use the alternative depreciation system (ADS) to depreciate any farming assets with a recovery period of 10 years or more. IRC § 168(g)(1)(G). This also means the farmer cannot use bonus depreciation on those assets. Once this election is made, it is irrevocable. IRC § 163(j)(7)(C).

S. Employer-Provided Meals

The TCJA reduces the deduction for meals provided for the convenience of the employer to 50 percent through 2025. After that time, the deduction is eliminated fully.

III. CONCLUSION

The TCJA is the biggest change to the tax code since 1986. Although we have some proposed guidance, it may take some time before certain provisions, such as the IRC §199A deduction, are understood in practice. Some farming businesses may need to make changes to their business structure in response to the new law. One significant issue for many taxpayers is how their states will respond to the new federal law. In states with an income tax, legislators are working to determine to what extent their states' tax codes should conform to federal law.