Iowa State University
OF SCIENCE AND TECHNOLOGY

CENTER FOR
Agricultural Law & Taxation

AALA Tax Update

October 26, 2018

Modified Individual Tax Rates

- Most agricultural businesses operate as sole proprietor or pass-through business.
- **From 2018 through 2025**, the Act generally lowers individual tax rates.

Old Law	TCJA
Seven brackets at 10, 15, 25, 28, 33, 35, and 39.6%	Maintains seven brackets at 10, 12, 22, 24, 32, 35, and 37%; expires after 2025
Single filer rate schedule:	Single filer rate schedule:
10% >$0	10% >$0
15% >$9,525	12% >$9,525
25% >$38,700	22% >$38,700
28% >$93,700	24% >$82,500
33% >$195,450	32% >$157,500
35% >$424,950	35% >$200,000
39.6% >$426,700	37% >$500,000

Increased Standard Deduction

- Of the roughly 143 million tax filers in the U.S., about 48 million itemize deductions.
  - The Act will *significantly* decrease that number by eliminating many itemized deductions and increasing standard deduction.
  - For 2018 through 2025, the Act increases the standard deduction to $24,000 for married filing jointly, $12,000 for single taxpayers, and $18,000 for head of household.
  - The additional standard deduction for the aged or blind continues at $1,300 in 2018.

Eliminated Many Itemized Deductions

Miscellaneous Itemized Deductions Subject to the 2% Floor, including:

- *Unreimbursed* ***employee*** expenses (including, home office expenses, uniform expenses, travel expenses, meals & entertainment expenses, license fees, tools used for work, and job search expenses)
- Tax preparation expenses
- Safe deposit box rental
- Hobby expenses
- Investment fees and expenses

Unreimbursed Employee Expenses

- Hits certain types of employees hard:
  - Truckers
  - Salespeople
  - Employees with a home office

State & Local Taxes

- Individual taxpayers can now claim as an itemized deduction **only an amount up to $10,000** ($5,000 for married filing separately) per year for state and local income taxes and/or property taxes paid during tax years 2018 through 2025 (Schedule A).
    - ***Property taxes incurred in a trade or business continue to be fully deductible on a Schedule C, Schedule E, or Schedule F.***

Charitable Contributions

- Largely unchanged, but with increase in standard deduction and loss of many itemized deductions, many charitable contributions will no longer result in a tax deduction.
  - The Act does *not change* the ability of those over 70 1/2 to make qualified charitable distributions from an IRA, without including those distributions in income.
  - **The Act does not change the ability of farmers to make a charitable contribution of commodities without including those distributions in income.**

Withholding and Estimate Tax Issues

- Withholding Tables Adjusted in January
- IRS "Paycheck Checkup"
  - https://www.irs.gov/individuals/irs-withholding-calculator
  - GAO Report: More underwithholding…

Suspended Personal Exemptions

- The Act suspends the personal exemption from 2018 through 2025.
  - The personal exemption was $4,050 for each taxpayer and dependent in 2017.

Child/Dependent Tax Credit

- Through 2025, increases child tax credit to $2,000 (up from $1,000).
  - Applies to children *under* 17 years.
    - New: $500 nonrefundable credit for other qualifying dependents.
- Qualifying income amounts are significantly increased ($400,000 for MFJ instead of $110,000 to begin phase-out).
- $1,400 is refundable

Meals & Entertainment

- Tax Cuts and Jobs Act disallows business deduction for *entertainment* expenses.
  - Prior to act, there was 50 percent deduction if such an expense was directly related to business.
  - Notice 2018-76 says meals with clients/potential clients (if separately invoiced) are still 50 percent deductible
- Meals consumed while on business travel continue to be 50 percent deductible.

Meals for Convenience of Employer

- Meals for the convenience of employer are now 50 percent deductible and will be 0% deductible after 2025.

- Should continue to be excluded from employee’s income under IRC § 119(a) if Treas. Reg. § 1.119-1(a)(2)(ii) conditions are met.
- If meals are not excludable from income, expense is deductible as compensation.

Estate Tax Provisions

- Doubled the basic exclusion to $11,180,000 per person for estate and gift and generation skipping tax.
- $15,000 annual exclusion retained.
- Portability Retained
- Basis Adjustment Retained
- **Basic exclusion amounts reset to pre-Act levels in 2026.**

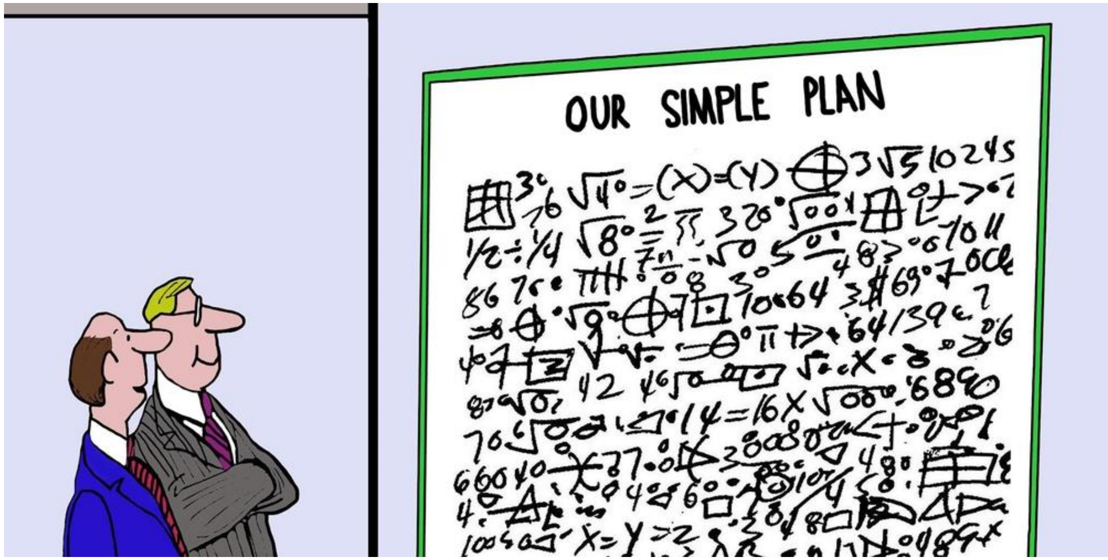
Corporate Income Tax Rate

- *Permanently* lowers the *maximum* corporate tax rate from 35% to 21%, beginning in 2018.
- Fiscal year C corps apply a blended rate (between old rate and new rate), based upon IRC §15.
  - Confirmed by IRS Notice 2018-38 (4/16/2018)

Corporate Tax Rate – Now a Flat Rate

- Small corporations may consider conversion to S Corporation in light of new law.
- Many see a rate increase.
  - Old Rates:

Taxable Income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35



NEW IRC § 199A DEDUCTION

Qualified Business Income

- The **net** amount of qualified items of income, gain, deduction, and loss with respect to **any qualified trade or business** of the taxpayer.
- QBI **does not include** wages, reasonable compensation, guaranteed payments, non-business interest income, non-business annuity income, dividend income, or capital gain. IRC § 199A(e)(4).
- QBI does not include IRC § 1231 gain or loss treated as capital. It does include IRC § 1245 gain.

U.S. Trade or Business

- Proposed § 1.199A-1 states 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."
  - **LEAVES MUCH UNCERTAINTY WITH RESPECT TO RENTAL INCOME.**

Self-Rentals

- Solely for 199A, prop. regulations provide that rental of tangible or intangible property to related trade or business is treated as trade or business if they are **commonly controlled**.

INCOME THRESHOLDS ARE KEY FOR QBI DEDUCTION!

Calculating the QBI Deduction

- If your taxable income is below $315,000 for MFJ or $157,500 for singles:
  - the new 199A deduction for QBI is the **LESSER** of:
    - 20 percent of QBI OR
    - 20 percent of (taxable income – net capital gain)

Income Below Threshold

- James, single
- Taxable income = $100,000 ($44,000 wages, $68,000 in QBI from farming operation, minus $12,000 standard deduction)

199A Deduction =

- Lesser of:
  - .20 * $68,000 = $13,600 OR
  - <u>.20 * $100,000 = $20,000</u>

= **$13,600**

James' taxable income will be $86,400.

ABOVE THRESHOLD – LIMITATIONS KICK IN

Specified Service Trade or Business Limitation (Not QBI)

SSTB

- Health (including veterinarians)
- Law
- Accounting
- Actuarial Science
- Performing Arts
- Financial Services
- Brokerage Services
- **Consulting**

NOT SSTB

- Engineering
- Architecture
- Sales of pharmaceuticals
- Real estate agents and brokers
- Insurance agents and brokers
- Property management
- Taking deposits and making loans

Specified Service Trade or Business Limitation

- **SSTB limit does not apply if income is below threshold.**
- SSTB limit is phased in over next $50,000/$100,000
- If income above phase-in, **no deduction for SSTB** (income is not QBI).

W-2 Wage / Property Limitation

If it applies, the W-2 wage / property limitation limits the QBI deduction to the *greater* of:

- 50% of W-2 wages paid by a qualified trade or business or
- 25% of the W-2 wages plus 2.5% percent of the unadjusted basis of qualified property immediately after acquisition (UBIA).

W-2 Wage / Property Limitation

- Does NOT apply if income is equal to or less than threshold **($157,500 / $315,000 (MFJ)).**
- Phased in over next $50,000 / $100,000.
- Fully applies if income above phasein ($207,500 / $415,000)
- Applies separately to each trade or business (unless aggregated)

Aggregation

- For taxpayers with income above the threshold,
  - Usually beneficial to aggregate trades or businesses to maximize W-2 wages.
  - When aggregating, deduction is calculated using combined QBI, W-2 wages and UBIA.

Special Rules for Patrons Selling to Coops

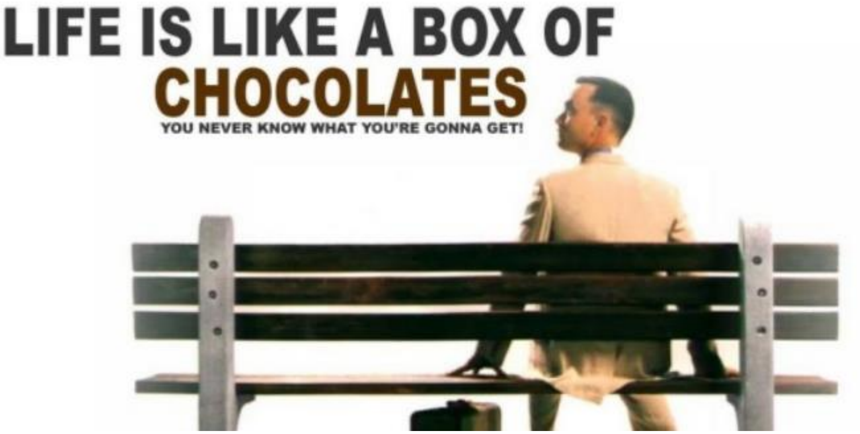
- Patrons selling to cooperatives must calculate 20% QBI deduction, then subtract **lesser** of:
  - 9% of net income attributable to coop sale or
  - 50 percent W-2 wages attributable to sale
    - *Note if they pay no wages, there is no reduction (20% QBI deduction)*
    - *Those who pay wages typically get only an 11% QBI deduction*
    - ***BUT ALSO…***

“New DPAD”

- Cooperative can choose to pass some or all of their deduction through to patrons (just like old DPAD).
- This 199A(g) deduction for patrons is limited by 100% of taxable income (not subtracting capital gain).
- If cooperative passes through deduction (may be up to 9% of QPAI), some farmers will get greater than 20 percent 199A deduction.
  - If not, some will have 11% deduction.

Bottom Line

Overall deduction may be less, more or the same if you sell to a cooperative as opposed to a non-cooperative, depending upon your individual situation. (Intended to be a bit unclear so as not to excessively influence marketing decisions).



Corporate Patrons

- The 199A deduction, including the new 199A(g) does not apply to taxpayers that are C Corporations.
- Section199A(g)(A) deduction 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."
  - What will happen with allocation?

Bonus Depreciation

- 100 percent bonus depreciation through 2022, beginning with:
  - Qualifying property acquired *and* placed into service after September 27, 2017
    - Also, can elect no bonus (elections cannot be revoked without IRS consent)
- Act provides that additional first-year depreciation (bonus) applies to *used*, as well as new property.

Section 179

- Beginning in 2018, the Act 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 are indexed for inflation beginning in 2019.
- They are permanent.

Like-Kind Exchange

- The Act retained IRC § 1031 like-kind exchange treatment for real property, but permanently eliminated it for personal property, beginning with exchanges occurring after December 31, 2017.
  - **Treated as a taxable sale and a purchase.**
- While increased expensing and depreciation options may offset impact, there are significant distinctions.
  - State distinctives (i.e. Iowa ***retains*** 1031 this year)
  - **SE tax/retirement considerations**

Farm Depreciation

- Beginning in 2018, the Act requires *new* farm equipment to be depreciated over a period of five years, instead of seven years.
- It also removes the requirement that this property is depreciated using the 150 percent declining balance method (except for 15 or 20-year property).
  - Farmers will use 200 percent declining balance method (unless elect out).
- These provisions apply to property placed in service after December 31, 2017.

Net Operating Losses

- Beginning in 2018, the Act eliminates the two-year carryback of net operating losses (five-years for farming businesses), but allows a **two-year carryback** of net operating losses in the case of losses incurred in the trade or business of farming.
- It also limits the net operating loss deduction to 80 percent of adjusted taxable income for **losses incurred after December 31, 2017.**
- Unlimited carryforward.

Excess Business Loss Disallowance

- The TCJA implements an excess business loss rule that replaces (and expands upon) the excess farm loss rule (through 2025).
  - Old rule: non-corporate farmers' losses (if they received an applicable subsidy) were limited to a threshold amount of $300,000 ($150,000 for married filing separately).
- **Now**: Non-corporate excess business loss exceeds $500,000 (MFJ)/$250,000 (single)
- Excess is treated as NOL. Mechanics a bit unclear pending guidance.

Business Interest Limitation

- Although the Act restricts business interest deductions generally to 30 percent of adjusted gross income (beginning in 2018), those restrictions do not apply to businesses with cash receipts below $25 million.
- The Act also allows a farming business (as defined in IRC § 263A(e)(4)) and agricultural cooperatives to elect not to be subject to the business interest limitation. Such farming businesses, however, would then be required to use ADS for assets with recovery period of 10 years or more.

Other Provisions

- Expanded Cash Accounting ($25 million gross receipts for C corporations)
  - Partnerships with such C corporations as partners not required to use accrual method. Farming S Corporations continue to be wholly excluded from accrual requirement, regardless of gross receipts
- Eliminated corporate AMT, but retained individual AMT (increased exemption amounts and phase-out thresholds)


Thank
You !