

Recent Developments in Federal Income Taxation

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First Wednesday Tax Update
October 3, 2018

To obtain today's outline and slides:

<https://tinyurl.com/outline-oct18>

<https://tinyurl.com/slides-oct18>

Notice 2018-68
2018-36 I.R.B. 418 (8/21/18)
Outline: item C.1.a, page 3

- Section 162(m) imposes a \$1 million limit on the deduction of publicly traded corporations for compensation to covered employees (generally, certain top corporate officers).
- The 2017 TCJA amended § 162(m) to:
 - Eliminate the exclusion from the \$1 million limit of commissions and performance-based compensation
 - Generally broaden the definition of “covered employee,” e.g., to include a person who *formerly* was a covered employee in years beginning after 2016
 - Expand the category of corporations considered to be publicly traded
 - Apply these changes to tax years beginning after 2017, with a grandfather rule for compensation paid pursuant to a contract in effect on 11/2/17, unless the contract is materially modified.
- Notice 2018-68 provides guidance on certain of these amendments, primarily (1) the rules for identifying covered employees, and (2) the operation of the grandfather rule.
- Proposed regulations are forthcoming and will incorporate this guidance.³

20% Deduction for Qualified Business Income
2017 TCJA § 11011
Outline: item D.2, page 3

- TCJA § 11011 adds Code § 199A, which generally allows a 20% deduction for “qualified business income.”
- Available to individuals, estates, and trusts for taxable years beginning after 2017 and before 2026
- Applies at the individual level
 - At partner or shareholder level for partnerships and S corps
 - Deduction is on Form 1040
 - Deduction is *not* an above-the-line deduction
 - Deduction reduces taxable income
 - Deduction is available both to those who itemize and those who take the standard deduction
 - Does *not* reduce self-employment tax

20% Deduction for Qualified Business Income

2017 TCJA § 11011

Outline: item D.2, page 3

- Qualified business income is produced by a “qualified trade or business”
- QTB is any trade or business *other than*:
 - Trade or business of performing services as an employee, or
 - A specified service trade or business
 - (Note: SSTB exclusion does *not* apply if taxable income is below specified thresholds—\$315,000 for MFJ and \$157,500 for all others)
- Specified service trade or business:
 - “any trade or business involving the performance of services in the fields of health, ... law, 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 1 or more of its employees”
 - Note architects and engineers are excluded

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20% Deduction for Qualified Business Income

2017 TCJA § 11011

Outline: item D.2, page 3

- Qualified business income:
 - Generally is net income from a qualified trade or business
 - Does *not* include:
 1. Income not effectively connected with the U.S. trade or business
 2. Specified investment-related items of income, gain, deduction, or loss
 3. Amounts paid to an S corporation shareholder that are reasonable compensation
 4. Guaranteed payments to a partner for services
 5. To the extent provided in regulations, payments to a partner for services rendered other than in the partner’s capacity as a partner
 6. Qualified REIT dividends or qualified publicly traded partnership income

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20% Deduction for Qualified Business Income
2017 TCJA § 11011

Outline: item D.2, page 3

- Determining the amount of the § 199A deduction:
 - Sum of 2 buckets
 - Apply 1 limitation
- Bucket 1: for each qualified trade or business, the lesser of:
 1. 20 percent of the qualified trade or business income, or
 2. The greater of:
 - A. 50 percent of the W-2 wages, or
 - B. The sum of 25 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.

Note: this W-2 wages and capital limitation does *not* apply to taxpayers whose taxable income is below the \$157,500/\$315,000 thresholds.

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20% Deduction for Qualified Business Income
2017 TCJA § 11011

Outline: item D.2, page 3

- Bucket 2: 20 percent of the sum of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.
- Limitation:
 - Sum of Buckets 1 and 2 cannot exceed taxpayer's taxable income reduced by the taxpayer's net capital gain.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Proposed Regulations: 83 Fed. Reg. 40,884 (8/17/18).
- Prop. Reg. §§ 1.199A-1 through 1.199A-6 address six general areas.
- Prop. Reg. § 1.643(f)-1 provides anti-avoidance rules for multiple trusts.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Operational Rules (Prop. Reg. § 1.199A-1)
- Determination of W-2 Wages and Unadjusted Basis of Property (Prop. Reg. § 1.199A-2)
- Qualified Business Income, Qualified REIT Dividends, and Qualified Publicly Traded Partnership Income (Prop. Reg. § 1.199A-3)
- Aggregation Rules (Prop. Reg. § 1.199A-4)
- Specified Service Trade or Business (Prop. Reg. § 1.199A-5)
- Special Rules for Passthrough Entities, Publicly Traded Partnerships, and Trusts (Prop. Reg. § 1.199A-6)
- Anti-Avoidance Rules for Multiple Trusts (Prop. Reg. § 1.643(f)-1)

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Operational Rules (Prop. Reg. § 1.199A-1)
 - Define certain key terms, including qualified business income, specified service trade or business, and W-2 wages
 - Provide that a “trade or business” is a “a section 162 trade or business other than performing services as an employee.”
 - Do not provide guidance on rental activities, other than limited situation of property rented or licensed to a trade or business that is commonly controlled
 - Provide guidance on computation of § 199A deduction for those with taxable income below and above the \$157,500/\$315,000 thresholds
 - Provide rules for carryover of negative amounts of qualified business income and combined qualified REIT dividends and qualified PTP income
 - Clarify that § 199A deduction has no effect on adjusted basis of partner’s partnership interest or adjusted basis of an S corporation stock

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Determination of W-2 Wages and Unadjusted Basis of Property (Prop. Reg. § 1.199A-2)
 - W-2 Wages and UBIA of qualified property are relevant for taxpayers whose taxable incomes exceed the \$157,500/\$315,000 thresholds
 - Rules of Prop. Reg. § 1.199A-2 regarding W-2 wages generally follow rules under former § 199 (the now-repealed domestic production activities deduction)
 - Difference: the W-2 wage limitation in § 199A applies separately for each T/B.
 - Wages must be “properly allocable” to qualified business income to be taken into account for purposes of § 199A (associated wage expense must be taken into account in determining qualified business income).
 - Amount of W-2 wages allocable to each trade or business generally is amount of deductions for those wages allocated to each trade or business.
 - Partner or S corporation shareholder’s allocable share of wages must be determined in same manner as that person’s share of wage expenses.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Determination of W-2 Wages and Unadjusted Basis of Property (Prop. Reg. § 1.199A-2)
 - Notice 2018-64, 2018-35 I.R.B. 347 (8/8/18) contains a proposed revenue procedure that provides guidance on methods for calculating W-2 wages for purposes of § 199A.
 - Provides three methods for calculating “W-2 wages.” The methods are substantially similar to those provided in Rev. Proc. 2006-47, 2006-2 C.B. 869, which applied for purposes of former Code § 199.
 - First method (unmodified Box method) allows for a simplified calculation.
 - Second method (modified Box 1 method) and third method (tracking wages method) provide greater accuracy.
 - The proposed revenue procedure is proposed to apply generally to taxable years ending after December 31, 2017.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Determination of W-2 Wages and Unadjusted Basis of Property (Prop. Reg. § 1.199A-2)
 - Provide guidance on determining the UBIA of qualified property.
 - Prop. Reg. § 1.199A-2(c)(1) restates statutory definition of qualified property, which is depreciable tangible property that is
 1. Held by, and available for use in, a trade or business at the close of the taxable year,
 2. Used in the production of qualified business income, and
 3. For which the depreciable period has not ended before the close of the taxable year.
 - Clarify that:
 1. UBIA is determined without regard to *both* depreciation and amounts that a taxpayer elects to treat as an expense (e.g., pursuant to § 179),
 2. UBIA is determined as of date the property is placed in service.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Qualified Business Income, Qualified REIT Dividends, and Qualified Publicly Traded Partnership Income (Prop. Reg. § 1.199A-3)
 - Gain or loss treated as ordinary under § 751 can be QBI if the other requirements of § 199A are satisfied
 - §1231 gain or loss is not QBI if the § 1231 “hotchpot” analysis results in these items becoming long-term capital gains and losses
 - §1231 gain or loss is QBI if the § 1231 analysis results in ordinary items
 - Losses previously suspended under §§ 465, 469, 704(d), or 1366(d) that are allowed in current year are treated as items attributable to the trade or business in the current year
 - Note: such losses carried over from taxable years ending before 1/1/18 are not taken into account in for purposes of computing QBI
 - Net operating losses carried over from prior years are not taken into account in determining QBI for the current year (except excess business losses disallowed in prior year by new § 461(l))

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Aggregation Rules (Prop. Reg. § 1.199A-4)
 - Prop. Reg. § 1.199A-4 permits, but does not require, taxpayers to aggregate trades or businesses for purposes of determining the § 199A deduction if requirements in Prop. Reg. § 1.199A-4(b)(1) are satisfied.
 - Treasury and the IRS declined to adopt the existing aggregation rules in Reg. § 1.469-4 that a
 - Five requirements must be satisfied for businesses to be aggregated (e.g., businesses have same tax year, neither business is a specified service trade or business)
 - Consistency rule: an individual who aggregates trades or businesses must consistently report the aggregated trades or businesses in subsequent taxable years.
 - Disclosure: taxpayers must attach to the relevant return a disclosure statement that identifies the trades or businesses that are aggregated.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Specified Service Trade or Business (Prop. Reg. § 1.199A-5)
 - Provide extensive guidance
 - Provide rules regarding what it means to be considered to be providing services in each of the categories set forth in the statute, e.g., to be treated as providing services in the field of law, accounting, medicine etc.
 - A T/B in which principal asset is reputation or skill of one or more employees means any T/B consisting of:
 1. T/B in which a person receives fees, compensation, or other income for endorsing products or services,
 2. T/B in which a person licenses or receives fees (or other income) for use of an individual's image, likeness, name, signature, voice, trademark, or symbols associated with that person's identity, or
 3. Receiving fees or other income for appearing at an event or on radio, television, or another media format.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Specified Service Trade or Business (Prop. Reg. § 1.199A-5)
 - De Minimis Rule: a trade or business (determined before application of the aggregation rules) is not a specified service trade or business if:
 1. It has gross receipts of \$25 million or less and less than 10 percent of its gross receipts is attributable to the performance of services in a specified service trade or business, or
 2. It has more than \$25 million in gross receipts and less than 5 percent of its gross receipts is attributable the performance of services in a specified service trade or business.

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20% Deduction for Qualified Business Income Proposed Regulations

Outline: item D.2.a, page 6

- Special Rules for Passthrough Entities, Publicly Traded Partnerships, and Trusts (Prop. Reg. § 1.199A-6)
 - Provide computational steps for passthrough entities and publicly traded partnerships
 - Provide special rules for applying § 199A to trusts and decedents' estates

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Deduction of State and Local Taxes

Outline: item D.1, page 11

- TCJA: An individual's itemized deductions on Schedule A for state taxes cannot exceed \$10,000.
 - Applies to aggregate of property taxes, and sales or income taxes.
 - Limit applies both to single individuals and married individuals filing jointly
 - Applies 2018 through 2025
- Some states have adopted workarounds, e.g., New Jersey gives a credit against property taxes for contributions to certain charitable funds.
- Notice 2018-54 (5/23/18): proposed regulations will "make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers."

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Deduction of State and Local Taxes

Proposed Regulations

Outline: item D.1.b, page 12

- Proposed Regulations: 83 Fed. Reg. 43563 (8/27/18).
- Prop. Reg. § 1.170A-1(h)(3):
 - Generally requires taxpayers to reduce the amount of any federal income tax charitable contribution deduction by the amount of any corresponding state or local tax *credit* the taxpayer receives or expects to receive.
 - However, a corresponding state or local tax *deduction* normally will not reduce the taxpayer's federal deduction provided the state and local deduction does not exceed the taxpayer's federal deduction.
 - To the extent the state and local charitable deduction exceeds the taxpayer's federal deduction, taxpayer's federal deduction is reduced.
 - Exception: the taxpayer's federal charitable contribution deduction is not reduced if the corresponding state or local credit does not exceed 15 percent of the taxpayer's federal deduction.
- Could have unintended consequences for pre-existing state tax credit programs, such as Georgia's Rural Hospital Tax Credit Program.

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Deduction of State and Local Taxes

Proposed Regulations

Outline: item D.1.b, page 12

- Examples:
 1. *Example 1.* A, an individual, makes a payment of \$1,000 to X, an entity listed in section 170(c). In exchange for the payment, A receives or expects to receive a state tax credit of 70% of the amount of A's payment to X. Under paragraph (h)(3)(i) of this section, A's charitable contribution deduction is reduced by \$700 (70% × \$1,000). This reduction occurs regardless of whether A is able to claim the state tax credit in that year. Thus, A's charitable contribution deduction for the \$1,000 payment to X may not exceed \$300.
 2. *Example 2.* B, an individual, transfers a painting to Y, an entity listed in section 170(c). At the time of the transfer, the painting has a fair market value of \$100,000. In exchange for the painting, B receives or expects to receive a state tax credit equal to 10% of the fair market value of the painting. Under paragraph (h)(3)(vi) of this section, B is not required to apply the general rule of paragraph (h)(3)(i) of this section because the amount of the tax credit received or expected to be received by B does not exceed 15% of the fair market value of the property transferred.

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Other Recent Developments

- Notice 2018-58 2018-33 I.R.B. 305 (07/30/18) (outline item F.1.a., page 13).
- REG-130244-17, Proposed Removal of Section 385 Documentation Regulations, 83 F.R. 48265 (9/24/18) (outline item H.1, page 14).
- REG-131186-17, Proposed Removal of Temporary Regulations on a Partner's Share of a Partnership Liability for Disguised Sale Purposes, 83 F.R. 28397 (6/19/18) (outline item B.1, page 14).
- T.D. 9833, Partnership Transactions Involving Equity Interests of a Partner, 83 F.R. 26580 (6/8/18) (outline item C.1, page 16).
- T.D. 9836, Substantiation and Reporting Requirements for Cash and Noncash Charitable Contribution Deductions, 83 F.R. 36417 (7/30/18)) (outline item B.1, page 17).
- Harbor Lofts Associates v. Commissioner, 151 T.C. No. 3 (8/27/18)) (outline item B.2, page 19).
- News releases IR-2018-187 (9/15/18) and SC-2018-01 (9/24/18)-IRS has provided relief from several filing and payment deadlines to those in areas affected by Hurricane Florence (outline item H.1.b, page 21).

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