36th Annual NHSCPA/NHBA Tax Forum
November 28, 2018

Recent Guidance on the 2017 Tax Cuts and Jobs Act and Impact on Choice of Entity

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I. Bonus Depreciation and Business Losses

A. Bonus Depreciation

The TCJA extended and expanded bonus depreciation for property placed in service by a taxpayer after September 27, 2017 and before January 1, 2027. IRC 168(k). Generally, property is eligible for bonus depreciation if it (1) has a normal depreciation recovery period of 20 years or less, (2) is computer software or (3) is water utility property. IRC 168(k)(2)(A)(i). Property subject to the alternative depreciation system under IRC 168(g) (most commonly property leased to a tax-exempt entity or financed by tax-exempt bonds, which property must be depreciated on a straight-line basis over a longer recovery period) is not eligible for bonus depreciation. IRC 168(k)(2)(D). Also ineligible for bonus depreciation are (1) certain property of regulated utilities (IRC 168(k)(9)(A)) and (2) certain property subject to floor plan financing (IRC 168(k)(9)(B)).

Special rules apply to: (1) property that takes more than one year to produce (IRC 168(k)(2)(B), IRC 168(k)(2)(E)(i)), IRC 168(k)(6)(B) and IRC 168(k)(8)); (2) certain film and television productions (IRC 168(k)(2)(A)(i)(IV) and IRC 168(k)(2)(H)(i)); (3) certain live theatrical productions (IRC 168(k)(2)(A)(i)(V) and IRC 168(k)(2)(H)(ii));(4) certain aircraft (IRC 168(k)(2)(C)); (5) certain leased property that is syndicated by the lessor (IRC 168(k)(2)(E)(iii)); (6) passenger automobiles (IRC 168(k)(2)(F)); and (7) certain fruit and nut bearing plants (IRC 168(k)(5), IRC 168(k)(6)(C) and IRC 168(k)(10)(A)). Further discussion of these special rules is beyond the scope of this summary.

The allowed bonus depreciation amount depends on when the property is placed in service:
September 28, 2017 – December 31, 2022, 100%
During 2023, 80%
During 2024, 60%
During 2025, 40%
During 2026, 20%
IRC 168(k)(6)(A)

Note that these rules relate back to September 27, 2017, but bonus depreciation is reduced for property that was acquired before September 28, 2017 but placed in service after September 27, 2017. IRC 168(k)(8). The percentage of bonus depreciation allowed for property acquired before September 28, 2017 is as follows based on when the property is placed in service:
During 2017, 50% (IRC 168(k)(8)(A)(i))
During 2018, 40% (IRC 168(k)(8)(B)(i))

During 2019, 30% (IRC 168(k)(8)(C)(i))
After 2019, 0% (IRC 168(k)(8)(D)(i))

In addition, under a special transition rule, a taxpayer may elect to claim 50% bonus depreciation (rather than 100%) for property placed in service during the taxpayer's first tax year ending after September 27, 2017 (regardless of when the taxpayer acquired the property). IRC 168(k)(10)(A).

A significant change under the TCJA is that bonus depreciation is now allowed for used property acquired and placed in service by a taxpayer and not just new property. IRC 168(k)(2)(A)(ii). Used property is eligible for bonus depreciation only if the taxpayer claiming bonus depreciation never used the property prior to acquiring it. IRC 168(k)(2)(E)(ii)(I). In addition, a taxpayer may claim bonus depreciation for used property acquired by the taxpayer and placed in service by the taxpayer only if: (1) the taxpayer did not acquire the property from a related person; (2) the taxpayer did not acquire the property from another member of the same controlled group; and (3) the taxpayer's basis in the used property is not (i) a carryover basis from the seller, (ii) determined under IRC 1014 upon the death of the prior owner or (iii) determined based on the taxpayer's basis in any other property. IRC 168(k)(2)(e)(ii)(II).

(Note that, under the TCJA, like-kind exchanges are now allowed only for real property. IRC 1031(a)(1). The allowance of bonus depreciation for used property has been identified as one of the reasons Congress decided to limit like-kind exchanges to real property only.)

Bonus depreciation is also allowed for purposes of computing a taxpayer's alternative minimum tax. IRC 168(k)(2)(G).

A taxpayer may elect not to claim bonus depreciation for all property in the same depreciation class placed in service in a year. IRC 168(k)(7).

B. <u>Changes to Net Operating Loss Rules</u>

Under the TCJA, beginning with losses first arising in 2018 or later, any net operating loss ("NOL") generally cannot be carried back to any prior tax year. IRC 172(b)(1)(A)(i). An exception to this general rule allows NOLs from farming to be carried back up to two years. IRC 172((b)(1)(B)(i). Another exception allows insurance companies other than life insurance companies to carry back NOLs for up to two years. IRC 172(b)(1)(C)(i). Taxpayers other than insurance companies that are not life insurance companies may carry forward NOLs indefinitely. IRC 172(b)(1)(A)(ii). Insurance companies that are not life insurance companies may only carry forward NOLs for 20 years. IRC 172(b)(1)(C)(ii).

Another significant change under the TCJA is that post-2017 NOLs carried to a tax year generally may only offset up to 80% of the taxpayer's taxable income in that year (determined before application of any NOLs carried to that year). IRC

172(a)(2). This special limitation does not apply to insurance companies that are not life insurance companies. IRC 172(f)(2).

C. New Limit on "Excess Business Losses" of Individuals

The TCJA added new section 461(l) that limits the losses a noncorporate taxpayer may use against non-business income. IRC 461(l)(1). An individual taxpayer may only use $250,000 of net business losses in a year against non-business income in the year. IRC 461(l)(3)(A)(ii)(II). The limit is doubled for taxpayers that file a joint return with a spouse. IRC 461(l)(3)(A)(ii)(II). The excess loss limitation is adjusted for inflation each year on the same basis that the income tax tables are adjusted each year under IRC 1(f)(3). IRC 461(l)(3)(B)

"Excess business loss" means the excess (if any) of a taxpayer's aggregate deductions from trades or businesses over the taxpayer's aggregate gross income from trades or businesses plus the $250,000/$500,000 loss limit amount. IRC 461(l)(3)(A). Section 461(l) does not define "trade or business." Because Section 461(l) only applies for 2018-2025 (IRC 461(l)(1)), however, unreimbursed business expenses incurred by a taxpayer in the business of being an employee will not be allowed deductions for these purposes. IRC 67(g) (suspending the deduction of miscellaneous itemized deductions (which include unreimbursed business expenses of an employee, which are not allowed as an "above the line" deduction in determining AGI as provided in IRC 62(a)(1)) for 2018-2025).

The new "excess business loss" limitation is determined at the individual partner or shareholder level for partners in partnerships and shareholders in S corporations. IRC 461(l)(4). A special ordering rule states that any "excess business loss" is determined after application of the passive loss rules under Section 469. IRC 461(l)(6). Existing rules state that the basis limitation rules (IRC 704(d) for partnerships and IRC 1366(d) for S corporations) apply before the at-risk limitation rules (IRC 465) and that the at-risk limitation rules apply before the passive loss limitation rules (IRC 469). Temp. Treas. Reg. 1.1469-2T(d)(6). Accordingly, an "excess business loss" can only arise after a taxpayer has satisfied the basis limitation rules, the at-risk rules and the passive activity rules.

Any "excess business loss" disallowed under Section 461(l)(1) is treated as a NOL carryover to the next taxable year and will be subject to the 80% taxable income limit on the use of NOLs. IRC 461(l)(2). A special rule under new Section 199A, however, treats an "excess business loss" not allowed under Section 461(l) as a reduction in the taxpayer's "qualified business income" ("QBI") in the next taxable year and not as a NOL, which would not reduce QBI in a subsequent year. Prop. Treas. Reg. 1.199A-3(b)(1)(v).

II. Compensation and Property Basis Under Section 199A

A. Generally

Wages and basis of business property are part of the Section 199A deduction calculation for taxpayers whose income exceeds the threshold amount plus the phase-in amount (in 2018, \$207,500 for an individual taxpayer or \$415,000 for married taxpayers filing jointly). IRC 199A(b)(2)(B). The calculation looks at whether (A) 20% of the taxpayer's QBI is less than (B) the greater of (i) 50% of the W-2 Wages with respect to the qualified trade or business ("QTB") or (ii) the sum of 25% of the W-2 Wages with respect to the QTB plus 2.5% of the unadjusted basis immediately after acquisition ("UBIA") of all "qualified property." IRC 199A(b)(2). The Section 199A deduction is still limited to 20% of a taxpayer's taxable income if that is less than the amount determined by these calculations. IRC 199(a).

B. W-2 Wages

"W-2 Wages" generally means wages subject to withholding plus elective deferral amounts under a Section 401(k), 403(b), 408(k)(6) (SEP), 408(p) (SIMPLE IRA) or 457(b) retirement plan. IRC 199A(b)(4)(A). The Internal Revenue Service has issued a notice and proposed Revenue Procedure that provide three methods for calculating wages. Notice 2018-64, 2018-34 I.R.B. 347 (Aug. 8, 2018). The allowed methods are as follows:

"*Unmodified Box Method*" – W-2 Wages are the lesser of the amounts reported in Box 1 or Box 5 of all Forms W-2 filed with the Social Security Administration. This method will generally not count amounts deferred under retirement plans (but may include amounts not subject to withholding) and so will not be fully inclusive or accurate.

"*Modified Box 1 Method*" – W-2 Wages are the amounts reported in Box 1, less any amounts in Box 1 not subject to federal income tax withholding (such as supplemental unemployment compensation benefits), plus amounts reported in Box 12 (retirement plan deferrals) under code D (401(k)), E (403(b)), F (SEP), G (457(b)) or S (SIMPLE IRA).

"*Tracking Wages Method*" – W-2 Wages as defined under IRC 199A are actually tracked and recorded as paid.

Only wages included on W-2 and W-3 returns filed with the Social Security Administration within 60 days after the due date for the returns (including extensions) may be included in the Section 199A calculations. IRC 199A(b)(4)(C); Prop. Treas. Reg. 1.199A-2(b)(2)(iii)(A). The W-2 Wages may be paid, and the W-2 and W-3 returns may be filed, by a third-party employer (such as a professional employment organization or PEO) as long as the employees are properly treated as officers or common law employees of the taxpayer. Prop. Treas. Reg. 1.199A-2(b)(2)(ii). A PEO paying wages and filing returns for common law employees of the taxpayer may not include the W-2 wages with respect to such employees in the PEO's own Section 199A calculations. Prop. Treas. Reg. 1.199A-2(b)(2)(ii).

The reporting requirement for W-2 Wages creates a potential mismatch between compensation paid (or deemed paid in the case of an S corporation) by a business, which reduces the business's QBI, and the W-2 Wages includable in the Section 199A calculations for the business. Prop. Treas. Reg. 1.199A-3(b)(4). For example, where an S Corporation is deemed not to have paid its employee-stockholders "reasonable compensation" for their services to the corporation (Rev. Rul. 74-44, 1974-1 C.B. 287), amounts distributed by the corporation to the stockholders and reported as dividends may be recharacterized as compensation for services and reduce the corporation's QBI. IRC 199A(c)(4)(A). Because the corporation would have originally reported these amounts as dividends and not as W-2 Wages, unless the corporation files corrected Forms W-2 and W-3 within 60 days after the original due date (including extensions), which is not likely in this scenario, the corporation will reduce its QBI but not increase its W-2 Wages by this amount. Prop. Treas. Reg. 1.199A-3(b)(2)(ii)(H).

Businesses taxed as partnerships are not subject to this "reasonable compensation" rule and so do not face the risk of having cash distributions recharacterized as compensation that reduces QBI. A business taxed as a partnership will, however, reduce its QBI by the amount of any guaranteed payments to partners for services under IRC 707(c) and by the amount of any payments to partners for services rendered by a partner other than in her capacity as a partner under IRC 707(a). Prop. Treas. Reg. 1.199A-3(b)(2)(ii)(I)-(J). Because a partner cannot be an employee of a partnership (Rev. Rul. 69-184, 1969-1 C.B. 256), these amounts are never reported on a Form W-2 and so cannot constitute W-2 Wages under Section 199A. Accordingly, a business taxed as a partnership generally has an incentive, solely for purposes of Section 199A, to avoid reporting payments to partners under IRC 707(a) or 707(c) and to report all cash payments to partners as cash distributions.

Where a taxpayer is engaged in more than one trade or business, the W-2 Wages must be allocated among those trades or businesses. IRC 199A(b)(4)(B); Prop. Treas. Reg. 1.199A-2(b)(1). W-2 Wages must be allocated among multiple trades or businesses in the same manner as the expenses associated with those wages are allocated among the taxpayer's trades and businesses. Prop. Treas. Reg. 1.199A-2(b)(3). In general, a taxpayer may allocate its expenses among multiple trades or business in any reasonable manner as long as long as the method chosen is applied consistently year-to-year and is reflected in the taxpayer's books and records for each trade or business. Prop. Treas. Reg. 1.199A-3(b)(5).

C. UBIA

UBIA generally means the unadjusted, original cost basis of "qualified property," which generally means any depreciable property used by the taxpayer in a QTB. IRC 199A(b)(6)(A); Prop. Treas. Reg. 1.199A-2(c)(3). UBIA is not adjusted for bonus depreciation. Prop. Treas. Reg. 1.199A-2(c)(2)(ii). UBIA is also not adjusted for regular depreciation or for any basis reduction for tax credits claimed by the taxpayer with respect to the qualified property. Prop. Treas. Reg. 1.199A-2(c)(3). UBIA is adjusted, however, to the extent the qualified property is used other than in a QTB. Prop. Treas. Reg. 1.199A-2(c)(3).

A special anti-abuse rule prevents a taxpayer from acquiring property near the end of a year with a principal purposes of increasing the Section 199A deduction. Prop. Treas. Reg. 1.199A-2(c)(1)(iv). Under this rule, property is not qualified property if it is (1) placed in service within 60 days before the end of a taxable year and (2) disposed of within 120 days after acquisition without having been used in a QTB for at least 45 days, unless the taxpayer can demonstrate that the acquisition and disposition of the property did not have a principal purpose of increasing the Section 199A deduction. Prop. Treas. Reg. 1.199A-2(c)(1)(iv).

A taxpayer includes the UBIA of any particular item of qualified property in its Section 199A calculations for a taxable year if the taxpayer continues to use the property in a QTB and the "depreciable period" of the property has not ended before the end of that taxable year. IRC 199A(b)(6)(A)(iii). The depreciable period of property begins when the property is placed in service and ends on the later of the 10th anniversary of the date the property is placed in service or the last day of the taxable year in which the property's normal depreciation life ends. IRC 199A(b)(6)(B).

If a taxpayer makes a capital improvement to qualified property, that improvement is treated as separate qualified property with its own UBIA and depreciable period. Prop. Treas. Reg. 1.199A-2(c)(1)(ii). Special basis adjustments made with respect to qualified property under IRC 734(b) or 743(b) are not treated as separate qualified property. Prop. Treas. Reg. 1.199A-2(c)(1)(iii).

If a taxpayer acquires property in a non-recognition transaction (such as a subsidiary liquidation under IRC 332, a transfer to or from a corporation under IRC 351 or 361 or a transfer to or from a partnership under IRC 721 or 731) or from another member of the same consolidated group, then, to the extent the taxpayer's basis in the property does not exceed the transferor's basis, the property is treated as placed in service by the taxpayer on the date the transferor first placed the property in service. Prop. Treas. Reg. 1.199A-2(c)(2)(iv)(A). If a taxpayer's basis in property acquired in a non-recognition transaction or from another member of the same consolidated group exceeds the transferor's basis in the property, then, to the extent of the additional basis, the acquired property is treated as separate qualified property placed in service on the date it is first placed in service by the taxpayer. Prop. Treas. Reg. 1.199A-(2)(c)(2)(iv)(B).

Absent an election by the taxpayer, qualified property acquired by a taxpayer in a like-kind exchange under IRC 1031 or an involuntary conversion under IRC 1033 is treated as placed in service on the date that the relinquished property was first placed in service by the taxpayer to the extent of the "exchanged basis" (generally the lower of the adjusted basis of the relinquished property or of the acquired property) of the property. Prop. Treas. Reg. 1.199A-2(c)(2)(iii)(A) (referencing Treas. Reg. 1.168(i)-6(b)). If a taxpayer has "excess basis" (as defined in Treas. Reg. 1.168(i)-6(b)(8)) in the acquired property (generally because the taxpayer recognizes gain on the like-kind exchange or involuntary conversion), the acquired property, to the extent of the excess basis, is treated as separate qualified property placed in service on the date it is first placed in service by the taxpayer. Prop. Treas. Reg. 1.199A-(2)(c)(2)(iii)(B). If a taxpayer makes the election under Treas. Reg. 1.168(i)-6(i)(1) not to have the special depreciation rules for property acquired in a like-kind exchange or involuntary conversion apply, then the replacement property is treated as placed in service on the date it is first placed in service by the taxpayer with respect to both the exchanged basis and the excess basis. Prop. Treas. Reg. 1.199A-2(c)(2)(iii)(C).

(Note that, under the TCJA, like-kind exchanges are now allowed only for real property. IRC 1031(a)(1). Accordingly, these special rules relating to like-kind exchanges will have limited practical application under Section 199A.)

III. State Tax Considerations for Choice of Entity after TCJA

Because New Hampshire does not conform its tax laws to the current Internal Revenue Code, the TCJA does not directly impact the determination of New Hampshire tax liabilities. This lack of conformity means that New Hampshire taxpayers must track certain tax items separately for state and federal purposes, and the TCJA expands the items that must be tracked separately.

New Hampshire currently uses the Internal Revenue Code as of December 31, 2016 as the starting point for most state tax calculations. NH RSA 77-A:1, XX(n). New Hampshire has, however, further limited the scope of conformity by not adopting certain federal rules such as those relating to bonus depreciation and the prior domestic production activities deduction. NH RSA 77-A, 3-b. New Hampshire also has its own NOL rules. NH RSA 77-A:4, XIII. New Hampshire has modified the Section 179 expensing rules as well. NH RSA 77-A, 3-a. As a result, even if New Hampshire updates the general conformity date to December 31, 2017 when the TCJA was in effect, it may not adopt all the provisions of the TCJA, such as bonus depreciation and the Section 199A deduction. Note also that the Section 199A deduction is a "below the line" deduction for individuals and does not reduce an individual's sole proprietorship income reported on Schedule C or the income of a partnership or S corporation.

It does appear that new Section 199A may have indirect effects on the choice of entity for small business in New Hampshire.

A. <u>Sole Proprietorships and Partnerships Likely Favored Over S Corporations</u>

An S corporation must reduce its QBI for the amount of "reasonable compensation" paid to shareholder-employees for services. IRC 199A(c)(4)(A). If an adjustment to QBI occurs after the due date for Forms W-2 and W-3, the reduction in QBI for an S corporation will not increase the W-2 Wages of the S corporation under Section 199A. Prop. Treas. Reg. 1.199A-3(b)(4).

A New Hampshire S corporation generally will deduct amounts paid as wages to its shareholders in determining gross business profits. NH RSA 77-A:1, III(b)(2); NH Rev. 302.01. Ignoring conformity differences (such as with respect to bonus depreciation and NOLs), a New Hampshire S corporation's QBI and gross business profits will be substantially the same.

Businesses taxed as sole proprietorships or partnerships are not subject to the "reasonable compensation" rule under Section 199A. IRC 199A(c)(4); Prop. Treas. Reg. 1.199A-3(b)(2)(ii)(H). Cash distributions or payments by a partnership to its partners do not reduce QBI unless the amounts are reported as guaranteed payments for services under IRC 707(c) or as payments to partners for services rendered by a partner other than in her capacity as a partner under IRC 707(a). Prop. Treas. Reg. 1.199A-3(b)(2)(ii)(I)-(J).

A New Hampshire partnership or sole proprietorship is allowed to reduce its taxable business profits (but not below zero) for payments to owners that constitute "reasonable compensation" whether or not those amounts were reported federally as guaranteed payments for services under IRC 707(c) or as payments to partners for services rendered by a partner other than in her capacity as a partner under IRC 707(a). NH RSA 77-A:4, III. (In New Hampshire, payments to partners for services are actually added back to a partnership's income to determine the partnership's gross business profits (NH RSA 77-A, III(c)) before being deducted as "reasonable compensation" under NH RSA 77-A:4, III.) As a result, unlike an S corporation, a New Hampshire partnership or sole proprietorship may reduce its New Hampshire taxable business profits for payments made to owners without reducing federal QBI. This strategy does require that a partnership not report the payments as guaranteed payments for services under IRC 707(c) or as payments to partners for services rendered by a partner other than in her capacity as a partner under IRC 707(a).

On the other hand, if a business has significant amounts of QBI (so that its owners have income in excess if the threshold amount plus the phase-in amount – in 2018, $207,500 for an individual taxpayer or $415,000 for married taxpayers filing jointly), it may be better off as an S corporation and increase its W-2 Wages under Section 199A.

B. <u>Using an LLC as an S Corporation</u>
New Hampshire S corporation shareholders are subject to a 5% tax ("NH I&D Tax") on dividends they receive from the S corporation. NH RSA 77:4, II. Distributions by an LLC that does not have transferable shares are not subject to the NH I&D Tax. NH RSA 77:4, III. (In this case, the LLC itself is subject to the NH I&D Tax on interest or dividends the LLC receives. NH RSA 77:3, I(b).)

An LLC may elect to be taxed as an S corporation. Treas. Reg. 301.7701-3. An LLC that elects to be taxed as an S corporation for federal income tax purposes is still treated as an LLC under the NH I&D Tax. NH DRA Declaratory Ruling 10391 (Jul. 26, 2013). An LLC that elects to be taxed as an S corporation for federal income tax purposes is taxed as an S corporation for purposes of the NH BPT. NH RSA 77-A:1, III(b). Accordingly, a New Hampshire LLC taxed as an S corporation must reduce its QBI under Section 199A for the "reasonable compensation" deemed paid to its shareholders if this amount is greater than the W-2 wages reported as paid to these shareholders (IRC 199A(c)(4)(A)), but an LLC taxed as an S corporation cannot take a "reasonable compensation" deduction under the NH BPT for amounts not reported as compensation for federal tax purposes (NH RSA 77-A:4, III(a)).

A New Hampshire corporation taxed as an S corporation may convert to an LLC, and that LLC may elect to be taxed as an S corporation. NH RSA 293-A:9.50(a); NH RSA 304-C:149, I. This conversion is a non-taxable "F reorganization" for federal income tax purposes. IRC 368(a)(1)(F). This conversion also does not have any immediate tax impact for New Hampshire tax purposes, including with respect to the NH BPT, the NH I&D Tax and the New Hampshire real estate transfer tax. NH DRA Declaratory Ruling 10391 (Jul. 26, 2013).

As a result of this statutory structure, some owners of S corporations that are currently state law corporations may benefit from converting a corporation to an LLC that elects to be taxed as an S corporation because that conversion might reduce the NH I&D Tax paid by the owners on cash distributions by the S corporation. The analysis required to make this decision can be complicated, and this analysis has now been further complicated by the availability of the Section 199A deduction under the TCJA.

C. Transition from an Employee to an Independent Contractor

The trade or business of performing services as an employee is not a QTB under Section 199A. Prop. Treas. Reg. 1.199A-5(d)(1). As a result, there is an incentive for some individuals who are employees to become independent contractors to take advantage of the Section 199A deduction. For federal tax purposes, whether this strategy makes sense depends on the profitability of the sole proprietorship (after accounting for, among other things, self-employment taxes and employer-provided benefits such as healthcare coverage) compared to the wages earned as an employee. In addition, Section 199A contains a presumption that a former employee who is performing substantially the same services for the same employer but now purportedly as a non-employee will still be treated as engaged in the trade or business of performing services as an employee with respect to that employer. Prop. Treas. Reg. 1.199A-5(d)(3)(i). In addition, if the taxpayer's taxable income is more the $207,500 ($415,000 for married couples filing jointly), the taxpayer will not benefit from becoming and independent contractor if the taxpayer's business is a personal services-type business (an "SSTB" under Section 199A). IRC 199A(d)(3).

Even if a former employee can qualify as a sole proprietor under Section 199A, that person must also consider that she will now be engaged in business in New Hampshire as a business organization subject to the New Hampshire Business Profits Tax (the "NH BPT") f her gross business income exceeds $50,000. NH RSA 77-A:6, I. As a result, this strategy will be less valuable n New Hampshire than in other states.