August 2018

Tax Talk

A quarterly publication of Bridges & Dunn-Rankin, LLP

Inside this issue:

Dear Clients and Friends,

It's been a crazy year here at Bridges & Dunn-Rankin. In late December of last year, Congress passed the most significant tax legislation we have seen in at least 31 years (*The Tax Cuts and Jobs Act*, or "TJCA") and we have been playing catch-up ever since.

The IRS has been playing catch-up as well, trying to formulate guidance for the interpretation and implementation of legislation which (including the Conference Committee's explanations) ran over 1,000 pages. In this regard, the IRS has just issued proposed regulations with respect to one of the more significant provisions in TCJA, the new 20% "qualified business income" (QBI) deduction for income from pass-thru businesses.

Meanwhile, the states continue their arms race to see who can offer the most tax credits; and the IRS has just issued proposed regulations requiring that (for donations made after August 27, 2018) you reduce the amount of your Federal charitable deduction by the benefit of any related state tax credit.

Kent Bridges, Managing Partner

Given the importance of the 20% QBI deduction and state tax credits to our clientele, we will feature those two items in this issue of our newsletter.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

The 20% Qualified Business Income Deduction

Included in the December 2017 tax legislation (*The Tax Cuts and Jobs Act* or "TCJA") was a new deduction for owners of pass-thru entities and sole proprietorships, the 20% "qualified business income" deduction (also referred to as the QBI deduction or IRC 199A deduction). Outside of possibly the reduction in C-corp tax rate, this new 20% QBI deduction is probably the most substantial provision in TCJA. Assuming you can qualify, the deduction can be up to as much as 20% of your profit from the business, which means shaving up to 7.4 percentage points off of your marginal tax rate.

Earlier this month, the IRS issued proposed regulations with respect to this new deduction. There were no real surprises in the proposed regulations. It appears that the IRS has pretty much stayed true to Congressional intent, and neither expanded nor contracted who and what can qualify. Overall, the proposed regulations are largely taxpayer friendly.

The proposed regulations (including Treasury's explanation of such) run 184 pages, so these are very complex rules, but we will try to summarize them here for you from a very high level.

The general rules - The deduction is computed at the individual owner level, and is essentially a new type of deduction in that it does not reduce adjusted gross income, but can be claimed without regard to whether you itemize. In general, the deduction is equal to 20% of K-1 or Schedule C "qualified business income", which does not include interest, dividends and capital gains (so you cannot double dip and get the lower rate on qualified dividends and capital gains while claiming this new deduction on the same income). In order to qualify for this special deduction, you have to meet one of two tests:

1. If your taxable income on married joint return is less than $315,000 (or up to $415,000 with partial deduction; and 1/2 of these amounts for single persons), then you will automatically qualify almost regardless of the type of business, and regardless of the amount of W-2 wages (if any) paid by the business; or
2. Alternatively, if your taxable income on married joint return will exceed $315,000 (or up to $415,000 for partial deduction; and 1/2 of these amounts for single persons), then the business cannot be a "specified service business" (defined further below), and your deduction is limited to the lesser of 20% of your profit from the business or 50% of your proportionate share of the W-2 wages paid by the business (or 25% of the W-2 wages plus 2.5% of the original cost of depreciable assets).

Proposed regulations - The proposed regulations are divided into six sections: (1) operational rules; (2) determination of W-2 wages and basis of depreciable property; (3) qualified business income; (4) aggregation of businesses; (5) specified service businesses and the business of being an employee; and (6) relevant passthrough entities. Each of these is discussed further below.

Operational rules - As noted above, there are essentially two sets of rules; one for individuals with income below $157,500 (or $315,000 for couples filing a joint return), and one for individuals or couples with taxable income above these threshold amounts. If your income is below the threshold

(Continued on page 2)

The 20% Qualified Business Income Deduction — continued

(Continued from page 1)

level, then almost any type of ordinary business income (other than W-2 income or K-1 guaranteed payments) will qualify for the 20% deduction (i.e. 1099-MISC income, Schedule C profit and K-1 income normally qualify). Once your taxable income (as computed after all of your personal deductions other than the 20% QBI deduction) goes above the threshold amount, then the rules get much more complicated and a number of potential limitations kick in (e.g. the income cannot be from a specified service business and your deduction cannot exceed your share of 50% of the W-2 wages paid by the business or 25% of the W-2 wages plus 2.5% of the original cost of depreciable assets). The deduction, while computed separately with respect to each flow-through business (unless you qualify under the "aggregation" rules), cannot exceed your net combined qualified business income from all flow-through entities nor 20% of your taxable income in excess of net capital gain. The income must be effectively connected to a business conducted within the U.S., and losses carry forward to reduce such income in the following year. "Reasonable compensation" (including K-1 guaranteed payments) is excluded from qualified business income. The deduction is for income tax purposes only, not for computing self-employment tax or the 3.8% Medicare tax on net investment income. Qualified REIT dividends and K-1 income from publicly traded partnerships are eligible for the deduction, and estates and trusts are eligible to claim the deduction.

Determination of W-2 wages and basis of depreciable property - The deduction is designed to encourage jobs creation, so (once your income goes over the threshold amounts discussed above) your deduction is generally limited to the lesser of 20% of your profit or 50% of your share of the W-2 wages paid by the business. In a concession to asset-intensive businesses (e.g. real estate), an alternative is provided to the 50% of wages paid limitation, whereby you can instead use 25% of the W-2 wages paid plus 2.5% of the original cost of the depreciable assets of the business (which have been held for less than the longer of 10 years or the specified depreciable lives of the assets). There was initially some concern as to whether W-2 wages paid by a third party (e.g. a PEO or an affiliated company) would qualify. Under the proposed regulations, a company does in fact get credit for wages paid to its common law employee by another entity.

Qualified business income - Qualified business income (QBI) is ordinary business income (not interest, dividends or capital gain) from 1099-MISC, Schedule C or K-1, plus qualified REIT dividends and qualified publicly-traded partnership income. It does not include the W-2 compensation of an S-corp shareholder, nor the K-1 "guaranteed payments" paid to a partner. Notably, while the IRS may assert that an S-corp shareholder's W-2 compensation has been understated (thus potentially overstating the 20% deduction), the IRS has indicated that it will not make this assertion with respect to partner guaranteed payments (creating the potential opportunity for partners to maximize the QBI deduction by favoring "distributive share" allocations over "guaranteed payments"). Ordinary income from the sale of a partnership interest (IRC 751 income) and income from the change of an accounting method (IRC 481 income) qualify as QBI. Your QBI for the year will be reduced by losses suspended in previous years under the passive loss rules, basis limitation rules and at-risk rules, but only if the losses were suspended in a tax year after 2017. Finally, only income from business conducted in the U.S. will qualify.

Aggregation of businesses - So what if you have structured your business through multiple entities, with most of the profit concentrated in one entity while most of the payroll is concentrated in another entity? There was initially some concern that many businesses might have to restructure in order to maximize the owners' QBI deduction. The proposed regulations, however, provide some relief here, by permitting individuals to elect to aggregate businesses in computing the QBI deduction limitations, so long as the same group of persons, directly or indirectly, owns at least 50% of each business being aggregated, and each of the businesses meet at least two of three other factors: (1) products or services which are the same or customarily offered together; (2) shared facilities or centralized business elements like accounting and HR; and (3) operated in coordination with or reliance upon one or more of the businesses in the group. Note that you cannot include a “specified service business” in your aggregated group.

Specified service businesses and the business of being an employee - Once your personal taxable income goes over the threshold amount, you are denied the deduction with respect to profit from a "specified service trade or business" (SSTB). Also, income received as an employee is ineligible for the deduction, regardless of your income level. An SSTB is defined for these purposes as "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 or owners". Engineering and architectural firms (which were originally included in the list of bad businesses) were specifically carved out by Congress (and thus enjoy the favorable benefit). With respect to the "reputation or skill" exclusion, the IRS has essentially limited this to those situations where someone lends their name to a business in exchange for a royalty or receives an endorsement fee or an appearance fee. With respect to the term "consulting", the proposed regulations define such for these purposes as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems". The proposed regulations go on to say "consulting does not include the performance of services other than advice and counsel, such as sales or economically similar services or the provision of training and educational courses". Real estate agents and brokers and insurance agents and brokers are specifically carved out from the definition of "brokerage services", and thus may enjoy the benefit (unless limited by another provision such as the "financial services" exclusion or the lack of W-2 wages paid). When the legislation was first enacted it was suggested by some tax advisors that SSTBs like

(Continued on page 3)

The 20% Qualified Business Income Deduction — continued

(Continued from page 2)

law firms should restructure into two entities with the administrative employees, real estate and valuable intangibles in one entity and the lawyers in another, and shift most of the profit to the entity which would arguably not be a disqualified SSTB. Not surprisingly, the proposed regulations include an anti-abuse provision which says that an SSTB includes any entity that provides 80% or more of its property or services to an SSTB if there is 50% or more common ownership. There was also some thought initially that many people currently classified as W-2 employees would seek to be reclassified as 1099-MISC contractors in order to avail themselves of the 20% deduction. The proposed regulations say that the fact that the "employer" issued 1099-MISC rather than W-2 will be disregarded if the worker has been misclassified, and the proposed regulations further provide a presumption that someone who has been treated as a W-2 employee in the past will continue to be considered an employee. On the other hand, it appears that "statutory employee" income is outside of these rules, and thus can qualify.

Relevant passthrough entities - While the QBI deduction is ultimately computed and claimed on individual returns, many of the determinations (e.g. whether or not the business is an SSTB) and computations (e.g. the individual owner's share of W-2 wages paid and original cost basis of depreciable property) must be made at the "relevant passthrough entity" (RPE; e.g. S-corp or partnership) level and reported to the owners on their Schedule K-1s. If the RPE fails to properly report these items to the owner, then the amounts are presumed to be zero. Accordingly, it is very important that passthrough entities get this reporting right.

Planning to maximize the QBI deduction - Much of our planning in order to maximize the QBI deduction for our clients includes (1) avoiding SSTB classification (e.g. taking great care with how the business is described on tax returns, at website, in marketing materials, etc.); (2) keeping taxable income below the threshold amounts in order to avoid the SSTB rules and 50% of W-2 wages paid limitation; (3) electing S status where necessary in order to get sufficient W-2 wages paid; (4) optimizing the mix of S-corp shareholder W-2 compensation and K-1 flow through income; (5) restructuring partnership agreements to favor "distributive share" over "guaranteed payments"; and (6) taking advantage of the "aggregation" rules.

Georgia Tax Credits

Georgia, like most states, offers a bounty of credits against its income tax; some of which fall into the almost too good to be true category. Some (e.g. the jobs credit, research credit and retraining credit) must be generated by a business entity, some can essentially be purchased (e.g. the low-income housing credit and the film credit), and others are based on taking some sort of action which the government is encouraging (e.g. the Georgia credit for donations to student scholarship organizations, public schools innovation fund, or rural hospitals). No matter your situation (and whether a business entity or an individual), the odds are that at least one of these credits is available to you; and with individuals' Schedule A itemized deduction for state and local taxes limited to a maximum of $10,000 per year for 2018 and forward, these credits can be more valuable than ever.

Qualified education expense credit - Individuals and businesses can receive a credit against their Georgia tax for contributions to qualified student scholarship organizations (SSOs). An SSO is a 501(c)(3) organization which allocates at least 90% of its annual revenue for scholarships to enable students in grades K through 12 to attend a Georgia school of their parents' choice. Married couples can claim a credit of up to $2,500, singles a credit of up to $1,000, and corporations a credit up to 75% of the amount of their Georgia tax liability. For individuals with income from a flow-through entity (e.g. S-corp, LLC or partnership) the amount is $10,000; with the limitation that the amount of the credit cannot exceed 6% of the income (including compensation) from the flow-through entity. For a married couple, the amount can be up to $20,000, if each has sufficient flow-through entity income. There is a $58,000,000 cap each year on the amount of credits that the Georgia Department of Revenue can award. You must pre-qualify your credit by sending a form to the DOR for approval. For all recent years, the cap was reached on January 1, the first day that GA DOR would accept applications, and DOR has allocated to those who applied on that day a prorated amount (about 50% of the otherwise limit). Accordingly, if you want to participate, you need to apply with an SSO prior to the year for which you wish to contribute in order that the SSO can submit your application to GA DOR on January 1.

Brock W. Bullard, CPA

Qualified education donation credit - Georgia has a fairly new credit that works just like the qualified education expense credit (aka SSO or Georgia GOAL) described above, except that it benefits innovation in public schools and the statewide cap is only $5,000,000 per year. In order to receive this credit, you have to first apply with the GA DOR, and then (once approved) make a donation to the Innovation Fund Foundation.

Rural hospitals donation credit - Very similar to the two education-related credits described above, Georgia offers a credit of up to $5,000 for singles and $10,000 for married couples for amounts donated to one of Georgia's approved rural hospitals. There is a statewide cap of $60,000,000 per year. To the extent the cap is not reached by July 1 of a year, individuals can apply for an amount in excess of the $5,000 or $10,000 limit (but very little remained available on July 1 of this year).

Low-income housing tax credit – In order to encourage the

(Continued on page 4)

Georgia Tax Credits — continued

(Continued from page 3)

development of affordable apartments for lower income persons, Georgia offers a tax credit for investment in such projects. Often, the credit cannot be fully utilized by the owner of the apartment project, so it is sold at a discount (e.g. 88 cents per dollar of credit) to others who can utilize it. Technically, the credit is not "transferable", but Georgia law generously permits the credit to be allocated to any partner in a partnership or any member of an LLC, such that the credit can essentially be purchased.

Film tax credit – In order to encourage the production of films in Georgia, the state permits film production companies a credit of up to 30% of their qualified expenditures in Georgia. To the extent the credit exceeds a company's Georgia income tax, it can be claimed as a credit against its withholding tax, and then further can also be sold to another taxpayer. Typically, the credit is sold to taxpayers who can use it for approximately 87 – 92 cents per dollar of tax credit.

R&D tax credit – Businesses can claim a Georgia credit for 10% of the amount by which their qualifying Georgia research expenses exceed a base amount; with the base amount generally determined by multiplying the company's ratio of R&D to revenue for the preceding 3 years by current year revenue. The credit can only offset 50% of current year tax liability, with any excess carrying forward for up to 10 years. Owners of S-corps and LLCs can claim the credit on their personal returns. Alternatively, the entity may make a special election to claim the credit as an offset against its Georgia withholding tax.

Jobs tax credits – Employers can receive tax credits of up to $4,000 per year for 5 years for each new job created in Georgia. The amount of the credit, the number of new jobs which must be created in order to be eligible for the credit, and the types of businesses eligible for the credit all depend on the geographic location of the employer (with more generous terms for new jobs created in less prosperous areas) and the type of new job created. The credit can be used to offset income tax or the employer's withholding tax obligation.

Employee training programs – Employers can receive a credit of up to $1,250 per employee for approved retraining programs, and a credit of up to $150 per employee for approved basic skills education.

Taxes paid to other states – Georgia residents are subject to Georgia tax on their worldwide income. However, Georgia permits a credit for taxes paid to other states, so long as the effective rate paid to the other state(s) does not exceed the Georgia rate on the same income.

Other tax credits – Additional tax credits available include those for angel investments, seed capital research fund investments, conservation easements, child care, caregiver's expenses, adoption of a foster child, diesel particulate emission reduction equipment, disaster assistance, driver's education expenses, employer-provided daycare, rehabilitation of historic homes and other structures, increasing port traffic, investment in manufacturing equipment and facilities, life insurance for national guard members on active duty, low-income persons, enterprise transportation vehicles (for transporting employees in less-developed counties to and from work), high-deductible health insurance, purchasing or retrofitting a home with accessibility features, rural physicians, and water resource conservation and development.

Federal tax rules - Historically, the IRS had not challenged the deductibility of a charitable contribution solely because a state provided a tax credit for such. However, with the states which were most negatively impacted by the new $10,000 per year limitation on itemized deduction for state and local taxes (e.g. California, New Jersey and New York) coming up with work-around solutions (e.g. "charitable" donations which would replace the payment of state income tax), the IRS issued proposed regulations on August 23 requiring that for donations made after August 27, 2018 you reduce the amount of your Federal charitable deduction by the benefit of any related state tax credit (but not by the benefit of a state deduction). Additionally, with respect to tax credits which can essentially be purchased (e.g. film credit or LIHTC), consideration must be given to whether you have a taxable gain equal to the spread between amount paid and face value of the credit.

Careful planning required - The knee-jerk reaction can be to assume that if you are a Georgia resident you should purchase GA film credit or LIHTC in amount up to 6% of your income. However, that is not necessarily the case. For example, if you have potentially significant exposure to the taxes of other states (e.g. the owner of a multi-state flow-through entity) and you offset all of your GA tax with film credit or LIHTC, you may essentially be wasting your "other states tax credit". Similarly, if you have a significant amount of GA R&D credit, you will generally not want to utilize purchased credits to reduce your GA tax below twice the amount of your GA R&D credit, because GA R&D credit can only offset 50% of your GA tax as reduced by all other credits. In all cases, careful planning and analysis should be undertaken before making a buying decision.

Bridges & Dunn-Rankin, LLP
CERTIFIED PUBLIC ACCOUNTANTS

400 Galleria Parkway, Suite 1050
Atlanta, GA 30339
Phone: 770-563-8888
Fax: 770-563-8885
www.bridgesdunnrankin.com

Bridges & Dunn-Rankin, LLP is an Atlanta-based full-service accounting firm serving clients in the technology, real estate, services, manufacturing, distribution, construction and healthcare industries, as well as high net worth families.