WASHBURN UNIVERSITY
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CURRENT ISSUES IN AGRICULTURAL LAW CONFERENCE

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Topical Coverage Today

- **Part 1**
  - I.R.C. §199A
    - Proposed regulations
    - Comparison with final regulations
    - Agricultural cooperatives
- **Part 2**
  - Estate and Business Planning Update
    - Selected Topics

The Qualified Business Income Deduction (I.R.C. §199A)

- **Proposed regulations (Aug. 8, 2018)**
- **Favorable aggregation provision**
  - Farming operations with multiple businesses can aggregate for QBID purposes
    - Allows a high income farming business to elect to aggregate commonly controlled entities into a single entity
    - Combine rental income from one entity with farm income from another entity and compute QBID based on combined income (and wages and QP if over income threshold)

QBID Proposed Regs.

- **Farms with multiple entities can allocate qualified W-2 wages to the appropriate entity than employs the employee under common law principles**
  - Don’t have to start payroll in each entity

Farm Client Does Consulting?

- **"Specified service trade or business" (SSTB) income is ignored if it is *less* than 10 percent of overall income from the business if average gross revenues are less than $25 million.**
  - In that instance, the income will be treated as "normal" business income for QBID purposes.

Example

- **Sam reports $75,000 of Sched. F income for 2018. He also reports $125,000 on Sched. C from consulting.**
  - Sam's QBI percentage is $75k/$200k = 37.5%
  - Sam exceeds the 10% threshold and none of the Sched. C income is QBI (it's SSB income)
  - Assume Sam's farm paid $10,000 for Sam's health insurance and he contributed $10,000 to a retirement plan.

Example (cont.)

- **Sam's QBI calculation:**
  - $75,000 from Sched. F
    - Less:
      - $3,750 retirement plan contribution
      - $10,000 related to health insurance (the farm paid it)
      - ½ of the s.e. tax deduction (total s.e. tax time .375 times .5) = $3,525
    - Result
      - $57,724
    - QBID would be $11,544.80

Handling a Business Loss

- **If a farmer or rancher only has one business and the business shows a loss, a QBID cannot be claimed in the current year and the loss will carry forward to the following year as a "separate" item of QBI.**
- **However, for farming and ranching business with multiple entities, if one entity shows a loss, that loss must be netted against the income of the other entities.**
  - For taxpayers that are beneath the income threshold, the net amount is multiplied by 20 percent to compute the QBID.
  - For taxpayers over the threshold, the proposed regulations contain a calculation procedure that will be favorable for farmers, ranchers and other taxpayers.

Rents – Proposed Regs.

- **Real estate leasing activities can qualify for the QBID without regard to whether they are active or passive in nature.**
  - *See, e.g., Prop. Treas. Reg. §1.199A-1(d)(4), Examples 1 and 2.*
- **This is certainly the case if the rental is between "commonly controlled" entities.**
- **For rentals not between commonly controlled entities, the income is QBI *if* the rental activity constitutes a trade or business under I.R.C. §162.**

Comparing Prop. Regs With Final Regs.

- **Final regs. issue on Jan. 18.**
  - Effective on publication in Fed. Reg.
  - Can rely on either final or prop. regs. for tax years that end in 2018.
  - Some parts of final regs. apply to tax years ending after 12/22/17 or to tax years ending after 8/16/18

Comparing Prop. Regs With Final Regs.

- **Losses**
  - Carryover losses that were incurred before 2018 and that are now allowed in years 2018-2025 will be ignored in calculating QBI for purposes of the QBID.
    - This is an important issue for taxpayers that have had passive losses that have been suspended under the passive loss rules.
    - Could a taxpayer also ignore pre-2018 suspended losses for purposes of the Excess Business Loss rule under I.R.C. §461(l)?

Comparing Prop. Regs With Final Regs.

- **Final regulations**
  - Any losses that are disallowed, suspended, or limited under I.R.C. §465 (passive loss rules) §704 and I.R.C. §1365 (or any other similar provision) are to be used on a first-in, first-out basis.
    - NOL deductions are not considered to be in connection with a trade or business
    - EBL not allowed for the tax year
      - Treated as NOL carryover and reduces QBI in that year

Commentary

- The IRS treatment of previously disallowed losses due to 469, basis and 465 appears to be incorrect.
  - These losses are treated as incurred in the year allowed.
    - For example, I.R.C. §465(a)(2) states that the loss "shall be treated as a deduction allocable to such activity in the first succeeding taxable year."
    - It loses its status as a loss in the earlier year and because a loss from the activity in the year allowed.
  - The IRS shouldn't have provided that QBI isn't reduced by the pre-2018 loss
    - Nobody will argue the point

Included and Excluded Items

- **Prop. Regs.**
  - QBI includes net amounts of income, gain, deduction, and loss with respect to any qualified trade or business
  - Business-related items that constitute QBI include…
    - Ordinary gains and losses from Form 4797
    - Deductions that are attributable to a business that is carried on in an earlier year
    - The deduction for self-employed health insurance under I.R.C. §162(I) T
    - The deductible portion of self-employment tax under I.R.C. §164(f).

Included and Excluded Items

- **Final regs.**
  - Consistent with the prop. regs. on the treatment of the self-employed health insurance deduction and retirement plan contributions.
    - QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a trade or business as determined under the rules of Prop. Treas. Reg. §1.199A-3(b).
      - The above-the-line adjustments for S.E. tax, self-employed heath insurance deduction and the self-employed retirement deduction are examples of such deductions.

Handling Deduction Items

- **Note:**
  - QBI is reduced by certain deductions reported on the return that the business doesn't specifically pay
    - Examples are the deduction for one-half of the self-employment tax, the self-employed health insurance deduction, and retirement plan contributions.

Handling Deduction Items

- **Key point:**
  - The self-employed health insurance deduction should not be removed from an S-corporate owner on their individual return because it has already been removed on Form 1120-S.
    - Do not deduct it twice.
    - If QBI were reduced by the amount of the I.R.C. §162(l) deduction on the 1040, QBI would be (incorrectly) reduced twice.
    - In other words, QBI should not be reduced by the self-employed health insurance from the S corporation or the partnership.
      - The deduction for the S corporation shareholder is allocated to the wage income, and the deduction for the partner is from the guaranteed payment.

Handling Deductions

- **The one-half self-employment tax deduction for the partner is allocated between guaranteed payments (if any) and that portion of the K-1 allocated income associated with QBI.**
- **Note:**
  - Some tax software programs are not treating this properly.
    - Watch for updates, such as a box to check on the self-employed health insurance screen.

Handling Deductions

- **Retirement plans**
  - The deduction for contributions to qualified retirement plans under I.R.C. §404 is considered to be attributable to a trade or business to the extent that the taxpayer's gross income from the trade or business is accounted for when calculating the allowable deduction, on a proportionate basis. *See Prop. Treas. Reg. §1.199A-3(b)(vi).*
  - Implications

Retirement Plan Contributions

- **When an S corporation makes an employer contribution to an employer-sponsored retirement plan, that contribution, itself, reduces corporate profits.**
  - Thus, there is less profit on which the QBID can potentially apply.
  - Thus, for some S corporation owners, a contribution to an employer-sponsored retirement plant will effectively result in a partial deduction, but still subject the entire contribution, plus all future earnings, to income tax upon distribution.

Retirement Plan Contributions

- **The final regulations make clear that sole proprietors and partners must also "back out" these amounts from business profits before applying the QBID.**
  - This rule will make 401(k)s with a Roth-style option more valuable.
- **What type of client may not care?**
  - Business owners of an SSB with income high enough to phase-out the QBID
  - Those who believe their future marginal tax rate will be significantly lower than the present marginal tax rate
  - Those who need to reduce their AGI to qualify for other deductions, credit, etc.

Retirement Plan Contributions

- **The final regulations do not address how deductions for state income tax imposed on the individual's business income or unreimbursed partnership expenses are to be treated.**
- **The final regulations also don't mention whether the deduction for interest expense attributable to a partnership interest or an S corporation interest is business related.**

I.R.C. 179 Deduction

- **Some tax software is presently reducing QBI passed through from an S corporation or partnership by the I.R.C. §179 amount which is passed through separately.**
- **Other tax software allows the practitioner to either include or exclude the I.R.C. §179 amount.**
- **A suggested approach is to always exclude it at the entity level because it is not known if it can be deducted on the taxpayer's personal return.**
- **Operating properly, tax software should calculate QBI with a reduction for the I.R.C. §179 deduction at the individual level.**

Excluded From QBI

- **Guaranteed payments for the use of capital in a partnership are not attributable to the partnership's business…**
  - Unless they are properly allocable to the recipient's qualified trade or business (not likely).
- **Also excluded from QBI are amounts that an S corporation shareholder receives as reasonable compensation or amounts a partner receives as payment for services under I.R.C. §§707(a) or (c).**

Treatment of Capital Gain/Loss

- **The QBID is limited to the lesser of 20 percent of taxable income less "net capital gains" as defined in I.R.C. §1(h).**
  - Long-term capital gains;
  - Qualified dividend income;
  - I.R.C. §1231 gain not taxed as ordinary income (they are ordinary to the extent of unrecaptured net I.R.C. §1231 losses from the prior five years);
  - I.R.C. §1250 gains (i.e., gain from real estate sales representing depreciation claimed);
  - Long-term rate for collectibles.

Capital Gain/Loss

- **The prop. regs. appeared to take the position that gain that is "treated" as capital gain is not QBI**
  - That would appear to have excluded I.R.C. §1231 gain from being QBI-eligible
    - Is this correct?

Capital Gain/Loss

- **The final regs. remove the specific reference to I.R.C. §1231 and provide that *any* item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss, including any item *treated as* one of these under any Code provision, is *not* taken into account as a qualified item of income, gain, deduction or loss.**

Final Reg. Definition of "Capital Gain"

- **Comprehensive definition.**
  - Includes any item that is reported on Schedule D plus qualified dividends.
    - Qualified dividends are specifically included in the term "capital gain" by reference to I.R.C. §1(h).
- **The I.R.C. §1231 gain character is determined at the shareholder level.**
- **If I.R.C. §1231 netting yields a loss, all of the I.R.C. §1231 gains and losses are treated as ordinary. This may require the practitioner to modify the QBI figure that was reported out on the K-1.**

Example

- **Tammy operates a dairy farm and has $400,000 of gains from selling raised breeding stock in 2018. Tammy also has a $200,000 loss on Sched. F. for 2018.**
  - None of the gains count as QBI
  - Tammy will have to carry over the $200,000 loss to 2019
  - Note:
    - If Tammy sells the milk through a co-op, any DPAD passed out to her can offset taxable income, including capital gains

Example

- **Billy has farm income of $150,000 and a long-term capital gain of $150,000 in 2018. He also has an ordinary loss from the sale of a rental property (not QBI) of $150,000.**
  - Tentative QBID is $30,000, but ordinary net ordinary taxable income is zero (less the standard deduction)
    - Actual QBID is zero

Example 1231/1245

- **Marcia buys a tractor for $300,000 and claims $250,000 of depreciation. She then sells the tractor for $200,000.**
  - The gain of $150,000 is Sec. 1245 gain and is taxed at regular rates
  - Could claim a 20% QBID on the $150,000 ($30,000) which would reduce the net gain to $120,000

Example – Traded Equipment

- **On trades – the amount of the Sec. 1245 gain is understated and the Sec. 1231 gain is overstated**
  - There is no Sec. 1231 gain until the equipment is sold for more than the original cost of the equipment rather than the adjusted tax basis of the equipment

Example – Traded Equipment

- **Jed I. Knight traded a tractor that had a FMV of $150,000 for a new tractor worth $400,000. Assume that Jed's basis in the new tractor is $200,000. Jed fully depreciates the new tractor and then sells it for $250,000.**
  - There is no Sec. 1231 gain until the selling price of the replacement tractor exceeds $400,000
  - There is $250,000 of Sec. 1245 recapture

Commodity Trading

- **The proposed regulations provided that "brokering" is limited to trading securities for a commission or a fee. *Prop. Treas. Reg. §199A-5(b)(2)(x).***
  - The concern was that a person who acquired a commodity (such as wheat or corn for a hog farm), and transported it to the ultimate buyer might improperly be considered to be dealing in commodities.
    - This would have resulted in the income from the activity treated as being from an SSTB.
    - None of the commodity income would have been eligible for the QBID for a high-income taxpayer.

Commodity Trading

- **The issue was also important for private grain elevators.**
  - A private grain elevator generates income from the storage and warehousing of grain; it also generates income from the buying and selling of grain.
    - Is the private elevator's buying and selling of grain "commodity dealing" for purposes of I.R.C. §199A?
    - If it is, then a significant portion of the elevator's income will not qualify for the QBID.

Commodity Trading

- **The final regulations clarify that the brokering of agricultural commodities does *not* constitute an SSTB and does so by pointing to I.R.C. §954.**
  - This is a big "win" for agriculture!

W-2 Wages

- **The final regulations specify that the IRS may provide for methods of computing taxable wages.**
- **Simultaneously with the release of the final regulations, the IRS issued Rev. Proc. 2019-11.**
  - The Rev. Proc. notes that it applies only for QBID purposes, and recites the W-2 wages definition from the proposed regulations.
    - Thus, statutory employees that a have a Form W-2 with Box 13 marked are not W-2 wages for QBID purposes.

W-2 Wages

- **Wages paid in-kind to agricultural labor are not eligible W-2 wages, but wages paid to children under age 18 are.**
  - For the background statutory analysis of this issue see: https://lawprofessors.typepad.com/agriculturallaw/2018/08/the-qualified-business-income-deduction-and-w-2-wages.html.

W-2 Wages

- There is no distinction between ag kid wages and non-ag kid wages.
- The exclusion from the general wage definition in 3401(a) applies to agricultural labor, *as defined in 3121(g)*, unless the compensation is wages under 3121(a) [IRC 3401(a)(2)].
  - Section 3121(g) defines agricultural labor as "all services performed on a farm, *in the employ of any person*" (emphasis added).
  - Employment is defined earlier in the section, *for purposes of this chapter* (i.e., Chapter 21 FICA – Sections 3101 – 3128), as any service, of whatever nature, performed by an employee for the person employing him [IRC 3121(b)].
  - However, excluded from the definition of employment is "service performed by a child under the age of 18 in the employ of his father or mother" [IRC 3121(b)(3)(A)].

W-2 Wages

- **Consequently, if child labor is already excluded from the definition of employment under subsection (b) (and therefor also excluded from the definition of wages under subsection (a)), how could it fall *within* the definition of agricultural labor under subsection (g)?**
- **The regulations expressly state that agricultural labor means only such agricultural labor as constitutes employment [Reg. 31.3121(a)(8)-1(a)].**
- **Since we do not have employment in a child labor situation, we do not have agricultural labor. If we do not have agricultural labor, we do not trip the exclusion from wages under 3401(a)(2).**
- **Child labor is described in 3401(a), and is not excluded from wages under 3401(a)(2) (under the ag exemption) because child labor isn't employment for purposes of 3401(a)(2).**

W-2 Wages

- **The proposed regulations set forth three methods for computing W-2 wages – unmodified box method; modified box 1 method; and the tracking wages method.**
  - The Rev. Proc. also provided special rules to use for a short tax year which requires the use of the tracking wages method.
- **Contractor payments made on Forms 1099 are not wages for QBID purposes.**
  - The regulations create a rebuttable presumption for three years that an individual is an employee.

Multiple Trades or Businesses

- **Items of QBI that are allocable to more than a single trade or business must be allocated among the several trades or businesses to which they are attributed using a reasonable method based on the facts.**
  - That method is to be consistently applied each year.
  - The same concept applies for individual items.
- **Trades or businesses conducted by a disregarded entity will be treated as conducted directly by the owner of the entity for QBID purposes.** ***Treas. Reg. §1.199A(e)(2).***

Income Tax Basis

- **Under I.R.C. §199A, higher income taxpayers compute their QBID in accordance with a wages/qualified property (QP) limitation.**
  - The amount of QP that is used in the limitation is tied to the what is known as the "unadjusted basis in assets" (UBIA).
- **The prop. regs. raised some questions about UBIA that needed clarified.**

Income Tax Basis

- **The final regs. clarify that the UBIA of property received in either an I.R.C. §1031 or 1033 exchange is the UBIA of the relinquished property.**
- **In addition, the placed-in-service date of the replacement property is the service date of the relinquished property.**
  - Similar concepts apply for transfers that are governed by I.R.C. §§351, 721 and 731.

Income Tax Basis

- **Property contributed to a partnership or S corporation under the non-recognition rules retains the UBIA of the contributor.**
- **In addition, an I.R.C. §743(b) adjustment is QP to the extent of an increase in fair market value over original cost.**

Income Tax Basis

- **On February 1, 2019, the Treasury released corrected draft final regulations under I.R.C. §199A.**
  - The corrections include, among other things, corrections to the definition and computation of excess I.R.C. §743(b) basis adjustments for purposes of determining the UBIA immediately after an acquisition of qualified property, as well as corrections to the description of an entity disregarded as separate from its owner for purposes of the QBID.
    - An I.R.C. §743(b) basis adjustment is to be treated as qualified property to the extent the adjustment reflects an increase in the FMV of the underlying qualified property.

Income Tax Basis

- **An "excess I.R.C. §743(b) basis adjustment" is an amount that is determined with respect to each item of qualified property and is equal to an amount that would represent the partner's I.R.C. §743(b) basis adjustment with respect to the property as determined under Treas. Reg. §1.743-1(b) and Treas. Reg. §1.755-1, but calculated as if the adjusted basis of all of the partnership's property was equal to the UBIA of such property.**

Income Tax Basis

- **I.R.C. §743(b) is the adjustment.**
- **I.R.C. §754 is simply the election to put it on the partnership books.**
- **I.R.C. §754 is allowed when an I.R.C. §743(b) adjustment is made, but not I.R.C. §734(b)**

Income Tax Basis

- **For entities, the UBIA is measured at the entity level, and the property must be held by the entity as of the end of the entity's tax year.**
- **As for a decedent's estate…**
  - The fair market value of property that is received from a decedent pegs the UBIA
  - The new depreciation period (for purposes of the computation of the limitation) is reset as of the date of the decedent's death.

Trusts

- **The final regs. specify that a non-grantor trust that is established for "a primary purpose" of avoiding income tax under I.R.C. §199A will be considered to be aggregated with the trust settlor/grantor for QBID purposes.**
- **In addition, distributable net income (DNI) transferred from a non-grantor trust to a beneficiary is treated as having been received by the beneficiary.**
  - This could lead to an increase in the creation of non-grantor, irrevocable, complex trusts.
- **The final regulations also did not place any limitation on the use of irrevocable trusts that are considered to be owned by the beneficiary(ies). *See I.R.C. §678.***

Trusts

- **However, this does not necessarily mean that there should be a rush to create irrevocable trusts.**
  - The IRS, supported by the courts, often view the substance of a transaction as more controlling than form when it believes that the entity was created primarily for tax avoidance purposes.
    - *See, e.g., Helvering v. Gregory, 293 U.S. 465 (1935).*

Final Regs. - Miscellaneous

- **Under the final regs., a veterinarian is engaged in the provision of health care and, therefore, is an SSTB.**
- **No clarity was given as to the treatment of insurance salesmen – they are often statutory employees**
- **The final regulations contain a three-year lookback period on the reclassification of workers from employee (W-2) status to independent contractor (Form 1099) reporting.**
  - Employees do not have QBI, but independent contractors can.

Aggregation – Multiple Businesses

- **As noted, the prop. regs. provide a favorable aggregation provision that allows a farming operation with multiple businesses (e.g., row-crop; livestock; etc.) to aggregate the businesses for purposes of the QBID.**
- **Allows a higher income farming or ranching business to make an election to aggregate their common controlled entities into a single entity for purposes of the QBID.**
  - This is particularly the case with entities having paid no wages or that have low or no qualified property.

Aggregation

- **Getting cash rents to count as trade or business**
  - Entities with cash rental income can qualify the income as QBI via common ownership (common ownership is required to aggregate)

Aggregation

- **Once the applicable threshold for 2018 ($157,500 for a single filer; $315,000 for a married filing joint return) is exceeded, the taxpayer must have qualified W-2 wages or qualified property basis to claim the QBID.**
  - Aggregation, in this situation, may allow the QBID to be claimed (assuming the aggregated group has enough W-2 wages or qualified property).

Aggregation – Common Ownership

- **Common ownership is required to allow the aggregation of entities to maximize the QBID for taxpayers that are over the applicable income threshold.** ***Prop. Treas. Reg. §1.199A-4(b).***
  - "Common ownership" requires that each entity has at least 50 percent common ownership.

Aggregation – Common Ownership

- **The common ownership rule does not require every person involved to have an ownership in every trade or business that is being aggregated, or that you look to the person's lowest percentage ownership.**
  - For example, person A could have a 1 percent ownership interest in entity X and a 99 percent ownership interest in entity Y, and an unrelated person could have the opposite ownership (99 percent in X and 1 percent in Y) and the entities would have common ownership of 100 percent (the group of people have 50 percent or more common ownership).

Aggregation – Common Ownership

- **The proposed regulations limited family attribution to just the spouse, children, grandchildren and parents.** ***See Prop. Treas. Reg. §1.199A-4(b)(3).***
  - Common ownership was limited to lineal ancestors and descendants.
    - Excluded were siblings – which are often involved in farming and ranching businesses.

Common Ownership – Prop. Regs.

- **In order to elect to aggregate entities together, the prop. regs. required *all* of the entities in a combined group to have the same year-end, and none could be a C corporation.**
  - But, rental income paid by a C corporation in a common group could be QBI if the C corporation was part of that combined group.
    - The interpretation is beneficial to farming and ranching businesses – many are structured with multiples entities, at least one of which is a C corporation.

Common Ownership – Final Regs.

- **The final regulations provide that siblings are included as related parties via I.R.C. §§267(b) and 707(b).**
  - This will be helpful upon the death of the senior generation of a farming or ranching operation.
- **In addition, the final regs. retain the 50 percent test and clarify that the test must be satisfied for a majority of the tax year, at the year-end, and that all of the entities of a combined group must have the same year-end.**
- **The final regs. also specify that aggregation for 2018 can be made on an amended return. The aggregation election can be made in a later year if it was not made in the first year.**

Aggregation - Disaggregation

- Once a taxpayer chooses to aggregate multiple businesses, the businesses must be aggregated for all subsequent tax years and must be consistently reported.
  - The only exception is if there is a change in the facts and circumstances such that the aggregation no longer qualifies under the rules.
- So, disaggregation is generally not allowed, unless the facts and circumstances changes such that the aggregation rules no longer apply.

Rents & QBI

- **The prop. regs. confirmed that real estate leasing activities can qualify for the QBID without regard to whether the lessor participates significantly in the activity.**
  - That's particularly the case if the rental is between "commonly controlled" entities.

The Rental Issue

- **But, the prop. regs. could also have meant that the income a landlord receives from leasing land to an unrelated party (or parties) under a cash lease or non-material participation share lease may *not* qualify for the QBID.**
  - If this is correct, it could mean that the landlord must pay self-employment tax on the lease income associated with a lease to an unrelated party (or parties) to qualify the lease income for the QBID.
  - Clarification was needed on the issue of whether the rental of property, regardless of the lease terms will be treated as a trade or business for aggregation purposes as well as in situations when aggregation is not involved.
    - Clarification is critical because cash rental income may be treated differently from crop-share income depending on the particular Code section involved. *See, e.g., §1301.*

The Rental Issue

- **Unfortunately, the existing caselaw doesn't discuss the issue of ownership when it is through separate entities and, on this point, the Preamble to the proposed regulations created confusion.**
  - The Preamble says that it's common for a taxpayer to conduct a trade or business through multiple entities for legal or other non-tax reasons, and also states that if the taxpayer meets the common ownership test that activity will be deemed to be a trade or business in accordance with I.R.C. §162.
    - But, the Preamble also stated that "in most cases, a trade or business *cannot* be conducted through more than one entity."
      - So, if a taxpayer has several rental activities that the taxpayer manages, the Preamble raised a question as to whether those separate rental activities can't be aggregated unless each rental activity is a trade or business.

The Rental Issue

- **The Preamble also raised a question as to whether the Treasury would be making the trade or business determination on an entity-by-entity basis.**
  - If so, triple net leases might not generate QBI.
- **But, another part of the prop. regs. extended the definition of trade or business beyond I.R.C. §162 in one circumstance when it referred to "each business to be aggregated" in paragraph (ii). *Prop. Treas. Reg. §1.199A-4(b)(i).***
  - This would appear to mean that the rental of property would be treated as a trade or business for aggregation purposes. *See Prop. Treas. Reg. §199A-1(b)(13).*

Rents – Final Regulations

- **Bare rent example removed**
- **No further details on QBI definition of T/B**
- **Factors:**
  - Type of rental property
  - Number of properties rented
  - Owner (or agent's) involvement
  - Ancillary services?
  - Terms of lease
  - Form 1099 filed?
- **For TIC ownership, if entity return not filed an implication is created that the activity is not a T/B**

Rents – Final Regulations

- **Rent paid by a C corporation *cannot* create a deemed trade or business**
  - May trigger need to restructure farming/ranching structures
  - Can't have a C corp. pay land rent and have it count as a T/B even if landlord establishes regularity and continuity under the lease

Rents – Notice 2019-7

- **Tentative guidance and request for comments on when a rental activity ("rental real estate enterprise") will be a T/B**
- **Safe harbor provided**
  - Property leased under a triple net lease is not a T/B unless…
    - Common control
    - There is a T/B of entering into and selling triple net leases
  - Note definition of triple net lease on p. 20
    - Example in rural settings would be a wind energy lease

Rental Safe Harbor

- **If the safe harbor tests are not met, the rental activity still might generate QBI based on the facts and circumstances**
- **Safe harbor can be relied upon by individual landlords as well as landlords that are S corporations and partnerships**
  - The lessor entity must be a pass-through entity or sole proprietorship

Rental Safe Harbor

- **Each individual taxpayer, estate or trust can elect to treat each separate property as a separate enterprise, or all similar properties as a single enterprise, for purposes of applying the safe harbor rules, except…**
  - Commercial and residential real estate cannot be considered as part of the same enterprise for testing purposes.
    - In other words, all commercial rents can be netted as one single enterprise, and all residential rentals can be netted as another enterprise.
- **But, real estate that is under a triple net lease, and real estate used as a residence by the taxpayer cannot be part of an aggregated enterprise for testing purposes because they cannot qualify to be included in the safe harbor.**

Rental Safe Harbor

- **For each separate enterprise, certain requirements must be satisfied *(the use of the safe harbor is done on an annual basis)* for the enterprise's income to be eligible for the safe harbor:**
  - Maintenance of separate books and records to reflect the income and expenses for each enterprise.
  - Aggregate records for properties that are grouped as a single enterprise.
  - Contemporaneous records (similar to auto logs) of time reports, logs, etc., with respect to services performed and the party performing the services with respect to tax years beginning January 1, 2019.
    - Inapplicable to 2018 returns or fiscal year filers for years ending before 2020.
  - For tax years 2018 through 2022, 250 or more hours of "rental services" must be performed to qualify the property for the safe harbor in each calendar year.
    - Time spent by owners, employees, agents, and independent contractors of the owners, which can include management and maintenance companies who have personnel who keep and provide contemporaneous records.
    - Advertising to rent or lease properties; negotiating and executing leases; verifying tenant information; collecting rent; daily management and repairs; buying materials and supervising employees and independent contractors.
    - Starting in 2023, 250 hours are needed in three out of five years.
  - Statement on the return (under penalty of perjury) that the rental enterprise satisfies the requirements.

Rents – Safe Harbor

- **The safe harbor does not apply to triple-net leases.**
  - A farm landlord that cash rents farmland via a triple-net lease will not qualify the rental income as QBI even if working more than 250 hours in the lease activity.

“Safe Harbor”

- “Safe harbor” means just that: you are protected if you meet the tests.
  - This is the same thing as not having to worry about capitalization of items below the de minimis safe harbor on repairs, supplies, etc.
    - It’s designed to eliminate an argument as to whether an item provides long-term benefit to the business.
    - It doesn’t mean that items which cost more can’t be supplies, but you have to convince the IRS.

Rent Scenarios

- What about a retired farmer that rents farmland out under a cash rent lease?
  - Collects the rent and pays the real estate taxes, insurance, etc.
  - Doesn't participate at least 250 hours managing the property on an annual basis
- **Conclusion**
  - Unsure for 2018
  - Post-2018, rental income is not QBI

Rent Scenarios

- What about a retired farmer that rents farmland out via a crop-share lease?
  - The landlord markets his share of the grain, goes to the FSA office, shares in input costs (to a degree)
  - Total time devoted to the rental activity never reaches 250 hours annually.
  - Doesn't report the lease income as subject to s.e. tax
- Conclusion
  - Arguably is QBI for 2018
  - Post-2018, not QBI, but it's a facts and circumstances test.

Rent Scenarios

- Married couple has several rental properties, both commercial and residential. They report the rental income on Schedule E. They participate more than 250 hours annually and are involved in the activity on a daily basis.
- Conclusion:
  - Rental income is QBI for 2018
  - Could elect the safe harbor in 2018 and beyond

Rents – Implications for Crop Lease Income

- **For crop share lease income, the landlord must do more than simply receive a share of the crop without incurring any crop-related expenses in order to qualify the lease income as QBI.**
- **If the landlord shares in crop expenses, the IRS will likely argue that the landlord must clear the 250-hour hurdle.**
  - While putting in less than 250 hours doesn't mean the lease income is not QBI, the landlord bears the burden to prove that it is.
- **Structured rental situations involving common ownership avoids the safe harbor restrictions (and under the final regulations "related parties" includes brothers and sisters).**
  - Thus, rent paid by an individual or pass-through entity to an individual or pass-through entity under common ownership qualifies as QBI.
    - If rent is paid by a C corporation under common ownership, it will not qualify as QBI, unless safe harbor rules satisfied (and (likely) self-employment tax is paid).

Rents – Safe Harbor

- **Most likely easier to satisfy by taxpayers having multiple properties**
- **Cannot be used by a taxpayer that rents their personal residence(s) out for part of the year.**
- **While most rental house scenarios, cash rents and crop shares won't qualify for the safe harbor**
  - They may qualify under common control without regard to any hour requirement
  - They can still generate QBI based on the overall facts and circumstances.

Rents – Safe Harbor

- **The common ownership rules trump the safe harbor rules.**
  - Qualifying the income of rental entities as QBI (e.g., land held outside a farming operating entity that is leased to the farming entity) via common ownership will not necessarily make the rental income that passes through to the owners subject to self-employment tax.
  - The only time the safe harbor rules apply is when rent is received from an entity that is not part of a common group.

Rents – Further Implications

- **If a farm entity pays rent to a sole proprietor farmer or pass-through entity with common ownership, no hours are required related to the rental income.**
  - The rental income, by default, qualifies as QBI unless it is paid by a C corporation.
  - In this situation, the lease could be a passive lease.
  - If the rental amount is set at fair market value, none of the income is subject to self-employment tax. *See, e.g., Martin v. Comr., 149 T.C. No. 12 (2017).*

Rents – Further Implications

- **Under the prop. regs., rents could by paid by a C corporation under common ownership and the rental income would qualify as QBI.**
- **Under the final regs., the rent must be paid by an individual or "relevant pass-through entity" (RPE).**
- **For farmers that farm as a C corporation and pay rent to themselves or an RPE, the rental income is QBI for 2018 via the prop. regs.**
  - None of this rent will count as QBI for 2019 and later years.
- **Remember - while the safe harbor can be utilized for post-2018 years, it requires the landlord put in at least 250 hours in the activity (which may trigger self-employment tax).**

QBID/DPAD and Ag Cooperatives

- **As initially enacted, I.R.C. §199A provided for a 20 percent deduction on *gross sales* to an agricultural cooperative.**
- **As amended, the incentive provided to a farmer to sell to an agricultural cooperative as opposed to a private grain buyer was removed and a transition rule put in place.**
  - The transition rule specifies that a farmer's calculation of their QBID for 2018 *does not* include grain sold to a cooperative if the cooperative accounted for those sales when calculating its domestic production activities deduction (DPAD) under former I.R.C. §119 on *its* 2018 return.

The Transition Rule

- **The transition rule will have an impact on many patrons**
  - Patrons that receive qualified payments (basically any payment from a co-op to a patron) from cooperatives with fiscal years that begin in 2017 and end in 2018 are subject to the transition rule.
    - For these patrons, a DPAD can be claimed (under the former rules) if the cooperative passed through the DPAD.
      - Form 8903 is available on the IRS website (Dec. 2018)
    - Such payments cannot be considered in the calculation of the patron's 2018 QBID.
      - The Joint Committee on taxation confirms this tax treatment in its *Bluebook* of December 2018.

Transition Rule – Key Point

- **A cooperative must report to the patron the amount of qualified payments made to the patron in 2018 that were included in the cooperative's DPAD computation from January 1, 2018 to the last day of the cooperative's fiscal year ending in 2018.**

Transition Rule - Remember

- **As in the non-cooperative setting, a patron of a cooperative cannot be a C corporation and benefit from the QBID.**
- **The transition rule has no application to grain sales to non-cooperatives.**
- **The transition rule only affects 2018 farm income tax returns.**
  - The timing of grain sales to a cooperative will not impact the QBID calculation for 2019 and beyond.

Transition Rule – Point of Emphasis

- **A farmer cannot use any of the sales made to a cooperative between January 1, 2018 and the cooperative's 2018 year-end in calculating the QBID (e.g., new DPAD).**
  - It is immaterial if the farmer is over or under the income threshold.
  - Net income related to such payments will not be QBI and also will not qualify for the DPAD (old).
  - The only deduction that the farmer may qualify for is the old DPAD that the cooperative passes through (if any).
    - But, this DPAD may have already been passed out by the cooperative in late 2017 resulting in no deduction in 2018.

Transition Rule - Example

- **Bob sells his grain to an ag cooperative. The cooperative's tax year ends on May 31, 2018.**
- **Bob sold $1 million of grain and 85% of the sales occurred from Jan. 1, 2018 to May 31, 2018**
- **In December of 2017, the co-op issued a DPAD to Bob of $15,000**
- **Assume the Bob's QBI before any co-op adjustment is $200,000 and he pays $40,000 of wages**

Transition Rule - Example

- **Bob can't use the 85% of sales to calculate QBI (reduced by associated expenses)**
  - He gets no QBID on the $170,000 of QBI
  - His gross deduction is $6,000 ($30,000 x. .2)
  - The $6,000 will be reduced by the lesser of 9% of $30,000 ($2,700) or 50% of $6,000 ($3,000) (assuming you can reduce wages by the 85%)
    - The reduction is $2,700
    - The final deduction is $3,300 (plus any DPAD from the cooperative (likely to be zero)

Transition Rule – The Return

- **A farmer must reduce their QBID (e.g., new DPAD) by the lesser of…**
  - 9% of QBI related to cooperative payments; or
  - 50% of wages allocated to cooperative net income.
- **A farmer can deduct the DPAD (old or new) that is passed through from the cooperative (limited to 100 percent of taxable income including capital gains).**
  - For calendar year 2018, a patron may receive two written notices… (
    - A notice of the DPAD reported on Form 8903 and which is deducted above-the-line; and
    - A notice of the new DPAD which is part of the new QBID and is reported on the special I.R.C. §199A worksheet.
      - Note: Form 1099-PATR that indicates patronage dividends, per-unit retains, DPAD, etc., does not break down the allocation between the old and new DPAD.

Transition Rule – The Return

- **The preparation of a patron's return requires a copy of each written notice of DPAD allocation to determine…**
  - The old/new DPAD
- **What else is needed?**
  - A copy of Form 1099-PATR
  - A breakdown of the sales and patronage received from the cooperative from Jan. 1, 2018 until the cooperative's year-end.

Ag Cooperative - QBID

- **Agricultural and horticultural cooperatives are allowed a deduction equal to 9% of the lesser of the cooperative's QPAI for the year or taxable income (determined without regard to patronage dividends, per-unit retain allocations, and non-patronage distributions).**
  - The deduction, however, cannot exceed 50% of the cooperative's W-2 wages for the year that are subject to payroll taxes and are allocable to domestic production gross receipts.
  - The cooperative may choose to either claim the deduction or allocate the amount to patrons (including other specified agricultural or horticultural cooperatives or taxpayers *other than C corporations*).

Ag Cooperatives - QBID

- **A cooperative's deduction is allocated among its patrons on the basis of the quantity or value of business done with or for the patron by the cooperative.**
- **Under IRC §199A(g), a cooperative cannot reduce its income under IRC §1382 for any deduction allowable to its patrons.**
  - This means that the cooperative must reduce its deductions that are allowed for certain payments to its patrons in an amount equal to the §199A(g) deduction allocated to its patrons.

QBID For Patrons

- **A cooperative passing through a portion of their deduction to the patron could raise the patron's QBID above 20 percent.**
- **A cooperative could issue non-qualified equity providing a tax benefit to the patron that would be redeemed to the patron at a later date.**
- **Cash patronage paid to a patron is part of the QBID calculation.**

QBID for Patrons

- **An eligible patron of an agricultural or horticultural cooperative that receives a qualified payment from the cooperative can claim a deduction in the tax year of receipt in an amount equal to the portion of the cooperative's deduction for QPAI that…**
  - Is allowed with respect to the portion of the QPAI to which such payment is attributable.
  - Is identified by the cooperative in a written notice mailed to the patron during the payment period described in IRC §1382(d).

QBID for Patrons

- **A qualified payment to a patron is any amount that meets three tests:**
  - The payment must be either a patronage dividend or a per-unit retain allocation.
  - The payment must be received by an eligible patron from a qualified agricultural or horticultural cooperative.
  - The payment must be attributable to QPAI with respect to which a deduction is allowed to the cooperative.

QBID for Patrons

- **The patron's deduction for allocated amounts from a cooperative does not depend on the patron's wage expense.**
  - The only limitation at the patron level is taxable income.
  - A patron is also not subject to the 20% of tentative taxable income limit.
    - Instead, the patron's QBID is limited to taxable income.
    - In addition, a patron who receives a QBID from a cooperative may offset any character of income, including capital gain.

QBID for Patrons

- **The patron's deduction may not exceed the patron's taxable income for the tax year**
  - Determined without regard to the deduction, but after accounting for the patron's other deductions under IRC §199A(a)).
    - However, for any qualified trade or business of a patron, the initial QBID is reduced by the lesser of: (1) 9% of the QBI allocable to patronage dividends and per-unit retains received by the patron, or (2) 50% of the W-2 wages (subject to payroll tax) with respect to the business.

QBID Patron Calculation

- **For a farmer reporting income and expense on Sched. F, is a patron of an agricultural cooperative, and pays no qualified wages, there are two steps to calculate the tax benefits.**
  - The cooperative's final QBID that is passed through to the patron can be applied to offset the patron's taxable income regardless of source.
  - The farmer/patron is entitled to an initial QBID equal to 20% of net farm income, subject to the wage limit that applies to taxpayers with income over the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others (2018)).

QBID Patron Calculation

- **For farmers who pay qualified W-2 wages and sell to agricultural cooperatives that also pay W-2 wages, their initial QBID is reduced by subtracting the lesser of 50% of W-2 wages or 9% of QBI attributable to the income from the cooperative.**
  - Thus, for a farmer with farm income beneath the threshold amount ($315,000 for MFJ taxpayers and $157,500 for all others), the QBID will never be less than 11% (i.e., 20% less 9%).

QBID Patron Calculation

- **If the farmer is above the income threshold amount, the W-2 wages/QP limit is applied before the 9% limitation.**
- **The farmer's QBID cannot exceed 20% of taxable income.**
  - To this amount is added any pass-through deduction from the cooperative to produce the total deductible amount.

Sales to a Processing Co-Op

- Most of these cooperatives use “pool” accounting for computing the farmer’s net from product sales to the co-op.
  - As processing occurs, the co-op will make advances to the patron and then have a final pool accounting to pass out the patron’s final profit.

Sales to a Processing Co-Op

- The pool accounting can take up to two years (from harvest to final sale of product)
  - Must determine how much of the payment received from crop “pools” that were paid during 2018.
    - It’s immaterial that the payment was received after the cooperative’s year-end.
    - If the co-op used those “pools” in computing the DPAD in the past, none of the payments are QBID deductible.

Farmers Selling to Non-Co-Ops

- **For farmers who sell agricultural products to non-cooperatives and pay W-2 wages, a deduction of 20% of net farm income is available.**
  - If taxable income is less than net farm income, the deduction is 20% of taxable income less capital gains.
  - If taxable income before the QBID exceeds the income threshold amount, the deduction may be reduced on a phased-in basis.

Should A Farmer Sell to a Co-Op Or A Private Buyer?

- **It depends on numerous factors.**
  - In general, a farmer with farm income over the applicable income threshold for their filing status obtains a larger QBID by paying qualified wages if the farmer does not have enough QP to generate the full QBID allowed.
  - Conversely, a farmer that is below the applicable income threshold derives a larger QBID by not paying qualified wages, or by paying qualified wages in an amount such that half of the wages paid is less than 9% of the farmer's Schedule F income that is attributable to the cooperative.

Sale of Personal Residence Post-Death

- **Income tax basis issues**
  - First death; second death
  - Fractional share rule/Consideration furnished rule (more detail on pp. 45-47)
  - Community property?
- **Loss potential**

Collecting Unpaid Estate Tax From Beneficiaries

- **Establishing liability**
  - Any transferee, surviving tenant or estate beneficiary is personally liable for any unpaid estate tax to the extent property received was included in the gross estate
  - Ringling case (S.D. 2019)
    - Three years to assess and 10 years to collect (from date of assessment)

Estate Planning in 2nd Marriage Situations

- **Favorable IRS ruling: PLR 201902023**
  - Revocable trust contained subtrust to hold benefits and distributions from retirement plan. IRA named trust as beneficiary
    - Death after RBD and after IRA distributions started
    - Subtrust terms said it was to be held for benefit of surviving spouse then to his kids
    - IRS conclusions:
      - Surviving spouse is designated beneficiary
      - Applicable distribution period is based on her longer life expectancy (she receives RMD as if she were designated sole beneficiary).
      - Funds left at her death pass to his kids

Can a State Tax a Trust Without Contact With the State?

- ***Wayfair* redux**
- **What does "physical presence" mean in the context of a trust??**

Reviewing E.P. Documents

- **Examine older (but common) will and trust language**
  - Outdated formula clause language

Corporations – Post TCJA

- **Considerations for entity formation post-TCJA**
  - Rates
  - Conversion tax cost
  - Fringes

Charitable Provisions

- **Can deduct cash contributions up to 60% of contribution base to qualified charities (Sec. 170(b)(1)(A) organizations)**
  - Disallowed amount carried forward for 5 years

Charitable Donations - TCJA

- **Repealed is the special rule for deduction for 80% of rights to purchase tickets to athletic events at higher education institution**
- **Can continue IRA-to-charity donation for over age 70.5 taxpayers**

TCJA – Impact on Charitable Giving

- **Fewer taxpayers will see a tax benefit of giving to charity due to the enhanced standard deduction**
  - Strategy: Prepay charitable via donor-advised fund (DAF)
  - Strategy: Qualified charitable distributions from an IRA (e.g., SEP or SIMPLE)
    - Excluded from gross income

E.P. For High Wealth Clients

- **Use of the GRAT (pp. 48-50)**
- **The IDGT (pp. 52-55)**

I.R.C. §179 & Trusts

- **Trusts are not eligible for Sec. 179**
  - But, pay attention to the type of trust
  - Revocable trusts are eligible
    - It's a grantor trust with retained dominion and control
    - Also, an irrevocable trust (or an estate) will not benefit from an entity's Sec. 179 election.

Hobby (and Passive) Losses

- *Robison v. Comr., T.C. Memo. 2018-88*
  - The petitioners, a married couple, worked for a technology company in the San Francisco Bay. During the years in issue, 2010-2014, the husband's salary ranged from $1.4 million to $10.5 million. He also was an Executive Vice President of Hewlett-Packard Co. In 1999, the petitioners bought a 410-acre tract in Utah for $2,000,000. They later acquired additional land, bringing their total land holdings to over 500 acres.

Profit Intent…But, Passive

- After refurbishing the property, they hired a full-time manager to operate the ranch. However, the plaintiffs never showed a profit from their "ranching" activity. They showed losses ranging from slightly under $200,000 to nearly $750,000 every year. The petitioners deducted the losses, which the IRS disallowed.
- The Tax Court applied the nine-factor test of Treas. Reg. 1.183-2(b) and determined that the petitioners did have a profit motive.
- However, the employment of a ranch manager indicated to the Tax Court that the petitioners might be engaged in a passive activity subject to the passive loss rules of I.R.C. §469.

Profit Intent…But, Passive

- Of the seven tests contained in Treas. Reg. §1.469-5T(a) to determine whether the petitioners were materially participating in the activity on a basis that was regular, continuous and substantial, the Tax Court determined that only two were relevant – the 500-hour test and the facts and circumstances test.
- The petitioners prepared logs showing that they devoted more than 500 hours to the activity during the years in issue, but the logs were prepared after-the-fact in preparation for trial.
- The Tax Court determined, that “a very significant portion” of the hours the petitioners spent on the activity were as investors rather than as material participants.

The "Kicker" – *Robison v. Comr., T.C. Memo. 2018-88*

- The presence of the paid manager destroyed the hours the petitioners devoted to management activities.
  - Accordingly, the Tax Court determined that the 500-hour test had not been satisfied.
- The presence of the manager also meant that the petitioners could not satisfy the facts and circumstances test.
  - Thus, the petitioners were entitled to claim the deductions for the losses from the ranching activity, but the deductions were suspended until years in which they showed a profit from the activity. In those, years, the deductions would be limited to the profit from the activity.
  - If they never showed a profit, the losses could be deducted upon sale of the activity.

TCJA – Income Taxation of Trusts and Estates

- **IRC §164(b) limits the aggregate deduction for state and local real property taxes to a $10,000 maximum annually**
  - Inapplicable to any real estate taxes or personal property taxes that a trust or an estate incurs in the conduct of a trade or business (or a Sec. 212 activity – income producing activity)

TCJA – Impact of Taxation of Trusts and Estates

- **Suspension of miscellaneous itemized deductions**
  - Investment fees and unreimbursed business expenses not deductible
    - Generally means a higher tax liability at trust/estate level
    - More income trapped inside the trust/estate
  - Unsure of the impact on deductibility of administrative expenses such as trustee fees
    - IRC §67 (2% floor on misc. itemized deductions) does not apply to admin. expenses incurred solely because the property is held inside a trust or an estate - they are above-the-line deductions that impact AGI
    - Guidance forthcoming???

TCJA -Trusts and Estates

- **Trust and estate - $600 personal exemption**
- **No AMT change (stays at $24,600)**
  - Subject to chained CPI
- **QBI deduction can be claimed by estate or trust with non-C corp. business income**
  - Claimed at estate or trust level
  - $157,500 threshold
  - Old Sec. 199 rules apply for apportioning W-2 wages and property basis between fiduciaries and beneficiaries

TCJA – Trusts and Estates

- **Bob's farming operation nets $1,000,000 annually but pays no wages and has no qualifying property**
  - Normally would get no QBID
- **If the farming income is routed through a trust (or multiple trusts) with the amount of trust income not exceeding the $157,500 threshold, a QBID can be generated**

THANK YOU!

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- **Join us this summer in Steamboat Springs, CO on August 13-14 for our summer farm income tax/estate and business planning seminar**
  - Details forthcoming