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2019 Tax Update for Construction Companies

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Dannible & McKee's Annual

Construction Conference

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The Tax Cuts and Jobs Act of 2017 (TCJA)

- Impact of the TCJA on construction:
  - Code Section 199A: Qualified Business Deduction.
  - Code Section 461(l): Excess Business Loss Limitation.
  - Code Section 163(j): Business Interest Expense Limitation.

Code Section 199A: Qualified Business Deduction

- QBI can be generated from the following:
  - Sole-proprietorships (Schedule C).
  - Rental property trade or businesses (Schedule E).
  - Disregarded entities (SMLLCs' Schedule C, Schedule E).
  - Pass-through entities (Schedule K-1 reported on Schedule E).
  - Trusts and estates, REITs and qualified cooperatives.
- The QBI calculation is performed at the individual level, its not done at the entity level.
  - Entities, however, are required to provide taxpayers with all the information required by the taxpayer to calculate the deduction.

Code Section 199A: Qualified Business Deduction (con't.)

- The QBI deduction, while very taxpayer friendly, is wrought with complexities in its application and reporting.
- For 2018, we received many pass-through K-1's from other accountants that did not properly identify or report QBI.
- With all the complexities involved and with additional guidance being issued throughout the year, this is an area where proper planning can result in significant tax savings for taxpayers.

Qualified Trade or Business Definition

- A ***qualified trade or business*** is defined as any trade or business **other than**:
  - The business of performing **services as an employee**.
    - The final regs provide for anti-abuse rules to prevent taxpayers from classifying themselves as independent contractors if they are really employees under the normal Federal tax rules.
      - Independent contractor is not treated as an employee if the independent contractor was not an employee during the last three years.
  - A ***specified service business (SSB)***.
    - However, in any year that a taxpayer's taxable income is **at or below the taxable income threshold amount** (explained below), that taxpayer can treat an SSB as a qualified trade or business.

Rental Real Estate - Final Regs.

- QBI includes income from **rental real estate activities** if such activities rise to the level of a **trade or business**.
  - Rental activities are regular and continuous enough to constitute a trade or business.
  - Factors to consider are the taxpayer's intent and involvement with the property (i.e., showing the property for rent, collecting rents, purchasing materials, paying expenses, providing services to the tenants, etc.).
  - There is **no 500-hour safe harbor test** for ***qualified real estate professionals*** like there is under the NIIT regulations.
  - Filing Form 1099s may help.

Rental Real Estate - Final Regs. (con't.)

- **Self-Rentals**: The rental or licensing of tangible or intangible property to a commonly controlled **non-C corporation** trade or business is **treated as a trade or business for QBI purposes**.
  - Same person or group of persons owns (directly or indirectly) 50 percent or more of the rental activity and trade or business activity.
  - Under the attribution rules, an individual is considered to own an interest in a trade or business held by a spouse, child, grandchild or parent.

Rental Real Estate - Safe Harbor

- **Revenue Procedure 2019-38 and IRS Notice 2019-7** - IRS finalized a safe harbor under which a rental real estate enterprise will be treated as a trade or business for the QBI deduction. If safe harbor requirements met, **the rental real estate enterprise will be treated as a single trade or business** for QBI deduction purposes.
- Rental Real estate enterprise may consist of a single property or interests in multiple **similar** properties.
- **Similar properties** - **Commercial properties** can be only be combined with other commercial properties as a single enterprise and **residential properties** can only be combined with other residential properties. **Mixed-use properties can be bifurcated** between commercial and residential and then combined with the applicable commercial or residential enterprise.

Rental Real Estate - Safe Harbor (con't.)

- Safe harbor requirements:
  - Separate books and records must be maintained for each rental enterprise.
  - At least 250 hours of rental service must be performed per year.
  - Contemporaneous records must be maintained.
  - Taxpayer must attach a statement to tax return describing the properties and representing that the safe harbor requirements were met.

Rental Real Estate - Safe Harbor (con't.)

- Certain rental real estate arrangements are excluded from the safe harbor as follows:
  - **Residence -** Real estate used by the taxpayer as a residence.
  - **Triple Net Lease -** Lease where tenant pays the taxes, insurance and maintenance.
  - **Self-Rental -** Rental real estate rented to a trade or business conducted by a taxpayer which is commonly controlled.
  - **SSB -** The entire real estate interest if any portion is treated as an SSB.

W-2 Wages and Property Limitation

- Applies to all taxpayers with QBI where taxable income exceeds the applicable threshold.
  - Once the taxpayer's taxable income threshold is exceeded, the wage and property limitation is imposed.
- For taxpayers with taxable income above the threshold amount, the QBI deduction cannot exceed the lesser of:
  - 20 Percent of the taxpayer's QBI with respect to the qualified trade or business; or
  - The greater of:
    - 50 Percent of the W-2 wages with respect to the qualified trade or business ("W-2 Wage Limit"); or
    - The sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the Unadjusted Basis Immediately after Acquisition (UBIA) of the business's qualified property.

Aggregation Rules - Final Regs.

- The final regulations provide for aggregation rules that permit taxpayers **to elect to combine** separate trades or businesses if the following requirements are met:
  - The same person or group of persons owns directly or indirectly (i.e., through attribution) 50 percent or more of each business.
  - The items of each business are reported in returns with the same tax year.
  - **None** of the businesses **are an SSB**.
  - The businesses satisfy **at least two** of the following factors:
    - They provide products, property or services that are the same or customarily offered together.
    - They share facilities, personnel, or other business resources.
    - They operate in coordination with, or reliance upon each other.

Aggregation Rules - Final Regs. (con't.)

- When aggregation is allowed, the taxpayer has the option to chose which businesses to aggregate (i.e., can be selective as to which businesses to aggregate).
- Aggregation is allowed at the **individual level or the entity level (RPE)**.
- The taxpayer calculates QBI, W-2 wages and the UBIA of qualified property for each business and then combines these amounts to compute QBI and the wage/property limit for the aggregated businesses.
- Failure to aggregate a business in one year does not preclude the taxpayer from including that business in a future year.
- The Taxpayer must consistently report the aggregation on his or her return.
- Additional businesses can be added if they are newly established.
- Change in circumstances will allow taxpayers to change prior aggregation if businesses no longer qualify.

Aggregation Rules - Final Regs. (con't.)

- **Planning Opportunity**.
- Aggregating businesses can allow an individual with high taxable income to claim a larger QBI deduction when otherwise subject to the wage/property limit.
- For example, aggregating one business with substantial QBI but little or no W-2 wages and another business with minimal QBI but considerable W-2 wages can result in a substantial QBI deduction while keeping them separate could result in a lower QBI deduction or even no QBI deduction.

Aggregation Rules - Final Regs. (con't.)

- **Netting of negative and positive QBI amounts and carryovers**.
  - Businesses with negative QBI amounts are allocated proportionately to businesses with positive QBI amounts.
  - W-2 wages and the unadjusted basis of qualified property of negative QBI businesses are not taken into account in calculating the aggregate wage/property limit.
  - If a taxpayer has an overall negative QBI for the year, the negative amount is treated as a loss from a qualified business in the following year.

Aggregation Rules - Final Regs. (con't.)

- **<u>Examples of businesses eligible for aggregation</u>**:
  - Restaurant and catering business that use same kitchen and staff.
  - Clothing manufacturer and retail store.
  - A group of hardware stores.

Excess Business Loss Limitation

- Code Section 461(l): Excess Business Loss Limitation.
  - TCJA limited losses from all types of business for noncorporate taxpayers.
  - Disallows excess business losses of noncorporate taxpayers if the amount of the loss is in excess of $250,000 ($500,000 in the case of a joint return).
  - These two thresholds are adjusted for inflation for taxable years beginning after December 31, 2018. For **2019**, inflation adjusted amounts are $255,000 and $510,000, respectively.
  - Excess business losses that are disallowed are treated as a net operating loss carryover to the following taxable year.

Excess Business Loss Limitation (con't.)

- **Example:**
  - In 2019, T, a single taxpayer, has deductions of $500,000 and gross income of $200,000 from a business or a net loss of $300,000. T's excess business loss is $45,000 ($500,000 - ($200,000 + $255,000)). The $45,000 excess business loss is treated as part of the taxpayer's NOL carryforward in later years.
- A Taxpayer's excess business loss is calculated on Internal Revenue Service Form 461.
  - A non-corporate taxpayer must file Form 461 if their net losses from all their trades or businesses are more than $255,000 ($510,000 for married taxpayers filing a joint return).

Limitation on Interest Deductions for Businesses

- **Prior Law -** Businesses were allowed to deduct 100 percent of their business interest expense.
- **TCJA -** Interest deductions for businesses with **average annual gross receipts over $26 million** for the 3 prior years generally are **limited to 30 percent** of the corporation's **adjusted taxable income**.
  - ***Adjusted Taxable Income*****:** Defined as the taxpayer's taxable income, computed without regard to:
    - Any item of income, gain, deduction or loss that is not properly allocable to a trade or business;
    - Any business interest expense or business interest income;
    - The amount of any net operating loss (NOL) deduction under Code Section 172;
    - The amount of any QBI deduction allowed under Code Section 199A; and
    - For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

Limitation on Interest Deductions for Businesses (con't.)

- Disallowed interest can be carried forward indefinitely.
- Special reporting rules apply to partnerships and S corporations.
- No sunset provision.

Limitation on Interest Deductions for Businesses (con't.)

Example:

- XYZ Corp has **net income of $90,000** after the following deductions, **depreciation and amortization - $60,000**, **business interest expense $100,000**.
- XYZ's **average annual gross receipts** for the past three years was **$30 million**.
- XYZ Corp's business **interest deduction is limited to $75,000**, calculated, as follows:
  - Adjusted taxable income = $250,000 ($90,000 + $60,000 + $100,000).
  - Limitation: $75,000 ($250,000 x 30%).
  - Allowable interest deduction: $75,000.
  - Disallowed interest deduction: $25,000.
  - Carryover of $25,000 subject to indefinite carryforward.
- After 2021, the business interest limitation would be $57,000 ($190,000 x 30%).
  - No addback for depreciation and amortization.

Limitation on Interest Deductions for Businesses (con't.)

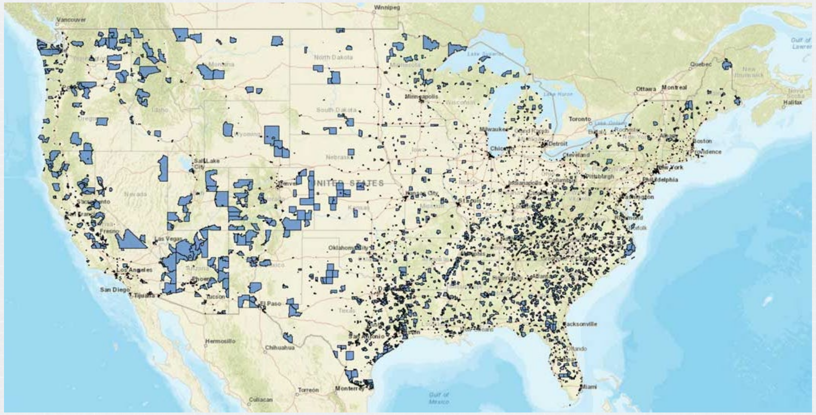
Exceptions:

- An electing **real property trade or business** or electing **farming business will not** be subject to the limitation.
    - However, such businesses must use the Alternative Depreciation System (which doesn't allow for bonus depreciation) to depreciate:
        - Nonresidential real property, residential rental property and qualified improvement property for real property trades or businesses.
        - Property with a recovery period of 10 years or more for farming businesses.

Qualified Opportunity Zones

Introduction to Qualified Opportunity Zones

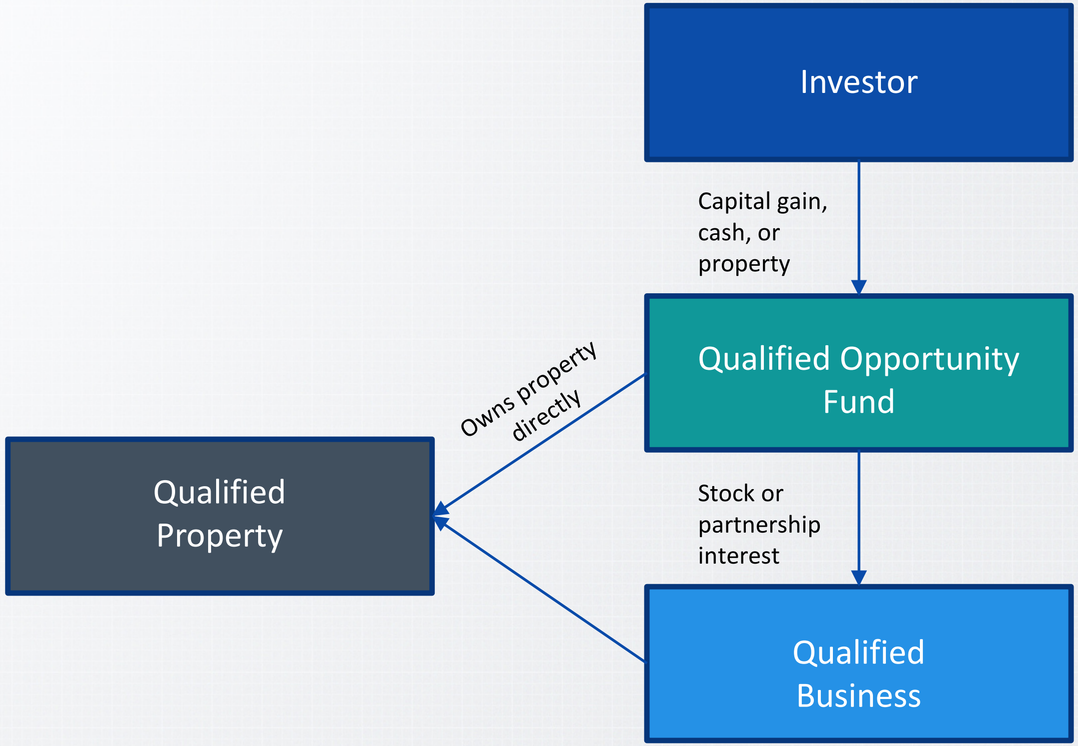
- The Tax Cuts and Jobs Act of 2017 added Opportunity Zones to the tax code as a tool to spur economic development in distressed communities across all 50 states, the District of Columbia, and five U.S. territories.
- Opportunity Zones are nominated by each state and the nomination is certified by the U.S. Treasury via the IRS.
- Under the new law, under certain conditions, new investments into these areas are eligible for preferential tax treatment.



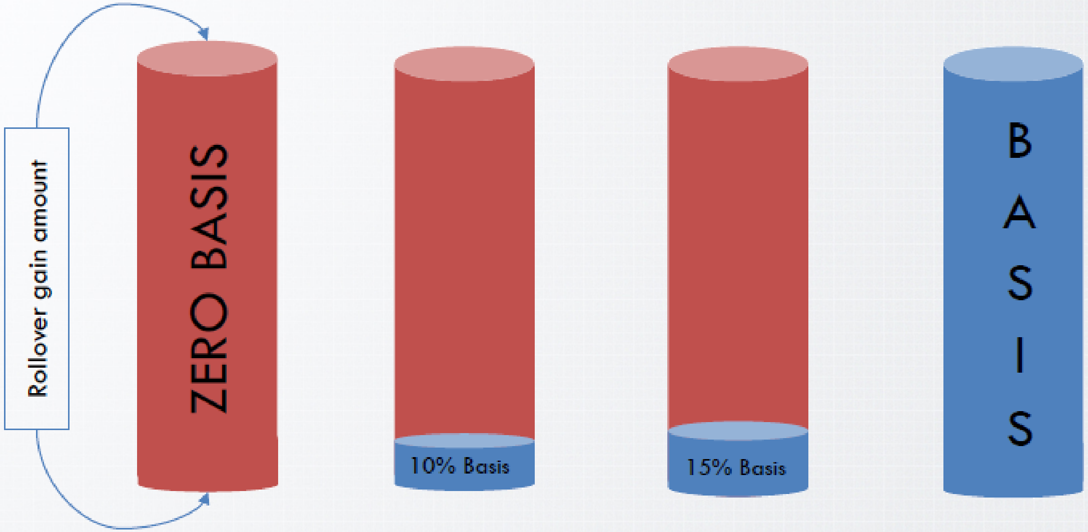
Introduction to Qualified Opportunity Zones (con't.)

- The U.S. Treasury has issued two sets of proposed regulations to clarify its stance. (Prop. Reg. §1.1400Z2)
  - First set of proposed regulations - October 2018.
  - Second set of proposed regulations - April 2019.
  - Third set of proposed or final regulations? - Most likely sometime in early 2020.

Overview


Investor
Capital gain, cash, or property
Qualified Opportunity Fund
Owns property directly
Qualified Property
Stock or partnership interest
Qualified Business

Investor: Partial Tax Exclusion on Deferred Capital Gain



Basis starts at zero

After 5 years, basis is increased by 10% of the rollover gain

After 7 years, basis is increased by an additional 5% of the rollover gain

At time of sale or exchange or taxable year that includes December 31, 2026, remaining rollover gain is recognized and tax is paid. If investment has lost value, gain is computed using fair market value

Investor: Post-Acquisition Appreciation Exclusion

- If the taxpayer holds their investment for at least 10 years from the date of investment, the taxpayer can elect (at the time of sale or exchange), to increase the basis of their investment to the fair market value.
- At this time, the original tax (if any) has already been paid on the rollover capital gain.
- The election essentially allows the taxpayer to exclude any additional gain on the sale of **an equity interest** held for more than 10 years in a QOF from tax. (Including any depreciation recapture).
- However, only capital gains will be excluded from the sale of **the underlying assets** of the QOF held for more than 10 years. (I.e. the entity will still have to consider depreciation recapture in income).
- The proposed regulations allow taxpayers to make this election until December 31, 2047.

Investor: Mixed Funding

- Any gain treated as a capital gain (including net Section 1231 gains) generated from a sale with an unrelated part qualifies.
  - Only the gain amount can be invested to be eligible for the tax benefits of deferral.
  - If any amounts of the proceeds over the amount of the gain are invested, this will create a "mixed fund." A mixed fund means that the investor will not receive benefits to the extent of the appreciation in the contributed property or for value received.
  - Additionally, any contributions aside from gains of cash or other property will create a mixed fund, however, these contributions are allowed.

Qualified Opportunity Fund Requirements

- A QOF must be either a partnership (including LLCs electing to be treated as a partnership) or a corporation (including Subchapter S corporations and LLCs electing to be treated as a corporation).
- **Cannot be an SMLLC (Schedule C Business or Schedule E Rental)**.
- QOFs must have 90 percent of its assets invested in QOZ property. Tested by the average taken at 6 months from the start of the tax year and the end of the tax year. (Must file **Form 8996 Qualified Opportunity Fund** with the tax return).
- No application or approval process. Entity makes election in the first year by filing the first Form 8996.

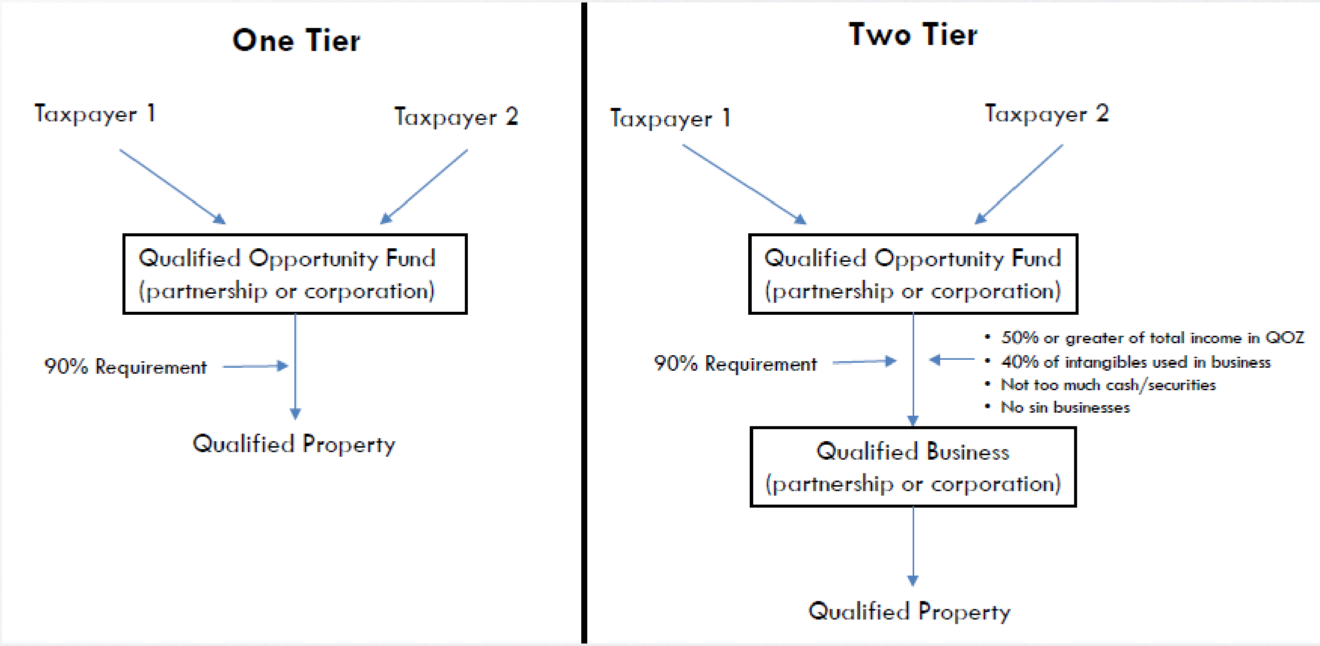
Qualified Opportunity Fund Requirements (con't.)

- For purposes of the 90 percent asset test, there are two possible valuation methods that the taxpayer may use. The method need not be consistent from year-to-year.
  - Applicable financial statement valuation method - based on book value reported on financial statements audited by a CPA.
  - Cost valuation method - based on the original cost basis of the property.

Qualified Opportunity Zone Property

Two types:

1. QOZ business property - generally new or substantially improved **tangible** business property (reasonable amounts of working capital are excluded and have a 31-month safe harbor).
2. QOZ Stock & QOZ partnership interest - equity interest in entities that own qualified property (qualified opportunity zone businesses).



Qualified Opportunity Zone Qualified Property

- Qualified property consists of tangible property used in the trade or business of a QOF or qualified business that meets the following requirements:
  1. Must be acquired by purchase from an unrelated individual after December 31, 2017.
  2. The original use of the property in the QOZ must begin with the QOF or qualified business, or the QOF or qualified business must substantially improve the property (existing structures being depreciated will not qualify under the original use test).
  3. Substantially all (70 percent) of the use of the property must be in the QOZ during substantially all (90 percent) of the QOF's holding period.
- Substantial improvement must occur within a 30-month period. This can be met by **doubling the basis** of the property in that time frame.
- Assets may not be aggregated.

Qualified Opportunity Zone Business

- Definition - a trade of business that satisfies the qualified property tests, one of the three safe harbor income tests, and the "sin business" test.

  - General qualified property test.

$$\frac{\text{qualified property} + \text{QOZ p'ship interest} + \text{QOZ stock}}{\text{all assets of QOF}} \geq 90\%$$

90% Requirement

- Applies in "one tier" and "two tier" structures
- Looks to all assets of QOF.
- May be a 63% test (90% * 70%) in a "two tier" structure

$$\frac{\text{qualified property}}{\text{all tangible property owned or leased by qualified business}} \geq 70\%$$

Substantially All (70%) Requirement

- Applies only in "two tier" structure
- Looks to tangible property of qualified business. Other assets are excluded from test
- Qualified business must also satisfy additional requirements which do not apply in "one tier" structure

Qualified Opportunity Zone Business (con't.)

- Safe harbor income tests - at least 50 percent of the total gross income of the qualified business must be derived from the active conduct of business in the QOZ. There are 3 tests to meet this.
  1. At least 50 percent of the services performed (based on hours) in the QOZ by employees and contractors.
  2. At least 50 percent of the amounts paid are for services performed in the QOZ.
  3. Tangible property and operational functions combine to generate 50 percent of gross income.
- Intangible property test - a substantial portion (40 percent) of the qualified business' intangible property must be used in the active conduct of business in the QOZ.

Qualified Opportunity Zone Business (con't.)

- Non-qualified financial property test - less than 5 percent of the average of the aggregate unadjusted bases of the property of the business is attributable to non-qualified financial property. Financial property for purposes of this test include securities, debt and certain financial instruments.
- "Sin business" test - business cannot be a golf course, country club, massage parlor, hot tub or suntan facility, racetrack or other facility used for gambling, or store whose principal business is the sale of alcoholic beverages for consumption off premises.

Other Business Updates

IRS Issues FAQ Guidance on Negative Tax Basis Capital Account Reporting for Partnerships

- The IRS has issued guidance in the form of an FAQ on the new **negative tax basis capital account** reporting requirement added to the 2018 Form 1065 instructions.
- The instructions require partnerships to report partners' tax basis capital accounts on Line 20 of Schedule K-1 if those amounts are negative at either the beginning or ending of the year.
- **Notice 2019-20** provides penalty relief for some partnerships that fail to report the amounts.
- The FAQ defines a partner's tax basis capital account, explains how it is calculated with examples, and provides a safe harbor that allows partnerships to calculate a partner's tax basis capital account by subtracting the partner's share of partnership liabilities under **IRC Section 752** from the partner's outside basis.

Accounting Method Changes

Accounting Method Changes - Cash Method

- **Prior Law -** A corporation, or a partnership with a corporate partner, may generally only use the **cash method** of accounting if the corporation or partnership met a gross receipts test (i.e., the average annual gross receipts of the entity for the three tax year period ending with the earlier tax year **does not exceed $5 million)**.
- **TCJA -** The cash method may be used by taxpayers (other than tax shelters) that satisfy a $26 million gross receipts test, regardless of whether the purchase, production or sale of merchandise is an income-producing factor.
  - Under the gross receipts test, taxpayers with annual average gross receipts that do not exceed $26 million (indexed for inflation) for the three prior tax years are allowed to use the cash method.
  - Use of this provision results is a change in the taxpayer's accounting method for purposes of *IRC Section 481*.

Accounting Method Changes - UNICAP

- **Prior Law -** The uniform capitalization (UNICAP) rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property.
  - ***Exception:*** Under pre-Act Law, a business with average annual gross receipts of $10 million or less in the preceding three years is not subject to the UNICAP rules for personal property acquired for resale.
- **TCJA** - **Any producer or re-seller** that meets the $26 million gross receipts test is exempted from the application of the *IRC Section 263A* UNICAP rules.
  - The exemptions from the UNICAP rules that are not based on a taxpayer's gross receipts are retained.
  - Use of this provision results in a change in the taxpayer's accounting method for purposes of *IRC Section 481*.

Accounting Method Changes - Long-Term Contracts

- **Prior Law -** An exception from the requirement to use the percentage-of-completion method (PCM) for long-term contracts was provided for construction companies with **average annual gross receipts of $10 million or less** in the preceding three years (i.e. they are allowed use other methods such as the completed contract method or an accrual method).
- **TCJA -** For contracts entered into after December 31, 2017, in tax years ending after that date, the exception for small construction contracts from the requirement to use the PCM is expanded to apply to contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $26 million gross receipts test.
  - Use of this PCM exception for small construction contracts is applied on a cutoff basis for all similarly classified contracts (so there is no adjustment under *IRC Section 481(a)* for contracts entered into before January 1, 2018).

NYS Reaction to TCJA

How has the TCJA Impacted NYS Taxpayers?

Fiscal Year	Total State Collections	Personal Income	Corporation and Business	Sales, Excise and User	Property Transfers	Other Taxes and Fees
2019	$73,679,612,447	$48,087,336,735	$6,828,134,224	$16,384,972,255	$2,203,598,367	$175,570,865
2018	75,995,291,042	51,501,337,750	6,140,512,850	15,748,063,844	2,432,907,540	172,469,058
2017	71,215,174,435	47,565,944,451	6,027,811,511	15,239,780,631	2,217,320,539	164,317,303
2016	71,627,564,571	47,055,282,776	6,913,034,483	14,820,694,938	2,683,861,375	154,690,999
2015	68,103,753,273	43,709,833,323	7,554,188,561	14,532,706,851	2,146,449,681	160,574,856

Tax Law Extenders

- Extend higher personal income tax rates for five years.
  - Top rate of 8.82 percent extended through 2024.
  - MFJ - $2,155,350.
  - HoH - $1,616,450.
  - Single - $1,077,550.
- Extend personal income tax limitation on charitable contributions for five years.

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Conclusion