2018 TAX UPDATE

While the Tax Cuts and Jobs Act dominated tax news in 2018, the new law and its clarifications were not the only big developments this year that construction taxpayers should be aware of.

STEVEN R. GLOVER

It is safe to say that the tax bill signed into law late in December 2017, unofficially known as the Tax Cuts and Jobs Act, dominated the 2018 tax news.[1] Since its signing, taxpayers and practitioners have been trying to determine what it all meant, considering some of the law was handwritten in the margins and contained errors. In this article, we will be discussing some of the clarifications that the U.S. Treasury issued recently. Meanwhile, everyone, in one fashion or another, has been an intended victim of identity theft or fraud. The Internal Revenue Service (IRS) issued a fact sheet this year informing taxpayers how IRS collection agents operate so that they have a heightened awareness of when they are being subjected to a scam. The IRS also proposed regulations on bonus depreciation, a powerful tax deferral strategy. Further, the IRS centralized partnership audit laws became effective in 2018. Partnerships and limited liability companies need to amend their agreements, and taxpayers need to understand their options when the IRS proposes a tax adjustment. Finally, two cases involving homebuilders once again confirm that a taxpayer's intentions and actions drive the character of subsequent gains and losses.

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2017 tax legislation: Tax Cuts and Jobs Act

The U.S. Treasury has issued numerous pronouncements and proposed regulations since December 22, 2017, to clarify taxpayers' and professionals' understanding of what Congress enacted with the Tax Cuts and Jobs Act. The following is a summary of some of the relevant guidance.

Qualified business income deduction. *Mechanics.* The qualified business income (QBI) deduction replaced the Internal Revenue Code (IRC) Section 199 domestic production activities deduction for tax years ending after December 31, 2017.[2] As an aside, a fiscal year taxpayer may be able to claim both the IRC Section 199A and 199 deduction.[3]

The deduction is 20 percent of the QBI generated from a partnership, S corporation, sole proprietorship, or trust/estate. The deduction is not based on a shareholder's reasonable salary or a partner's guaranteed payment.[4]

The 20 percent deduction is subject to one of two limitations.[5] The two alternate limitations are:

- 50 percent of the business's taxable wages or
- 25 percent of business wages plus 2.5 percent of the business's unadjusted basis in depreciable property.

The higher of the two calculated limitations is compared to the overall 20 percent deduction. The taxpayer then claims the lower of 20 percent of business net income or the limitation amount. Notwithstanding these alternate limitations, the QBI deduction cannot exceed the pass-through owner's taxable income.

One of the Section 199A planning ideas is to balance paying an owner a salary/guaranteed payment versus paying an equity distribution. For example, assume the business has $1 million of QBI. If the owner receives a $1 million salary (or guaranteed payment), he or she has income subject to a 37 percent maximum tax rate, and the company's income is zero. Since 20 percent of zero is zero, no one benefits from the Section 199A QBI deduction. If the owner does not receive any salary/guaranteed payment, the owner would report net taxable income of $800,000 ($1 million less a $200,000 QBI deduction).

So what is possible in terms of tax planning? Without other considerations, such as an S corporation shareholder needing a certain wage amount for qualified retirement plan purposes, keeping the salary lower and increasing the distribution will result in an overall lower income tax liability.[6] Please note that the statute requires a reasonable salary.[7] On the other hand, there is no requirement that a partnership pay a reasonable guaranteed payment. Therefore, the partnership should consider amending its agreement to provide a partner a priority profits allocation and distribution, since that payment would not reduce QBI.

Definition of qualified business income. In general, certain income sources do not qualify for the QBI deduction. One common example is one in which the contractor personally owns the real estate and leases the building to his company, which is then responsible for all the maintenance costs other than the real estate taxes. The issue is whether the rental property subject to a triple net lease is the owner's trade/business or investment. If the latter, Section 199A would not apply.[8]

The proposed regulations created a potentially taxpayer-friendly definition of a trade or business.[9] Any tangible or intangible property rental will be treated as a trade or business for the purposes of Section 199A if such property is rented to a commonly controlled trade or business.[10] Thus, the owner would treat the building rental and business activity together for purposes of the QBI deduction. The regulation's preamble acknowledges that this rule may work against a taxpayer by preventing it from improperly allocating losses or deductions away from a trade or business that generates QBI.

ONE OF THE SECTION 199A PLANNING IDEAS IS TO BALANCE PAYING AN OWNER A SALARY/GUARANTEED PAYMENT VERSUS PAYING AN EQUITY DISTRIBUTION.

The proposed regulations also answered another question regarding an eligible QBI business. The enacted law listed certain trades and businesses that, in general, would not qualify for the QBI deduction.[11] A construction contract clearly falls within the definition of a qualified business, but what about a construction management job? In reviewing the list of businesses that in general do not qualify, a construction management contract could be classified as consulting or a trade or business in which the principal asset is the reputation or skill of one or more of its employees or owners.

The regulations provided further definitional guidance. Consulting means the provision of professional advice and counsel to clients to assist the clients in achieving goals and solving problems.[12] The "reputation/skill" category has been whittled down to include only the following revenue streams (and therefore is not applicable to a construction management contract):

- product/service endorsement;
- use of an individual's image, likeness, name, signature, and so forth; and
- an event or media appearance.[13]

My suggestion is to tailor a management construction contract as narrowly as possible in terms of what services fall within "advice and counsel" and have a separate contract for nonconsulting services.

Definition of wages. As mentioned earlier, the QBI deduction is based, in part, on the particular QBI's taxable wages. It is not uncommon for a business to hire a professional employer organization, multiple certified professional employer organizations, or agents to take responsibility for the business's payroll function. The proposed regulations allow the common law employer (the business) to treat such wages as its own for the purposes of calculating its QBI deduction.[14]

Subsequent to the proposed regulations' issuance, the Treasury issued a proposed revenue procedure that provides guidance on methods for calculating W-2 wages for the purposes of Section 199A and the proposed regulations.[15] The guidance provides three methods for calculating W-2 wages.

In the unmodified box method, W-2 wages are, without modification, the lesser of:

- the total entries in Box 1 of all of the taxpayers' W-2 forms filed with the Social Security Administration or
- the total entries in Box 5 of all W-2 forms filed with the Social Security Administration.

In the modified Box 1 method, the taxpayer modifies the total entries in Box 1 as follows:

- Total the amounts in Box 1.
- Subtract from that amount wages that are not wages for federal income tax withholding purposes, including amounts that are treated as wages for the purposes of income tax withholding under IRC Section 3402(o) (for example, supplemental unemployment compensation benefits).
- Add to this calculation the amounts that are reported in Box 12 that are properly coded D, E, F, G, and S.

In the tracking wages method, the taxpayer actually tracks total wages subject to federal income tax withholding and makes appropriate modifications. W-2 wages are determined as follows:

- Total the amounts of wages subject to federal income tax withholding.
- Add to the calculation the amounts reported in Box 12 that are properly coded D, E, F, G, and S.

FOR A TAXPAYER THAT IS CURRENTLY USING THE PERCENTAGE OF COMPLETION METHOD AND DECIDES TO SWITCH TO AN EXEMPT METHOD, ONE RELEVANT ISSUE IS WHETHER IT NEEDS TO FILE FOR A CHANGE IN ACCOUNTING METHOD.

The Treasury has requested comments on this proposed revenue procedure. In particular, the Treasury Department and the IRS are still uncertain about the wage calculation for services performed in Puerto Rico.[16]

Tax accounting methods for average gross receipts less than $25 million. The Tax Cuts and Jobs Act expanded the pool of taxpayers who can:

- use an exempt method for reporting long-term construction contract revenue;[17]
- remain on, or switch to, cash basis; and
- avoid applying uniform capitalization (UNICAP) inventory costing.

This expansion was accomplished by raising the threshold to a $25 million or less average gross receipts during the preceding three-year period.[18] Thus, for tax years beginning after December 31, 2017, a contractor whose average gross receipts for the period 2015 through 2017 do not exceed $25 million can use a method other than percentage completion for its long-term contracts.[19]

For a taxpayer that is currently using the percentage of completion method and decides to switch to an exempt method, one relevant issue is whether it needs to file for a change in accounting method. In general, any time a taxpayer changes its tax accounting method, it must receive IRS consent, and such consent could be either automatic or nonautomatic.[20] There are different due dates for requesting an automatic or nonautomatic consent, and the IRS charges a user fee to request a nonautomatic change.[21] Under either type of request, if the consent is late, the taxpayer may not change its current method, regardless of whether it is a correct or incorrect method.

The Treasury issued guidance earlier in the year for taxpayers that want to change accounting methods based on being under the $25 million gross receipts threshold.[22]

Overall cash basis. The revenue procedure added a new provision to the general accrual to cash basis conversion mechanics.[23] A cash basis taxpayer includes in income open accounts receivable as they are actually or constructively received. For this purpose, an open accounts receivable is any receivable that is due in full in 120 days or less.

Long-term contracts. The IRS previously classified a change from the percentage completion method as a nonautomatic change. A change from the percentage completion method pursuant to this revenue procedure is an automatic change. This change applies to exempt long-term contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017. The significance of this effective date is as follows: The tax legislation's general effective date is for a tax year beginning *after* December 31, 2017, but if the taxpayer has a fiscal year ending after December 31 — say June 30, 2018 — then any contract entered into after December 31, 2017, may qualify for the automatic change, even though the tax year began *before* December 31, 2017.

A taxpayer may be able to change from the percentage completion method without requesting IRS consent. For example, assume a taxpayer has always used the percentage of completion method to recognize income. If the taxpayer's jobs were always long-term construction contracts and its gross receipts always averaged more than $10 million for the preceding three-year period, the taxpayer never adopted a method for an exempt contract. Now that the taxpayer falls under the $25 million threshold, it has nonexempt contracts and can elect an exempt method without requesting the IRS's consent. This is because the taxpayer has experienced a change in facts, not a change in accounting methods. If, on the other hand, the taxpayer's jobs were not always long-term construction contracts, or if its gross receipts averaged less than $10 million for the preceding three-year period, the taxpayer in essence adopted the percentage of completion method for its exempt contracts. Now a change from the percentage completion method to another exempt method requires filing a Form 3115. Any change under this revenue procedure is made on a cut-off basis, meaning that a contract started under one method finishes using that same method. Thus, there is no IRC Section 481(a) adjustment.

Revocation of S corporation election and change to accrual method from cash method of accounting. The tax legislation reduced the maximum 35 percent graduated tax rate on a C corporation to a flat 21 percent tax. The law also repealed the alternative minimum tax on a C corporation. For a certain fact pattern, switching to a C corporation from an S corporation may save significant taxes. Usually the right fact pattern includes:

- minimum owner cash payments (salary and dividend);
- the need to accumulate cash inside the corporation;
- a long-term vision to retain company ownership or an intent to go public; and
- assurance that the owners will sell stock rather the corporation's assets.[24]

The Treasury issued a revenue procedure with a special rule for a cash basis S corporation's conversion to a C corporation when the taxpayer must switch to the accrual basis method of accounting (i.e., fails the $25 million and under gross receipts test).[25] The conversion must take place in the entity's first year as a C corporation. The special rule provides that any resulting IRC Section 481(a) adjustment (positive or negative) is recognized over six years.[26]

To be eligible for this special rule:

- the C corporation had to have been an S corporation on December 21, 2017;
- the S corporation election must have revoked after December 21, 2017, but before December 22, 2019; and
- the S corporation must have the same shareholders in identical percentages on December 22, 2017, and on the S corporation revocation date.

An S corporation that can remain on the cash basis after it revokes its election but nonetheless changes to the accrual method in the C corporation's first taxable year may elect the six-year recognition period. The corporation makes such election on Form 3115, line 26.

Business meals and entertainment deduction. There are many favorable tax law changes for contractors and engineers. As I was speaking to clients, the one tax law change that piqued everyone's interest was whether the meals and entertainment deduction remained. Under a literal reading of the law changes, the general answer was that the 50 percent deduction was reduced to zero. A vast number of professionals and taxpayers did not believe this was Congress's

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intent, but that was how the law read. The Treasury provided transitional guidance on the deductibility of certain business meals.[27] As amended, the law generally disallows a deduction for expenses with respect to entertainment, amusement, or recreation. However, the tax legislation did not specifically address the business meals deduction.

The Treasury Department and the IRS intend to publish proposed regulations clarifying when business meal expenses are nondeductible entertainment expenses and when they are 50 percent deductible expenses. Until the proposed regulations are effective, taxpayers may rely on the guidance.

PARTNERSHIPS AND LIMITED LIABILITY COMPANIES CAN NO LONGER PROCRASTINATE — THE CENTRALIZED IRS PARTNERSHIP AUDIT REGIME IS IN EFFECT FOR TAXABLE YEARS ENDING AFTER DECEMBER 31, 2017.

In the meantime, under this notice, a taxpayer may deduct 50 percent of an otherwise allowable business meal expense if:

- the expense is an ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business;[28]
- the expense is not lavish or extravagant under the circumstances;
- the taxpayer or an employee is present at the furnishing of the food or beverages;
- the food and beverages are provided to a current or potential business customer, client, consultant, or similar business contact; and
- in the case of food and beverages provided during or at an entertainment activity, food and beverages are purchased separately from the entertainment, or the cost of the food and beverages is stated separately from the cost of the entertainment on one or more bills, invoices, or receipts. The entertainment disallowance rule may not be circumvented through inflating the amount charged for food and beverages.

The Treasury Department requested comments for future guidance to clarify further the treatment of business meal expenses and entertainment expenses. In particular, it requested comments concerning:

- whether and what further guidance is needed to clarify the treatment of entertainment expenses and business meal expenses;
- whether the definition of entertainment should be retained and, if so, whether and how it should be revised;
- whether the objective test in Treasury Regulations 1.274-2(b)(1)(ii) should be retained and, if so, whether and how it should be revised; and
- whether and what additional examples should be addressed in guidance.

Centralized IRS partnership audit regime

General background and rules. Partnerships and limited liability companies can no longer procrastinate — the centralized IRS partnership audit regime is in effect for taxable years ending after December 31, 2017. The rules were enacted under the Bipartisan Budget Act of 2015, which repealed the existing Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) rules that governed partnership audits.[29] The new partnership audit regime, in general, assesses and collects tax *at the partnership level*. While the details and intricacies of these rules are outside of the scope of this article, I do want to make the reader aware of certain considerations for 2018 income tax return filings.

As background, since Congress enacted TEFRA, the number and complexity of partnerships continued to increase, reflecting a shift in how business entities were structured — toward partnerships and away from C corporations. The IRS faced difficulties working through large partnership audits, since, under TEFRA, the IRS was required to pass the audit adjustments to partnership items on to the ultimate partners, a complex and time-consuming process.

In 2015, Congress enacted the centralized partnership audit regime as the exclusive method by which the IRS may audit a partnership in one unified proceeding. The change is expected to simplify TEFRA's burdensome processes, increase the IRS's ability to examine partnerships, particularly large and tiered partnerships, and make the tax assessment process more efficient.

Under the centralized partnership audit regime, the IRS no longer determines each partner's share of adjustments, followed by a separate computation to assess the correct tax due from each partner. Instead, under the default rules, the partnership is liable for an "imputed underpayment" based on the adjustments made at the partnership level.[30] The Joint Committee on Taxation observed that the intent of the imputed underpayment is to "determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt tax assessment and collection of tax attributable to the income of the partnership and partners."[31]

A partnership may not want to pay a potential income tax liability. The partnership does have a couple of alternatives. An eligible partnership may elect out of the centralized partnership audit regime.[32] The opt-out election is not a one-time election; it must be made on a timely filed tax return for each year the taxpayer wants the election to apply.[33] Partnerships that elect out of the centralized partnership audit regime are subject to the pre-TEFRA audit procedures under which the IRS must separately assess tax with respect to each partner under the deficiency procedures.

Another potential problem with the centralized regime and the partnership paying the tax deficiency arises when, in the current year, the partnership receives a notice that the prior year return has been selected for audit, and some of the partners in the current year were not partners in the prior year.

If the partnership cannot opt out of the centralized regime, it can elect to "push out" the tax payment responsibility to the partners rather than the partnership.[34] The partnership may elect to have those who were partners in the year being audited take into account the IRS adjustments and pay any tax due based on those adjustments.

A partnership elects to push out an imputed underpayment in two steps. First, the partnership must make an election no later than 45 days after the date the IRS mails the final partnership adjustments mailed by the IRS.[35] Second, the partnership must furnish a statement of each partner's share of any adjustment as determined in the final partnership adjustments to the affected partners.[36] An election is revocable only with the IRS's consent.[37]

Partnership representative. Another major difference between the centralized regime and TEFRA is that the partnership representative (PR) replaces the tax matters partner (TMP).[38] One will see that the PR has taken on much more responsibility than the prior TMP.

Partnerships need to select a PR each year.[39] This is a task that the owners need to do in 2018 — amend the partnership agreement to designate the PR. If the partnership does not designate a PR, the IRS has the authority to select any person for the role.[40] The PR is all-powerful during an IRS audit.[41] The PR has the sole authority to act on behalf of the partnership.[42] In fact, the PR is not bound by state law, the partnership agreement, or any other document or agreement.[43] The partnership and its owners are bound by the PR's actions and decisions. The PR does not need to be an owner. The partner group should choose this person rather than the IRS.

IF THE PARTNERSHIP CANNOT OPT OUT OF THE CENTRALIZED REGIME, IT CAN ELECT TO "PUSH OUT" THE TAX PAYMENT RESPONSIBILITY TO THE PARTNERS RATHER THAN THE PARTNERSHIP.

IRS advice to avoid scams

In May, the IRS alerted taxpayers and tax practitioners how the "bad guys" are impersonating IRS personnel by phone, by email, or in person to obtain tax information and money.[44] Criminals use fake names and phony IRS identification badge numbers. They are demanding and threatening — and do not reflect how the IRS handles enforcement matters.

Here are the facts. The IRS initiates most taxpayer contact through regular mail. However, there are special circumstances in which the IRS will call or come to a home or business, such as:

- when a taxpayer has an overdue tax bill;
- to secure a delinquent tax return or a delinquent employment tax payment; or
- to tour a business, for example, as part of an audit or during criminal investigations.

Even then, taxpayers will generally first receive a letter from the IRS.

The facts sheet released by the IRS noted that:

- The IRS does not demand that people use a specific payment method, such as a prepaid debit card, gift card, or wire

transfer. The IRS will not ask for debit or credit card numbers over the phone. For people who owe taxes, they should make payments to the U.S. Treasury or review IRS.gov/payments for IRS online options.
- The IRS does not demand immediate tax payment. Normal correspondence begins with a letter and taxpayers can appeal or question what they owe. All taxpayers are advised to know their rights as a taxpayer.
- The IRS does not threaten to bring in local police, immigration officers, or other law enforcement agencies to arrest people for not paying. The IRS also cannot revoke a license or immigration status. Threats like these are common scam artist tactics used to trick victims into believing their schemes.

THE IRS DOES NOT THREATEN TO BRING IN LOCAL POLICE, IMMIGRATION OFFICERS, OR OTHER LAW ENFORCEMENT AGENCIES TO ARREST PEOPLE FOR NOT PAYING.

If an IRS employee does make an official and/or unannounced visit, remember the following:

- All IRS representatives will provide their official credentials, called a pocket commission and a Homeland Security Presidential Directive (HSPD)-12 card. The HSPD-12 card is a government-wide standard form of reliable identification for federal employees and contractors. Taxpayers have the right to see these credentials. IRS employees can provide an additional method to verify their identification. Upon request, they are able to provide a toll-free employee verification telephone number.
- Collection employees will not demand immediate payment to a source other than the U.S. Treasury.
- IRS employees may call taxpayers to set up appointments or discuss audits but not without first attempting to notify taxpayers by mail.
- IRS employees conducting criminal investigations are federal law enforcement agents who will never demand money.

The IRS may assign certain overdue tax debts to a private debt collection agency. Its employees:

- will identify themselves and will ask for payment to the U.S. Treasury;
- will not ask for payment on a prepaid debit or gift card; and
- will not take enforcement action.

Finally, if a taxpayer feels that he or she is being scammed, there are several options to report it.

- Report impersonation scams to the Treasury Inspector General for Tax Administration, found on the "IRS Impersonation Scam Reporting" webpage.
- Report phone scams to the Federal Trade Commission using the FTC Complaint Assistant. Add "IRS Telephone Scam" in the notes section of the complaint.
- Report an unsolicited email claiming to be from the IRS or an IRS-related system like the Electronic Federal Tax Payment System to the IRS at *phishing@irs.gov*.

Land development and intent

The Tax Court heard multiple cases during the year involving a homebuilder's characterization of its land sale gain.[45] The underlying gist of the cases was whether the taxpayer's intention for the land was to hold it for sale in the ordinary course of its business or hold it for investment purposes. If the former, any gain or loss would be ordinary; if the latter. any gain or loss would be capital.

In *Barry G. Conner*, the taxpayer was the sole shareholder of an S corporation custom homebuilder. The S corporation would build homes without owning the land or maintaining an inventory of partially developed homes or land. The S corporation's main source of revenue was from the custom home sales, but it also owned large tracts of undeveloped land that it held for investment purposes, separate from the homebuilder operations.

The IRS had two tax issues with the corporation's income tax return. The first was that it claimed an ordinary loss disposing of its sales center and model homes.[46] Since the corporation depreciated the structures, the court allowed the ordinary loss treatment.

The S corporation also sold land to a charitable organization as a bargain sale, for which it claimed a deduction equal to the fair market value less the sales proceeds.

The IRS argued that the charitable contribution should have been the land's fair market value less the ordinary gain that the corporation would have recognized had it sold the land at its fair market value.[47]

The Tax Court held that the S corporation had not performed activities to develop the land; rather, it purchased and held the land for investment purposes. Therefore, because the land was held as a long-term capital asset and would not have generated any ordinary gain, the S corporation was entitled to a charitable contribution equal to the land's fair market value less any bargain purchase proceeds.

The taxpayer/shareholder also owned various tracts of land in single-member limited liability companies. The taxpayer purchased the land several years before the 2008 economic downturn and had planned to develop it into commercial and residential communities. After the economic environment shifted with the recession, the taxpayer abandoned the development plans. The land was not developed, and the taxpayer incurred expenses only from holding the real estate.

The taxpayer originally reported the expenses on his personal income tax return on Schedule C, with no associated income until the land sold — which he claimed as an ordinary loss. The IRS argued that the taxpayer's grouped limited liability companies (without regard to the S corporation, as it is a separate entity) did not meet the definition of a trade or business. The court agreed because the taxpayer abandoned his development plans after the recession. Therefore, as investment property:

- the interest expense was recharacterized as investment interest expense, reportable on Schedule A;
- the real estate taxes were deductible on Schedule A;
- the other land holding costs were deductible on Schedule A as investment expenses, subject to the 2 percent of adjusted gross income; and
- the loss on the land sale was recharacterized as a capital loss.

The taxpayer owned one other limited liability company that owned and rented commercial space. The LLC did not have any employees, but one of the S corporation's employees was the property manager and dealt with the day-to-day activities. The taxpayer reported the activity on his personal income tax return on Schedule E and made a real estate professional election.[48] The taxpayer argued that because he was a real estate professional, he materially participated in the aggregated rental real estate activities. However, as the IRS noted, this was the taxpayer's only rental real estate activity (the other activities were either the S corporation's home building or limited liability corporations that were holding land for investment purposes). As he did not own multiple activities to aggregate, only the time the taxpayer spent on this specific activity could qualify for material participation.[49] The Tax Court determined that the taxpayer did not materially participate in the limited liability company's activities. The losses were disallowed in the current year as a passive loss.[50]

In *Sugar Land Ranch Development*, the taxpayer acquired approximately 950 acres in 1998 that it intended to develop into residential and commercial spaces. Between 1998 and 2008, the taxpayer took steps to clean the land (which had previously been an oil field) and prepare it for development.

After the economic downturn in 2008, the taxpayer determined that its development plans were infeasible and made formal decisions in 2008 and 2009 to stop all development activities. He did not market or list the parcels for sale. The first sale occurred in 2012 when a homebuilder submitted an offer to purchase three land parcels.

The taxpayer reported the sale as a capital gain, since he had been holding the land since 2008 as an investment. The IRS argued that the taxpayer intended to hold the property as inventory in the ordinary course of its business and should therefore report the gain as ordinary income. The IRS pointed to the taxpayer's development plans and the cleanup costs to prepare the land. The Tax Court held that the taxpayer changed his intentions for the land, and his development activities changed to holding the property for investment purposes.

In summary, the taxpayer must base its tax position on the individual facts and circumstances of each separate entity and land parcel. While the taxpayer's original

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intention is important, intentions may change. The years immediately preceding the sale are important in evaluating the holding purpose. If the taxpayer is developing the land, then the laws point to ordinary income or loss. On the other hand, if the taxpayer in subsequent years passively holds the property, not performing any work other than incurring costs to hold the land, it is much more likely that the property is being held for investment purposes and would result in either a capital gain or loss.

Bonus depreciation changes

The 2017 tax legislation expanded the bonus depreciation rules as follows. The applicable percentage was increased back to 100 percent and extended through the end of 2022. In addition, bonus depreciation now applies to previously used equipment, rather than only applying to initial use property. The net result is that a taxpayer may be able to write off in full used or new equipment in the year it is placed in service.

IT IS IMPORTANT TO REMEMBER THAT BONUS DEPRECIATION IS THE STANDARD — IF IT APPLIES TO THE PURCHASED ASSET, IT IS PRESUMED TO BE USED.

Bonus depreciation applies to any modified accelerated cost recovery system (MACRS) property with a recovery period under 20 years. It should be noted that property depreciated under the alternative depreciation system (ADS) method is not eligible for bonus depreciation.[51]

The revised bonus depreciation rules apply to property acquired and placed in service after September 27, 2017. The term “acquired” is defined as the date the taxpayer has a written binding contract in place or, for self-constructed property, when more than 10 percent of the anticipated costs have been incurred.[52]

It is important to remember that bonus depreciation is the standard — if it applies to the purchased asset, it is presumed to be used. If the taxpayer would prefer not to utilize bonus depreciation, that taxpayer must make an affirmative election out and file it with its income tax return the year that the asset is placed in service.[53]

One taxpayer-friendly law change, it could be argued, was implemented with good intentions but abysmal execution. Congress created an asset category qualified improvement property (QIP) that replaced the separate qualified leasehold improvement property, qualified restaurant property, and qualified retail property categories. These three categories had MACRS 15-year useful lives.

While the Conference Committee Report documents Congress’s intent to give QIP a MACRS 15-year useful life, Congress made a drafting error and never assigned QIP a 15-year life. Therefore, until a technical correction bill, QIP is not bonus depreciation eligible and is subject to a MACRS 39-year useful life. One possible work-around is a cost segregation study on improvements to reclassify portions of the cost improvements to a shorter depreciable life (which would be bonus eligible).

Lastly, bonus depreciation can now be used on partnership IRC Section 743(b) basis adjustments. The rationale is that the property subject to the basis step-up was not previously used by the partner whom the step-up benefits. Similarly, the bonus depreciation rules do not apply to an IRC Section 734(b) step-up because it would benefit the partnership that already uses the property. ■

NOTES

[1] Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13304, 131 Stat. 2054, 2123 (2017).

[2] The QBI deduction is addressed in IRC § 199A; IRC § 199 was repealed effective for tax years beginning after December 31, 2017.

[3] Prop. Regs. 1.199A-1(f)(2). A taxpayer may rely on the proposed regulations for its tax year ending after December 31, 2017. The preamble states that there is no statutory requirement under IRC § 199A that a qualified item *arise* after December 31, 2017. Accordingly, for the purposes of determining QBI, wages, and unadjusted basis immediately after acquisition (UBIA), such items are treated as having been incurred by the individual during his or her tax year in which such pass-through entity taxable year ends. For example, the individual’s S corporation has a fiscal year that ends on September 30, 2018. When the S corporation issues its Schedule K-1 for the fiscal year ending on September 30, 2018, all QBI, wages, and UBIA incurred for the entire period from October 1, 2017, through September 30, 2018, qualify for the QBI deduction calculation, even though the new law did not technically exist before December 2017. Furthermore, at this point, there is no reason why the Schedule K-1 cannot report activity during the period from October 1 through December 31, 2017, as qualifying for the IRC § 199 domestic production activities deduction.

[4] IRC § 199A(c)(4). From now on, the terms partnership and partner may refer also to a two-member (or more) limited liability company and member.

[5] If the pass-through entity owner’s taxable income is less than $315,000 and the owner is married filing jointly, or if the owner is filing otherwise and has a taxable income less than $157,500, the wage and business limitations do not apply, and thus any type of business could qualify for the QBI deduction. Note that there could be a partial deduction (between 1 percent and 19 percent) for an individual filing

jointly with a combined taxable income not exceeding $415,000 (or $257,500 filing otherwise).

6 There could be other considerations, such as a bank covenant that has a lower limit on owner distributions than owner salary.

7 IRC § 199A(c)(4) states that QBI shall not include reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business. In essence, the IRS can impute a reasonable salary even if the shareholder does not receive one, thereby reducing QBI.

8 QBI is measured with respect to a trade or business according to IRC § 199A(c).

9 Prop. Regs. 1.199A-1(a)(13).

10 Common control is defined under Prop Regs. 1.199A-4(b)(1)(i).

11 IRC § 199A(d)(2)(A) excludes 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 one or more of its employees or owners. But remember, if a particular pass-through entity owner falls within the taxable income safe harbors listed in Note 5, then any of the aforementioned fields qualify for the QBI deduction.

12 Prop. Regs. 199A-5(b)(2)(vii).

13 Prop. Regs. 199A-5(b)(2)(xiv).

14 Prop. Regs. 199A-2(b)(2)(ii).

15 IRS Notice 2018-64, Internal Revenue Bulletin No. 2018-34: 347 (Aug 8, 2018).

16 IRC § 199A(f)(1)(c)(ii) provides that a taxpayer's Puerto Rican sourced wages connected to QBI shall be determined without regard to the IRC § 3401(a)(8) exclusion (for remuneration paid for services performed in Puerto Rico). Because bona fide Puerto Rican residents are not subject to federal income tax and do not receive Forms W-2, the methods provided in the proposed revenue procedure will be difficult to apply. The Treasury Department and the IRS request comments concerning appropriate methods for calculating W-2 wages.

PRIOR TO TEFRA'S ENACTMENT, THE IRS HAD TO OPEN AN EXAMINATION FOR EACH PARTNER AFFECTED BY AN ADJUSTMENT TO A PARTNERSHIP ITEM, FOLLOW DEFICIENCY PROCEDURES FOR EACH PARTNER, AND CALCULATE THE RESULTING TAX.

17 Exempt methods include, for example, completed contract method, cash basis, accrual basis without retention, and accrual basis.

18 IRC § 460(e)(1).

19 The previous threshold was a three-year average not exceeding $10 million for an entity other than a C corporation or not exceeding $5 million for a C corporation (unless a personal service corporation), as per IRC § 448(c). Also remember that if the taxpayer is not a C corporation, the difference between reporting on the percentage completion method and an exempt method is still an alternative minimum tax preference item.

20 IRS consent for a change of accounting method must be obtained using IRS Form 3115.

21 A taxpayer may file for an automatic change on its timely filed income tax return. A taxpayer must file a nonautomatic change request by the end of its taxable year. Refer to Form 3115 instructions. The fee for nonautomatic change requests was $9,500 for 2018. Refer to Rev. Proc. 2018-1 Appendix A, Internal Revenue Bulletin No. 2018-1: 1. The IRS issues the user fee schedule every year.

22 Rev. Proc. 2018-40, Internal Revenue Bulletin No. 2018-34: 320 (Aug 6, 2018). This revenue procedure covers the conversion to cash basis; exempts taxpayers from capitalizing certain costs, including certain home construction contracts; exempts taxpayers from the long-term contract percentage of completion method; and exempts taxpayers from accounting for inventories under IRC § 471.

23 Rev. Proc. 2018-40, Section 3.02, which modifies Rev. Proc. 2018-31 by adding Section 15.18.

24 Otherwise, an owner's salary could be taxed as the maximum 37 percent rate; an asset sale inside a corporation generates double taxation — inside the corporation at 21 percent and an additional 23.8 percent tax when the funds are distributed from the corporation (capital gains/dividend and net investment income taxes).

25 Rev. Proc. 2018-44, Internal Revenue Bulletin No. 2018-37: 426 (Aug 22, 2018).

26 The general IRC § 481(a) adjustment rule is that a negative adjustment is reported in the year of change, and a positive adjustment is recognized into income over a four-year period.

27 IRS Notice 2018-76, Internal Revenue Bulletin No. 2018-42 (Oct 3, 2018); IRC § 274 was amended by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13304, 131 Stat. 2054, 2123 (2017).

28 Ordinary and necessary expenses are defined under IRC § 162(a).

29 IRC §§ 6221–6241. Prior to TEFRA's enactment, the IRS had to open an examination for each partner affected by an adjustment to a partnership item, follow deficiency procedures for each partner, and calculate the resulting tax. Separate proceedings for each partner often resulted in inconsistent treatment among them with respect to the same adjustments. In some cases, inconsistent results occurred in the partner-level examinations themselves. In other cases, not all partners allocated the same items from the partnership were subject to an IRS examination because, for instance, the period of limitations on assessment had expired for some, but not all, partners. In addition, each partner could challenge the IRS adjustment in separate partner-level proceedings in different litigation forums and appellate venues, resulting in different outcomes with respect to the same partnership item. Over time, the size and complexity of partnerships increased, multiplying the disparate treatment of partners with respect to the same items from a partnership and increasing the burden on the IRS in examining and assessing taxes related to partnership issues at the partner level. In 1982, in response to these difficulties, Congress enacted the TEFRA partnership procedures to establish unified rules allowing the IRS to adjust "partnership items" at the partnership level in one proceeding. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level. Once a TEFRA proceeding was final, the IRS made corresponding computational adjustments to each partner's return to reflect the proper treatment of partnership items. The TEFRA partnership procedures automatically exempted certain partnerships with 10 or fewer direct partners. For those small partnerships, the IRS had to follow deficiency procedures for each partner, which required the IRS to adjust items from the partnership on each partner's return and to assess the resulting tax subject to the deficiency procedures in a separate proceeding at the partner level.

30 IRC § 6225.

31 Joint Committee on Taxation, "General explanation of tax legislation enacted in 2015," JCS-1-16: 65–66.

32 There are two conditions to be met when a partnership elects out of the centralized partnership audit regime. First, a partnership must have 100 or fewer partners. Under the statute, a partnership has 100 or fewer partners when it is required to furnish 100 or fewer Schedules K-1. See IRC § 6221(b)(1)(B). For a partnership that has an S corporation partner, each S corporation Schedule K-1 counts toward the 100 threshold. See IRC § 6221(b)(1)(B); 6221(b)(2)(A)(ii). Second, a partnership must only have eligible partners. Under the statute, eligible partners are individuals, C corporations, foreign entities that would be treated as C corporations if they were domestic, S corporations, and estates of deceased partners. See IRC § 6221(b)(1)(C). Note that a partnership with a grantor trust or single-member LLC cannot opt out. A part-

nership may elect out of the centralized partnership audit regime only on a timely filed return for a taxable year (including extensions), as outlined in IRC § 6221(b)(1)(D)(i). A partnership electing to opt out must disclose its partners' names and taxpayer identification numbers, as per IRC § 6221(b)(1)(D)(ii). If an S corporation is a partner, the partnership must also disclose information on each shareholder, according to IRC § 6221(b)(2)(A)(i).

[33] IRC § 6221(b)(1)(D). The fact is that all partnerships are subject to the centralized partnership audit regime unless they elect out.

[34] IRC § 6226(a).

[35] IRC § 6226(a)(1).

[36] The statement of each partner's share of the adjustment must be issued at such time and in such manner as provided by the Secretary; IRC § 6226(a)(2).

[37] *Ibid.*

[38] Department of the Treasury, "Partnership representative under the centralized partnership audit regime and election to apply the centralized partnership audit regime," TD 9839 (Aug 10, 2018); Treas. Regs. 301.6223-1.

[39] Treas. Regs. 301.6223-1(a), 301.6223-1(c).

[40] IRC § 6223(a).

[41] Treas. Regs. 301.6223-2.

[42] Treas. Regs. 301.6223-2(d).

[43] *Ibid.*

[44] "Avoid scams: Know the facts on how the IRS contacts taxpayers," IRS Fact Sheet FS 2018-12 (May 31, 2018).

[45] *Barry G. Conner, et ux. v. Comm'r.*, TC Memo 2018-6; *Sugar Land Ranch Development, LLC, et al. v. Comm'r.*, TC Memo 2018-21.

[46] IRC § 1231 allows that upon disposition of depreciable property, gains are generally recognized as capital and losses will generally be recognized as ordinary.

[47] IRC § 170(e)(1)(A) reduces the charitable contribution amount by the gain that would not have been long-term capital gain if the property contributed had been sold at its fair market value.

[48] IRC § 469(c)(7)(A) allows an individual spending more than 750 hours per year in a real property trade or business to treat all interests in rental real estate as a single rental real estate activity.

[49] According to Treas. Regs. 1.469-5T, material participation is generally more than 500 hours spent on the activity in a given year.

[50] IRC § 469(b).

[51] The ADS election can be made by a real property trade or business (including construction) to avoid the business interest expense limitation.

[52] Treas. Regs. 1.168(k)-1(b)(4)(iii)(B).

[53] Treas. Regs. 1.168(k)-1(e)(3)(ii).