TAX REFORM Q & A

Highlights & Updates

tperricelli@scottandco.com
www.scottandco.com
(803) 753-5244 *(direct)*

By Tony Perricelli, CPA

In early 2018, we learned about the new individual changes as a result of tax reform and discovered several changes that will have a tremendous impact on business owners. Almost a year later, we have additional clarification in some areas but many questions still remain.

Many of the tax reform changes were straightforward:

- reductions to corporate and individual tax rates
- increase in the standard deduction
- enhanced Sec 179 and revised bonus depreciation
- no more personal exemptions and miscellaneous itemized deductions

This Q&A is designed to highlight some other tax reform changes and what they mean to you and your business.

Q: What is the new "Pass-Through Deduction" and how do I qualify?
A: The Section 199A pass-through deduction allows a 20% deduction from taxable income for qualifying businesses. This new deduction is allowed for any business that is organized as a pass-through entity—sole proprietorships, partnerships, and S Corporations—and thus does not pay income tax directly but passes the income through to its owners to be taxed. The deduction is up to 20% of taxable income from the business each year.

Most businesses will qualify but there are some restrictions which kick in if your overall taxable income from all sources is greater than $157,500 if filing single or $315,000 if married filing joint with your spouse.

The first restriction is that income from a "specified service trade or business" (SSTB) is not eligible for the deduction. The new law references another tax code section (Section 1202) to define the term SSTB. The unlucky businesses include "…any trade or business involving the performance of services in the fields of health, law, engineering, architecture, 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" IRC Section 1202(e)(3)(A).

Section 199A makes three changes to this list:

1. it specifically removes architecture and engineering from the list
2. it adds owners to those for which the reputation or skill test applies, and
3. it adds services in the areas of investment management and dealing in financial securities.

If your business is not considered an SSTB, then the second restriction applies and could limit your deduction. The second restriction says your pass-through deduction is limited to either:

- 50% of W-2 wages paid by the business, or
- 25% of W-2 wages plus 2.5% of the original basis of assets owned by the business.

The IRS has provided some guidance on the details of calculating these limitations since many variables will exist, but there will certainly be more questions. It's best to plan in advance of preparing your tax returns so you can make any changes necessary to maximize the deduction.

Q: What are Opportunity Zones and how do they work?
A: Opportunity Zones are designated census tracts located in all 50 US states and 5 US territories. The zones were chosen by the states primarily as a means to encourage economic development in low income communities. To gain access to the tax benefits of Opportunity Zones, investors have to roll capital gains from an existing investment into the zones by means of Qualified Opportunity Funds, which are entities set up and maintained specifically to invest in the zones. Permitted entity types include C Corporations, S Corporations, Partnerships, LLCs taxed as either partnerships or corporations, REITs, and RICs.

The tax benefits of investing in Qualified Opportunity Funds fall into two categories.

- First, capital gains tax on the re-invested gain can be deferred for several years and even reduced if the new investment is held for at least 5 years. The deferral works similarly to a Section 1031 like-kind exchange used to roll over gains on real estate investments. Once an investor sells at a gain, he or she has 180 days to re-invest funds equal to the gain into a Qualified Opportunity Fund. This timely re-investment qualifies for the initial deferral until the new Opportunity Zone investment is sold, or through December 31, 2026— whichever comes first. If the Qualified Opportunity Fund investment is held at least five years, then the deferred gain is reduced by 10%. If held for another two years for a total of seven years after the initial re-investment, then the reduction goes to 15%.

- Second, gains earned after the initial investment is rolled into the Qualified Opportunity Fund can be sold without any capital gains tax if the fund is held for at least 10 years and the fund maintains its status as a Qualified Opportunity Fund. This includes gains earned on the money used to immediately invest in qualified property or stock/partnership interests as well as additional working capital consumed within 30 months of the initial setup of the Qualified Opportunity Fund if designated and used for qualifying costs such as property improvements.

Q: How does an entity qualify as a Qualified Opportunity Fund and stay qualified?
A: There are several requirements that must be met to be a Qualified Opportunity Fund and maintain this status.

- **Formation/Certification** – a qualifying entity, as described earlier, is either formed or has its governing documents amended to designate it as a Qualified Opportunity Fund.
- **Assets** – There are two asset requirements that must be met to remain certified. First, the Qualified Opportunity Fund must have at least 90% of its assets invested in Qualified Opportunity Zone investments. Second, the underlying Opportunity Zone business must have at least 70% of its physical assets located in a designated Opportunity Zone.
- **Allowable Investments** – There are two categories of allowable investments Qualified Opportunity Funds are permitted to make and remain certified.
  - First, funds can invest in Qualified Opportunity Zone Property (QOZP). QOZP is tangible property located in an Opportunity Zone that is acquired after 12/31/17 and after the certification date of a Qualified Opportunity Fund.
  - Second, funds can invest in Qualified Opportunity Zone Stock or Partnership Interests. Qualified stock can be common or preferred and must be acquired from the corporation in exchange for cash after 12/31/17.
- **Qualified Opportunity Zone Business** – As mentioned above, the stock or partnership interest acquired by the Qualified Opportunity Fund must be organized specifically to invest in a Qualified Opportunity Zone Business (QOZB). A QOZB is a business in almost any industry (see exceptions below) where:
  - At least 70% of its owned or leased property is Qualified Opportunity Zone Property
  - At least 50% of its gross income is generated from the active conduct of a trade or business
  - The business uses a substantial part of its intangible property in the active conduct of its trade or business, and
  - Less than 5% of its original tax basis in business property is nonqualified financial property.
- **Not Allowable Business Types** – Certain types of businesses are not allowed as Qualified Opportunity Zone Businesses including:
  - Shell Companies or Financial Services/Banks
  - Private or Commercial Golf Courses and Country Clubs
  - Massage Parlor/Hot Tub Facility/Suntan Facility
  - Racetrack or other gambling business
  - Liquor Stores

For more answers to questions asked about corporate and individual income tax changes, please contact Tony Perricelli, CPA at tperricelli@scottandco.com, or (803) 753.5244