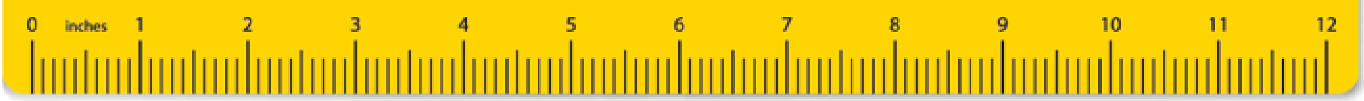
Highlights
to Help You
Navigate the
2019 Busy
Season

TAX SEASON toolkit

The 2019 tax busy season is quickly approaching. For most taxpayers, this will be the first season that impacts of the new tax reform will take place.

This means now is the time to familiarize yourself with tax updates that may affect 2018 tax-year filings—as well as items that may have been missed in 2017 filings.

Information as of Oct. 31, 2018



California and Federal Tax Reform

By San Saechao, CPA & Leia Williams

Tax reform—commonly known as the Tax Cuts and Jobs Act (TCJA)—affects individuals, businesses, tax-exempt entities and government entities. Many of these changes will affect individuals and organizations in California in various capacities, but it's worth noting California doesn't conform to most of the federal tax law changes. Below are changes to tax laws that California taxpayers should watch for.

Qualified Business Income Deduction

The IRS issued proposed regulations for the newly created Internal Revenue Code (IRC) Sec. 199A, which allows certain owners of sole proprietorships, partnerships, trusts and S corporations to deduct 20 percent of qualified business income. The deduction is subject to certain limitations and is effective for tax years beginning after Dec. 31, 2017, through Dec. 31, 2025.

California doesn't conform to IRC Sec. 199A, and there's no existing proposal to change for the 2018 tax year.

1031 Exchanges

The new federal law retains IRC Sec. 1031, *Exchange of Real Property Held for Productive Use or Investment*, for real estate exchanges. However, it may no longer be used to defer taxes for transactions involving personal property and is limited to like-kind exchanges of real property that isn't held primarily for sale.

California conforms to IRC Sec. 1031, as of the specified date of Jan. 1, 2015, with modifications, but it doesn't conform to the new federal change enacted by tax reform. Because of this, taxpayers may run into a situation where a like-kind exchange may qualify for deferred tax gain under California law and not federal law.

Full-expensing Deduction

The cost of certain tangible business use personal property assets can be written off using the full-expensing deduction—which allows for 100 percent depreciation—in the year they're placed in service to offset any capital gain or depreciation recapture recognized in the same or future years. California doesn't conform to these provisions.

State and Local Tax Deduction

Under federal tax reform, an individual's deduction for the aggregate amount of state and local taxes (SALT) paid during a calendar year is limited to $10,000—or $5,000 in the case of a married individual filing separately. SALT payments exceeding those amounts are not deductible for federal personal income tax purposes.

California conforms to the deductibility of taxes as of the specified date of Jan. 1, 2015, with modifications. For example, California doesn't allow a deduction for SALT paid in the calculation of income. California doesn't conform to the new federal SALT deduction limitation enacted by tax reform.

Tax Form Changes

Tax reform changed federal itemized deductions as well as the federal standard deduction amounts beginning with the 2018 taxable year. These changes significantly impact California Schedule CA (Forms 540 and 540NR) and California adjustments—requiring the Franchise Tax Board to make major changes to the forms.

Once made, these changes will put the entire form into a consistent format while allowing a taxpayer to see California adjustments made to each federal line item.

Untaxed Foreign Earnings

Under IRC Sec. 965, *Treatment of Deferred Foreign Income*, U.S. shareholders are now required to pay a one-time federal transition tax on untaxed foreign earnings of certain foreign corporations, as if those earnings had been repatriated—or deemed dividend—to the United States. This means certain taxpayers may have had to pay additional federal tax under IRC Sec. 965 when their 2017 federal tax returns were filed.

2017 adjustments: California doesn't conform to IRC Sec. 965, which means taxpayers that reported IRC Sec. 965 amounts on their 2017 federal tax return should have made an adjustment on their 2017 California tax return.

Adjustments after 2017: When a foreign corporation makes an actual dividend distribution of the previously tax foreign earnings, those earnings aren't taxed again for federal purposes. For California income tax purposes, the actual dividend distribution hasn't been taxed and may be includible in taxable income for California.

California Tax Credits

Earned Income Tax Credit

The California Earned Income Tax Credit has been extended by Senate Bill 855 to help put money in the pockets of low-income taxpayers. The bill revised the age limit for an eligible individual without a qualifying child to 18 years or older and increased the income thresholds.

The FTB web page (ftb.ca.gov) details credit amounts, income limits, qualifications, and additional information.

California Competes Tax Credit Extension

SB 855 also extends the California Competes Tax Credit (CCTC) program for an additional five years. CCTC is an economic development incentive to attract or retain businesses considering a significant new investment in California by reducing taxpayers' personal income tax or corporation tax.

In the CCTC program's 2018-19 fiscal year, the California Governor's Office of Business and Economic Development is authorized to negotiate up to $180 million in tax credits over three application periods. However, the application process is very competitive.

The first application period ended Aug. 20, 2018. The next two CCTC application periods for the program's 2018-19 fiscal year are shown in Figure 1.

FIGURE 1

PERIOD BEGINS	PERIOD ENDS	ALLOCATION
January 2, 2019	January 21, 2019	$75,000,000
March 4, 2019	March 15, 2019	To Be Determined

New Employment Credit Extension

SB 855 extends the New Employment Credit program for an additional five years. For further details on how to qualify for the credit, visit the FTB web page.

California Legislative Update

The California Lgislature proposed more than 900 bills in 2018. Here are selected highlights that may be useful to know for 2018 tax-year filings.

Corporate and LLC Dissolution, Cancellation & Tax Abatement

Signed by Gov. Brown on Sept. 22, 2018, and effective as of Jan. 1, 2019, Assembly Bill 2503 subjects domestic corporations and LLCs to administrative dissolution or administrative cancellation if their corporate powers were suspended by the FTB for 60 continuous months. As part of the law, the FTB must provide notice to the company of any pending action.

Once dissolution or cancellation has occurred, the bill authorizes the FTB to abate—upon written request by a qualified entity—the unpaid qualified taxes, interest and penalties for the taxable periods in which an entity certifies it wasn't doing business in California.

The bill also requires the FTB to prescribe rules and regulations to carry out these abatement provisions, which the agency is currently in the process of producing.

Partnership Audit Rules

On Sept. 23, 2018, the governor signed SB 274, incorporating into California law certain federal provisions related to the audit of partnerships. The bill requires a partnership to report each change or correction to the FTB for a reviewed period within six months after the date of each final federal determination if the following are true:

- Any item required to be shown on a federal partnership return is changed or corrected; and
- The partnership is issued an adjustment or makes a federal election for an alternative to payment.

SB 274 closely aligns with federal rules, but there are some differences where a partnership is unitary with another entity or where a partnership elects to push out federal audit adjustments to its partners.

While the federal partnership representative is the default representative in California, SB 274 does allow partnerships to designate a separate partnership representative for California tax purposes. It also includes provisions addressing tiered partnership structures that allow an additional 90 days from the federal deadline to comply with all necessary filing and payment requirements.

This bill took immediate effect upon signing.

2018 Disaster Losses

Taxpayers may deduct a disaster loss for any loss sustained in California during an event proclaimed by the governor to be a state of emergency. California hasn't conformed to the new federal tax law in this regard and instead generally follows the former federal law regarding the treatment of losses incurred because of a casualty or a disaster.

Hurricanes Florence and Michael

The FTB follows the announced federal postponement periods for hurricanes Florence and Michael. Affected taxpayers were granted an extension to file tax returns and make payments until Jan. 31, 2019, and Feb. 28, 2019, respectively. This means, for example, if Hurricane Florence impacted a taxpayer who earns income in California, that taxpayer has extra time to file a California tax return.

The IRS disaster relief web page (irs.gov/newsroom/tax-relief-in-disaster-situations) lists additional designated areas eligible for a postponement period, which the FTB will also follow, cancelling any interest and late-filing or late-payment penalties that would otherwise apply.

Other 2018 Disasters

Taxpayers may deduct a disaster loss for any loss sustained in a California city or county proclaimed by the governor to be in a state of emergency. For more information regarding California disaster losses, see the FTB website and Publication 1034, *Disaster Loss How to Claim a State Deduction*.

Figure 2 includes California Qualified Disasters published on the FTB website as of Oct. 31.

FIGURE 2

DISASTER CODE	INCIDENT PERIOD	DISASTER	COUNTY	GOVERNOR DECLARED	PRESIDENT DECLARED
95	January 2018	Southern California Mudslides	Ventura, Santa Barbara	Yes	Yes
96	March 2018	March Winter Storms	Amador, Fresno Kern, Mariposa, Merced, Stanislaus, Tulare, Tuolumne	Yes	No
97	June 2018	Pawnee Fire	Lake	Yes	No
98	July 2018	Klamathon Fire	Siskiyou	Yes	No
99	July 2018	West Fire	San Diego	Yes	No
100	July 2018	Holiday Fire	Santa Barbara	Yes	No
101	July 2018	Monsoonal Rainstorm	San Bernardino	Yes	No
102	July 2018	Cranston Fire	Riverside	Yes	No
103	July 2018	Carr Fire	Shasta	Yes	Yes
104	July 2018	Ferguson Fire	Mariposa	Yes	No
105	July 2018	River, Ranch & Steele Fires	Lake, Mendocino, Napa	Yes	No
106	August 2018	Holy Fire	Orange, Riverside	Yes	No

How to Claim a State Tax Deduction for Disaster Loss

Taxpayers can claim a disaster loss in the taxable year the disaster occurred or in the taxable year immediately before the disaster occurred. Use the disaster code from the chart shown above if e-filing.

If filing a paper return, print the following information in red ink across the top of the document:

- Disaster;
- Name of disaster in the governor's state of emergency proclamation; and
- The year the loss occurred as shown in the governor's state-of-emergency proclamation.

Miscellaneous

Independent Contractors: *Dynamex Operations West, Inc. v. Superior Court*

On April 30, 2018, the California Supreme Court issued a unanimous 82-page opinion in *Dynamex Operations West, Inc. v. Superior Court.* The ruling creates a new standard for California that presumes certain workers are employees instead of independent contractors. Companies that use independent contractors may be impacted.

As part of the decision, the court adopted a new ABC test to determine—for wage-order purposes—whether a hiring entity has engaged an employee or a contractor. This creates a challenging new standard for employers to consider when hiring a professional to provide services.

ABC Test: Under the new ABC test, a hiring business must demonstrate a worker meets all three of the following requirements to qualify as an independent contractor:

- Not controlled or directed by the hirer in connection with performing the work—both as defined in the contract as well as in reality;
- Performs work outside the usual course of the hiring entity's business; and
- Customarily engaged in an independently established trade, occupation or business of the same nature as that which the hiring entity performs.

There's ongoing work being done to provide more clarity around the application of these rules by California's Employment Development Department, as well as additional court cases. For now, they signal a significant shift in how independent contractor relationships are reviewed by authorities when there's an unemployment claim against a prior employer or an employment audit.

Corporate Refund and Personal Income Tax Interest Rates

The FTB will pay 1 percent interest on corporate refunds during 2018 and will begin paying 2 percent interest on corporate refunds beginning Jan. 1, 2019. The corporation overpayment rate will stay at 2 percent through June 30, 2019.

The interest rate for personal income tax underpayments and overpayments, corporation underpayments, and estimate penalties will stay at 4 percent through Dec. 31, 2018. This rate will increase to 5 percent for the period between Jan. 1, 2019, through June 30, 2019.

For interest rates after June 30, 2019, the FTB will provide more information on their website once available.

Doing Business in California and Economic-nexus Thresholds

"Doing business" is defined as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. For taxable years beginning on or after Jan. 1, 2011, a taxpayer is seen as doing business in California for a taxable year if any of the following conditions are satisfied:

- The taxpayer is organized or commercially domiciled in California;
- California sales exceed the lesser of $500,000 or 25 percent of total sales;
- The real property and tangible personal property in California exceed the lesser of $50,000 or 25 percent of total real property and tangible personal property; and
- The amount paid in California for compensation exceeds the lesser of $50,000 or 25 percent of total compensation paid.

To determine the amount of a taxpayer's sales, property and payroll for doing-business purposes, the FTB includes the taxpayer's pro-rata share of these items from partnerships, LLCs treated as partnerships and S corps.

The doing business thresholds for taxpayers are indexed for inflation and revised annually. For taxable years beginning on or after Jan. 1, 2012, these thresholds also have been indexed by California's Consumer's Price Index. See Figure 3 for more.

FIGURE 3

CALIFORNIA FACTOR	2018 TAX YEAR
SALES	$583,867
PROPERTY	$58,387
PAYROLL	$58,387

Additional Clarification on 'Doing Business' in California

Relating to the 2017 case of *Swart Enterprises, Inc. v. FTB*, the FTB issued a new legal ruling to modify Legal Ruling 2014-01. The modification provides additional distinction between "manager-member" LLCs and "member-managed" LLCs.

If an LLC classified as a partnership for tax purposes is "doing business" in California under Revenue & Tax Code Sec. 23101, the members of the LLC are themselves generally considered to be "doing business" in California. Legal Ruling 2018-01 states that "a narrow exception may apply in limited circumstances."

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2018 Federal Tax Update

Tax Cuts ad Jobs Act

The following are highlights of some of the provisions in the Act (P.L. 115-97) enacted Dec. 22, 2017, and generally effective for tax years beginning after 2017:

Deduction for Qualified Business Income

For tax years beginning after 2017 and before 2026, under new IRC Sec. 199A, an individual generally may deduct 20 percent of qualified business income from a partnership, S corp or sole proprietorship, as well as 20 percent of aggregate qualified real estate investment trust (REIT) dividends, qualified cooperative dividends and qualified publicly traded partnership income. Special rules apply to specified agricultural or horticultural cooperatives.

This new deduction is allowed *only* for federal *income* tax purposes.

A limitation based either on wages paid or on wages paid plus a capital element is phased in above a threshold amount of taxable income. A disallowance of the deduction with respect to specified service businesses also is phased in above the threshold amount of taxable income. For purposes of this new deduction, taxable income is computed without regard to the 20 percent deduction.

The new deduction is not allowed in computing adjusted gross income, but is allowed to reduce taxable income so that it is available to both non-itemizers and itemizers.

Threshold Amount: The threshold amount is $157,500 or $315,000 for joint returns, indexed for inflation for tax years beginning after 2018.

The range over which the phase-in of the limitations on specified service businesses, wages and capital applies is $50,000 or $100,000 for joint returns.

Adjustment: If taxable income exceeds the threshold amount but does *not* exceed $207,500, or $415,000 for joint returns, *and* if the W-2 wages/qualified property limitation for a qualified business, discussed below, is less than 20 percent of the qualified business income for that business, then:

A. The W-2 wages/qualified property limitation does not apply for that business; and
B. The 20 percent tentative deduction for the qualified business income from that business is *reduced* by the following computation:
   (1) Subtract the W-2 wages/qualified property limitation from that 20 percent tentative deduction; and
   (2) Multiply the result obtained under (1) immediately above by the following fraction:

$$\frac{\text{Taxable income exceeding the threshold}}{\text{\$50,000 (\$100,000 for joint returns)}}$$

Example: H & W file a 2018 joint return reporting $345,000 taxable income. H has a qualified business that is not a specified service business (discussed immediately below), has qualified business income of $75,000 and $20,000 of W-2 wages (for illustrative simplicity, there is no qualified property).

The $15,000 tentative deduction ($75,000 x .20) is reduced by the following computation:

Step (1) $\frac{\text{\$345,000 taxable income less \$315,000 threshold or \$30,000}}{\text{\$100,000}}$

Step (2): Step (1) result is 30 percent
Step (3). Excess of $15,000 tentative deduction over $10,000 (50 percent of W-2 wages) is $5,000
Step (4): $5,000 x .30 is $1,500
Step (5): Deduction for qualified business income is $13,500 ($15,000 less $1,500)

Specified Service Businesses

A specified service business is any business involving the performance of services in the following fields:

- Health
- Law
- Accounting
- Actuarial science
- Performing arts
- Consulting
- Athletics
- Financial services
- Brokerage services
- Any business whose principal asset is the reputation or skill of one or more of its employees or owners
- Investing and investment management, trading or dealing in securities [defined in Sec. 475(c)(2)], partnership interests or commodities [defined in Sec. 475(e)(2)].

Limitation Based on W-2 Wages and Capital

This limitation is the *greater* of:

A. 50 percent of the W-2 wages paid with respect to the qualified business; *or*
B. The sum of 25 percent of the W-2 wages with respect to the qualified business, *plus* 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Example: A taxpayer subject to this limitation does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The 2020 limitation is the greater of:

A. 50 percent of W-2 wages or $0; or
B. The sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the machine's unadjusted basis immediately after its acquisition: $100,000 x .025 = $2,500.

The limitation on the taxpayer's deduction is $2,500.

Determination of Taxpayer's Deduction

The deduction for qualified business income for the tax year is equal to the sum of:

1. The *lesser* of the combined qualified business income

amount the for the tax year, *or* an amount equal to 20 percent of the excess of the taxpayer's taxable income over any net capital gain [defined in Sec. 1(h)] and qualified cooperative dividends; *plus*

2. The *lesser* of 20 percent of qualified cooperative dividends *or* taxable income (reduced by net capital gain).

This sum may not exceed the taxpayer's taxable income for the tax year (reduced by net capital gain).

The 20 percent deduction with respect to qualified cooperative dividends is limited to taxable income (reduced by net capital gain) for the tax year.

The combined qualified business income for the tax year is the sum of the deductible amounts determined for each qualified business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.

The deductible amount for each qualified business is the *lesser* of:

(a) 20 percent of the taxpayer's qualified business income with respect to the business; *or*
(b) The *greater* of 50 percent of W-2 wages with respect to the business *or* the sum of 25 percent of the W-2 wages with respect to the business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Trusts and Estates

Trusts and estates are eligible for this 20-percent deduction. Rules similar to those under old Sec. 199, as in effect on Dec. 1, 2017, apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property for the relevant limitation.

Accuracy-Related Penalty

For purposes of determining a substantial understatement of income tax under Sec. 6662(d)(1)(A) for a taxpayer claiming this new Sec. 199A deduction for a tax year, a substantial understatement exists if the amount of the understatement exceeds the *greater* of:

- Five percent, instead of 10 percent, of the tax required to be shown on the return; *or*
- $5,000.

Business Meals, Entertainment and Transportation

For amounts paid or incurred after 2017, no deduction is allowed for:

- An activity generally considered to be entertainment;
- Membership dues to any club organized for business, pleasure, recreation or other social purposes; *or*
- A facility used in connection with any of the above items.

Also, no deduction is allowed for expenses to provide any qualified transportation fringe benefit to a taxpayer's employees and, except as necessary for ensuring an employee's safety, an expense for commuting transportation.

Taxpayers may still, generally, deduct 50 percent of food and beverage expenses for operating their business (e.g., meals consumed by employees on work travel).

For amounts incurred and paid after 2017, but *only* until Dec. 31, 2025, this 50 percent limitation is expanded to an employer's expenses for providing food and beverages to employees through an eating facility meeting the requirements for a *de minimis* fringe benefit and for the employer's convenience.

For additional information regarding the deductibility of business meals, see the Fed Tax column on Page 23.

2018 Schedule C (Form 1040)

On Oct. 17, the IRS released this Schedule C that reflects the following changes made by the Act:

1. No deduction for entertainment expenses (discussed immediately above);
2. The excess business loss limitation (described below) reportable on new Schedule 1; and
3. The limitation on the business interest deduction.

The Sec. 199A qualified business income deduction (discussed above and below) is reported on Form 1040.

Automatic Consent for Accounting Method Changes by Eligible Small Businesses

Eligible small businesses may use automatic consent procedures for several accounting method changes for tax years beginning after 2017, including:

1. A change to the overall cash accounting method;
2. Exemption from UNICAP rules under Sec. 263A for certain costs, including:
   (a) Self-constructed assets, and
   (b) Home construction contracts.
3. Accounting for inventories under Sec. 471 as non-incidental material or under the taxpayer's applicable financial statement method; and
4. Accounting for certain long-term contracts under Sec. 460, including a change from the percentage-of-completion method.

An eligible small business is a taxpayer, other than a tax shelter [as defined in Sec. 448(d)(3)], that has average annual gross receipts for the three prior tax years of $25,000,000 or less—adjusted for inflation.

See Rev. Proc. 2018-40 for further information

Proposed Regulations on Full Expensing of Fixed Assets

REG-104397-18, published in the *Federal Register* on Aug. 8, 2018, contains guidance regarding the additional first year depreciation deduction under Sec. 168(k) that reflect changes made by the Act. These proposals affect taxpayers who deduct depreciation for qualified property acquired and placed in service after Sep. 27, 2017.

The Act allows the additional first-year depreciation deduction for *both* new and used property.

These proposed regulations require the following conditions to be met for used property:

1. The property was not used by the taxpayer or a predecessor at any time before the acquisition;
2. The acquisition of the property meets the related party and carryover requirements of Sec. 179(d)(2) A, B and C; *and*
3. The acquisition of the property meets the cost requirements of Sec. 179(d)(3).

Qualified Improvement Property

The Act combines the following three types of improvement property into one new category under Sec. 168(e)(6) called Qualified Improvement Property:

- Qualified leasehold improvement property;
- Qualified restaurant property; and
- Qualified retail improvement property.

Under the old law, these three types of property were included in 15-year Property under old Sec. 168(e)(3)(E). The Conference Committee's Report states that this new combined category continues to have a 15-year cost recovery period.

However, the statute does *not* include this category in new Sec. 168(e)(3)(E). Therefore, under the statute, the 39-year recovery period for nonresidential real property applies by default.

Fiscal Year C Corps

For tax years beginning after 2017, the regular tax rate is 21 percent and the AMT rate is 0 percent. For tax years beginning in 2017 and ending in 2018, the blended rate prescribed by Sec. 15(a) must be used. IRS Notice 2018-38 (IRB 2018-18, Apr. 30, 2018) contains additional guidance.

Home Equity Debt

The Act disallows interest on home equity debt for tax years beginning after 2017 and before 2026. However, under IR-2018-32, this interest still is deductible if the debt proceeds are used for home improvements.

Advance Payments

The Act added new Sec. 451(c), which largely follows Rev. Proc. 2004-34. IRS Notice 2018-35 (IRB 2018-18, April 30, 2018) provides transitional guidance for advance payments received by accrual method taxpayers who elect this limited income deferral. The IRS intends to issue further guidance but noted that that taxpayers may rely on Rev. Proc. 2004-34 while awaiting this future guidance.

Like-kind Exchanges

Old Law: No gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business for investment.

Whether property is like-kind relates to the property's nature or character, not its grade or quality. Improved and unimproved real property generally are like-kind, as this distinction relates to the real property's grade or quality.

New Law: Like-kind exchanges are allowed *only* for *real* property that is not held primarily for sale.

Effective Date: This new rule generally applies to exchanges completed after 2017 unless the property:

- Disposed of by the taxpayer in the exchange is disposed of before 2018; or
- Received by the taxpayer in the exchange is received before 2018.

Net Operating Losses

Old Law: A net operating loss (NOL) generally is the excess of a taxpayer's business deductions over its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in those years—in the order of the tax years to which the NOL may be carried.

Different carryback periods apply to NOLs arising in different circumstances. Extended carryback periods are allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses. Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions.

New Law: The two-year carryback and the special carryback provisions are repealed, except for a two-year carryback for certain losses incurred in the trade or business of farming and for non-life insurance companies.

NOLs arising in tax years beginning after 2017 can only reduce 80 percent of taxable income in a carryback or carryover year (determined without the NOL deduction). This 80 percent limitation does not apply to non-life insurance companies.

NOLs can be carried over *indefinitely*, except for a 20-year carryover period for non-life insurance companies.

The following deductions are not allowed in computing an NOL:

- For qualified business income under Sec. 199A (discussed above); and
- For foreign-derived intangible income under Sec. 250.

Note: There is no longer a disallowance in computing an NOL for the domestic production activities deduction under Sec. 199 because this deduction has been repealed.

Effective Dates: According to the statutory language, the following changes apply to NOLs arising in tax years *beginning* after 2017:

- The new 80% limitation and its non-application to non-life insurance companies; and
- The computation of an NOL

All other charges apply to NOLs arising in tax years *ending* after 2017.

However, the legislative history indicates that all these changes apply to tax years beginning after 2017 (see June 2018 *California CPA*, Page 24).

Partnership Technical Terminations

Old Law: A partnership is considered as terminated under specified circumstances. Special rules apply to a merger, consolidation or division of a partnership.

A partnership is treated as terminated if no part of any business, financial operation or venture of the partnership continues to be carried on by any of its partners in a partnership.

A partnership also is treated as terminated if, within a 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. This type of termination is called a "technical termination."

Under regulations, this technical termination results in a deemed contribution of all the old partnerships assets and liabilities to a new partnership in exchange for an interest in the new partnership—followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.

The effect of a technical termination is not necessarily the end of the old partnership's existence, but rather the termination of some of its tax attributes, such as:

- The close of its tax year, potentially causing a short tax year;
- Partnership-level elections generally ceasing to apply; and
- Generally restarting partnership depreciation recovery periods.

New Law: Technical terminations of partnerships are repealed. However, the new law does not change the old law's rule that a partnership is considered as terminated if no part of any business, financial operation or venture of the partnership continues to be carried on by any of its partners in a partnership.

Effective Date: The new law applies to partnership tax years beginning after 2017.

Excess Business Losses

Draft Form 461, *Limitation on Business Losses,* was released Aug. 31 to report the limitation on excess business losses under new Sec. 461(l) for tax years beginning after 2017 and before 2026—except for C corps.

An excess business loss for the tax year is the excess of the taxpayer's aggregate business deductions over the taxpayer's aggregate business gross income or gain, plus a threshold of $500,000 for married filing jointly or $250,000 for other taxpayers—adjusted for inflation.

Disallowed losses are added to the taxpayer's NOL carryover.

Change from Cash to Accrual Accounting Method After Conversion from S Corp to C Corp

The Act added Sec. 481(d) to provide that, in the case of an eligible terminated S corp, any Sec. 481(a)(2) adjustment attributable to the revocation of its S election, i.e., a change from the cash to an accrual accounting method, is taken into account ratably during the six-tax year period beginning with the year of change.

An eligible terminated S corp is a C corp which was an S corp on Dec. 21, 2017 and, during the two-year period beginning Dec 22, 2017, revokes its S corp election. In addition, all of the owners of the S corp on the date of this revocation were the same owners, in identical proportions, on Dec. 22, 2017.

Rev. Proc. 2018-44(IRB 2018-37, Sept. 10,2017) clarifies that an eligible terminated S corp, permitted to continue to use the cash method, but still changes to the accrual method for the C corp's first tax year after the revocation, may take into account the resulting Sec. 481(a)(2) adjustment ratably during the six-year period beginning with the year of change.

Regulations to be Issued Clarifying that Certain Estate and Non-grantor Trust Expenses Remain Deductible

Sec. 67(a) provides that, in the case of an individual, miscellaneous itemized deductions for any tax year shall be allowed only to the extent that they exceed two percent of adjusted gross income (AGI).

Sec. 67(e)(1) pertinently provides that, for Sec. 67 purposes, an estate or trust's AGI shall be computed in the same manner as for an individual *except* that the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would *not* have been incurred if the property were *not* held by the estate or trust shall be treated as allowable in arriving at AGI.

The Act added Sec. 67(g) which provides that, notwithstanding Sec. 67(a), no miscellaneous itemized deductions shall be allowed for any tax years beginning after 2017 and before 2026.

Notice 2018-61 (IRB 2018-31, July 30, 2018) states that the Treasury Department and the IRS intend to issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in Sec. 67(e)(1), including the appropriate portion of a bundled fee, in determining the estate or non-grantor trust's AGI during tax years 2018-2025 when the application of Sec. 67(a) is suspended pursuant to Sec.67(g).

Guidance on Qualifying Relatives

Notice 2018-70, IRB 2018-38, Sept. 17, 2018, states that the IRS intends to issue proposed regulations that would provide that the Act's reduction in the personal exemptions to zero under Sec. 151(d)(5)(A) for tax years 2018-2025 will *not* be taken into account to determine whether a person is a qualifying relative under Sec. 152(d)(1)(B).

Accordingly, in defining a qualifying relative for purposes of various Code provisions that refer to the definition of a dependent under Sec. 152, the Sec. 151(d) exemption referenced in Sec. 152(d)(1)(B) will be treated as $4,150, adjusted for inflation, for tax years 2018-2025.

These other Code provisions include, without limitation:

- The head of household filing status under Sec. 2(b); and
- The new partial child tax credit for certain other dependents under Sec. 24(h)(4).

Fines, Penalties & Other Amounts

Under old Sec. 162(f), no deduction was allowed under Sec. 162(a), regarding ordinary and necessary business expenses, for any fine or similar penalty paid to a government for the violation of any law.

New Sec. 162(f), as amended by the Act, denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement or otherwise) to, or at the direction of, a government or a specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by that government or entity into the potential violation of any law.

An exception applies to payments that the taxpayers establishes are either:

1. Restitution, including property remediation; or
2. Payments to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement, as restitution, remediation or required to come into compliance.

Restitution for failure to pay any tax imposed by the IRC is deductible only to the extent it would have been deductible if it had been timely paid.

The IRS remains free to challenge the characterization of an identified amount; however, no deduction is allowed unless the identification is made.

Restitution or property remediation does not include reimbursement of government investigative or litigation costs.

New Sec. 162(f) applies only where a government, or other entity-treated in a manner similar to a government under new Sec. 162(f)(5), is a complainant or investigator with respect to the violation or potential violation of any law. An exception also applies to any amount paid or incurred as taxes due.

Reporting Requirements

New Sec. 6050X requires government agencies, or entities treated as such agencies under new Sec. 162(f)(5), to report to the IRS and the taxpayer the amount of each settlement agreement or order entered into where the total amount required to be paid or incurred to, or at the government's direction, is at least $600 or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the internal revenue laws.

This report must be made when the agreement is entered into, as determined by the Secretary of the Treasury.

New IRS Form

On Aug. 29, 2018, draft instructions were released for on upcoming new Form 1098-F.

Effective Date

New secs. 162(f) and 6050X are effective for amounts paid or incurred after Dec. 21, 2017, except that they would not apply to amounts paid or incurred under any binding order or agreement entered into before Dec. 22, 2017. This exception does not apply to an order or agreement requiring court approval unless the approval was obtained before Dec. 22, 2017.

Guidance on Qualified Business Income

On Aug. 9, 2018, proposed regulations, REG-107892-18, and a proposed revenue procedure were published in the *Federal Register*. Taxpayers can rely on these proposals until they are issued in final form.

Trade or Business

Qualified business income must be from a qualified trade or business under Sec. 199A(b)(1) and (2). Prop. Regs. 1.199A-1(b)(13) states a trade or business means a Sec. 162 trade or business other than the trade or business of performing services as an employee.

A taxpayer may have more than one trade or business, but a single trade or business generally cannot be operated through more than one entity.

Taxpayers cannot use the Sec. 469 passive activity rules to group multiple activities into a single business. A taxpayer *may* aggregate trades or businesses *if*:

- Each trade or business constitutes a trade or business;
- The same person or group owns 50 percent or more of each trade or business to be aggregated;
- None of the aggregated trades or businesses can be a specified service trade or business (see below); and
- The trades or businesses meet at least two of the three factors (discussed next) demonstrating that they are part of a larger, integrated trade or business.

Three Factors

1. The trades or businesses provide products and services that are the same or customarily offered together.
2. The trades or businesses share facilities or share centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources *or* information technology resources.
3. The trades or businesses are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group, for example, supply chain interdependencies.

Specified Service Businesses

These businesses are described above and generally *cannot* generate qualified business income—although this exclusion is phased in for lower-income taxpayers.

New De Minimis Exception

This exception allows a business to avoid classification as a specified service business if:

- Its gross receipts are $25 million or less for the tax year and less than 10 percent of those receipts are attributable to performing specified services; or
- Its gross receipts exceed $25 million for the tax year and less than 5 percent of those receipts are attributable to performing specified services.

No 'Crack and Pack'

A specified service business includes any trade or business that provides 80 percent or more of its property or services to a specified serviced business *if* there if 50 percent or more common ownership of the trades or businesses.

If a trade or business provides less than 80 percent of its property or services to a specified service business *and* there is 50 percent or common ownership of the trades or businesses, than that portion of the trade or business of providing property or services to the 50 percent or more commonly owned specified service business is treated as a part of the specified service business.

A 50 percent or more common ownership includes direct or indirect ownership by related parties within the meaning of secs. 267(b) or 707(b).

Example

CPA Firm is a partnership providing accounting services to clients, owns its office building and employs its administrative staff.

CPA Firm divides into three partnerships. Partnership 1 performs accounting services. Partnership 2 owns the office building, which it rents to Partnership 1. And Partnership 3 employs the administrative staff and provides administrative services to Partnership 1 for fees.

All three partnerships are owned by the same people, the original owners of CPA Firm. Because there is 50 percent or more common ownership of each of these three partnerships, Partnership 2 provides substantially all of its property to Partnership 1, and Partnership 3 provides substantially all of its services to Partnership 1, Partnerships 1, 2 and 3 will be treated as *one* specified service business.

Partnership Audit Rules

The 2018 Consolidated Appropriations Act, enacted March 23, 2018, as P. L. 115-141, contains several technical corrections to the 2015 Bipartisan Budget Act, P.L. 114-74 (discussed in the Aug. 2016 *California CPA*, Page 31).

One of these corrections includes a "pull-in" procedure which, if elected, allows modifying an imputed underpayment *without* requiring individual partners to file amended returns. This new procedure replaces the "push-out" election, which shifted liability to individual partners.

Under the "pull-in" procedure, partner payment and information could be collected centrally by the IRS. However, this procedure permits the partnership representative or a third-party accounting or law firm to collect this data and remit it to the IRS.

Gift Tax Returns

Effective Jan. 1, 2019, these returns must be filed with the IRS in Kansas City, Mo. instead of Cincinnati, Ohio.

Preparer Tax Identification Numbers (PTINs)

The IRS has announced that it is now PTIN renewal season for 2019 and that there is *no* fee/cost for 2019 PTINs.

Divisive Reorganizations

Rev. Proc. 2018-53 provides procedures for requesting private letter rulings (PLRs) on certain issues in divisive reorganizations under secs. 368(a)(1)(D) and 355. These procedures generally apply to PLR requests postmarked or received by the IRS after Oct. 3, 2018.

Social Security Tax

The maximum amount of earnings subject to the Social Security tax will increase from $128,400 for 2018 to $132,900 for 2019.

Other 2019 Inflation Adjustments

For 2019 pension plan and certain other limitations, see IRS Notice 2018-83, IRB 2018-47, Nov. 19, 2018. CPA

Stuart R. Josephs, CPA has a San Diego-based Tax Assistance Practice that specializes in assisting practitioners in resolving their clients' tax questions and problems. Josephs, chair of the Federal Subcommittee of CalCPA's Committee on Taxation, can be reached at (619) 469-6999 or stuartrjosephs@yahoo.com.