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Horse Industry Trots Into New Tax Landscape

Two major policy developments have dramatically changed the tax landscape for horse owners and millions of other Americans as they make financial plans for their businesses and families in 2018 and beyond: enactment of the Tax Cuts and Jobs Act of 2017, which rewrites major business and individual provisions of the tax code; and passage of the Bipartisan Budget Act of 2018 (aka, "tax extenders"), which extends for one year a host of tax incentives that expired at the end of 2016. Demands that the Internal Revenue Service (IRS) issue guidance documents to clarify the nearly 1100 pages of new tax law, especially provisions intended to reduce tax burdens on small business, have followed in the wake of the first major rewrite of the tax code since the Reagan Administration. As a broad spectrum of stakeholders push for IRS guidance, business interests including the American Horse Council continue to campaign for additional tax extenders and technical corrections to the new law. Based on the scope of the changes made to the code, AHC recommends that members consult their tax professionals to begin assessing their tax obligations moving into 2018 and beyond. Please see the below highlights from the new tax law and tax extenders package.

New Tax Laws for Business

New Law Imposes a 21% "Flat Rate" on Corporate Income - The Tax Cuts and Jobs Act reduces the corporate income tax rate from 35% to a flat rate of 21%, effective January 1, 2018. Tax reform proponents tout the new 21% flat rate as a central feature to a simplified tax system from a business perspective. AHC members filing as "C corporations," which are generally identified by the suffix, "Inc.," will see an immediate reduction in their official, or statutory tax rate. Examples of companies filing as "C corporations" would include racetracks, makers of pharmaceuticals and agricultural equipment, and large breeding operations governed by officers and a board of directors. While many policy experts believe that the new tax code will be easier to navigate from a business perspective, corporate taxpayers' effective liability will vary to the extent they are able to utilize the new code's remaining deductions, some of which are outlined below. Also, given the complexity and limitations emerging from the new provisions related to "pass-through" entities (see below), some AHC members may want to consider re-organizing as C corporations.

IRS, Tax Policy Officials, Must Clarify Scope of New Provisions for Small Business - While the new law establishes a 20% deduction for "certain services or trades" organized as "pass-through" entities, an army of stakeholders is requesting immediate guidance from IRS to define statutory terms that identify who benefits from the new deduction, and by how much. The plain language of the new statute provides that the deduction applies to the first $315,000 of joint income, or $157,500 for individual filers.

Furthermore, it will apply to certain “pass-through” entities such as partnerships, sole proprietorships and S corporations. As a general matter, the new provision could benefit small businesses that generally report incomes at or near the threshold level. While various types of “pass-throughs” constitute the fastest growing segment of AHC members, they also include the majority of U.S. farms.

In late January, the American Institute of Certified Public Accountants (AICPA) urged IRS to issue “immediate guidance in 39 areas affected” by the new tax law. The letter focused on three key issues, most notably a request to provide more information with respect to the 20% deduction for pass-through income, the new statute’s signature provision intended to provide relief for small business, including AHC members. The CPAs state that “the definition of specified trade or business … and the calculation of the new … deduction for complex business structures” pose a daunting challenge for tax experts seeking to advise clients in 2018 and beyond. The CPAs point out other specific issues raised by the new pass-through deduction, including the calculation of qualified business income (QBI), especially as it relates to “multi-tiered entities,” and how losses from one business might be “netted against gains from another.” The small business provisions are so opaque that a new coalition is emerging within the business community - including advocates from the “S Corporation Association,” among others - to address implementation issues as they arise in preparation for FY2018 filings. AHC will keep members informed about the availability of guidance and other information intended to clarify the small business provisions of the new law.

<u>Unrelated Business Income Tax (UBIT), Fringe Benefits –</u> The new tax law also addresses provisions that will impact AHC members operating in the non-profit sector. Fortunately, the law preserves an exemption for passive income from royalties, from unrelated business taxable income. The non-profit sector succeeded in convincing senators to drop a provision included in their bill that would have subjected royalty income to UBIT. Unfortunately, the tax code will now subject certain “fringe benefits” to UBIT, including parking, transportation costs such as mass-transit vouchers, and on-site athletic facilities.

Significantly, the new law will also require non-profits to calculate UBIT for each unrelated business activity. This will mandate multiple calculations by tax professionals advising organizations that run several unrelated business operations. The new requirement effectively prevents losses from one unrelated activity, such as proceeds from the sale of donated goods, to offset income from other unrelated business activities, such as trade shows or distribution of low-cost gifts related to an organization’s fundraising operation. Fortunately for non-profits, the IRS has identified the new requirements as a priority for issuing guidance. It’s not clear whether the agency will define “activity” in broad terms, grouping together sales from all publications, for example, as an unrelated business; or in more narrow terms, whereby each event, such as a trade show or discrete sale of an individual publication would require its own computation.

<u>Bonus Depreciation of Equipment -</u> In an important victory for the agriculture sector, the tax law includes 100% bonus depreciation through December 31, 2022, for property placed in service after September 27, 2017. This is an increase from 50% under the old law. In 2023, bonus depreciation will decline from 100%, to 80% in 2024, then by 20% increments each year through 2026. Farm equipment used in a business operation, breeding stock and race horses will benefit from the new deduction.

Section 199 Deduction - The new law eliminates the 3% deduction for "domestic production activities," also known as the "manufacturers' deduction." Domestic manufacturers of equine pharmaceuticals, agricultural equipment, and saddlery and tack will no longer be able to use this once popular tax break.

New Tax Laws for Individuals

While the new tax law may cause some AHC members to reconsider their current business classification, there are significant changes on the horizon for horse owners' individual filings. Significant increases in the standard deduction, major changes to the estate tax, and treatment of state and local taxes (SALT) will transform the way many horse owners approach their future tax filings.

Standard Deductions - According to tax reform proponents, the new law's doubling of standard deductions constitutes the central pillar for middle class tax relief. Beginning in FY2018, the new law will allow a $12,000 deduction for singles and $24,000 for married couples choosing not to itemize their deductions.

Estate, Gift Tax - The final law ultimately preserves the estate tax, but doubles the exemptions from $5.49 million to approximately $11.2 million for individuals. Raising the statutory threshold will reduce the number of farms and family businesses subject to the tax. It will also spare many family-run businesses from jumping over accounting hurdles to avoid the tax altogether. The new law retains the gift tax exclusion at $15,000 annually. In 2026, the benefits are scheduled to sunset, reverting to the old law.

State and Local Taxes (SALT) – The tax law includes a significantly downsized, itemized deduction for up to $10,000 of state and local property taxes. This provision – which eliminates the unlimited, longstanding deduction for state, sales and local property taxes - may pose challenges for AHC members who file returns in high-tax states next year. Although a handful of high tax states such as California and New Jersey are exploring "work around" measures to mitigate the impacts of the new limits on SALT deductions, AHC recommends that individuals consult with their tax professionals before attempting to take advantage of new, conforming vehicles that may be gaining traction at the state level.

Alternative Minimum Tax (AMT) – The new law preserves the AMT for individuals, but raises the exemption amounts from $50,600 to $70,300 for singles, and from $78,750 to $109,400 for married couples filing jointly. The new provision is expected to eliminate the AMT for a majority of farmers.

Capital Gains Tax - No change. Married taxpayers filing jointly pay no tax up to approximately $100,000. The threshold exemption amount for single taxpayers is $50,000. The maximum tax rate on capital gains remains 20%.

Mortgage Interest - The new law reduces the current $1 million cap on mortgage interest to $750,000, which the Internal Revenue Service (IRS) will apply to homes purchased after January 1, 2018.

Congress Passes One-Year "Extenders" Fix for Expired Incentives, Considers Next Steps

On February 9, Congress passed the Bipartisan Budget Act of 2018 to fund the federal government to March 23 and eliminate budget caps for one year, attempting to create flexibility that will allow lawmakers to address the nation's longer term funding issues, including FY2018 appropriations. Within the budget bill, lawmakers included a limited tax extenders package that renewed 36 expired provisions for FY2017 only, including the three-year depreciation measure for racehorses.

A group of business partners including AHC has agreed to campaign for extenders for FY2018 and beyond. A likely vehicle includes budget legislation that Congress must address prior to expiration of the current funding bill on March 23. Other vehicles include an infrastructure bill that would include a provision authorizing the sale of private activity bonds, thereby opening an opportunity for tax extenders. With respect to stand-alone legislation, a member of the House Ways and Means Committee informed AHC staff that his committee would likely focus on a package that includes 17 energy and conservation-focused credits. In the event tax extenders legislation gains traction, lawmakers may include "technical corrections" to address the underlying law's ambiguities.

AHC recommends that members consult their accountants or other tax professionals to begin assessing the new tax landscape for 2018 and thereafter. Meanwhile, AHC staff will continue to share information related to IRS guidance and possible rulemakings that the agency will initiate to implement the new law. To view a 550-page copy of an explanation of the final conference report for the Tax Cuts and Jobs Act of 2018 (H.R. 1, Public Law 115-97), please click here: http://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf. For more information related to the new tax laws and next steps, please contact Bryan Brendle, Director of Policy and Legislative Affairs, at bbrendle@horsecouncil.org.

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Qualified Business Income Deduction Under the Tax Cuts and Jobs Act

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Thomson Reuters, a major resource provider for tax professionals, recently stated: "Few provisions in the recently enacted Tax Cuts and Jobs Act are likely to have a greater impact or create more confusion than the new Code Section 199A deduction for noncorporate taxpayers for qualified business income." In very general terms, the qualified business income deduction (QBID) is an economic-growth provision which will have the impact of reducing taxes on income earned by many businesses operating in partnerships, S corporations, and sole proprietorships. The deduction first applies for tax years beginning after 2017. Computing the deduction, particularly applying the limitations, will be very complex in many cases. If TCJA was intended to simplify our tax code, the QBID provisions are counter-productive. Hopefully, the economic growth impact will outweigh the complexity.

When it is available, the QBID is 20% of business income, subject in certain cases to a complex array of limitations. Individuals, estates, and trusts can take the deduction; C corporations, now beneficiaries of a much-reduced tax rate (35% to 21%), cannot. For pass-through entities (partnerships and S corporations), the deduction is taken at the partner or shareholder level. The deduction is computed for each separate business in which one is an owner.

This article is not intended to cover many aspects and impacts of the QBID, but hopefully will provide readers with an understanding of the basic concepts.
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Let's start with a very simple example:

Qualified business income (QBI)		$200,000
Nonbusiness interest income	10,000	
Net capital gains	10,000	
Itemized deductions	<30,000>	
Taxable income before QBID		$190,000
Tentative QBI deduction ($200,000 x 20%)	$ 40,000	
Applicable limitation (20% of taxable income, excluding net capital gains and before the QBID (or $180,000))		$ 36,000
QBID	$ 36,000	
Taxable income ($190,000-36,000)	$154,000	

This example, as can be seen, shows the overall limitation: 20% of taxable income, reduced by net capital gains and computed before the QBID. The other limitations, discussed below, do not apply if taxable income (again, before the QBID) does not exceed \$157,500 for a single filer or \$315,000 for a joint filer (in both cases adjusted for inflation after 2018). Referencing the example above (taxable income before the QBID of \$190,000), if a joint return is being filed, the computation of the QBID is complete. If a single status return is being filed, two additional limitations must be considered.

One of the additional limitations concerns what types of business qualify for the QBID:

• Any trade or business qualifies **other than**:
    o A **specified service** trade or business:
• Includes services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investment management, and brokerage services, and
• Also includes any trade or business in which the principal asset is the reputation and skill of one or more employees or owners.
    o Performing services as an employee.

Keeping in mind that we have no IRS regulations, rulings, or other guidance available yet, and can only rely on the statutory language and underlying legislative branch committee reports, here are initial impressions of how some different businesses involving horses may fare under these rules:

Likely Qualifying:
• horse breeding operations
• horse racing or other performance horse operations
• horse boarding farms
• horse tack stores
• feed suppliers

Likely Not Qualifying:
• equine veterinarians (specified service)
• farm real estate brokers (specified service)

Perhaps Unclear:
• bloodstock agents (brokerage service or principal asset is reputation?)
• equine insurance (financial service or principal asset is reputation?)
• horse trainers (principal asset is reputation?)
• farriers (principal asset is reputation?)

Hopefully, future guidance will mitigate some of the uncertainty. Expect some controversy with tax authorities over whether certain businesses will qualify for the QBID. Remember that whether or not your business qualifies is relevant only if your taxable income exceeds the threshold amounts.

The second additional limitation applicable when taxable income exceeds the thresholds is quantitative. The 20% of QBI deduction is limited to the greater of:

1) 50% of the owner's share of W-2 compensation paid to employees of the qualifying business, or
2) the sum of 25% of such wages and 2.5% of the cost of the business' depreciable business assets.

An example may help:

Taxable income (before the QBID and excluding net capital gains) $600,000.
Two qualified businesses conducted: A with QBI of $200,000 and B with QBI of $300,000.
Joint filing status.
Allocated W-2 expense: A $50,000 and B $20,000.
Cost of depreciable business assets: A $100,000 and B $600,000.

	Business A	Business B
A. QBI	$200,000	$300,000
B. Tentative QBID (20% of QBI)	$ 40,000	$ 60,000
C. W-2 wage limitation (50%)	$ 25,000	$ 10,000
D. Alternative W-2 wage limitation (25%)	$ 12,500	$ 5,000
E. Property limitation (2.5%)	$ 2,500	$ 15,000
F. Wage + property limitation (D+E)	$ 15,000	$ 20,000
G. Limitation (greater of C or F)	$ 25,000	$ 20,000
QBID, before taxable income limitation (lesser of B or G)	$ 25,000	$ 20,000

The combined QBID from the two businesses ($45,000) is less than the overall taxable income limitation of $120,000 ($600,000 x 20%), so the QBID in this example is $45,000.

The qualified business and quantitative limitations for those with taxable income exceeding the afore-mentioned thresholds based on filing status are fully applicable when taxable income exceeds $207,500 single and $415,000 joint. These limitations reduce the QBID pro rata when taxable income is between $157,500 and $207,500 single and $315,000 and $415,000 joint.

Following are several other QBID features:

- Whether or not the owner is active or passive in the business is not relevant to the QBID.
- Investment income, whether reported directly or through a pass-through entity, is not QBI.
- W-2 compensation received is not QBI.
- Income from REIT dividends and business income reported by publicly-traded partnerships receives QBI treatment.
- If a person has multiple trades and/or businesses, some with negative QBI and others with positive QBI, the new rules effectively require a netting of the positive and negative QBI amounts. The negative QBI amounts will offset the positive QBI amounts and reduce the QBID amounts otherwise computed on the trades or businesses with positive QBI. If the netting results in a combined negative QBI, the net negative QBI is carried over to the following year.
- The QBID does not reduce self-employment income.
- The QBID is not separately computed in the alternative minimum tax calculation.
- The QBID does not increase a net operating loss.
- The taxable income threshold amount for estates and trusts is the same as for a single individual.

For business owners with taxable income below the lower end of the threshold amounts, computing the QBID is not too involved. For those above, the disqualification of many primarily service businesses and the complex limitations will knock many persons out of the deduction or will reduce the deduction's benefit for others.

To close, I remind readers that this article is not intended to be a complete coverage of this important part of TCJA. IRS guidance, hopefully issued sooner rather than later, may answer some of many questions currently unresolved.

Doug wishes to acknowledge his colleague Jack Miller for his diligent study of this area of TCJA and review of this article.

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