THE TAX INSTITUTE AT H&R BLOCK

TAX in the News

Tax Information for Tax Practitioners

October 17, 2018

TAX NEWS

Disaster Relief: Florida and Georgia (Hurricane Michael)—Parts of Florida and Georgia have been declared major disaster areas in the aftermath of Hurricane Michael. Federal deadlines for affected taxpayers are generally postponed until February 28, 2019, including the October 15 filing deadline for individuals and other taxpayers with valid extensions. IRS relief applies to both individual and public assistance counties. Disaster-related casualty losses may be claimed on 2017 or 2018 tax returns. Page 2

IRS Guidance Clarifies Deductibility of Business Meals Included With Entertainment Activities—The TCJA suspended the deduction for entertainment expenses but still allows a deduction for 50% of the cost of qualifying business meals. What happens when food is provided *during* an entertainment activity? Notice 2018-76 explains when taxpayers may deduct 50% of the cost of the food and when the cost is treated as a nondeductible entertainment expense. Page 3

Qualified Business Income Deduction – Part 6: Multiple Businesses and Aggregation Rules—In our discussions about the QBI deduction to date we've considered examples of taxpayers who have only one business. In this installment we'll explain how the deduction works for taxpayers who have more than one business, including businesses with losses, and when and how taxpayers may be able to aggregate multiple businesses to increase the deduction. Page 4

QUESTION OF THE WEEK

A naturalized citizen inherited a condominium in a foreign country. He isn't quite sure what he'll do with it. If he decides to rent it out for a few years, must he depreciate the property using ADS and a 40-year recovery period? Page 7

DISASTER RELIEF—Florida and Georgia (Hurricane Michael)

Parts of Florida and Georgia have been declared major disaster areas eligible for federal disaster aid to individuals and businesses. Be sure to check the IRS and FEMA links for updates to the covered disaster area. For Hurricane Michael, IRS has provided relief to both individual and public assistance counties.

Affected taxpayers have the option of waiting to claim 2018 disaster-related casualty losses on their 2018 tax return filed next year during the 2019 tax season or on an original or amended tax return for 2017 filed during 2018. In addition, the IRS has postponed deadlines for affected taxpayers to file returns, pay taxes, and perform other time-sensitive acts.

Affected taxpayers are those who:

- Live in the covered disaster area
- Have a main place of business located in the covered disaster area
- Have books and records needed to complete the return located in the disaster area
- Assist governments or qualified non-profit organizations in relief efforts
- Were injured or killed while visiting the area

Note: Generally, the IRS identifies affected taxpayers located in the disaster area and automatically applies filing and payment relief. Affected taxpayers outside the disaster area should call the IRS at 1-866-562-5227 to request tax relief.

Florida disaster: Hurricane Michael starting October 7, 2018

Georgia disaster: Hurricane Michael starting October 9, 2018

FEMA major disaster declaration announcements: DR-4399 October 11, 2018 (Florida) and DR-4400 October 14, 2018 (Georgia).

IRS releases: FL-2018-04, dated October 12, 2018 and GA-2018-04. Also see "Help for Victims of Hurricane Michael."

Covered disaster areas:

Florida: Bay, Calhoun, Franklin, Gadsden, Gulf, Hamilton, Holmes, Jackson, Jefferson, Leon, Liberty, Madison, Suwannee, Taylor, Wakulla, and Washington counties.

Georgia: Baker, Bleckley, Burke, Calhoun, Colquitt, Crisp, Decatur, Dodge, Dooly, Dougherty, Early, Emanuel, Grady, Houston, Jefferson, Jenkins, Johnson, Laurens, Lee, Macon, Miller, Mitchell, Pulaski, Seminole, Sumter, Terrell, Thomas, Treutlen, Turner, Wilcox, and Worth counties.

Georgia: news release (honors federal postponements)

Postponement periods: Tax returns and other time-sensitive acts due on or after the disaster starting date, and before February 28, 2019 are postponed until **February 28, 2019.**

This includes the following 2018 deadlines: The October 15 filing date for individuals and other taxpayers with valid extensions, quarterly payroll and excise tax returns due October 31, 2018 and January 31, 2019, and quarterly estimated tax payments due January 15, 2019.

Employment and other excise tax deposits due on or after October 7, 2018, and before October 22, 2018, must be deposited by October 22, 2018.

IRS GUIDANCE CLARIFIES DEDUCTIBILITY OF BUSINESS MEALS INCLUDED WITH ENTERTAINMENT ACTIVITIES

The TCJA disallows the deduction for business entertainment expenses but continues to allow the §274(k) deduction of 50% of the cost of qualifying business meals. Entertainment activities under Reg. §1.274-2(b)(1)(i) may include going to a night club, theater, sporting event, etc.

What happens if an entertainment activity *includes* food and beverages? Notice 2018-76 provides transitional guidance on the deductibility of expenses for business meals under such circumstances. The Treasury Department and IRS intend to publish proposed regulations on §274(k) as amended by the TCJA. In the meantime, taxpayers may rely on the guidance in this notice.

Under Notice 2018-76, taxpayers may deduct 50% of otherwise allowable business meal costs if all of the following are true. The first four items are the general requirements for deducting business meals. The fifth is the criterion for deducting the cost of food and beverages included in an otherwise nondeductible entertainment activity.

1. The expense is an ordinary and necessary business expense paid or incurred during the taxpayer's taxable year.
2. The expense is not lavish or extravagant under the applicable facts and circumstances.
3. The taxpayer, or an employee of the taxpayer, is present when the food or beverages are furnished.
4. The food and beverages are provided to a current or potential business customer, client, consultant, or other business contact.
5. When food and beverages are provided as part of an entertainment activity, the food and beverages are purchased separately from the entertainment or the cost is stated separately from the entertainment costs on bills, invoices, receipts, etc.

If the fifth requirement is not met, the food and beverages are treated as entertainment rather than business meals and the cost is not deductible. The notice provides three examples. Assume in each that the sporting events are entertainment activities and the first four business meal criteria are met.

Example 1: Taxpayer A invites a business contact to a baseball game and purchases the tickets as well as hot dogs and drinks for the guest. Because the food is purchased separately from the game tickets it is not an entertainment expense and 50% of the cost is deductible.

Example 2: Taxpayer C invites a business contact to a basketball game in a suite and purchases the suite tickets. Food and beverages are served in the suite. The cost of the food is not purchased separately from the tickets and not stated separately on the invoice. Therefore, the cost of the food is considered to be a nondeductible entertainment expense.

Example 3: Same facts except the cost of the food and beverages is stated separately on the invoice for the suite tickets. In that case, the cost of the food is considered a business meal expense rather than an entertainment expense and Taxpayer C may deduct 50% of its cost.

Note: The guidelines also caution against circumventing the entertainment disallowance rule by inflating food and beverage charges!

QUALIFIED BUSINESS INCOME DEDUCTION – PART 6: MULTIPLE BUSINESSES AND AGGREGATION RULES

So far in our qualified business income deduction (QBID) series we've covered the following:

- Part 1: Overview (TITN August 22, 2018)—the basics of the QBID calculation, eligibility, and terminology.
- Part 2: SSTBs (TITN August 29, 2018)—types of activities considered "specified service trades or businesses" for purposes of the QBID.
- Part 3: QBI Vocabulary (TITN September 19, 2018)—terms and definitions needed to perform the QBID calculations that apply to higher income taxpayers.
- Part 4: Reductions for non-SSTBs (TITN September 26, 2018)—how the QBID is calculated for taxpayers with income from non-SSTBs.
- Part 5: Reductions for SSTBs (TITN October 10, 2018)—how the QBID is calculated for taxpayers with income from SSTBs.

In this installment we'll explain how the QBID works when taxpayers have qualified business income (QBI) from more than one business. First, let's review. The basic QBID is 20% of the taxpayer's QBI or, if smaller, 20% of the taxpayer's taxable income net of any capital gain. When the taxpayer's taxable income exceeds $157,500 ($315,000 MFJ), the taxpayer must factor in a wage and property test which serves to reduce the QBID. The two elements in this test are "wages" and "unadjusted basis immediately after acquisition (UBIA)."

Multiple businesses – basic rules

In Part 3 we explained that QBI is the taxpayer's profit from each U.S. trade or business. QBI may be from a disregarded entity, such as a sole proprietorship, single-member LLC, or a farm. It may also be from a relevant passthrough entity (RPE) such as an S corporation or partnership. Generally, the QBID is calculated separately for each of the taxpayer's trades or businesses.

> **Example 1**. Carla has QBI from an S corporation (which is an RPE) and from a single-member LLC that files a Schedule C. Her respective shares of QBI, wages, and UBIA from the RPE are $85,000, $30,000, and $70,000 respectively. QBI, wages, and UBIA from the LLC are $150,000, $0, and $10,000 respectively. Carla's taxable income is $250,000. Both businesses are non-SSTBs.
>
> Carla's QBID from the RPE is $15,000, the smaller of:
>
> > $17,000 ($85,000 QBI × 20%), or
> >
> > The larger of
> > > $15,000 ($30,000 wages × 50%), or ✓
> > > $9,250 [($30,000 wages × 25%) + ($70,000 UBIA × 2.5%)]
>
> Carla's QBID from the LLC is $250, the smaller of:
>
> > $20,000 ($150,000 QBI × 20%), or
> >
> > The larger of
> > > $0 ($0 wages × 50%), or
> > > $250 ($0 wages × 25%) + ($10,000 UBIA × 2.5%) ✓
>
> Carla's total QBID is $15,250 ($15,000 + $250). If 20% of Carla's taxable income net of capital gain had been less than $15,250, her QBID would be limited to the lesser amount. In this example, 20% of her taxable income is $50,000 ($250,000 × 20%) so it does not factor into her deduction.

(Continued on page 5)

(Continued from page 4)

Businesses with losses

To this point in the series, every business in every example has had a profit. What happens if a business has a loss? The loss from one or more businesses (negative QBI) is allocated proportionally to businesses with profits (positive QBI). The QBI net of any loss adjustment is then used for the tentative 20% of QBI calculation for each business.

> **Example 2:** Using the same facts as in Example 1, Carla has a third business, another single-member LLC. This business sustained a $50,000 loss. The loss must be allocated proportionally to the two businesses that have profits.
>
> $235,000 total QBI for businesses with profits ($85,000 from RPE + $150,000 from LLC1)
>
> 36% RPE's share of total QBI ($85,000 / $235,000)
> $18,085 loss allocated to RPE ($50,000 loss from LLC2 × 36%)
> $66,915 QBI from RPE adjusted for loss ($85,000 QBI - $18,085 loss adjustment)
>
> 64% LLC1's share of total QBI ($150,000 / $235,000)
> $31,915 loss allocated to LLC1 ($50,000 loss from LLC2 × 64%)
> $23,617 QBI from LLC1 adjusted for loss ($150,000 - $23,617 loss adjustment)
>
> The QBI amounts adjusted for the loss will then be used to calculate 20% of QBI and compare the results to the wage/property limitations. In this example 20% of the RPE's QBI adjusted for the loss is $13,383. Since this amount is *less than* 50% of the RPE's applicable wages, the QBID for the RPE is $13,383. The QBID for LLC1 is not affected by the loss allocation because it is still limited to $250 as calculated above. Carla's total QBID is $13,633 ($13,383 + $250).

Before moving on, here are a few more points to understand about losses:

- As noted earlier, in this example, Carla's QBID is not limited by her taxable income. If that limitation did apply, her taxable income would *not* be adjusted for losses. Her total QBID would be compared to 20% of taxable income net of capital gain.
- If the net of all QBI from all businesses results in an overall loss, the QBID is $0. Any remaining negative QBI is carried forward to the next year and reduces the QBI deduction for that year.
- Notice that we didn't mention anything about wages or UBIA from LLC2. That's because 20% of negative QBI is, for all intents and purposes, $0. Since the QBID is the smaller of 20% of QBI and the wage/property test, these elements are not applicable. In the next section we'll see that things work differently when taxpayers aggregate multiple businesses for the QBID calculation.

Aggregation rules

If a taxpayer qualifies and chooses to aggregate multiple businesses, QBI, wages, and UBIA amounts from each separate business are combined for the QBID calculation. In order to aggregate multiple businesses for the QBID, *all* of the following conditions must be met:

1. The same person or group of persons must own 50% or more of each business.
    - Ownership may be direct or indirect, such as an interest owned by a spouse, child, or parent. For RPE ownership use capital or profits percentages for partnerships and use stock ownership for S corporations.
2. This ownership control must exist for the majority of the taxable year.

(Continued on page 6)

(Continued from page 5)

3. *All* of the businesses must have the same taxable year (without regard to short years).
4. None of the businesses may be an SSTB.
5. At least *two* of the following must be met. The businesses must:
   - Provide products or services that are the same or customarily offered together.
   - Share facilities or significant centralized business elements, such as HR, IT, manufacturing, purchasing, accounting, etc.
   - Operate in coordination with, or reliance on one or more businesses in the group, such as supply chain interdependence.

Example 3. Using the same facts as example 2, Carla owns 75% of the RPE, which is a restaurant. LLC1 is a catering business and LLC2 is a food truck. The restaurant buys the food for the other two businesses and food for LLC1 is prepared at the restaurant. Carla's accountant handles the tax returns and other financial matters for all three businesses. Assume all of the other tests are met and Carla qualified to aggregate her three businesses. Wages and UBIA for the food truck are $25,000 and $20,000 respectively.

Carla's QBID is calculated as follows:

$185,000 combined QBI ($85,000 + $150,000 - $50,000)
$55,000 combined wages ($30,000 + $0 + $25,000)
$100,000 combined UBIA ($70,000 + $10,000 + $20,000)

$37,000 ($185,000 combined QBI × 20%)

$27,500 ($55,000 combined wages × 50%), or ✓
$16,250 [($55,000 combined wages × 25%) + ($100,000 combined UBIA × 2.5%)]

Aggregating the three businesses results in a QBID of $27,500 for the combined calculation, which is nearly twice the total QBID of $13,633 in Example 2. Here, Carla clearly benefits by aggregating her three businesses for the QBID calculation.

Keep in mind that aggregation is optional. However, taxpayers who qualify and choose to aggregate must continue to do so each year unless they no longer qualify. The taxpayer must attach an election statement to the return each year. The statement should indicate that the taxpayer is aggregating multiple businesses under Prop. Reg. §1.199A-4(c) and include the name, EIN, and description of each business, including newly acquired businesses and businesses that have ceased operations.

Taxpayers who either do not qualify to aggregate multiple businesses or choose not to do so must calculate the QBID separately for each business and allocate losses as explained earlier. For instance, going back to Example 1, suppose the S corporation was an SSTB. Because Carla's taxable income is more than the upper threshold or ceiling for a single filer, her QBID for the RPE would be $0 and the only deduction available to her would be the $250 QBID for the LLC. She would not qualify to aggregate the multiple businesses (because one of them is an SSTB) so she could not combine the separate elements to improve the QBID.

Joint and separate return considerations

Aggregation. For QBID purposes, married taxpayers filing jointly are treated as one taxpayer and, as pointed out earlier, each spouse is considered to have an indirect ownership of the other's business for the aggregation tests. For instance, using Example 3, suppose Carla was married and filed jointly with her spouse, Ralph, who owns LLC2.

(Continued on page 7)

(Continued from page 6)

Assuming the same types of businesses, Carla and Ralph may choose to aggregate the three businesses for the QBID calculation if they qualify and choose to do so as per the same aggregation rules that apply to a single filer. And, just as with a single filer, if one spouse or the other owned an SSTB, or had less than a 50% ownership of a business, or a business operated on a different taxable year, then aggregation would not be possible.

Separate returns. In some instances, it may be beneficial for spouses to file separate returns. Using Example 1 facts, assume Carla has the ownership interest in the RPE, which is an SSTB, and Ralph owns the LLC, which is not an SSTB. Assume that their joint taxable income is over $415,000 but, if they file separately, Carla's taxable income is $350,000 and Ralph's is $90,000.

If Carla and Ralph file jointly, the only QBID available is the $250 QBID for Ralph's LLC. If they file separately, Carla's QBID would still be fully phased out, but Ralph would be eligible for a QBID of $18,000 (the smaller of QBI or taxable income times 20%). As he is under the $157,500 threshold for a separate filer, Ralph is not subject to the wage/property limitation and his only limitation would be his own taxable income. In this scenario, it is likely that Carla and Ralph would benefit by filing separately but before doing so they should make sure their separate taxes, even with the higher QBID, are still lower than they would be if they filed jointly.

QUESTION OF THE WEEK

Q. My client, who is a naturalized citizen, just found out he has inherited a condominium in a resort area in Italy. At this point, he is not sure what he wants to do with the property and is investigating several options, including the possibility of renting it for a few years. We've had discussions about reporting rental income and expenses if he decides to go that route. Is he required to use ADS and depreciate the property over 40 years?

A. Because this is a foreign rental property, your client is required to use the alternative depreciation system (ADS). However, the TCJA lowered the ADS recovery period for residential rental property to 30 years. The shorter period applies to property placed in service after December 31, 2017.

For property placed in service before January 1, 2018, the 40-year recovery period still applies. However, the 30-year recovery period can be applied to improvements made to foreign residential rental properties, such as adding a room or putting on a new roof. There is no change to the ADS 40-year recovery period requirement for foreign nonresidential rental properties.

If your client decides to rent out the condominium, he should also be mindful of possible foreign financial reporting obligations, such as FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)* and Form 8938, *Statement of Specified Foreign Financial Assets*. For instance, he would need to file the FBAR if he keeps a bank account in Italy to handle rent deposits and pay bills and the bank balance is more than $10,000 at any time during the year. See Comparison of Form 8938 and FBAR Requirements.