TAX in the News

Tax Information for Tax Practitioners

November 7, 2018

EA renewal—The 2019 renewal period runs from November 1, 2018, through January 31, 2019. Enrolled Agents with SSNs ending in 0, 1, 2, or 3 must renew during this period. See Annual Enrollment Renewal Period for details. Current enrollment for affected EAs will expire March 31, 2019. Those who do not renew will be placed in inactive status.

TAX NEWS

Qualified Business Income Deduction – Part 8: Review and Wrap-Up—This is the final installment of our QBID series. We'll go back over some of our earlier concepts and provide some additional information about the QBID calculation. Look for future articles as more guidance is released and more issues come to light. Page 2

Disaster Relief:

Northern Mariana Islands (Super Typhoon Yutu)—Parts of the Northern Mariana Islands have been declared a major disaster area for the second time because of Typhoon Yutu beginning October 24, 2018. Federal deadlines for affected taxpayers are generally postponed until February 28, 2019. Disaster-related casualty losses may be claimed on 2017 or 2018 tax returns. Although Typhoon Yutu started after October 15, an earlier typhoon included much of the same disaster area and takes in the October 15 extension deadline (see TITN October 10, 2018). Page 3

Alabama (Hurricane Michael)—Parts of Alabama have been declared a major disaster area because of Hurricane Michael beginning October 10, 2018. Federal deadlines for affected taxpayers are generally postponed until February 28, 2019, including the October 15 deadline for taxpayers with valid extensions. Disaster-related casualty losses may be claimed on 2017 or 2018 tax returns. Page 4

QUESTION OF THE WEEK

A client wants to buy a vacation home. Rather than securing a mortgage for that home, he wants to purchase it with a home equity loan on his primary residence because that's "easier." Since the loan would be used to buy a second home and he's still under the $750,000 mortgage limit would he be able to deduct the interest on the home equity loan? Page 4

ORIGINAL INSIGHTS

Tales from the Tax Court: What is reasonable compensation for S corporation employee-shareholders? — "Reasonable" doesn't always mean what you think it means. Full insight. View all insights at www.thetaxinstitute.com/insights/.

QUALIFIED BUSINESS INCOME DEDUCTION – PART 8: REVIEW AND WRAP-UP

We've come to the end of our qualified business income deduction series – for now. To conclude, we'll go back over some of our earlier points and provide some additional information about the QBID.

The basics, one more time. The QBID is a below-the-line deduction generally equal to 20% of the taxpayer's qualified business income (QBI). It is claimed on the taxpayer's individual tax return (on line 9 of Form 1040) and not on the business return. The business may be a disregarded entity, such as a sole proprietorship, a single-member LLC, or non-corporate farm. It may also be a passthrough entity such as a partnership or S corporation. A rental activity may also be eligible for the deduction if the activity rises to the level of a trade or business.

QBI is, essentially, the profit or loss from the business. It does not include capital gain, dividends, investment interest, or wages. It does include depreciation recapture which will typically be encountered when §1245 property is sold and gain attributable to depreciation is recaptured as ordinary income.

Taxable income…and taxable income. The QBID cannot be more than 20% of the taxpayer's taxable income. Here, taxable income means the taxpayer's ordinary taxable income (i.e. taxable income net of any capital gain) before the QBID itself. Other limitations apply when taxable income exceeds certain thresholds. For threshold purposes, taxable income means all taxable income, whether ordinary or capital, and again, without regard to the QBID itself.

The lower threshold amounts are $315,000 for joint filers and $157,500 for all other filers. These amounts will be adjusted for inflation after 2018. The upper threshold or ceiling amounts are $415,000 for joint filers and $207,500 for all other filers. The taxable income level between the two thresholds, up to $100,000 for joint filers and up to $50,000 for other filers, is referred to as the phase-in range.

Wage and property limitations. Once the taxpayer crosses the taxable income threshold, the QBID is further limited by a wage and property limitation. For purposes of this limitation, qualified wages are all wages paid by the business to its common law employees, including wages paid to S corporation shareholder-employees. Property refers to the unadjusted basis of the business's assets immediately after acquisition, or UBIA. Generally, UBIA means the cost basis of the assets before depreciation.

The basic wage and property limitation is equal to the larger of

1) 50% of qualified wages, or
2) 25% of qualified wages plus 2.5% of UBIA.

The limitation is applied somewhat differently for specified service trades or businesses (SSTBs) and non-SSTBs but, in either case, the QBID cannot exceed the limitation.

Non-SSTB

If taxable income is:

- Above the ceiling: the basic wage/property limitation applies.
- Between the lower threshold and the ceiling: the basic wage/property limitation phases in.

The QBID is the smaller of 20% of QBI or the applicable wage/property limitation.

SSTB

If taxable income is:

- Above the ceiling: the wage/property limitation is reduced to $0, and thus the QBID is $0.
- Between the lower threshold and the ceiling: qualified wages, UBIA, and QBI elements are all reduced; the wage/property limitation is then calculated on the reduced elements.

(Continued on page 3)

(Continued from page 2)

The QBID is the smaller of 20% of reduced QBI and the applicable wage/property limitation.

See TAX in the News September 26 and October 10, 2018, for full details of the non-SSTB and SSTB calculations.

REITs, PTPs, the combined QBID, and the bottom line. For taxpayers with real estate investment trust (REIT) dividends and publicly traded partnership (PTP) income, the QBID also includes 20% of these amounts. The REIT and PTP components are not subject to wage and property limitations. The *combined* QBID is equal to:

- 20% of QBI or, if smaller, the wage/property limitation, *plus*
- 20% of REIT dividends and PTP income.

Ultimately, the calculation circles back to the ordinary taxable income limitation. Once the combined QBID is determined, the final deduction is the smaller of the combined QBID or 20% of the taxpayer's taxable income net of capital gain.

As we stated at the outset, for many taxpayers, the QBID will simply be the smaller of 20% of QBI or 20% of ordinary taxable income. We'll have more QBID articles (including QBID questions of the week!) as more guidance is released and more issues come to light.

DISASTER RELIEF—

Northern Mariana Islands (Super Typhoon Yutu)

Alabama (Hurricane Michael)

Parts of the Northern Mariana Islands have been declared a major disaster area eligible for federal disaster aid to individuals and businesses. Parts of Alabama have now been included in the Hurricane Michael disaster area.

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.

Northern Mariana Islands disaster: Typhoon Yutu beginning October 24, 2018

FEMA disaster declaration announcement DR-4404 dated October 26, 2018

IRS release: NMI 2018-02, dated October 30, 2018

Covered disaster area: The Municipalities of Rota, Saipan, Tinian, and the Northern Islands

(Continued on page 4)

(Continued from page 3)

Postponement periods:

Tax returns and other time-sensitive acts due on or after October 24, 2018, and before February 28, 2019 are postponed until **February 28, 2019.** This includes the January 15, 2019 estimated tax deadline and quarterly excise and payroll tax returns due October 31, 2018 and January 31, 2019.

Employment and other excise tax deposits due on or after October 24, 2018, and before November 8, 2018, must have been deposited by November 8, 2018.

Note, although Typhoon Yutu started after October 15, Typhoon Mangkhut, which started September 10, included much of the same disaster area and takes in the October 15 extension deadline. See TAX in the News October 10, 2018.

Alabama disaster: Hurricane Michael beginning October 10, 2018

FEMA disaster declaration announcement DR-4406 dated November 5, 2018

IRS release: AL-2018-006, dated November 6, 2018

Covered disaster area: Geneva, Henry, Houston, and Mobile Counties

Postponement periods:

Tax returns and other time-sensitive acts due on or after October 10, 2018, and before February 28, 2019 are postponed until **February 28, 2019.** This includes the October 15 filing deadline for taxpayers with valid extensions, the January 15, 2019 estimated tax deadline, and quarterly excise and payroll tax returns due October 31, 2018 and January 31, 2019.

Employment and other excise tax deposits due on or after October 10, 2018, and before October 25, 2018, must have been deposited by October 25, 2018.

QUESTION OF THE WEEK

Q. A client called to say he is considering buying a small lake home that they'll use for long weekends, vacations, etc. and possibly for retirement in the future. To buy it, he is thinking of taking out a home equity loan on his primary residence because "that will just be easier than getting a mortgage on the new home." Will he be able to deduct the interest on the home equity loan? It would be used to buy a secondary residence and he is still well under the new $750,000 mortgage limitation.

A. Your client would not be able to deduct the interest on the home equity loan if he uses it to buy the lake home.

The IRS addressed this situation in IR-2018-32. Under this guidance, interest is deductible if all three of the following criteria are met:

- Loan proceeds are used to buy, build, or substantially improve the taxpayer's qualified residence.
- The loan is secured by the qualified residence and does not exceed the cost of the residence.
- The taxpayer has not exceeded the new dollar limitation for new qualified residence loans.

Taken together, the first and second points mean that a loan used to buy a qualified residence must be secured by the *same* qualified residence.

IR-2018-32, Example 2 discusses a situation in which a taxpayer takes out a loan to buy a primary residence and the loan is secured by that residence. The taxpayer then takes out another loan to buy a vacation home and this loan is secured by the vacation home. Since each loan is secured by its respective qualified residence, and assuming dollar limits are not exceeded, the interest on both loans is deductible.

(Continued on page 5)

(Continued from page 4)

The example goes on to explain that if the taxpayer had instead taken out a second loan secured by the primary residence but used to buy the vacation home, the interest on that second loan would be nondeductible because it is not secured by the vacation home. Also, it would not matter if the second loan was called a home equity loan, second mortgage, etc. – the point is that it would have to be secured by the vacation home in order for the interest to be deductible.

Applying these principles to your client's situation, although his lake home would also be a qualified residence, if he buys it with a loan secured by his main home the interest would not be deductible. Even though it might involve a longer process, if your client itemizes deductions and wants to deduct the interest on money borrowed to buy the new home, the loan must be secured by that home.