# The Implications of Tax Reform

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## Stated Goals of Tax Reform

- Simplicity
  - Pro – Fewer people will need tax preparers as the number of itemized deductions and the standard deduction have been simplified
  - Con – Stay tuned for the rest of the morning

## Stated Goals of Tax Reform

- Simplicity
- Enhance Competitive Position of US Corporations
- Reduce Tax Burden of All Individual Taxpayers

## Stated Goals of Tax Reform

- Enhance Competitive Position US Corps
  - Pro –
    - Corporate rates have decreased from 35 percent to 21 percent
    - Repatriation tax is being paid at favorable rates and hopefully money is invested in U.S. Assets
    - Favorable tax treatment of capital asset purchases

## Stated Goals of Tax Reform

- Enhance Competitive Position US Corps
    - o Con
        - Long-term economic effect is uncertain and the share of the tax cut dedicated to the decrease in corporate tax rates is over half of the cut in first five years and over 90 percent of cut in 10 year analysis.

## Stated Goals of Tax Reform

- Reduce Tax Burden of All Taxpayers
    - o Con
        - Many popular and long standing deductions, especially state and local taxes, were eliminated
        - Virtually all of the individual estate and pass-through business benefits terminate after 2025

## Stated Goals of Tax Reform

- Reduce Tax Burden of All Taxpayers
    - o Pro –
        - Rates reduced at all levels of income
        - Additional deductions for pass-through entities helps to equalize standing with C corporations

## Agenda

- Pass-Through Entity Provisions (Partnership / S corporation)
    - o Qualified Business Income Deduction on Pass-through Income.
- Other C corporation and Business Provisions
- Key Tax Accounting Methods
    - o Cash Method of Accounting Expansion
    - o Interest Expense Deduction Limitation
    - o Depreciation
- Individual Tax Provisions
- Other Considerations

## Taxation of Partnerships and Pass-Through Entities

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## Section 199A Deduction of Qualified Business Income

- Qualified trade or business includes any trades or businesses other than ***specified service*** trades or businesses:
  - Health, law, accounting, actuarial science, performing arts, consulting athletics, financial services, brokerage services, or any trade or business where the principle asset of such trade or business is the reputation or skill of one or more of its employees

## Section 199A Deduction of Qualified Business Income

- New deduction up to 20 percent of "Qualified Business Income" (QBI)
  - QBI - includes the net amount of domestic qualified items of income, gain, deduction, and loss with respect to the taxpayer's qualified businesses

## Section 199A Deduction of Qualified Business Income

- Specified Services (continued):
  - Investing and Investment management, trading or dealing in securities, partnership interests, or commodities
  - Kudos to the architects and engineers who dodged this definitional bullet

## Calculating the QBI Deduction

- Limits / Exceptions:
  - 20 percent 199A Deduction cannot exceed the greater of
    - (A) 50 percent of W-2 wages paid with respect to the QBI or
    - (B) The sum of 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis of qualified property

## QBI Deduction Example

| | Note | | | | |
|---|---|---|---|---|---|
| 1. Qualified Business Income | A | 4,000,000 | 20% | | 800,000 |
| 2. Wages Paid to Employees | B | 2,400,000 | 50% | 1,200,000 | |
| 3. Basis of Assets | C | 500,000 | 2.5% | 12,500 | |
| Sum of 2 & 3 | | | | | 1,212,500 |
| Lesser of 1 or Sum of 2 & 3 | | | | | 800,000 |

Notes:

A The business is not disqualified

B Includes wages of everyone including the owner and in the case of a partnership guaranteed payments

C Undepreciated cost for first 10 years or longer for real estate 27.5 (Residential) 39 (Commercial)

## Navigating the Specified Service Income & Wage / Basis Limits

| | Not Specified Service Income | Specified Service Income |
|---|---|---|
| Taxable Income < or = to Single $157,500; Joint $315,000 | No limits Apply | No limits Apply |
| Taxable Income Over Single $207,500 Joint $415,000 | Wage and Basis Limitation Apply in Full | Ineligible for QBI Deduction |
| Taxable Income between | Complex Phaseout | Complex Phaseout |

## QBI Deduction Example - Real Estate

| | Note | | | | |
|---|---|---|---|---|---|
| 1. Qualified Business Income | A | 500,000 | 20% | | 100,000 |
| 2. Wages Paid to Employees | B | - | 50% | - | |
| 3. Basis of Assets | C | 8,000,000 | 2.5% | 200,000 | |
| Sum of 2 & 3 | | | | | 200,000 |
| Lesser of 1 or Sum of 2 & 3 | | | | | 100,000 |

Notes:

A The business is not disqualified

B Includes wages of everyone including the owner and in the case of a partnership guaranteed payments

C Undepreciated cost for first 10 years or longer for real estate 27.5 (Residential) 39 (Commercial)

## QBI Impact

**QBI Impact on Tax Liability**

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Taxable Income | | | | | | | |
| Single Over | 9,525 | 38,700 | 82,500 | 157,500 | 200,000 | 500,000 | 7,000,000 |
| Married Over | 19,050 | 77,400 | 165,000 | 315,000 | 400,000 | 600,000 | 7,000,000 |
| **Highest Marginal Rate** | 12.0% | 22.0% | 24.0% | 32.0% | 35.0% | 37.0% | 37.0% |
| **Sample 20% Deduction (Marriec** | 3,810 | 15,480 | 33,000 | 63,000 | 80,000 | 120,000 | 1,400,000 |
| **Tax Savings from QBI Deduction** | $ 457 | $ 3,406 | $ 7,920 | $ 20,160 | $ 28,000 | $ 44,400 | $ 518,000 |

**The wages you receive from an S Corporation and the guaranteed payments you receive from a partnership are not QBI**

These are illustrative only to show that the higher your tax bracket the greater the impact. **QBI is a deduction not a credit.**

## QBI Planning and Discussion Nuggets

- Impact of Owner wages as opposed to profits in an S corporation
- Try to avoid guaranteed payment classification if a partnership or LLC
- Will more employees under the income limit want to be subcontractors (qualify for QBI and unreimbursed business expenses)

## QBI Unresolved Major Issues

- Lack of Guidance on Specified Service Trade or Businesses
- Lack of Guidance on what will be considered a "trade or business" for rental real estate
  - The last minute addition of 2.5 percent of basis deduction we think was intended to benefit both active and passive real estate investors but was poorly executed in the actual drafting of the law

## QBI Planning and Discussion Nuggets

- If a farmer sells a product to a co-op they get a 20 percent of sales QBI whereas they get a regular 20 percent deduction if they sell to a non co-op
- If you maximize the expanded depreciation deductions you may be wasting the benefits of marginal tax rate management and the QBI deduction

## Other Related Provisions

- Like-Kind Exchange Transactions under Section 1031
  - No longer applies to tangible personal property
    - Auto Trades
    - Equipment Trades
    - Other Tangible Personal Property

## C corporation Considerations

- Tax Rate
  - 21 percent - flat rate
  - AMT repealed
- Net Operating Loss
  - Carryback repealed – only carryforward
  - Limited to 80 percent of taxable income

## C Corporation and Business Provisions

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## C Corporation Considerations

- Planning Opportunities and Pitfalls
  - No AMT at corporate level is a factor for small (under $25M) commercial contractors who are subject to personal AMT
  - Double taxation is a problem for C corporations paying out dividends.

## C Corporation Considerations

- PA Corporation Impacts:
  - 9.99 percent tax rate for in state sales but if you sell tangible goods to primarily out of state customers this rate can be substantially reduced
  - Currently no bonus depreciation – may change
  - Flipside – §179 deduction not limited $25,000
  - New 30 percent PA limitation instituted for 2017 is a negative

## General Business Entity Provisions

- Accounting Methods
  - Interest Deduction Limitation
    - Disallowance of interest deduction in excess of 30 percent of EBITA income
    - Disallowed deduction carried forward
    - Businesses under $25M AAGR would be exempt
    - Real property trade or businesses can elect out

## General Business Entity Provisions

- Accounting Methods
  - Several thresholds increased to average annual gross receipts of $25M:
    - Cash Method
      - Inventories accounted on book method
    - Requirement for UNICAP (§263A)
    - Required use of POC for long-term contracts
      - Below threshold – any exempt contract method is permissible

## General Business Entity Provisions

- Accounting Methods
  - Depreciation
    - 50 percent bonus depreciation thru 9/27/17 – New property only
    - 100 percent bonus depreciation 9/28/17 – 12/31/22 – New and used property
    - §179 Expensing expanded to $1M
      - $2.5M Threshold to begin phase-out

## General Business Entity Provisions

- Tax Credits
  - R&D Credit – Retained
  - Benefit increased after 12/31/2017
    - Credit is reduced by 21 percent versus prior 35 percent
    - The repeal of AMT for Corporations
    - NOL's can only offset 80 percent of taxable income
- DPAD – Domestic Production Activities Deduction
  - Repealed for tax years beginning 1/1/18

## Fringe Benefits

- Qualified transportation fringe benefits
  - No employer deduction (except employer-provided transportation for safety)
- Qualified moving expenses (employer-paid)
  - Suspends exclusion for 1/1/2018 – 12/31/2026

## Fringe Benefits

- Achievement awards
  - Clarifies cash & equivalents and non-tangible property (e.g., theatre tickets) awarded for long service / safety achievement are included in income
- Qualified bicycle commuting reimbursements
  - Suspends exclusion from gross income for periods for 1/1/2018 – 12/31/2026

## Entertainment & Meal Expenses

- Entertainment expenses
  - No deduction for entertainment, or recreation activities, facilities, or membership dues related to such activities
  - Repeals the "directly-related-to" and "associated-with" exceptions to the deduction disallowance
  - Deduction allowed for amount included in employee's income
  - Holiday Party – Still 100 percent deductible

## Entertainment & Meal Expenses

- 50 percent deduction limitation for meals
  - Entertainment meals are non-deductible
  - Deduction for meals provided on or near employee's premises for convenience of employer reduced from 100 percent to 50 percent
  - Meals incurred on business travel are 50 percent deductible

## Retirement Plans

- Plan loan offsets
  - For participants who terminate with outstanding loans, loan is offset by reducing vested account balance
  - Participant may defer taxation on loan by rolling over and contributing balance to IRA
  - Timeline for making rollover is extended from 60 days after the offset to the due date (including extension) of income tax return for year of offset

## Retirement Plans

- 2016 disaster relief – qualified distributions
  - Distributions during 2016-2017 not exceeding $100,000
  - Avoids 10 percent early withdrawal tax
  - May include income ratably over 3-year period from date of distribution
  - Ability to recontribute all or a portion during 3-year period

## Individual Tax

## Ordinary Income Tax Rates

- The current seven tax bracket system is retained, but the rates are lowered for all taxpayers and the thresholds are adjusted below

| Tax Rate | Married Filing Jointly and Surviving Spouses | Single | Head of Household | Married Filing Separately | Estates & Trusts |
|---|---|---|---|---|---|
| 10% | $0 - $19,050 | $0 - $9,525 | $0 - $13,600 | $0 - $9,525 | $0 - $2,550 |
| 12% | $19,050 - $77,400 | $9,525 - $38,700 | $13,600 - $51,800 | $9,525 - $38,700 | N/A |
| 22% | $77,400 - $165,000 | $38,700 - $82,500 | $51,800 - $82,500 | $38,700 - $82,500 | N/A |
| 24% | $165,000 - $315,000 | $82,500 - $157,500 | $82,500 - $157,500 | $82,500 - $157,500 | $2,550 - $9,150 |
| 32% | $315,000 - $400,000 | $157,500 - $200,000 | $157,500 - $200,000 | $157,500 - $200,000 | N/A |
| 35% | $400,000 - $600,000 | $200,000 - $500,000 | $200,000 - $500,000 | $200,000 - $300,000 | $9,150 - $12,500 |
| 37% | Over $600,000 | Over $500,000 | Over $500,000 | Over $300,000 | Over $12,500 |

## Above-the-Line-Deductions

- Moving Expenses – Suspended through tax year 2025; however, still available for members of the U.S. military who move pursuant to a military order
- Alimony – Effective for divorce or separation agreements entered into after December 31, 2018*:
  - Deduction - The deduction for alimony or separate maintenance payments is repealed.
  - Inclusion - The inclusion of income by the recipient is repealed.
    - *Existing alimony or separate maintenance agreements are grandfathered, as are modifications to existing agreements*

**Please note the 1-year delay on the implementation of this provision*

## Standard Deduction & Personal Exemptions

- The standard deduction is increased to the following amounts:
  - Married Filing Jointly: $24,000
  - Head-of-Household: $18,000
  - All Other Taxpayers: $12,000
    - *The deduction is indexed for inflation in future years*
- The personal exemption is suspended through tax year 2025
  - The personal exemption for estates and trusts remains at $100 (complex), $300 (simple), $600 (estates)

## Itemized Deductions

- Medical Expenses – The AGI threshold is lowered to 7.5 percent for all taxpayers for tax years 2017 and 2018
- State and Local Taxes – Taxpayers are permitted a maximum $10,000 deduction on the sum of:

  (i) state and local real property taxes,

  (ii) state and local personal property taxes, and

  (iii) state and local income taxes (or sales tax, if elected)

## Itemized Deductions

- Mortgage Interest – Taxpayers are permitted to deduct the interest paid on acquisition indebtedness of up to $750,000
  - *Debt incurred on or before December 15, 2017, is grandfathered under the previous law of interest paid on acquisition indebtedness of up to $1,000,000*
- Home Equity Interest – The deduction for interest paid on home equity indebtedness is suspended

## Itemized Deductions

- Casualty Losses – Suspended through tax year 2025, unless the loss is attributable to a Federally declared disaster loss.
  - *If a taxpayer has a personal casualty loss gain, they may deduct personal casualty losses not attributable to a Federal declared disaster loss in the amount equal to no more than the personal casualty loss gain*.

## Itemized Deductions

- Charitable Contributions – Three modifications:

  (1) Cash contributions to public charities now have a 60 percent of AGI limitation (previously it was 50 percent)

  (2) Denial of charitable deduction for payments made in exchange for athletic seating rights

  (3) Removal of substantiation exception for certain contributions reported by the charitable organization

## Itemized Deductions

- Miscellaneous Itemized Deductions Subject to 2-percent floor - These have been suspended and include investment fees and expenses, tax preparation fees, and unreimbursed business expenses, among others
- "Pease" Limitation – Repeals the overall limitation on itemized deductions through 2025

## Business Losses

- Business Losses – Business losses are only permitted in the current year to the extent that they do not exceed the sum of:

  (i) Taxpayer's gross income and / plus

  (ii) $500,000 for joint filers or $250,000 for other taxpayers

## Net Operating Losses

- Net Operating Losses – The deduction allowed is now equal to the lesser of:
  (1) Total net operating loss carryovers plus carrybacks to such year, or
  (2) 80 percent of the taxable income computed without regard to the NOL
  - *NOLs can now only be carried forward to future tax years*
    - Carryover is limited to a maximum of 80 percent of the taxable income

## Business Losses

- Businesses Losses (Continued)
  - Excess businesses losses will be disallowed and added to the taxpayer's net operating loss (NOL) carryforward
    - Carryforwards are limited to the lesser of:
      (i) the carryforward amount or
      (ii) 80 percent of taxable income
    - *For pass-through entities, this is applied at the partner / shareholder level*

## Alternative Minimum Tax (AMT)

- The individual AMT has been retained
  - Exemption amounts increased to:
    - Joint Filers: $109,400 ($54,700 for MFS)
    - All other Filers: $70,300
  - The exemption phase-out thresholds are increased to:
    - Joint Filers: $1,000,000
    - All other Filers: $500,000
  - *Many of the tax preference items that are AMT addbacks have been suspended*

## Estate, Gift, and Generation-Skipping Transfer Taxes

- Estate and Gift Taxes – Beginning in 2018, the exemption for estate and gift taxes is increased to $10,000,000 (and adjusted forward for inflation from 2011)
  - *Inflation - There will be a roughly $11,000,000 estate and gift exemption starting in 2018*

## International Tax

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## Estate, Gift, and Generation-Skipping Transfer Taxes

- Generation-Skipping Transfer Tax
  - GST exemption is increased to $10,000,000 (and adjusted forward for inflation from 2011)
    - These increases are set to expire on December 31, 2025, and the exemption amounts will return to the pre-tax reform amounts

## Establishment of Participation Exemption

- 100 percent DRD for certain foreign source portion of dividends received from specified 10 percent owned foreign corporations (10 percent SFCs) by U.S. C corporations (other than RICs or REITs) that are U.S. shareholders (section 951(b)) of those foreign corporations
  - A 10 percent SFC is any foreign corporation with respect to which any domestiC corporation is a U.S. shareholder (such term does not include any corporation which is a PFIC with respect to the shareholder and which is not a CFC)
  - Applicable to distributions made after 12/31/17

## Establishment of Participation Exemption

- Reduce basis (but not below zero) in stock of 10 percent SFCs by exempt dividends (except to extent basis reduced under section 1059 by reason of such dividends) but only for purposes of determining loss on subsequent disposition of 10 percent SFC shares
  - Applicable for distributions made after 12/31/17

## Establishment of Participation Exemption

- SFC is (a) a CFC and (b) any foreign corporation with respect to which one or more domestiC corporations is a U.S. shareholder (such term shall not include any corporation which is a PFIC with respect to the shareholder and which is not a CFC)
  - SFC described in (b) treated as CFC for purposes taking into account Subpart F income
- Subpart F inclusion is mechanism for inclusion
- Can apply to non-corporate U.S. shareholders
- Deficits of certain SFCs available to reduce inclusion if certain conditions are satisfied

## Establishment of Participation Exemption

- U.S. shareholders (as defined in section 951(b)) of deferred foreign income corporations required to include their pro rata share of accumulated post-1986 deferred foreign income as of 11/2/2017 or 12/31/2017 (whichever is greater)
  - Deferred foreign income corporation is a specified foreign corporation (SFC) with positive accumulated post-1986 deferred foreign income on 11/2/2017 or 12/31/2017

## Establishment of Participation Exemption

- Very generally, 15.5 percent rate for E&P comprising of cash and cash equivalents/8 percent rate for E&P comprising of illiquid assets (see section 965(c) for specific details on computing rates)
- Election to pay liability in 8 installments (with amounts paid in later years increasing)
- Special rules for S corporation shareholders allowing them to elect to defer payment of tax liability until certain triggering events

## Modifications to Subpart F

- Expands the definition of U.S. shareholder to include U.S. persons who own 10 percent or more of the total value of all classes of stock of a foreign corporation
  - Applicable to taxable years of foreign corporations beginning after 12/31/17 and to taxable years of U.S. shareholders in which or with which such taxable years end

## Thank You

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## Modifications to Subpart F

- Eliminates the requirement that a corporation be controlled for an uninterrupted period of 30 days before subpart F inclusions apply
  - Applicable to taxable years of foreign corporations beginning after 12/31/17 and to taxable years of U.S. shareholders in which or with which such taxable years end