Tax Reform Update
New Rules
and
Planning Considerations

Rick Cooley and Brandi Fruik

Most significant tax law since 1986

- **Impacts** businesses, individuals, estates, non-profits, trusts.

- Some good news some bad news: **lowers tax rates but reduces or eliminates many popular tax deductions**.

Focus of discussion on business and individual tax reform.

Summary of business tax impacts:

- **New tax rate for C Corporations**. 21%, applies to PSC's as well.
- New "**qualified business income**" tax deduction for flow through businesses (S Corp, LLC, Partnerships)
- **Repeal** of corporate AMT.
- Doubling of **bonus depreciation** for assets purchased and placed in service after 9/27/2017 and before 1/1/2023 to 100%!
- Doubling of **Section 179** asset expensing election to $1.0 million.

Businesses continued:

- New **disallowance of deduction** for net interest expense.
- New limits on **NOL’s**.
- Elimination of the **Section 199** “Domestic Production Deduction” for 2018 for flow throughs and 2019 for C Corporations.
- Like kind exchanges **(1031’s)** limited to real estate property.
- New credit for **employer paid family/medical leave**.
- New limitations on deductions for **employee fringe benefits**: entertainment and some meals and transportation benefits.
- Partnerships: “**technical termination**” rules repealed.

Summary of individual tax impacts:

- **Lowers tax rates** up to 4-percentage points, depending on tax bracket.
- **Standard deduction** almost doubled. ($24,000 joint return, $12,000 single)
- Elimination of **personal exemptions** (through 2025)
- Doubling of **child tax credit** to $2,000.
- Elimination of the "**individual mandate**" under the ACA, starting in 2019.
- Lowers hurdle for **medical expense deduction** to 7.5% for 2018 & 2019, then back to 10%.
- $10,000 limit on **state and local taxes** (income, sales, real/personal property taxes).

Summary of individual tax impacts:

- Reduction to **mortgage debt limit** to $750,000 (two homes). Old $1.0 million limit grandfathered for loans before December 15, 2017.
- **HELOC interest** no longer deductible (2018 through 2025)
- Elimination of **miscellaneous itemized deductions** 2018 through 2025. Includes accounting and investment management fees.
- Elimination of **personal casualty loss deduction** except disaster areas.
- No more **moving expense deduction** except for certain military 2018 through 2025.
- **529 plan distributions** now allowed for high school and elementary school expenses up to $10,000 per year.

Summary of individual tax impacts:

- **AMT exemption** increased to $109,400 for joint returns, $70,300 for singles.
- Doubling of the **estate/gift tax exemption** to indexed $10 million ($11.2 million for 2018, indexed) per person through 2025.
- Elimination of the income based phase out on itemized deductions **(the Pease limitation)** through 2025.
- "**Kiddie taxes**" now assessed on investment income at new trust income tax rates. Earned income at individual tax rates.
- **Carried interest** taxed at short term capital gains rates unless held for three years.

What didn’t change?

- Exclusion of gain on sale of your residence (**Section 121**) still requires only two out of five years of occupancy. $500,000 exclusion preserved for joint filers.
- NO **FIFO** rule on the sale of securities. Specific identification still okay.
- **Investment interest deduction** preserved without change.
- **Qualified tuition** expense deduction
- **R & D Credit**.
- Capital gains rates remain the same. Lower rates on interest and short term capital gains.

Tax Rates:

- New corporate rate of 21% applies to C Corporation profits. Applies to personal service corporations as well as “**regular**” C Corporations. For tax years beginning after 12/31/2017.

- New corporate rate is a **flat tax rate** – no graduated tax brackets.

Depreciation:

- Enhanced **bonus depreciation deduction** – 100% deduction for assets acquired and placed in service after September 27, 2017. Applies to new and used assets. 100% expensing in effect through 2022, then gradually phased out.
- Increased **§179 expense** election to $1.0 million
- **Depreciation limits** for passenger vehicles increased: $10,000 first year, $16,000 second year, $9,600 third year then $5,760 thereafter.
- **Real property depreciation**: keeps 39 year and 27.5 year MCARS lives for non-residential and residential real estate and keeps the 15 year life for qualified improvements (QIP). Section 179 property includes QIP and roofs, HVAC, etc.

Corporate AMT:

- **Corporate AMT** eliminated permanently.

Business tax changes:

- **New limitation** on business interest deduction: beginning in 2018, interest deduction limited to 30% of EBITDA (taxable earnings before interest, depreciation and amortization) through 2021. 2022 and later years 30% of EBIT. Also adds back new 199A QBID deduction for pass-through entities.
- Real estate and farming businesses can elect out but must use alternative depreciation lives.
- Does not apply to businesses with less the $25 million in gross receipts.
- Carryforward of disallowed interest allowed indefinitely.

Business tax changes:

- **1031 exchanges**: exchanges after 12/31/2017 will now apply only to real property. Note: any gain/basis step up on personal property exchanges should be offset by 100% expensing through 2022 for personal property.

Business tax changes:

- **Entertainment expenses**: starting in 2018 no deduction for entertainment expenses, even business related entertainment. Disallows deduction membership dues for business or any social club dues. Meal deduction kept at 50% for business meals. Disallows deduction for no cost employee cafeterias. Employee events (holiday party) still 100% deductible.

Fringe Benefits:

- Previously certain employee benefits were **tax free** to employees and **tax deductible** to the employer.
- Included **transportation** (commuting, transit vouchers, fare cards), parking and on-site health facilities.
- New law requires employers to treat the benefits as **taxable** to the employee or have deduction disallowed.

Should flow through businesses switch to C Corporations?

- No, in many cases.
- C Corporations and owners still have "**two levels**" of tax on corporate income and shareholder dividends. Personal income tax rates remain high (up to 37%) if profit paid out as salary/bonus. Will depend on plan to get cash flow to owners, cash retention in business, whether a sale is anticipated, sale type (asset versus stock).
- If convert to C, then can't go back to S for five years. Also, built in gains considerations.
- Unknown: how long will the 21% C Corp tax rate last? 2020?
- Consider modeling based on your specific circumstances.

C Corporation vs. Pass-Through Entity (S Corp or Partnership)

- What are the **plans and objectives** for the Company and its owners?
- Does the Company need to **retain money** for growth or capital needs?
- What is the **continuity/exit strategy** of the Company? Sell assets, stock or gift? When?

C Corporation

- **C Corporation** tax rate is 21%.
- If Company **distributes a dividend**, the tax rate is 23.8%. Maximum combined tax rate is 39.8%.
- If Company **sells assets**, same maximum combined tax rate – 39.8%.
- If Company **pays out profits** as compensation, maximum tax rate is 39.9% (includes Medicare).
- **AMT repealed** – credits like R & D will be allowed. 50% of prior minimum credits are refundable.
- **NOLs** – can only be carried forward & offset 80% of future taxable income.

Pass-Through Entity (S Corp or Partnership)

- **Maximum** individual tax rate is 37%.
- If it's qualified business income, there's a 20% deduction. Maximum tax rate then is 29.6%.
- Specified service businesses are not qualified businesses. Engineering & architecture services are **excluded** from the specified service business definition – they are considered a qualified business.
- The **20% deduction** applies to only the pass-through qualified business income, but not compensation.
- Allows **basis build up** for future sale of assets and no double tax. Capital gains remain at 20%.
- **Pass-through losses** in aggregate are limited to $500,000 (MFJ). The excess losses are carried forward.

Depreciation

- After 9/27/2017 through 12/31/2022 (acquired & placed in service), bonus depreciation can be taken on "**used property**" and at 100% (or 50%). Consider creating an NOL for 2017 to carryback loss to open income years or to carryforward loss (limited to 80% of taxable income).
- Section **179 Expense Election** is increased to $1M (limited to taxable income) with the phase-out starting at $2.5M. Qualified real property now includes qualified improvement property, roofs, ventilation, air conditioning, fire protection, and alarm & security systems.

Fiscal Year End Companies

- **Consider changing year end** to a calendar year to take advantage of lower tax rates and depreciation incentives.

Reasonable Compensation

- **Reasonable compensation** has always been a hot issue with the IRS. C Corporations may pay too much compensation and S Corporations may pay too little. It is important to make sure owner compensation is at fair market value and well documented. The IRS can reclassify excess compensation to a dividend or dividends to compensation. The IRS is assessing penalties in this area and winning in court.

Excess Business Losses: the new hurdle to deducting business losses.

Present law hurdles:

- Tax basis
- At Risk limitations
- Passive loss limitations

New limit: excess business losses!

- Married filing joint limit $500,000, single $250,000, for aggregate business losses (2018-2025).
- Excess is carried forward and allowed as an NOL deduction (80% taxable income limit). Applies at owner level.

New Partnership Audit Regime

- Treasury is implementing a **new partnership audit regime** in 2018.
- Will replace the **old TEFRA** audit rules for many partnerships.
- Consolidated Partnership Audit Regime **(CPAR)**
- **Shift** will be to partnership/LLC level audits and audit adjustments, including assessment of tax, penalties, interest.
- Process will **streamline IRS's ability** to audit partnerships and push a lot of the audit work onto the partnership and tax preparer from the IRS.
- **Election out of CPAR** is possible for some partnerships based on size and type of partner (less than 100, no trusts, LLC or some foreign owners).

New Partnership Audit Regime

- Another **way out of CPAR** is for partners to amend their returns. Will work if partnership can't elect out of CPAR.
- **Third way out of CPAR** is for partnership to provide adjusted K-1's and partners then compute adjustments at the partner level.

Summary of QBID

- **QBID**: Qualified Business Income Deduction
- **Applies to**: K-1 income, proprietorship, rentals.
- Computed at **owner level**.
- Computed **business by business**.
- **Limits** based on income and business type.
- Additional limits for **service businesses** (doctors, lawyers, accountants) but excludes architects and engineers –you have good lobbyists!
- Limits based on **wages paid or wages and property**.

New Section 199A:

- Limits:
- **Individual filers**: income below either $315,000 (joint) or $157,500 (single) deduction will be lesser of 20% of flow through income or flow through income less net capital gains.
- Limits based on income (**non-service business**) of $315,000 joint and $157,500 for single filers.
- **Wages or wages and property**. 50% of wages or 25% of wages plus 2.5% of unadjusted basis in depreciable property.
- **Additional limits** for service businesses: **complete** phase out of deduction above $415,00 joint return, $207,500 single filer.

New Section 199A:

- Service businesses: **owner taxable income greater than** $415,000 joint or $207,500 single then no QBID deduction.
- Service businesses: **owner taxable income below** $315,000 joint or $157,500 single then same limit as for non-service businesses, lesser of 20% of QBI or QBI less net capital gains.
- Service business **owners taxable income between** $315,000 and $415,000 joint and $157,500 and $207,500 single, QBID is phased out ratably.
- **High income individuals**, non-service businesses: taxable income above $415,000 joint or $207,500 single QBID is limited to the lesser of 20% of QBID or 50% of W-2 wages from the business or 25% of wages plus 2.5% of the unadjusted cost basis of business depreciable property.
- Planning point: **pay wages to get QBID** if limited and costs of payroll don't exceed potential QBID benefit.

New Section 199A:

- QB loss carryover **will limit QBID** in subsequent years.
- QBID applies to **rental real estate activities**, if business income. Significant precedence for business income treatment in 9th circuit.
- Owner wages in S Corporations qualify for **QBID wages**. LLC/partnership guaranteed payments do not qualify. S Corp's wages to owners reduce QBI so will need to try and optimize balance between wages and profit distributions. Sole proprietor profit is the key.
- Owners take into account their pro-rata share of **flow-through business wages.**

Example: MFJ (Taxable Income of $500,000, QBI of $200,000 Non-service business or A & E Business)

Tentative QBI S Corp pass-thru (200,000 x 20%)			$40,000
Wage limit (wages 60,000 x 50%)		$30,000	
Max wage limit effect (40,000 QBI vs. $30,000) (lesser of tentative QBI or 50% wages) wage limit < TQBI		$30,000	
Phase-in limit calculation			
Taxable income	$500,000		
Threshold	$315,000		
Wage phase-out effect	$185,000		
Phase-out range (subject to 50% wage limit < TQBI)	$100,000	100%	
Reduction to QBI deduction (lower of wage limit or QBI)			($10,000)
QBI deduction after phase in (lower wage limit or TQBI)			$30,000

Excess business losses

- Will impact HNW individuals who are funding business losses with **portfolio income**.

Example:

- Single Individual with $500,000 in portfolio income (interest, dividends, capital gains) funding a start up venture with flow through business losses of $500,000. Business loss limited to $250,000 so adjusted gross income is now $250,000 versus $0 under old rules. "**Excess loss**" of $250,000 carries forward and is deductible as NOL with 80% income limit in next/future years.
- Business loss allowed against wages. **Limit** really applies to limit offset against portfolio income.

Individuals

- Repeal of Affordable Care Act "**individual mandate**" after 2018. Saves over $300 billion in revenue due to lower government subsidy of health care. Needed by Congress to qualify the tax bill under reconciliation.

New limit on tax deductions:

- $10,000 annual limit on tax deduction for combined real property, state income tax, state sales tax and/or personal property taxes. Hits high tax states (NY, NJ, CA, etc.) hard.
- NY and other states are already looking at ways to ease the pain through shifting to payroll tax or converting tax to charitable contributions.

Individuals

- No deductions for **unreimbursed employee business expenses** through 2025. Planning point: reimburse employees for business expenses – business not limited and not compensation to employee if under an "accountable plan."

- **Entertainment deductions** eliminated including for direct business entertainment. Includes dues for business clubs (Rotary).
- No deduction for **seat upgrade fees** for college athletic events. The "Tyee" rule. Did you renew in December??
- **Gambling losses** still allowed to offset gambling income, but includes transportation expenses.

Individuals

- Modification to **Qualified Equity Grants**. Modified eligibility and coverage rules for options and RSU's to receive favorable tax treatment. Election to defer income for up to five years.
- **Personal exemptions** repealed through 2025.
- **AMT**: higher exemption: Joint return: $109,400, single: $70,300. Higher phase out for exemptions: $1.0 million joint, $500,000 single.
- **Charitable contributions** income limit increased: 60% AGI for cash donations. 80% deduction for college seating rights repealed.

Individuals

- **Medical Expense deduction** floor lowered to 7.5% of AGI through 2018.
- **Alimony payments** no longer deductible after 2018. No longer income to recipient.
- **Unreimbursed employee business expenses** no longer deductible, 2018-2025.
- **Rollovers** permitted from 529 plans to ABLE accounts without penalty. Beneficiary needs to be same for both accounts.
- **Employee achievements awards** of cash or cash equivalents taxable.

Estates

- Exclusion from federal estate and gift tax **doubled** to $10 million through 2025. Indexed amount for 2018 is approximately $11.2 million.
- **New tax tables** for estate and trust income. Please see above.
- GST exemption **also doubled** to $10 million (indexed as above) for 2018-2025.

Private Foundations

- New fringe benefit rules apply. If the benefits aren't treated as taxable compensation to the employees, then foundation must pay UBIT on the value.
- No net operating loss (NOL) carry back. Losses carried forward indefinitely. NOL may only reduce 80% of taxable income.
- Changes to unrelated business income tax (UBIT):
  - Corporate rate is now a flat 21% on all taxable income
  - Income from each "business line" is now segregated. Losses from one line cannot offset income from another. Additional guidance needed.

Impact on business valuation and transactions.

- Lower tax rates should increase value of businesses over time as after tax cash flows should rise. Stock market valuation rise since passage of tax reform as indication.
- Immediate impact may be to reduce current earnings due to a charge to reduce a deferred tax asset for NOL's, tax credits, unused interest expense (GE, GM, etc.). Long term impact positive.

Tax Rates - MFJ

Brackets – MFJ	Current Law
$0 - 18,650	10%
$18,650 - 75,900	15%
$75,900 - 153,100	25%
$153,100 - 233,500	28%
$233,500 - 416,700	33%
$416,700 - 470,700	35%
$470,700 - 600,000	39.6%
$600,000 - and up	39.6%

Tax Rates – Married Filing Jointly (2018 – 2025)

MFJ	Rate
Not over $19,050	10%
$19,050 – 77,400	12%
$77,400 – 165,000	22%
$165,000 – 315,000	24%
$315,000 – 400,000	32%
$400,000 - $600,000	35%
Over $600,000	37%

Tax Rates – (Single)

Brackets – Single	Current Law
$0 – 9,325	10%
$9,325 – 37,950	15%
$37,950 – 91,900	25%
$91,900 – 191,650	28%
$191,650 – 416,700	33%
$416,700 – 418,400	35%
$418,400 – 500,000	39.6%
$500,000 and up	39.6%

Single (2018 – 2025)

Single	Rate
Not over $9,525	10%
$9,525 – 38,700	12%
$38,700 – 82,500	22%
$82,500 – 157,500	24%
157,500 – 200,000	32%
$200,000 - $500,000	35%
Over $500,000	37%

Estates and Trusts (2018 – 2025) – Also "Kiddie Tax" on unearned income

Single	Rate
Not over $2,550	10%
$2,550 – 9,150	24%
$9,150 – 12,500	35%
Over $12,500	37%

Standard Deductions (2018 – 2025)

	Standard Deduction
Single	$12,000
HOH	$18,000
MFJ	$24,000

Comment: Standard deduction

	Current Law	Tax Reform
%Taxpayers Itemizing	30%	4%

*Based on house bill – "Tax reform" numbers will be a bit higher

Today's Presenters

Rick is a shareholder in the firm's tax practice. He has a diverse clientele, including professional service corporations and high net worth individuals.

Rick specializes in providing federal & state tax services to firms in the construction and manufacturing industries. He also represents clients before the IRS regarding penalty abatement, delinquent return filings, offers-in-compromise, and installment agreement negotiations.

His practice emphasis includes federal and state income tax planning for Subchapter C and S corporations, partnerships, LLC's and high net worth individuals. A special emphasis in on income and estate tax planning for closely held commercial businesses and their owners.

Richard W. Cooley

Tax Shareholder
Clark Nuber PS
rcooley@clarknuber.com

As a senior manager in the firm's tax practice, Brandi enjoys working with closely held pass-through entities and high net worth individuals. She finds that by working with entities and their owners, she is able to see the complete picture and provide the most appropriate tax advice to them.

Her practice emphasis includes reviewing and supervising preparation of pass-through federal & state income tax returns, specializing in the areas of real estate and hospitality, including managing large client groups. She provides tax planning, consulting and research for a variety of complex transactions and scenarios.

Brandi Fruik

Tax Senior Manager
Clark Nuber PS
bfruik@clarknuber.com