# Tax Reform Update

# What It Means to Business Owners

Davis Wright Tremaine LLP
DEFINING SUCCESS TOGETHER

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# Individual Tax Reform

# Individual Tax Reform

- Effective January 1, 2018
  - Sunsets after 2025
- Lower tax brackets
  - Top rate of 37% starting at $600K ($500K single)
- Personal exemptions are eliminated
- Child tax credit increase from $1K to $2K (refundable portion increased to $1,400)

# Individual Tax Reform

- Itemized deduction changes
  - Medical expenses – 7.5% of Adjusted Gross Income for 2017 & 2018
  - State/local taxes – income/sales/property taxes capped at $10K
  - Mortgage interest limited to $750K on new loans after December 15, 2017
    - Home Equity Line of Credit interest deduction is suspended

# Individual Tax Reform

- Itemized deduction changes
  - Charitable contributions
    - Increased to 60% of Adjusted Gross Income (from 50%)
    - Eliminated deduction for payments in exchange for athletic seating rights.
  - Miscellaneous 2% of Adjusted Gross Income deductions suspended
  - Pease limitation suspended (elimination of deduction phase out)
  - Standard deduction increased to $24K ($12K single)

# Case Study – Example 1: Charitable Strategy/SALT Reduction

- Married wage earners
  - Two adults, both working, no children
  - Renting
  - Wages = $250K/year

# Case Study – Example 1: Charitable Strategy / SALT Reduction

| **Working Couple(renting)** | **2017** | **2018** |
|---|---|---|
| Wages | 250,000 | 250,000 |
| Exemption | (8,100) | 0 |
| **Charitable contributions** | **(13,000)** | **(13,000)** |
| State tax deductions | (20,000) | ~~(20,000)~~ (10,000) |
| **Total itemized deductions** | (33,000) | (23,000)* |
| Standard deductions | (12,700) | (24,000) |
| Taxable income | 208,900 | 226,000 |
| **Federal tax** | **45,377** | **42,819** |

Planning opportunity to bundle charitable deductions for several years into one. Planning provides **$3,360 in federal savings** over two years in this example.

**Note this is less than the standard deduction. Charitable contributions do not provide any extra tax benefit.*

# Individual Tax Reform

- Other provisions
  - Sec. 529 Plans allow qualified distributions for elementary and high school tuition up to $10K annual limit
  - Tax on alimony and deduction eliminated for agreements executed after 2018
  - Alternative Minimum Tax is nominally retained with increased exemption of $109,400 ($70,300 single)
  - Roth Conversions still allowed, however recharacterizations are no longer available

# Individual Tax Reform

- Net operating losses (NOL)
  - Limited to 80% of income
    - Excess business losses limited to 90% of income
  - Unused NOLs carried forward indefinitely
  - Cannot be carried back
- Business losses are limited to $500K ($250K single)
  - Excess losses added to (NOL) carry forward
  - Pass-through entity loss limitations applied at the partner/shareholder level

# Case Study – Business Losses Example

- Husband is a sole proprietor; wife is an employee, and they have two grown children

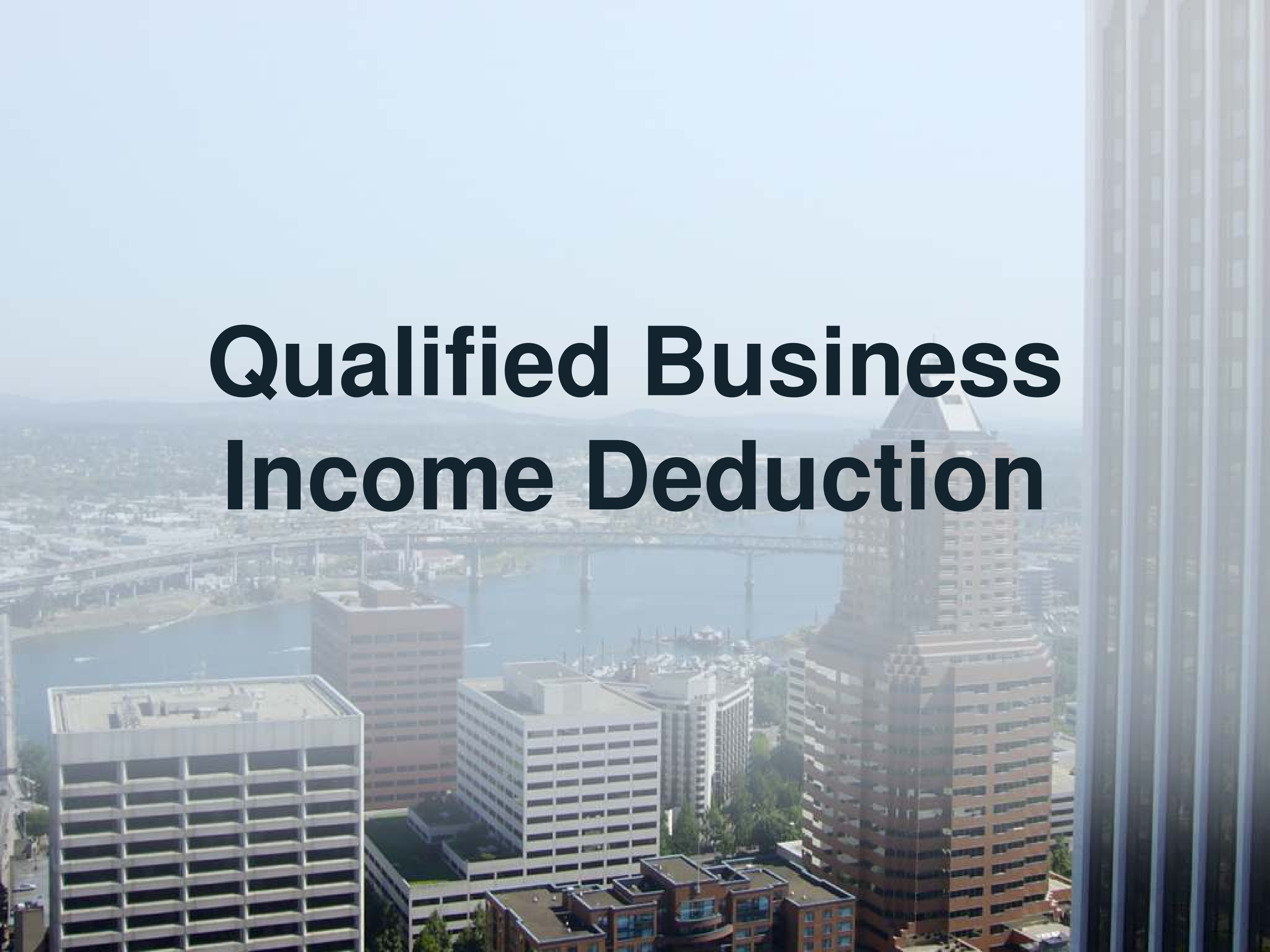
| **Income Source** | **2017** | **2018** |
|---|---:|---:|
| W2 Wages | $400,000 | $400,000 |
| Interest & Dividends | $25,000 | $25,000 |
| ST Capital Gains | $175,000 | $175,000 |
| Sch C Loss | ($600,000) | ($500,000) |
| **Total Income** | **$0** | **$100,000** |

# Case Study – Business Losses Example Cont'd

| **Federal** | **2017** | **2018** | **Difference** |
|---|---|---|---|
| Adjusted Gross Income | $0 | $100,000* | $100,000 |
| Personal Exemptions | ($16,200) | $0 | $16,200 |
| Itemized Deductions | ($59,500) | ($27,000) | $32,500 |
| Taxable Income | ($75,700) | $73,000 | $148,700 |
| **Income Tax** | **$0** | **$8,380** | **$8,380** |

*Schedule C losses limited to $500K
$100K NOL CF to 2019

# Qualified Business Income Deduction



# Qualified Business Income Deduction

- Deduction for qualified business income (QBI)
  - S corporations
  - Partnerships/LLCs
  - Sole proprietors
  - Trusts
- Deduction is applied to Adjusted Gross Income
- No material participation requirement

# Qualified Business Income Deduction

- QBI is any trade or business income <u>except</u> specified service businesses
  - Relies on reputation or skill of employees or owners
  - Exception does not apply if taxable income is less than $315K ($157,500 single) and phased out at taxable income of $415K ($207,500 single)
  - Excludes investment income other than qualified REIT dividends

# Qualified Business Income Deduction

- Deduction of 20% of QBI is limited to greater of:
  - 50% of W2 wages paid; or
  - 25% of W2 wages paid plus 2.5% of unadjusted basis of depreciable property
- Limitation does not apply if taxable income is less than $315K ($157,500 single) and phased out at taxable income of $415K ($207,500)
- Deduction is determined for each qualified business and combined to determine the net deduction

# Case Study – QB Income Example

› Single LLC business owner

| Federal | 2017 | 2018 | Difference |
|---|---:|---:|---:|
| LLC Income | $750,000 | $750,000 | $0 |
| SE Tax Deduction | ($17,930) | ($18,000) | ($70) |
| DPAD | ($65,890) | ($0) | $65,890 |
| Itemized Deductions | ($62,860) | ($15,000) | $47,860 |
| Qualified Income Deduction | ($0) | (143,400)* | ($143,400) |
| Taxable Income | $603,320 | $573,600 | ($29,720) |
| Tax Due | $194,740 | $175,480 | ($19,260) |

*QBI deduction is lesser of:
$750K LLC income x 20% = $150K
$1M allocable W2 wages x 50% = $500K or
$714K taxable income x 20% = $143.4K

# General Business Tax Reform

# General Business Tax Reform

- Accounting methods for small businesses with less than $25M in gross receipts
  - Cash basis
  - Inventory and UNICAP exceptions
  - Change in accounting method required
- Bonus depreciation
  - New <u>and</u> used property
  - 100% on assets placed in service between September 28, 2017 and December 31, 2022

# General Business Tax Reform

- Section 179 – $1M
  - Phase-out starting at $2.5M
- Real property depreciation
  - Qualified improvement property – 15 years*
  - Must use ADS lives if electing out of interest limitation
- Like-kind exchanges
  - Deferral only allowed on real property exchanges

*Congress inadvertently failed to add into Tax Cuts and Jobs Act (TCJA)

# General Business Tax Reform

- Carried interest gain subject to recharacterization to short-term capital gain unless:
  - Underlying asset has been held for at least 3 years; and
  - Partnership interest has been held for at least 3 years

# General Business Tax Reform

- Interest expense limitation
  - Deduction limited to 30% of taxable income before interest, depreciation and amortization expense
  - Disallowed deductions carry forward indefinitely
  - Double counting rule for pass through entities
  - Under $25M of gross receipts are exempt
  - Real property trades or business may elect out
- Domestic production activities deduction is eliminated

# General Business Tax Reform

- Research & Development expenses
  - Capitalized and amortized over five years starting January 1, 2022
- Miscellaneous expenses
  - Entertainment expenses fully nondeductible
  - All meals now 50% deductible
  - Qualified transportation fringe expenses for employees are nondeductible

# Corporate Tax Reform

# Corporate Tax Reform

- Effective January 1, 2018 without a sunset
- Flat 21% tax rate
  - Includes Professional Service Corporations (PSCs)
- Alternative Minimum Tax is eliminated
- Net operating losses (NOL)
  - Limited to 80% of income
  - Unused NOLs carried forward indefinitely
  - Cannot be carried back

# Case Study – Rate/DPAD Example

- ABC Corp is a manufacturer in Oregon

| | 2017 | 2018 | Difference |
|---|---|---|---|
| Gross Profit | $12,500,000 | $12,500,000 | $0 |
| Depreciation Expense | $350,000 | $350,000 | $0 |
| Interest Expense | $50,000 | $50,000 | $0 |
| Other Deductions | $5,500,000 | $5,500,000 | $0 |
| Net Income/(Loss) | $6,600,000 | $6,600,000 | $0 |
| DPAD | ($594,000) | $0 | $594,000 |
| Taxable Income | $6,006,000 | $6,600,000 | $594,000 |
| Tax Rate | 34% | 21% | |
| Tax Due | $2,042,040 | $1,386,000 | ($656,040) |

# Corporate Tax Reform

- C Corporation Conversions
  - Lower federal (and some state) tax rates
    - Loss of QBI deduction
  - Double taxation on dividends
    - Maximum effective rate of 39.8%
  - Deduction of state taxes
  - Impact on exit strategies
  - Foreign implications

# Corporate Tax Reform

- C Corporation Conversion Opportunities
  - Earnings reinvested to grow the business
  - Sec 1202 gain exclusion for small business stock
  - Foreign subsidiaries eligible for dividend received deduction
- C Corporation Conversion Dangers
  - Effective tax rates on QBI
    - As low as 29.6% (32.6% passive)
  - Flexibility of LLCs
  - Sale of business compared to S corp/LLC

# Corporate Tax Reform

- S-to-C Corporation Conversions
  - Occurring between December 22, 2017 and December 21, 2019
  - Identical ownership at conversion date
  - Distributions after 12 months prorata between accumulated adjustments account (AAA) and accumulated earnings & profits (AEP)

# Impact on Estate Planning

# Estate, Gift & GST Changes

- Exemptions
- Rates
- Duration of Law

# Estate, Gift & GST Changes

| | 2017 | 2018 | 2026 |
|---|---|---|---|
| **Individual** | $5.49M | $11.M* | $5.49M + inflation |
| **Couple** | $10.98M | $22.4M* | $10.98M + inflation |

- “Small, Medium and Large” Estates (as categorized by new Tax Law (under $11M, $11M-$22M & over $22M)

*Approximate – IRS to calculate and announce soon

# Estate, Gift & GST Changes

› New rates are here for 8 years
› December 31, 2025 is last day of new, current rates
› January 1, 2026 rates will return to 2017 law

# Oregon Estate Tax Facts

- Exemption
  - Individual $1M
  - Couple  $2M
  - No indexing for inflation, no portability
- Oregon Special Marital Property
  - Defers Oregon estate tax until death of surviving spouse (kids pay tax)
- Rates
  - 10-16%
  - 16% over $9.5M

# Washington Estate Tax Facts

- Exemption
  - Individual $2,193,000
  - Couple $4,386,000
  - Indexed for inflation, no portability
- Washington QTIP Election
  - Defer Washington estate tax until death of surviving spouse (kids pay tax)
- Rates
  - 10 – 20%
  - 20% over $9M

# Is the Income Tax the New Estate Tax?

- Income Tax Rates v. Estate Tax Rates
  - Federal 10% - 37%
  - Oregon 5% - 9.9%
  - Combined* 43%
  - *Net

  Estate Tax Rates
  - Federal 40%
  - Oregon 10 - 16%
  - Combined* 49.6%

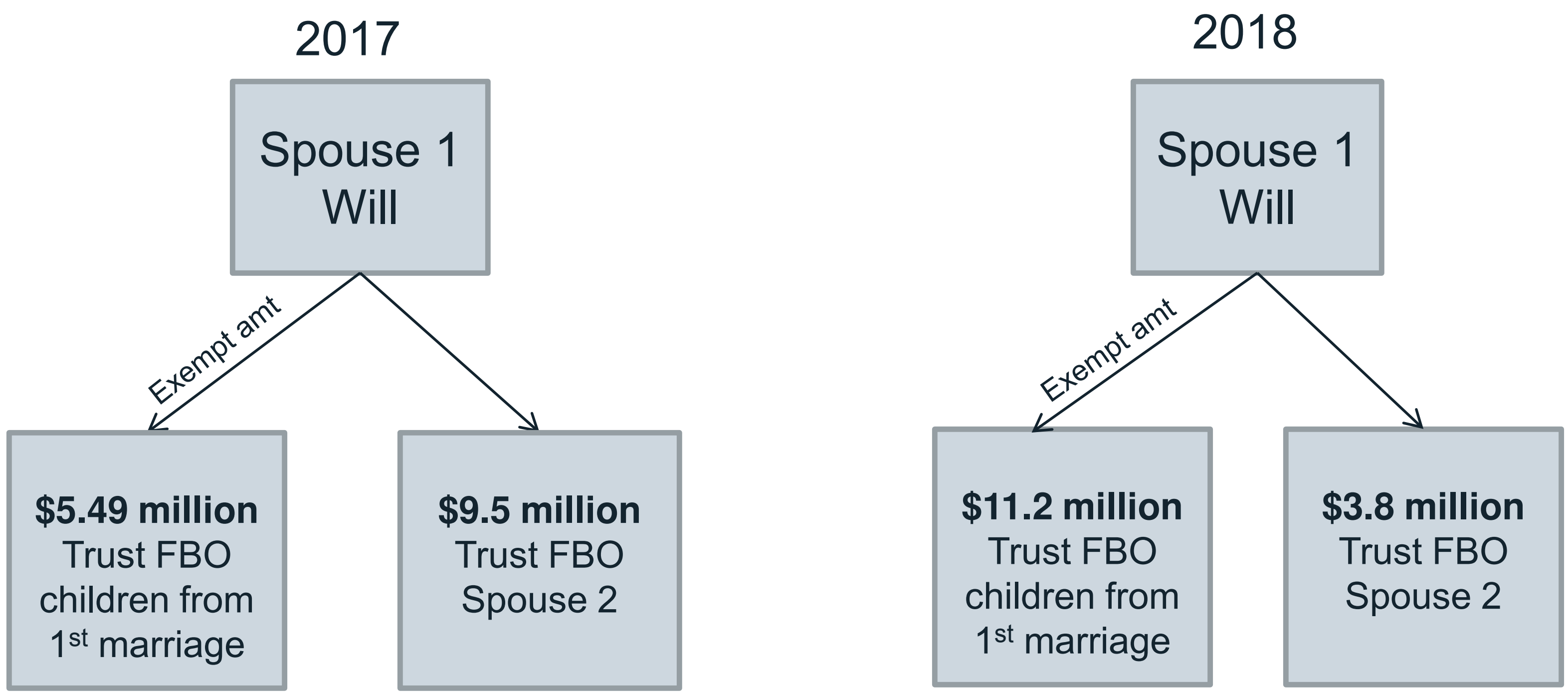
- ***But***, with high exemptions at Federal level, few people will pay estate tax while most all will pay income tax on sale of valuable assets
- Conclusion: Plan for stepped-up basis at death to avoid income tax if you are exempt from federal estate tax

# What to Do Now

- Review and Revise current plan
  - Does your current planning carry out your objectives?
    - A/B trust – mandatory allocations
    - Income tax consequences
  - Add flexibility to your plan to anticipate future changes
    - Portability for basis-step-up
    - Cascading Claytons
- Make Gifts
  - Repeat what you did in 2012 ("2012 on steroids")
  - Gift and/or sell more assets/value to trusts, children
  - Consider gifts to GST trusts ("generation skipping trusts") to avoid future estate taxation

# Issues with Your Old Plan - Allocations

› Married couple with $30M, 2nd marriage



# Issues with Your Old Plan – Income Tax

- Married couple with $30M

2017

Spouse 1 Will

Exempt amt

**$5.49 million Exemption Trust**
Excluded from Spouse 2's estate
Basis = 1st spouse DOD FMV

**$9.5 million Marital Trust FBO Spouse 2**
Included in Spouse 2's estate
Basis = 2nd spouse DOD FMV

2018

Spouse 1 Will

Exempt amt

**$11.2 million Exemption Trust**
Excluded from Spouse 2's estate
Basis = 1st spouse DOD FMV

**$3.8 million Marital Trust FBO Spouse 2**
Included in Spouse 2's estate
Basis = 2nd spouse DOD FMV

# What to Gift

- Good Assets to Gift
  - Cash
  - Notes
  - High basis assets
  - Assets likely to be retained for some time
- Bad Assets to Gift (if assets likely to be sold)
  - Low basis assets

# Differences Between Jurisdictions

- Oregon (income taxes, estate tax, no sales tax)
- Washington (sales tax, estate tax, no income taxes)
- Other (California, Nevada, etc.)
- "Live in Washington, shop in Oregon and die in California!"

# Estate, Gift & GST Changes

- Meghan developed a portfolio of valuable real estate held in multiple LLCs worth $25M
- Fred and Meghan (ages 60 & 55) have a large home and other assets worth $5M
- They have 3 children, all adults, and 2 minor grandchildren
- Fred supports his 80-year-old mother who’s not in great health

# Clawback Concerns?

- What if you make gifts between 2018-2025, then die after exemption reverts to 2017 levels?
- Possibility that your estate will include amounts gifted in excess of $5.49M. Most think this is unlikely.
- In general, benefit from gifting if you have a taxable estate.
- But, could be a concern if after gifting there are no assets remaining or estate has highly liquid assets.

# Estate, Gift & GST Changes

| | No Gift | Gift, Clawback | Gift, No Clawback |
|---|---|---|---|
| Gross Estate | $30M | $30M | $30M |
| Exemption used | $10.98M | $10.98M | $10.98M |
| Exemption remaining | $11.42M | $11.42M | $11.42M |
| 2018-2025 gifts | $0 | $11.42M | $11.42M |
| Fed. Gross Estate | $30M | $18.58M | $18.58M |
| Fed. Estate Tax | $10.3M | $10.7M | $6.5M |
| OR Taxable Estate | $28M | $16.58M | $16.58M |
| OR Estate Tax | $4.2M | $2.3M | $2.3M |
| **Total Estate Tax** | **$14.5M** | **$13.9M** | **$8.8M** |

# Questions?

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