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# Tax Reform Update: What It Means to Business Owners

February 6, 2018



# 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 \$1,000 to \$2,000 (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
- Own home but no mortgage
- Wages = \$250K/year



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



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

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



# Estate Tax Reform



- › Lifetime gift and estate tax exemption and Generation Skipping Tax exemption increased to (presumably) \$11.2M for 2018
- › No change to Washington and Oregon state estate tax exemption of \$2M and \$1M, respectively



# **Pass-Through Income Tax Reform**

# Pass-Through Income 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	<u>(\$600,000)</u>	<u>(\$500,000)</u>
<b>Total Income</b>	<b>\$0</b>	<b>\$100,000</b>



# Case Study – Business Losses Example

## Cont'd



<b>Federal</b>	<b>2017</b>	<b>2018</b>	<b>Difference</b>
Adjusted Gross Income	\$0	\$100,000*	\$100,000
Personal Exemptions	(\$16,200)	\$0	\$16,200
Itemized Deductions	<u>(\$19,500)</u>	<u>(\$24,000)</u>	<u>(\$4,500)</u>
Taxable Income	(\$35,700)	\$76,000	\$111,700
<b>Income Tax</b>	<b>\$0</b>	<b>\$8,740</b>	<b>\$8,740</b>

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

# 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 except 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	(\$7,860)	(\$15,000)	\$47,860
Qualified Income Deduction	<u>(\$0)</u>	<u>(143,400)*</u>	<u>(\$143,400)</u>
Taxable Income	\$658,320	\$573,600	(\$84,720)
Tax Due	\$216,520	\$177,920	(\$38,600)

\*QBI deduction is lesser of:  
\$750K LLC income x 20% = \$150K  
\$717K taxable income x 20% = \$143K



# **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 and 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



# 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

	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	<u>\$5,500,000</u>	<u>\$5,500,000</u>	<u>\$0</u>
Net Income/(Loss)	\$6,600,000	\$6,600,000	\$0
DPAD	<u>(\$594,000)</u>	<u>\$0</u>	<u>\$594,000</u>
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)



# Questions?



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