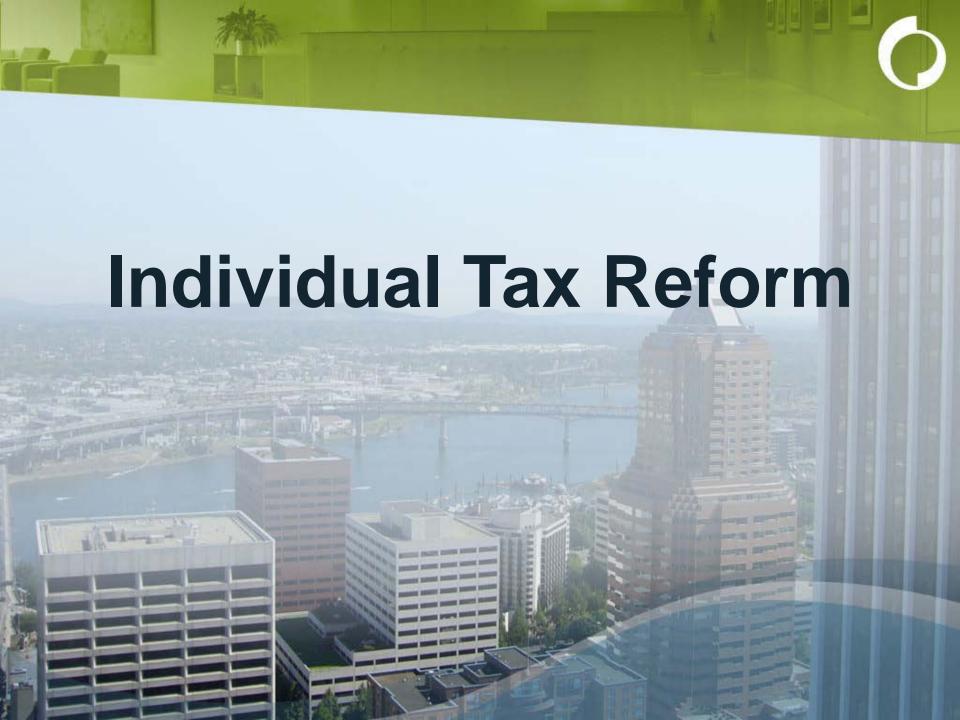


# Tax Reform Update: What It Means to Business Owners

February 6, 2018





- > 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)



- > 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



- > 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



## 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)
Property tax deductions	(20,000)	<del>(20,000)</del> (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.

<sup>\*</sup>Note this is less than the standard deduction. Charitable contributions do not provide any extra tax benefit.



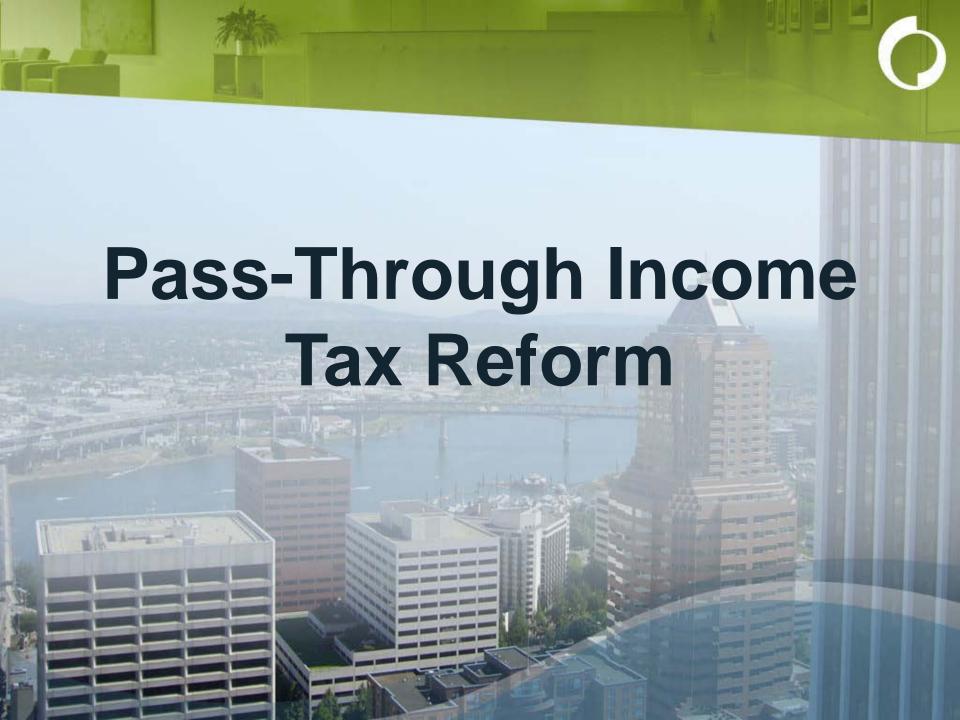
#### Other provisions

- 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



- 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>	(\$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	(\$19,500)	(\$24,000)	(\$4,500)
Taxable Income	(\$35,700)	\$76,000	\$111,700
Income Tax	\$0	\$8,740	\$8,740

### 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



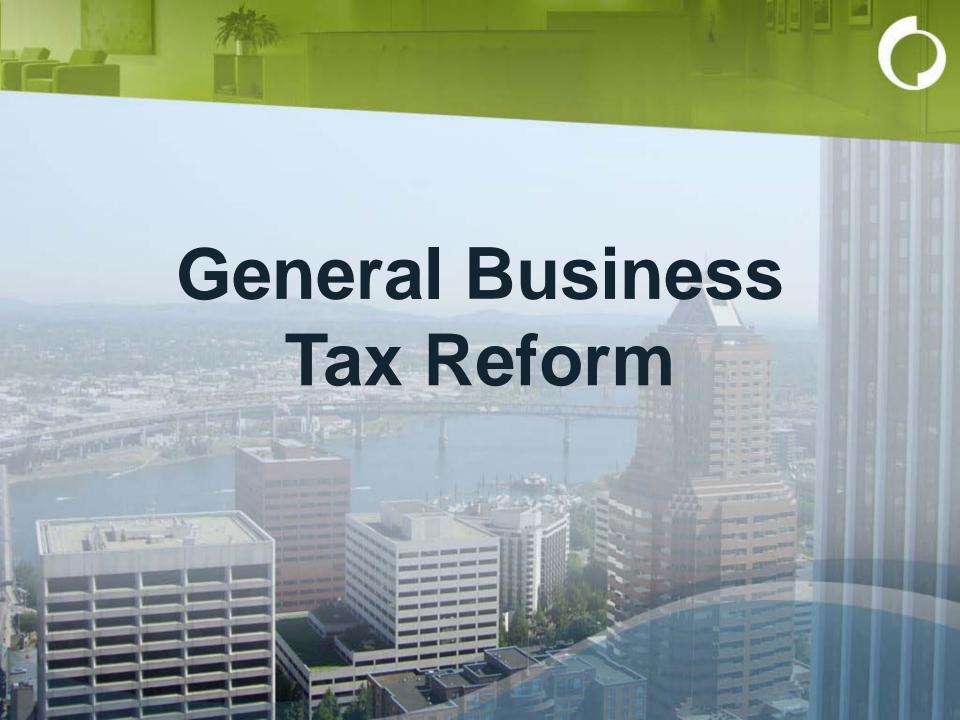
- > Deduction of 20% of QBI is limited to greater of:
  - 50% of W2 wages paid; or
  - 25% of W2 wages paid plus 2.5% of unadjusted basis of depreciable property
- Limitation does not apply if taxable income is less than \$315K (\$157,500 single) and phased out at taxable income of \$415K (\$207,500)
- 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	(\$7,860)	(\$15,000)	\$47,860
Qualified Income Deduction	<u>(\$0)</u>	(143,400)*	(\$143,400)
Taxable Income	\$658,320	\$573,600	(\$84,720)
Tax Due	\$216,520	\$177,920	(\$38,600)





- 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



- > 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



- 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



- 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



- > 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





- > 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

## O

#### > 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	(\$594,000)	<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)



- 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



- 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



- > 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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