Analysis of the Tax Cuts & Jobs Act of 2017

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Unified Framework For Fixing Our Broken Tax Code

- On September 27, 2017, the framework of the "Big Six" group of Congressional and White House tax-reform precepts was released. The document is titled "Unified Framework For Fixing Our Broken Tax Code."
- President Trump lays out four principles for tax reform:

1. Make the tax code simple, fair, and easy to understand.
2. Give American workers a pay raise by allowing them to keep more of their hard-earned paychecks.
3. Make America the jobs magnet of the world by leveling the playing field for American businesses and workers.
4. Bring back trillions of dollars that are currently kept offshore to reinvest in the American economy.

The stated aim is to create a fairer system that levels the playing field and extends economic opportunities to American workers, small businesses, and middle-income families.

Timing

- President Trump signed the Tax Cuts and Jobs Act into law on December 22, 2017.
- As you will see, there will be technical corrections and clarifications needed.
- Passing a technical corrections bill will require 60 votes in the Senate, meaning 9 Democratic Senators will need to vote for the bill.
- We need guidance SOON. 1st quarter estimated payments for 2018 are right around the corner.

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Evolution of the Tax Cuts

	House	**Senate**	**Final**
Corporate/Business Tax Changes	($846)	($697)	($653)
S Corp/Partnership/Sole Proprietorship Changes	($448)	($460)	($414)
International Tax Changes	$277	$104	$324
Estate Tax Changes	($172)	($94)	($83)
Remaining Individual Tax Changes	($224)	($348)	($629)
Total	**($1,413)**	**($1,495)**	**($1,456)**

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The Tax Cuts & Jobs Act

- IT IS IMPORTANT TO NOTE THAT ALL INDIVIDUAL CHANGES, THE ESTATE TAX CHANGES, AND THE CHANGES TO INDIVIDUAL LEVEL ALTERNATIVE MINIMUM TAX WILL EXPIRE ON DECEMBER 31, 2025.

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The Tax Cuts & Jobs Act Estate & GST Taxes

- The base exclusion amount exempt from estate and gift tax will be doubled from the 2011 $5M (as indexed for inflation to $5.6M in 2018) to $10M (also indexed for inflation and $11.2M in 2018).
- As such, with portability a couple will be able to effectively shield $22.4M from estate taxes beginning in 2018.
- WA estate tax exclusion unchanged

The Tax Cuts & Jobs Act

Single Individuals Income Tax Rates

If taxable income is:	The tax is:
Not over $9,525	10% of taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

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The Tax Cuts & Jobs Act

Married Filing Jointly and Surviving Spouse Income Tax Rates	
If taxable income is:	**The tax is:**
Not over $19,050	10% of taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000

The Tax Cuts & Jobs Act

Head of Household Income Tax Rates

If taxable income is:	The tax is:
Not over $13,600	10% of taxable income
Over $13,600 but not over $51,800	$1,360 plus 12% of the excess over $13,600
Over $51,800 but not over $82,500	$5,944 plus 22% of the excess over $51,800
Over $82,500 but not over $157,500	$12,698 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$30,698 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$44,298 plus 35% of the excess over $200,000
Over $500,000	$149,298 plus 37% of the excess over $500,000

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The Tax Cuts & Jobs Act

Married Filing Separate Income Tax Rates

If taxable income is:	The tax is:
Not over $9,525	10% of taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $300,000	$45,689.50 plus 35% of the excess over $200,000
Over $300,000	$80,689.50 plus 37% of the excess over $300,000

The Tax Cuts & Jobs Act
Standard Deductions/Personal Exemptions

- The standard deduction is increased to $24,000 for joint filers, $12,000 for individuals, and $18,000 for head of household.
- Personal exemptions are eliminated.
- Thus reduces those individuals itemizing by 90%.

The Tax Cuts & Jobs Act
New Tax Credit & Enhanced Child Tax Credit

- Child tax credit has increased from $1,000 to $2,000.
- The income phase out levels are increased so that the credits are phased out beginning at income levels of $200,000 for single filers and $400,000 for joint filers.
- The Act would limit the refundable amount of the child tax credit to $1,400.

The Tax Cuts & Jobs Act Deductions for AGI

- Repeals deductions for:
  - Alimony payments (for decrees finalized after 12/31/2018); will not be included in income of the recipient.
  - Moving expenses.
  - Section 199 Deduction (Domestic Production Activity Deduction). Deduction was 9% of income; available to manufacturing, construction, architecture, engineering, and other producers.

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The Tax Cuts & Jobs Act
Itemized Deductions

- The overall limitation on itemized deductions has been repealed meaning no more phase outs of itemized deductions!
- Changes to mortgage interest limitations:
  - Old Limit:
    - Interest is deductible $1,000,000 of home acquisition debt
    - $100,000 of interest for home equity debt is deductible.
  - New Limit:
    - Entered into after December 15th, 2017 Interest deductible on up to $750,000 of acquisition debt.
    - Interest expense related to home equity debt is not deductible unless qualified as another form of deductible interest.

The Tax Cuts & Jobs Act Itemized Deductions

- State and local tax changes:
  - Can only deduct a TOTAL of $10,000 of:
    - Real estate taxes, plus
    - State and local income taxes, plus
    - State and local personal property taxes, plus
    - General sales tax.
  - This doesn't apply to real estate taxes incurred in a trade or business activity or a Section 212 activity (i.e. investment property).
    - Thus, you can still deduct real estate taxes on a rental property.
  - This $10,000 limit ($5,000 if MFS) is NOT indexed for inflation.

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The Tax Cuts & Jobs Act Itemized Deductions

- Other Miscellaneous Deductions: No longer deductible. Things like:
  - **Unreimbursed employee expenses**
  - Tax preparation fees
  - Investment advisory expenses
- Casualty Losses:
  - Moving forward, we will only be allowed to claim a casualty loss deduction if the casualty is recognized in a federally declared disaster area.
- Medical Expenses:
  - Allowable subject to a 7.5% of AGI floor in 2017 and 2018
  - Allowable subject to a 10% of AGI floor in 2019-2025

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The Tax Cuts & Jobs Act Deductions

- Rules for charitable contributions are changed so that:
  - Prior limitation of 50% of adjusted gross income for cash contributions to charities becomes 60%.
  - The charitable deduction of 80% of the amount paid to a college or university for the right to purchase tickets for athletic events is terminated; (i.e. UW or WSU football tickets).

The Tax Cuts & Jobs Act Other Repealed Provisions

- Entertainment expenses are no longer deductible.
- Meals provided for the convenience of the employer (on the premises) that are nontaxable to the employee as a de minimis fringe benefit are now only 50% deductible (previously 100% deductible).
  - These will become wholly nondeductible after 2025.
- The expense of providing a qualified transportation fringe unless they're under an accountable plan (these are still tax-free to the employee).
- Technical terminations of partnerships (50% change in ownership triggers this). This means stub period returns for 50% or more ownership changes are no longer required.

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The Tax Cuts & Jobs Act Accounting Methods

- If average gross receipts are less than $25M (over the past three years, see Section 448), you can now:
  - Be on the cash method even if you are a C corporation or a partnership with a C corporation partner.
  - Be on the cash method even if you have inventory.
  - Avoid Section 263A (complex calculation that capitalizes a portion of overhead costs to inventory).
  - Use the completed contract method instead of percentage-of-completion to account for long-term contracts.
  - These will be automatic changes made by filing a Form 3115 with the 2018 income tax return.

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The Tax Cuts & Jobs Act Like-Kind Exchanges

- The rules are changed to allow for like-kind exchanges only with respect to real property.
  - Like kind exchanges are deferrals of gains on asset disposals as long as they are sold within like kind exchange rules.
  - No longer applies to vehicles or equipment.
- Transition rule:
  - If an exchange is in process by 12/31/2017 then it is allowed.

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The Tax Cuts & Jobs Act
Individual Alternative Minimum Tax (AMT)

- AMT will apply to less individuals with higher exemption amounts & exemption phase out amounts (phase out now begins at $500k for unmarried, $1M for married, up from $113k and $150k respectively).
- Also consider, most of the unfavorable AMT adjustments are gone:
  - Personal exemptions
  - State and local income taxes
  - Other miscellaneous itemized deductions

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The Tax Cuts & Jobs Act Hidden Revenue Raiser

- Old way for inflation: CPI indexes.
- New Way: “Chained CPI”, which will cause slower increases to tax brackets and phase outs year to year.

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Maximum deduction of 20% of income generated by sole proprietorships, most rentals, partnerships, S corporations, estates and trusts.
- Deduction is not available for specified service businesses unless under certain income thresholds.
- Does not reduce self-employment income taxes.
- No adjustment for Alternative Minimum Tax (AMT).
- Taxpayers can receive a 20% deduction from income from Real Estate Investment Trust (REIT) dividends and publicly traded partnership (PTP) income taxed at ordinary rates.

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Unless the business is specifically excluded by the specified service business definition, all trades or businesses qualify:
- Examples:
  - Restaurants
  - Manufacturers
  - Construction/Contractors
  - Retailers/Wholesalers
  - Tech firms
  - Hotels
  - Software developers

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- The service, W-2, and capital asset based limitations do NOT apply if taxable income is less than:
  - $315,000 if married,
  - $157,500 for all other taxpayers.
- The limitations are "phased-in" over the next:
  - $100,000 of income if married,
  - $50,000 of income for all other taxpayers.

The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- What is "qualified business income (QBI)?"
  - Income taxed at ordinary rates from a sole proprietorship, rental property, S corporation, partnership, estate, or trust.
  - Does not include:
    - Interest income
    - Dividend income
    - Long-term capital gain
    - Short-term capital gain
    - Income that is not effectively connected with a U.S. trade or business

The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction Limitations

- The deduction is 20% of QBI limited to the GREATER of:

  1. 50% of W-2 wages, OR
  2. 25% of W-2 wages plus 2.5% of original cost of depreciable property

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction Limitations

- 2.5% of original cost of depreciable property
  - Cost is included until the later of:
    - 10 years, or
    - Last year of depreciable recovery period
    - Does not include land
    - Must be owned at the end of the year

The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction Limitations

- Limited by Taxable Income:
  - The total deduction is then subject to an overall limitation equal to 20% of the excess of:
    - The taxable income for the year, over
    - The sum of net capital gain
    - By imposing this overall limitation, it ensures that the 20% deduction is not taken against income that is taxed at preferential tax rates.
  - Example: In 2018, A, a married taxpayer, has $100,000 of QBI, $100,000 of long-term cap gain, and $30,000 of itemized deductions, for total taxable income of $170,000. A's tentative Section 199A deduction is $20,000 (20% * $100,000). The deduction is limited, however, to 20% of taxable income ($170,000) in excess of net capital gain ($100,000), or $70,000. Thus, A's deduction for 2018 is reduced to $14,000.

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The Tax Cuts & Jobs Act
Sec. 199A: Changes in Effective Tax Rate

Tax Rates	199A Reduction	Effective Rate
10%	80%	8.0%
12%	80%	9.6%
22%	80%	17.6%
24%	80%	19.2%
32%	80%	25.6%
35%	80%	28.0%
37%	80%	29.6%

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- What is a "specified service business" that is not eligible for the deduction?
  - Section 199A references Section 1202(e)(3)(A), which states:
    - "any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees."
  - Then, Section 199A does the following:
    - Removes architects and engineers from the list of disqualified businesses.
    - Adds the following as disqualified businesses: investing and investing management, trading, or dealing in securities, partnership interests, or commodities.

The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Problems with the catch-all:
  - While Section 199A uses the term "specified *service* trade or business" to describe tis disqualified businesses, the language of the catch-all found in Section 1202(e)(3)(A) does not require that the taxpayer be providing services; rather, it merely requires that the principal asset of the business be the reputation or skill of its employees or owners.
  - Consider, then, a taxpayer who constructs made-to-order artisan woodworking for customers. This is clearly not a service business, but if customers come from far and wide to purchase custom products from the taxpayer, is the principal asset of the business the skill or reputation of the owner of the business? Or is it the finished product?

The Tax Cuts & Jobs Act 20% "Pass-Through" Deduction: Case Study

- Is there a big problem with the new Section 199A deduction?
- Based on a strict interpretation of the statute, it doesn't treat all business owners and entity types equally.
- Consider the following fact pattern:
  - H&W own a business. W is the key officer of the business and H is merely a co-owner.
  - The business builds and sells a product.
  - The business has no employees; rather, they gets by with the help of a few independent contractors.
  - The business has no substantial fixed assets.
  - Assume that in 2018, the business generates $500,000 of ordinary income. Assume further that this is also A's taxable income on his 2018 return. Let's look at how W's deduction varies depending on how he chooses to operate his business:

The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

Sole proprietorship:

- With income of $500,000 reported on Schedule C, W would begin the process of computing his deduction by simply multiplying his qualified business income (QBI) of $500,000 by 20%, yielding a tentative deduction of $100,000.
- The deduction, however, is limited to 50% of the W-2 wages paid by the business. H&W is a sole proprietorship and cannot pay W wages, and because there are no other employees, the business has no W-2 wages; as a result, the "50% of W-2 Wages" limitation is $0. In addition, because H&W's taxable income is above the top threshold of $415,000, the limitation applies in full.
- **Thus, A gets no deduction in 2018.**

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The Tax Cuts & Jobs Act 20% "Pass-Through" Deduction: Case Study

S Corporation:

- To comply with the "reasonable compensation" requirement, W pays herself $125,000 in wages during 2018. This reduces her flow-through income from $500,000 to $375,000.
- In computing QBI, Section 199A(c)(4) provides that QBI does not include "reasonable compensation paid to the taxpayer." This has been widely interpreted -- and I have shared the same view -- to mean that the $125,000 of wages W receives and reports on his Form 1040 are not included in his calculation of QBI and are thus not eligible for the 20% deduction.
- Thus, W is entitled to **claim a deduction of $62,500**, equal to the LESSER OF:
  - his QBI deduction of $75,000 ($375,000 * 20%), or
  - his W-2 limitation of $62,500 ($125,000 *50%).

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

Partnership:

- W pays herself a guaranteed payment of $125,000 in 2018, the same salary she drew in the S corporation scenario. This reduces flow-through income from $500,000 to $375,000.
- In computing QBI, Section 199A(c)(4) similarly provides that QBI does not include "any guaranteed payment...paid to a partner for services." As with the S corporation wages, this has been widely interpreted to mean that the $125,000 of guaranteed payments W receives and reports on the Form 1040 are not included in his calculation of QBI and are thus not eligible for the 20% deduction.
- W's QBI is $375,000, and the tentative deduction is $75,000.
- The deduction is limited, however, to 50% of the W-2 wages paid by the partnership. In this case, the partnership paid no W-2 wages, as guaranteed payments are NOT wages for these purposes. As a result, A's "50% of W-2 Wages" limitation is $0, and **W is entitled to no deduction.**

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

	Sole Proprietorship	S Corporation	Partnership
Business Income	$ 500,000	$ 500,000	$ 500,000
W-2 Wages	n/a	$ (125,000)	
Guaranteed Payments	n/a	n/a	$ (125,000)
Net Income	$ 500,000	$ 375,000	$ 375,000
QBI	$ 500,000	$ 375,000	$ 375,000
Tentative deduction (20% of QBI)	$ 100,000	$ 75,000	$ 75,000
50% of W-2 limitation	$ -	$ 62,500	$ -
Final Deduction	**$ -**	**$ 62,500**	**$ -**

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

- Now, consider this fact pattern:
  - Assume instead that in 2018, the same business laid out in the last Case Study generates $200,000 of ordinary income. Assume further that this is also H&W's taxable income on his 2018 return. Let's look at how W's deduction varies depending on how she chooses to operate her business.

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

- **Sole Proprietorship:**
  - With income of $200,000 reported on Schedule C, W's tentative deduction is $40,000.
  - Because W's taxable income is below the threshold of $315,000, the W-2 limitation does not apply. As a result, W gets a full deduction of $40,000 in 2018.

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

- **S Corporation**
  - Even with income of only $200,000, W is required to take reasonable compensation. Assume she pays herself $80,000; this reduces her flow-through income from $200,000 to $120,000. This reduces the QBI eligible for the 20% deduction to $120,000, W's tentative deduction becomes $24,000 (20% * $120,000). Because W's taxable income is less than the $315,000 threshold, the W-2 limitations do not apply.
  - Thus, W is entitled to claim a deduction of $24,000.

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20% "Pass-Through" Deduction: Case Study

- **Partnership**
  - Partnerships do not require guaranteed payments for services, so in this scenario, it would be best not to pay one since guaranteed payments are not QBI. This now mirrors the sole proprietorship scenario.
  - As with the previous two situations, the W-2 limitation does not apply, and W receives a deduction of $40,000.

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The Tax Cuts & Jobs Act
20% "Pass-Through" Deduction: Case Study

Summary:

	Sole Proprietorship	S Corporation	Partnership
Business income	$ 200,000	$ 200,000	$ 200,000
W-2 Wages	n/a	$ (80,000)	
Guaranteed Payments	n/a	n/a	
Net Income	$ 200,000	$ 120,000	$ 200,000
QBI	$ 200,000	$ 120,000	$ 200,000
Tentative Deduction (20% of QBI)	$ 40,000	$ 24,000	$ 40,000
50% of W-2 Limitation	n/a	n/a	n/a
Final Deduction	**$ 40,000**	**$ 24,000**	**$ 40,000**

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The Tax Cuts & Jobs Act
Netting of Income & Losses in Section 199A

- Netting of income/losses in Section 199A:
  - Must determine qualified business income for EACH separate qualified business.
  - QBI is NOT required to be a positive number.
  - Then, you start the process of claiming the deduction by taking 20% of qualified business income. Again, the rules do NOT say that the deduction must be a positive number, only that it be LESS than the W-2 limitations.
  - This indicates that you can generate a “negative deduction” from one business to reduce or offset a positive deduction.

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The Tax Cuts & Jobs Act
Sec. 199A Loss Carryovers

- 199A Losses carryover to subsequent years to offset future deductions.
- Example: In 2018, A is allocated qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B. A is not permitted a deduction under Section 199A in 2018 and has a carryover qualified business loss of $30,000 to 2019.
- In 2019, A has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the Section 199A deduction for 2019, A reduces the 20% deductible amount determined for the qualified business income of $70,000 ($14,000) from qualified businesses A and B by 20% of the $30,000 ($6,000) carryover business loss. Thus, A is entitled to a deduction of $8,000 in 2019.

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Problems with structuring around "specified service business" designation.
  - Many businesses are talking about "packing," (i.e., inserting qualifying businesses into disqualified businesses.
  - For example, a law firm acquires commercial building to get into the rental business.
  - Or a famous actress launches a skin care line.
  - Will this work?

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Section 1202 requires only that a disqualified business be "involved in the performance of services."
- Section 199A is determined on a business-by-business basis. So the IRS would likely carve out the law firm income and make that disqualified.

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The Tax Cuts & Jobs Act
Sec. 199A: 20% "Pass-Through" Deduction

- Another option is "cracking." You break apart a qualified business from a disqualified business.
- For example, a group of doctors forms a new entity to handle all of the human resources, billing, accounting, etc. for the doctors.
- Is this new business not in the field of health?
- Section 448 regulations state that providing administrative and support services to a disqualifying business will cause the corporation to be a personal service corporation.
- Might future guidance on Section 199A say the same thing, killing the "cracking idea?"

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The Tax Cuts & Jobs Act
Problems with the Wage Limitation

- Problems with the W-2 wage limitation:
  - What to do about leased employees/professional employer organizations/common paymasters?
    - It does not appear that a grouping regime is coming.
    - Regulations will dictate how W-2 wages are allocated among businesses.
  - What to do about shareholder compensation?
    - If shareholder compensation is included in the W-2 wage limitation, it would advantage S corporation owners relative to sole proprietors when income exceeds the threshold.

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The Tax Cuts & Jobs Act
Interest Deduction

- New Interest Deduction Limitation (Section 163(j)):
- DOES NOT APPLY WHEN REVENUE IS LESS THAN $25M
  - Net interest expense is only deductible to the extent of 30% of "adjusted taxable income"
  - Investment interest expense is not included for limitation
  - Any excess nondeductible interest expense can be carried forward indefinitely
  - Floor plan financing interest (motor vehicle dealerships) interest does not apply

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The Tax Cuts & Jobs Act
Interest Deduction

- Adjusted taxable income is taxable income BEFORE:
  - Any nonbusiness income/deduction/gain/loss,
  - Any business interest expense or income
  - Any net operating loss deduction
  - Any depreciation, amortization, or depletion deductions. (through 12/31/2021)
  - Section 199A deduction

The Tax Cuts & Jobs Act
Interest Deduction

- Example: For 2018, Corporation X has $100,000 of adjusted taxable income, $2,000 of business interest income, and $12,000 of business interest expense. It has no floor plan financing interest.
- X can deduct all $12,000 of its business interest expense, because that's less than the sum of its $2,000 of business interest income plus 30% of its adjusted taxable income (30% × $100,000 = $30,000).

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The Tax Cuts & Jobs Act
Interest Deduction

- For flow-through entities, the limitation is first applied at the entity level.
- Then, at the individual level, the limitation applies again, but you have to take 30% of YOUR income into consideration without adding in your share of the business income (avoids double counting of the same income for purposes of computing the limitation).

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The Tax Cuts & Jobs Act
Interest Deduction

- Doesn’t apply to electing “real property trades or businesses” with a significant trade-off for this election
- These businesses include the following:
  - Real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.
  - Hotels should qualify per Committee Report
- At the taxpayer's election, the business interest limitation doesn't apply to such trades or businesses, but depreciation is calculated using Alternative Depreciation System, which means no bonus depreciation, slower rates, and longer lives.

The Tax Cuts & Jobs Act
Limitation on Excess Losses

- "Excess business losses" of a taxpayer other than a corporation are not allowed.
- Loss limitation is $500,000 (if MFJ, $250,000 if single).
- It works like this: After a loss from an entity runs through:
  - The basis limitation rules of Sections 1366 or Section 704,
  - The at-risk limitation rules of Section 465, and
  - The passive activity rules of Section 469,
- Next, any loss that's allowable has to be netted with other losses and any income from a trade or business, and if the loss exceeds $500,000 (or $250,000 if single), the excess loss is not allowed in the current year.
- It becomes part of your NOL, which as we'll discuss later, is only allowable to the extent of 80% of taxable income in future years.

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The Tax Cuts & Jobs Act
Limitation on Excess Losses

- Example: Joe hits it big, selling a business for $50 million. He invests some of the proceeds, generating $1 million in investment income in 2018. He gets restless, and invests another chunk of money into a new partnership, which kicks off a loss of $800,000 to him in 2018.
- Before Section 461(l) was added to the Code, Joe would have been entitled to deduct the full $800,000 loss against his $1,000,000 of investment income.
- In 2018, however, only $500,000 of the loss will be available to reduce Joe's $1,000,000 of investment income. As a result, Joe has taxable income of $500,000, and the $300,000 "excess loss" becomes a net operating loss that Joe carries forward to 2019.

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The Tax Cuts & Jobs Act
Net Operating Losses (NOLs)

- Beginning with losses generated in 2018, no carrybacks are allowed.
- Carryforwards of losses generated in years beginning after 1/1/2018 are limited to offsetting 80% of taxable income.
  - This means that a taxpayer will have to differentiate between pre- and post-2018 NOLs when utilizing them in future years.
  - They can be carried forward indefinitely.
- This limit applies to both corporate and individual NOLs, so when you combine this with the limitation on “excess business losses” under Section 461(l), this will really hurt some individuals.

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The Tax Cuts & Jobs Act Corporate Tax Rate

- The corporate tax rate will be a flat 21% rate
- Personal service corporations would be subject to a flat 21% corporate tax rate, down from the current 35%. A personal service corporation is a corporation the principal activity of which is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting
- Fiscal year corporations straddling 1/1/2018 will have to do a straddle computation (35% * full year) = tax + (21% * full year) = tax
  - Then take each tax and multiply it by applicable portion of year, add up total.

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The Tax Cuts & Jobs Act
Corporate AMT

- Completely eliminated
- Huge win for big businesses (i.e. C corps w/ $50M+ in sales) taking general business credits such as Research and Development Credit, Work Opportunity Tax Credit, and TIP Credit

Golden Era of C Corporations?

- Each situation requires careful, individual analysis based on business composition, income generated, exit plan.

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Golden Era of C Corporations?

- Another thing to consider: Only C corporations are eligible for Qualified Small Business Stock '1202 stock' benefits.
  - Gain from the sale of this type of stock eligible for 100% exclusion (subject to limitations)
  - MUST be a C corporation
  - Must have assets less than $50M
  - <u>Can't be a service business (accounting, law, etc…)</u>
  - Must acquire stock at original issuance
  - Must be held for at least 5 years
- If you couple Section 1202 with lowered rates on corporate income and still-reduced rates on dividend income, suddenly C corporations look pretty good!

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Golden Era of C Corporations?

Assume a shareholder is considering a new business, and will invest $500,000. It will earn $200K annually, distribute half its earnings as a dividend, and the s/h expects the business to be worth $3M in five years.

- 2007 Landscape:
- Corporate rate: 34%
- Dividend rate: 15%
- Section 1202: limited benefit (50% exclusion but remaining 50% taxed at 28%)

1. Entity-level tax: $1,000,000 * 34% = $340,000
2. Dividend tax: $500,000 * 15% = $75,000
3. Tax on sale of stock: $2,500,000 * 14% effective 1202 rate = $350,000

TOTAL TAX OVER LIFECYCLE: $765,000

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Golden Era of C Corporations?

2018 Landscape

- Corporate rate: 21%
- Dividend rate: 23.8%
- Section 1202: 100% exclusion

1. Entity-level tax: $1,000,000 * 21% = $210,000
2. Dividend tax: $500,000 * 23.8% = $119,000
3. Tax on sale of stock: $0!

TOTAL TAX OVER LIFECYCLE: $329,000

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The Tax Cuts & Jobs Act Changes to Depreciation

- Qualified leasehold and retail improvements, qualified restaurant property have all been replaced by “qualified improvement property.” This was intended to have a 15 year depreciable life, but is currently 39 year unless a technical correction is passed.
- What is qualified improvement property?
  - Improvements made to the interior portion of nonresidential property anytime after the building has been placed in service.
  - Unlike the prior class of assets, there is no:
    - Lease requirement
    - Related party rules
    - Requirement that the improvement be made more than 3 years after building placed in service

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The Tax Cuts & Jobs Act 100% Expensing

- Taxpayers are able to fully expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain qualified property with a longer production period)
- No income limitations
- Then there will be a phase out period of four years:
  - 2023: 80%
  - 2024: 60%
  - 2025: 40%
  - 2026: 20%
  - 2027: 0%

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The Tax Cuts & Jobs Act
100% Expensing

- 100% expensing will apply to:
  - Any asset with a regular depreciation life of 20 years or less
  - Computer software
  - Qualified improvement property (if technical correction is made)
- It will not be allowable on assets depreciated using the ADS method.
- There is no longer a requirement that the asset be new; it must simply be the first use by the taxpayer.

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The Tax Cuts & Jobs Act
100% Expensing

- Depreciation of listed property:
  - for passenger autos with a weight of less than 6,000 lbs.
    - $10,000 for year 1
    - $16,000 for year 2
    - $9,600 for year 3
    - $5,760 for all other years until fully depreciated
  - If you claim 100% expensing, you can take an additional $8,000 for year 1 on listed property.
  - If you purchase an SUV (weight > 6,000 lbs.) the luxury auto rules don't apply. You can deduct the FULL COST in year 1 under the bonus depreciation rules.

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The Tax Cuts & Jobs Act
Section 179 Expansion

- Section 179 is increased to $1 million. Subject to taxable income limitations (bonus is better!)
- Phase-out of qualified assets starts at $2,500,000
- Qualified improvement property is eligible
- Can also now take Section 179 on:
  - Roofs
  - HVAC
  - Fire protection and alarm systems,
  - Security systems

The Tax Cuts & Jobs Act
Other Partnership Changes

- Change to "carried interest" rules
  - If you receive a profits interest in an investment partnership, and are allocated capital gains, you only get LTCG for those assets that were held by the partnership for longer than THREE years.
  - Investment partnership:
    - Consists of raising or returning capital, and EITHER
      - – investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or
      - – developing specified assets (securities, commodities, real estate, cash, options, partnership interests, etc…)

The Tax Cuts & Jobs Act Compensation Changes

- Section 83(i): In limited circumstances, an employee who exercises a nonqualified stock option or is granted restricted stock to settle a RSU can elect to defer the recognition of income until the EARLIER OF:
  - The date the stock becomes transferrable
  - The date the employee ceases to be an employee
  - The date the corporation goes public
  - Five years from vesting, or
  - The date the employee revokes the election.
- The AMOUNT of income is still determined on the earlier of:
  - The date the stock is transferable, or
  - No longer subject to a substantial risk of forfeiture
- Payroll taxes will still be due on the earlier of vesting/transferability

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The Tax Cuts & Jobs Act Compensation Changes

- Example: On January 18, 2018, A exercises the right to purchase $10,000 worth of X Co stock for $2,000. The stock vests on January 18, 2020 but is not transferable 2027.
- Assume when the stock vests in 2020, it is worth $15,000. If a Section 83(i) election is made in 2020 (upon vesting), A can defer the $13,000 of income ($15,000 FMV upon vesting less $2,000 exercise price) until the EARLIER OF:
  - The date the stock becomes transferable (2027)
  - The date A ceases to be an employee (assume never)
  - The date X Co. goes public (assume never)
  - The date X Co. revokes the election (assume never)
  - Five years from the date of vesting (2025)
- Thus, A can defer his $13,000 of income until 2025. Under current law, it would have to be recognized in 2020.

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The Tax Cuts & Jobs Act Compensation Changes

- Qualified employee: one who isn't:
  - A 1% owner
  - The current or former CEO
  - Related to one of the above
  - One of the four highest compensated employees
- Eligible corporation:
  - Stock is not publicly traded
  - The corporation has a written plan under which at least 80% of employees are granted options or RSUs under the same terms

International Provisions

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Revenue Raiser

	House	Senate	Final
Corporate/Business Tax Changes	($846)	($697)	($653)
S Corp/Partnership/Sole Proprietorship Changes	($448)	($460)	($414)
International Tax Changes	$277	$104	$324
Estate Tax Changes	($172)	($94)	($83)
Remaining Individual Tax Changes	($224)	($348)	($629)
Total	**($1,413)**	**($1,495)**	**($1,456)**

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Impacts to US Taxpayers

- Switch taxation of multi-national corporations (MNC) to a hybrid territorial system
  - Participation exemption
  - Transition tax
- Reduce incentives to keep money offshore
- Keep intangible property in the US
- Imposes a minimum tax on non-routine offshore earnings

IC-DISC: Retained!

- IC-DISC is a tax incentive available to manufacturers, producers, resellers, and exporters of goods that are produced in the United States with an ultimate destination outside the United States
- Under the IC-DISC structure, income from the IC-DISC is taxed as qualified dividend at max rate of 23.8%
- Under the original Senate bill, IC-DISC provisions would have been repealed effective 1/1/2018
- Ultimately saved under the reconciled bill

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Sale of U.S. Partnership Interest

- Revenue Ruling 91-32
  - Look through to the underlying assets to determine whether the sale of interest is US effectively connected income (ECI)
- Grecian Mining Case- 2017
  - Tax court ignored RR 91-32
  - Foreign partners not subject to US tax on sale of partnership interest
- Added Section 864(c)(8)
  - Follows RR 91-32
  - For sales after 11/26/2017- must look through to the partnership assets to determine whether there is US ECI
- Updated Section 1446 withholdings
  - Mimics FIRPTA withholding for sale of US real estate
  - For sale after 12/31/2017- 10% withholding tax required by buyer unless the seller can certify US residency status
  - If buyer fail to withhold, the partnership is required to withhold from distributions to the buyer equal to the required withholding amount

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Participation Exemption- Sec. 245A

- Old Rules-
  - Worldwide taxation
  - Foreign income is deferred from taxation until repatriation

- New Rules-
  - Beginning in 2018, 100% dividend received deduction is available for foreign dividends
  - Dividends must be from specified 10% owned foreign corporation
  - Only applicable to C-Corporations
  - DRD not available to hybrid dividends
  - No foreign tax credit or deduction allowed for foreign taxed paid on the dividends

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Deemed Repatriation/Transition Tax- Sec. 965

- To transition into a territorial system- AE&P purge
  - Taxed at reduced rate- cash or its equivalents 15.5% ; other 8%
  - Further guidance is needed to determine whether individuals would get these rates as well
- US shareholders of foreign corporation that has E&P, will have deemed repatriation of AE&P.
- This one-time tax is included on the 2017 tax return of calendar year tax payers
- For fiscal year taxpayers, tax is included on the return for the year that begins before 1/1/2018
  - Ex.- 6/30 FYE: tax due on the return for the period 7/1/2017 to 6/30/2018
- E&P measurement dates- greater of
  - 11/2/2017 or
  - 12/31/2017

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Foreign Bank and Financial Accounts Reporting- FinCEN 114

- Required for accounts with an aggregate of more than $10,000 at any time during the year
- Any account that the taxpayer owns **OR** has signatory authority over has to be reported
- Business foreign bank account- the entity has to file one and any employees who can sign or wire funds from the account must file a separate Form 114
- Due April 15th, but can be extended until October 15th
- When in doubt, file and report!
  - Penalty- $10,000 per form

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The Tax Cuts & Jobs Act

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