THE EFFECTS OF TAX REFORM

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On December 22, Congress passed the Tax Cuts and Jobs Act, making tax reform a reality. Having taken effect on January 1, 2018, it is important to understand how you and/or your business will be impacted. The following summary highlights major changes for individuals, businesses, international operations, and trusts and estates.

Individuals

First things first: Is your tax liability increasing or decreasing? The answer is not as simple as you might think. Under current law, there are seven tax brackets, with the highest bracket at 39.6%. Under the new law, the seven brackets are retained with the highest being 37%, but your liability may not decrease due to repeal or reduction of certain deductions. There are many provisions that will change the outcome of your tax bill, beginning in 2018.

The bill aims to simplify the filing process for individuals by reducing the number of calculations involved. In order to do this, the deductibility of many items was reduced or eliminated. For example, the deduction for state and local taxes, including state income tax, sales tax, and property tax, has been limited to a maximum of $10,000. The new law also eliminates the deduction for interest on home equity debt and decreases the limit on acquisition debt to $750,000. The deduction for mortgage interest was previously limited to $1 million of acquisition debt plus $100,000 of home equity debt. However, the new law retains the $1 million limit for debt acquired before December 15, 2017. Additionally, the deduction for alimony paid has been repealed and alimony received is no longer taxable income for divorce or separation agreements executed after December 31, 2018. Miscellaneous itemized deductions, such as employee business expenses and investment advisory fees, have also been eliminated.

To offset some of the lost deductions, the new law significantly increases the standard deduction. For married individuals filing jointly, the deduction was increased from $12,700 in 2017 to $24,000 in 2018. For those filing single, the deduction was increased from $6,350 to $12,000. This means that many people who previously itemized their deductions will now benefit from taking the standard deduction and their tax return will be simplified by not having to keep track of their itemized deductions. However, it is also important to note that all personal exemptions are eliminated. You will no longer be able to claim the personal exemption of $4,050 for yourself or any of your dependents.

While many were hoping the Alternative Minimum Tax (AMT) would be repealed, it remains intact for individuals. However, there is a silver lining. The new law temporarily increases the AMT exemption and phase-out amounts for individuals to a level that will prevent the imposition of AMT on most individuals.

The child tax credit is increased to $2,000 and the phase-out income level is increased to $400,000 for married taxpayers filing jointly. In addition, a $500 nonrefundable credit is available for non-child dependents.

The new law will limit the deductibility of net operating losses (NOL). In 2017 there is no limit on NOLs, but under the new law, net operating losses are limited to offsetting a maximum of 80% of taxable income and can no longer be carried back to previous years. However, NOLs can now be carried forward indefinitely. There is an exception that allows a one year carryback of losses related to certain natural disasters.

Additionally, the amount of pass-through business losses will be limited. This means that business losses that exceed a total of $500,000 if married or $250,000 if single will no longer be deductible in the year the loss is generated. The losses will be carried forward and treated as a net operating loss deductible up to 80% of taxable income in future years. This rule will expire at the end of 2025 and applies to losses passed through from the entity to the owners (e.g. Schedule C business, Schedule E rentals, and Partnership and S corporation K-1s).

Although the new tax law does not directly address The Affordable Care Act, it does repeal the individual insurance mandate. However, the 3.8% Net Investment Income Tax and the 0.9% additional Medicare tax remain.

Businesses

Many businesses will experience major changes when filing their 2018 tax return. The new law reduces the corporate tax rate from a maximum rate of 35% to a flat 21% rate and repeals the corporate AMT. The 21% rate will include personal service corporations. The new law also reduces the dividends received deductions of 80% and 70% to 65% and 50% respectively.

There is a substantial tax benefit given to owners of "pass-through entities," such as Schedule C sole proprietorships or LLCs, Schedule E rentals (LLC or owned individually), and flow through entities like partnerships and S corporations. The ordinary income (not capital gains or investment income) from these businesses may now be eligible for a deduction of up to 20% of the taxable income from each separate entity. For taxpayers with taxable income under $315,000 for joint, and $157,500 for single, there are no limitations to this deduction and 20% of the ordinary income generated from these activities will avoid income tax. For taxpayers above those income thresholds, there are limitations to the deduction. The deduction is limited to the lesser of 20% of income or 50% of W-2 wages paid by the entity. An alternative to the 50% of W-2 wages test is 25% of W-2 wages and 2.5% of the original cost of depreciable assets used in the business that will help landlords, who typically use management companies in lieu of employees on payroll. The deduction does not apply to specified service businesses (health, law, consulting, accounting, or financial or brokerage services) unless taxable income is below the phase-out thresholds, which runs from $315,000 to $415,000 for married filers and $157,500 to $207,500 for singles. These amounts will be adjusted annually for inflation. In the past, architecture and engineering has been considered a personal service business, but for the purposes of this deduction, they are not included as a specified service business and can take this deduction.

Examples:

A construction business operating as an S corporation earns $1M of ordinary taxable income in the year and included in that $1M of profit is $2M of W-2 wages paid to its employees. The deduction would be the lesser of:

1) 20% of $1M net income or $200k
2) 50% of $2M of wages or $1M

Since $200k is less than $1M the deduction is $200k. At the top marginal tax rate, the taxpayer would pay tax on $800k of income at the 37% top tax rate, or $296,000. This creates an effective rate of 29.6% on the $1M of taxable income.

Rental Real Estate:

An LLC earning $1M of net rental income pays zero wages since the LLC uses a management company. The cost of the building, not including land cost, owned by the LLC originally cost $3M. The deduction is the lesser of:

- 20% of the $1M net income or $200k

Or the greater of:

- 50% of wages is $0
- 25% of wages or $0 plus 2.5% of the $3M building or $75k for a total of $75k

Therefore, you will compare $200k to the greater of $0 or $75k, and the lesser of the two becomes the deduction. In this case, $75k of rental income will avoid income tax.

The law also redefines a "Small Taxpayer." Prior to the new law passing, the cash method of accounting was only available to C corporations with less than $5 million in average gross receipts and pass-through entities with less than $10 million in average gross receipts. Under the new law, this amount is increased to $25 million – making the cash method available to considerably more businesses. This new threshold also applies to the uniform capitalization rules (263A) for businesses with inventory.

Contractors with average gross receipts under $25 million will also no longer be subject to the percentage of completion rules. In 2017, all contractors with average gross receipts over $10 million are subject to the percentage of completion method. Contractors will still be subject to the percentage of completion rules for AMT purposes.

Businesses will also see a big change to the deductibility of interest expense. In 2017 there is no limit on the amount of interest expense that can be deducted. This will change in 2018. From January 1, 2018, to December 31, 2021, the deduction will be limited to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA). Beginning January 1, 2022, the same percentage will apply to earnings before interest and taxes (EBIT). Businesses with less than $25 million gross receipts will be exempt from the limitation and there is also an exception for real estate trades and businesses.

Additionally, the new law allows for 100% bonus depreciation of assets acquired after September 27, 2017. So instead of depreciating assets over several years, businesses will be able to deduct 100% of the cost. Unlike previous law, there is no limit on how much can be deducted

and the assets acquired can be new or used. This provision however, will begin to phase out 20% each year beginning in 2023 until it is completely phased out in 2027.

After 2017, the Act eliminates deduction for entertainment, club membership dues or recreation expenses. The current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria.

There is also a new law allowing a credit for employers who offer paid family and medical leave. The credit will be between 12.5% and 25% but will expire after 2019. In order to be eligible for the credit, employers must offer at least two weeks paid family and medical leave and the employee must receive at least 50% of their normal wages during their time on leave. Any employee earning more than $72,000 annually will not qualify for the employer credit.

Repeals

One major repeal was the deduction for Domestic Production Activities, which was 9% under the current law. This is significant for manufacturers, contractors, architects, and engineers who relied on the large deduction, but they will be eligible for the 20% business income deduction discussed previously which should be of greater benefit overall.

Also repealed is the use of like-kind exchanges to defer income on the sale of personal property assets. Real property will still be eligible for like-kind exchange and any exchanges for which there was a binding written agreement prior to December 31, 2017 will be allowed. However, this will not apply if the real property is held primarily available for sale.

Trusts and Estates

Estates and trusts have four new tax brackets with a maximum tax rate of 37%. Previously, the highest tax rate was 39.6% starting with income over $12,400. The estate tax exemption for married taxpayers filing jointly has been increased from $10.98 million to $22.4 million. The exclusion for Washington State is not affected by the new federal law and will be limited to $2,193,000 per person for 2018.

The kiddie tax, which aligns the child's income tax with the parent's tax return, still applies. However, instead of waiting for parents to file their return, the new trust rates apply to the child's income directly and the child will be able to file his or her income tax return prior to his or her parents.

Trusts and estates will also be allowed the 20% deduction, applied in the same manner as pass-through entities.

Additionally, there is a provision in the new law allowing nonresident aliens to be a beneficiary of an electing small business trust. Prior to January 1, 2018, nonresident aliens were precluded from being beneficiaries. This provision is made permanent and will not terminate in 2025.

International

The Tax Reform Act included far-reaching changes to US international tax rules. The Act imposes a one-time deemed repatriation tax on accumulated, untaxed earnings of foreign corporations. Prior to the Tax Reform Act, foreign earnings were generally not subject to U.S. taxation until repatriation of funds. The earnings held as cash or cash equivalents are taxed at 15.5% and all other earnings are taxed at a rate of 8%. A US shareholder may elect to pay its net tax liability on the deemed repatriation in eight installments. This one-time tax applies to domestic entities and US individuals with ownership in foreign corporations.

Overturning a recent court case, the new bill states that a non-US partner in a US partnership is generally considered to be engaged in US trade or business if the partnership is conducting trade or business in the US. Under the new rules, gain or loss from the sale or exchange on or after November 27, 2017 of a partnership interest effectively connected with a US trade or business must be computed as if the partnership sold all of its assets at fair market value on the date of transaction. For sales or exchanges after December 31, 2017, the transferee must withhold 10% of the amount realized on the transaction, unless the transferor provides documentation for a domestic individual or entity.

Many new income classifications were included in the bill that affect multi-national corporations. Global intangible low-tax income (GILTI) is one of the new categories of income that ended the deferral of taxation on foreign earnings. Generally, GILTI income is the excess income of foreign subsidiaries over a 10% rate of return on specified tangible business assets. GILTI income is included in the income of US shareholders. A US domestic corporate shareholder will generally be able to take a deduction on the GILTI amount and claim a reduced foreign tax credit. The deduction is 50% of the GILTI amount from 2018 to 2025, limited by the taxable income. Combined with the corporate tax rate of 21%, the effective tax rate for GILTI income for 2018 to 2025 is about 10.5%.

Foreign derived intangible income (FDII) is a new type of income category for US corporations. FDII is generally income from sale of property to a foreign person for foreign use, a license of IP to a foreign person for foreign use, and services provided to a person located outside the US. US corporations are required to include FDII in gross income, but will be allowed a deduction on the FDII. For 2018 to 2025, the deduction is 37.5%.

Foreign property taxes are deductible only when paid or accrued in carrying on a trade or business or for the production of income. Foreign property taxes are not deductible as an itemized deduction.

Important: The individual, estate, and trust provisions will expire at the end of 2025, while the corporate and international laws are permanent.

Overall, new tax legislation, including the Tax Cuts and Jobs Act, provides an opportunity for careful planning and strategic maneuvering. Now more than ever, it is important for individuals and businesses to work closely with knowledgeable tax professionals for optimal results. Please contact your BP advisor to discuss how the new tax law directly impacts you. We're here to help!