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TAX REFORM: IMPACT ON BUSINESSES AND INDIVIDUALS

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The 2017 Tax Act

- Signed into law on December 22, 2017
- Provisions apply NOW – to taxable years beginning after December 31, 2017
- Corporate and International Changes are “permanent;” almost all individual changes (including the new 20% deduction applicable to pass-through entities and sole proprietors) expire December 31, 2025
- The volume of new rules coupled with the speed with which the Act went through the legislative process has left practitioners and taxpayers scrambling to learn, understand and plan
- Will likely need corrections but enacting any corrective legislation will be very difficult with the current Congress (would either need 60 votes or would have to use budget reconciliation process (again) – using budget reconciliation will come with challenges (e.g., will likely not be a budget resolution before Spring, 2018 at the earliest; provisions have to have a “revenue effect”)
- No JCT Bluebook yet – only have House, Senate and Conference Committee “Explanations”

Significant Corporate Changes

- Permanent reduction in corporate tax rate from 35% to 21%
- No special rate for personal service corporations
- Repeal of Corporate AMT
- 80% dividends received deduction reduced to 65%; 70% dividends received deduction reduced to 50%
- NOLs incurred in taxable years starting after 12/31/2017 limited to 80% of taxable income; no carryback of such NOLs, but now unlimited carryforward
- Expanded availability of cash method

New Pass-through Deduction

- **Who can claim the deduction?** *Sole proprietors and owners of pass-through entities*
- **What is the amount of the deduction?**
- 20% of qualified business income for each “qualified trade or business,” subject to the W-2 wage and qualified property limitation, *plus*
- 20% of any qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income

New Pass-through Deduction (*Continued*)

- **What type of income is eligible for the deduction?**
- Must be effectively connected with a qualified U.S. trade or business
- NOT short-term and long-term capital gains and losses, dividends and dividend equivalents, certain commodity gains and losses, certain foreign currency gains and losses, certain notional principal contract income, and interest income or annuity income that is not business related;
- NOT “reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business, (which essentially means wage income),” IRC § 707(c) guaranteed payments for services, and non-partner capacity payments (under regulations)

Pass-through Deduction – Limitations

- If a taxpayer has less than \$315,000 (married filing jointly) or \$157,000 (all other filers) of taxable income before the deduction, the two main limitations on the deduction do not apply; however, the limitations are phased in over the next \$100,000 (or \$50,000) of taxable income
- **TWO MAIN LIMITATIONS:**
- **(1) Qualified trade or business does not include:**
 - A specified service trade or business, or
 - The trade or business of performing services as an employee

Pass-through Deduction – Limitations (Cont'd)

- A specified service trade or business is any trade or business:
 - Involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financials services, or brokerage services (this list specifically excludes engineering and architecture), OR
 - Where the principal asset of such trade or business is the **reputation or skill of one or more of its owners or employees**, OR
 - Which involves the performance of services that consist of investing and investment management, trading, or dealing in: Securities (as defined in IRC § 475(c)(2)), Commodities (as defined in IRC § 475(e)(2)), or partnership interests

Second Limitation – W-2 Wages and Qualified Investment Cap

- The deductible amount for each qualified trade or business is limited to the greater of:
 - 50% of W-2 wages with respect to the qualified trade or business, or
 - 25% of W-2 wages, plus 2.5% of the unadjusted basis of qualified property immediately after acquisition of all qualified property
- W-2 wages - with respect to any person for any taxable year, the amounts paid by such person with respect to employment of employees during the calendar year ending during such taxable year (and reported to SSA) and allocable to the QBI
- Qualified property - tangible property that is subject to depreciation

Pass-through Deduction – Overall Limitation

- Once the taxpayer computes the deduction, there is an overall limitation that applies. The deduction is equal to the LESSER of:
 - The combined qualified business income of the taxpayer (deductible amount for each qualified trade or business plus 20% of aggregate amount of qualified REIT dividends plus qualified PTP income) OR
 - 20% of the excess of taxable income minus the sum of any net capital gain
 - Why? To avoid allowing the deduction against capital gain income already taxed at 23.8% (20% capital gain rate plus 3.8% Net Investment Income Tax)

How might companies re-structure/re-think to take better advantage of pass-through deduction?

- If the W-2 Wage and Qualified Property cap would otherwise limit a company's ability to utilize the pass-through deduction: **consideration should be given to re-structuring independent contractor relationships as employment relationships**
- The W-2 Wage and Qualified Property cap does not apply to the 20% deduction applicable to qualified REIT dividends or qualified publicly traded partnership income; ***if this cap would otherwise limit the deduction and the entity is eligible, consideration should be given to operating as a REIT or PTP***
- If the deduction is unavailable because the pass-through is operating a specified service business but the entity is also operating a second business that is not a specified service business or the entity is operating an ancillary service, it is not entirely clear how the deduction applies – how are these businesses/activities grouped? **Consideration should be given to separating out a business/activity to which the deduction is available**

Excess Business Losses

- Taxpayers other than C corporations are NOT allowed to deduct “excess business loss”
- “Excess business loss” is an overall loss in excess of \$500,000 for married individuals filing jointly or \$250,000 for other individuals
- Carried forward indefinitely as an NOL under section 172 (which, under the new rules, are limited to 80% of taxable income); no carryback
- Applies at the partner/S-corp shareholder level
- Applies after the passive loss rules are applied
- SIGNIFICANT change – can no longer use excess active losses against other income (e.g., salary income, fee income, portfolio income).

INDIVIDUAL TAX CHANGES

Individual Tax Rates and Brackets

- Tax rates were reduced in all 7 tax brackets and the income levels triggering an upward adjustment have been increased.
- Reduction of the highest marginal rate from 39.4% to 37%.
- The income ranges defining each bracket will be adjusted by the chained consumer price index (CPI) measure of inflation.
- Net investment income tax of 3.8% continues to apply to joint filers with over \$250,000 of income (\$200,000 for single filers).
- The new brackets, rates and income levels expire on Dec. 31, 2025.

Capital Gains and Dividends

- The Act does not change the taxation of capital gains and qualified dividends or the tax rates, but the income levels at which the 15% and 20% rates apply were altered (and will be adjusted for inflation after 2018).
- For 2018, the 15% rate will start at \$77,200 for married taxpayers filing jointly, \$51,700 for heads of household, and \$38,600 for other individuals. The 20% rate will start at \$479,000 for married taxpayers filing jointly, \$452,400 for heads of household, and \$425,800 for single individuals.

Deductions

- The personal exemption has been eliminated and replaced with higher standard deductions.
- The standard deduction rises to \$12,000 for single filers, to \$18,000 for heads of household and to \$24,000 for joint filers.
- These amounts are up from \$6,500, \$9,550 and \$13,000 from last year.
- The overall limitation on itemized deductions has been eliminated through 2025, although certain itemized deductions have been limited on an individual basis.

State and Local Tax Deductions

- Individuals are no longer allowed unlimited deductions for state and local taxes.
- Individuals are allowed to deduct up to \$10,000 in state and local income or property taxes (\$5,000 for married taxpayers filing separately).
- The conference report on the bill specifies that taxpayers cannot take a deduction in 2017 for prepaid 2018 state income taxes.
- It is anticipated that these changes may trigger an increased number of taxpayers attempting to establish residency in states with lower taxes and 1031 like-kind exchanges.
- States with high taxes are looking for potential workarounds, such as allowing a charitable deductions to reduce state taxes.

Limitations on Home Mortgage Interest and Home Equity Debt

- For mortgages taken out after December 14, 2017, individuals may only deduct interest on the first \$750,000 of mortgage debt. Previously, taxpayers could deduct interest on up to \$1 million of mortgage debt plus \$100,000 of home equity debt.
- Interest on home equity loans is no longer deductible. This affects interest on all home equity loans even if the loan was taken out before December 15, 2017.

Miscellaneous Itemized Deductions

- All miscellaneous itemized deductions subject to the 2% AGI floor are disallowed through 2025.
- These deductions include unreimbursed employee expenses, investment management expenses and tax preparation fees.

Moving Expenses

- Under prior law, an employee could exclude qualified moving expense reimbursements from gross income or deduct qualified moving expenses that were not reimbursed.
- The Act suspends both the exclusion or moving expense reimbursements and the deduction for unreimbursed moving expenses for taxable years 2018 through 2025.
- However, the moving expense exclusions and deductions remain for members of the Armed Forces (or their spouses or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

Alimony

- Alimony and separate maintenance payments are not deductible by the spouse making such payments under any divorce or separation agreement executed after Dec. 31, 2018.
- The Act also repealed the provisions requiring these payments be included in income by the recipient.

Child Tax Credit

- Under prior law, the credit was worth up to \$1,000 per qualifying child, was refundable for taxpayers with earned income of at least \$3,000, and phased out (decreased) for taxpayers with AGI above \$75,000 (\$110,000 for joint filers).
- The Act doubles the credit amount but limits the refundable portion to \$1,400, which is adjusted for inflation after 2018. The credit begins to phase out for taxpayers with AGI above \$200,000 (\$400,000 for joint filers).

Alternative Minimum Tax

- The Act retains the AMT, but increases the exemption.
- The AMT exemption amount increases to \$109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return) and \$70,300 for all other taxpayers (other than estates and trusts).
- The phaseout thresholds are increased to \$1 million for married taxpayers filing a joint return and \$500,000 for all other taxpayers (other than estates and trusts).
- The exemption and threshold amounts will be indexed for inflation.

Estate, Gift and Generation-Skipping Taxes

- The act doubles the estate and gift tax exemption for estates of decedents dying and gifts made after Dec. 31, 2017, and before Jan. 1, 2026.
- The basic exclusion amount provided in Sec. 2010(c)(3) increased from \$5 million to \$10 million and is adjusted for inflation.

Estate Planning Opportunities

- Tax-driven estate planning structures may be simplified to reduce the cost of administration.
- Reconsider life insurance arrangements and owner buyout provisions.
- Transfer business interests to family members now to take advantage of increased exemption amounts.

BUSINESS TAX CHANGES

New Limit on Deduction of Business Interest

- Taxpayer's deduction for business interest expense cannot exceed (1) the taxpayer's business interest income plus (2) 30% of the taxpayer's adjusted taxable income
- Adjusted taxable income is defined as taxable income without regard to (1) items of income, gain, deduction or loss not properly allocable to the trade or business; (2) business interest or business interest income; (3) any net operating loss deduction; (4) the new 20% pass-through deduction; and (5) for tax years prior to years beginning in 2022, the deductions for amortization, depreciation and depletion
- Adjusted taxable income will be smaller beginning in 2022
- Does not apply to "small businesses" (average annual gross receipts for the three-year annual period ending with the prior year of \$25 million or less) or certain public utilities; no limit on floor plan financing interest (indebtedness used to finance acquisition of motor vehicles for sale or lease)

New Limit on Deduction of Business Interest

- Real property trade or business (as well as farming business or specified agricultural or horticultural cooperative) may elect out of limitation (but this election comes with a cost – must depreciate over longer depreciation periods; bonus depreciation not available); election irrevocable
- Existing debt is not grandfathered
- Consolidated group – all members treated as a single taxpayer
- Disallowed interest expense may be carried forward indefinitely subject to special rules for partnerships

Application to Partnerships and S Corps

- **Applied at entity level**; business interest deduction is taken into account in determining nonseparately stated income or loss
- Limitation **applies separately to each partnership owned by a taxpayer**
- For partnerships with Excess Business Interest (nondeductible because it exceeds the limit), that excess is allocated to the partners and there is a corresponding reduction in outside basis of partnership interest; **the partners carry forward that excess** (not the partnership) and can deduct it in future years against “excess taxable income” allocated to the partners from that same partnership

Modification of Expensing for Depreciable Assets

- Maximum amount that may be deducted is increased to \$1,000,000
- Dollar limit phased out beginning at \$2,500,000 of expenditures
- Expands availability to other property including commercial fire protection and security systems

Temporary 100% Expensing

- Increases first-year “bonus” depreciation deduction to **100%** which allows taxpayers to immediately write off the cost of certain qualified property
- Applies to both new and used property (as long as the acquiring taxpayer had not previously used the property and did not acquire it from a related party)
- Generally applies for taxable years through 2022 and is then phased down over next 5 years
- Planning Point: ***interaction of new NOL limitation (80% of taxable income) and 100% expensing*** – if 100% expensing would give rise to an NOL, may want to defer the purchase until the next year (assuming that full expensing remains available); companies have to consider the effect of full expensing on NOLs and try to plan purchases such that NOLs are not created or increased (if at all possible)

Expenses

- Entertainment Expenses – Disallows 50% deduction for entertainment expenses directly related to active conduct of trade or business (e.g., golf outing, sports tickets)
- Qualified Transportation Fringe Benefits – Company can no longer deduct amounts paid but employees can still exclude from income
- Employee Achievement Awards – only certain tangible personal property is deductible by employer and excludible by employee – does not apply to gift cards, vacations, tickets

Sexual Harassment or Abuse Settlements

- No deduction is allowed for any settlement, payout or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a non-disclosure agreement

Carried Interest

- Certain profits interests are now subject to three-year holding period for long-term capital gain
- Applies to partnerships involved in (1) raising or returning capital; (2) investing in or developing securities, commodities, real estate held for rental or investment, and certain financial instruments

Choice of Entity

- Prior to 2017 Tax Act a flow-through entity has generally been the best structure for privately held companies
- Avoids double tax on C corporations
- 21% corporate tax rate significantly reduces impact of double taxation
- Choice of entity decision is more complex now

Choice of Entity

- Need to consider many factors and run some financial models with different assumptions
- Likelihood that 20% pass through deduction will be available
- New international tax provisions – only C corporation can take advantage of 100% dividends received deduction against dividends from foreign subsidiaries that conduct active trade or business outside U.S.

Choice of Entity

- Does company want to distribute substantial portion of earnings to owners or reinvest earnings in growth of business
- Availability of section 1202 gain exclusion for certain small business stock
- What is exit strategy – likelihood of sale of business (stock sale v. asset sale)
- Basis step-up at death is still available

Choice of Entity

- Tax basis of equity interests in pass-through entity increase if entity retains earnings
- Ability to issue “profits interest” in a limited liability company or partnership
- Do not expect “mad dash” to convert to C corporation
- Pass-through entity – choice of limited liability company or S corporation

New Partnership Audit Rules

- Enacted in 2015
- Effective for tax years beginning after December 31, 2017
- Significant changes – adjustments made at partnership level can result in partnership tax liability unless elect to push out liability
- Partnership Representative deals with IRS
- Review organizational documents to see if these changes are addressed

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