Taking Advantage of Tax Reform: A Business Owner's Perspective

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INTRODUCTION

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Background

- The Tax Cuts and Jobs Act (the "Act") was signed into law by President Trump on December 22, 2017.

- This legislation contains many changes in taxation for businesses, individuals, and foreign business entities, as well as their United States ("U.S.") owners.

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Background (cont'd)

- Major elements of the Act include: (1) reducing tax rates for businesses and individuals; (2) a personal tax simplification by increasing the standard deduction and family tax credits, but eliminating personal exemptions and making it less beneficial to itemize deductions; (3) limiting deductions for state and local income taxes and property taxes; (4) repealing the individual mandate of the Affordable Care Act; and (5) shifting the U.S. international tax regime to a modified territorial system.

- The Congressional Budget Office reported that under the Act, individuals and entities like partnerships and S corporations would receive about $1,125 billion in net benefits (i.e. net tax cuts offset by reduced healthcare subsidies) over 10 years, while corporations would receive around $320 billion in benefits. The individual tax cuts fade over time and become net tax increases generally starting in 2027, while the corporate tax cuts are permanent.

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INDIVIDUAL TAX CHANGES

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Tax Rates

- For the tax years 2018-2025, individuals' taxable income will be in seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. After 2025, earlier rates will be in effect.

- The highest rate is for individuals with taxable income at $500,000 and above, and for married couples filing jointly at $600,000 and above.

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Capital Gains

- The basic capital gains structure has remained the same, with long-term capital gains at the 0%, 15%, and 20% brackets, while short-term gains are taxed as ordinary income.

- Additionally, the 3.8% net investment income tax is still in place.

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Standard and Itemized Deductions

- For tax years beginning after December 31, 2017 and before January 1, 2026, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years beginning after 2018.

- Also, for the above period, the deduction for miscellaneous itemized deductions that are subject to the 2% floor (which includes the deduction for tax preparation expenses, investment advisory fees, license and regulatory fees, and malpractice insurance fees, among many others) is suspended.

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Mortgage Interest

- For tax years beginning after December 31, 2017 and before January 1, 2026 (the general sunset date for the changed individual tax provisions), the deduction for interest on home equity indebtedness is suspended, and the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately).

- The new lower limit does not apply to any acquisition indebtedness incurred before December 15, 2017. Moreover, a taxpayer who entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchased such residence before April 1, 2018, shall be considered to incur acquisition indebtedness prior to December 15, 2017.

- The pre-Act $1 million/$500,000 limitations continue to apply to taxpayers who refinance existing qualified residence indebtedness that was incurred before December 15, 2017, so long as the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness.

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State and Local Taxes

- For tax years beginning after December 31, 2017 and before January 1, 2026, individuals face a new $10,000 cap on their deduction of certain state and local taxes for federal income tax purposes.
- All state and local income taxes are capped at $10,000, as are state and local property taxes that are not paid or accrued in carrying on a trade or business, which are combined in the $10,000 cap.
- There is no change to deductibility of state and local income taxes paid by corporations.
- The new $10,000 cap for individual deductions applies to income taxes paid directly with regard to income earned via pass-through entities (e.g., rental property held in a single-member limited liability company, or "LLC").

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State and Local Taxes (cont'd)

- Congress preserved the full deductibility of property (but not income) taxes paid in carrying on a trade or business or an activity related to the production of income.
- Foreign real property taxes may not be deducted as part of the new aggregate limit.
- A taxpayer who, in 2017, paid an income tax that was imposed for a tax year after 2017, generally could not claim an itemized deduction in 2017 for that prepaid income tax.
- New York, New Jersey, and Connecticut plan to sue the federal government over these changes.

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Deduction for Certain Pass-Through Income

- The biggest change impacting small business owners will most likely be the new qualified business income ("QBI") deduction for pass-through businesses such as S corporations, partnerships, and sole proprietorships.
- These entities are referred to as "pass-through" because expenses and revenues for these organizations are passed through to the owners' personal tax returns proportionately, to be taxed at individual rates.

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Deduction for Certain Pass-Through Income (cont’d)

- There are limitations for businesses such as accounting, consulting, law, and other similar professional services. These businesses are in certain cases excluded from receiving the QBI deduction because some legislators believed that these professions do not have as many employees, or have too many high-earning owners, and therefore should not be entitled to the same tax breaks.

- The new reform is organized to reward business owners that have many employees, and thus hiring is incentivized.

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BUSINESS TAX CHANGES

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Rate Changes and Deductions

- The former graduated rate structure for corporations is now a flat 21% rate.
- The corporate AMT is eliminated, and prior AMT credits can be utilized to obtain refunds.
- Bonus depreciation for 100% of new and used (i.e., the first taxable use does not need to begin with the taxpayer) “qualified property” is provided (if placed in service before January 1, 2023), with a 20% per-year phase down through 2026.
- Up to $1 million of “qualified real property” can be expensed under §179 of the Internal Revenue Code of 1986, as amended (the “Code”). If the cost of such qualifying property placed in service during the tax year exceeds $2.5 million, then the $1 million amount is proportionately reduced.

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Excess Business Losses

- In determining their taxable income for a taxable year, the shareholders of an S corporation and the partners of a partnership are allocated their share of the pass-through entity's losses for such year. However, there are a number of rules that limit the ability of these owners to deduct these losses (e.g., basis limitation, at-risk, etc.).
- The Act provides an additional one, namely that the "excess business" losses of a non-corporate taxpayer are disallowed.
- Beginning in 2018, through the 2025 tax year, taxpayers can only deduct up to $250,000 ($500,000 for married filing jointly taxpayers) of losses against non-business income. Amounts above the threshold are considered excess business losses.
- In the case of a partnership or S corporation, this provision is applied at the partner or shareholder level. Each partner's and each S corporation shareholder's share of the pass-through entity's items of income, gain, deduction, or loss are taken into account in applying the limitation for the taxable year of the partner or S corporation shareholder.
- The non-corporate taxpayer's excess business loss for a taxable year is carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years.

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Excess Business Losses (cont'd)

- For example, say that in 2018, Joe, a single taxpayer, has gross income of $200,000 from his business, and deductions of $500,000 from that business. He has a net loss of $300,000. He also has $300,000 of non-business income from interest and capital gains.

- Joe's business loss $300,000 is not allowed in full, but is limited to the $250,000 threshold under the Act. The remaining $50,000 of loss is considered an excess business loss

- Joe's $250,000 business loss is available to reduce his non-business income of $300,000, so Joe has 2018 adjusted gross income of $50,000 (it would be $0 in 2017). The $50,000 excess business loss is an NOL carried forward to 2019, subject to the Act's NOL rules.

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Other Important Provisions

- NOLs arising in tax years ending after December 31, 2017, the two-year carryback and the special carryback provisions are repealed, and for losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and, NOLs can generally be carried forward indefinitely. NOLs from earlier years are apparently subject to the earlier rules, and should be tracked separately, though guidance on this somewhat uncertain point is expected.

- Effective for transfers after December 31, 2017, the rule allowing the deferral of gain on like-kind exchanges under Code §1031 is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale (e.g., a building held for investment; personal property used in a trade or business, like a car, is no longer eligible). However, under a transition rule, the pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property (i.e., a reverse exchange) on or before December 31, 2017.

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QBI Deduction

- A non-corporate taxpayer, including a trust or estate, that has QBI from a partnership, S corporation, or sole proprietorship is potentially allowed to deduct up to 20% of that QBI.

- A limitation based on wages paid, or on wages paid plus a capital element, applies above certain thresholds, and the deduction is phased in for taxpayers with taxable income above a threshold amount (above $157,500 for single filers, or $315,000 for a married couple filing jointly) and below a cap.

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QBI: Trade and Business Limitation

- The QBI deduction does not apply to "specified service" trades or businesses (i.e., generally, the white collar professions, such as consulting, financial advisory, medicine, law, accounting, etc., but also athletics, performing arts, and fundamentally any trade or business where the principal asset is the reputation or skill of one or more employees).

- Engineering and architectural services are excluded from the above definition.

- The service business limitation begins phasing out in the case of a taxpayer whose taxable income exceeds $315,000 for married individuals filing jointly ($157,500 for other individuals), both indexed for inflation after 2018. The benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). The deduction also does not apply to the trade or business of being an employee.

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QBI: Limitations

- QBI does not include certain investment items, reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business, any guaranteed payment to a partner for services to the business under Code §707(c), or a payment under Code §707(a) to a partner for services rendered with respect to the trade or business.

- For pass-through entities, the deduction cannot exceed the lesser of 20% of QBI, or the greater of:

  - (i) 50% of the W-2 wages with respect to the qualified trade or business (the "W-2 wage limit"); or
  - (ii) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property" (defined in Code §199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year).

- The depreciable period begins on the date that the property is first placed in service, and ends on the later of 10 years after that date, or the last day of the last full year of the recovery period.

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QBI: Losses

- Under Code §199A(c)(2), if the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such an amount is treated as a loss from a qualified trade or business in the next tax year.

- The statute is not clear on how to net gains and losses in a multiple qualified trade or business scenario. Code §199A(b)(1) states that the "combined qualified business income amount" is the sum of the income, as determined by the percentage calculation on the previous slide, for each qualified trade or business carried on by the taxpayer.

- The Act's Conference Report appears to contemplate current year netting, providing an example where gains from one qualified trade or business are netted against losses from another to produce a loss carryforward.

- Neither the statute nor its legislative history contain rules for taking into account the W-2 wage and unadjusted basis in property limitations of Code §199A(b)(2)(B).

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QBI: Partners and Shareholders

- For a partnership or S corporation, each partner or shareholder is, for purposes of the deduction, treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year.

- A partner or shareholder's allocable share of W-2 wages is determined in the same way as the partner or shareholder's allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro rata share of an item. However, the W-2 wage limit begins phasing out in the case of a taxpayer with taxable income exceeding $315,000 for married individuals filing jointly ($157,500 for other individuals).

- The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for single filers).

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QBI: Basic Examples

- Tom earns $100,000 in a law firm that he operates as a single-member LLC. His taxable income equals $100,000.
- Tom's taxable income is below the threshold, even though he is in a specified service trade or business. His deduction equals 20% of $100,000, or $20,000.

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QBI: Basic Examples (cont'd)

- Mitch has $500,000 in taxable income working as a neurosurgeon in a medical partnership.

- He does not get the deduction, as he earns above the threshold and cap in a specified service trade or business.

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QBI: Basic Examples (cont'd)

- Natasha earns $200,000 in net income from her sole proprietorship, but has $50,000 of unrelated deductions.

- Her QBI deduction equals 20% of $150,000, or $30,000, because she cannot get the benefit of QBI treatment for income sheltered by other deductions.

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QBI: A Bit More Complex

- Dan operates a factory (note that this is not a specified service trade or business), has $100,000 of QBI, and also has taxable income is $1,000,000. The factory pays $30,000 in wages.

- Same facts, but the factory also has equipment with an original cost of $400,000.

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QBI: A Bit More Complex (cont’d)

- Dan’s tentative deduction would be $20,000 (20% of $100,000), but the factory only pays $30,000 of wages, which supports merely a $15,000 deduction (50% of $30,000; but, the final deduction is the lesser of the 20% QBI deduction or the greater of the 50% W-2 limitation/25% W-2 plus 2.5% depreciable property basis limitation).

- The equipment, however, supports a $10,000 deduction (2.5% of $400,000), which when added to $7,500 (25% of $30,000), yields a final deduction of $17,500 (which is less than the $20,000 tentative deduction).

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Summary of QBI Rules

- If your taxable income is equal to or less than $157,500, or $315,000 for a married couple filing jointly (adjusted annually), your QBI deduction is equal to 20% of your share of trade or business income from pass-through entities such as partnerships, limited liability companies (taxed as partnerships), or S corporations.

- Between the above thresholds and an additional $50,000 cap, or a $100,000 cap in the case of a married couple filing jointly, special rules phase out amounts that would otherwise qualify for the QBI deduction.

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Summary of QBI Rules (cont'd)

- If your taxable income exceeds the applicable threshold and corresponding cap, then the QBI deduction only applies to qualified trade or business income (i.e., non-service business income; if below the threshold and cap, the deduction is available to all businesses).

- If your taxable income exceeds the applicable threshold and corresponding cap, then the QBI deduction is limited to the lesser of: (i) 20% of QBI; or (ii) the greater of 50% of W-2 wages paid by the business, or the sum of 25% of such W-2 wages plus 2.5% of the cost of certain property used in the business.

- If your taxable income exceeds the applicable threshold but not the corresponding cap, then the 20% QBI deduction is reduced by a pro rata amount. This applies to service businesses as well.

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QBI: A Note of Caution

- Code §6662 imposes an accuracy-related penalty equal to 20% of any underpayment of federal tax resulting from a substantial understatement of income tax (i.e., the amount of tax required to be shown on a return is understated by the greater of 10% or $5,000).

- The QBI statute includes a provision reducing the threshold to the greater of 5% or $5,000 in the case of any taxpayer that <u>claims</u> the deduction. The penalty is applied regardless of whether the understatement arose specifically from the QBI deduction, or from some other error.

- Taxpayers can therefore be in a doubly difficult situation, in that they are more likely to have a substantial understatement because the threshold is lower, and a greater portion of any understatement will be in excess of the 5% threshold, and would therefore be subject to the 20% penalty.

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QBI: Implications and Questions

- What constitutes a business where the principal asset is the reputation and skill of one or more employees? Would plumbing qualify?

- What about multiple activities in a single business (e.g., an optometrist who sells glasses)? Would you be able to group QBI-generating activities as one can for passive activities? Is there another way (e.g., interdependence, similarity, common control and ownership, predominant purpose, etc.)?

- The complexity of partnership and S corporation filings is likely magnified due to increase in separately stated items (e.g., multiple businesses).

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QBI: Implications and Questions (cont'd)

- Potential restructuring of LLCs and partnerships
- S corporation "reasonable compensation" issues
- Professional Employer Organizations (PEOs) and common paymasters

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State Law Conformity: QBI

- The QBI deduction reduces taxable income but not adjusted gross income (i.e., "below-the-line," but not itemized; the IRS is expected to add it as a separate line item), so it will flow through only in states that start their taxable income calculation with federal taxable income (e.g., Colorado; they may decouple from the deduction anyway).
- No QBI deduction is permitted under New Jersey law, as the taxable income determination is statute-specific.
- New York's personal income tax calculation starts with federal adjusted gross income, so no QBI deduction is allowed under New York law either.

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State Law Conformity: Expensing of Assets

- The cost of certain business assets can be deducted in the year in which they are placed in service, instead of being depreciated over a long period.
- Many states already decouple from federal expensing and accelerated (bonus) depreciation provisions, and will automatically decouple from the expensing rule unless they affirmatively decide to adopt it.
- New York conforms to the federal rules for expensing under Code §179 (but not to the federal bonus depreciation rules) and should end up conforming to the increases thereunder, while New Jersey does not conform to federal rules for expensing or for bonus depreciation.

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State Law Conformity: Contributions to Capital

- The Act provides that contributions to a corporation's capital by a government entity (other than in exchange for stock) are taxable to the corporation.
- States may conclude that this is inconsistent with economic development policies and that they should decouple.

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State Law Conformity: Limitation on Deductibility of State Taxes

- High tax states like New York are attempting "workarounds," such as an optional employer payroll tax, or a potentially deductible charitable contribution in lieu of some property taxes.

- The federal government has already said that it likely would not respect such workarounds, even though several New Jersey towns have already created "charitable" trusts to which residents may contribute and offset a large percentage of their property taxes.

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APPENDIX

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Tax brackets for married taxpayers filing jointly

2017		2018	
10%	$0–$18,650	10%	$0–$19,050
15%	$18,651–$75,900	12%	$19,051–$77,400
25%	$75,901–$153,100	22%	$77,401–$165,000
28%	$153,101–$233,350	24%	$165,001–$315,000
33%	$233,351–$416,700	32%	$315,001–$400,000
35%	$416,701–$470,700	35%	$400,001–$600,000
39.6%	$470,701 or more	37%	$600,000 or more
Standard deduction:	$12,700	Standard deduction:	$24,000
Personal Exemption:	$8,100	Personal Exemption:	Eliminated

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Tax brackets for single filers

2017		2018	
10%	$0–$9,325	10%	$0–$9,525
15%	$9,326–$37,950	12%	$9,526–$38,700
25%	$37,951–$91,900	22%	$38,701–$82,500
28%	$91,901–$191,650	24%	$82,501–$157,500
33%	$191,651–$416,700	32%	$157,501–$200,000
35%	$416,701–$418,400	35%	$200,001–$500,000
39.6%	$418,401 or more	37%	$500,001 or more
Standard deduction:	$6,350	Standard deduction:	$12,000
Personal Exemption:	$4,050	Personal Exemption:	Eliminated

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QBI Taxable Income Thresholds

Married Filing Jointly

Income	Minimum	Maximum
Tier 1	$ -	$ 315,000
Tier 2	$ 315,000	$ 415,000
Tier 3	$ 415,000	and up

Single Filers

Income	Minimum	Maximum
Tier 1	$ -	$ 157,500
Tier 2	$ 157,500	$ 207,500
Tier 3	$ 207,500	and up

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Threshold to Receive QBI Deduction

Tier	Result
Tier 1 All Businesses	Receive Deduction
Tier 2 All Businesses	Deduction is Reduced
Tier 3 Businesses Other than Specified Service Business	Deduction is Limited
Tier 3 Specified Service Business	NO DEDUCTION

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