

The Tax Cuts and Jobs Act -

Hikes or Cuts: Do you really know how the tax reform affects your business and you personally?

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ACCOUNTING • TAX • ADVISORY

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CohnReznick LLP

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AGENDA

- Business Tax Changes
- Pass-thru Entity Example
- Individual Tax Changes
- Other Provisions
- Key Takeaway's and Strategies

Business Tax Provisions

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RATES



Tax Rate Structure For C Corporations

Pre-2018 Reform

- Corporations were subject to graduated tax rates up to 35%.
- Corporations were subject to flat AMT tax rate of 20%.

Post-2018 Reform

- The framework reduces the corporate tax rate to 21%. The Corporate AMT is eliminated.
- There is still no preferential tax rate for investment type income for C Corporations.
- Dividends paid to shareholders are still taxed at the shareholder's tax rates and the payment is nondeductible to the corporation, i.e. two layers of tax.

RATES (Cont.)

Tax Rate Structure For Pass-through entities (S Corporations, LLCs, Partnerships) and sole-proprietorships

Pre-2018 Reform

- No preferential treatment

Post-2018 Reform

- Owners will receive a deduction equal to 20% of their qualified business income. However, there are several limitations.
- Additionally, the 20% deduction will be unavailable for owners of professional “service” businesses if the owner’s taxable income is over \$157,500 (single filers), or \$315,000 (joint filers).



BUSINESS EXPENSE LIMITATION

NOL / Loss Usage

Pre-2018 Reform

Net operating losses (NOLs) were allowed a 2 year carryback and 20 year carryforward. NOLs could be deducted to the extent of taxable income.

Post-2018 Reform

Limitations on the use of Net Operating Loss (NOL) carry-forward or carry-back: Taxpayers would be able to deduct a net operating loss (NOL) carryover or carryback **only to the extent of 80% of the taxpayer's taxable income** (determined without regard to the NOL deduction). The Act would also **generally repeal all carrybacks** but provide a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses.

- Pre 2018 NOLs are not subject to the new lower limitation



COST RECOVERY (DEPRECIATION)

Bonus Depreciation

- **100%** immediate expensing of qualified assets acquired and placed in service **after September 27, 2017** and before January 1, 2023.
- Acquisition is based on a written binding contract.
- Expanded to include **used** property (not allowed under old law).
- Does not apply to public utilities, but would apply to the cost to produce qualified film and live theatrical productions.



COST RECOVERY (DEPRECIATION)

Leasehold (Improvement) recovery periods

- Qualified Leasehold Improvement Property, Qualified Restaurant Property, and Qualified Retail Improvement Property **definitions are removed and replaced** with Qualified Improvement Property (QIP).
- Congress meant for QIP to be 15 year property, but statute needs to be corrected.
- QIP is intended to be bonus eligible
- QIP must be placed into service after the date the building itself is placed into service. This is a taxpayer friendly addition to the law.



EXPANSION OF SECTION 179 EXPENSING



Pre-2018

- Section 179 was capped at \$500,000 and the phase-out beginning at \$2,000,000.

Post-2018

- Under the new law, businesses may **immediately expense up to \$1 million of the cost** of any tangible personal property, certain computer software, and certain qualified building property. If a business places more than \$2.5million of Section 179 property in a year, the amount available for expensing is reduced.
- Includes Qualified Improvement Property (election to include)
- Includes nonresidential roofs, HVAC, fire protection and alarm and security systems placed in service after the building was placed in service (election to include)

DEDUCTIONS



R&D Expenses

- Beginning in 2022, research and development expense, including software development costs, would need to be capitalized and amortized over 5 years.
- The credit amount is unaffected.
- Further IRS guidance is needed to determine how the post 2021 rules are applied to costs directly applicable to your business versus those you incur on behalf of a client/customer.

Repeal of Sec 199 Domestic Production Activities ("DPA") Deduction

- **Pre-2018**
Deduction equal to the lesser of 9% of qualified DPA Income or 50% of qualified DPA wages.
- **Post-2018 - REPEALED**



DEDUCTIONS

Elimination of Deductions for Employer Paid Employee Benefits:

- Expenses for entertainment (ball games and shows), amusement or recreation (on-site gyms), even if directly business-related.
- Membership dues for any club organized for business, pleasure, recreation or other special purposes, including association dues.
- Providing qualified transportation fringes (parking, transit passes, van pools, bicycle commuting expenses) and, except as necessary for ensuring the safety of an employee, the employee's commuting expenses.



DEDUCTIONS



Limitation on Employer Deductions For Employee Meals

- Employee travel meals - remains at 50% but beware entertainment taint.
- Employee meals on employer's premises for employer's convenience - 50% for 2018-2025, then 0% for 2026 and after
- Employee meals at employer eating facility (on-site employee cafeteria) that meets the *de minimis* fringe requirements (i.e., revenues equal or exceed direct costs) and for employer's convenience (entire eating facility qualifies as for employer's convenience if more than half of employees receive meals in facility for employer's convenience) - 50% for 2018-2025, then 0% for 2026 and after
- **Holiday Parties:** The provision allowing a 100% deduction for recreational, social or similar expenses primarily for the benefit of employees, (other than highly compensated employees) has not been changed.

DEDUCTIONS

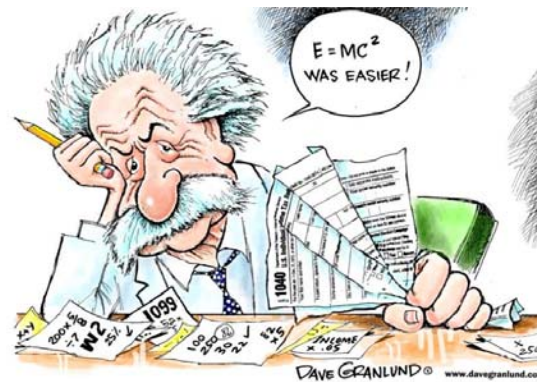
Meals Expense Summary

Type	Pre-2018	Post-2018
Meals at an entertainment activity	50% Deductible	Nondeductible
Business meals with client/prospect	50% Deductible	50% Deductible
Non-business meals with client/prospect	Nondeductible	Nondeductible
Reimbursed employee meals while on business travel	50% Deductible	50% Deductible
On-premise meals provided for the convenience of the employer	100% deductible	50% Deductible
Deminimis meals to employees from an on-site dining facility (cafeteria)	100% deductible	50% Deductible
Holiday party	100% deductible	100% deductible

OTHER BUSINESS RELATED ISSUES

Other Business-related issues

- Like-kind exchanges: Gain deferral from a like-kind exchange would only be allowed for a like-kind exchange of real property (i.e. real estate).
- Limited deferral under new Revenue Recognition provisions.
 - Unbilled A/R on financial statements, for example:
 - Rate variances
 - Fee withholding
 - Progress payments



OTHER BUSINESS RELATED ISSUES

Business Interest Expense Limitation

Businesses will be subject to a **net** interest expense limitation that applies to **net** interest expense exceeding 30% of adjusted taxable income (ATI) of the business (plus floor plan financing). The law provides an exemption for businesses with average gross receipts of \$25 million or less and for the following businesses:

- Electing real property trade or business
- Electing farming business
- Public utility
- Cost of the election is the use of the ADS method of depreciation and loss of bonus depreciation.



Disallowed interest expense above the 30% limitation carries forward indefinitely.

SMALL BUSINESS TAX REFORM



Small Business Accounting Method Reforms

- “Small business” = less than \$25mil in average annual gross receipts, including C Corporations
 - Cash method of accounting. Expansion of use of cash method of accounting
 - Accounting for inventories: Reduced need to account for inventories for tax
 - Capitalization and inclusion of certain expenses in inventory costs: Limits on UNICAP requirement
 - Accounting for long-term contracts: Limits on requirement to use “percentage of completion method.”
- When applying the \$25mil gross receipts test attribution will apply
- Six year spread on deferred gain for accounting method changes when converting from S Corporation to C Corporation.

Pass-through Entities

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20% Pass-through Deduction

Owners of pass-through businesses will receive a deduction equal to 20% of their qualified business income.

Qualified Business

- Eligible for entity types other than C Corporations.
- Exclusions for:
 - Being in the business of providing services as an employee
 - Specified Service businesses, above a phase-out threshold



Specified Service Business

- Health, law, 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 employee owners

20% Pass-through Deduction

Qualified Business Income

- Generally, all income of the business except that which is derived from investment activities
- Think of it as your operating income

The Deduction – equal to the lesser of;

- 20% of Qualified Business Income, or
- The Wage limitation



Wage Limitation

- Applies when taxable income exceeds \$157,500 (\$315,000 if MFJ)
- the greater of;
 - 50% of the W-2 wages with respect to the business, or
 - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property

20% Pass-through Deduction

This is an example!

Example

- Taxpayer files a joint tax return with spouse and resides in VA.
- Taxpayer is a shareholder in GovCon, Inc., an S Corporation
- GovCon, Inc. is in the business of software engineering and development.
- Taxpayer takes a salary of \$300,000 and receives the any remainder of compensation in the form of distributions from the S Corporation

20% Pass-through Deduction

Example

	<u>Pre</u>	<u>Post w/ 20%</u>	<u>Post No 20%</u>
Owner Compensation	300,000	300,000	300,000
Business Income	6,000,000	6,000,000	6,000,000
Non-owner Wages	(4,000,000)	(4,000,000)	(4,000,000)
Less: Owner Comp	<u>(300,000)</u>	<u>(300,000)</u>	<u>(300,000)</u>
Adjusted Business Income	1,700,000	1,700,000	1,700,000
Interest Expense Limitation	-	-	-
N/D Entertainment Expenses	<u>5,000</u>	<u>10,000</u>	<u>10,000</u>
Net Ordinary Business Income	1,705,000	1,710,000	1,710,000
Total Income	2,005,000	2,010,000	2,010,000
Sec 199 DPAD	(153,450)	-	-
SALT (6% for Virginia)	(111,093)	(10,000)	(10,000)
Other Itemized Deductions	(25,000)	(25,000)	(25,000)
3% Phase-out	46,133	-	-
Total Itemized Deductions	<u>(89,960)</u>	<u>(35,000)</u>	<u>(35,000)</u>
Total Deductions	(243,410)	(35,000)	(35,000)
Adjusted Net Income	1,761,590	1,975,000	1,975,000
Sec 199A Pass-through Deduction	-	<u>(342,000)</u>	-
Taxable Income	<u>1,761,590</u>	<u>1,633,000</u>	<u>1,975,000</u>
Highest Marginal Tax Rate	39.6%	37.0%	37.0%
Total Federal Tax	<u>642,820</u>	<u>543,589</u>	<u>670,129</u>
Tax Rate on Adj. Net Income	36.5%	27.5%	33.9%



Calculation of 20% Deduction in Example

- Identify the Qualified Business Income (QBI) = \$1,710,000
- Calculate 20% of QBI = \$342,000
- Calculate the Wage Limitation = \$2,150,000
 - $50\% \times \$4,300,000$
- Take the Lesser of 20% of QBI or the Wage Limit = \$342,000
- Owners of s-corporations may want to reduce their wage to the lowest reasonable level possible to enhance the 20% deduction, assuming that they are not limited by the wage limitation above.
- The full impact of a wage reduction strategy should be investigated as there could be other consequences such as altering the economic arrangement among shareholders without proper planning.



20% Pass-through Deduction

Example with Reduced Salary



	Pre	Post w/ 20%	Post No 20%
Owner Compensation	130,000	130,000	130,000
Business Income	6,000,000	6,000,000	6,000,000
Non-owner Wages	(4,000,000)	(4,000,000)	(4,000,000)
Less: Owner Comp	(130,000)	(130,000)	(130,000)
Adjusted Business Income	1,870,000	1,870,000	1,870,000
Interest Expense Limitation	-	-	-
N/D Entertainment Expenses	5,000	10,000	10,000
Net Ordinary Business Income	1,875,000	1,880,000	1,880,000
Total Income	2,005,000	2,010,000	2,010,000
Sec 199 DPAD	(168,750)	-	-
SALT (6% for Virginia)	(110,175)	(10,000)	(10,000)
Other Itemized Deductions	(25,000)	(25,000)	(25,000)
3% Phase-out	45,674	-	-
Total Itemized Deductions	(89,501)	(35,000)	(35,000)
Total Deductions	(258,251)	(35,000)	(35,000)
Adjusted Net Income	1,746,749	1,975,000	1,975,000
Sec 199A Pass-through Deduction	-	(376,000)	-
Taxable Income	1,746,749	1,599,000	1,975,000
Highest Marginal Tax Rate	39.6%	37.0%	37.0%
Total Federal Tax	636,943	531,009	670,129
Tax Rate on Adj. Net Income	36.5%	26.9%	33.9%

Excess Business Loss



- Non-C Corporate taxpayers are limited to claiming only \$250,000 (\$500,000 for MFJ) of excess business losses.
- That is, only up to \$250,000 (\$500,000 if MFJ) of excess business losses can be used to offset other nonbusiness income, such as interest.
- This is determined after applying at-risk and passive activity loss limitations.
- The excess business loss carries forward to the next tax year as an NOL.

Pre-2018 reform

- There was no limitation on using deductible business losses.

Individual Tax Provisions

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CHANGES TO INDIVIDUAL TAX BRACKETS



Pre-2018 Reform

Post-2018 Reform

Rate	Single	MFJ	Rate	Single	MFJ
10%	\$0-\$9,525	\$0-\$19,050	10%	\$0-\$9,525	\$0-\$19,050
15%	To \$38,700	To \$77,400	12%	To \$38,700	To \$77,400
25%	To \$93,700	To \$156,150	22%	To \$82,500	To \$165,000
28%	To \$195,450	To \$237,950	24%	To \$157,500	\$315,000
33%	To \$424,950	To \$424,950	32%	To \$200,000	\$400,000
35%	To \$426,700	To \$480,050	35%	To \$500,000	\$600,000
39.6%	Over \$426,700	Over \$480,050	37%	Over \$500,000	Over \$600,000

CHANGES TO STANDARD DEDUCTION

Pre-2018 Reform

- \$6,500 – single
- \$13,000 - MFJ

Post-2018 Reform

- \$12,000 – single
- \$24,000 – MFJ



- Personal exemptions (Pre-2018 reform was \$4,150/person) repealed for 2018
- Elimination of the Itemized Deduction Phase-out (reduced by 3% of AGI in excess of \$320,000 for MFJ or \$266,700 S)

REDUCTION OF STATE AND LOCAL INCOME AND PROPERTY TAX DEDUCTION

Pre-2018 Reform

- Full deduction (subject to various limitations) for all state and local income taxes and property taxes paid (election to deduct state and local sales taxes)

Post-2018 reform

- Deduction limited to \$10,000 for total of income (or sales) and property taxes paid, \$5,000 if MFS.



OTHER CHANGES

Mortgage Interest

Pre-2018 Reform

- Principal residence and second residence mortgage up to \$1 million plus \$100,000 of HELOC

Post-2018 Reform

- Principal residence and second residence mortgage up to \$750,000. No deduction for HELOC. Pre 12/16/17 mortgages are grandfathered



OTHER CHANGES

2% Itemized Deductions

Pre-2018 Reform

- Unreimbursed business expenses, tax preparation services, and investment expenses were deductible subject to 2% of AGI.

Post-2018 Reform

- All have been repealed.



OTHER CHANGES

Alternative Minimum Tax

Pre-2018 reform

- Exemption amount of \$86,200 for MFJ and phase-out beginning at \$164,100 for MFJ

Post-2018 reform

- Exemption amount of \$109,400 for MFJ and phase-out beginning at \$1,000,000 for MFJ
- Reduction of the allowable state tax deduction will reduce the number of people impacted by AMT.

Alternative Minimum Tax (AMT) Exemptions

Filing Status	Exemption Amount:
Individual	\$70,300
Married Filing Jointly & Surviving Spouses	\$109,400
Married Filing Separately	\$54,700

OTHER CHANGES



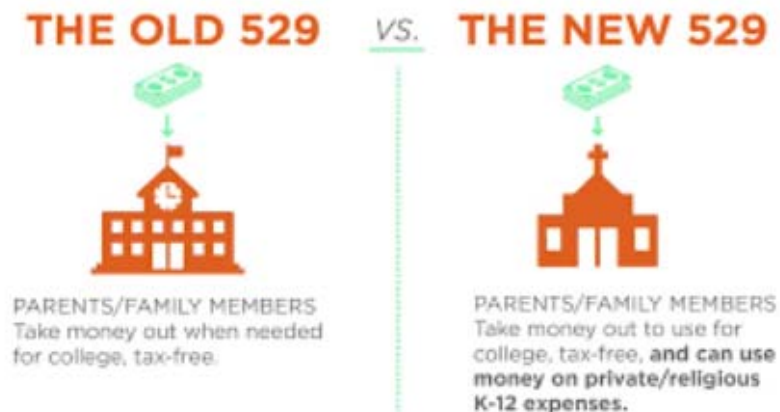
529 Plans

Pre-2018 Reform

- Distributions could be used only for post-secondary education.

Post-2018 Reform

- In addition to post-secondary education, up to \$10,000 per year per student can be used for elementary and secondary public, private or religious schools.



OTHER CHANGES

Alimony

Pre-2018 Reform

- Income to the recipient and a deduction for the payor.

Post-2018 Reform

- For agreements signed after 12/31/2018 (note that this is one year after the other provisions are in effect), income is no longer taxable for the recipient and there is no deduction for the payor.



Other Provisions

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Other Provisions



Estate Tax

- Lifetime estate & gift exemption doubled to over \$11 million per taxpayer

International Tax

- ALL US persons – corporations including S corporations, partnerships, trusts, individuals – owning 10% or more of a controlled foreign corporation (CFC) must pay a mandatory tax on the earnings and profits (E&P) held by the CFC

Sunset Date

- While some provisions are made permanent, many sunset in 2026 and revert back to pre-2018 law.

Key Takeaways and Strategies

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KEY TAKEAWAYS

20% Pass-through Deduction

- This could be very beneficial but further IRS guidance is needed and is forthcoming.

Depreciation

- Bonus depreciation is now 100% and is available for used property
- Planning is needed to maximize tax efficiency due to states that do not conform to federal provisions

Meals & Entertainment

- Meals are still generally 50% deductible but entertainment is nondeductible.

Corporate Tax Rates

- Yes, corporate rates are now much lower than individual rates but a pass-through tax structure is still beneficial for most taxpayers.

KEY TAKEAWAYS (Cont.)

Individual Taxes

- Despite the limit of the state income tax deduction, many taxpayers will see lower taxes due to AMT changes, generally lower tax rates, and the increased child tax credit.

Employer Deduction for Employee Benefits

- Any employer level deduction that is lost for an employee benefit can be gained back by paying employees more (increased salary) and passing the cost along to them.

Internal Accounting Changes

- As a result of the new tax law you should adjust you general ledger accounts to capture expenses in the most tax efficient way possible.

Questions & Answers

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