Understanding the Tax Reform Bill

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Agenda

I. Individuals
II. Qualified Business/Pass-through Deduction
III. Excess Business Loss
IV. Business Entities
V. International Tax
VI. Estates, Trusts and Gifts
### Individuals

**Taxable Income Level**

<table>
<thead>
<tr>
<th>Married Filing Jointly (Single Taxpayers)</th>
<th>Income Tax Rates</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2017</td>
</tr>
<tr>
<td>Not Over: $18,650 ($9,325)</td>
<td>10%</td>
</tr>
<tr>
<td>Not Over: $75,900 ($37,950)</td>
<td>15%</td>
</tr>
<tr>
<td>Not Over: $153,100 ($91,900)</td>
<td>25%</td>
</tr>
<tr>
<td>Not Over: $233,350 ($191,650)</td>
<td>28%</td>
</tr>
<tr>
<td>Not Over: $416,700 ($416,700)</td>
<td>33%</td>
</tr>
<tr>
<td>Not Over: $470,700 ($418,400)</td>
<td>35%</td>
</tr>
<tr>
<td>Over: $470,700 ($418,400)</td>
<td>39.6%</td>
</tr>
<tr>
<td>Over: $600,000 ($500,000)</td>
<td></td>
</tr>
</tbody>
</table>

- Tax rates are reduced for 5 of the 7 brackets and only the 10% and 35% rates remain the same
- Tax brackets are expanded; lower tax at similar levels of taxable income
- The MFJ highest tax bracket is $600k vs. single highest tax bracket at $500k
Individuals

1. Top individual tax rate lowered from 39.6% to 37%
   – No changes to preferential rates on dividends and long-term capital gains
   – Tax rates are reduced for 5 of the 7 brackets and only the 10% and 35% rates remain the same
   – Tax bracket bands are expanded; lower tax at similar levels of taxable income
   – Provides a marriage bonus: top rate for MFJ is $600k vs $500k for Single
   – Marriage penalty still exists for dual high income earners

2. Changes to Non-Itemizers
   – Standard deductions increased from $6.35k to $12k / $12.7k to $24k (S/MFJ)
   – Personal exemptions of $4,050 per person are suspended

3. Changes to Itemized Deductions – Simplification?
   – Medical Expenses – retroactive to 2017/enhanced through 12/31/18
     • 7.5% Floor and no adjustment for AMT
3. **Changes to Itemized Deductions (continued)**
   - **Limitation on State and Local/Real Estate tax deduction - $10k**
     - $5k for Single, MFS and HOH
     - Foreign real estate and income tax no longer deductible
     - Impacts those in high tax states and those with multiple homes
     - Still deductible for businesses reported on Schedule C, E and F
   - **Deductible mortgage interest capped for new loans - $750k**
     - $375k for MFS
     - $1M in debt is grandfathered if prior to effective date 12/15/17
     - Binding written contracts exception, if closed before 4/1/18
   - **Home equity loan interest deduction is suspended**
     - $100k deduction gone
     - Interest tracing rules still apply (investment and Business)
   - **Casualty loss deduction is suspended except for POTUS declared disasters**
3. Changes to Itemized Deductions (continued)
   – Miscellaneous itemized deductions subject to the 2% floor are suspended
     • Investment advisory and related deductions
     • Unreimbursed employee business expenses
     • Tax preparation and other tax related professional fees
   
   – The 3% “Pease” limitation on itemized deductions is suspended

   – Charitable cash donations AGI limit increased to 60% from 50%
     • No change to non-cash gift limitations
     • No change to 5 year carryover
     • The only discretionary deduction available
     • Consider bunching of charity every other year to take advantage of standard deduction
Some Observations:

– Many taxpayers will no longer itemize unless they have significant charity, home mortgage interest or investment interest expense
– Net Investment Income Tax of 3.8% may effectively increase due to loss of 2% and SALT deductions
– Many taxpayer’s state income taxes are increased due to loss of 2%, mortgage interest, and real estate tax deductions
– In state muni bonds will provide for a greater after-tax yield than out of state bonds

4. Other Changes to Items of Income and Deductions

– Alimony is not deductible (or taxable) for agreements effective 1/1/19 – no sunset
– Moving expenses not deductible (nor excluded from income), except for Armed Forces
– Like kind exchanges are limited to real estate only (applies to business entities as well)
– Entertainment expenses are no longer deductible (applies to business entities as well)
  • Meals are still deductible at 50%
– Small sacrifice: Members of Congress cannot deduct living expenses away from home
5. **Changes to Tax Calculations / Credits**

   - Alternative minimum tax is retained with higher exclusions and phase outs
     - $109,400 MFJ, $70,300 Single, and $54,700
     - Full Phase out of exemption at $1M MFJ, and $500k all other taxpayers
     - Most taxpayers will no longer be subject to AMT
     - Charitable deductions will be worth more in 2018 and beyond
     - Consider Incentive Stock Option exercises

   - **Kiddie Tax – Modified to use the Trust and Estate tax rates**
     - Applies to unearned income / Earned Income is subject to single tax rates
     - Four tax brackets - 10%, 24%, 35% and 37% - Top tax bracket begins at $12,500
     - Tax could be more or less than under 2017 law, depending on parent’s tax rate

   - **Child Tax Credit – increased to $2,000 per child**
     - Full Phase out on income in excess of $400k MFJ, and $200k all other taxpayers
     - Portion of credit that is refundable is $1,400
     - Must provide a Social Security number to be eligible
Individuals

6. Other Notable Tax Changes
   – Unwinding of a Roth IRA conversion is eliminated
     • Can still re-characterize a non-eligible ROTH IRA
   – Section 529 plan expansion of use of distributions to expenses of K-12
     • Capped at $10k per year
   – Individual mandate of the ACA repealed effective 1/1/19
   – Inflation adjustments – Chained CPI vs All Urban Consumers CPI – No sunset

7. New Law Provisions – Not simplification, more complexity:
   – 20% Qualified Business Income (QBI) Deduction / Pass Through Deduction
   – $500k Limitation on excess business losses of non-corporate taxpayers
Qualified Business Income Deduction
(a.k.a. Pass-through Deduction)

1. Deduction equal to 20% of “qualified business income” from a pass-through entity, including a Schedule C, E, F
2. QBI Deduction is limited to the lesser of the calculated amount or 20% of “modified” taxable income (TI excluding net capital gains), without considering the QBI deduction
3. QBI Deduction effectively reduces the top tax rate to 29.6%
4. Only businesses that operate domestically will qualify
5. Also applies to trusts and estates
6. Not an above the line deduction, not a below the line deduction, it’s reported after taxable income
7. REIT, PTP, and Coop dividends also qualify
Qualified Business Income Deduction
(a.k.a. Pass-through Deduction)

How does it work?

8. MFJ/Other taxpayers with taxable income of $315k/$157.5k or less – the deduction is 20% of QBI. For taxpayers in the $315k/$157.5k bracket their effective income tax rate becomes 19.2%.

9. MFJ/Other taxpayers with taxable income in excess of $415k/$207.5k – the deduction is limited to the greater of:
   – 50% of W-2 wages paid by the business (Wage Base), or
   – 25% of W-2 Wage Base plus 2.5% of unadjusted basis of qualified property
Qualified Business Income Deduction
(a.k.a. Pass-through Deduction)

How does it work?

10. Qualified Property is:

   – Depreciable tangible property in service at the end of the taxable year;
   
   – Used at any point in the production of QBI during the taxable year; and
   
   – Still having a depreciable period that has not ended before the close of the taxable year.

Everything except Land and Intangible Assets should qualify.
11. Unavailable to Specified Service Business owner’s if taxable income exceeds $415k (MFJ)
   - Specified Service Business - “any trade or business involving the performance of services in the fields of 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 employees”
   - The final version includes statutory language to exclude architects and engineers from the Specified Service Business definition

12. For Specified Service Business owners, QBI deduction is phased-out from $315k - $415k (MFJ) of taxable income
13. S Corps and Partnerships make QBI/Wage Base/Asset Basis calculations and then report amounts on K-1s. Then amounts combined on Form 1040/1041 as one.
   – No forms have been created as of yet.

14. Some items of income not eligible
   – Short and long term capital gains
   – Payments in lieu of dividends
   – Interest and dividends
   – Foreign currency gains
   – Gains on commodity transactions other than through the business
   – Net income from notional principal contracts
Qualified Business Income Deduction  
(a.k.a. Pass-through Deduction)

- Will there be opportunities to transfer ownership in S Corps and Partnerships to Trusts for your children, in order to minimize the taxable income thresholds?  
  - Yes: if part of comprehensive estate planning  
  - ??: if only to maximize QBI deduction
Qualified Business Income Deduction Flowchart

Is modified taxable income over $315k/$157.5k threshold?

Yes

Is business a specified service business?

Yes

Deduction equals lesser of:
- QBI x 20%
- The greater of:
  - W-2 wages x 50% or
  - W-2 wages x 25%
  + 2.5% of unadjusted basis of asset

No

Deduction reduced

No

Deduction = QBI x 20%

Is modified taxable income over full $415k/$207.5k threshold?

Yes

No deduction

No

Deduction reduced

Is modified taxable income over full $415k/$207.5k threshold?

Yes

No deduction

No

Deduction reduced
QBI Examples

1. Rebecca is married and reports $500k taxable income before the QBI effect on her MFJ tax return ( > $315k threshold—therefore, the W-2 wage base and depreciable property matter). She owns 100% of an S Corp that manufactures furniture using rented equipment--it owns no depreciable property. The S Corp pays $100k in wages to Rebecca and $120k to its two employees.
   – The S Corp generates $400k of QBI and reports 100% of it on Rebecca’s K-1. Her tentative QBI Deduction is $80k--but only if her S Corp pays at least $160k in W-2 wages.
   – Total wages paid by the S Corp is $220k—50% of $220k Wage Base = $110k.
   – She gets to take the $80k QBI deduction.
2. Same facts as in #1, except Rebecca runs her manufacturing business as a sole proprietorship and pays her two employees $120k in wages and she owns manufacturing equipment with an original cost of $1.4M.
   – Rebecca’s QBI would be $500k and she should tentatively qualify for a $100k QBI deduction.
   – The $120k Wage Base allows for a $60k QBI deduction.
   – The $120k Wage Base and the $1.4M in assets would provide for a $65k QBI deduction (25% of Wages [$30k] + 2.5% of $1.4M [$35k]).
   – Rebecca’s QBI deduction would be $65k.
QBI Examples

3. Same facts as in #1, Rebecca runs her manufacturing business through a Partnership—where she owns 99% and her husband owns 1%. Instead of wages, the Partnership pays her a Guaranteed Payment of $100k and $120k in Wages to its two employees.

- The Partnership generates $400k of QBI. The tentative QBI Deduction is $80k—but only if the Partnership pays at least $160k in W-2 wages.
- The allowed QBI Deduction is $60k [$120k Wage Base X 50%]. Guaranteed Payments are not considered wages.
Excess Business Loss

1. Recognized by a Non C Corporation.
2. In excess of $500k/$250k for MFJ/Other.
3. Shall be disallowed and treated as a Net Operating Loss Carryover.
4. In the case of a partnership or S Corp, the provisions applies at the partner or shareholder level.
5. EBL rules shall be applied after the application of the passive activity loss rules (Section 469).
6. This would appear to apply to Sole Proprietors.
7. There is no guidance on excess business losses.
Business Entities

Provisions Affecting Business Tax Returns

1. Graduated corporate rates reduced from 35% to a flat 21%. This provision does not sunset.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $50,000</td>
<td>15</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25</td>
</tr>
<tr>
<td>Over $75,000 but not over $10,000,000</td>
<td>34</td>
</tr>
<tr>
<td>Over $10,000,000</td>
<td>35</td>
</tr>
</tbody>
</table>

2018

21% flat rate

FYE C Corps have a blended corporate rate
Provisions Affecting Business Tax Returns

1. Repeal AMT for C Corps. This provision does not sunset.
2. 30% limitation on interest deductions – N/A if Gross Receipts < $25m
3. Easier to qualify for cash method of accounting < $25m
4. Entertainment expenses no longer deductible
5. Dividends received deduction modified due to new 21% tax rate
6. 100% bonus depreciation deduction
   – Applies to assets placed in service after September 27, 2017
   – Is now applicable to both new and “used” qualified property
   – Phases out over 5 years after 2022
7. Section 179 deduction increased to $1m with higher phase out
8. Like kind exchanges limited to real estate only
9. Net operating losses generated in 2018
   – Cannot be carried back
   – Can only offset 80% of future taxable income
   – Do not expire
10. Full NOL carryforward/carrybacks are still available for farmers and property and casualty insurance companies
International Tax Highlights

• One-time tax on foreign earnings
• Minimum tax on “Global Intangible Low-Taxed Income” or (“GILTI”)
• Move to quasi-territorial system with a 100% dividends received deduction – Participation Exemption.
• Incentives for Foreign-derived Intangible Income
• Repeal of 30-day CFC Rule
• Other significant changes
Transition Tax
(Deemed Repatriation)

- As part of the transition to move from a global system to a territorial system of taxation, the new law imposes a transition tax on offshore earnings accumulated by foreign corporations through December 31, 2017.
- The transition tax applies to all types of U.S. shareholders of Controlled Foreign Corporations.
- Rate of Tax:
  - **US C Corp. Shs**: 15.5% tax rate for cash and 8% tax rate for non-cash of E&P.
  - **US Individual Shs**: 17.5% tax rate for cash and 9.05% for non-cash of E&P.
Transition Tax
(Deemed Repatriation)

• **Installment Payments**
  US shareholders can elect to pay liability in installments over 8 years (8% for the first 5 years, then 15% for 6\textsuperscript{th} year, 20% for 7\textsuperscript{th} and 25% in 8\textsuperscript{th} year).

\textit{No interest applies on installment payments.}
Transition Tax

(Deemed Repatriation)

• S Corporations may elect to defer the transition tax until triggering event.

Three types of triggering events:
1. The corporation ceases to be an S corporation
2. Liquidation or sale of all corporate assets, a cessation of business or similar event.
3. Transfer of shares of stock in the S corporation by the shareholder

• Upon triggering event, the S corporation shareholders can make an installment payment election to pay tax over 8 years.
Global Intangible Low-Taxed Income (GILTI)

• GILTI imposes a minimum tax on certain foreign income.
• GILTI = Net CFC tested income – [(10% * “Qualified Business Asset Investment”) – interest expense)]
• Net CFC tested income refers to income that is not otherwise taxed under anti-deferral provisions and to U.S. trade or business income.
• Qualified Business Asset Investment (QBAI) is average of adjusted basis of depreciable Specified Tangible Property used in a trade or business.
• 80% foreign tax credit and 50% deduction for GILTI is available to C corporation shareholders. Resulting in an effective income tax rate of 10.5% for C Corp. and up to 37% tax rate for other taxpayers.
• No FTC or deduction is available for non-C corp. shareholders.
Participation Exemption

Dividends Received Deduction (“DRD”)

• Income that is not otherwise GILTI taxed, or any other category of Subpart F (i.e. anti-deferral income provisions) can be repatriated free of U.S. tax to a C Corporation Shareholder. This is accomplished through a “dividends received deduction.”

• The above rule only applies to domestic corporations that own at least 10% or more of foreign subsidiaries.

• This is effective for distributions made after Dec. 31, 2017.
Foreign Derived Intangible Income (FDII)

- New incentive for US corporations that earn “foreign derived intangible income” (FDII).
- Generally, provides a deduction of 37.5% of its FDII.
- Results in a 13.125% effective tax rate on its FDII.
- FDII is income attributable to the sale of property to foreign persons for use outside the U.S., or to services provided to persons outside the U.S. (i.e., export of goods or services).
Foreign Derived Intangible Income (FDII)

- Deemed Intangible Income = Deduction Eligible Income – 10% (Qualified Business Asset Investment or QBAI).
- QBAI is the average of the adjusted bases of tangible property used in trade or business. Similar to GILTI.
Repeal of “30-Day CFC Rule”

• Before the repeal of “30-Day CFC Rule” a U.S. shareholder was not subject to Subpart F income (i.e., anti-deferral provisions) if it did not own the stock of the CFC for 30 days or more during the year.

• Foreign individual that own a foreign corporation which held appreciable US situs assets (US real estate, US stocks and bonds, etc.) would not be subject to US estate tax upon death.

• After foreign individual’s death, an election would be made to treat the foreign corporation as a flow-through entity. The election would step-up the basis of the appreciable assets to fair market value while avoiding US income tax on the built-in gain.

• With the repeal of 30-day CFC rule the above tax strategy is no longer recommendable.
Other Outbound Changes

- IC-DISC provisions was not repealed.
- Section 956 – Investment in U.S. property (anti-deferral provision) was not repealed.
- Section 954(c)(6) was not extended beyond 2019. This section provides an exception to Subpart F income for dividends received by CFC under look-through rule.
- Property produced in the U.S. will be U.S. source income regardless of place where title of property passes. Conversely, property produced outside the U.S. will be foreign source income.
Other Outbound Changes

• Section 958(b)(4) was repealed effective in 2017. Now downward attribution from a foreign person to U.S. person is applied. This can make a US corporation the shareholder of a brother-sister foreign corporation through the common ownership of foreign parent corporation.

• U.S. shareholder is now determined by 10% vote of stock OR value in foreign corporation. Previously, US shareholders were only those who had 10% vote of stock.
• New interest deduction limitation applies to all taxpayers: corporations, individuals, partnerships, S corporations.
• Limitation applies regardless of whether debt is to a related or unrelated party.
• Interest deduction is limited to 30% of “Adjusted Taxable Income” (ATI) plus interest income and any floor financing interest.
• Limitation does not apply to small businesses, those with gross receipts of less than $25 million determined on an aggregate basis of affiliated group.
Interest Deduction Limitation

Section 163(j)

• No interest limitation applies to “electing real property trade or business”. This includes any real property development, construction, acquisition, rental operation, management, leasing or brokerage trade or business.

• The new law does not provide guidance on how disqualified interest carryforward or unused excess limitations from old Section 163(j) will be treated.
Base Erosion Anti-Abuse Tax (BEAT)

- This is a minimum tax on related-party deductible payments. It applies to corporations with annual gross receipts of $500 million or more and related-party deductible payments totaling more than 3% of overall deductions.
- This tax applies to domestic payments to foreign related parties.
- The tax rate is 5% in 2018, and 10% in 2019 to 2025. For banks and registered securities dealers the tax rate is 1% more of the above rates.
- A corporation's “modified taxable income” (MTI), reduced by its regular tax liability.
- MTI is taxable income increased by any deductible payment made to a related foreign person.
Base Erosion Anti-Abuse Tax (BEAT)

- BEAT is applicable to US C corporation or foreign corporation engaged in a US trade or business with combined gross receipts of $500 million or more determined on an aggregate basis of affiliated group.
- Based Erosion Payments includes interest, royalties, rent and service fees paid or accrued to “related foreign party.”
- Base Erosion Payments do not include: cost of goods sold (provided the payments of COGS are not to an inverted company) or amounts paid or accrued for services that qualify for “use of the services cost method “ (Treas. Reg. Section 1.482-9) and qualified derivative payments.
Other In-Bound Changes

• Sale of partnership interest by a foreign partner is subject to tax to the extent the underlying assets are connected with U.S. trade or business or U.S. assets. This new section repeals Grecian Magnesite court decision and follows Rev. Rul. 91-32. The court held that the sale of partnership interest was not taxable.

• Foreign Corporations will be taxed at the same tax rate as domestic corporations.

• Disregarded domestic LLCs will need to file Form 5472 if they are owned by a foreign person. The penalty for not filing the form is $25,000 per violation.
Estates, Trusts and Gifts

1. Estate and Gift Tax - What has changed?
   – Effective 1/1/18 the estate and gift tax exemption doubles to approximately $11.2m per individual and $22.4m per married couple
     – Generation skipping transfer tax exemptions match the lifetime exemption
     – The exemption is indexed for inflation using the Chained CPI index, due in February
     – Change will sunset on 12/31/25 and revert to $5.6m

2. Estate and Gift Tax - What has NOT changed?
   – No changes to the top estate tax rate of 40%
   – No changes to step-up in basis or in portability of exemptions
   – Non resident alien exclusion of $60,000 not increased
   – Annual gift tax exclusion for 2018 is $15,000
3. Trust Income Tax Changes

- Four tax brackets - 10%, 24%, 35% and 37% - Top tax bracket begins at $12,500
- $100, $300 and $600 Exemptions still apply
- Trusts are eligible for the 20% QBI Deduction and the QBI Threshold for Trusts is $157,500
- State and Local and Real Estate taxes are subject to the same $10k limit as individuals
- 2% deductions are suspended with the exception of those administrative expenses that would not have been incurred if the trust property were held by an individual
  - i.e., trustee fees, trust tax preparation fees, distribution expenses
- Excess deductions upon termination of a trust (other than capital losses) are not deductible at the beneficiary level, so care must be taken to time deductions and income
- Electing Small Business Trust beneficiaries can be an NRA – No sunset
- Electing Small Business Trusts can now deduct charity similar to individuals – No sunset
4. Some Observations

– A review of your estate plan should be done, no matter what your net worth
– With the doubling of lifetime exemptions, many taxpayers will no longer be subject to estate tax
– Unique opportunity for those who expect to be subject after the sunset in 2025
– For the ultra high net worth who continue to be subject, all the traditional wealth transfer strategies still apply (Lifetime gifts through GRATS, FLPS, IDGTs, etc.)
– Planning would still be required for those taxpayers who live in states that have decoupled from Federal law
– The estate and gift tax exemptions sunset in 2025, so theoretically large gifts today might be “clawed back” at death, however the new law requires that the Secretary of the IRS address this issue through regulations.
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