PRIVATE CLIENT SERVICES
YEAR-END TAX PLANNING

The impact of tax reform

November 15, 2018
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<thead>
<tr>
<th>Name</th>
<th>Title</th>
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<tr>
<td>Tony Wood</td>
<td>Principal</td>
<td>Private Client Services Practice National Leader</td>
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<td>Tommy Wright</td>
<td>Partner</td>
<td>Private Client Services Central Region Practice Leader</td>
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<td>Matt Talcoff</td>
<td>Partner</td>
<td>Private Client Services Practice Industry Leader &amp; Northeast Regional Leader</td>
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<tr>
<td>Carol Warley</td>
<td>Partner</td>
<td>Washington National Tax Estate &amp; Gift Tax Leader</td>
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# Agenda

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<td>2018 tax environment</td>
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<td>Individual income tax planning</td>
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<td>Estate planning</td>
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<td>Foreign reporting</td>
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2018 TAX ENVIRONMENT
Introduction – Where do we begin (a teaser)

1. It’s a **new (tax) world**
2. Compliance increased but **with opportunity**
3. **Modeling** is critical
   - Entity choice, transactions, charity, carried interests, etc.
4. **Transaction planning** is multidimensional
   - 1202 qualified small business stock, qualified opportunity zones, asset v. stock, states and more
5. **Deduction planning** – Charitable over state and local tax
6. **Business income**
   - Pass-through, net operating loses, meals and entertainment, accounting methods, capital expenditures, interest
7. **Estate and gift** planning and action
### Election results - Congress in 2018 and 2019

<table>
<thead>
<tr>
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<th>115(^{\text{th}}) Congress</th>
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<td>Runoff</td>
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<td>Vacancies</td>
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What’s on the legislative agenda?

1. Tax Reform 2.0 – House Republicans introduced and approved legislation in 3 separate bills. (Senate has not voted on it or expressed interest in it.)
   - Protecting Family and Small Business Tax Cuts Act of 2018
   - Family Savings Act of 2018
   - American Innovation Act of 2018

2. Democratic agenda – focus on ‘fairness’
   - Rolling back the tax decrease given to the top 1 percent
   - Reinstatement of the Affordable Care Act (ACA) individual mandate to ensure that millions do not lose their health insurance

3. President’s agenda – 10 percent tax cut for middle income taxpayers
IMPACT OF INDIVIDUAL INCOME TAX PROVISIONS OF TAX CUTS AND JOBS ACT OF 2017 ON PLANNING

2018 Planning
Key individual provisions 2018-2025

- Seven tax brackets ranging from 10 percent to 37 percent
- Personal exemption is eliminated
- Standard deduction increased to $12,000 (single), $18,000 (head of household) and $24,000 (joint filers)

Significant impacts on personal deductions

- Mortgage interest limited to the first $750,000 of principal value (no inflation adjustment) debt incurred after 12/15/2017 (unless grandfathered loan; caution as to changes in loan)
- State and local tax deduction limited to $10,000, combined for income, sales and property taxes ($5,000 for married filing separately)
- Retains the charitable contribution deduction, but limits or eliminates other deductions
Key individual provisions 2018-2025 (continued)

Repealed 2% miscellaneous itemized deductions including investment advisory fees, unreimbursed employee business expenses, tax advisory fees, job hunting, etc.

Repealed charitable deduction allowed in conjunction with purchase of college athletic tickets

Medical expenses deductible to extent exceed 7.5% of AGI for 2018 and 10 percent of adjusted gross income (AGI) for 2019 & later

Repealed casualty loss & theft loss deductions except for federally declared disaster areas

For divorces after 2018, alimony no longer deductible in 2019 & later and alimony income is not includable in income after 2019; no change for pre-2019 divorces unless agreements executed or modified after 2018

Repealed deduction for moving expenses
Child tax credit increased from $1,000 to $2,000 and phase-out is increased from $110,000 to $400,000 of taxable income for joint filers; $1,400 of the credit is refundable.

Retains the alternative minimum tax (AMT); exemption increased from $86,200 to $109,400 for joint filers. Increases the phase-out threshold to $1 million for joint filers.

Repeals the individual mandate penalty (ACA) by lowering it to $0, effective Jan. 1, 2019.

Doubles the estate tax exemption from $5.6 million to $11.2 million.

Many of the provisions are temporary, expiring on December 31, 2025.
Planning in light of tax law changes

• With new rules and limits on deductions, consider ‘bunching deductions’ into alternating tax years while claiming the standard deduction every other year (unless deductions are high)

• Analyze alternatives to home mortgage deductions where debt balance exceeds the applicable limit; can you restructure debt to qualify as investment interest expense?

• Consider using a donor advised fund to maximize and prepay future charitable giving
• Utilize health savings accounts (HSAs) to fund medical on pre-tax basis ($3,450 for self, $6,900 for family; add $1,000 for age 55 or older)

• Investment advisory fees no longer deductible – consider alternatives: mutual funds, carried interest for advisors, *Lender Management, LLC v. Commissioner* case ‘restructuring’ for ultra high net worth individuals

• Allocate accounting and tax prep fees to business income, rental property, etc. Cause business to pay them as compensation
Planning in light of tax law changes (cont.)

• Up to $10,000 annually of 529 plan assets may be used per student (regardless of number of plans) for public, private and religious elementary and secondary schools.

• 529 plan assets may be rolled over to an Achieving a Better Life (ABLE) account without penalty as long as the ABLE account is owned by the beneficiary of 529 plan or a member of the beneficiary’s family.

• ABLE accounts offer a tax advantaged way to fund qualified disability expenses for a beneficiary who became blind or disabled before age 26. Treatment is similar to 529 college savings plans. Aggregate contributions are limited to $15,000.
Planning in light of tax law changes (cont.)

• Kiddie tax simplification allows for filing of child’s tax return before parents return is completed

• 37 percent tax rate applies above $12,500 of taxable investment income after applying a $2,100 exemption for investment income

• Divorces and modifications after 2018 – alimony no longer deductible and no longer taxable for divorces or modifications in 2019 forward

• No change in law for pre-2019 divorces
Planning in light of tax law changes (cont.)

• Prohibition against re-characterizations of Roth IRA conversions does not prohibit the ‘back door’ Roth contribution

• Make non-deductible IRA contributions; convert to Roth IRA later; existing deductible IRAs create issues when converted

• IRA contribution limits
  – 2018 = $5,500 ($6,500 if age 50 or over)
  – 2019 = $6,000 ($7,000 if age 50 or older)
Donor advised funds for charitable planning

• Donor advised funds (DAFs) in lieu of private foundations – avoid tax filings and complexities

• Funding DAF entitles you to deduction at time of funding. Disbursements to qualified charities can be made later. No required annual payout from DAF at this time

• Can accept gifts of appreciated long term capital gain property – primarily publicly traded securities; some accept private company shares

• Avoid tax liability on unrealized appreciation
Charitable contribution planning

- Gifts of cash gifts to public charities (including DAFs) can be deducted up to 50/60 percent of your adjusted gross income (AGI)
- Gifts of appreciated long term capital gain (LTCG) property to public charities can be deducted up to 30 percent of your AGI
- AGI limits for gifts to private foundations: 30 percent for cash; 20 percent for appreciated LTCG corporate stock that is traded on an established market (not a publicly traded partnership)
Charitable contribution planning (cont.)

• Taxpayers age 70.5 or older allowed to make direct contributions from their IRAs to qualified charities (not including donor advised funds or private foundations) up to $100,000 per year which counts towards their required minimum distributions from their IRAs. Ideal for those using the standard deduction or those with large medical expenses.

• Charitable remainder trusts (CRTs)
• Charitable lead trusts (CLTs)
Charitable contribution planning (cont.)

- CRTs: Donate property, receive a partial charitable deduction for the present value (PV) of amount going to charity
- Receive annual annuity from the CRT for a term
- CRT is tax exempt and pays no income tax on its income/gains. Can be used to receive appreciated securities and liquidate tax free; diversify portfolio; income taxed to donor
- At end of CRT term, assets pass to charity
Charitable contribution planning (cont.)

• CLTs: Contribute assets or cash, receive a tax deduction (donor or trust); income/gains taxed
• Charity receives annual annuity for a term
• At end of trust term, assets pass to family or back to donor
• Upfront gift to family of PV of assets passing at trust termination
• Results favorable in low interest rate environment
SECTION 1202 STOCK
Exclusion of gain
Section 1202 corporate small business stock

- Qualifying corporate 1202 stock offers significant income tax advantages
- ‘Eligible’ gain can be excluded from AGI and not subject to alternative minimum tax
- Gain exclusion is greater of $10 million or 10 times original basis in shares (max $500 million) when shares held more than five years
- Original issue domestic C corporation stock
- Applies to qualifying shares gifted or inherited; holding period carries over for five year test
- Gross assets test at issuance – $50 million ceiling
- Active business requirement for holding period (80 percent asset test)
• Qualified trades/businesses exclude:
  – Service businesses (consulting, law, engineering, accounting, health, architectural, actuarial)
  – Performing arts and athletics
  – Financial services, brokerage services
  – Banking, insurance, financing, leasing, investing
  – Farming
  – Oil and gas and mining industries
  – Hospitality industry
  – Rental real estate and other real estate activities
• C corporation status for operating period – 21 percent tax rate on profits versus 29.6 percent or 37 percent for flow through

• Shareholder gain on liquidation after holding five years can be eliminated thus reducing the tax costs of C corporation status where corporate assets are sold to buyer

• Gain exclusion applies where stock is sold instead of asset sale
NET OPERATING LOSS & EXCESS BUSINESS LOSS CHANGES

Post 2017 losses
Individual net operating losses

• For net operating losses (NOLs) arising in tax years ending after Dec. 31, 2017
  – NOL deduction limited to 80 percent of taxable income (determined without regard to such NOL)
  – Example: A has $90 NOL in 2018 that is carried forward to 2019. In 2019, A has $100 of taxable income. The NOL carryforward can only offset $80 of 2019 taxable income, and the remaining $10 NOL is carried forward indefinitely
Individual net operating losses (cont.)

• For most taxpayers, carryback is repealed, but NOLs can be carried forward indefinitely
  – Terminate on death, but under section 1.642(h)-1, trust losses may flow to beneficiary

**Exception**

• Two year carryback for farming trade or business (defined in section 263A(e)(4))
Limitation of excess business losses (2018-2025)

- Non-corporate taxpayers will be limited on the amount of net business losses that can be claimed in any one year.
- Annual net loss limitation is $250,000 per taxpayer ($500,000 for joint filers).
- Excess losses carry forward as net operating losses, subject to 80 percent limit on deductibility.
- ‘Excess business loss’ = aggregate business deductions over aggregate business gross income and gains plus the annual dollar threshold amount of $250,000/$500,000.
QUALIFIED OPPORTUNITY ZONE BENEFITS

Alternative to 1031 exchanges?
Background to qualified opportunity zones

• Tax Cuts and Jobs Act established qualified opportunity zone (QOZ) program
  – New sections 1400Z-1 and 1400Z-2 of the Internal Revenue Code
• Intent is to spur economic growth in low income/distressed areas by harvesting unrealized gains and injecting capital into areas
• Many unanswered questions; various groups have submitted comment letters that request specific guidance
• Proposed Treasury regulations issued October; more coming later this year
Qualified opportunity zone map – Treasury certified 8,761 QOZs

Source: Novogradac
Overview of qualified opportunity zone program

Taxpayers can get capital gains tax deferral (and more) for making timely investments in qualified opportunity funds (QOFs) which invest in qualified opportunity zone property.
1. Deferral of gain recognition from original transaction until possibly 2026

2. Partial forgiveness (exclusion) of gain from original transaction (10 to 15 percent exclusion possible)

3. Forgiveness (exclusion) of additional gains from the QOZ fund investment
Step 1 – Investor sells appreciated assets

• Investor sells appreciated assets and reinvests the gain into a QOF
  – Any type of existing asset qualifies (stocks, real estate, etc.). There is no ‘like-kind’ requirement. Cannot be sale to ‘related party’.

• The gain amount must be invested into a QOF within 180 days of the sale or exchange triggering the gain. Use trade date for public stocks.

• **TAX BENEFIT #1**
  – Investor defers paying income tax on gain amount reinvested into a QOF until sold or until Dec. 31, 2026
  – Investor can invest the return of their principal investment as well as the gain, but only the portion of a QOF investment attributable to the reinvested gain will be eligible for deferral tax benefit under QOF
Step 2 – QOF invests in qualifying property

- If a partnership sells an asset and allocates the qualifying capital gain to its partners, can the partners reinvest the gain into a QOF and get the associated tax benefits? **Yes** Proposed Treasury regulations allow re-investment within 180 days of partnership year end (Dec. 31 usually) – so by June 29

- All capital gains clearly qualify, but what about:
  - Section 1231 gains? **Yes**
  - Ordinary income/gains? **No**
  - Depreciation recapture? Ordinary income – **No**; Unrecaptured 1250 gain – **Yes**; this is simply a rate differential (25 percent) but a capital gain
  - Section 465 mark to market income of dealers? **No**
Step 3 – Timing of payment of the deferred tax

- The investor pays tax on the original deferred gain at the earlier of (i) the sale of their interest in the QOF, or (ii) Dec. 31, 2026

- **TAX BENEFIT #2**
  - If the investor has held its QOF investment for at least five years, 10 percent of the deferred gain is permanently forgiven; 90 percent taxed
  - If the investor holds its QOF investment for at least seven years, an additional five percent (for a total of 15 percent) of the deferred gain is permanently forgiven; 85 percent taxed

- Note that to get the seven year benefit, an investor must invest in an QOF no later than Dec. 31, 2019. If invested after Dec. 31, 2021, no five year benefit
Step 4 – Possible elimination of tax at exit from QOZ

• The QOF program incentivizes long-term investments

• **TAX BENEFIT #3**
  – If the investor holds its QOF investment for at least 10 years, there is no tax at all on the gain realized by the investor at exit.
  – Applies only to that portion of interest acquired equal to original deferred gain amount due to ‘split investment’ rule of IRC 1400Z-2(e)(1)

• The language in the Code currently implies that the exit must be an entity sale
  – Unless/until there is clarifying guidance on this point, set up QOFs to hold a single asset to facilitate an entity sale at exit
Example

• Marie sells an existing investment on June 1, 2018, and realizes a capital gain of $300
• Marie invests $300 (gain amount not proceeds) in a qualified opportunity fund on Sept. 1, 2018, and makes the appropriate election
• Since Marie invested an amount equal to her gains within the 180 day window, she pays no tax on the $300 gain in 2018 achieving tax deferral
Example (cont.)

• Marie sells on Oct. 1, 2022, the asset acquired Sept. 1, 2018
  – 2022 tax on full $300 of gain because she only kept her QOZ investment for four years. Marie still gets four years deferral for the tax on 2018 gain

• Marie sells on Oct. 1, 2023
  – 2023 tax on $270 of gain since she gets the benefit of the 10 percent reduction of gain by holding the asset for five years ($300 original gain less $30)

• Marie sells on Oct. 1, 2025
  – 2025 tax on $255 of gain since she gets the benefit of the 15 percent reduction of gain by holding the asset for seven years ($300 original gain less $45)
Example (cont.)

• If Marie holds QOZ investment beyond Dec. 31, 2026, the tax on $255 of the deferred gain (only 85 percent) will be triggered on her 2026 tax return even though she still holds the QOZ investment
  – There is a deemed sale Dec. 31, 2026, for the original gain amount (or the FMV of QOZ investment over its basis on this date, if less)

• HOWEVER, if we assume that QOZ investment appreciates to $700 when she sells on Oct. 1, 2028, Marie pays no tax at all on the $400 appreciation ($700 value minus $300 investment) since she held the QOZ investment for 10 years
Comparing section 1400Z-2 to section 1031 like-kind exchange

• Deferral of original transaction gain
  – 1400Z – temporary on 85 percent, possibly permanent on 15 percent
  – 1031 – temporary, unless basis step up at death of owner

• Deferral of gain on new investment
  – 1400Z – permanent exclusion after 10 years
  – 1031 – no exclusion, but deferral available through 1031 exchange

• Timing
  – 1400Z – no identification rule, 180 days to invest
  – 1031 – 45 day identification rule, 180 days to invest
Comparing section 1400Z-2 to section 1031 like-kind exchange (cont.)

- **Investment amount to obtain deferral**
  - 1400Z – Only amount of original gain required to be re-invested
  - 1031 – Amount realized on sale required to be re-invested

- **Source of investment**
  - 1400Z – any source; no tracing of original gain sale proceeds
  - 1031 – sale proceeds must be reinvested; constructive receipt rules apply

- **Type of investment**
  - 1400Z – must be interest in a QOZ fund, not limited to real estate
  - 1031 – must be ownership of like-kind real estate
Comparing section 1400Z-2 to section 1031 like-kind exchange (cont.)

• Construction
  – 1400Z – developments must reach minimum target amount within 30 months after investment
  – 1031 – like-kind rules require qualifying improvements exist at time of acquisition
Timeline of a QOF – Investment

**July 1, 2018**
Taxpayer enters into a sale that generates $1 million of capital gain (not proceeds)

**Dec. 27, 2018**
(within 180 days), Taxpayer contributes entire $1 million of capital gain to a QOF

- Taxpayer is deemed to have a $0 basis in its QOF investment
- QOF invests the $1 million in QOF property
**Timeline of a QOF – Exit**

- **Dec 31, 2023**
  (after 5 years), taxpayer’s basis in investment in QOF increases from $0 to $100,000 (10%)

- **Dec 31, 2025**
  (after 7 years), taxpayer’s basis in investment in QOF increases from $100,000 to $150,000 (15%)

- **Dec. 31, 2026**
  $850,000 of the $1 million of deferred capital gains are taxed and the basis in QOF investment increases to $1 million.

- **Dec 31, 2028**
  (after 10 years), Taxpayer sells investment for $2 million. Basis in the investment is deemed to be FMV. The effect is no tax on appreciation in QOZ investment.
BUSINESS OWNER PLANNING CONSIDERATIONS
Tax provisions impacting the business owner – Planning and complying

1. Corporate tax rates reduced from a top rate of 35 percent to 21 percent (permanent)
2. Individual tax rate of owners reduced from a top rate of 39.6 percent to 37 percent
3. Pass-through entity deduction up to 20 percent of the qualified business income (2025)
4. Enhanced depreciation deductions for capital expenditures (bonus and section 179 $1 million)
5. Alternative minimum tax (AMT) repealed for corporations and higher exemption for individual owners
6. Potential limit on Interest deduction based on 30 percent of modified taxable income
7. NOL rule changes generally reduce value of NOL carryforwards (80 percent rule) and eliminate carryback
8. Active business loss limitations apply at the individual level
9. Small business exemptions exist for limits on interest deduction and accounting methods
10. Many tax credits preserved (tips, Work Opportunity Tax Credit (WOTC), research and development (R&D))

11. Charitable contribution deductions preserved

12. Deduction for domestic production activities (section 199) was repealed

13. Elimination of tax deductions for entertainment (but not business meals)

14. Transition to modified territorial system, global intangible low-tax income (GILTI), foreign derived intangible income (FDII) and base erosion and anti-abuse tax (BEAT)

15. Decoupled and diverse state income tax systems

16. Carried interest provisions added with three year holding period

17. Transaction related changes including limits on interest deductions and enhance write-offs

18. Estate and gift tax exemptions nearly doubled to approximately $11 million
2018 and 2019 planning accelerate deductions / defer income

- Review accounting methods
- Review deferred taxes
- Advance payments
- Accrued expenses (i.e. bonuses)
- Bad debts
- Year end transactions
- Cash basis taxpayers
- Manage AGI
- Inventory methods
  - Lower of cost or market (LCM), subnormal goods, uniform capitalization (UNICAP) rule
- Tax legislation impacts
- Section 199A pass-through deduction
  - Margin impacts tax deduction
- Prepaid expenses
- Cost segregation
- Bonus depreciation
- Self insured (incurred but not reported - IBNR)
- Credits
  - R&D, WOTC, TIPs, empowerment zones
- Evaluate entity selection
CORPORATE TAX RATE CUTS

The choice of entity question
Planning around the new rates (C corporation/entity choice)

• New income tax rules (C corporations)
  – $100 of corporate income
    • Less $21 tax at 21 percent rate
  – $79 of cash on balance sheet
    • Less $15.8 tax at 20 percent rate
  – $63.2 of after tax cash
    • 36.8 percent combined income tax rate
    • 3.8 percent tax on $79 or $3
  – All-in 39.8 percent tax rate

• Planning opportunities
  – Defer the 20 percent dividend and 3.8 percent NII tax
    • Reinvesting cash in the business
  – Avoid the 20 percent dividend and 3.8 percent net investment income (NII) tax
    • At death or
    • Stock gifts to charity that would otherwise be made in cash
  – Reduce the 20 percent dividend and 3.8 percent NII tax
    • if shares held by lower-rate taxpayers
    • including from gifts, trusts, etc.
PASS-THROUGH ENTITIES
Number of tax filings by entity type

Number of Returns Filed
1980 – 2012

Source: IRS
Section 199A – Qualified business income deduction (20 percent pass-through deduction in a nutshell)

- Deduction limited to 20 percent of qualified business income
- Applies to operating income of active businesses (available to active or passive investor)
  - If at 37 percent tax rate then the 20 percent deduction results in an approximately 29.6 percent federal tax
  - Compared to
    - 21 percent top corporate tax rate
    - 37 percent top individual tax rate
    - 39.8 percent top corporate/dividend tax rate
    - 29.6 percent potential pass-through tax rate
- Does not apply, generally, to service professions or financial businesses
- Additional limitations based on greater of
  - 50 percent of W-2 wages (i.e., business must pay W-2 wages of 40 percent of income for full 20 percent deduction) or
  - 25 percent of W-2 wages plus 2.5 percent of original cost of depreciable, tangible property
- Business type and wage/asset limits do not apply below income limits ($315,000 married filing jointly)
- Only applies to income taxes (not self employment or NII tax calculations)
Highlights from the proposed regulations – Summer 2018

• Helpful guidance regarding ‘specified service trades or businesses’
• New aggregation regime – similar to (but different from) passive activity grouping rules
• Taxpayers will need to analyze their revenue streams looking for ‘good’ income and ‘bad’ income
  – De minimis rule and related ‘cliff effect’ can wipe out the deduction
• Unless changes are made in final regulations, businesses and owners may see increased reporting complexity
Year-end planning – Section 199A

• The proposed regulations would impact several strategies that might have generated a benefit

• Opportunities still exist to impact the potential deduction
  – Wage and asset limitations
  – Income limitations
  – Aggregation opportunities
  – Planning around the ‘cliff effect’
    • Separate trades or businesses
    • Considering expense allocation methodology
  – Analyzing other income streams
Business entity examples

• Pass through with and without 20 percent deduction versus C corporation
• Domestic manufacturer versus non-domestic manufacturer
• Annual taxable income of $1 million
• Individual owners taxed at top federal tax rate
• Assume state tax rate of 6.5 percent
### Summary business entity federal tax pre and post TCJA - $1 million of income

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<th>New rules</th>
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<td>- Pass-through with 20% deduction</td>
<td>$334,620</td>
<td>$296,000</td>
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<tr>
<td>- C corporation</td>
<td>$295,750</td>
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<td>- Tax difference</td>
<td>$38,870</td>
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Pass-through entity — without 20 percent deduction (non-domestic manufacturer)

• Old rules
  - Income $1 million
  - State taxes ($65,000) - deduct
  - Taxable income $935,000
  - Federal tax of $370,260 (39.6 percent)
  - Effective federal rate of 39.6 percent on net income after state taxes

• New rules
  - Income $1 million
  - State taxes ($65,000) – non deduct
  - Taxable income $1 million
  - Federal tax of $370,000 (37 percent)
  - Effective federal rate of 39.57 percent on net income after state taxes
  - Net result - $260 less tax
  - Lower federal tax rate but no state income tax deduction
C corporation (non domestic manufacturer)

• Old rules
  – Income $1 million
  – State taxes ($65,000) - deduct
  – Taxable income $935,000
  – Federal tax of $327,250 (35 percent)
  – Effective federal rate of 35 percent on net income after state taxes

• New rules
  – Income $1 million
  – State taxes ($65,000) - deduct
  – Taxable income $935,000
  – Federal tax of $196,350 (21 percent)
  – Effective federal rate of 21 percent on net income after state taxes
  – Net Result - $99,400 less tax
  – Lower C corporation tax rate
  – State taxes deductible
Pass-through domestic manufacturing entity—with 20 percent deduction

**Old rules**
- Income $1 million
- Domestic manufacturer deduction ($90,000)
- State taxes ($65,000) - deduct
- Taxable income $845,000
- Federal tax of $334,620 (39.6 percent)
- Effective federal rate of 35.79 percent on net income after state taxes

**New rules**
- Income $1 million
- Pass-through deduction ($200,000)
- State taxes ($65,000) – non deduct
- Taxable income $800,000
- Federal tax of $296,000 (37 percent)
- Effective federal rate of 31.65 percent on net income after state taxes
- Net result - $38,260 less tax
- Pass-through deduction
- No state tax of domestic manufacturer deduction
Same domestic manufacturing company example as a C corporation

• Old rules
  - Income $1 million
  - *Domestic manufacturer deduction* ($90,000)
  - State taxes ($65,000) - deduct
  - Taxable income $845,000
  - Federal tax of $295,750 (35 percent)
  - Effective federal rate of 31.63 percent on net income after state taxes

• New rules
  - Income $1,000,000
  - State taxes ($65,000) - deduct
  - Taxable income $935,000
  - Federal tax of $196,350 (21 percent)
  - Effective federal rate of 21 percent on net income after state taxes
  - Net result - $99,400 less tax
  - Lower tax rate
  - No manufacturing of pass-through deduction
Caution with C corporation Sale of business – Assume $3 million LTCG

• Pass-through (new rule)
  – $3,000,000 of income
  – $195,000 in state taxes
  – $3,000,000 taxed at 20 percent
  – No tax on distributions
    - Federal tax of $600,000
    - Effective federal rate of 21.39 percent on net income after state taxes

• C corporation (new rule)
  – $3,000,000 of income
  – $195,000 in state taxes
  – $2,805,000 taxed at 21 percent
  – $2,215,950 of dividends taxed at 23.8 percent
  – Federal tax of $1,116,446
  – Effective federal rate of 39.80 percent on net income after state taxes
  – Double tax
Corporation v. flow-through – Analysis is critical

- Major factors that have the potential to affect the entity choice analysis include:
  1. Owner’s exit strategy (sale or passing on to future generations)
  2. Owner’s eligibility for the pass-through deduction
  3. Owner plan for business earnings (distribution or reinvestment)
  4. Rate of return on reinvested business earnings
  5. Presence of a large international footprint
  6. High effective state tax rate
  7. Presence of tax carryforwards and other tax attributes (AAA, suspended losses, etc.)
  8. Estate planning considerations
CAPITAL EXPENSES
Depreciation, expensing, bonus depreciation
Depreciation - complex analysis but generally...

1. Basic, pre-bonus depreciation rules, viewed as non-economic by some, remain in baseline (MACRS)
2. 100 percent bonus depreciation through 2022, then phased out through 2026
3. Applies to new and used property acquired
4. Changes to real property depreciation complex, and may depend on applying business interest limitations
5. Applied for property acquired after Sept. 27, 2017
6. Qualified improvement property (QIP) remains (Qualified LHI, restaurant and retail improvement eliminated) – But no life provided and needs to be 20 years or less to be 100 percent bonus eligible
7. Section 179 - $1 million permanent expensing, s/t limitations and phase-outs beginning at $2.5 million (individuals not trusts)
   - QIP interior of non-residential rental property and will include roofs, HVAC, fire protection, security systems
   - Careful planning needed
8. State conformity is a question and an opportunity
BUSINESS INTEREST DEDUCTIONS CUTBACK
Important changes to interest limitations

1. Caps net interest deduction at 30 percent of an amount based on earnings before interest, tax, depreciation and amortization (EBITDA) for four years, then limits the deduction to 30 percent of earnings before interest and taxes (EBIT)

2. Taxpayers with average gross receipts of $25 million or less and car dealers using floor plan financing loans to fund their inventory are excluded from the interest limitation

3. Allows ‘limited’ deductions to carry forward forever

4. Various exceptions for real estate, utilities, farming and certain small businesses

5. Special rules for partners and partnerships
Interest limitation using EBITDA

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $500,000

30 percent of base = $150,000
No limitation applies

Carryforward allowed indefinitely
Interest limitation using EBIT

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $300,000

30 percent of base = $90,000
$10,000 interest is ‘limited’

Carryforward allowed indefinitely
OTHER IMPORTANT BUSINESS DEDUCTION LIMITATIONS, LIBERALIZATIONS, OR DEFERRALS
Good news

• Financial statement deferred tax liability is reduced
• Corporate **AMT** repealed after 2017 (but Individual AMT remains)
• Expanded use of **cash method** of accounting for small C corporations and partnerships with C corporation partners with < $25 million gross receipts
• Expands the uniform capitalization (**UNICAP**) small business exception
• Generally exempts certain small business taxpayers from requirement to keep **inventory**
• Expands **percentage of completion** method exception for certain construction contracts
• Retains **R&D** credit (but amortization after Dec. 31, 2022)
• Retains other credits including **TIPs** and **WOTC** (for hires on or before Dec. 31, 2019)
• Favorable **depreciation** rules (but QIP?)
• Repeals **technical termination** of partnerships
Not good news

• No more manufacturer’s deduction (section 199)
• No more NOL carrybacks – some limitations and modifications to the carryforward rules
• Modifies the exclusion from income of certain contributions to capital (e.g., state/city grants)
• Limits like-kind-exchanges to certain real property
• Increased limitations on deductibility of certain expenses of entertainment
• Limits on business interest expense
• Limit on state income tax deductions for flow-throughs
• Deemed repatriation (good news, bad news)
• Changes public company executive compensation deductibility (section 162(m)) rules
Section 274 – Meals and entertainment changes

- **Entertainment expenses** – Effective Jan. 1, 2018, such expenses are generally 0 percent deductible, even if expense was for business purposes

- **Meals expenses** – Effective Jan. 1, 2018, most meal expenses are 50 percent deductible. TCJA eliminated de minimis exception to the 50 percent deduction limit for food and beverage expenses
  
  - **Administrative issues** – Difficult to find meal expenses in invoices (e.g., a bill for copy paper, office supplies, coffee and other beverages). Company must determine amount of food and beverage costs from these bills. Work with suppliers to require separate reporting
  
  - **Charity sporting events** - Work with charity to indicate advertising expenses, food expenses (50 percent deductible if identifiable), charitable donations, and actual entertainment cost (0 percent deductible)

- **Notice 2018-76** clarified that where business meal and entertainment expenses are together (e.g., a meal consumed with a client at a ball game), the meal is still 50 percent deductible SO LONG AS the meal amount is separately identified or separately billed
New loss limitation rule applies to taxpayers other than corporations

• Prohibits deducting ‘excess losses’ against wage and/or investment income

• Excess business loss
  – The excess of deductions from all trades or businesses of the taxpayer in excess of
  – Gross income from such businesses plus $250,000 (single or MFS) or $500,000 (joint)

• Limitation is applied at the individual or trust level, not at the entity level

• Losses limited by rule carry over as NOL

• Excess loss limit applied after passive activity loss limits are applied
Important changes to NOL deductions

• Carryback and carryforward
  – Repeals the carryback period (two-year)
  – Provides for an indefinite carryforward period
  – Applicable to losses arising in taxable years ending after Dec. 31, 2017

• Limits NOL deduction to 80 percent of taxable income for losses arising in taxable years beginning after Dec. 31, 2017
CLOSE-UP ON REAL ESTATE
Multiple moving pieces in commercial real estate

• Reduced pass-through tax (via 20 percent deduction) likely to apply in many cases
• Real estate investment trusts (REITs) automatically get that benefit, possibly including mortgage REITs
• Potentially serious limits on ‘active losses’
• Business interest disallowance will not apply
  – But at the cost of some depreciation benefits
• Like-kind-exchanges preserved
• Carried interest defined, but essentially preserved, longer holding period
CLOSE-UP ON PROFITS INTERESTS AND CARRIED INTERESTS
Treatment of carried interest

• Expressly recognizes the concept of different treatment for profits interests in an ‘applicable trade or business’ defined as
  – A regular, continuous and substantial activity of
  – Raising or returning capital, and either
    • Investing in or disposing of specified assets, or
    • Developing specified assets
  – Specified assets include securities, commodities, real estate, cash, options, derivatives and partnership interests

• But, for now, only applies a three-year holding period
Private equity considerations

• Generally good news for treatment of carried interest if held for three years
• Business interest limitations may limit leverage
• NOL rules and other rules may require restructuring
• Reconsider choice of entity (partnership versus corporation) for portfolio companies
• Founders or other individuals may have rate issues, self-employment issues and net investment income tax issues
• Write off of used assets in M&A transaction
OVERVIEW OF THE STATE TAX CONSIDERATIONS
State taxation – Decoupled and diverse state income tax systems

• Conformity and decoupling
  – Rolling, fixed, selective, mixed

• Some provisions broaden federal income base (e.g., interest expense limits)
  – Potential windfall for states

• Some provisions reduce federal income base (e.g., bonus depreciation)
  – Expect decoupling for state purposes

• Other state responses
  – State income tax systems and rates could change
  – Deduction and exemption eliminations, base expansions
  – New taxes, e.g., gross receipts taxes
  – Continued aggressive nexus expansion

• Many planning opportunities exist
  – Location selection, nexus
  – Choice of entity and state specific elections
  – Capital expenditures, section 179
  – Credits and incentives
OVERVIEW OF INTERNATIONAL BUSINESS PROVISION - GILTI
GILTI – One of the changes

• Old law
  – U.S. taxation of the earnings of foreign corporations was deferred until earnings were repatriated via a dividend or an income inclusion under Subpart F occurred

• New law - GILTI
  – New section 951A creates new category of ‘Subpart F-like’ income that requires inclusion of foreign earnings in U.S. taxable income on a current basis
  – Effectively allows for only a certain portion of earnings to be exempt from U.S. tax
  – Appears to cast a much broader net than traditional Subpart F rules
  – Complex rules to administer
Some Observations on GILTI

• GILTI will impact almost every taxpayer that has ownership in a foreign corporation, including individuals, trusts, partnerships, S corporations and C corporations.

• Individuals and trusts taxable at ordinary income rates unless a section 962 election is made but Section 250 deduction is NOT available.

• Section 250 deduction not allowable in calculating NOL.

• MUST use ADS depreciation to calculate GILTI, not optional; may need two sets of books (one for GILTI and existing set).

• GILTI may apply even if a client has no low-taxed foreign earnings.

• State impact may vary from federal.
Other observations

• Proposed GILTI regulations were issued on Sep. 13., 2018; two more sets of regulations are expected by year end

• Proposed GILTI Form 8992

• Schedule I-1 on Form 5471

• Financial statement presentation
Managing GILTI

• GILTI planning opportunities may include:
  – Converting to a C corporation
  – Inserting a C corporation to hold foreign operations
  – Making section 962 elections
  – Check-the-box planning
  – Planning into the high tax exception
  – Planning for a potential exit of a controlled foreign corporation (CFC) investment
  – Section 338 planning
  – Consolidated group planning
  – Maintaining ADS tax depreciation of CFC fixed assets
  – Transfer pricing
  – Accounting methods review for CFCs
ESTATE PLANNING
Estate planning subsequent to the enactment of tax reform

- Estate, gift, and generation-skipping transfer tax exemption amounts have increased to $11.18 million per taxpayer, in essence a doubling all transfer tax exemption thresholds.
- Estate, gift and generation-skipping tax rates remain at 40 percent.
- Window to use the increased exemptions or lose them because these exemptions are scheduled to revert back to less than $6 million beginning in 2026. Your estate plan needs to be flexible and consider the impact of this sunset.
- If you want to use the increased exemptions what is the best use? Is there debt that you want to forgive? Additional gift transfers?
- It is unexpected that anything will change in the next two years given the political landscape.
Estate planning subsequent to the enactment of tax reform (cont.)

- Estate plans need to be reviewed to consider whether unintended results will occur based on the increased exemptions. Do you know how your assets would pass at death?
- Does your plan include trust funding and if so how much is being funded into each trust now and is this appropriate based on your goals and objectives?
- The goal should now be making sure the surviving spouse receives a basis adjustment at death if no longer subject to estate tax and thus a change to your plan if necessary to accomplish.
- Should you restructure entities to eliminate a valuation discount if you are no longer subject to estate tax?
What are some of the mistakes you can make?

- Not planning for flexibility – flexibility is critical when planning for the future to be able to adapt to unforeseen circumstances
- Not properly reporting a gift tax or sale transaction – with the result that the time for the IRS to audit stays open
- Not filing gift tax returns – this can result in missed important tax benefits particularly as it relates to protecting future generations from estate tax
- Not working with sophisticated advisors and taking the simple approach – specialized knowledge is important to avoid future issues and complexity is often required to achieve the best result
- Not reviewing beneficiary designation forms and the titling of assets – your will doesn’t control where certain assets pass
What are some of the mistakes you can make? (cont.)

• Not giving consideration to income tax issues such as the basis adjustment that occurs at death
• Not giving consideration when doing trust planning to who likely will spend the money
• Not planning for trust state income tax when doing trust planning – where do the beneficiaries and the trustees live?
• Not having a review of your life insurance – is it still needed? Is the policy still state of the art and able to sustain itself?
• Not communicating your estate plan with family members particularly if some family members have been favored over others
Estate and gift tax considerations with closely held businesses

• Timing important so don’t wait to plan
• Focus on succession planning is critical
• If you want to sell
  – Planning is important if your business is growing to transfer appreciation to future generations
  – When the deal is done it is too late
• If you want to keep
  – How much do you want to transfer to your heirs; are they involved in the business?
  – How will the estate tax be paid?
    • Life insurance
    • How to finance with either the government or a third party
Planning for the golden years

• Have you planned for incapacity utilizing revocable trusts and/or powers of attorney

• Have you put a plan in place to protect your assets from persons who take advantage of you as you get older?
FOREIGN REPORTING
Foreign reporting required for U.S. citizens and domestic entities

- FinCEN Form 114 Report of Foreign Bank and Financial Accounts (FBAR)
- Individuals and domestic entities must file if there is an ownership interest or signature authority over foreign financial accounts that meet the reporting threshold
- Reporting required if the aggregate value of financial accounts exceeds $10,000 at any time during the calendar year
- Penalties for not filing applicable
• Form 8938 Statement of Specified Foreign Financial Assets
  - Individuals and domestic entities must file if there is an ownership interest in a specified foreign financial asset and value exceeds a certain threshold
  - Foreign financial account maintained by a foreign financial institution
  - Certain foreign investments not held in a financial account such as stock or foreign entities
  - Filing thresholds start at $50,000 of value depending on the type of entity
  - Minimum penalty is $10,000 for failure to file and increases from there
  - Statute of limitations for the IRS to audit remains open if not filed
Foreign reporting required for U.S. citizens

- Form 3520 Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts
  - For transactions with foreign trusts
  - If more than $100,000 received from a nonresident alien
  - Minimum penalty is $10,000 for failure to file and increases from there
  - Undisclosed foreign financial asset penalties
  - Statute of limitations for the IRS to audit remains open if not filed
Foreign reporting required for U.S. citizens (cont.)

- Form 3520-A Annual Information Return of Foreign Trust With U.S. Owner
  - Annual information return for a foreign trust
  - Minimum penalty is $10,000 for failure to file and increases from there
  - Statute of limitations for the IRS to audit remains open if not filed
Foreign reporting required for U.S. citizens (cont.)

- Form 926 Return by a U.S. Transferor of Property to a Foreign Corporation – reporting for certain transfers result in a filing requirement
- Form 8865 Return of U.S. Persons With Respect to Certain Foreign Partnerships – reporting for certain transfers result in a filing requirement
- Form 8621 Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund – reporting for certain distributions, gains, and elections
- Form 5471 Information Return of U.S. Persons With Respect to Certain Foreign Corporations – reporting for certain officers, directors and shareholders
- Form 8858 – Information Return of U.S. Persons With Respect to Foreign Disregarded Entities – reporting for certain tax owners of foreign disregarded entities
- Penalties are applicable for not filing and the statute of limitations for the IRS to audit remains open
Thank you

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