Webinar: 2018 Year-End Tax Planning for Privately-Held Companies (Part 1)

Speakers for this session include:

AAFCPAs
great minds | great hearts

Businesses Carry a Lighter Tax Load in 2018

Mostly very good news for corporations

- *New!* **Flat 21% tax rate — a big drop for all but the smallest corps**
  - Rates for C corporations used to be graduated, generally:
    - 15%: up to $50,000
    - 25%: $50,001 to $75,000
    - 34%: $75,001 to $10 million
    - 35%: over $10 million
  - PSCs paid a flat 35% rate
- *New!* **Corporate alternative minimum tax (AMT) repealed**
  - Rate used to be 20%; smaller corps were exempt
  - Corps can fully use AMT credit carryovers in 2018-2021 tax years
- *New!* **Dividends-received deduction reduced**
  - For 2018 and later, if a C corp owns 20% or more of another corp's stock, it can deduct 65% of dividends received from that stock (down from 80%)
  - If it doesn't own at least 20%, the deduction is 50% (down from 70%)

New QBI deduction for pass-throughs

- **Available to noncorporate owners of pass-through entities**
- **Deduction of up to 20% of qualified business income (QBI)**
  - Defined as the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business
  - Doesn't include certain investment items, reasonable compensation paid to an owner for services rendered to the business, or guaranteed payments to a partner or LLC member treated as a partner for services rendered to the partnership or LLC
- **Not allowed in calculating adjusted gross income**
- **Reduces taxable income similarly to an itemized deduction**
- **Subject to limits that partially apply if income falls within the phase-in range and fully apply above the top of the range**
  - Married filing jointly: $315,000-$415,000
  - Other taxpayers: $157,500-$207,500

When the income-based limit applies

- **The QBI deduction generally can't exceed the greater of:**
  - The owner's share of 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
  - The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property
- **Owners of specified service businesses generally can't claim the deduction**
  - Examples include businesses that involve investment-type services and most professional practices
  - Engineering and architecture practices are specifically excluded from this limit and thus may be eligible for the QBI deduction

Other Considerations on Entity Selection

- **S-Corps converting to C-Corp must wait 5 years before electing S status again**
- **Accumulated Earnings Tax**
  - Wealth can't be continuously accumulated at C-Corp level; must be distributed to owners
- **Reasonable Compensation Requirements**

Depreciation – the basics

- **Assets with a useful life of more than one year generally must be depreciated over a period of years**
- **Modified Accelerated Cost Recovery System (MACRS)**
    - Generally more advantageous than straight-line method
    - Larger deductions in early years of asset's life
- **Midquarter convention**
    - If more than 40% of the year's asset purchases are in the last quarter
    - Less favorable than MACRS

Sec. 179 expensing election

- **Allows you to deduct rather than depreciate asset purchases**
- *New or used* assets qualify, such as:
    - Equipment, furniture and off-the-shelf computer software
    - ***New!*** More assets eligible under the TCJA
        - Qualified improvement property — expanded definition from leasehold-improvement, restaurant and retail-improvement property
        - Depreciable tangible personal property used primarily to furnish lodging
        - Certain improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems
- ***New!*** TCJA nearly doubles expensing limit, to $1 million
    - Break begins to phase out dollar for dollar when total asset acquisitions for the tax year exceed $2.5 million (up from $2.03 million)
    - The amounts will be indexed for inflation
- **Can't reduce net income below zero to create a net operating loss**

Bonus depreciation

- **Additional first-year depreciation for qualified assets**
- ***New!* The TCJA temporarily increases it to 100%**
  - Qualified assets placed in service after Sept. 27, 2017, but before Jan. 1, 2023
  - For 2023-2026, it's scheduled to be gradually reduced
  - For certain property with longer production periods, the reductions are delayed by one year
- ***New!* The TCJA expands qualified assets to include not just new but also used assets**
  - Tangible property with a recovery period of 20 years or less, off-the-shelf software and water utility property
  - Due to a drafting error, qualified improvement property will be eligible only if a technical correction is issued, which is expected

WARNING: Under the TCJA, in some cases businesses may not be eligible for bonus depreciation starting in 2018.

Vehicle-related deductions

- **Deduct actual out-of-pocket expenses (fuel, insurance, depreciation, etc.) or mileage**
  - 54.5 cents per business mile driven in 2018
- **Purchases of *new or used* vehicles may be eligible for Sec. 179 expensing**
- **Passenger automobiles are subject to lower limits**
- **If a vehicle is used for both business and personal purposes:**
  - Associated expenses must be allocated between deductible and nondeductible use
  - Depreciation limit is reduced
  - If business use is 50% or less, the straight-line method must be used

WARNING: If bonus depreciation is elected for passenger vehicles, no additional depreciation can be taken until Year 7.

The TCJA reduces and eliminates some breaks

- ***New!*** **Interest expense deduction limited**
  - For tax years that begin in 2018 or later, businesses generally can't deduct interest expenses in excess of 30% of adjusted taxable income
  - The limit doesn't apply to taxpayers with average annual gross receipts of $25 million or less for the three previous tax years
  - Some other taxpayers are also exempt
- ***New!*** **Big changes to meal & entertainment expense deductions**
  - For amounts paid or incurred after Dec. 31, 2017, business-related entertainment expenses are no longer deductible. Meals provided during entertainment events are 50% deductible if purchased separately from the event.
  - Meal expenses incurred while traveling on business are still 50% deductible, but the 50% disallowance now also applies to meals provided:
    - Via an on-premises cafeteria
    - Otherwise on the employer's premises for the convenience of the employer

More breaks eliminated or curtailed

- ***New!*** **Section 199 deduction eliminated**
  - Also known as the “domestic production activities deduction” or “manufacturers’ deduction”
  - Will be missed by more than just manufacturers
- ***New!*** **Section 1031 “like-kind” tax-deferred exchanges narrowed**
  - No longer available for personal property assets
  - Real estate can still qualify
- ***New!*** **Compensation deduction limit tightened**
  - Deductions for amounts paid to certain principal executive officers generally can’t exceed $1 million per year
  - Subject to a transition rule for amounts paid under binding contracts in effect as of Nov. 2, 2017

Employee benefits

- **Qualified deferred compensation plans**
  - Pension, profit-sharing, SEP and 401(k) plans, SIMPLEs
  - Employer contributions are deductible; employee contributions can be pretax
- **Tax-advantaged accounts for health care expenses**
  - Employer contributions are deductible by the employer and not included in employee income
  - Employee contributions (if allowed) are pretax
  - Employee withdrawals for qualified expenses are tax-free

Fringe benefits

- **Some aren't included in employee income, yet the employer can deduct any portion of the benefit it pays and typically also avoid payroll tax**
- **Examples include:**
  - Employee discounts
  - Group term-life insurance
  - Health insurance
- ***New!*** **Deductions for commuting costs and transportation fringe benefits eliminated**
  - Includes parking allowance, mass transit passes and van pooling
    - These benefits are still tax-free to recipient employees
  - Also eliminated are employer deductions for providing commuting transportation to an employee, such as hiring a car service
    - Exception: If the transportation is necessary for the employee's safety

Play-or-pay provision

- **A penalty can be imposed on “large” employers if just one full-time employee receives a premium tax credit**
  - “Large” employers generally include those with at least 50 full-time employees or the equivalent
  - Premium tax credits are available to employees only if:
    - They don’t have access to “minimum essential coverage” from their employer, or
    - Coverage that the employer offers is “unaffordable” or doesn’t provide “minimum value”
- **The IRS has issued detailed guidance on what these terms mean**

TCJA changes net operating loss (NOL) rules

- **NOLs occur when operating expenses and other deductions exceed revenues**
- ***New!*** **Only 80% of taxable income can be offset with NOL deductions (down from 100%)**
- ***New!*** **NOLs now can be carried forward indefinitely (instead of only up to 20 years)**
- ***New!*** **NOLs can no longer be carried back two years to generate current tax refund**

New limit on “excess” business losses

- **Applies to deductions for current-year business losses incurred by noncorporate taxpayers in 2018 through 2025**
- **Such losses generally can’t offset income from other sources exceeding the applicable thresholds**
  - Married couple filing jointly: $500,000
  - Other filers: $250,000
- **Examples of other income sources include:**
  - Salary and self-employment income
  - Interest, dividends and capital gains
- **Disallowed losses are carried forward to later tax years**
  - Can then be deducted under the NOL rules

Tax credits

- **Particularly valuable because they reduce taxes dollar for dollar**
- **Research credit**
  - For increasing research investments
  - Now easier for smaller businesses and start-ups to benefit
- **Work Opportunity credit**
  - For hiring from certain disadvantaged groups, such as:
    - Ex-felons
    - Certain veterans
    - Individuals who’ve been unemployed for 27 weeks or more
  - Maximum credit per adult worker ranges from $2,400 to $9,600
  - There’s no limit on the number of eligible individuals you can hire

WARNING: Certification from the appropriate State Workforce Agency generally must be requested within 28 days.

More tax credits

- **New Markets credit**
  - For making qualified equity investments in certain low-income areas
  - Scheduled to expire Dec. 31, 2019
- **Small-employer retirement plan credit**
  - Small employers (generally those with 100 or fewer employees) may be eligible for a $500 credit per year for three years
  - Credit is limited to 50% of qualified start-up costs
- ***New!*** **Family medical leave credit**
  - For providing paid family and medical leave to employees
  - Available for 2018 and 2019
  - Equal to a minimum of 12.5% of the employee’s wages paid during that leave (up to 12 weeks per year) and can be as much as 25% of wages paid
  - Ordinary paid leave that employees are already entitled to doesn’t qualify

One more credit

- **Small-employer health care credit**
  - Maximum credit is 50% of premiums paid
  - Employer must contribute at least 50% of total premium or a benchmark
  - Full credit available for employers with 10 or fewer FTEs who on average earn less than $26,600 per year
  - Partial credit available to employers with fewer than 25 FTEs who on average earn less than $53,200
  - To qualify for the credit, online enrollment in the Small Business Health Options Program (SHOP) generally is required
  - The credit can be taken for only two years
    - They must be consecutive
    - Credits taken before 2014 don’t count

Exit planning

- **Buy-sell agreement**
  - Controls what happens to the business when a specified event occurs
  - Critical to factor in tax and funding issues when drafting
- **Succession within the family**
  - Sell and/or give interests
  - Consider gift and estate tax consequences
  - Valuation discounts may reduce the taxable value
- **Employee stock ownership plan (ESOP)**
  - Qualified retirement plan allows employees to be owners
  - Can provide liquidity and various tax benefits
- **Selling to an outsider**
  - If you find the right buyer, you may be able to sell at a premium
  - First put your business into a sell-ready state

Sale or acquisition

- **Tax consequences can have a major impact on the transaction's success — or failure**
- **Installment sale**
  - Often used when buyer lacks sufficient cash or pays a contingent amount based on the business's performance
  - Also used when seller wants to spread gain over a number of years
    - Could help avoid triggering the 3.8% net investment income tax
    - Could also help avoid 20% long-term capital gains rate
  - Can backfire on the seller
    - Must report depreciation recapture in year of sale
    - If tax rates increase, overall tax could be more
- **Considerations for corporations**
  - Asset vs. stock sale
  - Tax-deferred transfer vs. taxable sale

Cash Basis Limits

- For C corporations and partnerships with C corporation partners, cash basis gross receipts limit raised

- For tax years beginning after 12/31/17, if the average annual gross receipts for the prior 3 years was less than $25 million, then cash basis is allowed. The prior threshold was $5 million for corporations.

- $25 million adjusted for inflation for tax years beyond 2018

- Other business entities (e.g. S corporations, sole proprietorships, partnerships) are also subject to $25 million threshold

Uniform Capitalization (263A)

- UNICAP requires some costs to be capitalized into inventory
  - Some examples of costs that could be capitalized
    - Insurance
    - Rent
    - Repairs & Maintenance
    - Taxes
- TCJA increases UNICAP small business taxpayer exemption from $10 million to $25 million average gross receipts over prior 3 years
- Now available to both producers and resellers of both real and personal property for tax years beginning after 12/31/17

Inventory under IRC Section 471

- Eligible small businesses may treat inventory as materials and supplies, and deduct in the year used/consumed in the taxpayer's operations
- Inventory generally deemed to be used/consumed in the year the items are provided to the customer
- Prior 3 year average gross receipts threshold increased from $10 million to $25 million
- May also elect to conform to taxpayer's method of accounting reflected in its applicable financial statements, or other books and records

Accounting Method Changes Form 3115

- Taxpayers making multiple accounting method changes may be eligible to file a single Form 3115

- Automatic changes apply when changing to overall cash method, exception from capitalizing costs under Section 263A, and exception from requirement to account for inventory under Section 471

- If Section 481(a) Adjustment required, 4 years allowed to pay additional tax due. If adjustment results in less taxable income, entire deduction may be taken in year of change.

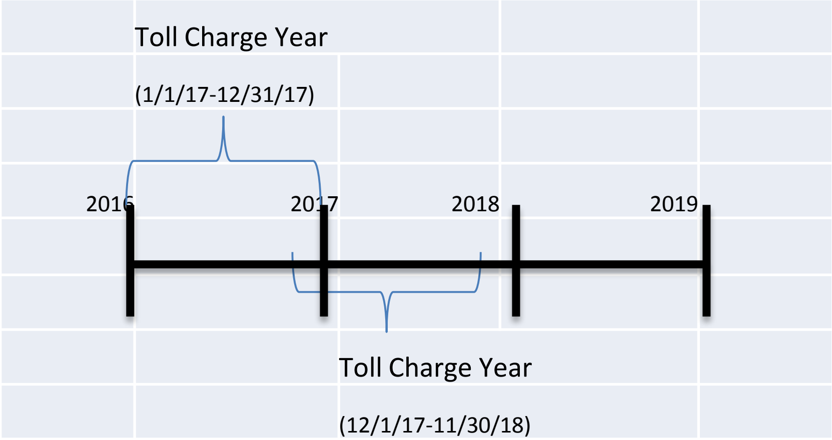
TCJA International Tax Provisions: IRC 965 & GILTI

Foreign earned income repatriation: What is IRC §965?

- IRC 965 provides for a mandatory deemed repatriation
- Also referred to as a one-time “toll charge”
- In the form of subpart F inclusion
- Equal to a US shareholder’s share
- Of net accumulated post-1986 untaxed earnings and profits of their foreign subsidiaries
- As of November 2, 2017 or December 31, 2017, whichever is higher
- Taxed at a decreased rate of 15.5% and 8%

IRC §965 – Mandatory deemed repatriation

- Why does it matter **NOW**?
  - Because the Act applied on the last taxable year beginning before 1/1/2018.
    - For calendar year filers → 2017 tax year.
    - For fiscal year filers → 2018 tax year.
  - Certain taxpayers may have to pay tax resulting from IRC section 965 when filing their 2017 US tax returns.



- Consider amending 2017 returns if IRC 965 was missed

IRC §965 – Foreign earned income repatriation

- Who is subject to the toll charge?
  - Specified foreign corporations (SFCs) with **positive** earnings & profits (E&P) either on **11/2/2017** or **12/31/2017** (whichever is higher).
    - Controlled foreign corporations (CFC)
    - Foreign corporations with a 10% domestic corporate shareholder
- Who must report IRC 965 amounts on a 2017 return?
  - Direct US shareholder
  - Direct **or Indirect** partner in a domestic partnership that is a US shareholder of a foreign corporation
- Tax base subject to toll charge?
  - Post-1986 deferred foreign earned **income** determined as of 11/2/2017 or 12/31/2017 – whichever is higher
    - Excludes previously taxed subpart F income
    - Excludes effectively connected income with US trade or business
- Effective tax rate?
  - 15.5% for cash and cash equivalent assets (example: cash, **net** of A/R, CDs, commercial papers, etc.)
  - 8% for other assets (non-cash earnings)

Toll charge – cash position

- Taxpayers must determine their aggregate foreign cash position as of 3 separate dates:
  - Close of the last taxable year beginning before 1/1/18
  - Average of 2 preceding tax years ending prior to 11/2/17
- For calendar year taxpayers:
  - 12/31/17
  - Average of 12/31/15 and 12/31/16
- The result: is the greater of the 2 aggregate amounts

IRC §965 – Elections

- Elections to consider due with an extended return:
  - Section 965(h): election to pay the net tax liability in installments
    - Installment payments of up to 8 years, no interest charged
    - If not elected – entire toll charge is included in the tax liability of that year and will be due on the **unextended** due date of the TR
  - Section 965(i): election available to a shareholder in an S corporation to defer payment of net tax liability
  - Section 965(m): election available to real estate investment trust to recognize the section 965 mandatory inclusion in installments
  - Section 965(n): election NOT to apply an existing net operating loss against the net tax liability
- Election under Reg. 1.1411-10(g) for Net Investment Tax purposes

IRC §965 – States

- State conformity to the IRC 965 is a piecemeal adoption:
  - For Massachusetts:
    - Per MA G.L. c. 63, §§ 1, 30, MA generally follows the IRC as amended and in effect for the tax year → must also include the income under IRC §965 when computing MA corporation excise tax
  - Confusion about the starting point of state income tax return
    - Non conforming states will tie to the federal tax return (line 28/ line 30 Form 1120)
    - Conforming state will need state specific adjustment to include 965(a) and 965(c)
  - Conforming states: confusion about the reporting/ inclusion of 965(a) and 965(c)
    - CO: 965 income should be included in line 1 on the CO tax return
    - CT: 965 income should be reporting on schedule D line 9 – Other income
  - Expense disallowance
    - States have expense disallowance provisions related to dividends
    - Some states require 965(a) be included but disallow 965(c) deduction
  - States may not recognize before-mentioned elections
    - VT, IL, or CT does not allow a taxpayer to defer payment of any portion of the tax associated with Section 965 income
  - Differences in documentation of section IRC 965 on the tax return
    - IL requires e-filing taxpayers to email rev.BitSupplemental@illinois.gov the transition tax statement as a PDF format

What is GILTI?

- New provision under the IRC section 951A and was enacted as a part of the TCJA.
- New anti-deferral tax on certain earnings of a CFC
- GILTI stands for Global Intangible Low-Taxed Income
- Not applicable if GILTI income is taxed in a foreign jurisdiction at a tax rate of 13.125% or higher
- If no one else taxes the income, the US will tax high offshore profits of CFCs at a 10.5% rate (half the US corporate rate)
- GILTI is similar to subpart F in that it is income that deemed repatriated in the year earned
- Who does it apply to?
    - 10% US shareholders of CFCs
- So who really is GILTI?
    - Essentially the income generated by a CFC's IP is GILTI

How to compute what income is generated by IP?

- IRC 167 Depreciable Assets used in a Trade or Business
  - 10% rate of return allowed for these assets without triggering GILTI
- IRC 197 Intangible Assets:
  - Marketing intangibles
  - Computer software
  - Designs, patterns, formula
  - Customer based intangibles, copyrights, patents
  - Amortizable goodwill
- Income generated by these assets is deemed to be repatriated as GILTI
- Income is not specifically traced to the intangible assets – formula provided by law determines income allocation to IP

GILTI = Net CFC Tested Income – (10% x Qualified Business Asset Investment) – Interest Expense

Current Year Inclusion of GILTI

Step 1

Aggregate pro-rata share of tested income from all CFCs

Minus

Aggregate pro-rata share of tested loss from all CFCs

Equal

Aggregate pro-rata net tested income from all CFCs (A)

Step 2

10% of Aggregate pro-rata share of QBAI

Minus

Interest expense which gives rise to the tested income

Equal

Net deemed tangible income return (B)

GILTI = A Minus B

How is GILTI Taxed

- C Corp GILTI gets a 50% Dividend received deduction, so the effective tax rate is 10.5% with an 80% FTC offset
- Individual GILTI is taxed at the highest ordinary rate with no FTC
- The GILTI provision is particularly detrimental to US taxpayers other than C corporations because these deductions allowable under the provision are only applicable to C-corporation taxpayers.
- Individual structuring for GILTI:
  - Check the box on the foreign entity
  - Form a C Corp in the US and drop CFC stock into it
  - S Corporation may revoke “S Election”
  - Consider IRC 962 Election
- The GILTI provisions are far reaching and we encourage you to consult with your AAFCPAs tax advisor

Questions?

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Wednesday, October 17, 2018 9-10am	Tuesday, October 23, 2018 9-10am	Thursday, October 25, 2018 9-10am

Thank You