# NEW YEAR, NEW TAX CODE

## How Sweeping Changes Will Impact You

### Insights from Friedman LLP's Tax Experts

**Presented By**

FRIEDMAN LLP®

ACCOUNTANTS AND ADVISORS

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# SPEAKERS

## Robert Charron, Partner and Tax Practice Leader

Bob Charron has more than 30 years of public accounting experience. He joined the firm as Tax Operations partner, overseeing tax policies and processes. Bob works to enforce best practices and uniformity across all tax procedures to increase efficiency and expand the firm’s client base.

## Ryan Dudley, Partner, International Tax Practice

Ryan Dudley specializes in developing cross border commercial structures and financing strategies to optimize international operations and transactions. With nearly 20 years of public accounting and investment advisory experience, Ryan's clients have ranged from Fortune 50 multi-national corporations, to private equity and hedge funds, through to small businesses and start-ups.

## Kimberly A. Dula, Partner, Tax Practice

Kim Dula has 25 years of experience providing tax planning and compliance services to high net worth individuals and their closely-held businesses and private foundations. Kim also provides her clients with consulting and compliance services required to fulfill their estate, gift and fiduciary needs.

## Michael J. Greenwald, Corporate and Business Tax Practice Leader and Partner

Michael has over 30 years of experience in public accounting. He has served clients in a variety of industries, including financial services, technology and media, manufacturing, wholesale distribution, private equity, real estate, construction, and professional services. Michael is the Chair of the Partnership Taxation Technical Resource Panel of the AICPA.

# WHO IS FRIEDMAN LLP?

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**Friedman LLP's clients have the advantage of working with a mid-size accounting firm that combines the staff and resources of a large firm with a philosophy of personal responsibility for our clients.**

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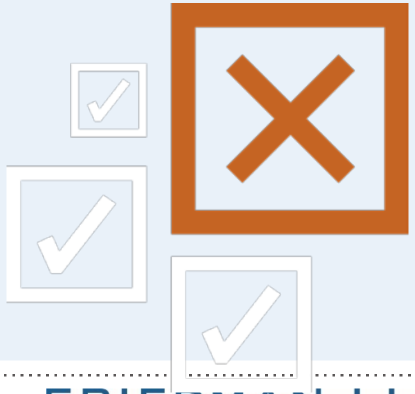
# PRESENTATION OUTLINE

- Overview of The Tax Cuts and Jobs Act (TCJA) and its major elements
- Understanding the impact and consequences of various tax reform changes
  - Individual income tax and estate tax provisions
  - Business tax provisions
  - International tax provisions
- Key takeaways from the TCJA to avoid pitfalls and reap advantages of the new tax landscape



# Individual Income Tax and Estate Tax Provisions

# Individual Income Tax

- New individual income tax rates and brackets effective for tax years beginning after 12/31/17
- Continue to have seven tax brackets
- Highest rate will go from 39.6% down to 37%
- Married Filing Joint filers – 37% will start at $600,000
- Single filers – 37% will start at $500,000

# Individual Income Tax (continued)

- Increase in standard deduction - $24,000 for Married Filing Joint filers, $18,000 for Head of Household, $12,000 for all other taxpayers
- Personal exemptions are eliminated
- Kiddie tax is modified
- Capital gains tax generally remains unchanged
- Alternative Minimum Tax remains for individuals

# Individual Income Tax (continued)

- Net Investment Income tax of 3.8% and Medicare surtax (on wages and self-employment income) of .9% both remain
- State and local tax deduction is SEVERELY limited
- Changes to the mortgage interest deduction
  - limited to acquisition indebtedness of $750,000
  - no deduction for home equity indebtedness
  - NO CHANGE to the exclusion of gain from sale of principal residence rules

# Individual Income Tax (continued)

- For 2017 and 2018 only, the medical deduction threshold decreases to 7.5% of adjusted gross income (“AGI”) for all taxpayers
- 50% of AGI limitation related to deduction for charitable contributions increased to 60%
- Miscellaneous itemized deductions are eliminated
- Overall phase out of itemized deductions is eliminated
- Alimony deduction and related income inclusion does not apply to agreements executed AFTER December 31, 2018

# Individual Income Tax (continued)

- Moving expenses have been eliminated
- Changes to the child tax credit
  - Phase out limits have increased
  - Credit has increased from $1,000 to $2,000 per child
  - Refundable component
  - $500 credit for certain “non-child” dependents

# Individual Income Tax (continued)

- In most cases, losses related to a personal casualty or theft loss will not be deductible
- Beginning in 2018, $10,000 (per year) of distributions from a 529 plan can be used for elementary or secondary schools (public, private and religious)

# Estate Tax

- Exclusion amount has been doubled from $5 million to $10 million beginning January 1, 2018
- With inflation adjustments, this amount should be $11.2 million for 2018 ($22.4 million for a married couple)
- Generation skipping tax will follow the exclusion amounts
- Annual exclusion amount for 2018 is $15,000

# Pass-Through Deduction

- NEW DEDUCTION FOR 2018: The pass-through deduction is generally 20% of a taxpayer's qualified business income (QBI) from a partnership, S corporation, or sole proprietorship, subject to limitations.
  - QBI is defined as the net amount of items of income, gain, deduction, and loss with respect to a qualified trade or business, excluding certain types of investment income, reasonable compensation paid to the taxpayer, and guaranteed payments to a partner.

# Pass-Through Deduction (continued)

- Service Related Business:
  - Certain service related businesses such as healthcare professionals, law, accounting, consulting, and financial services are NOT eligible for the deduction. Generally any service related business whose "principal asset" is the "reputation or skill" of one or more of its employees would not be eligible.
  - Exception for those in the engineering and architecture industries.

# Pass-Through Deduction (continued)

- Exception to service business rule:
  - Married Filing Joint filers with taxable income less than $315,000
  - Other filers with taxable income less than $157,500

# Pass-Through Deduction (continued)

- Wage and Capital Limitation:
  - Applies to taxpayers whose taxable income exceeds the thresholds of $157,500 and $315,000 for single and MFJ filers, respectively
  - Limits pass-through deduction to the lesser of:
    - 20% of the taxpayer’s combined QBI <u>or</u>
    - The greater of:
      - 50% of the W-2 wages relating to the qualified trade or business <u>or</u>
      - 25% of the W-2 wages relating to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

# Business Tax Provisions

# Corporate Tax Rate

- Flat 21% rate effective for tax years beginning after 12/31/17.
- Per IRC Section 15, new rate is prorated for fiscal year corporations.
- Does not require a special rate for personal service corporations.
- No expiration.
- Corporate AMT repealed for tax years beginning after 12/31/17.
- Reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%. Also reduces the corresponding taxable income limitations.

# Accounting Methods

- New threshold for cash method, need for inventories, percentage of completion method, UNICAP:
  - Average gross receipts of less than $25 million (indexed for inflation) for the prior three taxable years
  - Change will require an adjustment under Sec. 481
- Guidance is expected soon

# Interest Deduction Limitation

- Deduction for net interest expenses incurred by a business limited to the sum of business interest income, 30% of the business's adjusted taxable income (EBITDA), and floor plan financing interest.
- Businesses with average annual gross receipts of $25 million or less are exempt from the limit.
- Disallowed interest carried forward indefinitely.
- Real property trades or businesses that elect to use the alternative depreciation system are not subject to the limitation.
- The interest deduction limit does not apply to certain regulated public utilities or to certain electric cooperatives.
- Applies to tax years beginning after December 31, 2017.

# Contributions to Capital

- Modifies, but preserves Sec.118, which continues to apply only to corporations.
- Does not include:
  - any contribution in aid of construction or any other contribution as a customer or potential customer, and
  - any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).
- Effective for contributions made after Dec. 22, 2017.

# Net Operating Losses

- Limited to 80% of taxable income for losses arising in tax years beginning after Dec. 31, 2017.
- Carried forward indefinitely but no carrybacks.
- NOLs carried forward from prior years not limited.

# Excess Business Loss Limitation

- For tax years beginning after December 31, 2017 and before January 1, 2026
- Non-corporate taxpayers only
- Excess business loss is computed as follows:
  - Aggregate deductions of the taxpayer for the taxable year which are attributable to trades or businesses of such taxpayer plus $250,000 (200 percent of such amount in the case of a joint return).
- Excess is treated as a net operating loss
  - Question – since NOLs don't appear to be included in the computation of excess business loss and since NOLs can be carried forward (although limited to 80% of taxable income), is this essentially just a deferral and not a limitation?

# Cost Recovery Provisions

- Section 179
  - Limit increased to $1 million
  - Phase-out threshold increased to $2.5 million
  - Qualified real property now includes all qualified improvement property and certain improvements (roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems) made to nonresidential real property.
- Depreciable lives
  - Qualified Improvement Property – 15 years (maybe)
  - Eliminates the separate definitions of "qualified leasehold improvement property", "qualified restaurant property", and "qualified retail improvement property"
  - ADS life for qualified improvement property reduced to 20 years
  - ADS life for residential real property reduced to 30 years
  - Applies to property placed in service after Dec. 31, 2017

# Cost Recovery Provisions (continued)

- Bonus Depreciation
  - 100% for property placed in service after September 27, 2017
    - Property acquired before that date not eligible even if not placed in service
  - Used property eligible
  - Expensing rate declines from 2022 to 2026
  - Eligible property also includes qualified film, television, and live theatrical productions initially released, broadcast, or staged live after Sept. 27, 2017

- Listed Property
  - The Act increases the depreciation limitations under §280F for passenger automobiles placed in service after December 31, 2017
  - $41,360 over the first four years
  - Also, computers and peripheral equipment are no longer considered listed property

# Real Estate Related Changes

- Like-Kind Exchanges
  - Effective for transfers after 12/31/17, only real estate not held primarily for sale qualifies for Section 1031 exchange treatment
  - Personal property associated with exchanged real property is not included
  - Like-kind exchange no longer available for:
    - Equipment trade-in
    - Vehicle trade-in
    - Aircraft
    - Art Work
- Advance Refunding Bonds
  - Under prior law, governmental bonds and qualified 501(c)(3) bonds could be advance refunded only once, and other private activity bonds could not be advance refunded at all.
    - Now advance refundings are not tax-exempt.
      - Current refundings (i.e., where the refunded bonds are redeemed within 90 days of issuance of the refund bonds) are still permitted.

# Real Estate Related Changes (continued)

- Tax Credits
  - New Markets Tax Credit – not repealed
  - Low-Income Housing Tax Credit – not repealed
  - Rehabilitation Tax Credit
    - 10% Credit for pre-1936 buildings is repealed
    - 20% credit for rehabilitation of certified historic structures and certain qualified rehabilitations is retained
      - Now taken ratably over 5 years starting with the year placed in service rather than all at once
    - Applies to amounts paid or incurred after December 31, 2017
      - Transition rule available

# Real Estate Related Changes (continued)

- Carried Interests
  - Three year holding period for capital gains in an "applicable partnership" but…
    - Only if the interest was transferred to the taxpayer in connection with the performance of substantial services
      - Doesn't apply to capital interests
      - Doesn't apply to corporations
    - Only for "applicable trade or business"
      - Raising or returning capital, and either investing in or developing specified assets
      - Specified assets include:
        - Securities
        - Commodities
        - Real estate held for rental or investment
        - Options or derivative contracts with respect to any of the foregoing
      - Some commentators think it doesn't apply to Sec. 1231 gains
    - Gain is triggered if transferred to someone else within three year period

# International Tax Provisions

# International Tax: Updated, Not Simplified

## Outbound Investors

- New Tax Rate for US Corporations and Pass Through Income
- Participation Exemption
- Mandatory Income Inclusion of Accumulated Foreign Earnings
- Changes to the Controlled Foreign Corporation ("CFC") Regime
- New Foreign Derived Intangible Income ("FDII")

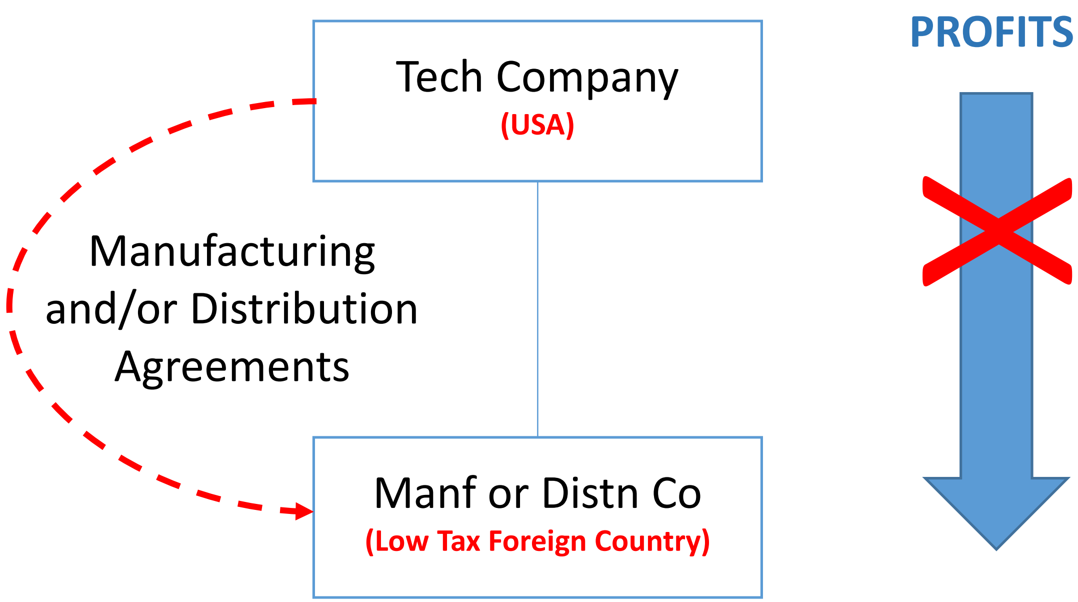
## Inbound Investors

- Earnings Stripping Rule Modification
- Repeal of Grecian Mining
- Base Erosion and Anti-Abuse Tax ("BEAT")
- Increased Penalties for Certain Reporting Failures

# New Tax Rate for US Corporations and Pass Through Income

## *United States No 3 in World*

3rd highest corporate tax rate in the world – 2016 survey by the Tax Foundation



# Participation Exemption

- Deduction equal to 100% of the foreign sourced portion of dividend income
  - Foreign source portion
- Limited to dividends from shareholders with 10% or greater interests
- Holding period
- Available to US corporations, not US individuals (or flow through entities)
- Deduction is not available for:
  - Dividends from Passive Foreign Investment Companies (PFICs) unless they are CFCs
  - Hybrid dividends
  - Foreign taxes incurred with respect to the dividend (e.g., dividend withholding tax)
- No foreign tax credit allowed for dividends offset by participation deduction

# Participation Exemption

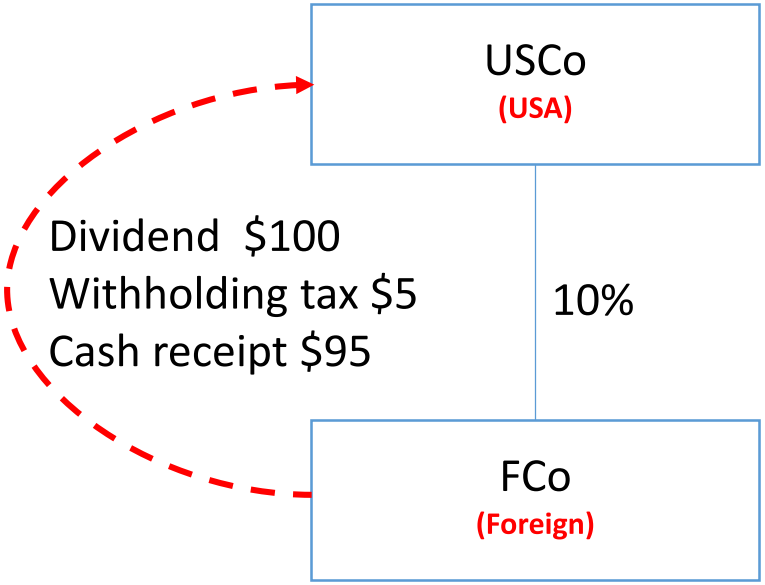
- US corporation owns 10% of FCo.
- FCo pays a dividend.
- FCo is not a PFIC.

**Previously**

| | |
|---|---|
| Dividend | 100 |
| US income tax | 35 |
| Foreign tax credit | (5) |
| Incremental US tax | 30 |

**Participation Regime**

| | |
|---|---|
| Dividend | 100 |
| Deduction | (100) |
| Net income | Nil |
| Incremental US tax | Nil |



# Mandatory Income Inclusion of Accumulated Foreign Earnings

**Income Subject to New Regime**

- Necessary step to transition from worldwide taxation to territorial tax system.
- Certain US shareholders in foreign corporations must recognize their share of certain income of foreign corporations.
- Affected shareholders:
  - All US shareholders owning 10% of a CFC (not limited to corporations)
  - All US C-corporations owning 10% of a foreign corporation
  - Individuals owning 10% where a C-corp owns 10% of a foreign corporation
- Applies with respect to the 2017 tax year for calendar year foreign subsidiaries (the last year beginning before January 1, 2018).
- Can also apply to gains from sales of interests in CFCs and gains to the extent that they are recast as dividends.

# Mandatory Income Inclusion of Accumulated Foreign Earnings (continued)

**Income Inclusion Calculation**

- Income inclusion is the higher of:
  - Accumulated post 1986 E&P at November 2, 2017 and
  - Accumulated post 1986 E&P at December 31, 2017.
- "Previously taxed earnings" ("PTI") and income earned as part of a US trade or business taxed in the United States are excluded from this tax.
- E&P deficits and E&P surpluses of certain commonly held foreign corporations can be offset in determining the shareholder's income inclusion.

# Mandatory Income Inclusion of Accumulated Foreign Earnings (continued)

**Tax Calculation**

- Special deduction is allowed to reduce the amount of tax to:
  - 15.5% of the aggregate foreign cash position, i.e., generally the liquid assets
  - 8% of the excess accumulated foreign earnings
- Any foreign tax credit with respect to this income should be substantially limited (although not eliminated)
- Election to pay the tax over 8 years

***IF THIS APPLIES, IT AFFECTS YOUR <u>2017</u> INCOME TAX RETURN***

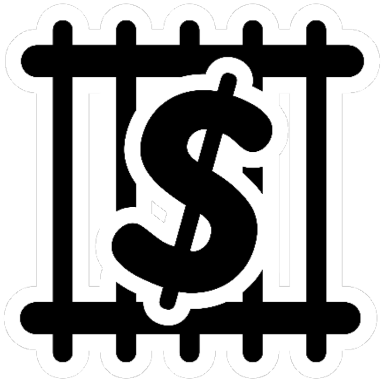
***FOR MOST TAXPAYERS, ELECTIONS TO DEFER TAX SHOULD BE MADE BY <u>APRIL 15, 2018</u>***

# Changes in the CFC Regime

- Subpart F remains intact!
- What will constitute a CFC expanded
  - 30 day rule repealed
  - US shareholder definition based on vote or value, not just vote
  - Attribution of ownership through foreign entities
- Significant policy shift – minimum tax regime

Global
Intangible
Low
Taxed
Income

GILTI Regime



# Changes in the CFC Regime (continued)

**GILTI**

- Applies to US Shareholders of CFCs
- Applies to almost all income, net of expenses and losses, except for:
  - Income subject to US tax as effectively connected to a US trade or business
  - Subpart F income
  - High taxed income
- Note, absence of identifiable intangible assets is not relevant
- Income reduced by “Net Deemed Tangible Income Return” which is calculated as 10% of depreciable assets less an interest allocation

# Changes in the CFC Regime (continued)

**US Shareholders – Corporations**

- GILTI is included in income
- 50% deduction allowed
- Partial foreign tax credit may be allowed for local corporate income tax paid
- Effective tax rate: 10.5% to 13.125%

**US Shareholders – Individuals**

- GILTI is included in income
- Taxed at marginal rate – up to 37% (no special relief)

# New Foreign Derived Intangible Income

- New regime
- Allows a deduction for 37.5% of FDII for a US corporation
- FDII arises from:
  - The sale of property to persons outside of the United States for use and consumption outside of the United States.
  - Sale of services to a person outside of the United States or with respect to property outside of the United States.

| | |
|---|---|
| Sales to foreign persons outside the United States | $1,000 |
| FDII Deduction | 375 |
| Taxable Income | 625 |
| Tax at 21% | 131.25 |
| Effective Tax Rate | **13.125%** |

# Earnings Stripping Rule Modification

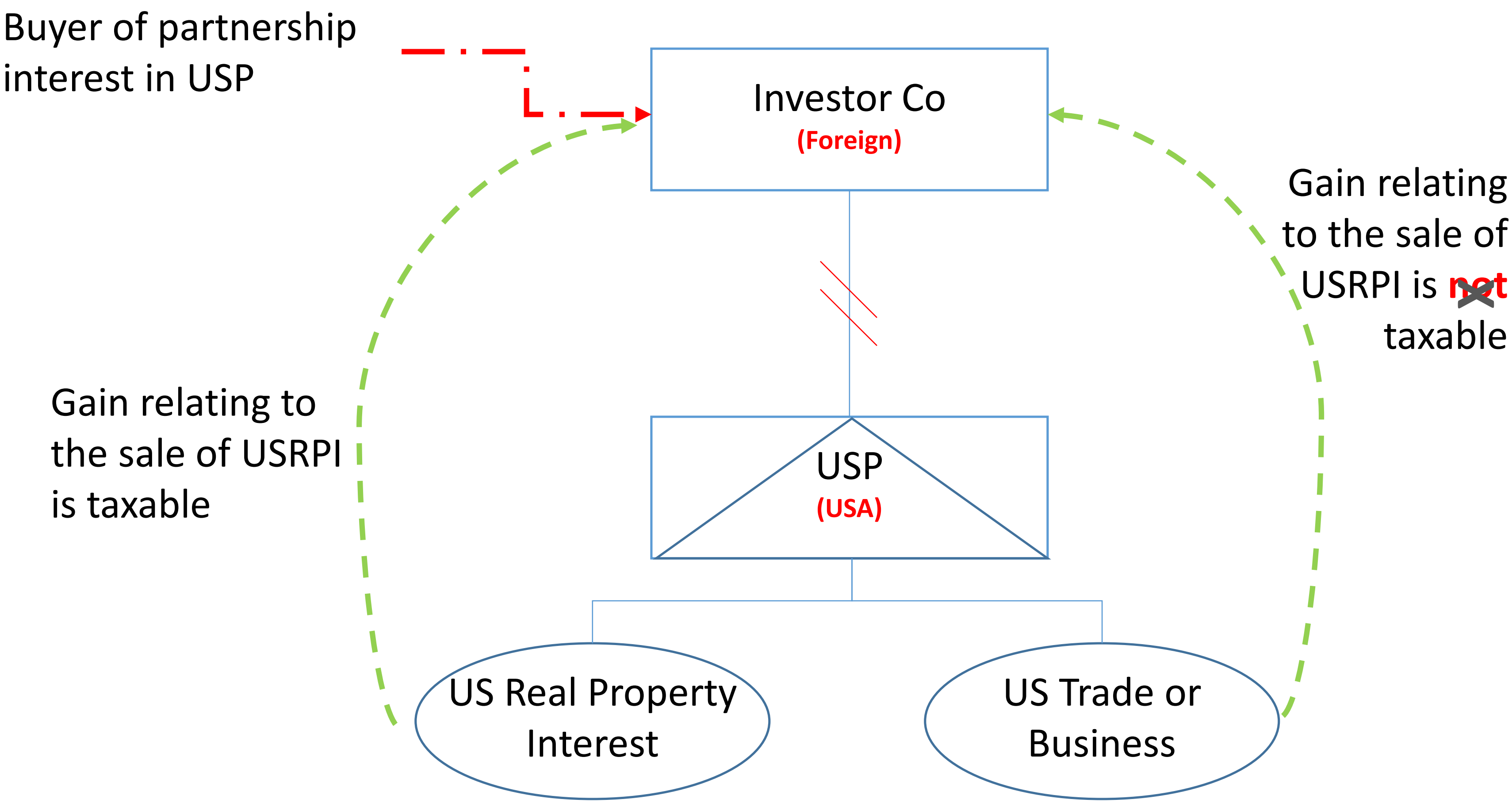
**Previously…**

- Earnings stripping rule applied to defer “related party” interest where:
  - the debt/equity ratio exceeded safe harbor and
  - the net interest expense exceeded 50% of the Adjusted Taxable Income

**New rule…**

- Earnings stripping rule applies to defer any debt where the gross interest expense (adjusted for non-investment income) exceeds 30% of the Adjusted Taxable Income
- Adjusted Taxable Income similar to EBITDA (EBIT from 2022)
- Applied at the partnership level then the partner level
- Can apply to consolidated group, not an affiliated group
- Electing real property trade or business
- Small business exception - $25m average annual gross receipts

# Repeal of Grecian Mining



# Base Erosion and Anti-Abuse Tax

**New BEAT Regime**

- Applies to corporations with average gross receipts in excess of $500m annually.
- Generally applies where:
  - There are deductible payments to related foreign parties
  - Payments exceed 3% of all expenses
- BEAT is calculated as
  - 10% (5% for 2018) of "modified taxable income" minus
  - Regular tax liability (reduced by certain tax credits)
- Modified taxable income excludes base erosion payments – generally payments to related persons that are deductible or are included in the basis of depreciable assets - and NOLs.

# Increased Penalties for Certain Reporting Failures

- Certain transactions with related foreign persons need to be reported, e.g., Form 5472
- Additional disclosures for the new BEAT regime
- Increased penalties - $10,000 to $25,000

# Questions?

# THANK YOU!

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## To Discuss Your Situation And How Tax Changes May Impact You, Contact Your Friedman Advisor or Email Us:

**rcharron@friedmanllp.com**

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