Beyond the Numbers

FINEMAN WEST & COMPANY

Once In A Lifetime Overhaul of Tax System is Almost Here

By: Jeffrey Dunn, Principal

Business Provisions

1. It seems that the writers feel service and professional jobs will grow along with the rest of the economy and happen without incentives. Although many professions and service businesses provide high paid jobs, under the new act, many of these businesses are taxed at the highest rates and are receiving the least benefit from new tax breaks.

2. Flow-through **Passive** businesses with large capital investments in real estate, fixed assets, and intellectual property are heavily favored. In the House version, **Passive** business owners will pay taxes up to 12% lower than other taxpayers.

    a. It seems that the writers feel tax incentives are needed to spur capital investment in the US and capital investments will create a huge number of new jobs in this country.

3. Although Flow-through **Active** businesses are paying higher tax rates, they do get tax breaks if they make certain large capital investments.

    a. **Active** businesses will be able to completely write off personal property and fixed assets as they purchase it. This will be retroactive to September 28, 2017.

    b. **Active** businesses include manufacturing, retail, wholesale, professional services, hotels, restaurants, transportation, and other businesses where employees actively sell merchandise or services to customers.

    c. Real Estate may be **Active** or **Passive**, depending on the circumstances.

4. All businesses whether **Active** or **Passive** will be able to write off $1 million in property purchases that qualify for Section 179. Provided they meet all rules and requirements.

5. C Corporations will only pay 20% tax and will be the only entity that can still deduct state income taxes.

    a. International companies will often choose locations for new ventures and for offices based on countries that have the lowest corporate tax rates. Many international companies may now start to favor the US when they relocate, expand, and add new businesses.

    b. It may pay for many US companies that plow all their profits back into their businesses to convert to C Corporations.

6. US owned foreign corporations can currently avoid all US tax by leaving their profits overseas.

    a. This had the effect over the years that corporations avoided moving their profits back to the US, corporations moved a lot of their income generating property out of the US, and corporations preferred to invest and create jobs outside the US.

    b. Not only were there no US taxes paid on overseas profits, but the profits were being used for overseas investments and to create overseas jobs.

    c. There will be a one-time tax that may be as much as 14.49% of all untaxed profits currently outside the country. Once this tax is paid on their next tax return, corporations can bring their past profits into the US for investment and job creation with no additional Federal taxes.

    d. In the future, profits distributed from foreign corporations back to US corporate owners will be tax-free.
        i. This will encourage US corporations to send their profits back to the US in the form of dividends in the future.
        ii. Rules are also being changed so corporations will pay more tax if future profits are left overseas.

7. Leveraged business owners with sales of more than $15 million will have their interest expense limited to 30% of EBITDA (Earnings before interest, taxes, depreciation, and amortization).

    a. The writers want growth through capital contributions over growth through borrowing.

    b. Interest of more than 30% of earnings will be added back to calculate taxable income.

    c. Unused interest deductions can be carried forward indefinitely.

    d. A business with a loss could have taxable income after adding back disallowed interest.

    e. Right now businesses use strategies to wipe out as much taxable income as they can in the current year to reduce or eliminate income taxes.
        i. Businesses with debt may now be forced to try and increase income and taxes.
        ii. Entities will need to have earnings of 3 times interest to get a full deduction.

8. Businesses will no longer be allowed to carry back net operating losses and will only be able to offset 90% of taxable income in future years.

    a. When a taxpayer has a bad year, they will no longer be able to carry back the loss to get a large refund. Once tax is paid it is gone.

    b. In future years, they will not be able to completely zero out tax with a prior loss.

    c. Unused losses can be carried forward indefinitely.

9. For businesses with receipts of less than $15 million, a lot of complicated tax rules that increase income tax will disappear.

    a. C Corporations will now be allowed to use the cash method of accounting in the same circumstances as other business entities.

    b. Operating costs will not have to be capitalized into inventory and other assets (UNICAP).
    c. Inventory rules will ease, allowing the taxpayer to use the cash method of accounting and to treat merchandise as non-incidental materials and supplies.

    d. Long term construction contracts will be simplified. Instead of recognizing profits throughout the job, taxpayers will be able to wait until job items are completed.

10. Meals and entertainment expenses are taking a large hit.

    a. Deductions for all entertainment and recreation expenses are eliminated, even if the expenses have a connection to the taxpayer’s business.

    b. Holiday parties, picnics and other entertainment activity expenses for employees generally will not be deductible, except for food and beverages served on the employer's premises.

    c. Meals served at an employer operated facility at or near the employer's business premises will no longer be deductible after 2025.

    d. Non-entertainment business meals and meals while traveling will still be deductible at 50%.

11. Compensation will be taxable as earned, not when received in later years.

    a. Employees will be immediately taxed in the current year on income they are promised, even if they are not paid until a later year.

    b. Businesses will no longer be able to delay salaries to help cash-flow or to help employees minimize taxes.

    c. On compensation contracts where services are not provided, employees will be immediately taxed. For instance, non-compete agreements will be immediately taxed when signed.

12. Owners who receive carried ownership interests instead of compensation will be taxed at higher ordinary rates unless held for three years.

Individual Provisions

To simplify the tax code and cut taxes for many individuals, many special interest deductions are disappearing and being replaced by a larger standard deduction and lower tax rates.

1. For average taxpayers, doubling the standard deduction means they no longer have to run around and figure out their itemized deductions every year.

    a. The standard deduction will now give many taxpayers a higher benefit than if they itemize deductions and allow them to file one page returns.

2. In recent years, for higher earning taxpayers, a lot of their deductions were reduced or eliminated anyways.
    a. Alternative minimum tax, phase-outs, floors, caps, haircuts, and other rules originally meant to hit wealthy taxpayers now affect the middle class and upper-middle class taxpayers.

    b. Many taxpayers paid the alternative minimum tax at 28% in place of the traditional income tax with progressive tax brackets.
        i. Most deductions on typical returns do not reduce the 28% AMT tax.
        ii. Only the home mortgage deduction and charitable contributions typically do. These deductions are still being allowed.

3. The base income level at which the Alternative Minimum Tax starts to apply will increase from $75,300 to $109,400 for married taxpayers and increase from $37,650 to $70,300 for single taxpayers.

    a. Although the AMT tax applies at a higher income level, many middle class and upper-middle class taxpayers may still have their federal tax bumped-up to 28% by the AMT tax.

    b. The Research and Development Credit along with other credits will still be limited by the AMT tax.

    c. Taxpayers can no longer immediately deduct research and experimentation costs in lieu of the credit. They must now capitalize them and amortize the costs over five years.

4. The most controversial deduction being eliminated is the State Income Tax.

    a. For a taxpayer in the 40% federal tax bracket, it was like the federal government paid 40% of your state tax for you.

    b. So this is a blow to taxpayers who live in high tax states.

    c. State tax deductions will not even be allowed for business income.
        i. Except for C Corporations.

    d. There are various ways to move income outside of California taxation.
        i. More taxpayers may want to consider these options.

5. Some other deductions and credits that may be reduced or eliminated are:

    a. Home Property Taxes will be capped at $10,000

    b. Medical Expenses above 7.5% of AGI will only be allowed through 2018

    c. Employee, Financial, and Investment Itemized Deductions are eliminated

    d. Personal Exemptions are eliminated

    e. Moving Expenses are eliminated

    f. Dependent Care Assistance is eliminated

    g. Adoption Assistance is eliminated

    h. Credit For Plug-In Electric Drive Motor Vehicles is eliminated

    i. Alimony Deduction on new divorces is eliminated

6. Exclusion for gain on sale of home.

    a. A taxpayer will have to live in their home for five of the last eight years to get the $250K/$500K exclusion on gain.

7. 1031 like-kind exchanges will still be allowed, but they will be limited to sales of business and investment real estate.

8. The amount of an estate that a taxpayer can pass tax-free to their heirs is likely to increase to at least $11.2 million.

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Tax Planning/Business Restructuring Ideas

The first step for future planning is to determine the different tax rates for owners of different business types:

Tax Percentage on	C Corporation		Passive Pass-Through		Active Pass-Through	
Original Income	**Fed Only**	**CA and Fed**	**Fed Only**	**CA and Fed**	**Fed Only**	**CA and Fed**
If Undistributed	20.0%	27.1%	28.8%	41.1%	29.7%	44.3%
Tax on Distribution	19.0%	26.3%				
Tax if Distributed	39.0%	53.4%	28.8%	41.1%	29.7%	44.3%

Assumptions:

For Passive - LLC and House Version Used, For Active - S corporation and Senate Version Used Professionals and Specified Service Trades may be taxed as high as 52.9% (39.6% Fed + 13.3% CA)

CA Real Estate and Intellectual Property

Real estate, trademarks, and other property that you may sell in the near future, you do not want trapped inside a C corporation. You will eventually pay 53.4% tax as you distribute out profits or sell the assets. For these same assets held long-term, you may want them inside a C Corporation to take advantage of the state tax deduction and a low 27.1% combined corporate tax rate.

CA Active Businesses with Intellectual Property

You may want to reorganize active businesses and split off intellectual property. Converting the operating company to a C Corporation taxed at 27.1% (if profits kept in business) and putting all intellectual property into an LLC taxed at 41.1%. Both types of income would then be taxed well below the top individual tax rate of 52.9%.

CA Professional Firms and Service Companies with Intellectual Property

If professional firms and personal service companies don't do anything, the owners will pay tax at 52.9%. To the extent they have trademarks, know-how, trade secrets, and other intellectual property, they may be able to transfer them into an LLC and be taxed at 41.1%.

Move to State Without Income Tax

In the table above, it is obvious that owners and businesses could possibly have huge savings by moving their homes or businesses to states without income taxes. Depending on where they ship to and where they provide services they could have huge tax savings. There are also ways to move income to other states without the owner or business actually moving. Although this may be complicated and costly, it may be worth doing now for more taxpayers.

For any questions or concerns on how this might affect you, plese contact our office to speak with one of our tax professionals.

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