THE POWER OF BEING UNDERSTOOD

AUDIT | TAX | CONSULTING

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TAX REFORM

Lessons learned after first tax season

November 12, 2019

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Agenda

- Introduction
- Observations
- Tax compliance matters
- Tax planning considerations

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OBSERVATIONS

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Observations on impact of tax reform - Individuals

- Tax reform added compliance costs and complexity but it did not necessarily impact the actual tax. Many taxpayers did not seem much of an impact to their actual overall tax liability as a result of reform.
- There were withholding changes and tax planning that may have affected the amount of refund rather than strictly being a significant change in tax liability.
- The tax reform provisions (i.e., change in AMT exemption, state tax limitation, reduction in tax rate) caused tax to increase in some areas and decrease in others so even though there were a number of changes, the overall impact was minimal.
- Nonconformity of state issues – specifically MN such as bonus depreciation and itemized deductions. It was much more complex and required additional planning
- Carried interest 3 year hold rule under 1061 – included for information purposes but was confusing for investors and LPs on what they should do
- Significant amount of additional reporting on the K-1s
- Basis on individuals will be more of an issue for S Corporation shareholders as it will need to be reported on the return if you have had distributions or losses
- Seeing more bunching of charitable planning, specifically for those that are unable to itemize due to lack to mortgage interest, state tax limitation, etc. Individuals are giving to donor advised funds or setting up foundations
- Home mortgage interest limitation should also be reviewed in greater detail
- Switch mortgage interest to investment interest expense – in general, review the mortgage interest situation

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Observations on impact of tax reform - Businesses

- Section 163(j)
  - $25 million average annual gross receipts exemption applies to a lot of business
    - If business does not meet exemption, calculation is done at the business level
    - If business meets exemption, calculation is done at owner level
- Uncertainty surrounding Section 199A 20% deduction for flow through entities

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IMPACT OF INDIVIDUAL INCOME TAX PROVISIONS OF TAX CUTS AND JOBS ACT OF 2017 ON PLANNING

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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

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

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

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

Repealed deduction for moving expenses

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

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Key individual provisions 2018-2025 (continued)

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

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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

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Planning in light of tax law changes (cont.)

- 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.

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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

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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

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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)

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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

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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)

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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)

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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

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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

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NET OPERATING LOSS & EXCESS BUSINESS LOSS CHANGES

Post 2017 losses

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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

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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))

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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

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QUALIFIED OPPORTUNITY ZONE BENEFITS

Alternative to 1031 exchanges?

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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

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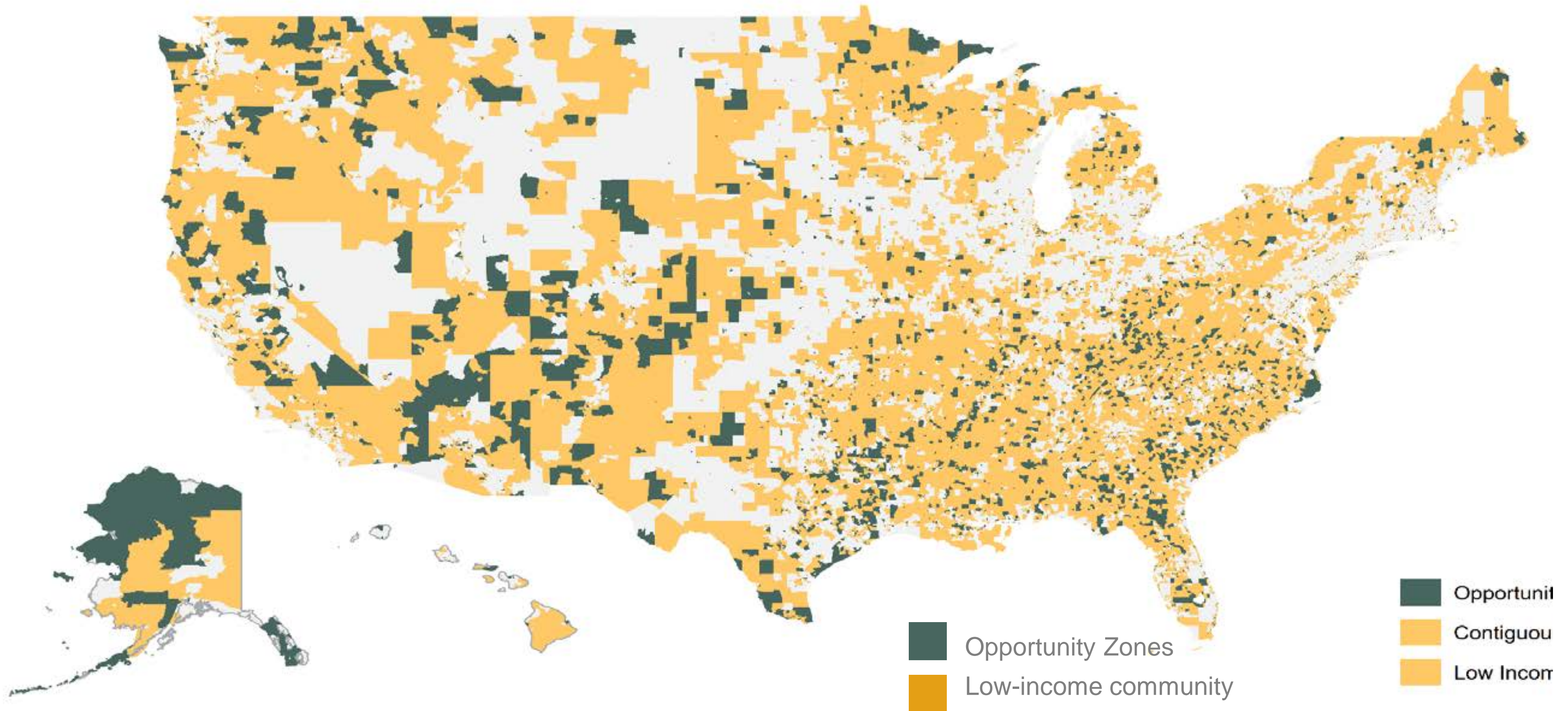
Qualified opportunity zone map – Treasury certified 8,761 QOZs



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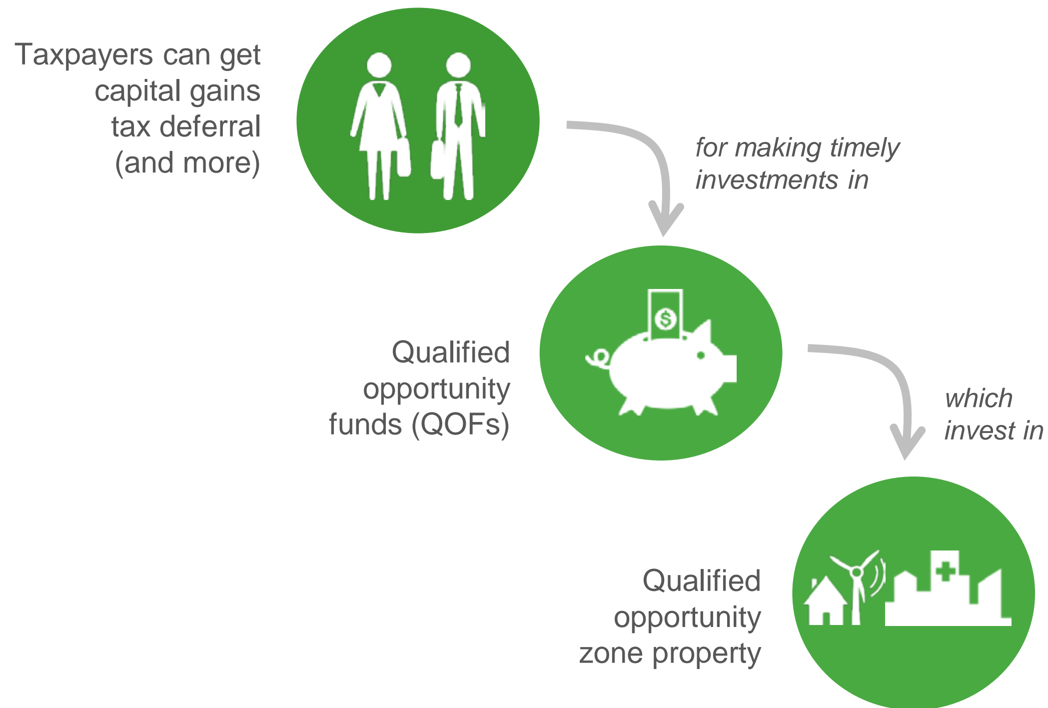
Overview of qualified opportunity zone program



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Tax benefits to investors in Qualified Opportunity Fund (QOF)

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

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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

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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**

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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

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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

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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

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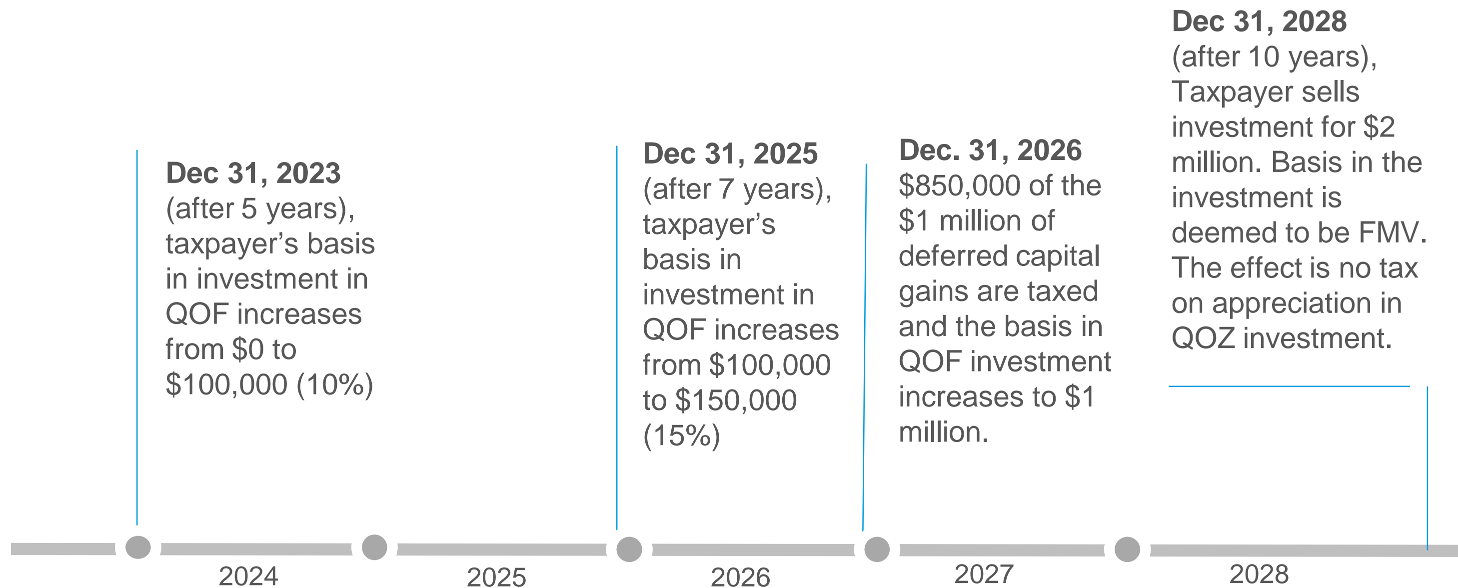
Timeline of a QOF – Exit



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BUSINESS OWNER PLANNING CONSIDERATIONS

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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

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Tax provisions impacting the business owner – Planning and complying(cont.)

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

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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

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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)

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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

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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

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CAPITAL EXPENSES

Depreciation, expensing, bonus depreciation

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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

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BUSINESS INTEREST DEDUCTIONS CUTBACK

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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

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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

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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

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OTHER IMPORTANT BUSINESS DEDUCTION LIMITATIONS, LIBERALIZATIONS, OR DEFERRALS

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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

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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

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OVERVIEW OF THE STATE TAX CONSIDERATIONS

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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

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Minnesota tax bill

- Passed May 24, 2019
- Conforms many tax laws with Federal tax law changes
- Minnesota DOR issuing notices to taxpayers for revisions to tax liabilities for 2017 and 2018 returns prior to tax conformity passed
- Taxpayers should not file amended returns for adjustments related to 2017 and 2018 tax law changes

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Resource: MNCPA Minnesota Tax Law Conformity/ Nonconformity Guide – *login required*

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Minnesota Tax Law Conformity/Nonconformity Guide

Federal Tax Code	Full conformity in Minnesota	Partial conformity in Minnesota	No conformity in Minnesota	Effective date	Notes
Standard deduction	X			Tax year 2019	The state standard deduction corresponds to the federal amounts allowed, but are subject to a reduction if the taxpayer's income exceeds the threshold amounts ($194,650 for most, except for married filing separate). See Article 1, Sec. 17.

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Resource: MN Department of Revenue Tax Law Changes page

- https://www.revenue.state.mn.us/tax-law-changes

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ESTATE PLANNING

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Estate planning subsequent to the enactment of tax reform

- Estate, gift, and generation-skipping transfer tax exemption amounts have increased to $11.18 million (2018) per taxpayer, in essence a doubling all transfer tax exemption thresholds
  - 2019 exemption: $11.4 million; 2020 exemption: $11.58 million
- 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

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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?

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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

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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

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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

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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?

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QUESTIONS AND ANSWERS?

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