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Tax Talk

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Dear Clients and Friends,

As you undoubtedly know, tax legislation is working its way through Congress right now which has the potential to make the most significant changes to the Internal Revenue Code since The Tax Reform Act of 1986 (TRA '86).

While many have compared the current proposed tax legislation to TRA '86, beyond its comparable breadth, there are substantial differences. TRA '86 was bipartisan legislation which substantially reduced the top individual rate (from 50% down to 28%) and top corporate rate (from 46% down to 34%), while shutting down tax shelters which had been encouraged by the very high tax rates, and essentially imposing a single tax rate (generally 28%) on all types of individual income (i.e. there was no preferential treatment for long-term capital gains, dividends, etc.). The current proposed legislation (which is entirely Republican, with no Democratic support) is focused primarily on cutting the corporate rate (from 35% to 20%), with most of the remaining provisions an attempt to (partially) pay for the corporate rate reduction. The bill passed by the House also included a repeal of the estate tax, but what appears more palatable to moderate Republicans in the Senate is a doubling of the exemption level.

The Republican-controlled Congress, feeling under great pressure to demonstrate that it can accomplish something legislatively, has targeted getting this done by Christmas. The House has passed its version of *The Tax Cuts and Jobs Act*, and the Senate Finance Committee has passed its version of the same. The full Senate will vote on legislation, and, assuming the Senate can pass a bill, it will then be a matter of the House and Senate reconciling the differences in their respective bills to come up with something that can pass in both chambers. Ultimately, this tax legislation may come down to the demands of a handful of Republican senators whose votes are essential.

Kent Bridges, Managing Partner

Typically, the last issue of our newsletter each year is devoted primarily to year-end tax planning. This year, however, given the significance of the proposed tax legislation, we will focus the entire issue on it. The general mantra for year-end planning this year is defer income and accelerate deductions, as the theme of the proposed legislation is rate reduction combined with elimination of deductions.

We hope that you will enjoy this issue and gain from it some useful information.

Sincerely,

Kent Bridges

The Tax Cuts and Jobs Act — Business Provisions

As we go to print with this newsletter, proposed tax legislation is working its way through Congress which has the potential to make substantial changes to the Internal Revenue Code, and to impact (for better or worse) virtually every US-based business and individual. The House has passed its version of *The Tax Cuts and Jobs Act*, and the Senate Finance Committee has passed its version of the same. There are differences between the two to be reconciled, and changes are likely to occur even before the Senate passes a version of the legislation. With that caveat, below is a summary of the most significant proposed changes which will impact businesses. In a separate article in this newsletter, we address the provisions which directly impact individuals.

Reduction in corporate rate - The current top Federal rate on C-corp taxable income is 35%. Combined with effective state rates, the rate can be in excess of 40%. This is generally viewed as being uncompetitive globally. As a result of various deductions and credits, the actual effective rate (as a percentage of GAAP earnings) is generally much lower (average probably closer to 20%), but clearly the high marginal rate does encourage companies to attempt to relocate outside the U.S. or leave earnings parked offshore. Accordingly, the centerpiece of the proposed legislation is a reduction in the top Federal corporate rate to 20%. The House would make the rate reduction effective for 2018. The Senate would defer such to 2019. For "personal service corporations" (e.g. accounting firms and law firms) the rate would be 25%. Assuming the C-corp rate is cut to 20%, many S-corps and LLCs may want to analyze the possible benefit of converting to C-corp status; particularly if they are retaining earnings in the business rather than distributing such to owners.

Rate on pass-through income - Most privately held companies in the U.S. are structured as flow-through entities. So if you cut the corporate rate, what do you do for flow-throughs (where tax is paid at the already higher individual rate)? And if you reduce the

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Member in the Spotlight — Anna Thibodeaux

The first voice you usually hear when you call our office and the first face you see when you visit our office is that of Anna Thibodeaux. She is also the one who turns rough drafts of tax returns and financial statements into the nice finished package you receive, makes sure your tax returns, extensions and other documents get filed by certified mail, manages our power of attorney filings with IRS, manages our incoming and outgoing mail, FedEx, UPS and couriers, gets copies of your tax returns to your bankers when requested, manages our file room, etc., etc.

Anna is a native of Lafayette, Louisiana, and attended The University of Louisiana at Lafayette. She resides in Smyrna with her husband Kane and enjoys spending time with family and friends, travelling, sewing, cooking Cajun dishes and competing in sports.

Bridges & Dunn-Rankin is proud to have Anna Thibodeaux as a member of our firm.

Anna C. Thibodeaux

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rate on pass-through business income, how do you avoid individuals attempting to structure all of their income as K-1 income in order to take advantage of the lower rate? This has become one of the potentially more contentious issues in the Senate, with Senator Ron Johnson (R-Wisconsin) threatening to withhold his support for the bill unless a generous provision is made for flow-through entities. The House version provides for a maximum rate of 25% on "qualified business income". For a business in which you do not actively participate, this can mean 100% of the net income from conduct of an active business, but for a business in which you are an active participant it generally means only 30% of the net income (the remainder being deemed to come from the owner's performance of services). The 30% amount can be increased if you demonstrate under a complex formula that your business is capital intensive. The Senate version would instead provide a deduction of up to 17.4% of qualified business income (with a limitation that the deduction could not exceed 50% of the W-2 wages paid by the business). Both the House and Senate (except at lower levels of income under the Senate version) would prohibit owners of professional service firms, performing artists, athletes, consultants, financial services firms and brokerage services from enjoying the lower rate.

Section 179 and depreciation - The House and Senate proposals vary somewhat, but both would essentially permit immediate write-off for the cost of most depreciable assets (other than buildings), whether new or used, placed in service from late 2017 through 2022. Buildings (whether residential or nonresidential) would have a depreciable life of 25 years.

Business interest expense deduction - The deduction for business interest expense would generally be limited to 30% of net income. Companies with average revenue below $15 million and also certain industries (most notably real estate) would be exempted from this rule.

Net operating losses (NOLs) - Under current law, an NOL can be carried back 2 years or forward 20 years. The ability to carry a loss back and recover tax paid in an earlier year can be a lifeline for a company (or its individual owners, in the case of a flow-through entity) that has had a reversal of fortunes. The proposed legislation, however, would eliminate the ability to carry back an NOL.

Excess business losses - The Senate would limit to $250,000 for singles and $500,000 for couples the amount of a business loss from a flow-through entity which can offset other sources of income.

Domestic production activities deduction (DPAD) - The DPAD (up to 9% of profit from qualified production activities) would be repealed.

Entertainment expenses - Under present law, 50% of entertainment expenses are deductible, so long as sufficiently connected to a business discussion. The proposed legislation would eliminate the deduction entirely.

Like-kind exchanges - The ability to do a tax-free exchange of like-kind property would be limited to real estate.

Private activity tax-exempt bonds - The exclusion from taxable income for interest paid on private activity bonds would be repealed (including, in particular, bonds issued to build professional sports stadiums).

Repeal of various credits - Various tax credits such as the credit for clinical testing expenses of certain drugs, the employer provided child care credit, the rehabilitation credit, the work opportunity credit, the new markets credit and credit for expenditures to provide access to disabled persons would be repealed.

R&D - The R&D tax credit is retained. However, under the Senate bill, R&D expenses (including software development) incurred after 2025 would have to be capitalized (rather than expensed, as is currently the rule) and amortized over 5 years (15 years for R&D performed outside the US). Given that this change would not be effective until 2026, it appears to be a gimmick designed to help meet a Senate budget reconciliation rule which prohibits adding to the deficit outside the 10-year window (and, in fact, assuming that government revenue reaches a certain threshold this change is essentially eliminated by another provision). Nevertheless, if this rule ever takes effect it could be disastrous for technology companies.

Low income housing tax credit (LIHTC) - The LIHTC is retained, but the industry could be negatively impacted by a lower corporate rate (less demand for the Federal credit) and repeal of the private activity tax-exempt bond interest exclusion (which means the "4% LIHTC" would no longer exist).

Executive compensation - Under current law, the deduction for compensation paid by a public company to its top executives is limited to $1,000,000 per year each, except to the extent tied directly to performance. Under the proposed legislation, the

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performance-based exceptions would be removed. For tax-exempt organizations, a 20% excise tax would apply to executive compensation in excess of $1,000,000 per year.

Domestic international sales corporation (DISC) - The DISC rules, which were designed to encourage exports, permit a company to effectively convert a portion of its profit from export sales to qualified dividends eligible for the more favorable rate on such. These rules would be repealed.

Foreign provisions - The foreign-related provisions in the proposed legislation are extensive and complex, but essentially move the US towards a "territorial based system" (i.e. US tax applies only to income earned domestically), while providing rules to prevent "base erosion". The legislation would also provide for a one-time tax on the earnings of US companies' foreign subsidiaries which are currently parked off-shore. Under the House version, this one-time tax would be 14% on liquid assets and 7% on non-liquid assets. Under the Senate version, the rates would be 10% on liquid and 5% on non-liquid. The tax could be paid in installments over 8 years.

The Tax Cuts and Jobs Act — Individual Provisions

In a separate article in this newsletter, we addressed the provisions of the proposed tax legislation which primarily affect businesses. Below is a summary of the provisions which pertain primarily to individuals.

Changes to individual rates - Under current law, ordinary income is subject to seven different rate brackets (10% to 39.6%), with the rate increasing as income increases. Long-term capital gains and qualified dividends are subject to lower rates (0%, 15% & 20%). The "Obamacare tax" on net investment income is in addition to these rates (3.8% for higher income taxpayers). The House would reduce the number of rates on ordinary income to four (12%, 25%, 35% & 39.6%), while the Senate would retain seven brackets but change them to 10%, 12%, 22.5%, 25%, 32.5%, 35% & 38.5%. Rates on long-term capital gains and qualified dividends would essentially be unchanged, and the 3.8% Medicare Tax on net investment income would remain.

Repeal of deduction for state and local taxes (SALT) - Under current law, individuals can take an itemized deduction for state and local income tax (or sales tax) and property tax. Probably the most contentious item in the proposed legislation is the elimination of such deduction. For those whose income is primarily from long-term capital gains and qualified dividends, the alternative minimum tax under current law already often negates the benefit of this deduction. However, for individuals with substantial ordinary income, this deduction can be worth almost 40 cents on the dollar. Because a disproportionately large portion of the benefit of the SALT deduction goes to residents of "blue states", which tend to elect Democrats, this change is viewed by many as being very politically motivated. The House version would provide for a deduction of up to $10,000 of real estate property tax, while the Senate version eliminates the deduction entirely. The changes would be effective beginning in 2018. Accordingly, unless you will clearly lose the benefit due to alternative minimum tax (AMT) addback, you should likely go ahead and pay your state income tax by December 31, 2017 (and there may be some state benefit to doing so, even if in the AMT).

Repeal of miscellaneous itemized deductions - Under current law, investment expenses and unreimbursed business-related expenses incurred as an employee are deductible, although a 2% of income limitation and addback in computing alternative minimum tax often eliminate the benefit. The House bill eliminates the deduction for unreimbursed employee business expense and the Senate version eliminates all miscellaneous itemized deductions.

Mortgage interest - Under current law, individuals can deduct interest on up to $1.1 million of debt on primary home and a second home, with up to $100,000 of such debt being home equity indebtedness. Under the House version, for debt incurred after 11/2/17 the debt limitation would be $500,000, and only debt on principal residence would qualify. Debt incurred after 11/2/17 to refinance pre-11/2/17 debt would qualify (with some limitation). The Senate version leaves the existing rules as is, except for elimination of the deduction of interest on $100,000 of home equity debt.

Michael A. Sudduth, CPA

Medical expenses - Under current law, individuals can deduct their unreimbursed medical expenses, to the extent such exceed 10% of their income. Because of this 10% floor, the deduction only benefits those who have substantial medical expenses relative to their income. Both the House and Senate would repeal this deduction.

Charitable - The proposed legislation largely leaves charitable donations untouched, except for increasing to 60% the amount of income which can be offset by cash donations, while eliminating entirely the deduction for any amount which entitles you to purchase athletic tickets.

3% of AGI floor - Under current law, to the extent your income exceeds $155,650 as a single or $311,300 as a couple, your itemized deductions are reduced by 3 cents for each dollar of income thereafter. Both the House and Senate versions repeal this limitation.

Gain from sale of home - Under current law a couple can exclude up to $500,000 of gain ($250,000 for singles) from sale of home so long as used as primary residence for at least 2 of the preceding 5 years. Both the House and Senate would change this to require 5 of last 8 years.

Alimony - Under current law, alimony is taxable to the recipient and deductible by the payor. Because the payor is typically in a higher tax rate bracket than the recipient, this generally results in a net tax benefit, and such is often factored into the settlement reached between divorcing spouses. For divorce agreements entered into after 2017, the House version eliminates both the deduction and the income inclusion.

Carried interests - Under current law, the receipt of a "future profits interest" (a/k/a "carried interest") is not subject to tax, and

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the character of future income from it is often long-term capital gain. The fact that hedge fund managers have been able to take advantage of these rules has repeatedly brought them in the bulls eye for potential tax legislation. During the campaign, Trump said carried interests should be taxed as ordinary income. The above notwithstanding, the House version is silent with respect to carried interests and the Senate version would merely require a 3-year holding period in order to qualify for long-term capital gains treatment. The new rule is intended to apply only to "portfolio investment on behalf of third party investors". Notably, real estate held for rental or investment would come under these rules.

Moving expenses - Currently, employers can exclude from taxable pay reimbursement of qualified moving expenses or the employee can take deduction if not reimbursed. Both exclusion and the deduction would be repealed.

Repeal of other exclusions - A variety of other exclusions would potentially be repealed, including the exclusions for employee achievement awards, dependent care assistance, adoption assistance, and educational assistance programs.

Educator's "above the line" deduction - The House made the mistake of suggesting this deduction of up to $250 for out of pocket expenses for classroom supplies would be repealed, but the Senate has suggested instead doubling the amount to $500.

Standard deduction - Individuals have the choice of either claiming itemized deductions or claiming a "standard deduction". The proposed legislation would roughly double standard deduction amounts to approximately $12,000 for singles and $24,000 for couples. This significant increase, combined with the elimination of the deductions for state and local taxes and miscellaneous itemized deductions would mean substantially fewer taxpayers would itemize. Nonprofit organizations fear this would mean a decrease in charitable contributions, since these taxpayers would no longer derive a tax benefit from charitable donations.

Personal exemptions - Current law provides a personal exemption of $4,050 for each member of the family, with such amount being phased out for higher income taxpayers. Both the House and Senate versions eliminate the personal exemption.

Child tax credit - The House would increase the child tax credit to $1,600 per child, and the Senate version would increase such to $1,650. In each case, the credit would continue to be phased out for higher income taxpayers, but at a higher level of income ($500,000) under the Senate version.

Repeal of AMT - Both the House and Senate versions repeal the highly unpopular alternative minimum tax (AMT). As a practical matter, to the extent that the deductions for state and local taxes and miscellaneous itemized deductions are repealed, the AMT would be a non-issue for most individuals going forward anyway, since it is the addback of these deductions which most typically results in AMT. Provision is included to permit individuals who have incurred AMT in past years due to "timing differences" (e.g. exercise of ISOs or depreciation differences) to recover such AMT paid as a credit in future years.

Estate tax - Under current law, an individual can leave up to $5.5 million to his or her heirs tax-free, and a married couple up to $11 million. Amounts above and beyond this (unless left to charity), are subject to an estate tax of up to 40%. Republicans have long pledged to repeal the estate tax, and the House Republicans have made good on that pledge in their version of tax reform (basically doubling the exemption effective for 2018, and eliminating the estate tax entirely for those dying after 2023). Complete repeal is a tougher sell in the Senate, however. The Senate version essentially doubles the exemption amount ($11 million per individual, or $22 million for married couple), but does not repeal the estate tax.

Quick Notes

In the last issue of our newsletter, we reported that Seattle had joined the short list of cities with an income tax, and that such tax was likely not legal under Washington law. As expected, King County Superior Court has since ruled that just because you call an income tax an "excise tax" that doesn't make it legal when state law prohibits an income tax.

For 2018, the Social Security wage base increases to $128,400, the maximum wage base for computing retirement plan contributions increases to $275,000, the maximum amount which can be contributed to a defined benefit plan increases to $220,000, the maximum amount which may be contributed to a defined contribution plan increases to $55,000, and the maximum permissible elective 401(k) deferral increases to $18,500 ($24,500 for those age 50 and older). The maximum permissible contribution to an IRA remains at $5,500 ($6,500 for those age 50 and older).

The annual gift tax exclusion increases to $15,000 for 2018, and the lifetime estate and gift tax exclusion amount will increase to $5,600,000.

Bridges & Dunn-Rankin, LLP
CERTIFIED PUBLIC ACCOUNTANTS

400 Galleria Parkway, Suite 1050
Atlanta, GA 30339
Phone: 770-563-8888
Fax: 770-563-8885
www.bridgesdunnrankin.com

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