

AGC Financial Issues Committee

Tax Discussion

June 7, 2018

Cord Armstrong

Al Clark

Barry Fischman

Perry McGowan

Agenda

- **QBI Deduction – Unintended consequences and unanswered questions**
- **New Tax Law and Your Financials**
- **Accounting Method Changes for New \$25m Threshold**
- **Transfer Tax Issues and Estate Planning under TCJA**
- **New Rules on Conformity with Financial Statements – Group Discussion**
- **Clarification of New Rules with M&E Expenses**
- **Review of Anticipated Technical Corrections**

QBI Deduction – Unintended Consequences

- Presently two identical businesses can have different results depending on type of entity and amount of taxable income
- Assume two identical businesses with no employees – A is a sole prop., B is a sub S shareholder
- Case 1
 - Each businesses QBI is \$500k before owner wages and B pays himself \$200k – Both owner’s taxable income is above the \$315k/\$157.5k thresholds
 - Results - A’s tentative QBI deduction is \$100k – however due to the wage limits his QBI deduction is zero - B’s tentative QBI deduction is \$60k – 50% of the wages is \$100k so his QBI deduction is \$60k
- Conclusion – The S shareholder benefits due to the “reasonable compensation” requirement compared to a sole prop

QBI Deduction – Unintended Consequences

- **Case 2**
 - Same facts as Case 1 but each businesses QBI is \$150k before owner wages and B pays himself \$70k – Both owner’s taxable income is below the \$315k/\$157.5k thresholds
 - Results - A’s QBI deduction is \$30k (no wage limitation) - B’s QBI deduction is \$16k
- **Conclusion – An S shareholder is at a disadvantage compared to a sole prop when the owners taxable income is below the \$315k/\$157.5 thresholds due to the “reasonable compensation” requirement**

QBI Deduction – Unintended Consequences

- **An S shareholder can also be at a disadvantage compared to an LLC owner**
- **Note there is no requirement that an LLC owner pay himself a guaranteed payment**
- **Case 3**
 - **A is an LLC member and B is an S shareholder – each business has QBI of \$1m before owners salary – A is not paid a guaranteed payment and B pays himself \$200k – both businesses have employees and the share of the non-owner wages allocated to A and B is \$400k**
 - **Results – A's tentative QBI deduction is \$200k – 50% of the wages is \$200 so his QBI deduction is \$200k – B's tentative QBI deduction is 160K – 50% of the wages is \$300k so his QBI deduction is \$160k**

QBI Deduction – Unintended Consequences

- **The differences in the prior examples could be resolved by:**
 - **Providing that the W-2 wage limitation does not include wages to S corporation owners, and**
 - **Providing that any “reasonable compensation” or guaranteed payments are included in QBI (the original House version supported this)**
 - **“ net business income includes amounts received by the individual taxpayer as wages , director fees, guaranteed payments properly attributable to the business activity”
...“this rule is intended to ensure that the amount eligible for the 25-percent tax rate is not erroneously reduced because of compensation for services” ...”from the individual’s share of passthrough income”**
 - **Another solution would be to expand the “reasonable compensation” requirement beyond S corporations and apply it to sole props and LLC members**

QBI Deduction – Unanswered Questions

- Specified Service Business Definition
- “Any business involving the performance of services in the fields of health, law, **consulting**, etc.”
- How much consulting activity is needed to taint the entire business and prevent it from taking a QBI deduction?
- Treasury can give us a safe-harbor, for example 50% to help clarify
- Maybe spinning off the service activity into a different entity is needed but we don’t know

QBI Deduction – Unanswered Questions

- **Specified Service Business Definition**
- **We also have the catch-all phrase “or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners”**
- **Presently this phrase threatens any business who is not engaged in one of the specifically listed service businesses**
- **The term “principal asset” will lead to confusion and guidance is needed to narrow the scope of this catch-all phrase (i.e. clarifying the phrase only applies to service businesses or a quantitative test)**

QBI Deduction – Unanswered Questions

- **Other Issues**

- **Does QBI include IRC Sec. 1231 gain? QBI does not include short or long term capital gains – a sec. 1231 gain at the business level can eventually be treated as long-term capital gain but that’s determined at the individual level – therefore it seems reasonable to include it in QBI since it is not investment related income**
- **Is rental income QBI? Presumably so since we have the wage plus unadjusted property limitation but a “trade or business” is generally not defined and often does not apply to rental activities in the code – Perhaps a safe harbor in the Regs. similar to the real estate professional under IRC Sec. 1411 is needed**

QBI Deduction – Unanswered Questions

- **Wage Allocation Issues**
 - **Since 199A requires the deduction to be determined for each separate qualified trade or business (not by activity) , W-2 wages paid by a management company are not allowed to be allocated to operating businesses for purposes of the wage limitation**
 - **An elective grouping election would remedy this problem**
 - **Or a simple provision that allows taxpayers to take into account any wages paid by another entity provided that the wages were paid to the employees of the taxpayer similar to the DPAD regulations**

QBI Deduction- Lower Penalty Threshold

- **Increased Accuracy Related Penalty**
- **TCJA amended IRC Sec. 6662 for any taxpayer who claims the QBI deduction**
 - **The understatement is now “substantial “ if the amount exceeds the greater of:**
 - **5% (decreased from 10%) of the tax required to be shown on the return; or**
 - **\$5,000**
 - **The lower threshold applies if the QBI deduction is on the return, even if the deduction is unrelated to the understatement**
 - **The higher exposure is particularly harsh given all of the uncertainty surrounding this new deduction**



New Tax Law And Your Financials

New Law and Financials

C Corp 21% rate – immediate headlines

- **“Citigroup reports \$18 bln loss on one-time tax items” 1-16-2018**
- **“United Health raises 2018 profit outlook citing tax benefits”... on a one-time tax benefit of \$1.21 per share” 1-16-2018**
- **Goldman Sachs \$4.4 bln one-time tax charge in first quarter 2018 1-17-2018**
- **Bank of America \$3 bln charge, profits cut in half from one-time tax charge 1-17-2018**
- **Caterpillar \$1.3 bln charge for new tax rates**

New Law and Financials

C Corp 21% rate - PTP reorganizations

- **KKR has switch to a C corporation from an PTP, others may also**

New Law and Financials

C Corp 21% rate – DTA and DTL

- **DTA can include loss carryovers, credit carryovers, warranty reserves, bad debt reserves**
- **DTL can include depreciation differences**
- **ASC 740 requires recognition of the change in the period in which the rate change is enacted, which is 2017**

New Law and Financials

C Corp 21% rate – equity changes

- **Companies with deferred tax assets will take a hit to income in 2017**
- **Companies with deferred tax liabilities will see increased income and equity in 2017**
- **Companies switching from S to C will take a hit to equity in the year of change**

New Law and Financials

C Corp 21% rate - calculation

- **Not all DTL or DTA is federal tax, state tax is also a component**
- **Not all DTL or DTA are computed at the statutory maximum rate, resulting in a flat 14% reduction**

New Law and Financials

C Corp 21% rate – valuations

- **Valuations will change for taxable entities**
- **Valuations will change for non-taxable entities, such as an ESOP owned company, which are generally valued as if taxable.**
- **Lower tax may mean higher ESOP purchase obligations**
- **M & A will have impact of lower tax rate**
- **Valuation benchmarks are no longer benchmarks**

New Law and Financials

C Corp 21% rate – FASB ASUs

- **ASU 2018-02 reclassify stranded tax effects from AOCI to retained earnings**
- **ASU 2018-05 issued pursuant to SEC bulletin for tax effects to be calculated, estimated, or as soon as possible**

New Law and Financials

Accrual method conformity requirement

- **Conformity requirement may see companies deferring revenue accruals on the financials to save on taxes**

New Law and Financials

Amendment to Sec. 451(b)

Deferral limited to financial statements for:

Accrual method tax reporters

Any item of gross income

When an “applicable financial statement”

Revenue of performance obligations: book = tax

Exempts:

Taxpayers without financial statements

Items using a special method

New Law and Financials

Performance obligation conformity

- **If multiple performance obligations recognized for GAAP, conforming price on each obligation required for Tax**

New Law and Financials

LKE for equipment

- **Like kind exchanges may be similar for GAAP and Tax after 2017**

New Law and Financials

Different disclosures

- **NOL carry forward disclosure will be more complicated for pre and post TCJA**
- **Book / tax differences will change for expensing, interest deductions, etc.**

New Law and Financials

Individual rate change to 37% top

- **Off-balance sheet calculation of deferred taxes for pass-through will drop for 2017, for actual taxes after 2017**
- **Actual off-balance sheet change will depend on all other changes, not just the top rate, such as no 199, new 199A**

New Law and Financials

Changes in Method if under \$25M AAGR

- **New deferred tax liabilities for 2018 for companies now eligible for exempt methods**
- **Deferred tax calculations will be complicated with the change based on cutoff method**
- **Possible new required disclosures for “uncertain tax positions”**

New Law and Financials

Changes in Method if under \$25M AAGR

- **Inventory accounting has different rules for GAAP compared to Tax**
- **Tax rules for exempt contractors account for inventory under non-incidentals materials concept**

New Law and Financials

Changes in Method if under \$25M AAGR

- **Calculation of deferred tax for net operating loss utilization will change**

New Law and Financials

Changes in 20% deduction for S corp

- **Any deferred tax calculation, off balance sheet by financial statement users, based on the use of the 20% deduction is based on the company trade or business. Will be more complicated**
- **Groupings or separations for 199A may differ from financial consolidation**

New Law and Financials

More differences of reported expenses

- **Non-deductible differences between GAAP deductions and Tax deductions for entertainment, moving costs, interest, etc.**
- **More expensing on the tax return = more deferred tax liability on the financial statements**

New Law and Financials

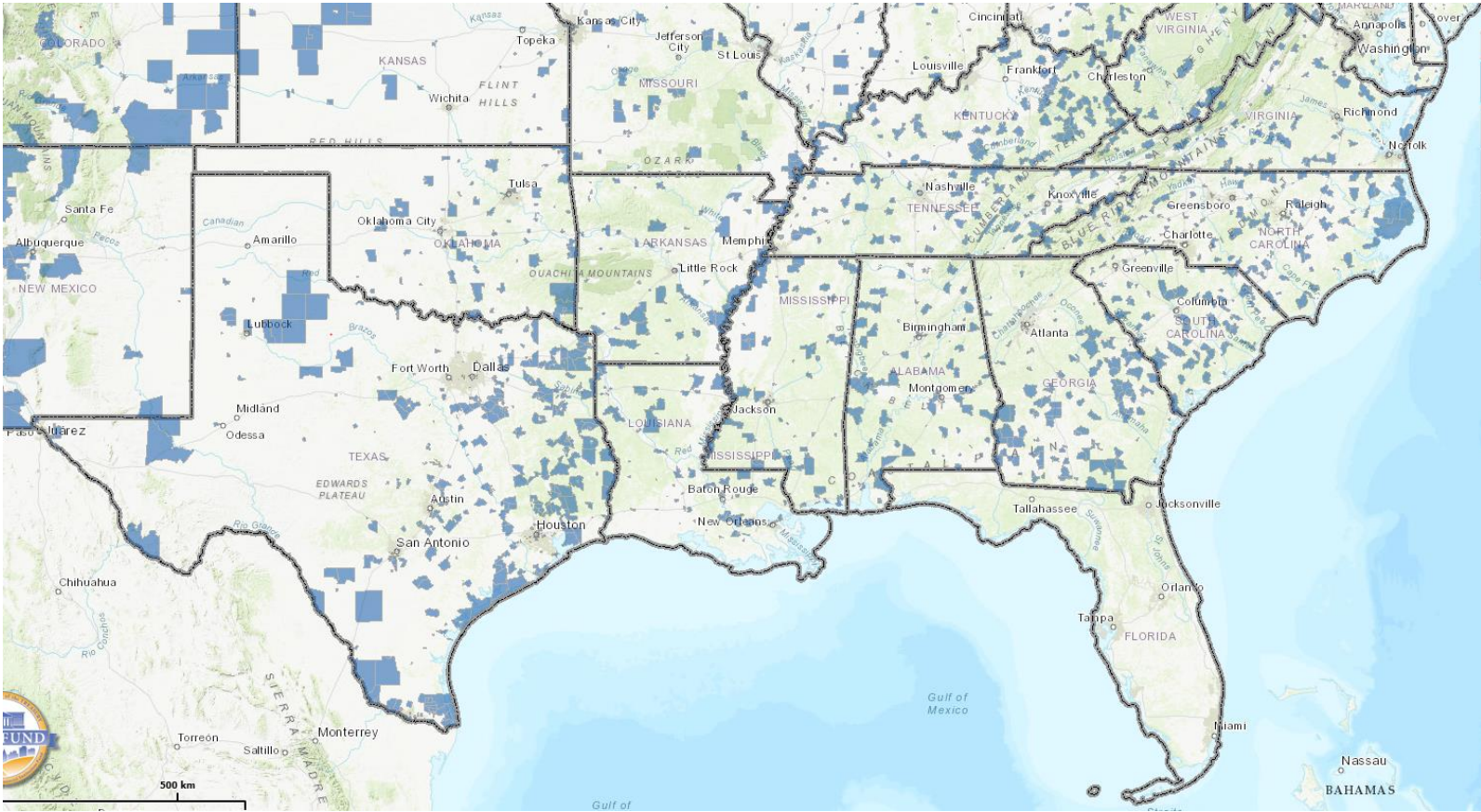
Interest deduction limitation

- **Interest in excess of the new 30% rule will be a part of the new deferred tax calculation for the financials**
- **New FASB lease accounting rules may put more interest on the financial statements compared to the tax return.**

Qualified Opportunity Zones

- “A QOZ is an economically-distressed community”.
- QOZ’s retain designation for 10 years.
- With reinvestment, investors can defer tax on any prior gains until the earlier of the date realized, or 12/2026.
- If the investor holds the investment in the Opportunity Fund the increase their basis:
 - 10% for 5yr, 15% for 7 yr hold.
 - Fund gains exempt after 10yrs.

Zones in the Southeast



New Methods Guidance

- **Rev. Proc. 2018-29 issued 5/10/2018**
 - For FASB “performance obligation” standards
 - **Does NOT address TCJA changes** to Sec 451
 - Use either a 481 adjustment or cut-off method
 - Applies to 460 changes if PCM isn’t required
 - Use in 1st three years ending post 5/10/2018
 - Simplified 3115 filing for book/tax conformity
 - May include many method changes, but each must be separately computed

New Methods Guidance

- General consent procedures Rev. Proc. 2015-13
- Automatic changes listed in Rev. Proc. 2018-31
 - Few substantive changes
 - **No update for TCJA** Tax Reform changes
 - Adds Section 19 for “Special Rules for LTCs” [Reserved]
- Notice 2018-35 issued 4/12/2018
 - Rev. Proc. 2004-34 continues in transition

New Tax Law & Your Financials

Alan K. Clark

Smith, Adcock and Company LLP

Perry McGowan

CliftonLarsonAllen

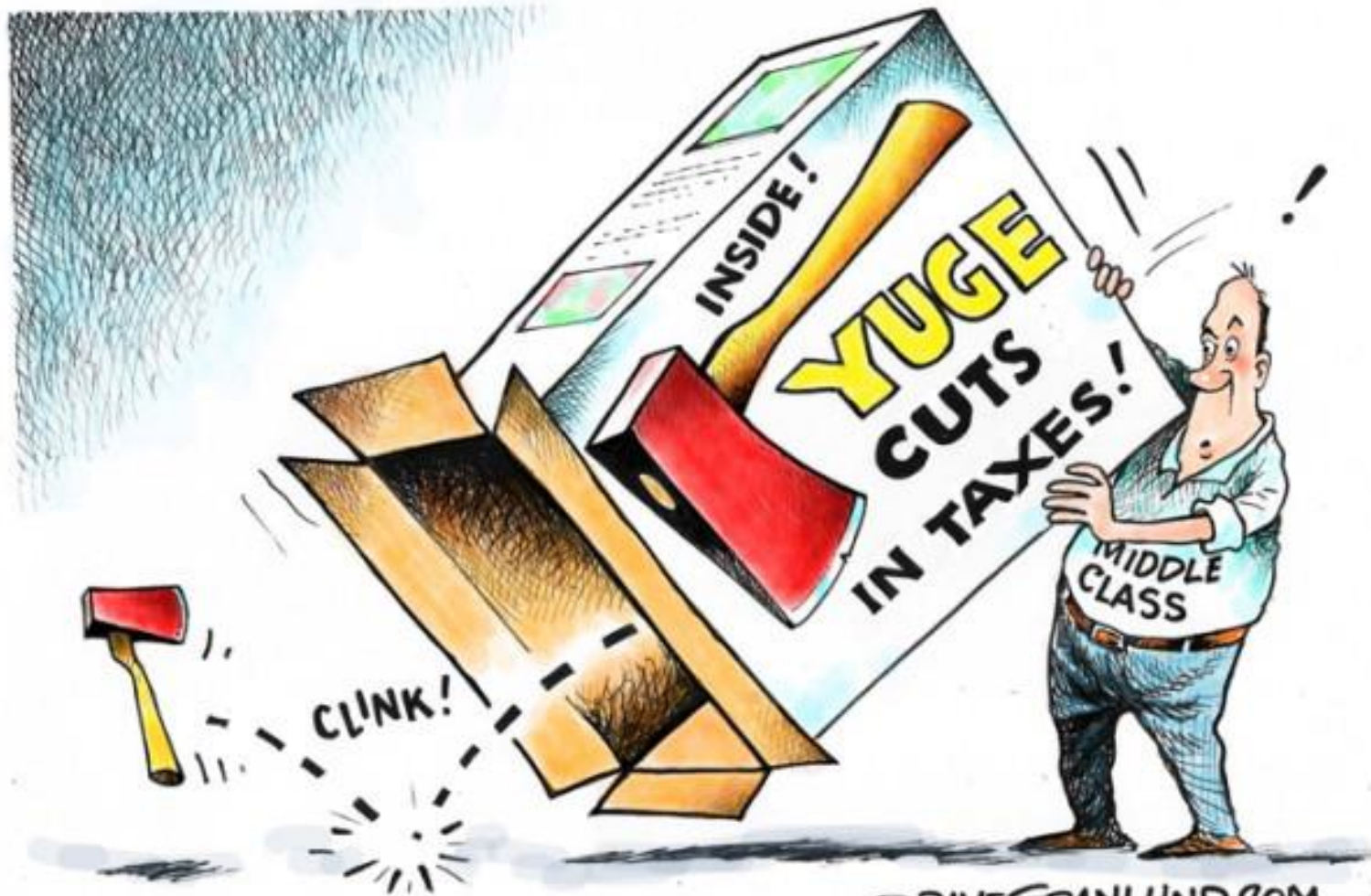


Tax Cuts and Jobs Act Summary of New Tax Provisions – Transfer Tax Issues and Estate Planning Considerations

Presented by:

Barry A. Fischman, Partner, CPA, MST

Barry.Fischman@marcumllp.com



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Discussion Points – Transfer Tax Changes

- I. Transfer Tax
- II. Income Tax Provisions
- III. Estate Planning Considerations
- IV. Wealth Transfer Techniques

Transfer Tax – Changes Under the New Law

- The Act doubles the estate and gift tax exclusion amount for estates of decedents dying and gifts made after December 31, 2017 and before January 1, 2026.
- The Generation-skipping transfer (GST) tax exemption is also doubled.
- As of January 1, 2018, exemption is \$11,180,000 per person (\$22,360,000 for a married couple).

TCJA - Estate, Gift and GST

- Estate & Gift Tax Exemption:
 - For 2018 through 2025, the \$5,000,000 Basic Exclusion Amount (as adjusted for inflation – which exempted \$5.45 million in 2017) is doubled to \$10 million (as adjusted for inflation after 2011), and is expected to be approximately \$11.2 million in 2018 (\$22.4 million per married couple).
 - Regulations are to be issued to account for computation for the differences in the basic exclusion amount at time of death and at date of gift.
 - Annual gift tax exemption amount for 2018 is \$15,000 to each donee, 30,000 for spouses who consent to split their gift.
- Estate Date of Death Basis Rule – is retained
- Generation Skipping Tax Exemption is increased in accord with the estate and gift tax exemption.

Income Tax Provisions Impacting Trusts and Estates

- Tax Provisions for individuals generally apply to trusts.
- The \$10,000 limit on deducting state and local taxes applies to trusts.
- No miscellaneous itemized deductions allowed.
- Other miscellaneous estate or trust expenses not subject 2% limitation allowed
 - Executor and trustee fees
 - Accounting and legal fees
 - Deductions for appraisals, court fees

Estate Planning Considerations

- Fewer decedents will have to pay the estate tax in 2018 and future years
- Review state estate tax consequences
- Review formula clauses

Married Couples with Assets Over \$11 Million

- Consider using some of the increased gift tax exclusion to save estate tax in case exclusion amount is reduced back to \$5.5 million
- Better to make gifts now even if there is a clawback. Would still remove appreciation on the property from estate
 - Forgiveness of outstanding loans
 - Equalizing gifts to children/grandchildren
 - Save state estate taxes

TCJA - Estate, Gift and GST

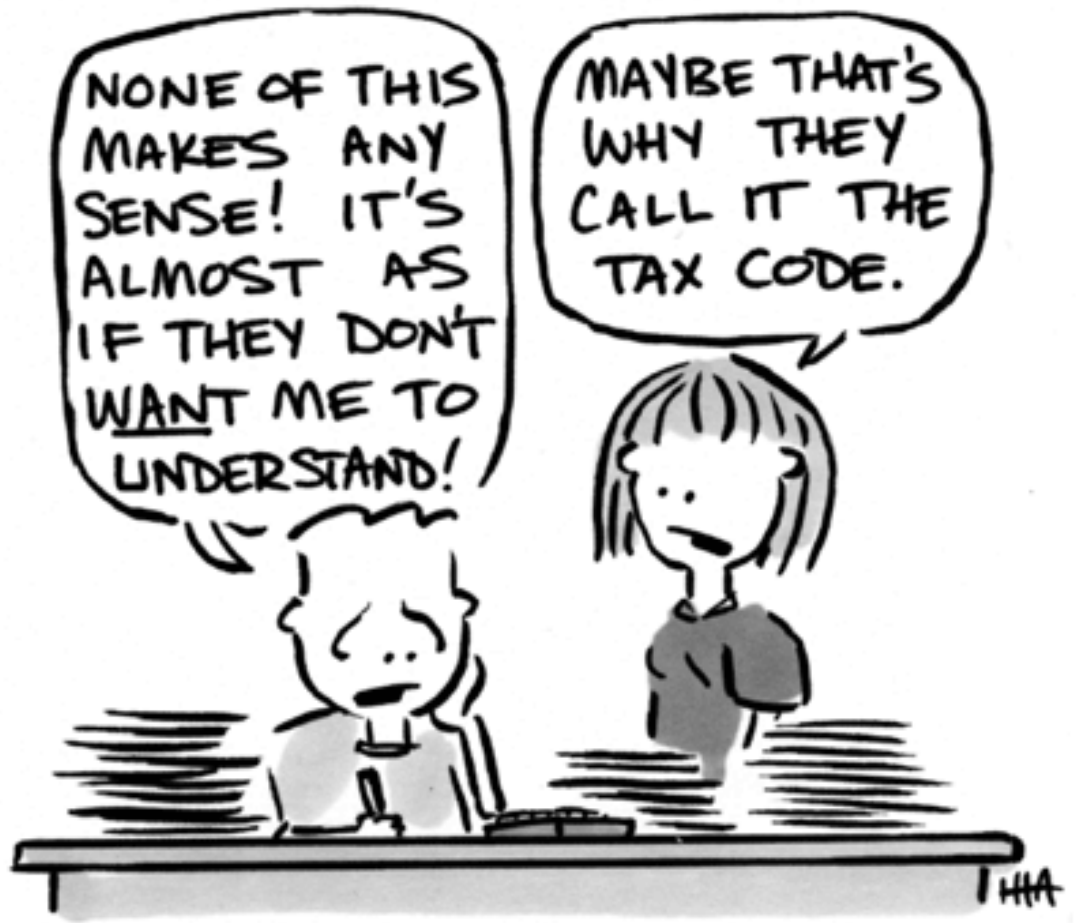
- Estate & Gift Tax Planning Opportunities:
- Update wills and estates
- What is my company worth?
 - Valuation discounts for
 - Lack of marketability
 - Lack of control
 - Non-voting stock
- Gifting strategies
 - Leverage annual exclusion gifts
 - Leverage gift tax exemptions.
- Trusts make good owners
- Review life insurance coverage

Popular Wealth Transfer Techniques

- Grantor Retained Annuity Trusts (GRATs)
- Gifts to Dynasty Trusts
- Spousal Lifetime Access Trusts (SLATs)
- Intra Family Loans
- Sales to Intentionally Defective Grantor Trusts
- IRA rollover to Roth IRA
- Stretch out IRA RMD planning

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Review of Technical Corrections

One Hundred Tenth Congress
of the
United States of America

AT THE FIRST SESSION

*Begun and held at the City of Washington on Thursday,
the fourth day of January, two thousand and seven*

An Act

To amend the Internal Revenue Code of 1986 to make technical corrections, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the “Tax Technical Corrections Act of 2007”.

2018



What is a Technical Correction?

- Must be “purely technical” and can not change underlying policy
 - Example: A new provision mistakenly cross-references the wrong section of the IRC.
- Must align the legislative text with Congressional intent
 - Should not contradict the Committee Report or JCT description
- Shouldn't “score” as a revenue loss (or gain).
 - Since JCT estimated what Congress intended (rather than what was written), then it should not score.

How Are Technical Corrections Fixed

- Legislative process operates under a consensus model
- Theoretically, majority AND minority staff of House Ways and Means, Senate Finance, Joint Committee on Taxation, and Treasury tax staff all must agree to the “technical correction”
- The list is compiled by JCT and eventually a bill is introduced
- Partisanship may affect discussions—retaliation for Obamacare
- BUT BUT BUT, some TCJA technical corrections, have already passed (“grain glitch,” “Newman’s Own Foundation Fix”)

Major Technical Corrections Identified Thus Far

- Qualified Improvement Property
 - TCJA consolidated restaurant, retail and leasehold improvement property into a new category: “Qualified Improvement Property” depreciable over 15 years
 - Drafting error means depreciable over 39 years
- Net Operating Loss Carryback
 - Incorrect beginning after/ending after effective date means carrybacks applying to fiscal years that end *after* 12/31/17 would be disallowed retroactively.
 - Hopefully minimal impact on construction, but huge impact on retail sector

Other Possible Solutions

- Ignore the law!!!
- “Four horsemen” letters