TAX

INSIGHTS

ON NAVIGATING THE NEW TAX LAW

PHILADELPHIA BUSINESS JOURNAL THOUGHT LEADER FORUM SPONSORS

THOUGHT LEADER FORUM

INSIGHTS

On Navigating the New Tax Law

With the new Tax Cuts and Jobs Act in place, business leaders in all industries are seeking information on how it impacts them. The Philadelphia Business Journal hosted a Thought Leader Forum with two tax professionals.

Participants were Steven P. Kopew, CPA, Partner Philadelphia Tax Practice Leader, RSM US LLP and Thomas E. Barber, CPA, Partner, Tax Services, Mazars USA LLP.

What are the biggest assumptions or questions you find yourself answering about the Tax Cuts and Jobs Act?

Kopew: My clients are interested in different aspects of the new law, depending on their circumstances. However, there are certain questions that seem to be of high interest to most clients. For example, should they change the entity type of their business? For flow-through entities, they want to determine if the qualified pass-through income deduction applies.

Other questions relate to new limitations such as the new business interest limitation, the new net operating loss rules and the new excess business loss limitation.

They want to know about their ability to claim the enhanced 100% bonus depreciation deduction and expanded Section 179 deduction.

If they have foreign operations, they want to know about new transition tax that applies for the 2017 tax year. They are also interested in other new international provisions, such as those related to Global Intangible Low-Taxed Income (GILTI), the Base Erosion Anti-Abuse Tax (BEAT) and Foreign-Derived Intangible Income (FDII).

Barber: With any tax legislation that is passed comes confusion and uncertainty in terms of what this really means to any taxpayer. There will be winners and losers as tax legislation must be revenue neutral by law.

For individuals, the immediate questions raised are, "how will this impact me?" There is the immediate knee jerk that they will be losing the benefit of itemizing deductions and personal exemptions, but with the lower tax rates and expanded ranges the lower tax rates cover, we are finding many individuals are net winners.

Even though this Act has been touted as tax simplification, on the corporate side of the house, it is anything but that. Yes, tax rates have dropped, but new tax provisions have been created and others have been significantly modified. Yes, there is 100% bonus depreciation, but we now see new limitations being imposed on interest expenses. Multi-nationals now may be dealing with deemed repatriation of earnings tax related to their foreign investments, along with reviewing their cross-border transactions with foreign related affiliates they have, which create U.S. tax deductions. These arrangements now need to be scrutinized in order to plan around the maze of rules imposed under the Base Erosion Anti-Abuse Tax (BEAT) and Global Intangible Low Tax Income (GILTI) regimes, to avoid potentially adverse tax consequences.

What are the three most significant changes for corporations in the tax reform bill?

Barber: With the most sweeping changes in U.S. corporate tax law since the enactment of the Tax Reform Act of 1986, we see the most significant corporate tax changes being: (i) the drop in the Corporate rate reduced to 21% from 35%, beginning in 2018, coupled with the repeal of the corporate AMT, (ii) the increase in bonus depreciation from 50 to 100%, starting after Sept. 27, 2017 and (iii) the change in the limitation of interest deductions to 30% of Earnings before Interest, Tax, Depreciation and Amortization (EBITDA).

The drop in the corporate tax rate and the expansion of bonus depreciation should free up funds for business expansion/ capital expenditures and dividend distributions and have already been cited as reasons why companies have issuing immediate employee bonuses.

The new interest expense limitation provision, expands the limitation to cover all interest and not just foreign related party interest. This will cause heavily leveraged taxpayers to review how their business is capitalized and will likely impact future financing of capital expenditures and acquisitions.

Kopew: The C corporation income tax rate dropping from 35% to 21% produces an all-in top income tax rate for individual corporate shareholders of 36.8% (39.8% when including the net investment income tax). This tax rate is close to the new top individual income tax rate of 37%. That reduction is tantamount to the virtual elimination of the so-called "double tax differential" on corporate income if the income was taxed at the highest individual rate. However, it is important to note that certain pass-through income could be taxed at lower rates. For example, some pass-through income could be taxed at an effective 29.6% rate, which is why the choice of an entity requires discussion and analysis. The corporate AMT is also being eliminated. On the negative side, new limitations are imposed on deducting business interest and net operating losses.

How will the reduced federal tax rate impact the deferred tax assets and liabilities for financial statement reporting purposes?

Kopew: With the reduction of the corporate tax rate from 35% to 21%, businesses will need to restate their deferred tax assets and liabilities on their financial statements to account for the effective tax rate when those deferred items will reverse. For example, a company that had a $1 million-dollar piece of equipment that was deducted for taxes in 2017 at a 35% tax rate saved $350,000 in current federal income taxes. If the financial statement depreciation would occur over the following seven years, then the deferred tax liability on the financial statement would have been $350,000. However, with the lower 21% corporate tax rate, the deferred tax liability will now only be $210,000, resulting in a permanent tax benefit of $140,000. Detailed scheduling maybe necessary due to the uneven nature of many provisions.

> **"Even though this Act has been touted as tax simplification, on the corporate side of the house, it is anything but that."**
>
> **THOMAS BARBER**
> **Mazars USA LLP**

Barber: For years ending December 31, 2017 and thereafter companies must have their deferred tax balance determined based on the new 21% rate vs. the old 35% tax rate. Companies with large deferred tax assets (e.g., net operating loss carryforwards) will see a deferred tax charge, while companies with net deferred tax liabilities (e.g., those with unrealized portfolio gains) will see a deferred tax benefit. For U.S. GAAP purposes, the tax effects of changes in tax rates are recorded in income from continuing operations irrespective of the source of the income or loss to which the deferred tax item is related, which means companies with significant deferred tax balances related to unrealized investment gains (losses), must run these changes through their income statement. Unlike U.S. GAAP, IFRS accounting requires the changes in the tax rate related to other comprehensive income (e.g., unrealized gains(losses) must be recognized in equity consistent with the recognition of original amount.

What are the main issues and opportunities a business owner should consider when choosing between continuing to operate as a flow-through entity (such as an S Corp, LLC or Partnership) as opposed to converting to a regular C Corporation due to the lower 21% corporate tax rate?

Barber: While a 21% federal corporate tax rate is enticing, taxpayers should evaluate their short-term and long-term goals before making any decision. Choosing C corporation status may create more cash flow and operational flexibility, but these benefits are diminished to the extent owners take money out in salary or dividends. Distribution of earnings means two levels of taxation, i.e. entity level and individual level. Also, many states, including Pennsylvania ("PA"), have higher corporate rates vs. individual taxes. The benefits of one level of tax are especially recognized when an entity sells the assets of its business. While the sale would be taxed once as a flow through entity, it would be taxed at the C corporation level and again at the individual level upon liquidation. Further, the new IRC 199A 20% pass through deduction means the effective tax rate for individuals on qualified pass through income could be as low as 29.6% vs. the top individual tax rate of 37%, thereby potentially lessening savings achieved by converting to a C corporation. There are other considerations including 1202 stock, deduction of state taxes and other matters beyond our scope.

Kopew: One important consideration is determining an owner's exit strategy. A business owner who will hold the business and transition it to family members may benefit from the lower 21% federal income tax rate for C corporations, while a business that may sell in the next few years may be better off keeping its current flow-through entity structure, as many buyers want to acquire assets that unfortunately would result in a double tax to the seller in a C corporation scenario. Another consideration is to decide whether you think the new rules will not be changed again in a few years, as often happens with major tax reform legislation, particularly if it is passed on a party-line vote. Let's say you are considering C corporation status for its tax rate advantages and the ability to defer a good portion of the tax that would otherwise be due on reinvested earnings. If you view the new law as relatively permanent, then you must still determine whether in fact you will reinvest most of your income or distribute it currently.

Will the state of Pennsylvania and the city of Philadelphia allow a business to claim the 20% qualified business income deduction?

Kopew: For federal tax purposes, the 20% qualified business income deduction (Section 199A) is a reduction to federal Adjusted Gross Income (AGI) to arrive at federal taxable income. Pennsylvania's personal income tax system is a gross income system and does not adopt the Internal Revenue Code (IRC) or start with federal taxable income. Pennsylvania does

permit specific additions and subtractions to gross income from a business, but there currently is no provision to permit the federal 20% deduction. Therefore, it appears that Pennsylvania's tax computation would not include the 20% qualified business income deduction absent action by the state legislature to enact a specific state-level adjustment: (As of the publication of this article, Pennsylvania has not enacted provisions allowing for a state-level qualified business income deduction).

Barber: Philadelphia is one of many jurisdictions considering both the domestic and international provisions of the TCJA. Philadelphia, like many places, does not automatically conform to the federal tax code. Because the 20% IRC 199A deduction is not taken at the entity level, expect that there will be no benefit to filers of the Business Income and Receipts Tax (BIRT), as the City's starting point is the entity's "income or loss as reported or reportable to the federal government." Other sections of the BIRT regulations have adjustments for pass through entities, and those sections probably do not encompass the deduction. Similarly, the starting point of the Net Profits Tax does not accommodate, what, in effect, is a personal deduction on the federal level. Nor does the School Income Tax appear to give a personal deduction. As of the writing of this, the Philadelphia Department of Revenue has not posted any guidance with regards to conformity with new IRC 199A.

How is the 20% pass-through deduction calculated?

Barber: This is much more difficult than just taking 20% of a pass-through's net income! That is only the starting point. Assuming a taxpayer qualifies for the deduction (and there is much uncertainty about that!), then they have several hurdles to overcome, including the amount of wages paid and their overall qualified business income from all sources reported on their Form 1040. Whether a taxpayer qualifies for the deduction is based on the type of business, and while there are specific service businesses that don't qualify for the deduction (accounting, legal, medicine, brokerages, consultants), the statute is written so broadly that it may pull in, for example, plumbers. But, as with the limitations to be discussed below, if a taxpayer's overall income is under certain thresholds, then these businesses will still qualify.

A taxpayer's IRC 199A 20% deduction can be limited to 50% of wages paid by the pass through, and further limited by a maximum of 20% of their overall taxable income. However, all that might not matter if they are under certain income thresholds, which range from $315,000 to $415,000 for taxpayers who file jointly, and 50% of those amounts for all other taxpayers.

Kopew: A new exclusion or deduction of 20% of qualified business income will effectively reduce the tax rate on such income by 20%. Thus, qualified income otherwise taxed at the top rate of 37% will be taxed at 29.6%. Income otherwise taxed at 24%, for example, will be taxed at 19.2%.

For individuals with income below $315,000 for joint returns, it is more straight forward. For every $100 of business income, only $80 is subject to tax. The computation is the same for higher-income taxpayers, except that more restrictions apply to qualify for the deduction. The business must either pay substantial wages (twice the amount of the 20% deduction being claimed) or invest in substantial amounts of tangible, depreciable property used in the business. In addition, the business may not be on a list of forbidden service businesses in various fields such as law, health, accounting, consulting, brokerage, financial services, performing arts, actuarial science, and some others.

What is Section 965? Please explain why is this important to business owners.

Kopew: One of the most significant new provisions of the Tax Cuts and Jobs Act is the one-time deemed repatriation of previously untaxed post-1986 earnings and profits of specified foreign corporations. Coordinated with the new participation exemption rules, the deemed repatriation of previously tax-deferred earnings marks a substantial shift in the U.S. tax landscape for internationally active taxpayers.

Depending on whether the earnings are held in liquid or illiquid assets, two different tax rates (15.5% or 8%, respectively) effectively apply under Section 965. The deemed repatriation rules will begin affecting tax returns for years ending Dec. 31, 2017. Fiscal year taxpayers will be required to comply with the Section 965 rules on their first return whose year ends after Dec. 31, 2017.

Because of the effective dates of the deemed repatriation and related tax liability, affected taxpayers will need to quickly assess different attributes of their foreign subsidiaries, including each company's historical earnings and profits, balance sheet positions, foreign tax pools, and related party transactions.

Barber: TThe Tax Act introduced a one-time mandatory repatriation tax under Section 965 effective for tax year 2017 ("Section 965 tax", at reduced rates). The Section 965 tax is a deemed distribution of the companies deferred foreign income with respect to certain Specified Foreign Corporations ("SFC"). The deferred foreign income refers to a SFC's post – 1986 earnings and profits ("E&P"). A U.S. shareholder would pay the Section 965 tax on their E&P as determined on the measurement dates of Nov. 2, 2017 or Dec. 31, 2017 (whichever amount is greater). The reduced tax rate is accomplished via a deduction against a U.S. shareholder's subpart F inclusion amount that is necessary to result in a 15.5% tax rate on cash or cash equivalent E&P, and an 8% tax rate on non-cash E&P.

Business owners must be cognizant that the deemed repatriation is not elective, except to the extent the Section 965 tax may be paid over a period of eight years or if shareholders of an S-corporation avail themselves of a special deferral election with respect to their Section 965 tax liability. Business owners also may take advantage of foreign tax credits or net operating losses to offset the Section 965 tax.

Note the IRS released IR-2018-53 on March 13, 2018 answering frequently asked questions (FAQs) regarding how to report and pay the Section 965 tax.

How will the Corporate AMT Repeal/Refund affect a business moving forward?

Barber: With the repeal of the Alternative Minimum Tax ("AMT") beginning after Dec. 31, 2017, corporations no longer will have to deal with this parallel tax regime.

THOUGHT LEADERS

STEVEN P. KOPEW

Partner, Tax Services
RSM US LLP

Steven P. Kopew is the partner who heads the Philadelphia tax services group and has been with the firm since 1993. Before his current position, he was a member of the Arthur Andersen & Company's tax department.

Steve leads all aspects of tax engagements including tax planning, tax compliance and business advice. His clients include complex international and multi-state private and public companies. Steve invests significant time consulting with his clients who are acquiring, selling or reorganizing their business. He reviews and consults on complex accounting for income tax and uncertain tax position engagements. He has extensive experience in resolving federal and state tax controversies.

Steve has extensive experience and expertise in the manufacturing, wholesale distribution, technology and financial institutions industries and is an active member in the firm's related industry teams. Steve has a Bachelor of Science from Drexel University and a Master's degree in taxation from Temple University.

THOMAS E. BARBER, CPA

Partner, Tax Services
Mazars USA LLP

Tom Barber provides tax services predominately to the insurance industry, and leads the tax support team for GAAP, IFRS, and Statutory financial statement audits.

Tom's more than 30 years of experience include leading numerous tax engagements for both public and non-public enterprises, including preparing and reviewing income tax returns and income tax provisions. He has advised on Internal Revenue Service audit and tax controversy, co-sourcing and out-sourcing arrangements, tax basis analyses, deferred tax validations (GAAP and Statutory), accounting method changes, tax due diligence, and Sarbanes-Oxley compliance.

Prior to joining Mazars in 2011, Tom held the position of Executive Director at Ernst & Young LLP's Financial Services Office – Insurance Tax Services practice. Previously, Tom spent six years as a Managing Director with LECG Corp. (formerly Smart Business Advisory & Consulting, LLC), specializing in tax services for the insurance industry.

Tom has a Bachelor of Business Administration in Accounting from Temple University.

AMT credit carryforwards can still be used to reduce regular tax and any remaining unused.

AMT Credits are refundable no later than 2021. However, it should be noted that there is uncertainty as to whether AMT credit carry forwards that are now refundable by statute are subject to past Section 383 limitations or future Section 383 limitations based on post-2017 ownership changes.

Because any available AMT credits are fully refundable, corporations can now recognize this deferred tax asset in their U.S. GAAP tax provisions if previously it was subject to a full or partial valuation allowance as it is guaranteed to be utilized and/or refunded no later than 2021.

Kopew: The corporate AMT was repealed, and existing AMT credits can offset regular tax liability and, if not used, will be refunded. Therefore, the full AMT credit will offset regular tax liability or be refunded by the 2021 tax year. For financial statement purposes, this could result in a release of a valuation allowance against any AMT credits since those credits are now ultimately realizable, either as a reduction of future regular tax liability or as a refund.

The new partnership qualified business income deduction affects certain business-types differently. Walk us through the differences between service trades or businesses and small business stock and who qualifies and who doesn't for the qualified business income deduction.

Kopew: As noted, certain service trades or businesses are generally ineligible for the 20% deduction if they exceed the income threshold. Using language from Section 1202 (the qualified small business stock definition), specified trades or businesses include any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. Certain financial trading and dealing activities are also excluded. Engineering and architectural firms were removed from this "bad" list in the final enacted legislation but are included in the definition of qualified small business stock in Section 1202.

However, there is a catch-all category that is somewhat vague and confusing. It excludes 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. This test could effectively bring architects and engineers back into the forbidden list – and exclude many other businesses – possibly in a manner that was not intended. On the other hand, it is not clear that similar words in Section 1202 and the new pass-through rules will be interpreted and applied similarly because the policies of the two provisions are quite different. We are awaiting more guidance from the IRS on these matters.

Barber: While the IRC Section 199A business income deduction and IRC Section 1202 small business stock exemption each create tax savings, fitting into their provisions is another matter.

The Section 199A deduction is available to sole proprietors and owners of pass-through entities. The deduction is equal to 20% of the qualified business income, subject to certain limitations. However, businesses that perform services in the fields of health, law, accounting actuarial science, performing arts, consulting, athletics, financial services, brokerage services, and investment management or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its employees or owners do not qualify for the deduction. Real estate enterprises, manufacturers and distributors are examples of companies that should benefit from the IRC Section 199A deduction. Notably, architects and engineers are not excluded from the Section 199A deduction. The Section 199A deduction is still available to owners of nonqualified businesses if the owner's taxable income is below a specific threshold.

The AICPA has asked for guidance from the IRS on many IRC 199A related items. The IRS is asking the practitioner community to provide specific areas on which they want guidance. We've only seen the beginning...

How do you advise clients on the Tax Cuts and Jobs Act to make it easier for them to navigate?

Barber: There is a wealth and a flood of information in the news, in print and on the web that our clients see almost every day, that quite frankly can be overwhelming and intimating to some. It's our duty as tax advisors and consultants to meet with our clients to tailor a plan to help them understand what U.S. tax reform really means to them and help them to plan accordingly in order to put them in the best place they can be from a tax perspective. Also, it is important to advise them that there many questions that are unanswered as we await additional guidance to be provided as many of the provisions are not clear.

It's important to meet with our client's face to face, listen to their needs and concerns and then walk them through the relevant pieces of the Act that directly impact them. Each client's fact pattern is unique, and we must target sections of the Act in relation to the client. Some client's care mostly about the cash tax implications, estate planning and wealth transfer while others need to understand what that means to their companies' financial statements and effective tax rate. Small businesses are now questioning their tax entity form, should they be an S-corporation, partnership or C-Corporation.

Kopew: The TCJA has many complex provisions and can be overwhelming. Some provisions may apply but have little effect for a specific taxpayer, while other provisions can have a tremendous impact. The first thing I would recommend is to have your tax advisor go through the Act and determine which provisions affect your business. Then, they can help you ascertain which ones are likely to have a material effect on your tax liability and assist with further analysis related to the provisions material to you.

This will help you focus your initial planning on the most material provisions. This law was enacted on Dec. 22, 2017 after speeding through the legislative process. There are many provisions that require further clarification and additional guidance from the Treasury and IRS. Therefore, tax planning should start now but may need to be updated as additional guidance is issued.

THE POWER OF BEING UNDERSTOOD
AUDIT | TAX | CONSULTING
RSM
RSM US LLP is the U.S. member firm of RSM International, a global network of independent audit, tax and consulting firms. Visit rsmus.com /aboutus for more information regarding RSM US LLP and RSM International.