Federal Income Tax Issues Post - 2017

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New Tax Rates

- Maximum Individual Rate on Ordinary Income of 37%
- Maximum Long Term Capital Gains Rate of 20%
- Maximum "C" Corporation Rate of 21%
- Trusts' and Estates' maximum rate starts at $12,500 (indexed)
- If the "Pass Through" income qualifies for the Section 199A deduction, the qualified income is effectively taxed at 80% of the rate that would otherwise apply (e.g. maximum individual rate of 29.6%)
- ***Federal Estate and Gift Tax Rate, when applicable: 40%***

OTHER INCOME TAX CHANGES

- The "Kiddie Tax" is imposed at Trusts and Estates tax rates.
  - This tax is no longer determined based on Parents' Tax Rate
- The deduction for state and local taxes is limited to $10,000 /yr.
  - This also applies to Trusts and Estates.
- Miscellaneous Itemized Deductions that were subject to a 2% AGI threshold are disallowed for 2018-2025.
- IRS Notice 2018-61 attempts to clarify the new limits as applied to trusts and estates. Regulations will be issued, to clarify this area.
- Executor's and Trustee's fees *should* still be deductible, because these would not have been incurred but for the estate or trust.
- For Trusts & Estates, Excess Deductions on Termination and Capital Loss Carryovers are disallowed from 2018 to 2025.

OTHER INCOME TAX CHANGES
(continued)

- The Section 691(c) deduction is still available.
- Example:
  - Single decedent dies in 2018, with a taxable estate of $18 million.
  - Included in her estate is a $5 million traditional IRA.
  - The Federal Estate Tax attributable to the IRA is $2 million (40% FET Rate).
  - As the IRA is included in income, under Section 691(a), the recipients of the IRA are entitled to a Section 691(c) deduction of $2 million, which is not subject to the 2% of AGI limit.
  - Note: It’s only the initial $5 million of the IRA that, as distributed, is allocated the deduction. Hence, as the IRA grows in value and is distributed, the Section 691 (c) deduction must be tracked.

OTHER INCOME TAX CHANGES
(continued)

- The charitable contribution deduction for Electing Small Business Trusts (ESBT's) is computed under Section 170, not Section 642(c).
- The Corporate Alternative Minimum Tax is repealed. Before repeal, this had the potential to impose income tax on life insurance proceeds received by "C" Corporations. This was an issue in a Redemption (entity purchase) form of Buy-Sell Agreement.
- Like-Kind Exchanges are limited to exchanges of real property.
- A sale of 50% or more of the capital and profits interest of a Partnership is no longer a deemed termination.
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OTHER INCOME TAX CHANGES
(continued)

- A sale of a life insurance policy is taxable only if the proceeds exceed: premiums paid, less dividends and less withdrawals. This has simplified the gain (if any) calculation.
- Prior to this change, the seller of a policy had to determine the portion of the premiums paid that were allocated to “pure” life insurance”, which portion was not included in the basis of the policy sold. The theory was that the insurance coverage benefit had been consumed, so therefore no credit was given upon sale for that portion of the premiums paid.

Pass-through Income Deduction

- Allows a 20% deduction of **"qualified business income" (QBI**) to non-corporate taxpayers subject to limitations, to be known as the **Section 199A deduction**.
- The deduction is limited to the greater of:
    - 50% of allocable W-2 wages **or**
    - Sum of 25% of W-2 wages plus 2.5% of the unadjusted basis of all qualified tangible property ("QTP")
- Limitations do not apply to individuals with income below certain thresholds ($157,500 for individuals, and $315,000 if married filing jointly, indexed annually).

Pass-through Income Deduction

- Without the W-2 wages limitation, an individual in control of and who works for a Pass-Through Entity could reduce his or her income to zero, shifting the net income to the bottom line, thereby increasing the income that effectively is taxed at only 80% of wages income.
- It is anticipated that Regulations will be issued requiring some level of minimal W-2 wages to the owner who provides services to the Pass-Through Entity, to prevent this type of shifting of income to the lower taxed category. Note that this is the converse of the ages-ago dispute that taxpayers and the IRS engaged in regarding “reasonable compensation,” when C Corporations wanted to pay higher salaries to employee-owners, to reduce the C corporation’s net income.

Proposed Reg. 1.199A-2 – Operational Rules

- W-2 Wages Defined
  - Includes wages paid by a person other then a common law employer
  - Requirements by the SSA filing within 60 days
  - Special rules for Short-tax periods
  - Allocation between multiple Trades or Businesses

- UBIA of Qualified Property
  - Improvements included
  - Does not include 734(b) and 743(b) adjustments
  - Special rules for 1031s and tax-free exchanges under (351, 721, etc.)

What is Qualified Tangible Property("QTP")?

- QTP is tangible property in a qualified trade or business subject to Code Sec 167 depreciation allowance that is:

  a) Held by, available for use in the QTB at the close of the tax year
  b) Used in production of Qualified Business Income
  c) ***Depreciable period**** has not ended before the close of the year

- ****Depreciable period*** is the (i) later of the date that is 10 years, or (ii) last year of full recovery period that would apply to the property under MACRS.

Non-Corporate Taxpayers

- Non-corporate taxpayers are defined as:
    - S-corporations
    - Partnerships and LLCs (taxed as a pass-through)
    - Sole Proprietorships
    - Trusts and Estates
- 20% deduction is applied to partnerships and S-corporations at the partner or shareholder level
- Effective for tax years beginning after December 31, 2017
- Deduction **will expire** after December 31, 2025

Special Rules for Trusts and Estates

W-2 Limitation Applicability to Trusts and Estates:

- W-2 income from entities owned by trusts and estates are apportioned between the beneficiaries and fiduciaries under Section 199(d)(1)(B)(i).
- **Grantor trusts** – grantor of the trust is allocated all W-2 Income.
- **Non-grantor trusts** – apportioned W-2 wages are based on the relative proportion of the estate's or trust's distributable net income distributed or required distributed to the
    - Beneficiary **or**
    - Retained by trust or estate

QUALIFIED BUSINESS INCOME (QBI)

- QBI must first be calculated to determine the 20% pass through deduction.
- QBI is the net amount of **domestic** qualified items of income, gain, deductions and loss with respect to the qualified trade or business of the taxpayer.

QUALIFIED BUSINESS INCOME (QBI)
(Continued)

- Qualified Business Income does <u>not</u> include:
  - Capital gains (short and long-term)
  - Dividends
  - Interest income unless allocable to a trade or business
  - Foreign sourced income
  - Reasonable compensation paid to the taxpayer by any qualified trade or business
  - Guaranteed payments paid to a partner for services rendered for a trade or business

TYPES OF BUSINESSES THAT QUALIFY

- Taxpayers must receive income from a **Qualified Trade or Business** to be eligible for the 20% deduction.
- Does a Qualified Trade or Business include Real Estate Entities?
- Can more than one Qualified Trade or Business be included in a single legal entity?
- **"Specific service business"** is not a qualified trade or business.
    - **Exception** for taxpayers with income lower than the threshold amount ($315K for MFJ and $157.5K for other filers with potential phase-out).

SPECIFIC SERVICE BUSINESSES

- What is a “specific service business”? Answer:
  - Any trade or business involving the performance of services in the fields of health, law, accounting, actuarial sciences, performing artists, consulting, athletics, financial services, brokerage services, investment management, trading or dealing in securities as all defined under IRC 1202(e)(3)(A)*.
  - Includes businesses where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners.
  - Includes services that consist of investment management; trading; or dealing in securities, partnership interests and commodities.

**Excludes Architects and Engineers*

WHERE IS THE DEDUCTION REPORTED?

- S Corporation Shareholders will report their allocable share of QBI and W-2 wage/qualified property limitation from each Qualified Trade or Business on their individual or trust/estate tax return to calculate the 20% deduction.
- Businesses will need to provide this information on the shareholder’s/partner’s Form K-1.
- IRS will need to provide guidance probably through notices or regulations on the details of this reporting.