JANOVER LLC

Certified Public Accountants · Advisors

Relationships beyond calculation

2018 YEAR END TAX REVIEW

www.janoverllc.com

NEW YORK CITY
485 Madison Avenue
9th Floor
New York, New York 10022

LONG ISLAND
100 Quentin Roosevelt Blvd
Suite 516
Garden City, NY 11530

Prior to year-end is an optimal time to review records and business/investment activities not only to ascertain tax liabilities for the year but, more importantly, to determine whether there are any strategies that can be put into effect prior to year-end to reduce the annual tax bill. The 2017 Tax Act has put into effect for 2018 sweeping tax changes presenting opportunities to many, especially those with business passthrough income, but also contains pitfalls for the unwary. Following is a summary along with some planning ideas for year end in the categories of (1) individual (including estate & gift tax matters), (2) business and (3) international tax considerations.

I. Individual Tax Considerations

1. Rates, Standard Deduction

The top tier rate for individuals has been reduced to 37%. In addition, the standard deduction for individuals who are married and file jointly has increased from $13,000 to $24,000; for individuals it has increased from $6,350 to $12,000. On the other hand, the personal exemption has been repealed. In addition, the itemized deduction for state and local taxes (income, real estate, property, etc.) is now limited to $10,000.

2. State Tax Workaround Individual Tax Deduction Limitations

Some states, notably New Jersey and New York, have offered workarounds for this limitation attempting to take advantage of the increased charitable deduction, which is now increased to 60% of adjusted gross income instead of 50%. The states created funds whereby individuals can make a charitable contribution to the state in lieu of e.g., paying property taxes and then get a property tax credit for the amounts contributed. However, IRS has already proposed regulations disallowing such deductions. Connecticut has offered a different workaround for passthrough businesses by promulgating a state income tax at the entity passthrough level and allowing an individual state income tax credit for the state income taxes paid by the passthrough business entity to the state.

New York has also created an elective "Employer Compensation Expense Program" (ECET) which allows employers to annually elect to pay tax for employees earning over $40,000. In return the employee gets a credit. The program requires the employer to make an election online to pay this optional tax on behalf of the employee no later than December 1st of the prior year viz., 2018 for 2019. As with Connecticut, this workaround has a much stronger likelihood of passing IRS scrutiny and should be kept in mind for New York employers.

3. **Itemized Deductions**

Mortgage interest expense for new mortgages after December 15, 2017 has been reduced to interest on loaned amounts of $750,000. Mortgages in effect prior to 2018 remain grandfathered in terms of interest deductibility. In addition, interest expense for home equity loans and lines of credit is disallowed. However, to the extent it can be shown that the home equity loan or line of credit was used for home improvement, interest thereon remains deductible.

Only a couple of remaining itemized deduction expense limitations have been increased. For example, medical expenses incurred during 2018 have a reduced floor for deductibility of 7.5%, lowered from 10%. The Pease rule, which limited itemized deductions for higher income taxpayers, has been eliminated. As a result, to the extent a higher income taxpayer can claim itemized deductions in excess of the standard deduction (and not fall within AMT – which now has a higher exemption ceiling of $70,000 for single taxpayers and $109,400 for married taxpayers filing joint which completely phase-out at 500,000 of AMTI for single taxpayers and $1 million of AMTI for married filing joint), taxable income is reduced.

As noted, the ceiling for charitable contributions has increased from 50% to 60% of adjusted gross income. Individuals may want to consider “bunching up” on charitable contributions to, for example, pay at year end two years’ of contributions. Donor advised funds are an ideal vehicle to control timing of charitable contributions. Under these circumstances, the charitable contribution deduction in, for example, every other year may be pivotal in causing itemized deductions to exceed the standard deduction and yield tax savings.

Miscellaneous itemized deductions, previously limited to amounts in excess of a floor of 2% of adjusted gross income, have been repealed. Therefore, accounting fees, investment and investment advisory fees and unreimbursed employee expenses are no longer deductible. The manner of investment holdings has consequently taken on increased importance.

For example, since investment advisory fees are no longer deductible, taxpayers should consider structuring family offices to create carried interests in lieu of investment fees for those being paid to handle investments and advisory services in pooled fund type structures. Alternatively, offshore structures can potentially be created and implemented to achieve deductibility. One caveat to the foregoing is that carried interests now must be held for more than 3 years for the recipient to be able to have a flow through of capital gains treatment.

Investment interest expense remains deductible to the extent of investment expenses. Given the new limitation to 30% of EBITDA on business interest expense, which does not apply to investment interest expense, investors should be mindful as to appropriate structure and ownership for leveraged investments.

Casualty losses for individual taxpayers are now limited to federally declared disaster areas. Therefore, casualty losses previously allowed for Madoff-type losses are no longer deductible. In addition, excess business losses which previously could offset other taxable income now are limited to $250,000 for single taxpayers and $500,000 for married taxpayers filing jointly. Taxpayers anticipating losses this year should

be mindful of this limitation and may consider accelerating gains that could be shielded by otherwise disallowed net losses.

4. **Kiddie Tax, 529 Plans**

Taxpayers who have shifted investments to their children should be mindful that the tax rates for investment income, "kiddie tax", have been modified to trust rates on the income. Trusts now have a very low threshold of $12,500 to reach the maximum individual income tax rate of 37%. Therefore, where possible, transactions that defer recognition of income such as purchase of tax deferred annuities may be a consideration. On the other hand, there has been an expansion of 529 plan eligibility such that funds can now be used for education prior to college - not just college as before.

5. **Taxable Income Adjustments; Credits**

Yet another significant change relates to alimony agreements. While existing alimony agreements continue to remain fully deductible as an adjustment against gross income for payers, alimony agreements entered into after this year will no longer be deductible to the payer. Taxpayers in this situation should try to finalize agreements before year end or settle based on property division rather than alimony payments.

In addition, moving expenses are no longer allowed in calculating adjusted gross income. Employer reimbursements are now taxable. However, 2017 expenses incurred, even if reimbursed in 2018, remain deductible per recent IRS guidance.

The child tax credit has also been increased to $2,000 from $1,000 in 2017 per eligible child. There is also a Non-Child Dependent Credit of $500 for a dependent who is not an eligible child.

6. **Estate and Gift Tax Planning**

The 2017 Tax Act doubled the exclusion to $11,180,000 per person applicable for years through 2025. Since this amount is to be adjusted for inflation, it will increase every year. However, about 14 states still continue to impose an estate tax. This includes New York and Connecticut (which also has a gift tax). Taxpayers who are below the federal exemption amount should continue to be mindful of the lower state exemption amounts in their planning documents. The annual gift exemption amount was increased during 2018 to $15,000 from $14,000 last year.

There have been no changes in the tax law for nonresident aliens. Such individuals holding US tax sitused property should continue to review treaty provisions, if applicable, and structure their holdings to minimize exposure including, where feasible, using corporations to avoid any transfer taxation, especially given the reduced income tax rates now in effect or corporations.

II. Business Tax Considerations

1. Rates

Corporate tax rates have been reduced to a flat 21% rate (bracketed rates and alternative minimum taxes for "C" corporations were eliminated). The low rate has triggered greater consideration toward doing business as a "C" corporation in lieu of a passthrough (viz., partnership, sole proprietorship, or S corporation). However, the tax rate imposed at the entity level should not be the only consideration as distributions to shareholders of net earnings are subject to another 23.8%, or an overall combined corporate and individual effective tax rate of slightly below 40%. This should be contrasted from the maximum graduated individual income tax rate which is now at 37%. Therefore, in the absence of other considerations, electing to be taxed as a corporation does not, per se, yield tax savings to business owners if distributions to shareholders are contemplated.

2. Qualified Business Income Deduction

For businesses set up as passthroughs, a new 20% deduction for "qualified business income" was enacted in an attempt to put such businesses on more equal footing with "C" corporations. In reality, this provision has many contingencies that must be met to qualify, with limitations based on the type of business, the amount of overall taxable income, the amount of wages, adjusted cost of depreciable property, levels of common ownership in passthrough entities and even type of entity passthrough (e.g., partnership vs. S corporation). Individuals with business income should have a thorough review of their holdings to ensure maximum utilization of this deduction.

3. New Interest Expense Limitations

A trap for the unwary is a new limitation of interest expense promulgated under the 2017 Tax Act. Business interest expense deductibility is limited to 30% of EBITDA (earnings before interest, taxes, depreciation and amortization). This will result in phantom taxable income where the interest expense is in excess of 30% of EBITDA and can be especially problematic in loss years where there may be negative cash or no positive cash flow.

Smaller businesses may escape this limitation since it applies to businesses with gross receipts in excess of $25 million. However, automatic aggregation rules apply such that entities with common ownership all count as one business for purposes of this $25 million gross receipts rule. Consequently, breaking up partnership or S corp businesses into smaller entities will not escape this rule.

In short, leveraged businesses should be very mindful of these interest expense limitations. Some planning steps can be taken to avoid this limitation. This includes restructuring debt by instead issuing carried interests to lenders where possible. Specified elections can also be made for real estate businesses to avoid this limitation as long as a timely election to claim straight line depreciation over alternative depreciation system life for buildings and leasehold improvements is effectuated.

4. **Depreciation, Expensing**

Bonus depreciation has been expanded to now include used property placed into service. IRC § 179 expense deduction cap has been increased to $2 million with a phase-out at $2.5 million and includes certain building systems such as HVAC and the internal structural framework of a building. In weighing which of the two to choose, it is recommended to consider IRC § 179 first as states often have an adjustment disallowing bonus depreciation but may allow IRC § 179 expensing.

5. **Meals and Entertainment**

While entertainment expenses are no longer deductible, any meals that are not within "reasonable" parameters are likewise nondeductible as they can be viewed as entertainment and thus nondeductible. After hours or on-premises meals that are provided for the convenience of the employer that used to be fully deductible are now only deductible at 50%.

6. **Net Operating Losses, Intellectual Property**

Business net operating losses incurred after 2017 are now deductible only at the 80% level against future earnings. Net operating losses incurred prior to that date remain fully deductible. Self-created patents, trade secrets and the like are no longer eligible for capital gains treatment. Hence, self-developed patents held by passthroughs on sale are taxed at ordinary income rates. Whereas previously intellectual property licensing agreements were written to be construed as a sale or exchange for tax purposes, there may be greater interest in keeping such agreements to a shorter term in the event the law is changed with a change in Congress or simply negotiate for a higher price to cover for the increased tax liability.

7. **Like Kind Exchanges; Tax Deferral Options**

Deferred income recognition for like kind exchanges is now limited to real estate. Previously, deferred like kind exchange treatment was available for personal property as well. The eligibility terms were somewhat narrower in scope than real estate but it was still possible. However, a new opportunity for gain deferral was promulgated under the 2017 Tax Act that should not be overlooked: The creation of qualified opportunity zones.

8. Qualified Opportunity Zones

Qualified opportunity zones allow for the deferral of long and short and term capital gains for current investments in nearly all asset classes. In contrast to IRC § 1031 like kind exchanges, these new provisions allow for investment of just the gain rather than the full corpus of a current investment, a deferral of the gain for length of the holding period, and an opportunity to abate taxation on the gains. The program is limited to eligible specified low-income census tracts and requires longer term investment which can be in the form of a partnership fund or corporate investment.

9. Methods of Accounting

Cash method accounting is now available to contractors with average annual gross receipts of up to $25 million. This has been increased from the prior revenue threshold of generally $10 million. This change is especially important for contractors. Businesses who have previously exceeded the $10 million threshold but are below the $25 million threshold can file for automatic change in method of accounting.

Similar thresholds of $25 million have been put into effect for required uniform capitalization of inventory as well as for Percentage of Completion method of accounting for long-term contracts. Both of these provisions generally allow for earlier expensing of items for those below the threshold.

III. <u>International Tax</u>

The single largest change in this area was the repatriation tax that created inbound deemed dividend income for all foreign holdings of US corporations and for all holders (individual or entity) of controlled foreign corporations. U.S. "C" corporations alone have been able to claim a 50% reduction in these amounts. All other taxpayers were eligible for either an 8-year payout election option or a longer term deferral for those holding foreign entities under an S corporation – that, is S corporation shareholders have been able to elect deferral of the repatriation tax until triggers such as change in ownership or dissolution of the business.

As a continuing item of anti-deferral, a new Global Intangibles Tax Regime ("GILTI") has been put into effect. The impact of this provision, as creating additional taxable income, is especially significant in the passthrough/individual income tax space as this new anti-deferral regime forces continued repatriation of a significant component of foreign sourced income for owners of a "controlled foreign corporation" (greater than 50% ownership) in situations viz., where income exceeds viz., 10% of foreign depreciable assets.

Taxpayers who have "controlled foreign corporations" should be mindful of this regime and potentially consider restructuring into "C" corporate ownership of foreign entities given that corporations, unlike individuals, can exclude 50% of this ongoing repatriated income and have a greater eligibility to claim foreign tax credits against this income.

In general, taxpayers with offshore holdings should review their structures and holdings in light of the provisions of the 2017 Tax Act to avail themselves of cost savings opportunities and avoid costly income repatriation, especially in situations where foreign tax credits are largely unavailable to shield the income repatriation. Under the new law, offshore taxpayers seeking inbound investment should avail themselves of the tax opportunities created to incentivize their investment.

The foregoing are some of the more significant areas for year-end planning. Contact your Janover Advisor for more information.

This client alert was compiled by **Magda Szabo, CPA, JD, LL.M.,** Tax Partner at Janover LLC.

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