Federal and North Carolina Tax Update

Presented by: Tim Robinson

February 21, 2019

HPG looking beyond the bottom line.℠
Hughes Pittman & Gupton, LLP

Agenda

- Individual Developments and Planning
- Business Developments and Planning
- North Carolina Tax Developments

Individual Developments and Planning

- Tax Cuts and Jobs Act ("TCJA")
  - ❑ Lower individual ordinary tax rates (maximum rate reduced from 39.6% to 37.0%)
  - ❑ Long-term capital gains and qualified dividend rates retained at 0%, 15%, or 20%
  - ❑ 3.8% net investment income tax retained
  - ❑ 0.9% additional Medicare tax for high earners is retained
  - ❑ Standard deduction doubled to $12,000 for singles, $18,000 for head of household, and $24,000 for joint filers
  - ❑ Personal exemptions eliminated

Individual Developments and Planning

- Kiddie Tax
  - Beginning January 1, 2018:
    - Taxable income of a child attributable to earned income is taxed under the rates for single individuals
    - Taxable income of a child attributable to net unearned income is taxed according to the brackets applicable to trusts and estates
    - The child's tax is unaffected by the tax situation of the child's parent or the unearned income of any siblings
  - Applies if:
    - The child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time;
    - The child's unearned income exceeds $2,100 in 2018; and
    - The child does not file a joint return

Individual Developments and Planning

- Child Tax Credit – increased to $2,000
- Itemized deductions
  - Mortgage interest – debt limit decreased to $750,000 for new mortgages after 12/15/2017
  - Home equity interest deduction eliminated after 12/31/2017
  - Charitable contributions
    - Limit increased to 60% of adjusted gross income
    - No deduction if athletic event seating rights are received
  - State and local tax deduction limited to $10,000

Individual Developments and Planning

- Itemized Deductions – continued
  - Casualty loss deduction repealed, except for federal declared disaster areas
  - Medical expense limitation reduced to 7.5% of adjusted gross income (AGI) for 2018 only, 10% thereafter
  - Miscellaneous itemized deductions subject to 2% AGI floor eliminated
  - 3% of AGI phase out of itemized deductions is repealed

Individual Developments and Planning

- More TCJA
  - Excess business losses (business losses exceeding $500k for joint returns and $250k for other returns) must be carried forward and treated as part of the taxpayer’s NOL. NOL’s are limited to 90% of taxable income (80% for years beginning after 12/31/22)
  - Section 529 plans can distribute up to $10,000 per student for elementary and high school tuition beginning after 2017
  - Re-characterization rules relating to Roth IRA conversions were repealed
  - Plan loans outstanding on termination or separation can be contributed to IRA by due date of tax return for that year

Individual Developments and Planning

- Alimony income/deduction rules repealed for instruments executed after 2018
- Moving expense deduction repealed for tax years after 2017, except for Armed Forces
- AMT
  - Individual AMT survives through 2025 with new thresholds
  - New exemption amounts of $109,400 for joint filers and $70,300 for single filers
  - New exemption phase-out amounts of $1,000,000 for joint filers and $500,000 for single filers

Individual Developments and Planning

- Consider bunching charitable contributions by using donor-advised funds
- Make certain your employer is using an accountable plan so employee business expenses are not lost
- The 2018 Form 1040 is a 5½ x 8½ double-sided “postcard” with six additional Schedules
- Existing W-4’s are likely inaccurate and should be updated

Business Developments and Planning

- Corporations
  - Flat 21% tax rate
  - Effective for years beginning after 12/31/2017
  - PSCs are also taxed at 21%
- Choice of entity analysis will change due to:
  - Lower corporate rate
  - Preferential rate for dividends and LTCG's
  - Section 1202 exclusion
  - 199A applicability

Business Developments and Planning

- Corporate Tax Rates – Reasons for change
  - Competitive rate 30 years ago but not today
  - U.S. maintained the highest corporate tax rate
    - Canada 26.5%
    - England 19%
    - Ireland 12.5%

Depreciation and Expense Deductions

- Expanded Section 179 effective for property placed in service after 12/31/2017
  - The annual limitation is raised to $1,000,000
  - The threshold for phasing out the deduction is increased to $2,500,000
  - The SUV limitation remains at $25,000
  - All limits are increased for inflation for years beginning after the 2018 calendar year

Depreciation and Expense Deductions

- Bonus depreciation expanded
  - Increased from 50% to 100% for property placed in service after 9/27/2017
  - Bonus depreciation will phase out from 2023 to 2027
  - Used property now qualifies – property no longer must be newly manufactured – the property must be newly placed in service by the taxpayer
  - Property may not have been acquired from a related party
  - Qualified improvement property no longer qualifies

Depreciation and Expense Deductions

- Depreciation limits for luxury vehicles increased
- The following table assumes $8k bonus depreciation

Depreciation Limits	2017	2018
Year 1	11,560	18,000
Year 2	5,700	16,000
Year 3	3,450	9,600
Each subsequent year	2,075	5,760

Business Deductions

- Limitation on business interest
  - Interest deduction limited to:
    - Business interest income, plus
    - 30% of adjusted taxable income, plus
    - Floor plan financing interest
  - Limitation does not apply to taxpayers with average annual gross receipts of less than $25 million
  - Disallowed interest carryforward indefinitely

Business Deductions

- Modification of net operating loss provisions
  - Two-year carryback is repealed
  - NOLs may be carried forward indefinitely; however, only 80% of taxable income in future years may be reduced by NOLs
  - Effective for NOL’s arising in tax years beginning after 2017

Business Deductions

- R&D expenses must now be amortized over five years
  - Prior law permitted immediate expensing
  - Effective for expenses incurred after 12/31/2021
  - Amortization must continue after disposal or abandonment
- The domestic production activities deduction (DPAD) is repealed for tax years beginning after 2017
- Like-kind exchange rules only apply to real property, effective for exchanges after 12/31/2017
- Technical termination rules for partnerships – repealed; effective for tax years beginning after 2017

Meals & Entertainment

- Entertainment – generally no longer deductible
- Meals – generally still 50% deductible
- Exceptions
  - De minimis fringe benefit meals, such as meals for employees working overtime – formerly 100%, now 50%
  - Meals for employees at a qualified employer-operated facility – formerly 100%, now 50% reduced to 0% after 2025
  - Meals and entertainment reported as taxable compensation – formerly 100%, now still 100%
  - Meals and entertainment for recreational and social activities for the benefit of non-highly compensated employees – formerly 100%, now still 100%

Meals & Entertainment

- Exceptions continued
  - Meals and entertainment made available to the general public – formerly 100%, now still 100%
  - Meals and entertainment sold to customers – formerly 100%, now still 100%
  - Meals provided to employees subject to the U.S. Department of Transportation hours-of-service limitations – formerly 80%, now still 80%
  - The costs of tickets to qualified fundraising charitable sporting events are no longer deductible

Meals & Entertainment – Cheat Sheet

	2017 Expenses (Pre - TCJA)	2018 Expenses (Post TCJA)
Employee Recreation Expenses (meals and facilities)	**100% deductible** if the primary benefit is for employees other than highly compensated employees (Ex Holiday party or company picnic, even if off site)	**100% deductible**
Entertaining Clients (non-meals)	**50% deductible**	**No deduction**
	Event tickets, 50% deductible for face value of ticket, anything above face value is non-deductible	
	Tickets to qualified charitable events are 100% deductible	
Business Meals (Employee Travel Meals and client meals)	**50% deductible**	**50% deductible**
Meals Provided for Convenience of Employer (on premises)	**100% deductible** provided they are excludible from employees' gross income as de minimis fringe benefits (Ex on premises employee dinners, office coffee, office snacks etc); otherwise 50% deductible	**50% deductible** (nondeductible after 2025)

Accounting Methods for Small Taxpayers

- Cash method of accounting for all small taxpayers
  - The average gross receipts limit has been raised from \$5M to \$25M
  - Inventory–Producers or resellers with less than \$25M average gross receipts may treat inventories as non-incidental materials and supplies providing that the treatment conforms to the taxpayer's financial accounting treatment of inventory
  - Uniform capitalization (Section 263A) is not required for producers or retailers with less than \$25M in average gross receipts

Business Tax Credits

- New credit for paid and family leave
  - Effective for years after 2017 and prior to 2020
  - Employers providing paid family and medical leave are allowed a general business credit against regular tax and AMT
  - The credit is 12.5% of wages paid, plus an additional .25% for each percentage point in excess of 50% of the employees salary for which the employer provides coverage
  - The maximum permissible credit is capped at 25%

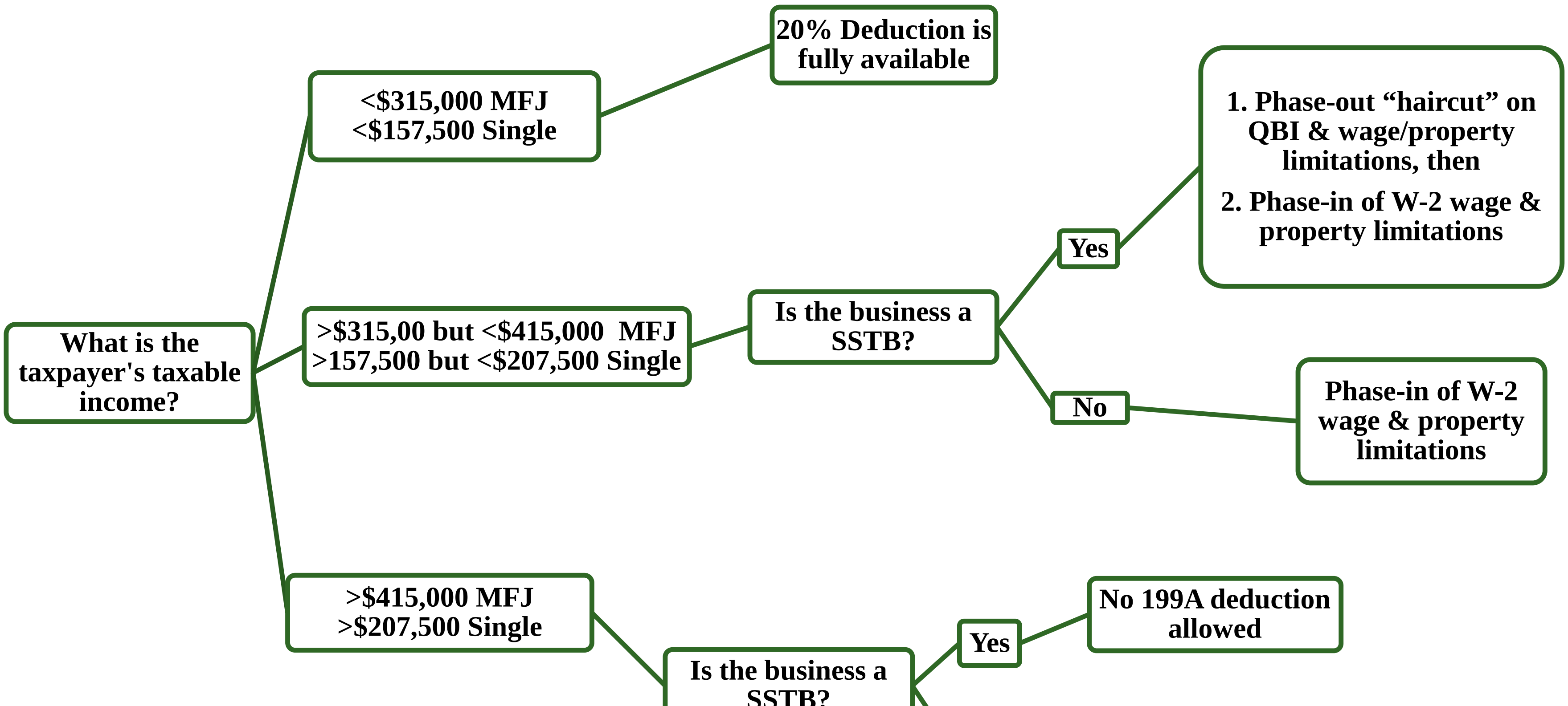
Business Tax Credits

- Rehabilitation Credit
  - 10% credit for rehabilitating buildings constructed prior to 1936 has been repealed
  - 20% credit for rehabilitating certified historic structures has been retained but the credit is now required to be taken ratably over a five-year period
  - The orphan drug credit has been reduced from 50% to 25% and taxpayers may elect to take a reduced credit instead of reducing otherwise allowable deductions

IRC Section 199A

- Pass-through Business Income
  - 20% deduction for qualified business income
  - Deduction may be limited to greater of 50% of W-2 wages or sum of 25% of W-2 wages plus 2.5% of unadjusted basis immediately after acquisition of qualified property
  - Deduction in computing taxable income, not AGI
  - Available whether itemize or not
  - Qualified income does not include investment income or compensation-like income

Section 199A Decision Tree



**at any point the taxpayer's deduction cannot exceed 20% of taxable income less net capital gains

199A "Process" – 15,000 foot view

- Step 1 – determine "SSTB" status separately for all businesses of the taxpayer
- Step 2 – compute QBI for **<u>EACH</u>** business of the taxpayer (do not combine)
  - If one business has negative QBI that does not exceed all business with positive QBI, the negative QBI is allocated to positive QBI in the proportion of positive QBI
  - If one business has negative QBI that exceeds the sum of all businesses with positive QBI – no allocation is necessary
    - The net loss is carried over and treated as a separate loss in the following year. Loss in following year is allocated using above method

199A "Process" – 15,000 foot view cont'd

- Step 3 – determine "W-2 wages" and "unadjusted basis of property" for **EACH** business
- Step 4 – determine the "QBI amount" for EACH business using the "decision tree" i.e 20% of QBI (subject to "hair-cut" and wage/property limitations)
- Step 5 – Aggregate all of the "QBI amounts" for each business
- Step 6 – Apply the overall 20% of taxable income limitation

What is a SSTB?

- "Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or owners"
- The "reputation or skill of 1 or more employees or owners" clause was clarified only to be applicable to situations where the taxpayer is endorsing products/services, licensing his image, likeness, or voice, etc., or appearing at an event or on some media format.

What about consulting?

- Consulting Services are defined in Prop. Reg. Sec. 1.199A-5(b)(vii) as "the provision of professional advice and counsel to clients to assist the client in achieving goals and solving problems."
  - Sales or economically similar services or the provision of training and educational courses is not an SSTB.
  - The performance of consulting services embedded in, or ancillary to, the sale of goods or performance of services on behalf of a trade or business that is otherwise an SSTB is not consulting if there is not separate payment for the consulting services.

What is not a SSTB?

- Specified Service Business – specifically excluded (1202(e)(3)(a) definition) – NOT SSTBs
  - banking, insurance, financing, leasing, investing, or similar businesses,
  - Any farming business (including the raising or harvesting of trees)
  - Any business of operating a hotel, motel, restaurant, or similar business
  - Architects and engineers

199A Planning Considerations

- Married filing separately?
- C vs S
- Schedule C - S corporation election?
- Wages game and reasonable compensation
  - "2/7 rule"
  - Multiply taxable income before W-2 wages by 2/7 to get the W-2 wages to maximize the 199A deduction
- Partnership preferred allocation of income to increase QBI vs guaranteed payment
- Segregation of activities SSTB from non-SSTB
- Reduce taxable income to stay under threshold amounts
  - Claim bonus or 179
  - Cost segregation
  - Retirement plan contributions

Partnership K-1 Statement

- Box 20 disclosure - same for SSTB and non-SSTB

Part II **Information About the Partner**

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code

Some Guy

8 Net short-term capital gain (loss)

9a Net long-term capital gain (loss)

9b Collectibles (28%) gain (loss)

9c Unrecaptured sec 1250 gain

19 Distributions

20 Other information

*	STMT

Schedule K-1 Section 199A Items, Box 20 Statement 4

Code	Description	Amount
	Trade or Business -	
Z	Section 199A qualified specified service income	22,310.
AA	Section 199A W-2 wages	146,319.
AB	Section 199A unadjusted basis	10,901.

S corporation K-1 Statement

- Box 17 disclosure - non-SSTB

17	Other information
A	952.
V	22,310.
W	146,319.
X	10,901.

V Section 199A income
W Section 199A W-2 wages
X Section 199A unadjusted basis
Y Section 199A REIT dividends
Z Section 199A PTP income

- Box 17 disclosure - SSTB

17	Other information
A	952.
V *	22,310.
W	146,319.
X	10,901.

Schedule K-1 — Section 199A Income, Box 17, Code V — Statement 3

Description	Amount	Shareholder Filing Instructions
Sec 199A - Qualified Service Income	22,310.	See Shareholders Instructions
Total	22,310.	

REACH - *R*espect for relationships and results, *E*xcellence, *A* balanced life, *C*lient satisfaction, and *H*onesty and integrity

Mission - Working Together To REACH Success

Vision - To be an independent business that drives market leadership and inspires the entrepreneurial spirit through the principles of REACH

HPG

North Carolina Tax Developments

- North Carolina decouples from:
  - Deferrals/exclusions for investment in Qualified Opportunity Zones
  - Foreign repatriation tax
  - Global intangible low-taxed income
  - Foreign derived intangible income deduction
  - The corporate tax rate is reduced from 3.0% to 2.5%; effective for 2019
  - The individual tax rate is reduced from 5.499% to 5.250%; effective for 2019

North Carolina Tax Developments

- The NC franchise tax will apply to partnership electing to be taxed as corporations
- NC corporate tax will be calculated using a single sales factor beginning in 2018
- NC did not adopt market based sourcing for income from services and intangibles
- NC will grant automatic extensions to persons filing a federal extension effective for taxable years beginning on or after 1/1/2019

Questions?

Tim Robinson, Tax Director

Email trobinson@hpg.com

Direct: 919-232-5944