

TAX REFORM BOOTCAMP

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Who is Jeff Baker & Associates, PS

We are a full service CPA Firm located in Tacoma, Washington.

Jeff Baker & Associates has served individuals and businesses since 1981. We strive to be a firm that is a valued asset to our clients all year round – anticipating needs, understanding their business, and providing the expertise and insight to help achieve goals.

We cater to a wide variety of clients ranging from individuals to business owners and corporations.

We specialize in the following:

- Tax Preparation & Planning
- Financial Reporting
- IRS Representation
- Accounting Services
- QuickBooks Services
- Real Estate Transactions
- Estates & Trusts

We provide financial services that focus on the unique needs of Business Owners, Contractors, Rental Property and Real Estate Holdings, Stock and Investments, Estates and Trusts.



Objective:

At the end of this workshop, you will know...

- What the individual changes are under the new tax reform
- What are relative tax pros and cons of the basic business structures (sole proprietor; partnership; LLC; Corporation).
- What the new 20% Pass through deduction means and how it may apply to your business
- When to take Important Steps with your CPA to save on taxes



Individuals

Tax Reform Changes



The Basics

- Still seven tax brackets
 - 10%, 12%, 22%, 24%, 32%, 35%, 37%
- Exemptions are repealed
- Higher child tax credit (\$2,000) for qualifying children
- Increase in standard deduction: \$24,000 for married taxpayers; \$18,000 for head of household; and \$12,000 for single taxpayers



Itemized Deductions Changes

- Medical deduction threshold is 7.5% for 2017 & 2018
 - Reverts to 10% starting in 2019
- Mortgage interest limited to \$750k of debt
 - Debt prior to 12/15/17 is grandfathered
- Home equity interest no longer deductible
- State and local tax deduction is limited to \$10k (\$5k if MFS)-
note schedule A only
- Misc. deductions subject to 2% threshold no longer deductible
- Gambling losses & other expenses incurred to the extent of
winnings (2017 only gambling losses)



Adjustments/Income Exclusion Changes

- **Alimony -**
- The treatment of alimony payments will change substantially at the end of 2018. For agreements entered into after December 31, 2018, the payor spouse will no longer be able to deduct alimony payments, and the payee spouse will not include receipt of alimony payments in income.
- **Moving Expense reimbursements exclusion**
 - 2017-excluded from Wages if expense would have been deductible. Deduction allowed subject to mileage and time tests.
 - 2018- not allowed except Members of Armed Forces
- **Student Loans**
 - 2017 - taxable discharge of indebtedness unless contingent on working for period of time in certain professions
 - 2018 - Not included in income if due to death or total and permanent disability
- **Distributions from qualified retirement plans**
 - 2017-distributions included in taxable income
 - Possible 10% early withdrawal penalty
 - 2018-for qualified 2016 disaster distributions ONLY
- **Sec 529 plan College Savings Accounts:**
 - 2017 - used for qualified higher education expenses
 - 2018 distributions for private school including elementary or secondary public, private, or religious schools.
 - Up to \$10,000/year.



Affordable Care Act impact

- Penalty to maintain insurance coverage (individual mandate) is repealed for 2019 and forward
- **HOWEVER**, still in effect for 2017 and 2018
- 2017 penalty:
 - Higher of 2.5% of yearly household income, **or**
 - \$695 per person (\$347.50 per child under 18)
 - Expected to be a revenue generator with penalty gone fewer people getting subsidized coverage
 - Less paid out in premium tax credits



Dividend and capital gains rates unchanged

- The top tax bracket for qualified dividends and capital gains is 20% (23.8% if the net investment income tax applies).

- Here's the breakdown:

0% for MFJ taxpayers with < \$77.2k taxable income

15% for MFJ taxpayers with between \$77.2k and \$479k taxable income

20% for MFJ taxpayers with taxable income greater than \$479k



20% pass-through deduction

- 20% of qualified business income
- Qualified business income definitions
 - Qualified trade/business income
 - Not a specified trade/business
 - Trade/business involving performance of services
 - Does not include investment income
 - Does not include reasonable compensation paid from S corporation or guaranteed payments paid to a partner
 - Phase-out limitation



Business & Pass Thru Entities



Sole Proprietorship

- Most Common form of Entity Type 1.26 million filed as Schedule C's in 2016 (70% of all business filings)
- Is simplest and cheapest form
- Is formed with one owner
- File a Master License Application - Dept of Revenue (DOR)
- May be right for many
- Income flows to individual via Schedule C
- Drawback - owner cannot be on payroll
- **A Schedule C can also qualify for the new (2018) 20% business income deduction.**



Partnerships

- A relationship between two or more persons who join together to carry on a trade or business.
- At least 2 people • Husband and wife owning a joint business are generally a partnership - Can elect out
- Each person contributes money, property or skill & expect share in Profit & Loss
- Draw back is that you must share power and have unlimited liability
- MUST have a Partnership agreement
- Preferably by an Attorney - Handshake days are gone
- Accountants CANNOT give legal advice!
- Spend the money now for a proper set-up to save long and costly battles in the future
- Subject to Self Employment Tax
- Partnership income eligible for the new 20% qualified business income tax deduction on partners' returns
- Partners can not be employees of the partnership. (Big drawback!)



C -Corporations

- Corporations are treated by the law as legal entities, separate from its owners (shareholders).
- Individual Liability Protection
- Shareholders receive dividends- 1099-DIV
- Employees receive Form W-2 ▪ NOT subject to Self Employment (SE) Tax (pay Income Tax)
- Possible double taxation (income taxed at corporate level and dividends taxed at individual level)



S-Corporations

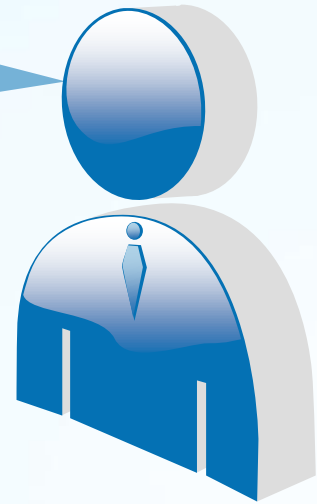
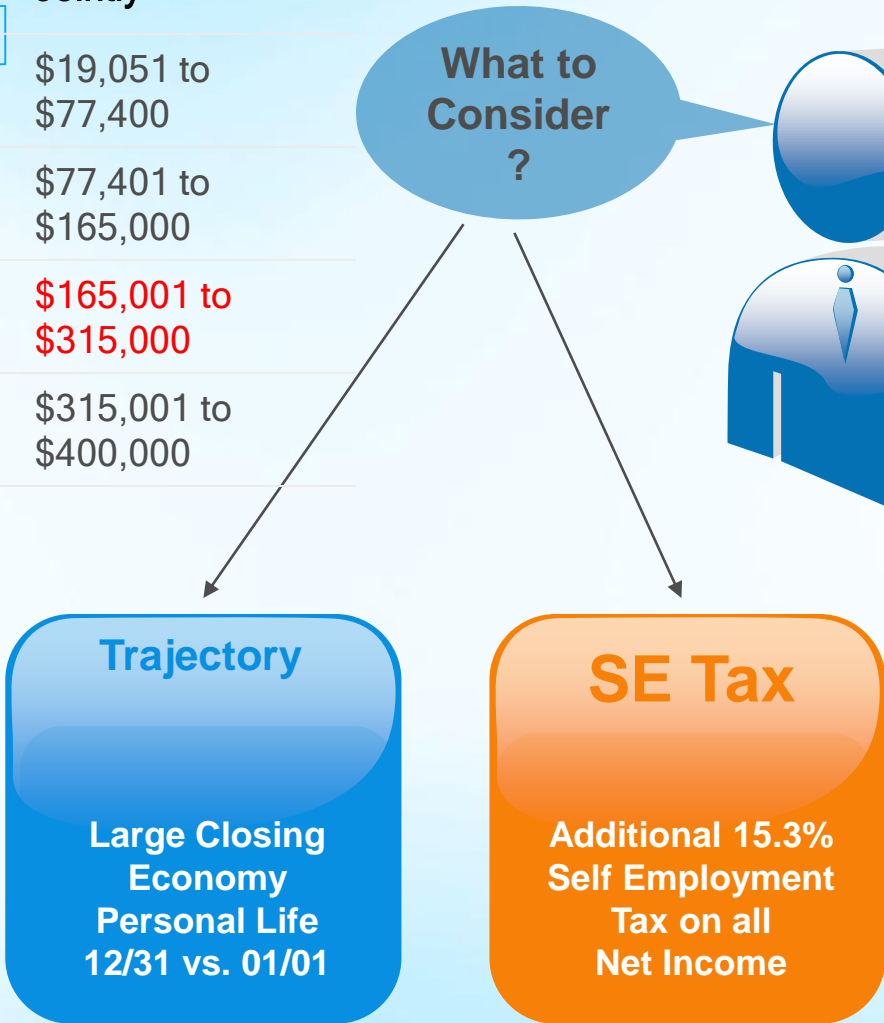
- S Corporation (S-Corp) - Files Form 1120S
- Election to be taxed similar to a partnership (Form 2553 to make election by 15th of 3rd month)
- 100 S/H limit, No Foreign ownership
- Reasonable compensation (**shareholders CAN be employees**)
- An S-Corp does not pay tax on income from daily operations.
- All income, losses, deductions and credits generated by the SCorp pass through to it's S/H
- NOT Subject to SE Tax (Wages subject to FICA)
- **Sub S income eligible for the new 20% qualified business income tax deduction on shareholders' returns**



When is it time to form an entity?

Rate	Individuals	Married Filing Jointly
12%	\$9,526 to \$38,700	\$19,051 to \$77,400
22%	38,701 to \$82,500	\$77,401 to \$165,000
24%	\$82,501 to \$157,500	\$165,001 to \$315,000
32%	\$157,501 to \$200,000	\$315,001 to \$400,000

24% Income Tax
15.3% SE Tax
39.3% Total Tax



Entity Choice

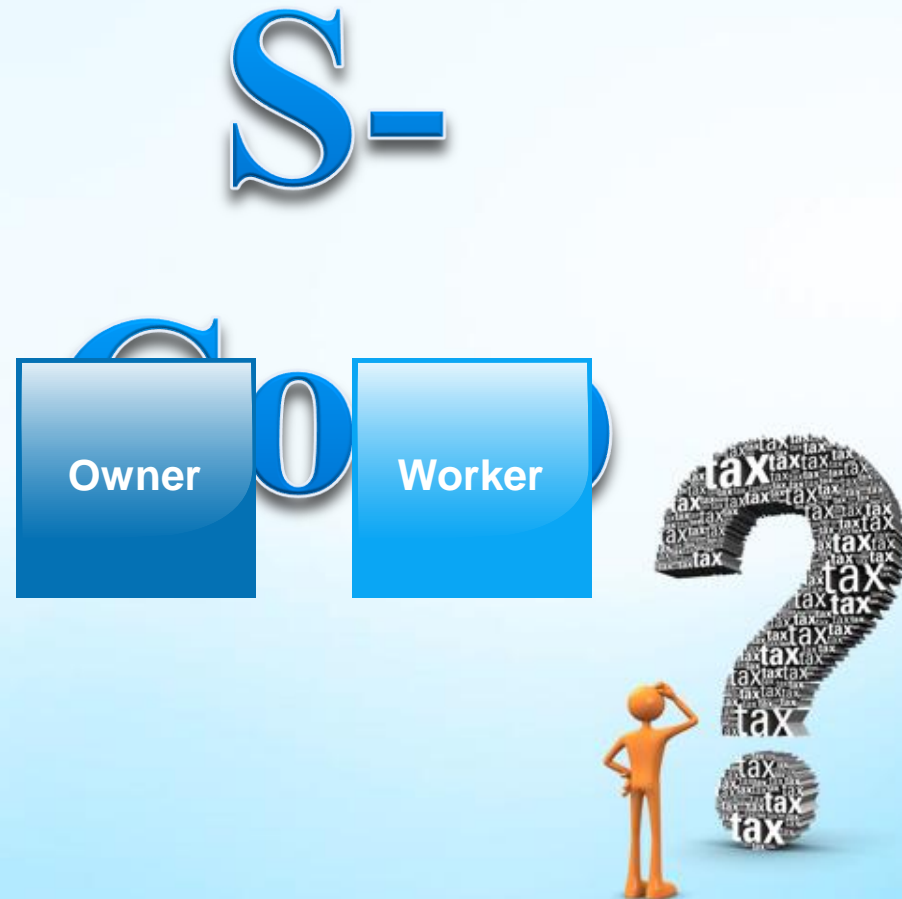
Self Employment Tax

An S-Corp. allows you to manage the amount of self-employment you pay each year.

You are able to do this by paying some of your net income through payroll (subjected to SE tax) and the rest in distributions not subjected to SE tax.

This way you wear two hats:

- Owner – K1 not subjected to SE tax
- Worker – subjected to payroll tax (W-2)



Single Member LLC vs S-Corporation

S-Corp vs. Individual (1040)			
	S-Corp		1040
Total Income	\$ 200,000		\$ 200,000
Total Expenses	\$ 50,000		\$ 50,000
Net Profit Before Salary	\$ 150,000		\$ 150,000
Salary	\$ 50,000		\$ -
<u>Taxes</u>			
Income	Same		Same
Self Employment Tax	\$ -		\$ 22,950
FICA Employment Taxes	\$ 7,650		\$ -
Washington Unemployment	\$ 378		\$ -
Federal Unemployment	\$ 42		\$ -
<u>Cost</u>			
Annual Filing	\$ 150		\$ -
Tax Return Preparation	\$ 2,500		\$ 1,000
Payroll Preparation	\$ 425		\$ -
Total Taxes and Cost	\$ 11,145		\$ 23,950
S-Corp Tax Savings	\$ 12,805		



S-Corporation

STATE
Washington Secretary of State

FEDERAL
IRS -Tax Return

Corporation
S-Corp

LLC

Single Member LLC
S-Corp

S-Corp

Single Member LLC
S-Corp

NOTE: an election is needed for any of the entities to be
taxed as an S-Corp.



S-Corp

How it Works

- **Need to Set Up Company With State of Washington**
- **S-Corp Election**
- **Separate Bank Account and Records**
- **Separate Tax Return (1120S) – K1 flows to individual return**
- **Payroll For All Workers – “Fair and Reasonable Salary”**



Sec 199A



Sec 199A- Pass-through Entity Changes

- New Code Section 199A available to all entities BUT corporations
 - S Corporations ▪ Partnerships ▪ LLCs and ▪ Sole proprietors (Schedule C) ▪ Includes single member LLCs ▪ Not electing to be taxed as a C Corp ▪ Estates and trusts



Sec 199A- Pass-through Entity Changes

- Qualified business income (QBI) defined in 199A(c)
- As defined in Section 199A(c) appears to mean “active” income ▪ Ordinary income less ordinary deductions ▪ From sole-proprietorship, S Corporations or Partnership ▪ Excludes wages earned as an employee ▪ Excludes guaranteed payments ▪ Specifically excludes investment income ▪ Short and long term capital gain/loss ▪ Dividend income ▪ Interest income ▪ Income not effectively connected with a US trade or business
- Excludes: ▪ Investment income, dividends, interest ▪ Short-term, long-term capital gain/loss items, Annuity not related to trade or business ▪ Reasonable compensation paid to taxpayer ▪ Guaranteed payments ▪ Still to come - Regulations around payments to partners not in capacity as partner



Sec 199A- Pass-through Entity Changes

- Qualified Trade or Business defined by exception: ▪ “The term “qualified trade or business” means any trade or business other than: (A) a specified service trade or business, or (B) the trade or business of performing services as an employee”
- Specified Service trade or business includes performing services in fields of:
 - Health, law, accounting, actuarial science, performing arts, engineering, architecture, consulting, athletics, financial services, brokerage services ▪
 - OR ▪ Any trade or business where primary asset is the reputation or skill of 1 or more of its employees
- 199A(d)(2)(A) does allow engineering and architecture



Sec 199A- Pass-through Entity Changes

2018 - New Code Section 199A

- Possible deduction for 20% of qualifying business income
- Complex rules
- Limitations
- Both “good” and “bad” ones ▪
- Thresholds
- Some guesswork (IRS to provide regulations)

Referred to as the 20% pass-through business deduction

- Maximum percent is 20% of net taxable income (NTI) from pass-through
- Not the same as saying will get 20%)
- Deduction is formula driven
- Formula used depends on each taxpayers individual situation



Sec 199A- Pass-through Entity Changes

- Simplest formula
 - 20% of net taxable income from pass-through
 - Full formula ▪ Several limitations using
 - (A) 20% of net taxable income from pass-through; and
 - (B) a combination of percentages applied to wages and PPE
- Two more complex (hybrid) formulas allowing for a:
 - Phase-out of the deduction for personal service business & Phase In



Sec 199A- Pass-through Entity Changes

- If taxable income below \$315,000 MFJ or \$157,500 others
 - 20% of trade or business income from any pass-through
- If taxable income above \$415,000 MFJ or \$207,500 others
 - Personal service = Zero 199A deduction
 - For all others: ▪ With zero wages and zero PPE = Zero 199A deduction
 - With zero wages and have PPE likely limited to 2.5% of PPE
 - With wages paid likely limited to 50% of wages



Sec 199A- Pass-through Entity Changes

- If taxable income between \$315,000 - \$415,000 MFJ or \$157,500 - \$207,500 others
- Personal service then deduction gets closer to zero the closer to the upper cap
- All others - deduction moves from 20% of QBI to either 50% of wages or 25% wages + 2.5% PPE the closer to the upper cap

Deduction computed for each pass-through entity

Taxable income at shareholders/partners level



Sec 199A- Pass-through Entity Changes

Section 199A: Talking Points Schedule C Example 1

Filing MFJ (\$315,000 - \$415,000)

Qualified PPE	\$30,000	\$50,000	\$50,000
	<u>Sole Prop.</u>	<u>Sole Prop.</u>	<u>Sole Prop.</u>
Business Income	\$314,000	\$416,000	\$416,000
W-2 wages paid to employees	\$-	\$-	\$(200,000)
Net Taxable Income	\$314,000	\$416,000	\$216,000
Final QBI	<u>\$314,000</u>	<u>\$416,000</u>	<u>\$216,000</u>
Deduction:			
Lesser of 20% QBI or	\$62,800	\$83,200	\$43,200
Greater of 50% wages or	\$-	\$-	\$100,000
25% wages + 2.5% PPE	\$-	\$-	\$51,250
Final Deduction	<u>\$62,800</u>	<u>\$-</u>	<u>\$43,200</u>

Sec 199A- Pass-through Entity Changes

- Specified Service trade or business includes performing services in fields of: **Health, law, accounting, actuarial science, performing arts, engineering, architecture, consulting, athletics, financial services, brokerage services** • **OR** • **Any trade or business where primary asset is the reputation or skill of 1 or more of its employees**
- Section 199A - Taxpayers Taxable Income Exception
- Numerator = how far into the range you are
- Denominator = \$50k or \$100k MFJ
- Applicable percentage modification
- Amount 20% of QBI > limitation based on wages & PPE
- General rule would apply except for income > threshold
- Excess benefit lost modification



Sec 199A- Pass-through Entity Changes

Section 199A – Taxpayers Taxable Income Exception Modifications Step 4a Example 5

Facts:

Client has business income from Disqualified business of
Client's pass-through entity pays wages of
Client's pass-through entity has original cost of fixed assets of
Client files a joint return and has taxable income of

	Ownership %	Allocated Share
200,000	100%	200,000
75,000	100%	75,000
95,000	100%	95,000
350,000		

Step 1	Compute excess taxable income		$\$35,000 = (\$350,000 - \$315,000)$		
Step 2	Compute applicable percentage		$65\% = 100\% - 35\% [(\$35,000/\$100,000)]$		
	Apply the applicable percentage				
	Qualified business income	\$130,000	200,000	65%	
	W-2 wages	\$48,750	75,000	65%	
	Basis in QPPE	\$61,750	95,000	65%	
Step 3	Calculate deduction under general rules using results in step 2				
	Lesser of: 20% of qualified business income	A	20,000	130,000	20%
	or the Greater of:				
	50% wages or	B	24,375	48,750	50%
	25% of wages + 2.5% of unadjusted basis PPE		12,188	48,750	25%
			1,544	61,750	2.5%
		C	13,731		
	Greater of B or C	D	24,375		
	Lesser of A or D	E	24,375		
Step 4	Compute excess deduction using results from step 3	F = A - E	1,625		
Step 5	Compute reduction in excess benefit				
	Excess amount	F	1,625		
	Amount of benefit lost		569	35%	
Step 6	Reduce the amount computed in 3 for 199A(b)(2)(A) by the result in 5		25,431		

Sec 199A- Pass-through Entity Changes

Section 199A – Taxpayers Taxable Income Exception Modifications Step 4b Example 6

Example:

Facts:

Client has business income from ~~Qualified~~ business of 200,000
 Client's pass-through entity pays wages of 75,000
 Client's pass-through entity has original cost of fixed assets of 95,000
 Client files a joint return and has taxable income of 350,000

		Ownership %	Allocated Share
200,000		100%	200,000
75,000		100%	75,000
95,000		100%	95,000
350,000			

Step 1 Lesser of: 20% of qualified business income or the Greater of: 50% wages or 25% of wages + 2.5% of unadjusted basis PPE	A	200,000	20%	40,000
	B	75,000	50%	37,500
		75,000	25%	18,750
	C	95,000	2.5%	2,375
				21,125
Greater of B or C	D			37,500
Lesser of A or D	E			37,500
Step 2 Excess amount	F = A - E			2,500
Step 3 Amount of taxable income over threshold				
Taxable income	MFJ	350,000		
Threshold amount		315,000		
Amount of taxable income over threshold	G	35,000	35%	
Step 4 Apply the ratio in 3 to the result in 2	H = F * G			875
Step 5 Reduce the amount computed in 199A(b)(2)(A) by the amount of reduction in 199A(b)(3)(B)(iii)	I = A - H			39,125

Income Fluctuation/Tax Reform

We address income fluctuation with
TAX PLANNING.

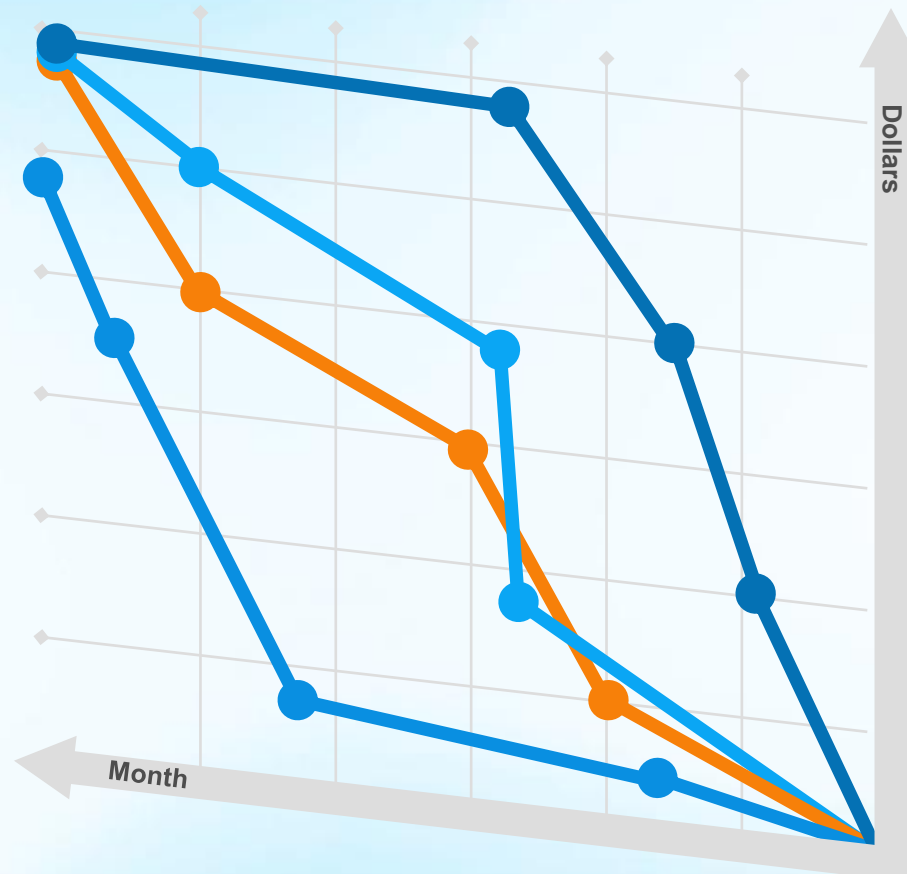
Best Practices is to meet with your
CPA in late October / early November
to review income and expenses for the
year.

We do it at the end of the year so we
have accurate numbers for most of the
year and can more accurately project
the last few months.

Then we have time to make changes:

- adjust payroll
- make estimated tax payments
 - suggest extra expenses
 - make large purchases
- setup and contribute to retirement
 - and many more

If you wait until the year is over,
it's too late.



Final Questions?

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