Navigating The Modern Tax Landscape
In This Session – What We Will Cover

• The rapidly changing tax landscape and how it affects individuals, businesses, and not-for-profit entities.
• We will discuss various types of taxes including:
  + Federal Income Taxes
  + State Income and Franchise Taxes
  + Sales and Use Taxes
• Cover some planning opportunities to minimize taxes.
Tax Changes for Individuals
Tax Changes Affecting Individuals

• Top tax bracket drops from 39.6% down to 37%
  + Next bracket is not reached until higher amounts of taxable income
• Increased limitations on mortgage interest expense
• State tax deduction limited
  + Used to be unlimited amount of property taxes and income/sales tax
  + Now can only deduct up to $10,000 of total state taxes (Including property taxes)
• Several items no longer deductible at all
• Increased standard deduction
Lowest Individual Tax Rates

• Top tax bracket drops from 39.6% down to 37%
• In 2017, a taxpayer paid at the highest bracket beginning with $470,700 of taxable income for married filing jointly
  + For 2018, a taxpayer does not hit the top 37% rate until $500,000 of income.
• The brackets for the lower rates also moved.
  + For example, a MFJ taxpayer with income of $235,000 would have been in the 33% bracket for 2017. For 2018 (after the Tax Bill) that individual would be in the 24% bracket.
Mortgage Interest Expense

- Under the new tax law, individuals can deduct a lower amount of mortgage interest.
- For mortgages originating after 2017, interest is only deductible on the first $750,000. Previously this limit was $1 million.
- Originally this Bill had stricter limitations, but both of these changed in the final Bill. These changes were both wins for the construction industry.
  - Original versions of the Bill limited this to $500,000 and only “primary residences” were eligible.
  - Originally HELOC interest was supposed to be non deductible, but this changed.
    - HELOC interest is deductible as long as the proceeds are used to buy, build or substantially improve the taxpayer’s home that secures the loan.
State Tax Deduction

• Previously, a taxpayer could deduct real estate taxes paid plus the greater of:
  + Sales tax paid, or
  + State income taxes paid

• Under the new law a taxpayer can deduct real estate, state income, and sales taxes (no longer either/or), but the total deduction for these taxes cannot exceed $10,000.
Non-Deductible Items

• Several Items are no longer deductible including:
  + Tax preparation fees
  + Investment management fees
  + Contributions given in exchange for seating rights at athletic events

• While still deductible, medical expenses have higher limits before they become deductible.
  + Typically only seen on individuals that have significant medical events during the year.
Increased Standard Deduction

• Individuals have two options for deducting certain personal expenses:
  + Standard Deduction
  + Itemized Deduction(s)
• If an individual does not want to add up all of their deductible items, or if the total of those items is less than a certain amount, the individual may use the standard deduction on their return.
• In 2017 the standard deduction was $12,700 for MFJ. In 2018 that number is $24,000.
• More taxpayers are expected to use the standard deduction for 2018, this lowers the value of items that people used to deduct as an itemized deduction.
Assume a MFJ taxpayer in 2017 has $100,000 of income and the following deductions:

- $100,000 of income would be the 25% tax bracket for 2017

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>Value of Deduction</th>
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<tbody>
<tr>
<td>State Taxes</td>
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<tr>
<td>Mortgage Interest</td>
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<td>$750</td>
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<td>Charitable Contributions</td>
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<td>$500</td>
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<td>2% Misc Deduction</td>
<td>$1,000</td>
<td>$250</td>
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<tr>
<td>Deductible Medical Costs</td>
<td>$2,000</td>
<td>$500</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>$20,000</strong></td>
<td><strong>$5,000</strong></td>
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Now we look at the same taxpayer in 2018 and compare.

Because the total itemized deductions ($15,000) is less than the standard deduction ($24,000), the taxpayer gets no benefit for the itemized deductions.

<table>
<thead>
<tr>
<th></th>
<th>2018</th>
<th>Value of Deduction</th>
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<tbody>
<tr>
<td>State Taxes</td>
<td>$10,000</td>
<td>$-</td>
</tr>
<tr>
<td>Mortgage Interest</td>
<td>$3,000</td>
<td>$-</td>
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Federal Tax Changes for Businesses
Tax Changes Affecting Businesses

• Corporate tax rate lowered from as high as 35% down to a flat 21%
• Ability to use cash-method of accounting
• No longer have to use the percentage of completion method
• No more 50% deduction for “entertainment”
• Limits on deductibility of interest
• 100% depreciation on certain equipment, including used equipment
• 20% passthrough deduction
Lower Corporate Tax Rate from 35% to 21%

• Under the old tax law, the corporate rate was as high as 35%
  + The old rate was graduated, meaning that the tax rate changed depending upon your income (like it does for an individual)
• Corporations now pay a flat tax of 21%, regardless of their level of income
• So, do I want to be a C-Corp now that the rate is lower?
The lower corporate rate might sound appealing, but let’s do some quick math. Corporation makes $100, first it must pay $21 of tax leaving $79 for the owner. Next, when the owner receives the $79 from the corporation there will be a tax as high as 23.8% on that amount ($79 X 23.8% = $18.80). Total tax paid on $100 of income is $39.80 ($21.00 + $18.80). Effectively the C-Corp has a tax rate of 39.8% versus the highest individual rate of 37%.

+ Passthrough treatment is typically favorable for most companies.
Cash Basis Method of Accounting

- Certain taxpayers will now be able to use the cash method of accounting.
- This method is available to taxpayer with annual gross receipts under $25 million.
- Advantages include the ability to not recognize income until payment is received as opposed to recognizing income when the customer is billed.
- The ability to expense inventory when purchased may also be available.
Percentage of Completion Method

• For taxpayers under $25 million of annual receipts, the use of the percentage of completion method is no longer required.
• Under this method, income would be recognized based upon how much of the project had been completed
  + Whether the customer had been billed or paid yet did not make a difference.
• Under the new method, taxes owed can better match cash collected.
Limitations on Deduction for Meals and Entertainment

• One item that changed is that businesses are no longer allowed to deduct 50% of meals and entertainment.

• Anything considered “entertainment” is now non-deductible.
  + This would include amounts paid for tickets to sporting events.

• Food and beverage is limited to only 50% being deductible.
Limitations on Deduction for Interest Expense

• Many business will now have a limitation on how much interest expense they can deduct.
• This could have a direct impact on subcontractors, but could have a larger indirect impact on the industry.
• Highly leveraged companies may not be able to deduct all of their interest.
  + This means that companies may slow down certain projects as the cost of borrowing becomes higher.
100% Bonus Depreciation

- Assets purchased can be completely expensed in the year placed in service.
- Applies to new and used equipment.
  - In the past, this was only available for new equipment.
- Typically only applies to personal property.
  - Special carve out for roofs and HVAC allowing them to be expensed, but with some stricter requirements.
- Set to slowly phase down starting 2023.
There was supposed to be a provision in the new tax law allowing bonus depreciation on “qualified improvement property” or “QIP.”

QIP is an improvement to the interior, non-structural portion of a building that is not relating to an enlargement or an elevator/escalator.

Due to a drafting error, this was not included in the Bill.

- Instead of people able to expense these projects immediately, companies have to depreciate them over 39 years.
- This could slow down projects as companies will no longer get the immediate tax deduction.
- This error will take “an act of Congress” to fix.
20% Passthrough Deduction

- The Bill introduced a large benefit for owners of passthrough businesses.
  + Partnerships, LLC’s, S-Corps, and Sole Proprietorships
- The owners of these businesses may be taxed on only 80% of their income.
- LOTS of caveats!
  + The deduction has several factors that can limit the amount of the deduction
    - Property used
    - W-2 Wages paid
  + Only certain industries can use this deduction
C-Corp Vs. PTE

- C-Corp rate is “only” 21% but the effective rate is 39.8%.
- PTE makes $100 of income, since the entity doesn’t pay taxes, but the owner does we tax this amount at the individual rates.
- Assuming worst case scenario (i.e. owner is at the highest 37% tax rate) then the owner would pay $29.60 of tax.

  \[
  \frac{(\$100 - (\$100 \times 20\%)) \times 37\%}{\$100 - \$20} \times 37\%
  \]

  \[
  \$80 \times 37\%
  \]
Federal Tax Changes for Not-For-Profits
Federal Changes Impacting NFP’s

• The impact by the tax law will be more indirect for NFP’s.
• As previously discussed, more individuals will use the standard deduction.
• If an individual uses the standard deduction, the tax advantages of the charitable contributions are gone.
  + If an individual gets a tax deduction, donating $100 only costs the individuals $63 since they can get a $37 deduction.
  + With no tax benefit of the deduction, donating $100 costs the individual $100
• One way around this is call “bunching”.
Recent State Tax Changes
Changes in State Taxation

• There have been many changes to state taxation recently.
• These changes center around two main issues:
  + When can a state tax you?
  + When do you have to file in a state?
• These changes have significant effects to both for profit and not-for-profit entities.
When Can a State Impose Tax

• The ability for a state to impose tax on an individual or business is limited by the US Constitution.
  + This provides a fairly “gray” definition that has been further revised by the US Supreme Court.
• Recently states have started to impose something called “economic nexus”
• Under these rules, just having customers in a given state can require you to pay income taxes there.
  + Previously the rules required you to physically be in a state, not just having a customer there.
• It is a “cliff” approach, meaning once a state has the right to tax you they can tax your business activity in all states.
Sales Tax and Economic Nexus

• Just like for income taxes, economic nexus also applies to sales tax.
• This can be a “got ya” as sales tax is not supposed to be a liability of the company, but of the customer.
  + If tax is due, but wasn’t collected it becomes the liability of the company.
  + The company’s owners and officers can be held personally liable for these amounts.
Sales Tax and NFP’s

• But we are a not for profit, we do not pay sales tax……
• While NFP’s are generally exempt from paying taxes, it does not mean they are exempt from collecting and remitting sales tax.
  + The most common place this is seen is fundraising events and campaigns.
  + Some states will exempt “casual and occasional” sales, but these exemptions are often narrowly applied and not applicable.
Detection Risk

• States are getting much better at finding taxpayers who are not complying.
  + Searching company websites
  + Looking at trucks and vehicles on the roads
  + Checking insurance registrations
Weighing the Pros and Cons

• If you discover that you may have a filing obligation in a state there are a couple of steps to follow:
  + Calculate the liability
    • This would include any interest and penalties
  + Calculate the “cost of compliance”
    • This includes the cost and preparing returns as well as time invested
  + Determine detection risk
    • How likely is it that a state finds me?
    • If a state finds me how much will I owe?
  + Develop an action plan (typically one of three options)
    • Enter into a Voluntary Disclosure Program
    • File on a prospective basis
    • Continue to monitor and reassess later
Planning Tips for Minimizing Tax Liabilities
Planning Tips for Taxpayers

• Review year-end income and look at purchases
• Explore all available refunds
• Look into the Federal and State tax incentives
Reviewing Year End Taxable Income

• One way to minimize tax liability is to work with a tax profession and review the year before December 31st.

• With 100% bonus depreciation, buying a piece of equipment in the fourth or first quarter can make a big difference.
  
  + If taxable income predicted for the year, accelerate any equipment purchases into current year to offset income.
  
  + If taxable loss expected, defer purchases until the subsequent year to better manage tax liabilities and maximize deductions.
Explore Tax Refunds

• One common item overlooked in the construction industry are credits for “alternative fuels”.
• This does not mean we have to convert all our equipment to electric!
• A tax credit is available for use of certain alternative fuels including bio-diesel and LNG/LPG.
  + Many forklifts and lift trucks run on LPG.
• A refund is also available for off-road use of highway diesel.
  + Highway diesel (generally purchased at a gas station) has been taxed for use on the roads. If this fuel is used “off-road” then a refund of the tax (24.3 cents per gallon) is available on your tax return.
Another Credit often overlooked in the Research and Development Credit (R&D Credit).

This credit has a lower threshold than some may realize.

Items can be claimed for the credit even if the thing created is sold to the customer. It doesn’t need to be “blue-sky” initiatives.

Things to ask when considering that credit:
   + “Can we do what the customer wants”
   + “How are we going to figure out if we can do it”
   + “If we can do it, what will the final design look like”

Many jobs, while similar to previous jobs, each present unique challenges.

Many States also offer R&D credits that piggyback off of the Federal credit.
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