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
  + Sate 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 there 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.

Devaluing the Deduction, Part 1

- 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

	2017	Value of Deduction
State Taxes	$ 12,000	$ 3,000
Mortgage Interest	$ 3,000	$ 750
Charitable Contributions	$ 2,000	$ 500
2% Misc Deduction	$ 1,000	$ 250
Deductibel Medical Costs	$ 2,000	$ 500
	$ 20,000	$ 5,000

Devaluing the Deduction, Part 2

- 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.

	2018	Value of Deduction
State Taxes	$ 10,000	$ -
Mortgage Interest	$ 3,000	$ -
Charitable Contributions	$ 2,000	$ -
2% Misc Deduction		$ -
Deductibel Medical Costs		$ -
	$ 15,000	$ -

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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 Coproate 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?

C-Corp Taxation – The Double Tax Trap

- 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.

100% Bonus Depreciation and Real Property

- 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.

  [$100 – ($100 X 20%)] X 37%

  [$100 - $20] X 37%

  $80 X 37%

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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 **<u>paying</u>** 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

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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 Taxbale 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 out 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

Tax Credits

- 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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Questions?

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Paul Morrow

Manager, Tax Advisory Services

Paul.Morrow@dhg.com

901-259-3599