



Tax Cuts and Jobs Act Summary of New Tax Provisions

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Tax Cuts and Jobs Act – Individual Changes Tax Rates

ALL INDIVIDUAL TAX CHANGES EXPIRE AFTER 2025

Individual Tax Rates – 7 brackets Maximum

Maximum Rate of 37%

| <u>Single</u> | <u>Joint</u> | <u>H of H</u> | <u>Trusts/Estates</u> |
|---------------|--------------|---------------|-----------------------|
| \$500,001+ | \$600,001+ | \$500,001+ | \$12,501+ |

TCJA – Individual Changes

Preferential Income Tax Rates

- Preferential rates still apply to long-term capital gain and qualified dividends. However, the 20% rate no longer begins when the taxpayer reaches the highest ordinary income rates.

| | <u>Single</u> | <u>Joint</u> | <u>H of H</u> | <u>Married Sep</u> |
|-------|---------------|--------------|---------------|--------------------|
| ▪ 15% | \$38,600 | \$77,200 | \$51,700 | \$38,600 |
| ▪ 20% | \$425,800 | \$479,000 | \$452,499 | \$239,500 |

- This bracket is essentially where the 20% rate would start under current law.

TCJA – Individual Changes

Standard Deduction/Personal Exemptions

- Standard Deduction increased to \$24,000 for joint filers, \$18,000 for single filers with at least one qualifying child, and \$12,000 for single filers through 2025.
 - The additional standard deduction for the elderly or disabled are retained
 - Adjustment for years after 2018 based on C-CPI-U
- Personal Exemptions repealed through 2025.

TCJA– Individual Changes

AMT, Kiddie Tax

Retention of Individual Alternative Minimum Tax for 2018 and later years

- Increase in the AMT Exemptions to \$109,400 (from \$84,500) for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and \$70,300 (\$54,300) for all other taxpayers (other than estates and trusts). The trust exemption of \$24,100
- The phase-out thresholds are increased to \$1,000,000 for married taxpayers filing a joint return, and \$500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

Kiddie Tax Change

- Tax on Net Unearned Income no longer based on Parent's Marginal Rate.
- Child uses trust rates (other than 12% rate) and brackets to determine tax on Net Unearned Income.

TCJA – Individual Changes

SALT Deductions

- **SALT – A limited deduction of up to \$10,000 allowed to an individual for non-trade or business and non-section 212 activities**
 - **State and local income taxes/sales tax;**
 - **Property Taxes**
 - **Foreign property taxes cannot be deducted under this exclusion.**
- This raises a potential double tax issue for those in high income tax states. Note that foreign tax credit/deduction still allowed.
- Trade or business taxes remain deductible (i.e., amounts deductible on Schedule C, E or F)
- The bill specifically provides that for tax years beginning after 2017, payment is deemed made on the last day of the tax year for which the payment is made – barring a 2017 deduction for pre-paying 2018 taxes.

TCJA – Individual Changes

Casualty Losses/Medical Expenses

Personal casualty losses

- Casualty losses (other than trade or business losses or for profit activity losses) are limited to transactions resulting from a federally declared disaster through 2025.

Medical expense deduction is retained

- For years after 2017 and 2018, the 7.5% threshold applies to all taxpayers without AMT impact.

TCJA – Individual Changes

Mortgage Interest/Moving Expenses

- **Mortgage interest** For tax years 2018 through 2025, deduction will be limited to interest on acquisition debt of up to \$750,000.
 - This applies to a primary and secondary residence.
 - The deduction with respect to “home equity” debt is repealed.
 - For “acquisition debt” in place before December 15, 2017, the old \$1,000,000 acquisition debt limit will continue to apply.
 - After 2025, taxpayers can use the old \$1,000,000 (\$500,000) rule regardless of when the debt was created.
- **Moving expenses.**
 - Above the line moving expense deduction not allowed for 2018-2025
 - Allowed for members of armed forces for certain expenses (in-kind moving and storage expenses)
- **NOTE:** Qualified Employer provided moving expenses reimbursement taxable for 2018 through 2025.

TCJA – Individual Changes

Charitable Contribution Deduction

- **Charitable Contribution deduction retained and modified for 2018 through 2025.**
 - The 50% adjusted gross income limit for cash contributions to public charities and certain private foundations is increased to 60%. The 5-year excess deduction carryover rule is retained.
 - 80% deduction for amounts to university athletic seating rights is eliminated.

TCJA Individual Changes

Miscellaneous Itemized Deductions

- **2% Miscellaneous Itemized Deductions repealed for 2018-2025**
 - Tax Preparation Expenses
 - Unreimbursed Employee Business Expenses
 - Repayments of income under claim of right (under \$3,000)
 - Share of deductible investment expenses from pass-through entities
 - Repayment of Social Security benefits
 - Trustee fees for IRA, if billed separately
- **Pease Limitation on Itemized Deductions repealed**

TCJA – Individual Changes

Alimony

- **Alimony payments** - deduction repealed for any divorce decree or separation agreement executed or modified after 2018
 - Corresponding Income Inclusion rules for such alimony eliminated

TCJA – Miscellaneous Provisions

- Gain Exclusion on sale of Principal Residence. \$250,000 (\$500,000 joint return) gain exclusion is retained for sales after 2017.

TCJA – Expiration Individual Rules

- All of the Individual Tax changes expire after 12/31/2025 – meaning that all of the rules revert back the current rules, including (but not limited to)
 - Elimination of ACA Individual Mandate penalty
 - Income tax rate cuts
 - Expanded child tax credit
 - Repeal of Personal exemptions
 - Expanded standard deduction
 - Repeal of Alternative Minimum Tax
 - Repeal of Miscellaneous Itemized deductions
 - Repeal of changes to mortgage interest deduction (including deductibility of home equity loan interest)
 - Repeal of state and local income and property taxes
 - Moving expense deduction rules

TCJA – Corporation Provisions

Rates/AMT/Dividend Exclusion

- Tax Rates: Corporate rate is set at a flat 21% rate for C corporations after 2017
 - Special rate for personal service corporations is eliminated. Taxed at a flat 21%
 - Maximum rate on long-term capital gains is eliminated.
- Alternative Minimum Tax: Repealed after 2017
 - Provision for a refund of AMT credit for years 2018-2021 at a rate of 50% of the credit available for the year over the amount used against regular tax for years 2018, 2019 and 2020 and a rate of 100% of the excess for 2021.
- Dividend Exclusion
 - After 2017, the 80% and 70% exclusions are reduced to 65% and 50%, respectively
- ***Update – Blended rate calculation based on days***

TCJA – Pass-Through Entities

- The TCJA creates a 20% deduction to the qualified business income through 2025.
 - The deduction generally does not apply to specified service businesses (however there is an exception for “small businesses”, discussed below).
 - Clarifies that this is not a deduction taken in reaching AGI (it will be a post AGI adjustment) and therefore does not affect phase-outs affected by AGI. It will be available to both itemizers and non-itemizers.
 - The Bill applies to deduction to trusts and estates . Rules similar to section 199 rules allocate W-2 wages and property basis between the fiduciary and beneficiary will apply.
- Qualified business income includes REIT dividends

TCJA – Pass-Through Entities

Wage Limitation

- The limitation on the deduction is the greater of:
 - 50% of W-2 wages with respect to the qualified trade or business; or
 - 25% of W-2 wages for the qualified trade or business plus 2.5% of the adjusted basis of tangible property subject to depreciation immediately after acquisition. The property must be held at year end, not have reached the end of its “depreciation period” (i.e., the later of 10 years from date of acquisition or the last full year of its recovery period) during the year, and have been used in the qualified trade or business during the year.
- The W-2 limitation does not apply to certain Small Pass-Through Trades or Businesses (discussed later)
- There is an overall limit of 20% of taxable income (without this deduction)

TCJA – Small Pass-Through Business

- Small Pass-Through Business
- The 20% deduction applies to specified service business (which would not otherwise qualify) where taxable income is not greater than \$315,000 for joint filers and \$157,500 for other filers.
 - This is subject to a phase-out over a \$100,000 range for joint filers (\$50,000 for others)
 - Specified service business (subject to exclusion) includes the fields of law, accounting, consulting, medicine, financial services, performing arts, or any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners, the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.
 - Engineers and architects are excluded from Specified Service Businesses.

TCJA – S corps

- The W-2 wage limitation does not apply to small pass-through business where taxpayer taxable income is not greater than the threshold amounts above.
- Where the 20% QBI deduction is limited by the 50% W-2 wage deduction, the optimal amount of W-2 wages is 28.5714% of QBI prior to wage deductions.

TCJA – Partnership Rules

- Partnership Technical Termination Rule under IRS sec 708 repealed after 2017.
 - Partnership is treated as continuing even after a sale of 50% or more of capital or profits interest.
- Carried Interest
 - After 2017, long-term capital gain treatment for a carried interest requires a holding period of 3 years (despite a section 83 election).
 - An interest held for less than 3 years would be treated as short-term capital gain (not as earnings).
 - Certain interests held by corporations would be exempt

TCJA – Accounting Rule Simplification

- Accounting Methods
- \$25 million gross receipts thresholds established:
 1. Cash Basis: Requirement that this rule be satisfied for all prior years is repealed.
 2. Cash Basis: Businesses with inventories allowed to use cash basis subject to having annual gross receipts of \$10 million is increased to the new \$25 million level. Inventories can be treated as non-incidental costs or treated in conformity with the taxpayer's financial accounting method.
 3. UNICAP: Businesses, including producers, fully exempt from the costs capitalization rules, if average gross receipts are under the \$25 million threshold.
 4. POC: The exemption for required use of the percentage of completion method subject to new threshold (for long-term contracts to be completed within a 2-year period). This would allow use of the completed contract method or any other acceptable method. Threshold will be indexed.

TCJA – Accounting Provisions

- **Income Recognition Rules**

- The new law requires an accrual basis taxpayer to recognize income no later than the tax year of inclusion on certain GAAP or IFRS Applicable Financial Statement (or other financial statement designated by Treasury) – with an exception for long-term contracts to which section 460 applies or where another code section applies to the revenue recognition (excluding OID and certain debt instruments).
 - Under this rule the “all events” test is deemed satisfied when the income is recognized on the financial statement for tax years beginning after 12/31/2017.
- Section 481 adjustment resulting included over a six-year period.

TCJA – 100% Bonus Depreciation

- Bonus Depreciation. Allow immediate expensing of the cost of new investments in depreciable assets acquired after September 27, 2017, and before January 1, 2023.
- Percentage reduces 20% pa from 2023 to 2026
- Exclusions:
 - Qualified property does not include public utility property
- Included as Qualified Property
 - Qualified property expanded to include qualified film, television and live theatrical productions.
 - ***Applies to both new and used property.***

TCJA – Sec 179 Expensing

- Section 179 expensing is increased to \$1,000,000 for years 2018 to 2022.
 - Phase-Out of the 170 expense in \$2.5M to \$3.5 M range of acquisitions.
 - These amounts are indexed for inflation after 2018.
 - Section 179 property expanded to include:
 - Qualified energy efficient heating and air conditioning property will be included as Section 179 property.
 - Property used to furnish lodging.
 - Qualified real property improvements including roofs, heating, ventilation, air-conditioning, fire, alarm and security systems.

TCJA – Depreciation of Real Property

- Real Estate Depreciation for property placed in service after 12/31/2017.
 - ADS period for residential real property is lowered to 30 years.
 - Recovery for qualified improvement property reduced to 15 years.
 - ADS period for qualified improvement property to 20 years.
 - **Separate definitions of qualified leasehold improvement qualified restaurant and qualified retail improvement property are eliminated.**
 - **A real estate trade or business which elects out of the limitation on interest deduction to use the Alternate Depreciation System (ADS) to depreciate the real property and qualified improvement property.**

TCJA – Depreciation Changes

Luxury Autos/Listed Property

- Luxury Auto Depreciation. The bill increases the passenger auto limits for each for auto acquired after 12/31/2017
 - Year 1: \$10,000
 - Year 2: \$16,000
 - Year 4: \$9,600
 - Other: \$5,760
 - Limits indexed for inflation post 2018
- Listed Property: Computers and peripheral equipment removed from listed property definition.

TCJA – Interest Deduction Limits

- Interest Deduction Limitation
 - Every business, regardless of form, would be subject to disallowance of a deduction for net interest expense in excess of 30% of the business' adjusted taxable income. Net interest expense is determined at the tax filer level (e.g., the partnership versus a partner).
 - Interest not deducted can be carried over indefinitely
 - Small Business Exception – Business with average gross receipts of less than \$25 million
 - “Adjusted Taxable Income” – for years beginning before 1/1/2022, does not consider deductions for depreciation, amortization, or depletion.
 - Electing Real Property Trade or Business can be excluded from this rule (but note impact on depreciation – i.e., must use ADS depreciation)
 - Electing Farming Business (which would be required to use ADS recovery system) for property with 10 years or more recovery period.
 - The Interest Deduction Limitation will not apply to certain regulated public utilities and certain electric cooperatives.

TCJA – Update

Interest Limitation Notice 2018-28

- Investment Income or Expense – No for C Corp, Yes for pass-through entities
- Future guidance is expected to:
 - Confirm 30% is calculated at the consolidated level
 - Provide clarity on treatment of disallowed deductions when change in ownership
 - Address different activities in the consolidated group
 - Confirm Non-separately stated income will be a separate calculation
 - Address sharing of partnership's interest income – special allocations
- IRS has remained silent on the excess of Adjusted taxable Income above the 30%

TCJA – NOL and Loss Deduction Limits

- Net Operating Loss Deductions
 - Carryback generally eliminated (but a 2 yr carryback is permitted for farming businesses.)
 - Limited to 80% taxable income for NOLs created in 2018 and later.
 - Unlimited carryovers
- Limitation on Losses of Non-Corporate Taxpayers (for 2018 tax years through 2025)
 - Losses allowed limited to a threshold (\$500,000 for joint filers; \$250,000 for others) for non-corporate taxpayers.
 - The excess (unused) losses are carried forward and treated as part of the NOL carryforward to a subsequent year.
 - The limitation applies at the partner or S shareholder level

TCJA – 1031/DPAD

- Like Kind Exchange
 - After 2017, like-kind exchanges will apply only to real property
 - Exception where either leg of transaction is received or exchanged pre 1/1/2018.
- Domestic Production Activity Deduction repealed for tax years beginning after 12/31/2017.

TCJA – Other Deductions Updates

- Transportation Cost
 - Not deductible unless included in income
 - Increased payroll
 - Renegotiated rental agreements – beware of sales tax
- Entertainment Deduction – ***Denied***
- Meals
 - Generally 50%
 - 100% if taxable compensation
 - Recreational/Social/Holiday party 100%

TCJA – Updates

- Carried Interest – 3 year rule – Applicable to S Corp
- UBTI for Non-Profits - Qualified Transportation Benefits
- Co-operative planning
- Prepaid Taxes and Charitable Alternatives
- Profits Interests – Member at Date of Grant – No W2

TCJA – Deduction for Settlements

- Limitation of Deduction.
 - The bill would disallow a deduction under IRC section 162 for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if the payments are subject to a nondisclosure agreement. Effective for amounts paid or incurred after the date of enactment.
 - NOTE: Payments made after date of enactment under a prior settlement or court order do not appear to be grandfathered.

TCJA - Estate, Gift and GST

- Estate & Gift Tax Exemption:
 - For 2018 through 2025, the \$5,000,000 Basic Exclusion Amount (as adjusted for inflation – which exempted \$5.45 million in 2017) is doubled to \$10 million (as adjusted for inflation after 2011).
 - Regulations are to be issued to account for computation where to account for the differences in the basic exclusion amount at time of death and at date of gift.
- Estate Date of Death Basis Rule – is retained
- Generation Skipping Tax Exemption is increased in accord with the estate and gift tax exemption.



STATE & LOCAL TAX UPDATE

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Today's Discussion

- Sales Tax
- Income Tax
- Amazon FBA
- 2018 Tax Cuts and Jobs Act State Update
- General Reminder

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Sales Tax

NEXUS

Quill v. North Dakota (1992)

- The Commerce Clause gives Congress the power to regulate commerce among the states, and that the negative corollary of this power, called the “Dormant Commerce Clause,” prohibits states from placing undue burdens on or discriminating against interstate commerce, and accordingly requires a “substantial nexus” between a state and the activity that it seeks to tax.
- **Rule of Law:** Physical presence is required for Nexus.

NEXUS

South Dakota v. Wayfair, Inc. (2018)

- The Court has agreed to hear the case, with oral arguments heard on April 17, 2018 and a decision expected by the end of the current term in June 2018.
- Opinion seems to have shifted from Quill likely being overturned to less likely being overturned.
- **Potential New Law:** Physical presence is NOT required for Nexus. \$100,000 or 200 transactions would create sales tax nexus.

Remote Seller Economic Nexus

- Two types
 - Based upon sales and/or transactions
 - Required notification– AL, CO, LA, OK, VT
 - Collection
- States with some sort of Brightline Economic Nexus standard for sales and use tax.
 - AL, IN, ME, MA, SD, WA, WY, ND, TN, VT
 - NOTE: MOST ARE DELAYED DUE TO COURT CASES
 - Considering: AR, GA, MS, NE NC UT
- Why is this important?
 - Quill is used for other taxes than just sales/use tax.
 - Compliance burden on companies

Florida Commercial Rent Tax Changes

- Prior Law
 - 6% tax on commercial rents and/or leases
 - Applicable to rents on or before 12/31/2017
- New Law
 - 5.8% tax on commercial rents and/or leases
 - Applicable to rents on or after 1/1/2018
- Applicable County Taxes
 - Some FL counties impose an additional tax
 - Miami-Dade County imposes additional 1% tax

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Income Tax

Income Tax Nexus

- Doing business (not 86-272 protected)
 - Property
 - Payroll
 - Services
- Brightline
 - AL, CA, CO, CT, MI, NY, TN
 - Corporation A has \$1 million of sales in California (BL is \$500k+ inflation). Corporation A will have a filing requirement for tax year 2011 and will be subject to the \$800 minimum tax, assuming its activities in the state do not exceed P.L. 86-272
- Economic Nexus
 - Almost all states, definition varies.

Income Tax – Kentucky Update

- Corporate Income Tax
 - KY updates IRC conformity date to December 31, 2017, for tax years beginning on or after January 1, 2018
 - KY will continue to decouple from IRC bonus depreciation
 - New corporate rate of 5%
 - KY Domestic Production Activities Deduction has been eliminated
 - KY Apportionment Changes from 3-Factor with double weighted sales to single sales factor.
 - KY adopted “market based” sourcing, so sales of services are sourced to the state where the customer receives the benefit. However, communications, cable or internet access services will be sourced under “cost of performance” or the state where the service is performed.
 - From TY 2018 forward, unitary reporting will be required; however, KY adopted the *Joyce* approach meaning only KY-sourced sales from members with KY nexus will be included in the sales factor.
 - Changes to NOLs.

Income Tax – Maryland Update

- Prior Law
 - 3 Factor Apportionment with 2x's Sales
- Phase in of Single-Sales Factor
 - 2018—Property, Payroll and 3x's Sales
 - 2019—Property, Payroll and 4x's Sales
 - 2020—Property, Payroll and 5x's Sales
 - 2021— Property, Payroll and 6x's Sales
 - 2022—Thereafter Single-Sales Factor
- Qualifying Worldwide-Headquartered Companies
 - Can elect to use old apportionment or phased in apportionment until 2022.

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Amazon & Third Party Warehouses

Nexus: The Amazon Issue

- Shipping Methods
 - Fulfilled By Amazon (FBA)
 - With FBA, Amazon stores the sellers merchandise at any one of a number of fulfillment centers, which could be in any state.
 - Amazon as a Store Front
 - Using Amazon as a Store Front, sellers store merchandise in their home state and ship merchandise when an order comes in through Amazon.
 - Selling to Amazon
 - Under this method, a sale of merchandise is made directly to Amazon and Amazon then resells the merchandise.
- States are becoming more aggressive with audits related to Amazon, we have seen audits in MA and CA due to Amazon FBA.

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2018 Tax Cuts and Jobs Act States Update

2018 Tax Cuts and Jobs Act States Update

- States that **have not** addressed the new federal law include:
 - AK, AL, CA, CO, CT, DC*, DE, HI, IA, IL, IN, KS, LA, MA, MD, ME, MN, MO, MS, MT, NC, ND, NE, NH, NJ, NM, NV, OK, PA, RI, SC, TN, TX, VT, WA and WY (35 in total).
- States that **have** addressed some portion of the new federal law include:
 - AR, AZ, FL, GA, ID, KY, MI, NY, OH, OR, SD, UT, VA, WI and WV (15 in total).
- States that **have conformed** with the federal treatment of income inclusion under the new federal law include:
 - AZ, FL, GA, KY, MI, NY, and UT (7 in total).
- States that **have conformed with certain caveats** to the federal treatment of income inclusion under the new federal law include:
 - ID, NY, OH, OR, SD, VA, WI and WV (8 in total).



General Reminders

NEXUS ISSUES TO BE AWARE OF

- Nexus
 - Potential nexus issues arise when companies use the following:
 - Mobile sales force
 - Remote employees
 - Independent contractors
 - 3rd party warehouses
 - Online sales
 - Perform repairs or installations
 - Large contracts where no physical presence
 - Attend trade shows
 - Register with the Secretary of State
 - Best reasons to look into nexus
 - Acquisitions
 - Expanding business
 - You never have
 - Reasons to look into nexus
 - Voluntary Disclosure Agreement
 - So your clients know the exposure

Best Practices

- Get apportionment for all states, not just states you are filing in.
- Spend some time to see if apportionment makes sense, compare to prior years.
- Understand all the state filings of your clients, you should know where they are filing sales tax returns, have licenses, and are registered with the secretary of state.
- Google search your client, go to their website.



Research and Development Tax Credit

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Research & Development Tax Credit

- Since 1981, the R&D Tax Credit (IRC Section 41) has been rewarding companies for developing new and improved products and processes.
- The R&D credit has been permanently extended as part of the Protecting Americans (PATH) from Tax Hikes of 2015.
- The R&D credit has also been enhanced for additional benefits such as the credit being able to reduce payroll taxes and alternative minimum tax.

R&D Tax Credit: Direct Benefits

- To Advance technology in the United States
- U.S. sourced activity only
- Does not include capital expenditures
- Credit is available to large and small businesses
- State credits available in addition to the federal credit.
- \$1 for \$1 Reduction on taxes owed or taxes paid



R&D Tax Credit: Direct Benefits

- Additional future tax savings from continuing credit activities
- Significant credits / cash back from previous three years' returns if amended
- Credits that have not been utilized may be carried back one year and forward 20 years
- Overall increase in company assets and value. Credit carry forwards may be recorded as Deferred Tax Assets
- Credit in addition to deducting the expenses - like a second bite of the apple



What types of industries qualify?

- Manufacturing – approx 71.2% of firms who claim the Credit
 - Adhesives
 - Aerospace
 - Agriculture
 - Wineries/Breweries/Food Industry-see separate slide later
 - Fabrication
 - Engineering firms
 - Construction Contractors
 - Architect Firms
 - Chemical
 - Tool and Die
 - Machine Shops
 - Energy
 - Furniture makers
 - Software and Hardware Development
 - Electronics
 - Game Developers
 - Jewelry Designers
 - Biotechnology/Medical Devices
 - Pharmaceutical
- Professional Services – approx 12.4% of firms who claim the Credit
 - Lumber companies/Forestry
 - Musical instruments
 - Apparel
 - Telecom
 - Waste management
 - Veterinary Clinics
 - Banks, mortgage & titles companies (internally developed software)



State R&D Tax Credits

States offer State R&D Tax Credits, in addition to Federal Credits



Florida R&D Credit

- The 2017 Florida R&D credit must be applied for by March 26, 2018.
- The Florida R&D credit is only available to C-corps.
- The total R&D credit available for 2017 is \$16,500,000.
- In order to qualify the taxpayer must be part of a target industry: business in the manufacturing, life sciences, information technology, aviation and aerospace, homeland security and defense, cloud information technology, marine sciences, materials science, and nanotechnology.

R&D Credit – Payroll Tax Offset

- Starting in 2016 the R&D credit can potentially offset payroll taxes
- Gross receipts for 5 years or less.
- The company must have less than \$5 million in gross receipts
- Will reduce the company's portion of payroll taxes.
- This is a great benefit for start-ups and companies that do not have taxable income.

R&D Credit – Alternative Minimum Tax

- Eligible Small Businesses:
 - Less than \$50M in average annual gross receipts over prior 3 years
 - \$50M threshold applied at both entity and shareholder/partner level
- Credit can offset both regular and AMT liability
- Applies to credits generated in 2016 forward

Research & Development Tax Credit

■ R&D Credit Defined-the 4 criteria

- *New or Improved Business Component*
 - Product
 - Process
 - Software (Internal or External)
 - Technique
 - Formula, or
 - Invention
- *Technological in Nature*
- *Elimination of Uncertainty*
- *Process of Experimentation*

****NOTE: A patent is strong indication of R & D and provides an excellent avenue for identifying and documenting R & D**



Excluded Expenditures

- **Quality control testing**
- **Advertising and promotion**
- **Customer surveys**
- **Efficiency surveys**
- **Management studies**
- **Research for literary, historical or similar projects**
- **The acquisition of another's patent, model, production or process**
- **Legal cost to file for patent, i.e. lawyers fees are not viable costs**



Process of Experimentation

- **Experimentation involves the evaluation of one or more alternatives where there exists an uncertainty as to the appropriate design of the business component.**
- **Development activities**
 - **May include evaluation of alternatives through trial and error**
 - **Must be designed to achieve a result that was uncertain at the outset**
 - **Testing of one or more hypothesis**
 - **Refining or discarding the hypothesis as part of a design process**
- **Evaluate and test alternatives through:**
 - **Modeling**
 - **Simulation**
 - **Systematic trial and error**

Failure is ok! The taxpayer does not need to succeed to claim the Tax Credits!

Don't Be Misled!

- THERE IS NO REQUIREMENT THAT THE DEVELOPMENT OF A NEW PRODUCT OR PROCESS MUST SUCCEED!
- THERE IS NO REQUIREMENT THAT THE COMPANY MUST DO SOMETHING THAT HAS NEVER BEEN DONE BEFORE!
- COMPANIES WITHOUT THEIR OWN PRODUCTS ARE NOT ELIMINATED FROM BEING ELIGIBLE.
- NOT JUST FOR INVENTIONS AND PATENTS
- SIZE DOES NOT MATTER! ALL COMPANIES CAN BE ELIGIBLE.

How Different Businesses Drive R&D Tax Credits

- **New Products:** Some businesses are continually engaged with new products and projects. This would include:
 - Consumer products manufacturers such as toy manufacturers, apparel companies, machine shops, job shops, and cosmetic companies
 - Design firms such as architects, engineers, and design and build contractors
- **New Processes:** Some companies are process-intense including food processors, pharma, software developers, and technology firms.
- **Testing:** Some businesses require a lot of new product testing including electrical and electronics.
- **Quality Control:** Food and pharma companies
- **Outside Development and Contractors:** Software, engineering, and design and build firms.
- **Software:** Software development for internal use can qualify in addition to software development for resale.

Many Businesses Think They Do Not Qualify

- Only a fraction of small and mid-sized companies eligible for the Research and Development tax credit take advantage of it; many don't even try because they erroneously assume they don't qualify.
- Today's goal is to prove to you and your client that they can take advantage of the credit and Marcum should be on their team
- R&D credit is open to a vast amount of industries, from apparel, to rockets to dairy farmers.
- In June 2014, the IRS made it easier for small to mid size companies to claim the credit
- Improving outdated products or processes is enough to qualify
- Eligible businesses can claim unclaimed credits for past open year (3 years) or maybe more if NOL
- Carryover for 20 years so ideal for start ups

Internal Use Software

- Until recently, required additional proof to be eligible for R&D credit
- Software development projects can qualify for R&D tax credits with additional criteria for software developed primarily for use by the taxpayer deemed 'internal-use' software.
- IRS issued newly released regulations which defines what types of projects are internal use. Calls for three additional tests:
 - The software would result in a reduction in cost or improvement in speed or other measurable improvement, that is substantial and economically significant, if the development is or would have been successful.
 - The software development involves significant economic risk, in that the project involved a significant commitment of resources, and because of technical risk, the taxpayer is uncertain as to recovery of project dollars within a reasonable period.
 - The software is not commercially available.
 - Removal of new and innovation criteria (yipee-more on that.)

FedEx Case

- Thanks to the recent FedEx Case, the eligibility of the credit for internal use developers has become more generous.
- FedEx invested in computer software to manage and control package delivery.
- Extra layer of standards in law for credit for internal use
- High Threshold of Innovation Test
- FedEx argued that this was an unenforceable law by the IRS
- In and out of courts for years
- Won in district court. IRS changed rules in 2015.
- Removed innovation test.
- This makes qualifying for R&D easier for software companies or internal use software developers.

R&D Activities For Technology Companies

- Coding for new software architecture or algorithms
- Functional enhancements and new capabilities for existing applications, designed to create a competitive advantage Intranet and
- Internet software in which scale and complexity present technological challenges
- Development of flexible, high-quality, and scalable rule engines to manage and automate complex business structures and models
- Development activities to better manage customer relationships through improved collection, storage, and analysis techniques
- Specialized technologies, such as artificial intelligence or voice recognition applications
- Interactive software to support the delivery of multimedia entertainment, such as music or video streaming or Internet video games
- Testing of new solutions

Research and Development - Manufacturing Tax Tips

- The existing R&D Tax Credit is overlooked because most manufacturers do not understand that their everyday activities already qualify for the credits.
- Business owners are confused about which activities qualify and how to create documentation to substantiate.
- On a day-to-day basis, manufacturing companies across the country are designing or improving new products or coming up with a new process.
- The R&D Credit is seeking to reward these types of companies

Everyday Activities Client do That Can Qualify

- Designing the process to fabricate the metal to reduce shrinkage and increase its quality
- Programming CNC machines
- 3D CAD Engineering with programs like SolidWorks
- Developing and testing of prototypes
- Quality assurance – First-piece quality inspections
- Designing and developing of specialty tooling and fixtures
- Considering alternative metals to develop the product
- Considering different metal thicknesses
- Developing engineering drawings
- Developing weld procedures
- Bending of metal (e.g. sheet metal) has to consider the stressing and stretching
- Considering strength of final product for application (meets specifications)

False Myths That Businesses May Believe

- The R&D Credit is only for companies inventing something new
- The R&D Credit is only for companies with test tubes and labs
- The R&D Credit will not apply to my industry
- The R&D Credit is only for big companies
- The R&D Credit will not help with state taxes
- The R&D Credit will not help Bottom Line
- Too Good To Be True
- The Credit is Going Away



Implications of the 2017 Tax Act: International

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§ 951A – GILTI: General Rule

- A new inclusion under Subpart F
 - But not “subpart F income” under 952 – state income tax implications
- § 951A – Current Year Inclusion of Global Intangible Low-Taxed Income by United States Shareholders
 - (a) IN GENERAL.—Each person who is a United States shareholder of any controlled foreign corporation for any taxable year of such United States shareholder shall include in gross income such shareholder’s global intangible low- taxed income for such taxable year.

Definitions and Formulas

- GILTI = the excess, if any of “net CFC tested income” over “net deemed tangible income return”
- Net CFC Tested Income = the shareholder’s aggregate “tested income” from all CFCs (with CFC gains netted against CFC losses)
 - Tested Income = gross income less deductions (including taxes) allocable against such gross income, determined without regard to 5 categories of income:
 - A CFC’s U.S. source income effectively connected with a U.S. trade or business
 - Subpart F gross income
 - Certain high-taxed Subpart F income
 - Dividends received from a related person
 - Foreign oil and gas extraction income

Definitions and Formulas

- Net Deemed Tangible Income Return = 10% of depreciable tangible property used in a trade or business (section 167) to produce tested income (Qualified Business Asset Investment)
 - Exclusive of certain interest expense
 - Special rule for dual use property
 - Basis determined under 168(g) depreciation system, calculated daily
 - Include distributive share of QBAI of partnership in which CFC is a partner

Simple Example

CFC P&L

| | |
|---|------------------|
| CFC Gross Income | \$400.0 |
| CFC Total Deductions (other than taxes) | <u>(\$200.0)</u> |
| CFC Taxable Income | \$200.0 |
| Foreign Taxes Paid (at 13.10% rate) | <u>(\$26.25)</u> |
| CFC Net Income | \$173.75 |

Determine Net CFC Tested Income

| | |
|---|------------------|
| Tested gross income | \$400.0 |
| Deductions allocable against tested gross income | (\$200.0) |
| Foreign taxes allocable against tested gross income | <u>(\$26.25)</u> |
| Net CFC Tested Income | \$173.75 |

Determine Net Deemed Tangible Income Return

| | |
|-----------------------------------|------------|
| CFC QBAI | \$200.0 |
| QBAI Exclusion Percentage | <u>10%</u> |
| Net Deemed Tangible Income Return | \$20.0 |

Determine GILTI Inclusion (before section 78 tax gross up)

| | |
|------------------------------------|----------|
| GILTI net income (NCTI Less NDTIR) | \$153.75 |
|------------------------------------|----------|

Next Steps

- Individual U.S. shareholders are done – they are taxed on GILTI at ordinary income rates (37% plus state), with no section 78 gross up and no foreign tax credits; be wary of phantom income issues
- For corporate U.S. shareholders, additional steps:
 - Determine Deemed Paid Credit and GILTI Inclusion
 - Deemed paid credit = 80% of taxes attributable to GILTI Net Income:
 - Taxes attributable = total taxes times GILTI inclusion over total positive CFC income
 - Only domestic corporations eligible for deemed paid credit
 - Individual U.S. shareholders not eligible
 - No carrybacks or carryforwards
 - Foreign tax credit limitation of 904 applies to GILTI as a separate basket
 - GILTI Inclusion = GILTI Net Income plus Section 78 Gross Up (taxes attributable)

§ 250 – Deduction for GILTI: General Rule

- Domestic corporations then determine the GILTI Deduction and U.S. Tax
 - (a)(1) ALLOWANCE OF DEDUCTION. IN GENERAL.— In the case of a domestic corporation for any taxable year, there shall be allowed as a deduction an amount equal to [] —
 - (B) 50 percent of—
 - (i) the global intangible low-taxed income amount (if any) which is included in the gross income of such domestic corporation under section 951A for such taxable year, and
 - (ii) the amount treated as a dividend received by such corporation under section 78 which is attributable to the amount described in clause (i).
 - The section 250 deduction yields an effective U.S. federal rate on the GILTI income of 10.5%
 - Which suggests that an effective foreign tax rate of 13.125% covers the U.S. tax (i.e., 80% of 13.125% = 10.5%)

Simple Example (continued)

| | |
|-----------------------|----------------|
| ▪ Net GILTI Inclusion | \$153.75 |
| ▪ Foreign Taxes Paid | <u>21.00</u> |
| ▪ Dividend Inclusion | 174.75 |
| ▪ Deduction | <u>(76.88)</u> |
| ▪ Net Inclusion | 97.87 |
| ▪ Corporate Tax | 20.55 |
| ▪ Tax Credit | (20.55) |

FDII

- FDII allows for a lower U.S. rate on certain income earned by the U.S. group
- Works much like the GILTI inclusion and deduction, but with key differences:
 - Relates to native U.S. group income rather than CFC income
 - Deduction is 37.5% (rather than GILTI's 50%) - 13.125% effective federal rate
 - Both deductions to decrease in 2026
 - FDII to 21.875% - 16.41% effective federal rate
 - GILTI to 37.5% - 13.125% effective federal rate

FDII (continued)

- The reduced rate is available on “foreign derived intangible income”
 - Start with total gross income, then
 - Exclude 5 categories of gross income to determine “deduction eligible income”
 - 951(a)(1)
 - GILTI
 - Financial Services Income – banks can’t benefit from FDII
 - Domestic oil and gas extraction income
 - Foreign branch income
 - Subtract from DEI 10% of US Group’s QBAI (same concept as under GILTI, but assets must be used to produce deduction eligible income) to determine “deemed intangible income”
 - FDII = the portion of the above that is earned by selling/licensing/etc. property and services to foreign persons for foreign use
- Deductions for FDII and GILTI can’t exceed U.S. group taxable income

Sample Example (continued)

Pass Through

- Pass through entity is a services business and generates \$30M in revenue, 90% of which are to non US customers. Costs and expenses are \$25M.
- Pass through income of \$5M taxed at 37% = \$1,850,000.

C Corporation

- Assume FDII = \$4.5M, resulting in a deduction of \$1,687,500 (37.5%).
- As a C corporation, taxable income is \$5M - \$1,687,500 = \$3,312,500.
- C corporation tax at 21% = \$695,625
- After tax proceeds distributed = \$4.3M, taxed at 23.8% = \$1,025K
- Total C corporation/shareholder tax = \$1.7M

Section 245A DRD

- Allows DRD for the foreign-source portion of any dividend received by a domestic corporation which is a United States Shareholder with respect to any “specified 10% owned foreign corporation”
 - Specified 10% owned foreign corporation is any corporation with respect to which a domestic corporation is a United States Shareholder, excluding PFICs
 - Foreign-source portion determined by dividing the earnings of the foreign corporation, excluding ECI and dividends from 80% owned domestic corporations, by the total earnings of the corporation
 - Determined at the end of the taxable year in which the dividend is paid, and ignores any distributions made during that year
- Foreign tax credits under 901 disallowed; section 902 repealed
- Deduction denied for hybrid dividends

A large, abstract graphic on the left side of the page, composed of several overlapping triangles in various shades of teal and blue, creating a dynamic, geometric pattern.

Questions and Answers