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A Special Tax Development Deserves a Special Edition

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Tax Cuts and Jobs Act’s Effect on Personal Income Tax

Pass-Through Entities
The Pros and Cons of the New Section 199A Pass-Through Deduction

International Tax
U.S. Tax Reform’s Reach on International Tax

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State Tax Considerations of Federal Tax Reform

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What Do You Think?
Jolt from Tax Act Springs PICPA to Action
A Note from the Chair

A Special Tax Development Deserves a Special Edition

Only a few short months ago, we had an incredible digital-only edition of the Pennsylvania CPA Journal lined up for you that covered issues like robo accounting and the value of CPA independence.

Then it happened. In the most significant overhaul of the tax code since the Tax Reform Act of 1986, President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017.

We on the Pennsylvania CPA Journal Editorial Board knew what needed to happen. We needed to offer our readers a publication dedicated to this landmark reform from the perspective of Pennsylvania CPAs. And our Editorial Board responded to the call like champs.

As our authors began submitting copy, we quickly noticed that we were not getting column-length pieces for each assigned category, but rather feature-length explorations of different aspects of the tax legislation. These are big issues that required special attention, and the design of the magazine needed to reflect that.

So here you have 11 features addressing everything from pass-through entities, to personal income tax changes, to agribusiness, to charitable giving, and more. We’re presenting by the PICPA.

Therefore, in the area of accounting and assurance, “Financial Reporting Needs to Adjust to New Tax Act,” by James J. Newhard, CPA, discusses the tax act’s impact on financial statement reporting under U.S. GAAP. Among the factors he explores are the reduction of the U.S. corporate tax rate and the repeal of the corporate Alternative Minimum Tax.

There has been a lot of media coverage of the new tax rates for businesses, so Aaron R. Riden, CPA, chose to look at other areas in his “Tax Act Affects More in Business than Tax Rates.” He shines a light on how several other components of the new tax law are poised to affect company operations in 2018 and beyond. Among the areas he discusses are human resources, employee benefits, and asset purchases.

Two topics we do not always get to cover are included here: agribusiness and business valuation. In “Tax Reform and Agribusiness: Opportunity and Controversy,” Barry D. Groebel, CPA, and Bryanna L. Fredericks, CPA, look at how the new tax law provides several benefits for Pennsylvania farmers. “Corporate Tax Reform and Its Impact on Private Company Valuation” by Michael A. Zaydon, CPA, Tony Diab, and Jeffrey M. Dahlgren, examines some of the key tax reform changes that will impact future company valuations, including limitations on interest deductibility, accelerated depreciation, and net operating loss limitations.

These are just a few of the featured topics available in this issue. Tax reform is a huge development, and we will be writing about it for some time. But if you think of something you want covered, let me know and we will work to get it into a future issue.
YOUR 2018 CONFERENCE PLANNER

Featuring Critical Updates on the Tax Cuts and Jobs Act

These PICPA conferences tackle significant changes, including the far-reaching implications of the Tax Cuts and Jobs Act. Leading industry experts and accomplished professionals deliver updates in niche areas, share case studies and lessons learned, and prepare you to take on the rapidly changing accounting industry.

The Changing Landscape of Employee Benefit Plans
May 1
Harrisburg: Course No. 668700
Webcast: Course No. 668701

Not-for-Profit Conference
May 14-15
King of Prussia: Course No. 714800
Webcast: Course No. 714803
Single-day registration also available!

Pennsylvania School District Conference
May 31
Philadelphia: Course No. 148300
Limited seating available!
Webcast: Course No. 148301

Health Care Conference
June 13-14
Hershey: Course No. 700000
Webcast: Course No. 700003
Single-day registration also available!

Women’s Leadership Conference
June 28
King of Prussia: Course No. 649100

Government Accounting Conference
July 9-10
Hershey: Course No. 708900
Webcast: Course No. 708903
Single-day registration also available!

Conference on Pennsylvania Taxes
July 20
Cranberry: Course No. 400100
July 23
Harrisburg: Course No. 400101
July 24
Malvern: Course No. 400102
Webcast: Course No. 400103

Financial Institutions Conference
Sept. 26
Harrisburg: Course No. 708600
Webcast: Course No. 708601

Construction Industry Conference
Oct. 16
Malvern: Course No. 703400
Webcast: Course No. 703401

Multistate Tax Conference
Oct. 23
Malvern: Course No. 541200
Webcast: Course No. 541201

Personal Financial Planning Conference
Nov. 8
Malvern: Course No. 583800
Webcast: Course No. 583801

Valuation & Forensic Accounting Conference
Nov. 13
Malvern: Course No. 754000
Webcast: Course No. 754001

Insurance Conference
Nov. 28-29
Malvern: Course No. 709100
Webcast: Course No. 709103
Single-day registration also available!

Accounting & Auditing Conference
Dec. 5
Malvern: Course No. 690100
Webcast: Course No. 690101

Visit www.picpa.org/conferences to register.
The Tax Cuts and Jobs Act of 2017 is the most significant reform to the Internal Revenue Code (IRC) since the 1986 Tax Reform Act. The Tax Cuts and Jobs Act (Tax Act) dramatically changes 2018 tax filing for both individuals and corporations. This article focuses mainly on the changes affecting individual tax filers.

Tax Filer Statistics

The number of federal tax returns filed in 2015 (the most recent data available) was 150.5 million returns. These returns had total income reported amounting to $10.4 trillion. Of the 150.5 million tax returns filed, 103 million used the standard deduction rather than itemizing deductions.

A total of 114 million taxpayers who filed had taxable income, which amounted to $7.3 trillion, or an average of $61,404 of taxable income per return. Twenty percent of filers did not have taxable income. The average federal tax rate was 14.3 percent, but after accounting for refundable tax credits the average rate was closer to 13.3 percent.

About 6.2 million Pennsylvanians during this period filed federal tax returns, with total income of $410 billion. The per tax return income average was $66,129.

The following Pennsylvania 2015 federal tax filer statistics provide some local context:

- About 3.06 million tax returns were filed as single (about 49 percent of all tax returns).
- Almost 81 percent, or 2.46 million, of Pennsylvania single filers had taxable income under $50,000.
- Pennsylvania had 725,000 head of household tax returns filed, with 570,000, or 79 percent, of this category having earned less than $50,000 in taxable income.
- Pennsylvanians who filed married filing jointly totaled 2.3 million tax returns, with 625,000 of these re-
turns, or 27 percent, having income less than $50,000.

The three filing statuses noted reveal that 4.3 million Pennsylvanians, or 69 percent of those who filed federal tax returns in the state, had taxable income less than $50,000.

Given the number of Pennsylvania federal tax filers who had income less than $50,000, I will, where appropriate, narrow any discussion of tax reform’s impact to highlight this group.

**Deductions and Brackets**

In assessing the impact of tax reform, we must assess where the most IRC changes have occurred. Much of the focus has been on the loss of particular itemized tax deductions. But as defined above, about 1.7 million (68 percent) of the American tax filing public (and 69 percent of Pennsylvanians) have been using the standard deduction and are unaffected by the loss of itemized deductions.

However, a significant portion (about 31 percent) of Americans do itemize on their federal tax return. In Pennsylvania, about 1.7 million, or 27 percent, itemized their federal tax return. These percentages indicate that Pennsylvania is in line with both the national itemizing and standard deduction filing rates.

While we should not minimize the impact of tax reform on itemized tax returns (and the dollar impact of itemized deduction changes may be more significant), the inclusion or exclusion of certain itemized deductions does not appear to impact a majority of Americans or Pennsylvanians.

The Tax Act maintains the same tax filing statuses with single, head of household, and married filing jointly being the prevailing choices. What has changed is that for each filing status there has been an increased standard deduction amount, and income thresholds and filing status tax rate changes have been made.

**Standard deduction** – The standard deduction has increased between 84 percent and 92 percent over the 2017 standard deduction for the three main filing statuses.

Here is the 2018 standard deduction for each filing status had the law not been changed compared with the new standard deduction: single went from $6,500 to $12,000; married filing jointly went from $13,000 to $24,000; married filing separately went from $6,500 to $12,000; head of household went from $9,350 to $18,000.

The standard deduction rates have increased dramatically, but one must consider the Tax Act’s corresponding elimination of the personal exemptions. When factoring in the elimination of personal exemptions, the standard deduction increase may seem muted for some.

For example, a single filer who did not itemize a 2018 tax return would have had a $6,500 standard deduction and a personal exemption of $4,150. This would have offset adjusted gross income (AGI) by $10,650. That same single filer (not itemizing), using only the new higher standard deduction with no personal exemption, would offset taxable income by $12,000.

The key, however, for understanding all of a tax filer’s potential savings lies in the newly enacted tax bracket changes.

**Tax brackets** – Each tax bracket rate under the Tax Act, except the 10 percent and 35 percent tax brackets, is lower than the corresponding bracket rate under the old tax law. Additionally, the range of income amounts contained within certain brackets has been changed.

Under the old tax law there were seven brackets: 10 percent, 15 percent, 25 percent, 28 percent, 33 percent, 35 percent, and 39.6 percent. Under the new law, and regardless of filing status, the seven tax brackets have been adjusted to 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent.

Many tax filers can expect to see some increased tax savings given the fact that standard deductions have increased and some tax credits have been expanded.

**Assessing the Tax Act Impact**

In assessing the specific changes on tax filing, first I’ll examine the changes made to the tax brackets and income threshold amounts, and then I’ll explain some federal tax filing data of Pennsylvanians.

**Single filers** – The 2017 and 2018 tax bracket income thresholds for single filers are displayed in charts A and B below.

The first three single-filer brackets are fairly similar regarding income thresholds. Under the old brackets, the income taxed at 10 percent was taxed up to a maximum of $9,325; now the income maximum is $9,525.

The old second tax bracket, with a 15 percent tax rate, has been decreased to a 12 percent tax rate. As discussed above, the standard deduction is increased for each filing status.

For example, a single filer with income under $12,000 will have a $12,000 standard deduction and a personal exemption of $4,150, for a net benefit of $7,850. A single filer with income under $9,325 is taxed at 10 percent, with an AGI of $9,325. Under the Tax Act, the income taxed at 10 percent is $9,525, with an AGI of $9,525. These amounts represent a significant increase in tax savings.

**Tax Brackets for Individual Taxpayers**

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $9,325</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>$9,326 - $37,950</td>
<td>$932.50 + 15% of the amount over $9,325</td>
</tr>
<tr>
<td>$37,951 - $91,900</td>
<td>$5,226.25 + 25% of the amount over $37,950</td>
</tr>
<tr>
<td>$91,901 - $191,650</td>
<td>$18,713.75 + 28% of the amount over $91,900</td>
</tr>
<tr>
<td>$191,651 - $416,700</td>
<td>$46,643.75 + 33% of the amount over $191,650</td>
</tr>
<tr>
<td>$416,701 - $418,400</td>
<td>$120,910.25 + 35% of the amount over $416,700</td>
</tr>
<tr>
<td>$418,401+</td>
<td>$121,505.25 + 39.6% of the amount over $418,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $9,525</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>$9,526 - $38,700</td>
<td>$952.50 + 12% of the amount over $9,525</td>
</tr>
<tr>
<td>$38,701 - $82,500</td>
<td>$4,453.50 + 22% of the amount over $38,700</td>
</tr>
<tr>
<td>$82,501 - $157,500</td>
<td>$14,089.50 + 24% of the amount over $82,500</td>
</tr>
<tr>
<td>$157,501 - $200,000</td>
<td>$32,089.50 + 32% of the amount over $157,500</td>
</tr>
<tr>
<td>$200,001 - $500,000</td>
<td>$45,689.50 + 35% of the amount over $200,000</td>
</tr>
<tr>
<td>$500,001+</td>
<td>$150,689.50 + 37% of the amount over $500,000</td>
</tr>
</tbody>
</table>
max tax rate of 15 percent and an income threshold up to $37,950, compares to a present 12 percent tax rate and a threshold of $38,700 of taxable income.

Four out of five Americans have taxable incomes within these lower two brackets, regardless of filing status. The second bracket captures the most taxpay-ers overall – in excess of 40 million.

The third 2017 tax bracket of 25 percent compares with a new lower bracket rate of 22 percent. However, the new corresponding income threshold amount has been lowered from $91,900 to $82,500.

The single-filer bracket with the most significant income threshold change is the old 35 percent bracket. The income previously included in this bracket has increased, from a narrow amount of $416,701 to $418,400 to a much wider income range of $200,001 to $500,000. This new 35 percent bracket income threshold amount was almost entirely within 2017’s 33 percent tax bracket. Thus, not every single filer will see their tax bill decline.

For the most affluent single filers – those with incomes in excess of $500,000 – taxable income amounts substantially over this top bracket amount will generate significantly higher tax savings. The top rate reduction to 37 percent from 39.6 percent for substantially higher and unlimited taxable income amounts will generate substantial savings for the 0.01 percent of all single tax filers taxed at this highest tax rate.

In Pennsylvania, 80 percent (2.4 million out of 3.06 million) of all single filers’ tax returns disclosed federal tax-able income of less than $50,000. This income threshold would place these filers in the new 22 percent tax bracket or below.

We can compare the old and new brackets and determine the tax savings for those with incomes at various levels within the $50,000 range. We will use $25,000, $35,000, and $50,000 to cover a range of taxable incomes.

For taxable income at $25,000, the 2017 tax amount due would be $3,283. For 2018, the tax amount due would be $2,809, for a savings of $474 (or 14.4 percent). See the income level comparisons in chart C above.

**Tax Brackets for Head of Household Taxpayers**

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax Due</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 - $13,350</td>
<td>10% of taxable income</td>
</tr>
<tr>
<td>$13,351 - $50,800</td>
<td>$1,335 + 15% of the amount over $13,350</td>
</tr>
<tr>
<td>$50,801 - $131,200</td>
<td>$6,952.50 + 25% of the amount over $50,800</td>
</tr>
<tr>
<td>$131,201 - $212,500</td>
<td>$27,052.50 + 28% of the amount over $131,200</td>
</tr>
<tr>
<td>$212,501 - $416,700</td>
<td>$49,816.50 + 33% of the amount over $212,500</td>
</tr>
<tr>
<td>$416,701 - $444,550</td>
<td>$117,202.50 + 35% of the amount over $416,700</td>
</tr>
<tr>
<td>$444,551+</td>
<td>$126,950 + 39.6% of the amount over $444,550</td>
</tr>
</tbody>
</table>

**Head of household** – The 2017 and 2018 tax bracket income thresholds for head of household filers are in charts D and E to the left.

The head of household 10 percent tax bracket has a $250 increase to the threshold from 2017 to 2018. The second bracket has a rate reduction down to 12 percent, and a $1,000 increase in the threshold amount – up to $51,800.

The head of household threshold at the second tax bracket is much higher than it is for single filers. The 2018 12 percent single filer tax bracket has a maximum income threshold of $38,700, but the 12 percent tax bracket for head of household has a threshold of $51,800. When comparing single 2018 income thresholds versus head of household 2018 thresholds there is a significant variance between 2017 and 2018.
Much of the fourth through seventh tax bracket income thresholds, as seen in the 2018 single bracket changes, have been broadly aggregated into the new 35 percent bracket ($200,001 to $500,000). Previously, the 35 percent bracket had narrowly defined income threshold amounts between $416,701 and $444,550. What previously took three incremental bracket increases to achieve, the new brackets “get there” (to 35 percent) in one larger bracket.

Using Pennsylvania’s federal statistics, 78 percent, or 569,000 of the 725,000 federal returns filed in the state, had income below $50,000. Therefore, in assessing the impact of Tax Act changes on head of household filers in Pennsylvania, a presentation of three income levels can be seen in chart F at the top of the page.

For Pennsylvania head of household filers at or near these three taxable income levels, a tax savings should be anticipated. Dependents and the corresponding exemptions must also be considered as affecting head of household tax savings, as well as the savings for those who are married filing jointly.

Exemptions and credits – Dependent exemptions, as previously stated, will no longer reduce AGI to arrive at taxable income. For those with dependents, the possibility of a larger Child Tax Credit (CTC) or the Earned Income Tax Credit (EITC) are distinct savings possibilities.

Pennsylvanians took the following credits and exemptions:
- Approximately 11 million personal exemptions, with the exemption amount being $4,000 in 2015 (and subsequently indexed higher).
- 3.4 million dependent exemptions.

These statistics support the idea that potential 2018 tax savings may be greater for some than the savings demonstrated from only tax rate and income threshold changes.

The 2018 CTC has been increased from $1,000 to $2,000, and the phase-out threshold has been increased from $75,000 to $200,000. This may be the single largest individual Tax Act change, and many additional Pennsylvanians will avail themselves of these dependent-related tax credits.

Chart G below shows the new phase-out levels for the CTC.

This change means that more taxpayers will receive the CTC, and it will be higher for many already receiving the credit. Many Pennsylvanians may find this realization more agreeable than the mere reduction of adjusted gross income by the eliminated exemption amount.

The tax savings from EITC has not been altered by the Tax Act.

A head of household filer’s potential tax savings, when compared to 2017, is shown in chart H on this page.

This additional refund is due in part to the decreased tax rate and, more significantly, to the increased CTC.

Married filing jointly – The 2017 and 2018 tax bracket income thresholds for

---

### Chart F: Old and New Tax Bracket Comparisons for Head of Household Taxpayers

<table>
<thead>
<tr>
<th></th>
<th>$25,000</th>
<th>$35,000</th>
<th>$50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>2017 tax due</td>
<td>$3,082</td>
<td>$4,582</td>
<td>$6,832</td>
</tr>
<tr>
<td>2018 tax due</td>
<td>$2,728</td>
<td>$3,928</td>
<td>$5,728</td>
</tr>
<tr>
<td>Difference</td>
<td>$354 (11% saved)</td>
<td>$654 (14% saved)</td>
<td>$1,104 (16% saved)</td>
</tr>
</tbody>
</table>

---

### Chart G: Child Tax Credit Phaseout Levels

<table>
<thead>
<tr>
<th></th>
<th>Full Credit</th>
<th>Partial Credit</th>
<th>Phased Out – No Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single</td>
<td>0 - $200,000</td>
<td>$200,001 - $240,000</td>
<td>$240,001 +</td>
</tr>
<tr>
<td>Married Filing Jointly</td>
<td>0 - $400,000</td>
<td>$400,001 - $440,000</td>
<td>$440,001 +</td>
</tr>
<tr>
<td>Head of Household</td>
<td>0 - $200,000</td>
<td>$200,001 - $240,000</td>
<td>$240,001 +</td>
</tr>
<tr>
<td>Married Filing Separately</td>
<td>0 - $200,000</td>
<td>$200,001 - $240,000</td>
<td>$240,001 +</td>
</tr>
</tbody>
</table>

### Chart H: Potential Tax Savings for Head of Household Filers

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wages/AGI</td>
<td>$40,402</td>
<td>$40,402</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personal Exemption</td>
<td>$8,100</td>
<td>$0</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>$9,350</td>
<td>$18,000</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$22,952</td>
<td>$22,402</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>15%</td>
<td>12%</td>
</tr>
<tr>
<td>Tax</td>
<td>$2,775</td>
<td>$2,416</td>
</tr>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Withholding</td>
<td>$4,876</td>
<td>$4,214</td>
</tr>
<tr>
<td>Tax Credit (Child Tax Credit)</td>
<td>$1,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>Tax Due (Refund)</td>
<td>($3,097)</td>
<td>($3,798)</td>
</tr>
</tbody>
</table>
married filing jointly filers can be seen in charts I and J on the right.

The married filing jointly income thresholds are usually double the 2018 single filer income thresholds.

About 27 percent of Pennsylvanians who submitted married filing jointly federal returns had incomes less than $50,000. This category generally includes the wealthiest Pennsylvanians.

To cover the same percentage of Pennsylvanians (as analyzed previously at about 80 percent), we need to increase the income threshold. A $200,000 threshold covers about 90 percent of all married filing jointly Pennsylvanians.

For the comparison table displayed in chart K below, Pennsylvania taxable income threshold amounts of $50,000, $100,000, and $200,000 are used.

This group of married (and wealthier) Pennsylvanians continues the tax savings trend. Additional factors, previously discussed, may impact this category’s results. The broader availability of the CTC (coupled with the existing EITC) will mitigate the loss of some itemized deductions and the personal and dependent exemptions.

Since 90 percent of all married filing jointly Pennsylvanians have taxable income less than $200,000, more married Pennsylvanians should qualify for the expanded CTC because many likely have dependent children.

Taxpayers at higher income levels, such as those married filing jointly, likely will continue to itemize their tax returns as they have done previously.

Consider these points about Pennsylvanians filing 2015 married filing jointly returns with itemized deductions:

• 1.7 million federal tax returns from Pennsylvania used itemized deductions.
• 1.4 million federal tax returns from Pennsylvania had incomes in excess of $50,000.

Nearly all Pennsylvanians who itemized on their federal return had state and local tax deductions. There were 1.57 million Pennsylvanians who took state and local tax deductions, totaling $11 billion. The average deduction was $7,001. This deduction will be eliminated in 2018.

If we apply the 22 percent married filing jointly tax bracket, which incorporates many Pennsylvanians, to the projected loss of a Pennsylvanian’s average state and local itemized tax deduction of $7,001; these itemized filers would have a corresponding tax increase of $1,540.

Only those with other, higher itemized deductions, or those with dependents, can be certain of how to quickly mitigate or offset the loss of one particular itemized deduction or other lost or limited deductions. Other itemized filers, losing certain deductions and without tax credits, will be looking to the decreased tax rates to potentially mitigate the effect of higher taxable income.

The loss of certain itemized deductions in the new Tax Act will, for many itemizers, especially those without dependents, increase taxable income.

More tax filers who previously itemized will now file taxes using the standard deduction. Those married taxpayers who previously itemized but didn’t have a mortgage interest deduction, for example, may not have sufficient itemized deductions to surpass the higher 2018 standard deduction threshold.

Conclusion

Many Pennsylvanians, at differing levels of income and with differing filing statuses, will be uniquely affected by the Tax Cuts and Jobs Act. The underlying complexity of the act needs to be evaluated for all clients so that we CPAs can fully understand the benefits received and the benefits taken.

Tax planning, when addressed at the earliest possible time and while our clients are tax-focused, will minimize the Tax Act’s unanticipated consequences.

Sean J. Brennan, CPA, is president of Brennan and Company CPA PC in Philadelphia, and chair of the PICPA Federal Taxation Committee. He can be reached at sean@brennanandcompa-nypa.com or on Twitter @brennanandcomp.

Sean J. Brennan, CPA
The Tax Cuts and Jobs Act provides a significant benefit for many business owners in the form of a 20 percent deduction of their qualifying business income from a pass-through entity. Unfortunately, there is a high level of complexity, ambiguity, and lack of official guidance in trying to determine what type of income qualifies and how much. Taxpayers and their advisers need answers.

**Background**

Pass-through businesses (sole proprietorships, S corporations, partnerships, and LLCs) represent about half the workforce, over 60 percent of the reported business taxable income, and over 95 percent of all business tax return filings, according to the Tax Foundation.1 Pass-through income prior to the Tax Cuts and Jobs Act (and ignoring state taxes) was subject to a federal marginal income tax rate as high as 39.6 percent plus, in many cases, an additional 3.8 percent Medicare surtax, for a potential federal income tax obligation of about 43.4 percent. C corporations, before tax reform, had a double tax burden of about 50.5 percent (i.e., a 35 percent C corporation rate plus 20 percent preferential rate on after-tax earnings disbursed as dividends or otherwise reflected in a greater value of a later sale of the stock or assets, plus the 3.8 percent Medicare surtax). This seven-point tax rate difference demonstrates the popularity of pass-through vehicles.

After the Tax Cuts and Jobs Act, and again ignoring state taxes, the top federal personal marginal income tax rate has dropped to 37 percent, bringing the regular pass-through total for federal income tax down to about 40.8 percent after possible Medicare surtax. The new C corporation double tax burden is now 39.8 percent (21 percent C corporation rate plus 20 percent preferential rate on the after-tax earnings disbursed as dividends or otherwise reflected in a greater value of a later sale of the stock, plus the 3.8 percent Medicare surtax). In short,
pass-throughs appeared to have lost their seven point tax rate advantage.

As a result, Congress provided partial relief for pass-throughs in the form of Section 199A.

Effective for tax years beginning after Dec. 31, 2017, through 2025, individuals, trusts, and estates are eligible for a 20 percent deduction from their allocable domestic qualified business income (QBI) from each partnership, LLC, S corporation, sole proprietorship, disregarded entity, real estate investment trust (REIT), qualifying cooperative, and qualifying publicly traded partnership. However, there are several limitations:

- There are limitations on the amount of the deduction based on the level of W-2 wages and tangible depreciable property in the business, although this is not applicable below certain adjusted gross income (AGI) thresholds, above which the limitation is phased in.
- Income from most service businesses may not qualify (known as “specified service businesses”), although there is an AGI threshold below which the taxpayer can be exempted from this. Above which, the exemption phases out.
- The deduction is to be taken as a reduction of the taxpayer’s overall taxable income, not against AGI, and is therefore not affected by whether or not the taxpayer itemizes. This means the deduction does not actually reduce the business net income, which could still be subject to self-employment tax and the Medicare surtax.
- Several provisions apply to the impact of cooperatives, REITs, publicly traded partnerships, and their related dividends and distributions, but these cause even more complexity and taxable income for the year over the sum of any net capital gain plus qualified cooperative dividends; plus, the lesser of 20 percent of the qualifying cooperative dividends, or the taxpayer’s taxable income minus any net capital gain. In no event can the deduction exceed the taxpayer’s taxable income for the year as reduced for any net capital gain. And the term taxable income for this purpose is determined without regard to the Section 199A deduction.
- Subject to deduction limitation, these are “any trade or business involving the performance of services in the fields of health, law, 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 one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.” For guidance as to what constitutes a specified service, the Conference Report to Accompany H.R. 1 – Tax Reform Act of 2017 provides some clarification.

<table>
<thead>
<tr>
<th>Section 199A Definitions and Provisions</th>
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<tbody>
<tr>
<td><strong>QBI</strong> – This is the net amount of qualified items of income, gain, deduction, and loss with respect to the qualifying business. If such net item is a loss, then that loss apparently first offsets any QBI from other businesses that year, and any net loss remaining is treated as a deduction in the next year. Any QBI deduction that next year must be reduced by 20 percent of such qualified business loss carryover.</td>
</tr>
<tr>
<td><strong>QBI deduction</strong> – The taxpayer’s QBI deduction will generally be equal to the lesser of the taxpayer’s combined QBI for the taxable year, or an amount equal to 20 percent of the excess of the taxpayer’s services rendered in connection with that trade or business.</td>
</tr>
<tr>
<td><strong>Deductible amount</strong> – For purposes of computing the combined QBI, this is generally the lesser of the following:</td>
</tr>
<tr>
<td>• 20 percent of the taxpayer’s QBI with respect to each qualified business, or</td>
</tr>
<tr>
<td>• A W-2 wage/qualifying property limitation defined as the greater of 50 percent of the W-2 wages with respect to the qualifying business, or the sum of 25 percent of the W-2 wages with respect to the qualifying business, plus 2.5 percent of the “unadjusted basis immediately after acquisition” of all qualified property.</td>
</tr>
</tbody>
</table>

Exception: The above wage/asset limitation in determining the deductible amount will not apply to taxpayers with less than $315,000 (married filing jointly) or $157,500 (all other) of taxable income before deduction, and the limitation is phased in under a complex calculation over the next $100,000 (married filing jointly) or $50,000 (all others) of taxable income before limitation.

Additionally, it appears that a taxpayer may be able to claim the deduction even if they are above the AGI thresholds, and even though they may not have any W-2 wages in the business (such as a sole proprietorship), as long as they have tangible assets in the business.

**Qualified property** – This is tangible depreciable property, still being depreciated as of the close of the tax year, and within its first 10 years of depreciable life.

**Qualifying trade or business** – Generally, any type of business except specified service trades or businesses or a trade or business of performing services as an employee.

**Specified service trade or business** – Subject to deduction limitation, these are “any trade or business involving the performance of services in the fields of health, law, 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 one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.” For guidance as to what constitutes a specified service, the Conference Report to Accompany H.R. 1 – Tax Reform Act of 2017 provides some clarification.

In their haste to enact this legislation, the tax writers created lots of ambiguity and omitted numerous clarifications.
Cuts and Jobs Act refers to established law for defining personal service corporations in Internal Revenue Code Section 448. Also note, the statute exempts architectural and engineering services from being disqualified services.

Exception: Even if a taxpayer has a “specified service trade or business” subject to the deduction limitation, the deduction will still be available to taxpayers with income less than $315,000 (married filing jointly) and $157,500 (single). This is phased out under some complex calculations over the next $100,000/$50,000 respectively, including the interaction of the general wage and asset limitations discussed earlier.

Examples
Here is an example from the above referenced Conference Report: Assume that a taxpayer who is subject to the AGI limitation does business as a sole proprietorship conducting a widget-making business that is not a “specified service business.” The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of 50 percent of W-2 wages (or $0) or the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition ($100,000 x 0.25 = $2,500). The amount of the limitation on the taxpayer’s deduction therefore is $2,500.

Here is an expanded example I put together.

Assume a taxpayer does business as a qualifying S corporation conducting a widget-making business that has qualifying business income of $3 million in 2018. The taxpayer is the sole shareholder. Therefore, prior to any AGI limitation that would trigger the wages/property limitation, the deductible amount would normally be 20 percent, or $600,000.

Now, assume the taxpayer is well above the AGI threshold amounts and is therefore subject to the previously discussed wage/property limitations. The business has 25 employees in 2018 with W-2 wages of $1 million, and has unadjusted basis in depreciable property (immediately after their acquisition) of $8 million.

The taxpayer’s limitation in 2018 would be the greater of 50 percent of W-2 wages ($500,000), or the sum of 25 percent of W-2 wages ($250,000) plus 2.5 percent of the unadjusted basis of qualifying property (2.5 percent x $8 million = $200,000), which totals $450,000.

The amount of the limitation on the taxpayer’s deduction is therefore $500,000.

Other Provisions
For partnerships and S corporations, the deduction is applied at the partner or shareholder level, generally by taking into account the allocable share of the entity’s separately stated items, and uses the same allocable share in determining the applicable wage and asset limitation.
AICPA and PICPA Concerns Regarding Section 199A

In relation to the definition of QBI:

- How is QBI determined: at the activity level within an entity or at an aggregate-entity level by looking at the principal business only?
- Can there be a de minimus rule to exempt a small amount of nonqualifying income mixed into the business, say 5 percent?
- What is meant by the language in the Conference Report that QBI will not include reasonable compensation or guaranteed payments paid to the taxpayer for services rendered in connection with that trade or business? Does this mean the related expense is not deducted in determining QBI; not included as additional QBI; or is a reduction of QBI?
- Clarification is needed on whether a taxpayer must offset ordinary income from the business with any related deductible business interest expense.
- Guidance is needed on whether a taxpayer can aggregate the relevant metrics from various pass-through businesses if they are managed as one business in determining the wage/asset limitations, especially when the taxpayer has businesses integrated in a vertical or horizontal entity structure under common control.
- Examples are needed for how current qualifying business losses are treated. For example, confirmation that they offset QBI from other qualifying businesses in the same year before the 20 percent deduction is calculated, and how the carryover of excess losses will work.
- How will losses from other sections, such as 469 passive losses, originating in a current year or prior year, be treated in determining current year QBI? Do such prior passive losses offset passive income from that same business in the current year, and does the remaining prior passive loss offset current year QBI from that same business?
- Confirmation is needed that a passive owner or shareholder is also eligible for the deduction, and that a rental real estate activity also qualifies.
- Examples are needed of what is meant by disqualifying income if it is dependent on the “reputation or skill of one or more of its employees or owners.”
- Specific and additional examples are needed of disqualifying income from “specified service businesses.”
- Guidance is needed as to how to include the items of income flowing through to the owner/shareholder from a fiscal year K-1, especially one that ends in 2018 and began prior to the new law.
- Clarification is needed as to exactly what types of business-related items make up QBI. For example, what about unrecovered Section 1250 gain, Section 1245 recapture income when the asset or the business is sold, Section 1231 gains, and gain on sale of business intangibles?
- How is the character of QBI affected, if at all, when it passes up through multiple other pass-throughs? Which may have other types of businesses, some of which may have QBI and some may not? How will REIT income, or other types of QBI, be treated when passed through other entities? In other words, how will these provisions work when there are multiple tiers of entities?
- How does this all interact with alternative minimum tax, which still exists for individuals?

With regard to the W-2 wage limitation calculations once the applicable AGI thresholds are exceeded in order to determine the allowable deduction:

- How are taxpayer wages or guaranteed payments treated in determining the wage limitations: fully included or excluded?
- What if a business uses independent contractors vs. employees? Could there be a substance-over-form standard used to allow those payments in the overall W-2 limitation?
- Clarification is needed as to how to compute the available deduction when a taxpayer is subject to the “double phaseouts” of being in a disqualified service business, and also to the wage and asset limitations.

With respect to the 2.5 percent of the “unadjusted basis immediately after acquisition” calculation:

- How is unadjusted basis determined in the case of a tax-free acquisition, such as a like-kind exchange of real estate, a statutory merger, or a gift or inheritance?
- Will improvements be allowed to be added to the original unadjusted basis?
- How does the factor in property acquired midyear or sold midyear?
- What if the business was not held all year?
- What if property is recorded as a capitalized lease?
- Will assets placed in service before 2018 be allowed to be included or only new additions?
- Will unadjusted basis be considered before applying bonus expensing and Section 179 expensing?

If the taxpayer has a substantial understatement of income tax as a result of an improper Section 199A deduction, the taxpayer will be subject to the 20 percent accuracy-related penalty if the understatement is more than the greater of 5 percent (not 10 percent) of the tax required to be shown on the tax return, or $5,000.

Unanswered Questions

In their haste to enact this legislation, the tax writers created lots of ambiguity and omitted numerous clarifications. On Feb. 21, 2018, the AICPA sent a formal letter to the Treasury Department and the IRS outlining more than 50 concerns arising from the ambiguity of the statutory language of Section 199A. The AICPA stressed the importance for quick guidance regarding the concerns due to the fact that the law is already in effect and will impact estimated payments coming up this spring, it will affect how entities should be structured, and it will affect tax planning and compliance situations.

The sidebar on the left is a list of many of AICPA’s concerns as well as several others originating from PICPA’s Federal Taxation Committee. (There are others that are too technical for the scope of this article, but could nevertheless be significant under specific taxpayer facts and circumstances.)

Effects on Choice of Entity

Congress appears to have intended that Section 199A effectively would exempt up to 20 percent of qualifying income in a pass-through business, thus lowering the highest federal individual marginal rate on such income to a maximum effective rate of 29.6 percent (i.e., 80 percent of the new highest federal individual statutory rate of 37 percent), plus a possible 3.8 percent Medicare surtax for a total pass-through maximum federal tax obligation of 33.4 percent. This compares to 40.8 percent for pass-through owners who are not eligible for this new qualifying deduction.
(as calculated in the beginning of this article).

Therefore, this new deduction would give pass-through owners, if they qualify, a continued federal income tax rate advantage of about seven points over the new C corporation double tax burden rate of about 39.8 percent.

Of course, as explained in the beginning of this feature, even the lower federal maximum effective federal tax burden of 33.4 percent on pass-through income (if the owner qualifies) is not as attractive as the new 21 percent rate of C corporations (i.e., without taking distributions or intent to sell, and hope to avoid the accumulated earnings tax until such stock could pass to the next generation with a step up in basis at death).

However, businesses in Pennsylvania must also consider how choice of entity will impact state income taxes. After tax reform, assuming the taxpayer is a Pennsylvania resident and the business is entirely in state, the comparative analysis changes a bit. Specifically, if a business is held in C corporation form, with the intent to take distributions or exit via a sale, the total maximum federal and state tax burden becomes 48 percent (i.e., about eight points more than previously calculated due to the additional 9.99 percent Pennsylvania corporate tax rate less a 21 percent federal benefit). A qualifying pass-through’s total federal and Pennsylvania rate would be 36.5 percent (i.e., about three points more than previously calculated due to the 3.07 percent state individual rate assumed to be effectively nondeductible after tax reform). The advantage of operating in qualifying pass-through form in Pennsylvania is about 11.5 tax-rate points over being in C corporation form.

But if an owner believes he or she does not need the distributions or has an intent to sell, and feels that if the business were held in C corporation form he or she could defend against an accumulated tax problem until the business can pass to the next generation, then the new combined federal and state C corporation rate of 28.9 percent (i.e., 21 percent federal plus an effective 8 percent Pennsylvania corporate rate) is attractive compared with the new qualifying pass-through maximum federal and state rate of 36.5 percent.

**Planning Considerations**

You may have already begun to imagine the planning possibilities Section 199A opens up. Here are 10 to consider:

- Consider using the 20 percent deduction in calculating 2018 estimated tax payments if you are comfortable with your facts and circumstances allowing you, or your client, eligibility.
- Reconsider your form of doing business. Consider what restructuring may be needed to fit qualifying activities into a pass-through entity if you are not presently into one.
- Perhaps the tax-rate differentials make you wonder if the best path is to take advantage of the new 21 percent C corporation rate (assuming no need for distributions and no intent to sell the company in the near future; can defend against accumulated earnings tax exposure; and are waiting for shareholders to pass and get a step up in basis).
- Review organization agreements and tax elections to avoid missteps to protect the choice of having a pass-through entity.
- To optimize the deduction, what activities or businesses could be structured among a group of companies, or establish new companies within your control, to maximize eligible activities and businesses?
- Consider what wages or guaranteed payments are taken out or not taken out to optimize the W-2 wage portion of the limitation calculation. If you are a sole proprietorship or LLC, you would not have W-2 wages to yourself, so does that mean you should consider becoming an S corporation to optimize that calculation?
- Should wages be reallocated within the businesses if presently centralizing them into one large W-2 pool in one company and charging the affiliates their share?
- If you have kept tangible depreciable property outside certain businesses and charged them rent, should some be moved into the businesses that could use more of that for the tangible property portion of the limitation calculation?
- Reconsider making some independent contractors more like employees to boost the W-2 calculation.

- If you believe a business qualifies for the Section 199A deduction, then review carefully what business activity codes and descriptions you are already providing the IRS, or plan to in the future, to increase the chances going forward they accept the Section 199A deduction.

**Conclusion**

For those who want to be aggressive in applying Section 199A provisions, I suppose this could be an opportunity. For those who are more risk averse, the lack of clarity is problematic. Hopefully this article has enlightened you about this significant opportunity; and if you were already aware of it, you may now realize there are numerous unresolved questions about how to apply it. I strongly recommend you read through the Conference Report and search for ongoing guidance from the AICPA and U.S. Treasury over the next few months before you advise on it or commit to an approach in order to stay up to date with any answers regarding the many pitfalls and planning opportunities.

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3 Jason Watson, “Taxpayer’s Comprehensive Guide to LLCs and S Corps: 2018 Edition,” Watson CPA Group. (Special thanks for the early publishing of guidance on this topic.)

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The Tax Cuts and Jobs Act of 2017 (Tax Act) has brought significant changes to international taxation. This article summarizes some of the more salient international tax features contained within the Tax Act. From an international tax perspective, the new tax law embraces a limited territorial system (as exists with most U.S. trading partners), seeks to protect the U.S. tax base from perceived cross-border erosion, and creates an incentive for intangible property (IP) investment in the United States at a globally attractive effective tax rate of 13.25 percent.

Due to the complexity of the new rules—which were written in a very brief timeframe with little to no input from the business and economic community on their implications—the U.S. Treasury and IRS are expected to be issuing significant guidance over the next 12 to 18 months.

A Territorial Tax Regime
The U.S. corporate tax system has been converted from a worldwide tax deferral system to a limited hybrid territorial regime (depending upon the facts and how heavily a company is invested in hard assets of foreign subsidiaries). The hybrid system retains the controlled foreign corporation (CFC) provisions, but with some modifications. In essence, the U.S. tax system moves to a quasi-global consolidation. A 100 percent dividends-received deduction (DRD) is permitted for U.S. C corporations that own 10 percent or more of a foreign corporation (referred to as a specified 10-percent-owned foreign corporation) that meet certain conditions. Foreign tax credits (FTCs) are eliminated on exempt actual-foreign-source dividends (deemed-paid credits under Section 902 are eliminated entirely). The DRD is not available for dividends received from a hybrid dividend. A hybrid dividend is one where the foreign entity receives a deduction or other tax benefit from taxes imposed by the foreign country. Individual
owners of flow-through U.S. or foreign entities are not entitled to the DRD territorial tax regime.

**Mandatory Repatriation “Toll Charge”**

The Treasury Department estimates that U.S.-owned foreign corporations have about $3 trillion of foreign earnings that have been U.S. tax deferred. There is a one-time mandatory Subpart F inclusion, where U.S. shareholders owning at least 10 percent of certain foreign corporations include in income for the foreign corporation’s last tax year beginning before 2018 the U.S. shareholder’s pro rata share of the aggregate net post-1986 accumulated earnings and profits of the specified foreign corporation (SFC) – to the extent such earnings and profits have not been previously subject to U.S. tax – determined as of Nov. 2, 2017, or Dec. 31, 2017, whichever is higher. For this purpose, earnings and profits are determined without regard to distributions made during the taxable year that includes the measurement date, unless made to another SFC. The mandatory inclusion applies to all U.S. persons meeting the applicable conditions, whether or not they are eligible for the new participation exemption system.

Determining the mandatory inclusion amount will require historic studies and updated calculations to pinpoint the various relevant tax attributes (such as earnings and profits, tax pools, basis, separate limitation losses, overall foreign losses, overall domestic losses, expense allocation methodologies, reorganizations, etc.). The provision includes several anti-abuse rules intended to prevent taxpayers from reducing earnings and profits subject to the mandatory deemed repatriation inclusion and deferring its application to a later year.

The earnings and profits are subject to a reduced tax rate (15.5 percent) for domestic corporations with respect to cash and cash equivalent assets on the balance sheet, and an 8 percent rate for the balance. The cash and cash equivalent balances are computed at Dec. 31, 2017, and the average of Dec. 31, 2016 and 2015. The greater of the two is used. A deduction is allowed for domestic corporations based on a percentage of the mandatory inclusion amount to arrive at the reduced tax rate. Since the deduction
is based on the U.S. corporate tax rate, U.S. individuals that are U.S. shareholders will likely pay a higher tax rate than 15.5 percent and 8 percent. For 2017, the individual tax rate is 39.6 percent versus the U.S. corporate tax rate of 35 percent. For fiscal-year foreign corporations subject to the mandatory inclusions, the rate U.S. individuals pay will be even greater given the U.S. individual rate only drops from 39.6 percent to 37 percent in 2018, whereas the U.S. corporate tax rate in 2018 drops from 35 percent to 21 percent. An election can be made to pay the tax over eight years interest free, with owners of S corporations – and regulated investment companies (RICs) and real estate investment trusts (REITs) – permitted to make an election to defer payment indefinitely until a “triggering event” occurs.

Taxpayers with carryover net operating losses (NOLs) may consider the election to forego use of the NOL to offset the mandatory repatriation inclusion if they find it advantageous to use foreign tax credits rather than letting them expire or if they find the NOL more valuable against higher rate future income. Foreign tax credit carryforwards from prior years are available to offset the inclusion.

**Global Intangible Low-Taxed Income**

Starting in 2018, a U.S. shareholder of any CFC must include in gross income its global intangible low-taxed income (GILTI) in a manner generally similar to inclusion of Subpart F income. GILTI is the excess of the U.S. shareholder’s net CFC’s tested income over the shareholder’s net deemed tangible income return, which is an amount equal to the excess of 10 percent of the aggregate of the shareholder’s pro rata share of the qualified (hard) business asset investment (QBAI). (U.S. shareholders can defer a 10 percent return on their hard assets; the rest is a GILTI inclusion.)

For any amount of GILTI included in the gross income of a domestic corporation, the U.S. corporation gets a 50 percent deduction (37.5 percent after Dec. 31, 2025) and can potentially credit 80 percent of foreign income taxes imposed on the GILTI inclusion, subject to expense apportionment. Expense apportionment may increase the rate of foreign tax credits needed to offset the U.S. tax on the GILTI inclusion to a U.S. corporation.

Ignoring expense apportionment, if the foreign tax rate on the GILTI is at least 13.125 percent (before 2026), there will be no U.S. residual tax on the GILTI inclusion. Individual owners of CFCs or individual owners through U.S. flow-through entities that own CFCs do not get the 50 percent deduction or the underlying foreign tax credit against their GILTI inclusion. Individuals may want to consider the pros and cons of making a Section 962 election to mitigate GILTI. The GILTI foreign tax credit for U.S. corporate shareholders is in its own separate GILTI basket, and is a year-by-year foreign tax credit calculation with no allowance for carryovers or carrybacks of excess GILTI foreign tax credits.

**Foreign-Derived Intangible Income**

For U.S. domestic corporations for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, a deduction is permitted equal to the sum of 37.5 percent of its foreign-derived intangible income (FDII). After Dec. 31, 2025, the deduction for FDII is reduced to 21.875 percent.

The FDII of any domestic corporation is the amount that bears the same ratio to the corporation’s deemed intangible income as its foreign-derived, deduction-eligible income bears to its deduction-eligible income. In other words, a domestic corporation’s FDII is its deemed intangible income multiplied by the percentage of its deduction-eligible income that is foreign-derived.

Deduction-eligible income means, with respect to any domestic corporation, the excess of the gross income of the corporation determined without regard to certain exceptions to deduction-eligible income over deductions (including taxes) allocable to such gross income (referred to as deduction-eligible gross income). The exceptions to deduction-eligible income are the Subpart F income of the corporation determined under Section 951; the GILTI; any financial services income (as defined in Section 904(d)(2)(D)); any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; any domestic oil and gas extraction income; and any foreign branch income (as defined in Section 904(d)(2)(J)).

Foreign-derived, deduction-eligible income means, with respect to a taxpayer for its taxable year, any deduction-eligible income of the taxpayer that is derived in connection with property that is sold by the taxpayer to any person who is not a U.S. person and that the taxpayer establishes, to the satisfaction of the Secretary of the Treasury, that this is for a foreign use, or for services provided by the taxpayer that the taxpayer establishes are provided to any person, or with respect to property, not located within the United States. The deduction only applies to domestic C corporations (other than RICs and REITs), and is not available for individuals, or individuals that own a flow-through entity or S corporation.

This provision provides a reduced tax rate on certain qualifying income related to certain sales of property to foreign persons for foreign use (e.g., export sales and services provided for foreign persons).

This provision appears to have been intended to establish the United States as an attractive jurisdiction as an intangible property principal under certain circumstances. The rate of tax on the FDII is 13.125 percent. (100 - 37.5 = 62.5 x 21 percent = 13.125) This is the same rate of tax on the GILTI. The new Tax Act is attempting to take out the historic foreign bias of owning intangibles for U.S. domestic corporations by attempting to
level the playing field with respect to U.S. versus foreign ownership of intangibles.

Other International Items
The Tax Act affects several areas of international tax planning. Below are some of the highlights:

• The benefits of the deduction against the mandatory inclusion are denied and a 35 percent U.S. tax is imposed without eligibility for a foreign tax credit if a U.S. shareholder does an inversion transaction within the 10-year period following enactment of this provision.

• Base erosion and anti-abuse tax (BEAT) of 10 percent (5 percent in 2018) is imposed on deemed base erosion payments for foreign-owned U.S. groups (and certain U.S. owned groups that make BEAT payments to their foreign subsidiaries) with average annual gross receipts of $500 million or more. This includes interest, royalties, payments under a qualified cost-sharing agreement, service payments, items disguised as derivatives, purchase of depreciable and amortizable property, reinsurance premiums, and payments to inverted groups. NOLs cannot be used to offset the BEAT.

• Business interest expense is limited for all U.S. taxpayers to 30 percent of earnings before interest, taxes, depreciation, and amortization. In 2022, the limit becomes 30 percent of earnings before interest and taxes.

• Solely for the purpose of determining a loss, a domestic corporate shareholder’s adjusted basis in the stock of a specified 10-percent-owned foreign corporation is reduced by an amount equal to the portion of any previous dividend received from that corporation that is exempt by the DRD.

• If a domestic corporation transfers substantially all the assets of a foreign branch to a specified 10-percent-owned foreign corporation, the domestic corporation recaptures any previously deducted losses from that foreign branch, irrespective of the value versus the basis of the assets.

• Prior to the Tax Act, a U.S. person could transfer the assets used in the active conduct of a foreign trade or business and foreign goodwill and going concern value from a branch to a foreign corporation tax-free, provided it met a tax-free provision of the Internal Revenue Code (subject to a branch loss recapture rule). This was referred to as the active trade or business exception. This has been struck from the IRC, making incorporating foreign branches extremely difficult taxwise going forward. The Tax Act also made clear that foreign goodwill and going concern value are now 367(d) intangibles subject to the outbound super-royalty provisions when transferred from the United States to a foreign corporation.

• The definition of a U.S. shareholder for determining who owns 10 percent or more of a foreign corporation in testing the foreign corporation for whether it is a CFC and subject to the Subpart F provisions is now either 10 percent vote or value. Prior to the Tax Act it was just those that held 10 percent or more vote to determine who is in for the test.

• Foreign-based company oil-related income is repealed from Subpart F income.

• A U.S. shareholder who avoided Subpart F shipping income by investing the assets was required to report Subpart F income when the assets decreased. This has been repealed.

• The limitation of Section 958(b)(4) on downward attribution is repealed. This can make foreign groups that have a U.S. subsidiary in them CFCs.

• To be a U.S. shareholder of a CFC, the U.S. person had to hold the shares for an uninterrupted period of 30 days or more during the year. That rule has been repealed. This means a U.S. shareholder of a CFC is the one who holds the CFC on the last day of the year, irrespective of how many days they held the shares.

• A deduction is denied for any hybrid transaction. This is for interest or royalties paid from the United States to a related party where there is no corresponding inclusion, or the related party is allowed a deduction.

• The sale-sourcing rules have been amended to source income to where the property is produced (manufactured). The 50/50 sourcing rule of Section 863(b) has been modified.

• The fair market value method for determining allocation of interest expense for determining FTCs has been repealed.

• Taxpayers can make an election to increase the percentage from 50 percent to 100 percent of their pre-2018 unused overall domestic losses.

• A foreigner’s gain on the sale of a U.S. partnership interest that generated U.S. effectively-connected income is taxed as U.S. effectively-connected income. This overturns Grecian Magnesite Mining, Industrial & Shipping Co. SA v. Commissioner of Internal Revenue, 149 T.C. no. 3 (July 13, 2017).

• A new foreign tax credit basket is created for foreign branch or flow-through income. Given that GILTI income goes into its own foreign tax credit basket and the change to the sourcing sale rule, among other changes, U.S. individuals and U.S. corporations that are in an excess general limitation FTC position may find it difficult going forward to generate foreign source general limitation income to use up those excess credits.

The Takeaway
The Tax Act has significantly altered the international taxation landscape. The playbook that international tax specialists have been using has been turned completely on its head. The new playbook is heavy in the need to do numbers crunching. Given the short time in which the Tax Act was completed, there will be unintended results. Planning may be difficult until the Treasury Department and IRS provide needed guidance and clarity.

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When the Tax Cuts and Jobs Act (Tax Act) was signed into law on Dec. 22, 2017, the primary focus naturally fell on federal and international taxes, which were directly affected. However, there will be related impacts on the 50 states and many localities that will be diverse, compelling, and ongoing for years to come.

The states’ varied approaches to conformity with the Internal Revenue Code (IRC) in their own tax structures will be put to the test as multistate taxpayers and practitioners apply the new federal law. The states are just starting to address the federal changes through legislation and administrative guidance, and this information will continue to develop over time. But there are some important short-term state tax implications that need to be addressed for financial statement reporting, tax compliance, and tax and transaction planning.

IRC Conformity
How the states incorporate the IRC into their own system of taxation varies widely. With the Tax Act’s addition of new code sections and the significant revision of others, a state’s conformity with the IRC must be the starting point for analysis. Approaches to conformity can be divided into rolling, fixed date, and selective.

- Under rolling conformity, federal tax changes are automatically reflected, unless the state specifically decouples from a provision.
- Fixed-date conformity requires the state to affirmatively update its IRC reference to incorporate some or all of the federal tax changes.
- Under selective conformity, only specific IRC sections are adopted. These sections may refer to the current IRC as of a specific date, and the new IRC sections must be adopted.

Regarding corporate income taxes, 22 states (including Pennsylvania) and the...
District of Columbia have rolling conformity with the IRC, and 21 states have fixed-date conformity.² The remaining states that impose a corporate income tax follow selective conformity.

For individual taxes, 18 states and the District of Columbia have rolling conformity, and 19 states have fixed-date conformity.³ Pennsylvania is among the remaining states lacking conformity to federal individual income tax. Each federal tax law change must be examined to determine if the changes are immediately applicable or only upon further action.

**Corporate Taxes**

A signature piece of the Tax Act is a reduction in the federal corporate tax rate from 35 percent to 21 percent beginning in tax year 2018. The rate reduction drives many other federal provisions, and is likely to influence a significant amount of planning by taxpayers. For state purposes, this only has a direct corporate tax impact in the four states (Alabama, Iowa, Louisiana, and Missouri) that allow a full or partial federal income tax deduction. However, the rate reduction has wide-ranging effects for pass-through entities, more fully discussed below.

**Net operating loss** – The Tax Act limits the deductibility of net operating losses (NOLs) generated in tax years beginning after Dec. 31, 2017, to 80 percent of taxable income, with no carryback and an unlimited carryforward period. Federal NOLs generated prior to 2018 remain subject to the current two-year carryback and 20-year carryforward.⁴ For federal income tax purposes, taxpayers may seek to defer income to 2018 or accelerate deductions to 2017 to maximize NOLs prior to the 80 percent limitation, all of which should be examined for state tax implications.

Most states do not follow the federal NOL rules under IRC Section 172, and instead compute state-specific NOLs. States such as Maryland, Missouri, and Virginia that do follow IRC Section 172, or limit their state NOLs to the amount claimed federally, may be subject to the new limitations. Pennsylvania does not conform to federal NOL rules, and state taxpayers should not be affected by these changes.⁵ Act 43 of 2017 continues to limit Pennsylvania’s NOL use to 30 percent of taxable income in tax year 2017, 35 percent in tax year 2018, and 40 percent in tax years 2019 and thereafter.⁶

**Net interest expense** – Beginning in tax year 2018, the Tax Act generally limits the deduction for net business interest expense to 30 percent of adjusted taxable income, with disallowed amounts carried forward indefinitely.⁷ Adjusted taxable income changes from EBITDA (earnings before interest, taxes, depreciation, and amortization) to EBIT (earnings before interest and taxes) in 2022. This change is expected to significantly reduce the deductible net interest expense.

The former version of IRC Section 163(j) explicitly required a consolidated calculation of net interest expense, whereas the current version does not, and may lead to calculating the limitation without such netting between entities. (See IRS Notice 2018-28, April 2, 2018, for guidance on interest deduction limits.) This may result in significantly different interest expenses on a separate company basis. Further complicating matters, some states, including Pennsylvania, already have some form of intercompany interest expense disallowance. Companies in these states that are subject to federal interest expense limitations and have both third-party and intercompany debt need to determine how much of the federal limitation is attributable to intercompany debt, and which portion remains subject to state expense disallowance rules.

The application of these rules to state income taxes presents an opportunity for taxpayers to review their legal entity structures and debt structures to understand and mitigate the impact of IRC Section 163(j) now and in advance of more restrictive limitations coming in 2022.

**100 percent bonus depreciation** – The Tax Act allows 100 percent bonus depreciation on certain property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023.⁸ The bonus depreciation is reduced 20 percent annually over the subsequent five years.

Many states already either decouple from or significantly modify the existing 50 percent bonus depreciation deduction, and are expected to continue or expand their decoupling provisions to avoid negative fiscal impacts. Pennsylvania Corporation Tax Bulletin 2017-02 provides the

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Department of Revenue's guidance that no depreciation will be allowed on 100 percent bonus assets, and that cost recovery is deferred until the property is sold or otherwise disposed of. This position, applicable solely to corporate net income taxpayers, places Pennsylvania as the only state to completely disallow depreciation on certain property. As of the time of this article's submission, legislation has been introduced in Pennsylvania to allow modified acceleration cost recovery system depreciation (H.B. 2017) or 100 percent bonus depreciation (S.B. 1056).

Section 179 depreciation – The maximum amount a taxpayer may deduct under IRC Section 179 has increased to $1 million, and the phase-out threshold amount has been increased to $2.5 million. Thirty-six states currently adopt IRC Section 179 expensing allowances and investment limits, while seven states offer small-business expensing regimes with their own expensing limits. Section 179 applies to businesses on the basis of the volume of capital expenditures, not entity formation, and is thus available to small corporations as well as pass-through businesses. Similar to bonus depreciation, states will view this as a potential revenue reduction, and may consider decoupling from this provision, requiring taxpayers to continue to track basis and depreciation for state purposes.

Deemed repatriation – Under the Tax Act, unrepatriated foreign earnings from most subsidiaries are treated as Subpart F income subject to a one-time transition tax in 2017 of 15.5 percent for cash and cash equivalents and 8 percent for other assets. Deductions are provided in IRC Section 965(c) to achieve these reduced rates. Taxpayers may elect to pay the resulting federal income tax over an eight-year period, a position that is not expected to be adopted by most states. States may elect to maintain deferral on the deemed repatriation until a triggering event, such as a change in S corporation status or a sale of substantially all of its assets or stock. On March 13, 2018, the IRS issued guidance that this one-time tax will be reported on a separate schedule and not through the regular income tax calculation. It remains unclear for most states whether this IRS guidance will ultimately avoid the complex analysis of how the one-time tax is calculated for state income tax purposes. Regardless, states may view the deemed repatriation as included in federal taxable income, thus forcing taxpayers to determine myriad issues, including the amount of state repatriation, treatment under Subpart F, dividends receiving deduction treatment, availability of the IRC Section 965(c) deduction, nonbusiness income treatment, and impact on apportionment factors. Each issue may impact the amount of 2017 tax to be remitted with upcoming tax returns or extensions. (See Pennsylvania Information Notice 2018–1, scheduled to be released in late April 2018.)

Global intangible low-taxed income – Beginning in 2018, shareholders in the United States are required to include as income the global intangible low-taxed income (GILTI) of controlled foreign corporations (CFCs), with a corresponding 50 percent deduction of the GILTI inclusion amount. GILTI is defined as the excess net CFC “tested income” over a routine return on certain qualified tangible assets. Calculation is on a consolidated federal basis, allowing loss entities to offset others with tested income. The state calculations of GILTI may differ where CFCs are owned by different U.S. taxpayers.

Unlike deemed repatriation income, GILTI is codified in a new IRC section, which may not result in Subpart F income and may not be addressed by the existing state dividends received deduction provisions. If any part of the GILTI is included in a state’s taxable base, fair apportionment issues may arise if there is no apportionment factor representation from the CFC creating the GILTI income. Some increase in the apportionment denominators may cure the fair apportionment issues, but it is unclear under what mechanism this could occur or how it would be calculated for states that traditionally include only the taxpayer’s income from normal operations in the sales factor.

Foreign-derived intangible income – A new incentive was added for most domestic C corporations that earn foreign-derived intangible income (FDII), generally providing a deduction of 37.5 percent of the sum of a taxpayer’s FDII plus 50 percent of its GILTI. This results in a 13.125 percent effective tax rate on excess returns on certain foreign-derived income. States may decouple from this provision or impose significant limitations. Some states have already taken legislative action, including Idaho and Illinois.

Base erosion and anti-abuse tax – Beginning in 2018, the base erosion and anti-abuse tax (BEAT) operates as a minimum tax on certain large multinational corporations engaged in excessive base erosion as a means to prevent companies from pulling earnings out of the U.S. through payments to foreign affiliates. BEAT operates as a separate tax system, and would require states to enact their own similar systems. This currently seems unlikely given the number of states that currently impose addback provisions on intangible payments to related parties (including foreign related parties).

Pass-Through Entities and Individual Taxes

The reduction in the federal corporate tax rate to 21 percent makes corporate rates lower than the highest individual rates. Even with the 20 percent deduction for qualified business income (QBI), owners of pass-through entities may be subject to...
tax at a rate higher than the corporate rate. (See story on page 9.)

Many states begin their individual income tax calculations with either federal taxable income or adjusted gross income. Pennsylvania does not. It is important to note that the QBI deduction is taken after adjusted gross income, and would only be a benefit in states that use federal taxable income as a starting point.

To obtain the lower 21 percent tax rate, pass-through entities are considering converting to or electing C corporation status for federal income tax purposes. There are, however, critical state tax consequences that must be considered before making this decision, including tax rate and apportionment differences. Pennsylvania, for example, taxes pass-through entity owners at a 3.07 percent personal income tax rate, compared with a corporate net income tax rate of 9.99 percent. Other states do not impose individual income taxes on pass-through entity owners, but do tax C corporations. Further, there are differences in apportionment formula weighting and sourcing rules that can yield significantly different results if pass-through entities elect C corporation taxation. For example, Pennsylvania personal income tax requires equally weighted apportionment factors and cost of performance receipts sourcing for services compared with single sales factor apportionment and market-based service receipts sourcing for C corporations. These rate and apportionment differences can significantly affect the analysis, and need to be considered in conjunction with the federal analysis.

State and local tax deduction of individual taxes – One of the most significant revenue raisers in the Tax Act is the $10,000 federal limitation on state and local tax deductions.16 This limitation greatly impacts high-tax states, such as California and New York.

In Pennsylvania, this change inspired some to prepay 2018 real estate taxes to generate deductions in 2017. While a deduction for any prepayment of 2018 state and local income taxes is expressly prohibited by the Tax Act, it does not explicitly prohibit a deduction for prepaid 2018 real estate taxes. Notably, on Dec. 27, 2017, the IRS issued an advisory opinion on the prepayment of property taxes that said, in part, “In general, whether a taxpayer is allowed a deduction for the prepayment of state or local real property taxes in 2017 depends on whether the taxpayer makes the payment in 2017 and the real property taxes are assessed prior to 2018.”17

The limitation has generated a substantial amount of controversy in high-tax states, such as New Jersey, New York, and California.20 States are considering a variety of options to preserve the deductions, including converting employee wage withholding to employer-paid payroll tax, allowing taxpayers to make charitable contributions to the state in lieu of personal income taxes, and taxing pass-through entities at the entity level, rather than at the individual owner level.

Conclusion

Most states are beginning to project increased revenue due to federal tax reform. The states expect to benefit from base broadening provisions without corresponding rate reductions. A recent study estimated a 12 percent average increase in state taxes, with Pennsylvania projecting the highest increase at 14 percent.21

The balance between state and federal taxes is likely to undergo a major shift. A reduction in federal tax rates and overall collections necessarily leads to the increased importance of state taxes – not only state income taxes, but also non-income taxes such as sales and property taxes, which make up the majority of state tax collections. The value of well-executed state tax planning formerly offset by a 35 percent federal corporate tax effect will now only be reduced by the new 21 percent federal corporate rate.

The potential outcomes will take time to analyze and digest. As states wrestle with how to address, incorporate, or decouple from certain Tax Act provisions, taxpayers and practitioners should take action to determine the impacts and opportunities.

1 H.R. 1, Public Law No. 115–97 (2017).
3 Id.
4 IRC Section 172.
7 IRC Section 163(j)(1) and (2).
8 IRC Section 168(k).
9 IRC Section 179.
11 IRC Section 965. Specified foreign corporations are defined to include all CFCs and all other foreign corporations (which are not passive foreign investment corporations) with at least one United States corporation as a shareholder.
12 IRC Section 965.
14 IRC Section 250(a)(1)(B).
15 IRC Section 951A.
16 IRC Section 250(a)(1)(A).
17 IRC Section 11(b).
18 IRC Section 164.

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On Dec. 22, 2017, President Donald Trump signed the Tax Cuts and Jobs Act (Tax Act). Several provisions have extraordinary implications to financial statement reporting under generally accepted accounting principles in the United States (U.S. GAAP). ASC 740, Accounting for Income Tax, is fairly extensive and robust, but there is no precedent for the extent of corporate changes found in the Tax Act. This discussion highlights some of the material matters.

The Tax Act lowered the federal corporate tax rate to a flat 21 percent, which commenced Jan. 1, 2018. While the sum total of all temporary differences for all reporting periods up to and including Dec. 31, 2017, were deferred tax measured at 35 percent, the rate change to 21 percent represents a 40 percent decrease of all full-reversal-period amounts. But the change in tax rates is only the tip of the iceberg.

**Reduction of the U.S. Corporate Tax Rate**

ASC 740-10-05-5 states that there are two basic principles related to accounting for income taxes in application of the recognition and measurement aspects: to recognize estimated taxes payable or refundable on tax returns for the current year, and to recognize deferred tax liabilities and/or assets for the estimated future tax affects attributable to temporary differences and carryforwards. So, at any financial reporting date, deferred tax liabilities (for C corporations) represent the cumulative future tax costs of reversing temporary differences that will increase future taxable income and/or income tax, and deferred tax assets represent the cumulative future tax benefits of reversing temporary differences that will decrease future taxable income and/or income tax, each provided for at the statutory rate of 35 percent (since 1993). Additionally, some items of deferred tax, generally assets, have had an allowance assessment associated with its items pertaining to the expectation of realization of the tax ben-
benefits. Items such as net operating losses, capital losses, and minimum tax credits may present questions about realizability, especially those items that have specific expiration dates.

Off the bat, ASC 740-10-30-8 provides that deferred liabilities and assets be cumulatively valued based on the enacted rate in effect at the report date. In this case, Dec. 22, 2017, represents the date of enactment for the 21 percent rate, meaning that financial statements for periods ending after that date (such as the calendar year ending Dec. 31, 2017) will need to be revalued using the new 21 percent rate. The impact of the tax rate change to 21 percent is to be recognized as a component of income tax expense in the reporting period including that date of enactment. So, even though the new rate would not change the current liabilities until tax years after 2017, the deferred tax assets and liabilities would be revised at Dec. 31, 2017.

Some additional matters also will apply to any state tax temporary differences (per ASC 740-10-55-20) that affect the calculation of deferred federal taxes. Accordingly, the federal deferred tax effects of state–deferred taxes and unrecognized benefits related to state taxes must be measured.

There are some other tax law changes that may have implications with the tax rate reduction adjustments. As discussed below, to the extent valuation allowances previously provided might need reconsideration, these reconsideration adjustments would also be reflected at Dec. 31, 2017.

**Repeal of the Corporate Alternative Minimum Tax**

The corporate alternative minimum tax (AMT) has been repealed for years beginning after Dec. 31, 2017, but remaining unused minimum tax credits (from prior corporate AMT) will be permitted to be applied against regular tax in 2018 through 2021. Credits above the offsettable tax may be refunded at 50 percent in 2018 through 2020, and any remaining balance in 2021. Because of the nature of the corporate AMT, many businesses may have provided a valuation allowance due to uncertainty that the benefit would be realized. Now with the Tax Act, this valuation allowance may need to be reconsidered, as well as realizability.
Several Tax Act provisions have extraordinary implications to financial statement reporting under generally accepted accounting principles in the United States.

Net Operating Losses
Net operating losses (NOLs) arising in years beginning after Dec. 31, 2017, will be limited in use to offset future taxable income, in that the NOL cannot exceed 80 percent of the future taxable income. Further, NOLs may no longer be carried back to earlier tax years. However, the carryforward limit of 20 years has been lifted, so NOLs may now be carried forward in perpetuity. As with deferred tax assets arising from AMT credits, deferred tax assets may have had a valuation allowance provided over uncertainty of realization. With no expiration for carryforward, full realization is quite likely.

Expensing Provisions
The Tax Act provides for 100 percent expensing of fixed assets acquired and placed in service on or after Sept. 27, 2017, and through Dec. 31, 2022. The expensing decreases 20 percent per year thereafter, reaching 0 percent in 2026. Use of these accelerated deductions with tax recognition of 100 percent expense in the year acquired will accelerate the recognition of deferred tax liabilities.

The Tax Act combines qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property into a group eligible for faster write-off, depreciable over 10 years (previously 15 years). Further, these improvement costs are now eligible for the Section 179 expense election.

Depreciation limitations for listed automobiles can have offsetting implications elsewhere, such as the 80 percent limit with NOLs, usable minimum tax credits, and restrictions to allowable interest expense (discussed below).

Interest Deduction Limitation
The Tax Act limits permitted net interest expense to 30 percent of adjusted taxable income. The taxable income has an add-back to earnings before interest, taxes, depreciation, and amortization (or EBITDA). Allowable net interest expense is the lesser of the actual interest expense or 30 percent of the adjusted income above. This applies in 2018 through 2021. Thereafter, the adjusted income adds back only the interest expense and taxes. Any excess in allowable interest is suspended and carried forward to a future year (without expiration). Interest expenses not currently allowed, thus, will generate timing difference to yield more deferred tax assets.

Note, there is a small-business exemption (businesses with gross receipts under $25 million) where the interest limitations will not apply, as well as an exemption (from add-back) for floor plan interest.

Executive Compensation
Internal Revenue Code Section 162(m) has been expanded to specifically include the CFO as a covered employee, which limits the deduction for compensation to a maximum of $1 million. While the CFO may, in some companies, already have been classified as a covered employee, this adds another key C-suite employee to potential nondeductible compensation. While not a deferred tax issue, it will impact taxes currently payable. Permanent changes (differences that never reverse) also affect the effective annual income tax rate.

Valuation and Uncertain Positions
Historically, deferred tax assets may have had valuation provisions for uncertainty of realization (primarily due to expirations of carryforward benefits). Without carryforward expiring deductions and losses, many of these valuation provisions may be less likely to be required.

With regard to uncertain tax positions (referred to as FIN 48 matters), the provisions and related financial statement disclosures are triggered by tax positions that reach the more-likely-than-not threshold.3 Accordingly, many of the limiting provisions of the new tax law, especially with regard to interpretations applied before deeper regulations are provided, may result in additional accrued tax liabilities and disclosure of said interpretations.

International Provisions
The Tax Act subjects a one-time transition tax for unrepatriated foreign earnings at a rate of 15.5 percent for earnings and profit attributable to cash and certain liquid assets, and 8 percent on other earnings and profit. Additionally, global intangible low-taxed income (GILTI), which imposes a tax on foreign income in excess of a deemed return on intangible assets of a foreign corporation, and Base Erosion and Anti-Abuse Tax (BEAT), which is calculated using a lower rate applied to a calculation that eliminates the deduction for certain base-erosion payments made to foreign corporations, are among the more involved and complex changes to international reporting that will likely be outside the expected scope of most nonpublic companies. However, the expansiveness of the related disclosures (necessary to fully and understandably convey the implications) will be significant.

Meals, Entertainment, Dues, and Memberships
The repeal of all entertainment expenses; membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes; and any meals deemed entertainment (and 50 percent of meals provided to employees through employer eating facility) creates an increase in lost deductions, particularly for businesses that invest heavily in networking to drive sales and revenue. The impact of the effective annual tax rates will need to be accounted for.
ASU 2015-17

Accounting Standards Update No. 2015-17 (ASU 2015-17) provides great simplification. It allows companies, upon adoption, to reflect all deferred taxes as long-term liabilities and/or assets, rather than the long-standing requirement of bifurcating deferred tax assets and liabilities as current and long-term based on expected timing of reversal. ASU 2015-17 applies to public companies for years beginning after Dec. 15, 2016, and for nonpublic companies in years beginning after Dec. 15, 2017. However, ASU 2015-17 permits early adoption, which appears to be a “no brainer” for private companies to simplify the complexities the Tax Act presents.

Companies Not on a Calendar Year

Companies that are not on a calendar year (with the natural corporate tax rate transition) have extra concerns and considerations with regard to prorating the tax rates, and with regard to subsequent events. For companies that had financial reporting periods before the enactment date but before the issuance of their financial statements, ASC 855, Subsequent Events, would necessitate the adjusting of the applicable (impacted) balances because of the rate changes and deferred taxes. For entities that have a fiscal year ending in 2018 (and beginning before the date of enactment), the implications of the blend into 2018 (and beginning before the date of enactment) have extra concerns and complexities the Tax Act presents.

FASB Weighs In

With all the interpretations being applied, the FASB has begun to weigh in. Here are its thoughts on five implementation issues and one other issue for which an exposure draft has been provided:

- Private companies, NFPs, and SAB 118 – Private companies and nonprofits have been permitted to apply SEC Staff Accounting Bulletin (SAB) No. 118, even though SEC’s views and interpretations are not directly applicable to these entities. The bulletin will permit reporting with reasonable estimates for the changes that may not be readily and specifically identified because the financial statement implications of the Tax Act change for the period on enactment. A company should disclose its accounting policy of applying SAB 118 in accordance with paragraphs 235-10-50-1 through 50-3 of ASC 235, Notes to Financial Statements.

- Whether to discount the tax liability on deemed repatriation – The FASB ruled that there should be no liability discount in company financial reports (no interest is imposed on the unpaid eight-year liability).

- Whether to discount refundable AMT credits – The FASB ruled that when it is determinable that the AMT credits will be used or ultimately refunded, such credits should not be discounted in company financial reports.

- Accounting for BEAT – The FASB ruled that deferred tax assets and liabilities should be measured in the financial statements at the regular tax rates rather than the lower rate used in calculating the BEAT (like AMT and alternate computations payable if higher).

- Accounting for GILTI – The FASB ruled on an optional election (policy election) to either recognize deferred assets/liabilities for basis differences expected to reverse as a result of the GILTI provisions in future years, or to include the tax on GILTI in the period in which it occurred, based on specific facts and circumstances.

- Accounting for stranded tax effects – The FASB voted to propose a one-time reclassification from accumulated other comprehensive income (AOCI) to retained earnings from the stranded tax effects from the new law’s tax rates. The proposal became GAAP via ASU 2018-02. Accordingly, the rate differential between the 35 percent rate and the newly enacted 21 percent will represent the reclassification of “stranded amounts.” Stranded tax effects are from the prior recognition of other comprehensive income (OCI) items (market losses and impairment recognitions, for example) where the deferred tax assets and liabilities hit AOCI. However, with the tax law enactment, all deferred tax asset and liability adjustments occur through comprehensive income and, thus, directly to retained earnings. The reclassification would, essentially, take that unadjusted spread of deferred tax consequence on other comprehensive income transactions, and restate them in AOCI at the new statutory rate. The ASU amendments are effective for all entities with fiscal years beginning after Dec. 15, 2018, as well as the interim periods within those fiscal years. Further, early adoption is permitted. If the ASU is not adopted until 2019, the update should be applied retrospectively to each period or periods in which the tax law rate change has been affected. When applied, entities would present reclassifications in the statement of shareholder equity and disclose them for the period of reclassification: the nature and reason for the change in accounting principle; description of prior-period info that is retrospectively adjusted; and the effect of the change on affected financial statement line items.

1 Temporary (or timing) differences represent the items of revenue and expense recognized for financial statement purposes as compared to the recognition for income tax purposes.

2 Treasury Regulation Section 1.162-27(c)(2)(i): a covered employee is one who, as of the last day of the year, is (a) the CEO, or (b) among the four highest-paid employees (exclusive of the CEO).

3 Per ASC 740-10-25-6: “An entity shall initially recognize the financial statement effects of a position when it is more likely than not, based on technical merits, that the position will be sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation process, if any.”

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For those in corporate accounting – especially those operating on a calendar year who have closed the books on 2017 – it is time to start thinking about how the Tax Cuts and Jobs Act (Tax Act), passed in December, will impact our employers. The drop in corporate rates, changes to the taxation of foreign operations, and elimination of the corporate alternative minimum tax have received significant media coverage. In fact, you may have started to address these changes when preparing your 2017 corporate tax provision. This article will focus on other components of the new tax law that could impact your company’s operations in 2018 and beyond.

A few of the changes could affect your employer’s human resources department and employee benefits offerings. For instance, there has been a change to transportation benefits. Previously, an employer could exclude qualified commuting expenses (parking, public transit, etc.) from employees’ wages and take a business deduction for them. The Tax Act has eliminated the employer’s deduction for such expenses, though the expenses may continue to be excluded from employees’ taxable compensation. Employers offering this pretax transportation benefit should reexamine whether it is worth continuing without the deduction from business income.

Another impact on human resources could come from the clarification of employee achievement awards and exclusions from employees’ taxable income. The Tax Act specifies cash, gift cards, vacations, meals, lodging, entertainment event tickets, and investment securities as being excluded from the definition of tangible personal property; therefore, they are ineligible for exclusion from employee compensation. If your company has historically given such items as employee awards, other tangible property may have to be substituted or payroll processes will need to be updated to capture these awards, which are now deemed taxable.

Not all revisions to employee benefits have been negative. For example, there is a new credit for paid family or medical leave. To be eligible for the credit, employers must establish a written policy that defines minimum benefits for all qualifying employees and includes certain employee protections specified in the law. Employers could be eligible for a credit of 12.5 percent to 25 percent of wages paid for a maximum of 12 weeks of paid employee family or medical leave. Companies already offering paid leave programs will want to make sure their programs are compliant with the new requirements and verify that payroll systems are capturing the data needed to compute the credit.

As unemployment continues to fall and competition for top talent increases, this change presents an opportunity to add a new employee benefit that is now subsidized by the federal government.

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Beyond employee benefits, tax reform made a significant change to business entertainment and meal expenses. Business entertainment, amusement, or recreation that was formerly 50 percent deductible is no longer deductible to any extent. Business meals that were 50 percent deductible retain that deduction, and employer-provided meals that were previously 100 percent deductible are now generally reduced to 50 percent deductible. Corporate accounting departments need to be aware of these new deductibility classifications to make sure that expenses are aggregated correctly when computing taxable income.

Business decision makers should be aware of the expansion of bonus depreciation allowances when considering asset purchases for the next several years. Full expensing of qualified capital assets is available through 2022, with a phaseout through 2026. Used property, with limited exceptions, has been added to the definition of qualified property. The timing of significant asset purchases should continue to be factored into general tax planning for businesses, and the expansion to include used property may now provide more flexibility.

The Tax Cuts and Jobs Act is complex and includes many changes that may or may not impact your organization. Now that the 2017 year-end is behind most of us, now is the time to think about how tax reform might impact your company’s employee benefits, payroll, entertainment, capital asset purchases, and other areas. CPAs in industry can lead the way by maximizing tax incentives and efficiently keeping our employers compliant with new business tax requirements.

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More taxpayers will benefit from the higher standard deduction under the Tax Cuts and Jobs Act of 2017, so it is probable that fewer people will itemize deductions. This raises the question of whether or not 501(c)(3) organizations will see contributions decrease. CPA financial planners must develop a menu of options for their clients that continue to provide tax saving benefits while also fulfilling their philanthropic goals.

If the expectation is that people who have been charitably inclined will continue to be charitably inclined, we should revisit how the intent can be fulfilled and substantiated. If a taxpayer no longer itemizes deductions, they might think they no longer need to substantiate those deductions. However, if there is a chance that they could itemize or use methods other than cash for their donations, they should continue to obtain and retain such documentation. Publication 1771, Charitable Contributions Substantiation and Disclosure Requirements, provides guidance for both the donor and charitable organization in an easy to understand format.

Even for the taxpayer who has not previously itemized and does not plan to itemize, there may be options more beneficial than opting for cash contributions. As of 2018, cash donations are limited to 60 percent of adjustment gross income, but that may not provide a benefit if the limitation is irrelevant. Other options include donating appreciated long-term securities or using part or all of a required minimum distribution from individual retirement accounts (not available from qualified plans) for those age 70½ or older, thereby saving income taxes in both cases.

In the case of using required minimum distributions, the distribution is made directly from the IRA to the charitable organization. While that amount is included in the taxable portion of the 1099-R, the preparer needs to reduce the taxable amount by the qualified charitable distribution (QCD). Hence, it is important to keep records whether the taxpayer itemizes or not and to avoid double dipping. If neither of these are options, cash gifts still serve the purpose of fulfilling one’s charitable intent. Taxpayer’s need to understand that different rules apply among the various strategies available.

The QCDs can be as little as $0 up to the required minimum distribution amount, not to exceed $100,000 per taxpayer. This is a page-one adjustment and an immediate benefit. Advisers must emphasize to nonitemizing taxpayers that taking required minimum distributions, depositing them in the bank, and then writing checks to charity is not saving them any income taxes. The result of low-
CPA financial planners must develop a menu of options for their clients that continue to provide tax saving benefits while also fulfilling their philanthropic goals.

erating their page one income could have added benefits in lowering the amount of taxable Social Security as well. For higher-income filers, the QCD may also lower Medicare’s income-related monthly adjustment amount (IRMAA) by keeping income under IRMAA thresholds.

When donating long-term holdings of securities, a taxpayer transfers the holding directly to the charitable organization without having to sell it first. The deduction for donations of long-term appreciated assets is limited to no more than 30 percent of adjusted gross income (AGI) for donations to public charities and 20 percent to private foundations. Any unused charitable contribution may be carried forward for five years until used or exhausted. Planning, therefore, may include accelerating income on the tax return to take advantage of unused charitable contributions. This would require particular attention in the next several years to avoid losing any carryforward if the standard deduction is larger than itemized deductions.

One giving strategy that has been around for some time, and often used by higher-net-worth individuals, is a donor-advised fund (DAF). Donor-advised funds could be considered by those who have not reached the age of required minimum distribution. The QCD is not allowed for DAFs. It is a viable option for those wanting to donate cash, appreciated securities, restricted stock, nonpublicly traded assets, or other assets. Some DAF providers will even accept some cryptocurrencies. Regardless, the option to place several years of giving into a DAF may produce more tax benefits than would otherwise be afforded under the new tax law.

Here’s an example: A 50-year-old taxpayer makes a donation to her church of $4,000 per year over 10 years, totaling $40,000. If she has appreciated securities in her portfolio of the same value and donates them to a DAF, she would get a deduction for the fair market value of $40,000 without realizing any gains. To deduct the full amount, she would have to have about $134,000 of income because of the 30 percent limitation, or $67,000 of income if donating the same in cash. This would bump Schedule A itemized deductions over the standard deduction threshold. Along with this, she would also have other available deductions, such as mortgage interest.

The contribution continues to stay invested and somewhat controlled by the donor. The donor recommends grants to her favorite charities that have passed the screening and due diligence review of the custodian holding the DAF. Grants may be made over time, on a predetermined schedule, or all at once at a later time to one or more charities and may be subject to minimum amounts, depending on the custodian. The fund may allow multiple donors as well as other privileges that may be extended to family members and friends wishing to be involved or encouraged to embrace philanthropy. This has been a traditional consideration in estate planning as well.

With the recent Tax Cuts and Jobs Act, the federal estate tax exemption was doubled to $11.2 million per individual, which may impact charitable giving as well. An old adage often heard was that people would rather give their money to charity than to the government. If that was the incentive, then we may see less transfers of wealth during lifetime or at death because fewer people will be subject to estate taxes.

Outside of the estate tax savings, many people may wait to fulfill their charitable giving until death so that they are sure to have adequate resources during their lifetime. When a person has retirement accounts and nonqualified accounts and chooses to benefit both charitable organizations and individuals at his or her death, how those bequests or transfers are funded should be reviewed. Giving taxable accounts to nonprofits that do not pay income taxes seems obvious, but often specific dollar amounts to charity are stated in a will while retirement accounts name individual beneficiaries. Uncovering the implications of charitable giving takes time and planning.

Advising on charitable giving under the new tax law will require additional consideration of all the options that clients have. Coordinating the giving options can continue to save taxpayers money, regardless of whether or not they itemize on their tax returns. Many taxpayers believe their tax preparation just got easier, when that may not be the case at all. Ultimately, the more taxes they save, the more they have available to fulfill their philanthropic endeavors or to meet their own cash needs, and CPA financial planners need to get this message out.

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Managing Your Firm through Tax Reform Implementation

By Carl Peterson, CPA, CGMA

When the Tax Cuts and Jobs Act reworked the tax code, it happened fast. And your clients want answers, fast. They want to know how the new law affects them now and going forward, but we don’t yet have clarity on some of the specifics or regulations to guide us.

Clients are calling about the rules for business meals and entertainment expenses, and if they can move them to marketing; they want to know what QBI is and if they should worry about it. To field these inquiries, staff needs to get up to speed, too.

Do you have the right processes in place to manage the opportunities that come from these challenges?

Firms, at a minimum, need to address the following as soon as they can:

- Education
- Prioritizing clients and their inquiries
- Internal processes
- Managing expectations

Education is one of the first priorities.

The AICPA tax reform webpage (www.aicpa.org/taxreform) is a great resource for guidance, as is PICPA’s www.picpa.org/taxreform. Tax software providers and research providers also are pushing out information on the new tax act, but that will only take a firm so far. How do you communicate the changes with your clients from a practical standpoint directly related to their industries? My firm would always go to industry-specific organizations. For example, as a niche practice in...
the real estate and construction industry, we monitored trade organizations for the homebuilding and commercial contractor industries for tax articles. Their experts provide practical implementation strategies that can help shape conversations with clients specific to that industry.

As soon as the Tax Cuts and Jobs Act passed in December 2017, clients began calling – not only your best clients, but your smaller clients, too. You had to react right away to requests for your time and expertise; perhaps you put many on hold until the end of tax season. Prioritize that client list now. Review the list, and rate your clients A, B, C, D, or F (friends and family). While you may want to terminate F-rated clients, practically it would be better to terminate your D clients. With tax reform, you may be able to then move some C clients to a higher rating. As tax season winds down, this is an opportune time to terminate clients who cause you the most stress during tax season. If you need help with this process, the AICPA Private Companies Practice Section has a great tool to guide you through rating your clients and example termination letters. With the turbulence of tax reform, you need to prioritize which clients you will reach out to first and be their trusted adviser who works through the impact of the new tax law.

There is a lack of clarity to much of tax reform, so it’s imperative that you astutely manage the process, meeting the challenges and opportunities. Not only must you prioritize your client list, but also create a new workflow project or item for each client. That workflow item could be as simple as “Tax Planning 2018.” If your firm is paperless, use a workflow process application. For those still in a paper environment, create a tax-planning lead sheet for every client. You can’t afford to miss out on this opportunity to engage the client. Build out the new workflow item and assign it to appropriate staff with reasonable completion dates. Also, include status reports on this new workflow item to weekly staff meetings.

The opportunity to deepen your client relationships as their trusted adviser starts with managing client expectations. Every year when you do tax planning, consulting, accounting, and advisory services for a client, you are managing their expectations. Major tax reform creates anxiety in clients. Assuring them that your firm has it under control will ease that anxiety. Be proactive. Communicate through your firm website or newsletters, but also through personal outreach. Schedule some time for you and your client to dive into their business, and advise them on the impact of tax reform and what they can do to move their business forward.

Managing client expectations is important, but so is managing staff expectations. Bring staff into the planning process. This will create transparency, give them a voice to improve firm processes, and set their expectations in responding to change. Staff want to contribute to firm operations. Give them an opportunity to participate in identifying education needs, client ratings, workflow processes, and client outreach. Build a team approach. Clarity of the Tax Cuts and Jobs Act may take two or three years as the IRS and U.S. Treasury roll out applicable regulations and guidance. Firms don’t have the luxury to sit back and wait. The time is now for planning and managing change to position the firm for the opportunities that come with major tax reform.

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Carl Peterson, CPA, CGMA
The Tax Cuts and Jobs Act (Tax Act) makes numerous direct changes to tax-exempt organization taxation, as well as major changes to individual and corporate taxation that will indirectly affect tax-exempt organizations. Significant disruption to the taxation landscape for tax-exempt organizations is under way.

Charitable Contributions
There have been several changes to tax law that may affect the amount of contributions available to the charitable sector in the foreseeable future. The Tax Act nearly doubles the standard deduction, therefore the number of households that are expected to itemize will decrease from about 30 percent to 5 percent. Thus, there is expected to be a decrease in charitable giving because individuals will not be itemizing and receiving a deduction on their tax returns for these contributions. According to the Council on Foundations, the potential loss is estimated to be as high as $26 billion in contributions per year. The impact may be offset by an increase in the charitable deduction limit for cash contributions from 50 percent of adjusted gross income to 60 percent.

Furthermore, the threshold for taxable estates and gifts increased from $5 million to $11.2 million, and eventually disappears as of Dec. 31, 2025. The effect of the increase in the threshold will be to lessen the incentive to donate portions of an estate to charity because more property can be transferred tax-free to beneficiaries.

Unrelated Business Income Modifications
For tax years beginning after Dec. 31, 2017 – except when there is a net operating loss (NOL) carryover from a tax year beginning before Jan. 1, 2018 – tax-exempt organizations may not use losses from one unrelated trade or business to offset income from another unrelated trade or business. Gains and losses from each unrelated business activity have to be calculated separately. The Tax Act currently does not define what is considered to be a separate activity, therefore distinguishing various activities may be difficult. An example may be that a taxable loss on an investment cannot be netted against taxable rental income. Absent further guidance from the IRS, organizations will need to use professional judgment in isolating current unrelated activities. The process may include auditing the unrelated activities to determine if all expenses and allocations are reasonably assigned to each activity (overhead allocations need to be activity specific), tracking any NOLs created before Jan. 1, 2018, and tracking segregated NOL schedules for each activity on a prospective basis.

Effective for amounts paid or incurred after Dec. 31, 2017, the Tax Act requires
tax-exempt organizations to report the costs of certain fringe benefits as unre¬lated business income (UBI) where the benefits are provided by the organization to their employees and are not included in the employees’ taxable income. The fringe benefits subject to this provision include qualified transportation (commuter highway vehicle, transit passes), parking reimbursements, and on-site gyms. Assum¬ing an employer intends to continue providing these benefits, there are two possible approaches: continue to pay the fringe benefit and report the UBI on Form 990-T, or make the benefit taxable to the employee by including it in wages on Form W-2.

Another UBI impact is the lower 21 percent corporate tax rate that will be applied to overall taxable income. The new tax law also limits the NOL deduction to 80 percent of taxable in¬come (determined by excluding the NOL deduction itself), and disallows any NOL carryback, though it does allow for indefinite carryforwards.

Excise Tax on Employee Compensation
There is a provision in the tax law that seems designed to put tax-exempt or¬ganizations on par with taxable entities when it comes to compensation in excess of $1 million for top executives. The top five highest-compensated employees of exempt organizations will now be subject to a 21 percent excise tax rate on taxable wages in excess of $1 million. Taxable wages do not include qualified plan benefits such as Section 125 benefits or amounts set aside for retirement plan contributions. Taxable wages will include nonqualified plan deferrals when vested, whether or not payments have been made.

Tax-exempt organizations that must comply include all organizations de¬termined to be exempt under Section 501(a), farmers’ cooperative organiza¬tions exempt under Section 527(b)(1), governmental entities with excludable income under Section 115(1), and politi¬cal organizations described in Section 527(c)(1). Compensation paid by related organizations must be included in the analysis of executive compensation as well. Controlling and controlled organiza¬tions, including supporting organizations, organizations under common control, and sponsoring organizations of Volun¬tary Employees’ Beneficiary Associations (VEBAs) must also take their executives’ compensation into consideration.

These highest-compensated employees, deemed “covered” employees, are evalu¬ated on an annual basis, starting with the year ending Dec. 31, 2017. Covered employees must be assessed both on an entity–by–entity basis and as part of a controlled group. Predecessor organiza¬tions must also have their execu¬tives’ compensation examined. Covered employees include each year’s top five highest-compensated employees. Once an employee meets the covered employee definition, he or she will always be labeled a covered employee, and future compensation will be taxed as such. It is entirely possible that an organization may have to pay excise tax on more than five employee’s compensation in a given year.

Payments upon separation of service, defined as “excess parachute payments” of covered employees will also bear an excise tax, based on a calculation that is three times the employees’ most recent five-year average compensation. Any amount of the present value of the payment stream that is over the calculated amount will also be subject to the 21 percent excise tax.

Excise Tax on Endowments
Another provision, which was not un¬expected by many, was the introduction of a 1.4 percent excise tax on net investment income for private colleges and universi¬ties. Educational institutions with at least 500 students must pay the excise tax if the organization’s “nonrelated” assets (those not directly used in carrying out the organ¬ization’s education purposes) are valued at the close of the preceding tax year as being at least $500,000 per full-time student. The number of students is based on the daily average of full-time students. Part-time students are counted on a full-time equivalent basis. Net investment income is determined under rules set out in Section 4940(c), which was originally designed solely for private foundations. Only those colleges and universities with truly substantial endowments, such as Ivy League schools, will be affected. This provision is expected to apply to as few as 30 colleges across the country.

Advance Refunding Bonds
Advance refunding bonds are bond issues used to pay off another outstanding bond issue, but not within the 90 day require¬ment for current refunding. For advance refunding bonds issued after Dec. 31, 2017, the interest paid to advance refund bond investors is now taxable.

Education Savings
The Tax Act expands the use of Section 529 education savings plans to include deductions for certain elementary and secondary public, private, or religious school expenses. Tuition up to $10,000 per year will be “qualified higher education expenses” for purposes of using 529 plan funds.

The application of many of these provi¬sions will require additional guidance from the Department of the Treasury and the IRS. Tax-exempt organizations should evaluate how the changes could affect their busi¬ness operations and develop a proactive plan to address the impacts.

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The Tax Cuts and Jobs Act of 2017 includes several benefits for small businesses, including farmers. The new law provides an opportunity for most farmers to increase some deductions and to have income taxed at generally lower rates. However, as a result of hastily drafted language added in the final stages of the tax legislation, there was a controversial provision that had benefited farmers who sell products to cooperatives.

Opportunities
The Tax Cuts and Jobs Act includes the following changes that should benefit most farmers:

Lower personal income tax rates – Beginning in 2018, the top income tax rate was reduced from 39.6 percent to 37 percent, and most tax brackets were broadened to allow more income to be taxed at lower rates.

100 percent bonus depreciation – Assets acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023, are eligible for 100 percent bonus depreciation. In addition, used property now qualifies for bonus depreciation. It is important to note that Pennsylvania tax law currently does not allow bonus depreciation. For individuals and pass-through entities, bonus depreciation assets are supposed to be depreciated in a straight line over the regular depreciable life of the assets. Based on a notification from the Pennsylvania Department of Revenue, there would be no Pennsylvania tax depreciation on bonus depreciation assets for regular corporations. Cost recovery will only occur when an asset is disposed. There currently is proposed legislation to fix this problem in the Pennsylvania General Assembly.

Enhanced Section 179 deductions – Beginning in 2018, the maximum allowable Section 179 deduction has been increased to $1 million, up from the 2017 inflation-adjusted amount of $510,000. In addition, the phaseout threshold for the deduction has been increased to $2.5 million from the 2017 inflation-adjusted amount of $2,030,000. For Pennsylvania individual and pass-through business purposes, the allowable Section

Tax Reform and Agribusiness: Opportunity and Controversy
By Barry D. Groebel, CPA, and Bryanna L. Fredericks, CPA
179 deduction is only $25,000 and the phaseout threshold is $200,000.

Qualified business income deduction for individuals and pass-through entities – Beginning in 2018, qualified businesses operated by individuals and pass-through entities, such as S corporations and partnerships/LLCs, may be able to claim a tax deduction that is generally equal to 20 percent of the net income from that qualified business, limited to 20 percent of taxable income for the year. This general rule is modified for individuals with taxable income over these threshold amounts – $315,000 for joint returns and $157,500 for all others – and there are further restrictions on specific service-type businesses, such as doctors, attorneys, accountants, and consultants.

For individuals above the taxable income thresholds, the qualified business income deduction is limited to the lesser of 20 percent of the net income from the qualified business or the greater of 50 percent of W-2 wages with respect to the qualified business or the sum of 25 percent of W-2 wages with respect to the qualified business plus 2.5 percent of the unadjusted basis of all qualified property (generally the cost basis of fixed assets).

The overall deduction cannot exceed taxable income less net capital gains for the year.

For a farmer with annual taxable income below the taxable income thresholds, this new rule could result in a tax deduction equal to 20 percent of net farm income. Assuming the 20 percent amount is not further limited by net taxable income (after net capital gains), this could be a decent benefit for many farmers.

The benefit is potentially less favorable for farmers with taxable income above the threshold amounts, especially for a family farm that pays little or no W-2 wages and may not have significant qualified property. Here are a few examples.

Example 1 – Farmer A is married and has net farm income on Schedule F of $300,000 and taxable income of $250,000. This is a family farm with zero W-2 wages, and there are qualified assets of $1 million. Since taxable income is below the taxable income threshold of $315,000, the wage limits do not apply. Therefore, the deduction is 20 percent of net farm income, or $60,000 ($300,000 x 0.20), limited to 20 percent of taxable income.
It appears that in most situations Section 199A will be more beneficial to most farmers than the former Section 199.

A patron of a cooperative can calculate the QBID as 20 percent of qualified cooperative dividends received from the cooperative, limited to the patrons overall taxable income reduced by net capital gains. This provision is not affected by the wage limitations for taxable income over the threshold amounts.

The controversy stems from the definition of qualified cooperative dividends, which is sufficiently broad to include all payments the patron receives from the cooperative. Therefore, unlike farmers who are not cooperative patrons and calculate their deduction as 20 percent of net farm income, farmers who are cooperative patrons get to calculate their QBID as 20 percent of gross income.

As a result, many cooperative patrons may be able to reduce their taxable farm income to zero.

For example, assume the same facts as Example 1 above, but that the farmer is a cooperative patron and has $3 million of qualified cooperative dividends. For purposes of calculating the basic general deduction of 20 percent on net farm income, the farmer would reduce the farm income by the amount of qualified cooperative dividends. Therefore, the QBID is equal to the sum of:

• The lesser of qualified business income – 20 percent of farm income of $300,000, less $3 million of qualified cooperative dividends (zero), or 20 percent of taxable income

• Plus the lesser of 20 percent of qualified cooperative dividends – 20 percent of $3 million ($600,000), or taxable income reduced by net capital gains ($250,000)

The farmer can deduct $250,000 and reduce taxable income to zero.

This beneficial result for farmers who are cooperative patrons compared with farmers who are not members of a cooperative created an uproar in the agricultural community. There has been considerable coverage, including by The Wall Street Journal, Forbes, and the Tax Foundation.

Almost everyone, including Sens. Hoeven, Thune, and Roberts, agrees there needed to be a correction. There was speculation that a fix was to be included in a recent continuing resolution to keep the government funded.

As a result of the considerable media coverage and significant lobbying efforts by agricultural trade groups, Section 199A has been modified. The Consolidated Appropriations Act passed on March 23, 2018, included provisions to eliminate the special benefit for farmers who are members of a cooperative. The law was changed to allow cooperatives to calculate, and elect to pass through to members, a DPAD amount the same as under prior IRC Section 199. While this may still be somewhat beneficial to members of cooperatives, it generally retains the same rules for cooperatives as under prior law and does remove the apparently unintended significant benefit to cooperative members.

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The Tax Cuts and Jobs Act (Tax Act) became law in December 2017, and now private companies and their investors must consider how the changes in tax law impact business valuations. Specifically, stakeholders should consider how the Tax Act impacts their projected cash flows and the inputs and assumptions that drive the estimation of enterprise value (EV).

Key changes that may impact company valuations include the following:

- A corporate tax rate of 21 percent vs. 35 percent
- Limitations on interest deductibility
- Accelerated depreciation
- Net operating loss limitations

**Corporate Tax Rate**
The reduction in the maximum corporate tax rate from 35 percent to 21 percent is driving significant changes to business valuations. Incremental free cash flows from a lower tax rate can impact operational and investment decisions. It can affect capital allocation and investment decisions to drive top-line growth. We will explore this when we discuss the income-approach valuation methodology.

The decrease in the corporate tax rate will likely affect the value of companies’ deferred tax assets (DTA) and deferred tax liabilities (DTL). A DTA is a future asset, and if it will be used in a lower-rate environment the asset is worth less. A DTL is a future tax liability, and if the tax owed is lower due to the rate in effect, then the savings has a positive impact.

**Limitations on Interest Deductibility**
Companies that historically have employed a highly leveraged capital structure may see the most significant impact from the limitations on interest deductibility. The Joint Committee on Taxation estimates that this will increase revenue by more than $253 billion over the next 10 years, which makes it the highest estimated revenue raiser among the domestic business tax reform provisions.1

Beginning Jan. 1, 2018, corporate interest expense is generally deductible up to 30 percent of a company’s adjusted taxable income (ATI) plus business interest income. The Tax Act defines ATI similar to earnings before interest, taxes, depreciation, and amortization (EBITDA) for tax years 2018 to 2021.

In 2022 and going forward, ATI will be similar to earnings before interest and taxes (EBIT). Consequently, the limitation becomes more restrictive. This is consistent with the provision’s intent to incentivize near-term capital investments.

This provision may affect decisions on the optimal future capital structure for private companies in both the short term and long term. The interest expense limited by this provision is generally allowed to be carried forward indefinitely.

**Accelerated Depreciation**
The Tax Act permits immediate 100 percent expensing of capital expenditures, with certain exceptions.2 For property
placed in service after Sept. 27, 2017, and before Jan. 1, 2023, the allowable investment generally can be expensed immediately as opposed to being depreciated over time. There is a five-year phasedown of full expensing beginning in 2023. (There is an additional year for certain qualified property with longer production periods, such as certain aircraft.)

The provision for a 100 percent deduction generally applies to new and used qualified property. The objective of this provision is to induce investment that will benefit growth and expansion strategies.

Companies that need to purchase depreciable assets in the near future may become more attractive for private equity investors. This is because accelerated deductions on investment property could result in an increase in after-tax cash flows in the year of investment.

There is a potential for considerable interplay between the new immediate expensing and new interest limitation provisions. The deductions for capital expenditures are added back into interest limitation calculations until the end of 2021. This may provide a near-term ability to maximize the deductibility of business interest expense while still using the allowance for immediate expensing. From a liquidity perspective, companies should assess their funds to properly understand their capacity for immediate capital expenditures.

Net Operating Loss Limitations
A component of EV is the present value of the net operating loss (NOL) tax benefit. The Tax Act changed the rules for NOLs in several ways:

- NOL carryback deductions are disallowed
- NOL carryforwards are carried forward indefinitely (compared with the previous limitation of 20 years)
- Any annual NOL benefit is capped at 80 percent of taxable income

The new limitations and the indefinite carryforward generally apply to NOLs arising after 2017.

Companies that have generated or acquired NOLs should consider how NOLs will be used and the impact on the present value of this benefit. The NOL benefits will be less valuable than previously due to lower tax rates.

Valuation Methodology Considerations
The two primary methods used to value private companies are the market and income approaches. Both methods, associated processes, and models need to consider the impact of the Tax Act.

Market approach – The market approach uses data from guideline public comparable companies (GPC) and guideline transactions (GT) as the basis of comparison to a company’s performance and valuation. It uses market-based multiples of relevant financial metrics from comparable company and transaction market data.

The process of selecting a range of reasonable GPC or GT multiples under the new Tax Act may result in a change in the multiples when assessing comparability of historical multiples in relation to companies’ revenue and EBITDA growth, working capital needs, and leverage models, for example. Transactions priced prior to passage of the Tax Act may not have priced in the consideration for the new law, while public company multiples are constantly changing based on fluctuations in the public markets.

Differences in the underlying leverage ratio versus the comparable data set may require an adjustment to the data to estimate EV. Investors in companies within capital-intensive industries should consider the benefits from investments needed to drive strategy and value.

Income approach (the discounted cash flow method) – The use of a discounted cash flow method requires consideration of future cash flows, terminal value at the end of the projection period, and an appropriate market-based discount rate.

The Tax Act may impact each of these components and associated models.

The projected cash flows to the company may be affected in the following ways:

- The lower tax rate of 21 percent should lead to higher free cash flows to the company.
- The immediate expensing of capital expenditures will impact the computed EBIT and total free cash flow projections because less cash will be spent on tax up front. The impact will likely be most significant through 2023, which is the prescribed sunset year for the immediate expensing provision.
- The impact on depreciation and capital expenditure projections will likely affect allocation of working capital and ultimately the free cash flows a company can generate.

Terminal period assumptions need to be considered. Target exit multiples should be aligned with the expectation of the company’s value in future years, which may be different from the prior year due to changes in business priorities resulting from the Tax Act. Any impact on trading multiples may affect the long-term growth model, often referred to as the Gordon Growth Model.

The discount rate, commonly referred to as the weighted-average cost of capital (WACC), will need to be reassessed in valuation models. The act may change the inputs to the WACC buildup in a few key ways.

WACC is a weighted-average between the cost of debt and cost of equity. Accordingly, a change in the target capital structure can have a significant impact on the WACC. The target capital structure used in the WACC may be based on the market or the company’s own capital structure.

Private and public companies with a
A high-leverage model may need to consider that some of the benefits of this model before the Tax Act may have changed after it went into effect. A market shift to a higher weighting to equity capitalization should be considered.

A component of the process to estimate the cost of equity in the WACC is the need to take public market betas, unlever the cost of capital, and relever the betas to align with the target tax-affected capital structure for the company. Changes to the tax rate and to companies’ capital structures as a result of the Tax Act will likely impact the unlevering and relevering of this input.

The cost of debt may also change for companies based on the following factors:

- The pretax cost of debt may be affected based on a company’s change in interest coverage and leverage ratios.
- The change in capital structure may affect a company’s public or implied credit rating.
- The cost of debt may be affected by the reduction in the corporate tax rate from 35 percent to 21 percent.

**Impact on Valuation Models**

The changes in corporate tax law have the potential to significantly impact established valuation models as a result of changes in business growth opportunities and companies’ operational and financing strategies. Accordingly, these changes may affect the views of venture capital and private equity investors.

A focus on methodology, process, and models can help companies and investors bring their valuations up to date and build confidence that the inputs and assumptions driving conclusions of fair value reflect a market participant’s perspective on current market valuations.

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1 See “Estimated Budget Effects of the Conference Agreement for H.R. 1” by the Joint Committee on Taxation, Dec. 18, 2017.
2 The provision includes exceptions for real estate businesses, farming businesses, and floor plan financing to acquire specified motor vehicles for inventory.

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Jolt from Tax Act Springs PICPA to Action

always challenge the PICPA team to be flexible, nimble, and open to experimentation to help us improve upon our relevance and responsiveness to members. With the passage of the Tax Cuts and Jobs Act at the end of 2017, this mind-set drove us to help members respond to this enormous change to the tax code.

The timing of the law’s passage and its quick implementation presented unique challenges to tax practitioners. Members were hard at work meeting 2017 filing deadlines while also fielding questions from clients on how the law impacts their tax situation. The Federal Tax Reform Guide presented by the Pennsylvania CPA Journal is a testament to the commitment and flexibility of the Editorial Board and your peers. It is only the first step in the long journey toward helping PICPA members navigate new tax realities.

As the tax legislation was being prepared, PICPA’s Federal Taxation Committee kept members apprised of developments through a series of blogs and podcasts. As early as January 2017, we were talking tax reform in our podcast series, CPA Conversations. The committee developed a series of CPA Now blogs that discussed the potential for tax reform in July; analyzed various proposals in November; provided a high-level summary in early January 2018.

Continuing Education

CPE offerings in the coming year will highlight many key provisions of the new law. For members who may find it difficult to travel to popular seminar locations, you will find that we have tripled our simulcast offerings this year, and there are quite a few tax updates scheduled.

As conference planning committee members met to discuss agendas, they explored the Tax Cuts and Jobs Act’s effects on their areas of expertise:

- The PICPA Not-for-Profit Conference agenda includes sessions on unrelated business income, the impact on charitable contributions, excise tax, net investment income, and fringe benefits.
- The PICPA Health Care Conference will dive into how tax cuts will affect reimbursements.
- PICPA Personal Financial Planning Conference speakers will uncover tax planning and estate planning strategies using the new playbook.
- The PICPA Pennsylvania School District Conference will look at financing options under the new tax act.
- Other fall PICPA conferences, including Financial Institutions, Multistate Tax, and Valuation & Forensic Accounting, are refining their sessions to address how federal tax law changes affect their areas of interest.

With a predicted decrease in itemized tax filers, some members will need to reshape their practices with a smaller amount of 1040 work. Tax strategy and wealth management will be growth opportunities, and the PICPA Personal Financial Planning Committee has been working on resources for those who want to explore building a PFP practice.

CPA Conversations is also an important learning tool. Here are a few of our current podcasts:

- “Analyzing Tax Reform Changes to the Pass-Through Income Deduction”
- “Tax Cuts and Jobs Act Means Big Changes for Pennsylvania Businesses”
- “Communicating with Clients about Tax Reform”

We will continue to provide more resources as strategies and regulations evolve. They will be housed in the Keep Informed section of the PICPA website. If you want to receive email updates, I encourage you to be sure that your PICPA profile reflects an interest in tax issues.

Pennsylvania Focused

The PICPA is keeping a close eye on developments at the state level, too. A big issue for Pennsylvania business owners has been bonus depreciation. The PICPA supports House Bill 2017, introduced by Rep. Frank Ryan, a PICPA member, which would restore depreciation deductions. The PICPA also supports Senate Bill 1056, which reverses the Department of Revenue Corporate Tax Bulletin 2017-02 and restores full depreciation. The PICPA developed an issue brief to share with legislators to help explain the implications the state’s position would have on businesses.

Consumer Outreach

PICPA’s CPA Image Enhancement Committee has developed resources to explain basic tax principles to consumers and small-business owners. Members wrote blogs explaining the tax law, changes in deductions, tax considerations related to choice of business entity, and a discussion on pass-through entities. The PICPA also produced a half-hour program on taxes that was aired on Pennsylvania Cable Network (PCN). We produced video snippets from the PCN program for Facebook and other video content that garnered more than 110,000 views.

Your PICPA colleagues are working hard to keep you, legislators, and consumers informed of emerging issues as we navigate the new tax law.

What aspects of the tax law do you believe merit additional PICPA attention?
Share your thoughts with Michael D. Colgan, CAE, CEO and executive director of the PICPA, at mcolgan@picpa.org.
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