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Feeling Taxed by Recent Tax Law Changes? Let Us Explain

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This is not intended to be legal advice and should not be relied upon. This is intended only as a general summary and not as specific tax advice that may be relied upon for any particular circumstances. For advice, please consult with your tax advisor.

THE TAX CUTS AND JOBS ACT OF 2017

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C Corporation Income Tax Rates Following the 2017 Act

- A flat 21% rate replaces the prior four-tier structure, which had a maximum 35% rate.
- Personal service corporations are also subject to the flat 21% rate.
- As under prior law, there is no special capital gain treatment.
- The changes are permanent.

Individual Income Tax Rates Following the 2017 Act

- ❖ The maximum rate is reduced from 39.6% to 37%.
- ❖ Other maximum individual rates remain the same as under prior law, i.e. (i) 20% on long-term capital gains; (ii) 25% on unrecaptured depreciation; (iii) 28% on collectibles; and (iv) Zero percent on sales of certain small business stock.
- ❖ The changes expire for tax years beginning after December 31, 2025.

The 3.8% Tax Following the 2017 Act

- As under prior law, the tax is imposed on net investment income, wages and self-employment income of individuals over a particular income level.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- The deduction results in a maximum effective rate for qualified business income of 29.6%, i.e., 37% minus 20% of 37%.
- The deduction applies to taxpayers other than C corporations, including owners of pass through entities, sole proprietorships, and trusts and estates.
- Qualified business income must be domestic income.

The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- Certain types of businesses are excluded, i.e., health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage, where the primary asset is the reputation or skills of one or more employees or owners, investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- Certain types of income is excluded, e.g., (i) reasonable compensation or guaranteed payments; (ii) capital gains and losses; (iii) dividends; (iv) nonbusiness interest; and (v) annuities.
- The deduction is limited to the greater of (i) 50% of W-2 wages or (ii) 25% of W-2 wages and 2.5% of the unadjusted basis of qualified property.
- The deduction is further limited to 20% of taxable income less capital gains.

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The New Deduction for 20% of Qualified Business Income Under the 2017 Act

- There are exceptions to the service business and wage and basis limitations in the case of taxpayers beneath certain income levels, i.e., (i) joint returns with taxable income of $315,000 or less; (ii) generally taxable income of $157,500 or less; and (iii) phase outs up to $415,000 or $207,500.
- The 20% deduction expires for tax years beginning after December 31, 2025.

Some Practical Tips for Business Owners Following the 2017 Act

- Partnerships are still often the preferred entity for taking losses due to liberal basis rules.
- Make sure rental real estate is a business and not merely an investment to qualify for the 20% deduction.
- Partnerships are still often the preferred entity for holding real estate or other tangible assets likely to appreciate substantially in value due to liberal loss rules, tax-free distributions, and 754 elections.

Some Practical Tips for Business Owners Following the 2017 Act

- ❖ If the 20% deduction will be available and the entity will likely distribute earnings currently, a pass through entity will likely be preferred over a C corporation.
- ❖ If the 20% deduction will not be available and the entity will likely distribute earnings currently, the rate differential alone will often not afford a basis for choice of entity.

Some Practical Tips for Business Owners Following the 2017 Act

- ❖ In the case of any entity that will accumulate profits for reinvestment in the business, a C corporation is often the superior choice.

Some Practical Tips for Business Owners Following the 2017 Act

- Pass through treatment will often be desirable in the case of an entity that views an asset sale as its exit strategy because this may avoid a double tax, afford capital gain treatment, and provide buyer a basis step-up.
- If a sale of equity is the contemplated exit strategy and Code Section 1202 treatment might apply to provide a zero percent tax, a C corporation could be the preferred choice of entity.

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Some Practical Tips for Business Owners Following the 2017 Act

- Be careful about converting to C corporation status because the 21% rate could be increased and there could be adverse tax consequences in going back to pass through status.
- Be careful not to incur a tax in converting a C corporation to a pass through for the 20% deduction because it will expire after 2025 or could be repealed earlier.
- Always remember, each case is a facts and circumstances analysis.

SOUTH DAKOTA V. WAYFAIR

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Nexus

- **Nexus:** Generally, the threshold of contact that must exist between a taxpayer and a state before the state has jurisdiction to tax the taxpayer.
- Before the decision in *Wayfair*, a state could compel an out-of-state seller to collect sales tax if the seller had a "physical presence" in the state.
- The physical presence standard has its history in the U.S. Supreme Court's interpretation of the U.S. Constitution in *National Bellas Hess, Inc.* and *Quill.*

South Dakota Senate Bill 106

- Effective May 1, 2016
- Economic nexus law that requires an out-of-state seller to collect and remit South Dakota sales and use tax if the seller:
  - Has gross revenue from sales in South Dakota exceeding $100,000; or
  - Engages in 200 or more separate transactions within the state.

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South Dakota Senate Bill 106

- Aimed at bringing the principles of *Quill* and *Bellas Hess* before the Supreme Court.
- "Given the urgent need for the Supreme Court of the United States to reconsider this doctrine, it is necessary for this state to pass this law clarifying its immediate intent to require collection of sales taxes by remote sellers, and permitting the most expeditious possible review of the constitutionality of this law." S.B. 106, Section 8(8).

South Dakota Senate Bill 106

- S.B. 106 contained a provision allowing a fast-track appeals process.
- Circuit Court entered summary judgment for Wayfair.
- Upon direct appeal to the South Dakota Supreme Court, S.B. 106 was held unconstitutional.
- U.S. Supreme Court accepted review on January 12, 2018, and heard oral arguments in April 2018.

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South Dakota v. Wayfair

- U.S. Supreme Court decided *South Dakota v. Wayfair Inc.*, 138 S.Ct. 2080 (2018) on June 21, 2018.
- 5-4 decision
- Narrow decision:
  - *Quill* and *Bellas Hess* overruled
  - Physical presence test is incorrect
  - Did not declare South Dakota's law valid

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South Dakota v. Wayfair: Factors

- Remote sellers have a competitive advantage
- Consumers have low rate of compliance with use tax laws
- Disincentive for businesses to have a physical presence in multiple states
- Present realities of the interstate marketplace

South Dakota v. Wayfair: S.B. 106

- Justice Kennedy did suggest S.B. 106 would be upheld because of three specific aspects of the law:
  - A "reasonable degree of protection" is afforded to small sellers due to its numeric thresholds (> $100,000 in sales <u>or</u> 200+ transactions);
  - Law prohibits retroactive collection; and
  - South Dakota is part of the Streamlined Sales and Use Tax Agreement (SSUTA).

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Post-*Wayfair*: S.B. 106

- U.S. Supreme Court remanded the case back to the Supreme Court of South Dakota.
- Supreme Court of South Dakota reversed Wayfair's motion for summary judgment and remanded the case back to the Circuit Court.
- Settlement: The settlement lifts the injunction that prohibited South Dakota from imposing sales tax collection obligations on the defendants. The three online retailers will start collecting the state's tax on Jan. 1, 2019.

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Post-*Wayfair*: State Action

- 31 states, including South Dakota, have dollar and/or transaction economic sales tax nexus laws pending or enacted:
  - AL, CO, CT, HI, IA, IL, IN, KY, LA, MA, MD, ME, MI, MN, MS, NC, ND, NE, NJ, NV, NY, OH, SC, SD, TN, UT, VT, WA, WI, WV, WY
- 4 states have elective regimes where remote sellers choose to either collect and remit sales tax or satisfy reporting and notification requirements:
  - GA, OK, PA, RI
- 15 states and the District of Columbia have no dollar or transaction economic nexus threshold:
  - AK, AR, AZ, CA, DC, DE, FL, ID, KS, MO, MT, NH, NM, OR, TX, VA

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Questions after *Wayfair*

- Will a state's sales tax nexus be enforceable?
- When do retailers have to start collecting sales tax?
- How long will retailers have to collect sales tax in a jurisdiction once it meets the threshold?
- What happens if a state does not provide software?

Impact of *Wayfair:* Next Steps

- ❖ Analyze sales footprint by conducting nexus studies
- ❖ Analyze economic nexus requirements in the states where footprint exists
- ❖ Determine types of products (or services) being sold into the states
- ❖ Put in place procedures for collecting resale or exemption certificates
- ❖ Monitor the laws of the states
- ❖ Be prepared to register and file in new states

PARTNERSHIP AUDIT RULES

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Partnership Audit Rules

- Effective for returns for tax years beginning on or after January 1, 2018.
- Necessitate consideration by all partnerships and LLCs taxed as partnerships of amending their partnership agreement or operating agreement.

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Partnership Audit Rules

- Audit adjustments, court proceedings, assessments and collection of tax deficiencies arising from partnership items will take place at the partnership level.
- Each partnership will need to appoint a partnership representative.
- As between the IRS and the partnership and its partners, the partnership representative will have broad authority to act on behalf of the partnership and partners.

Partnership Audit Rules

- Partnerships will be permitted to elect out of these provisions on a year-by-year basis if certain conditions are met. The conditions are generally:
  - There must be 100 or fewer partners; and
  - Each partner must be an individual or a corporation.

Partnership Audit Rules

- As an alternative to electing out, a partnership might be able to escape liability for these taxes in several possible ways, including:
  - The partners amending their individual returns for the year under audit and paying the taxes;
  - The partnership electing to push the tax liability out to the partners at the cost of an additional 2 percent interest charge; or
  - The partners agreeing to indemnify the partnership for an agreed-upon share of any tax liability.

Questions?