Kennerly, Montgomery & Finley, P.C.

KM Newsletter

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SPECIAL TAX REFORM EDITION:

Tax Reform and Plan Loans

By Ashley N. Trotto, Esq.

On December 22, 2017, President Trump signed into law H.R. 1, a congressional revenue act originally introduced in Congress as the Tax Cuts and Jobs Act ("TCJA"). The TCJA makes various changes to the rules governing retirement plans, including an important change to plan loan administration.

The change applies specifically to qualified plans (e.g., 401(k) plans), 403(b) plans, and governmental 457(b) plans.

Generally, upon separation from an employer's service, a participant's plan loan obligation is accelerated. If the loan is not timely repaid, the participant's account balance will be offset by the amount of the unpaid loan. That offset is treated as a plan distribution, which triggers taxation of the amount (and if the participant is under age 59 ½, a 10% early withdrawal penalty).

Under prior law, the offset amount could instead be treated as a non-taxable direct rollover if, within 60 days, the participant pays an amount equal to the loan offset to an Individual Retirement Account ("IRA") or other eligible retirement plan.

For loan offset amounts treated as distributed on or after January 1, 2018, the TCJA extends the 60-day rollover period to the due date, including extensions, for filing the participant's federal income tax return for the year of the offset.

However, this extension only applies to plan loan offsets arising from a participant's failure to repay a loan due to separation from service or plan termination.

Practically speaking, the extension gives participants a little extra time to come up with the funds necessary to make the required contribution following termination of employment to avoid taxation and to keep retirement plan funds intact.

Updates to loan documentation (e.g., Plan document, loan policy, SPD) and other participant loan communication pieces may be required and/or recommended to account for this change.

Ashley N. Trotto practices in the areas of ERISA law, pension and health and welfare plans, and employment law. Ms. Trotto assists private, governmental, and nonprofit clients in the design, implementation, and maintenance of their employee benefit plans and also helps those clients navigate the complicated landscape of the FLSA, HIPAA, COBRA, FMLA, ADA, and other employment-related legislation. If you have any questions about plan loan administration, please feel free to call me at 865-546-7311 or send me an email at atrotto@kmfpc.com.

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Overview of the New Tax Deduction for Pass-Through Business Owners

By Michael R. Crowder, Esq.

Major tax reform was approved by Congress in the Tax Cuts and Jobs Act on December 22, 2017. One of the significant changes in the Tax Cuts and Jobs Act is the addition of Section 199A to the tax code. On its face, Section 199A allows owners of pass-through entities (such as sole proprietorships, partnerships, S corporations, and LLCs) to take a deduction on their personal income tax returns of an amount equal to 20% of their income from the business.

More specifically, Section 199A provides, in part, that a taxpayer (other than a corporation) shall be allowed as a deduction for any taxable year an amount equal to 20% of the taxpayer's "qualified business income" or "QBI". "QBI" is defined as the net ordinary income that a taxpayer earns from a pass-through entity. QBI does not include any wages earned as an employee, short or long-term capital gains or losses, dividend income, interest income, guaranteed payments, or reasonable compensation. QBI must also be earned with respect to a "qualified trade or business".[1]

There are limitations to the 20% QBI deduction. For instance, the taxpayer is only allowed to deduct 20% of QBI up to a limit. That limit is the greater of (1) 50% of the taxpayer's allocable share of the "W-2 wages" paid by the business or (2) 25% of the taxpayer's allocable share of the "W-2 wages" paid by the business plus 2.5% of the taxpayer's allocable share of the "unadjusted basis" immediately after acquisition of all "qualified property". This limitation was seemingly put in place to prevent abuses where taxpayers might forgo being employees to instead become owners of pass-through entities that operate as independent contractors purely for the sake of receiving a 20% deduction on their income. The second part of this limitation is a special carve-out that allows owners of certain businesses that historically do not pay W-2 wages (like businesses with large rental holdings) a deduction they otherwise wouldn't have gotten because of the first part.

Additionally, owners of specific businesses, like businesses involving the performance of services in health, law, engineering, architecture, accounting, and brokerage services, are not allowed to take the 20% QBI deduction.

However, the above two limitations do not apply if the taxpayer's taxable income is less than a certain amount – currently $315,000, phased in up to $415,000, if married, and $147,500, phased in up to $157,500, otherwise.

As a final limitation, the taxpayer's 20% deduction is limited to 20% of the excess of the taxpayer's taxable income minus the sum of any net capital gain, regardless of the amount of the taxpayer's taxable income. This limitation prevents the deduction from applying to income taxed at the more favorable capital gains rates.

In sum, while the new Section 199A is complicated, it can provide a substantial tax benefit for certain owners of pass-through entities, with the right planning.

Michael Crowder works primarily in the firm's estate planning, and business & corporate law practices. If you have any questions or concerns about entity formation, tax planning, or estate planning, please contact Michael R. Crowder at (865)-546-7311 or email mcrowder@kmfpc.com.

[1] It is unclear whether "trade or business" as used in Section 199A means "Section 162 trade or business." This term will hopefully be further defined by the IRS in the near future.

Impact of the Tax Cut and Jobs Act on Nonprofits and Tax-Exempt Entities

By Brittany Brent Smith, Esq.

Much has been written about the effect of the Tax Cut and Jobs Act (the "Jobs Act") on for-profit partnerships and corporations and other small businesses, but how, if it all, are nonprofit and tax-exempt entities affected by the new law?

Perhaps surprisingly, the Jobs Act has the potential to impact nonprofit and tax-exempt entities in a number of areas:

- Executive compensation: The Jobs Act may impose an excise tax on the compensation of the highest compensated nonprofit employees. Nonprofits that pay these employees compensation over $1,000,000 will be liable for an excise tax of 21% of the amount above the $1,000,000 threshold.

- Charitable giving: The federal tax code will continue to allow an itemized deduction for charitable contributions, but because of other changes in the tax law, fewer people are likely to itemize. Some worry that if fewer people are able to itemize their deductions and therefore receive less of a direct tax benefit from charitable giving, fewer people will make charitable contributions.

- UBIT: Prior to the Jobs Act, all income was applied to all expenses in calculating unrelated business income tax (UBIT). Under the Jobs Act, each line of business will report its own income and expenses, and calculate the taxable amount for each business line.

- Nonprofit college and university endowments: The Jobs Act creates a new 1.4% excise tax on net investment income of nonprofit colleges and universities with assets of at least $500,000 per full-time student and more than 500 full-time students.

- Payment for employees' on-site gym membership, parking, and/or commuting expenses: The Jobs Act imposes a UBIT penalty of 21% on the amount tax-exempt employers pay for employees' on-site gym membership and commuting/parking expenses.

- College athletic events: Under the Jobs Act, donors are no longer entitled to deduct payments made to a college or college athletic department in exchange for college athletic event tickets or seating rights at a stadium.

This short list, while not exhaustive, illustrates that nonprofits and tax-exempt entities must also consider the effect the Jobs Act might have on their operations.

Brittany Brent Smith assists business and corporate clients with a range of business planning and operations services, including establishing, organizing, and maintaining their entities. For more information on nonprofit governance, please call Brittany Brent Smith at 865-546-7311 or email bsmith@kmfpc.com.

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Kennerly Montgomery Welcomes Attorney Marshall Peterson

The Attorneys of Kennerly, Montgomery & Finley, P.C. are pleased to announce the addition of Marshall H. Peterson as Of Counsel effective March 1, 2018. His practice concentrates in Estate Planning and Administration, Business Planning, Charitable Giving, and Litigation. The following are his thoughts on law, and being a lawyer with Kennerly, Montgomery & Finley.

This royal throne of kings, this sceptered isle, this earth of majesty, this seat of Mars. . .

Shakespeare: Richard II

In 13th Century England, property owners wanted to transfer their property to their heirs with as little cost and hassle as possible. One problem was that the Crown imposed a tax as property passed from one generation to another. A strategy developed whereby the landowner would transfer his (it was always "he" in that era) land, usually to a monastery, with an agreement that the transferring owner and his heirs after him, had perpetual use of the land. There was never a transfer of the land itself, so the tax was avoided. This technique was known as a "Use." Finally, in the 16th Century, Henry VIII, by means of the Statute of Uses, sought to put an end to this drainage of the royal revenues. The Use is the antecedent of what we call a "Trust." Just like our medieval cousins at the bar, modern trust and estate lawyers utilize trusts, and a multitude of planning techniques to lessen the burdens of property transfers across generations. Incidentally, Wills were not authorized until 1540 by the Statute of Wills, enacted due to outrage at the restrictions placed on Uses.

The historical background of the law, and how it forms the underpinnings of civil society, is much of why I am fascinated by, and devoted to law practice and the obligation it imposes to zealously represent clients.

I am proud to be a lawyer, and like all the lawyers in this firm, we advocate for our clients to achieve optimal outcomes when possible. Trusts and estates, and its allied areas such as business planning, and charitable giving strategies have been my area of practice since 1987. As counselors, we work with clients so their heritage and legacy can be transferred across generations.

I am privileged to practice with Kennerly, Montgomery & Finley, a firm with a proud heritage, and a legacy that with our continued pursuit of excellence will endure.

For more information about trusts and estates, business planning, and charitable giving please contact Marshall Peterson at 865-546-7311 or email mpeterson@kmfpc.com.

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