The Tax Route

financial information for the long haul

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Trump Administration Tax Reform Update

The president recently announced his tax reform plan. What could it mean for you?

On April 26, President Donald Trump announced his tax reform plan. The plan largely resembles the president's campaign proposals and the summary we provided in December. Below are the highlights from the updated proposal.

Business

- 15% corporate tax rate rather than the current 35%.
- Election for 15% tax rate on passthrough business income regardless of size.
  - Large passthroughs may be subjected to a second level of tax on distributions to owners if the 15% rate is elected.
- Research credit would be retained; however, all other business tax credits would be repealed including the Domestic Production Activities Deduction (DPAD).
- Repeal the Alternative Minimum Tax (AMT).
- U.S. manufacturing firms may elect to deduct the full cost of capital investments in the year placed in service. However, businesses that elect to deduct the full cost of capital improvements will be unable to deduct their net interest expense related to the capital improvements.
  - Congress has proposed deducting the full cost of both tangible and intangible assets, except for land, in the year placed in service.

Individuals

- Three proposed tax brackets of 10%, 25%, and 35%.
- Repeal of the 0.9% Medicare Hospital Insurance Tax.
- Repeal of the 3.8% Net Investment Income Tax.
- Capital gain maximum rate of 20% with lower rates for individuals not in top brackets.
- Repeal the Alternative Minimum Tax (AMT).
- Eliminate all itemized deductions with the exception of mortgage interest and the charitable contribution deduction.
- Increase the standard deduction to $30,000 for joint filers and $15,000 for single filers with personal exemptions and the head-of-household status eliminated.
- Creation of pre-taxed dependent care savings accounts to be used for child care and/or elder care expenses.
- Elimination of the federal estate tax.

The President's plan is roughly aligned with the House GOP's plan and both parties view tax reform as a way to stimulate the economy. As always, we will keep you updated throughout 2017 on major tax reform that may impact your business or personal tax situations. ■

Health Care Cost Savings

Should you look at alternatives to standard medical insurance plans?

If rising health care costs have sent your company searching for ways to reduce expenses, you should know there are alternatives to standard medical insurance plans. Your choices are not limited to either paying the higher costs yourself or transferring the burden to your employees. Tax-advantaged strategies are available which can mitigate the effect of rising costs for you and your staff members. Here are three ideas to consider.

1. Establish a Health Insurance Premium-Only Plan (POP)

This super simple option is often a good choice for small employers. With a POP, your employees are charged via payroll withholding for their share of health premiums. These withholdings are considered salary reductions for federal income tax, Social Security tax, and Medicare tax purposes. In other words, the POP allows your employees to pay their share of health insurance premiums with pretax dollars, which can save them a substantial amount of taxes over the course of a year.

At the same time, your company's taxes are also reduced. Reason: the salary reduction amounts are exempt from the employer's share of Social Security tax and Medicare tax. For 2017, the employer's share of these taxes is 7.65% of the first $127,200 of each employee's salary, including bonuses, plus 1.45% of compensation above $127,200 (up from $118,500 for 2016). Individuals with earned income above $200,000 or married couples with earned income above $250,000 must also pay an additional 0.9% in Medicare tax (no limit).

Because a POP is considered a "cafeteria benefit plan," it's governed by Section 125 of the Internal Revenue Code. This means your business will need to install a written plan and employee enrollment procedures when setting up the program. The POP cannot discriminate in favor of highly compensated employees or key employees. Despite these restrictions, it's generally easy and inexpensive to establish a POP with professional help.

Basic cost-reduction strategy: First, shift a higher percentage of premiums for employee health coverage to your employees. This reduces your company's costs. Then set up a POP to give your employees an offsetting benefit in the form of reduced income tax, Social Security tax, and Medicare tax. The same strategy also cuts the company's tab for Social Security and Medicare taxes.

2. Set Up a Flexible Spending Account Plan

How much can you save? For every employee who diverts $1,000 to a Premium Only Plan or a Flexible Spending Account, your payroll tax costs will generally be reduced by $76.50 (or 7.65% of the actual amount). The more employees who participate in these plans, the higher your potential savings.

This is apart from the tax savings collected by your employees, which are even greater because they save Social Security and Medicare tax, as well as income tax.

"Use it or Lose It" Rule Can Be Relaxed. In a welcome move for employers and employees, the IRS relaxed the rules involved in tax-saving flexible spending accounts. Employees may be able to get an extra 2 1/2 months after year-end to spend the money set aside in their accounts before they lose it. *(IRS Notice 2005-42)*

In order to take advantage of the grace period, however, employers must amend FSA plans by December 31 to permit the extra 2 1/2 months --

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Succession Planning: ESOP Overview

Have you considered an ESOP for your succession plan?

When family business owners sell C corporation stock for a big profit, they usually qualify for the current 20 percent maximum federal rate on long-term capital gains (assuming they've owned the shares for over a year). While a 20 percent rate is good, a tax-free sale to an ESOP could be even better.

Current rules: The maximum federal income tax rate on C corporation dividends is now 20 percent for single people with taxable income above $400,000 ($450,000 for married jointfiling couples). Upper-income individuals may also owe the new 3.8 percent Medicare surtax on dividend income. For other taxpayers with lower incomes, the tax rate on dividends is 15 percent.

Under these rules, ESOPs remain an attractive option.

An ESOP is a type of qualified employee retirement plan that companies can establish for their staff members. Unlike other kinds of qualified plans, an ESOP is intended to invest primarily in stock of the sponsoring employer (the corporation that established the plan). A newly-formed ESOP can borrow money from the corporation or from a commercial lender (or both) and use the resulting cash to buy some or all of the owner's shares. Under the tax rules, however, a newly formed plan must own at least 30 percent of the company stock.

After the ESOP acquires its shares, the corporation makes annual deductible contributions to the plan. Eventually, those contributions retire the ESOP's loan, at which point the plan owns the purchased shares free and clear. As the corporation's employees become vested in their accounts, shares are allocated to those accounts. Eventually, the employees become indirect stockholders through the ESOP.

ESOP Facts

History: The idea for employee stock ownership plans was conceived in the 1950s by Louis Kelso, a lawyer and investment banker. He believed businesses would be stronger if all employees had an ownership share.

Tax benefits: It wasn't until 1974 that the Employee Retirement Income Security Act (ERISA) wrote ESOPs into the Internal Revenue Code for the first time.

Number of plans: Early in 2008, there were more than 13,000 ESOPs and similar plans (stock bonus plans) covering more than 22 million participants nationwide. They are set up at both publicly traded and closely held companies.

As mentioned earlier, the corporation's contributions to the ESOP are used to pay both the principal and interest on the plan loan that was used to buy the business owner's stock. Since the contributions are deductible, the company effectively deducts both the principal and interest, which is a unique tax advantage. Even better, the business owner can elect to defer the federal income tax bill on the profit from selling shares to the ESOP. To do this, however, the owner must reinvest the stock sale proceeds in "qualified replacement securities" which can include publicly traded stocks and bonds.

The deferred gain reduces the tax basis of the replacement securities. The deferred gain isn't triggered until the owner finally sells the replacement securities. If the owner dies while still owning the replacement securities, the tax basis is stepped up to fair market value on the date of death (assuming the current basis step-up rule in the tax code remains in force). So the

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Catch Dangerous Traps

Watch out for traps in employee handbooks.

Could your employee handbook be dangerous? Have you ever looked through it, pretending to be an employee? Better yet, have you ever had your attorney read through your handbook to see how an employee might be able to use it in court?

This type of auditing can help spot potential time bombs... time bombs that employees could use against you.

Here are examples of what might be found - statements that might seem innocent but could turn into costly lawsuits.

In a company's definition of a "full-time employee," a handbook states:

"After completing a three-month probationary period, you then become a full-time permanent employee."

Why is this statement dangerous? You promised full-time employees permanent employment after they complete the first three months. Did you mean to promise an employment relationship that you could never terminate? A court could tell you permanent means permanent.

In a maternity leave policy, a handbook says:

"Pregnant employees are to notify management as soon as possible once they find out they are pregnant. Upon entering the seventh month of pregnancy, employees are required to begin a medical leave of absence."

Why is this policy dangerous? This is a loaded statement that pregnant employees could use to charge your company with discrimination. Under federal and most state laws, you must treat pregnant employees exactly as you treat other employees who are temporarily disabled. It must be voluntary for a pregnant employee to inform the company of her pregnancy and the need for a leave of absence.

An employee handbook has a statement on wages that reads:

"Discussion of wages among employees is prohibited. Any employee who violates this policy will be terminated."

Why is this statement dangerous? Because it violates the National Labor Relations Act, which gives employees the right to talk about working conditions, including wages. If the National Labor Relations Board finds you in violation of this law, your business can be heavily fined.

A policy in an employee handbook includes definitions of types of employees, with wording like this:

"Regular employees are paid on an hourly basis. Salaried employees are paid on a salary basis and are not eligible for overtime pay."

Why is this policy dangerous? Because paying an employee a salary doesn't automatically make the employee exempt from qualifying for overtime pay. Federal and state rules govern which employees are exempt from overtime pay and determine whether or not an employee qualifies for exemption. Simply paying an employee a salary or by the hour isn't the legal test. ■

Health Care Cost Savings Continued...

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through March 15 of the following year (assuming the plan operates on a calendaryear basis, which is usually the case). Employees can use unspent year-end balances to reimburse themselves for qualified expenses incurred within the grace period.

Another Welcome Modification: Setting up and operating a Flexible Spending Account (FSA) is more complicated than the POP option. Therefore, these plans are probably best suited to businesses with a larger number of employees.

Here's how FSAs work: Your company sets up a health care flexible spending account for each participating employee. Then, the employee makes an annual election to contribute a specified dollar amount of his or her salary to the FSA and these contributions are withheld from the employee's paychecks. To be reimbursed, the employee submits a claim for his or her share of health insurance premiums and uninsured medical expenses (up to the annual amount contributed to the FSA). The reimbursements are tax-free to the employee.

Employee FSA contributions are considered salary reductions, which means they are exempt from federal income tax, Social Security tax, and Medicare tax. So they allow your employees to pay out-of-pocket medical expenses (including their share of health premiums) with pretax dollars. Your company's taxes are also reduced, because the salary reduction amounts are exempt from the employer's share of Social Security and Medicare taxes.

Beginning back in 2013, there is another change designed to prevent or limit forfeiture of contributions. For employers who amend their plans, accountholders are permitted to keep up to $500 of unused funds in their accounts at the end of the plan year. The employer may choose to set a lower carryover amount.

This carryover of up to $500 does not affect the maximum contributions which can be made in the following plan year. For example, if an accountholder ends the year with $350 in his FSA plan, he can still contribute up to $2,600 (depending on the maximum the plan allows) in the following year. (The maximum in 2016 was $2,550.) Note: This carryover provision is only allowable if the employer amends the plan and if the employer does not also allow a grace period.

Essential to understand: The use-it-or-lose-it rule still exists, but the grace period greatly softens the blow by allowing employees more time to use their unspent FSA balances.

Like POPs, FSA plans are considered "cafeteria benefit plans" under Section 125 of the Internal Revenue Code. Therefore, your business will need to install a written plan and employee enrollment procedures. The plan cannot discriminate in favor of highly compensated employees or key employees. An FSA plan also requires significant administrative effort to enroll employees, handle the necessary payroll withholding, and process reimbursement claims. Many companies find it cost-effective to hire a third-party plan administrator to take care of all the details.

Finally, many companies place an annual lid on the amount an employee can contribute to the health care FSA. This is important, because employees can request reimbursement for expenses up to their annual contribution long before the contributions have actually been collected through the payroll withholding. Under the Patient Protection and Affordable Care Act (PPACA), the limit is $2,550 for 2016 (unchanged from 2015). This limit will be adjusted for inflation in subsequent years.

Basic cost-reduction strategy: First, shift a higher percentage of employee health premiums to your employees, or increase the insurance plan deductibles. Or take both actions. Your company's costs will be reduced. Then, set up an FSA plan to give your employees an offsetting benefit in the form of reduced income, Social Security, and Medicare taxes. The FSA also cuts the company's Social Security and Medicare tax bills.

3. Install a Health Reimbursement Arrangement (HRA)

The option to set up an HRA can be attractive to larger employers. Here's how it works: Every year, the company agrees to contribute a fixed amount to each eligible employee's account. Employee contributions are not allowed. The company deducts the HRA pay-ins. However, the contributions are tax-free to employees (no federal income tax, Social Security tax, or Medicare tax). Your employees can then submit claims to be reimbursed for uninsured medical expenses, including their share of health insurance premiums, if applicable. Reimbursements are tax-free. In effect, the employee is able to pay for out-of-pocket medical expenses with pretax dollars, up to the amount contributed to the employee's HRA account.

Since your company must pay for all HRA contributions, this arrangement only saves money when it's combined with a much-less-generous employee health insurance program. The idea is that your company's health insurance costs will be drastically reduced, which allows you to return some of the cost savings to employees in the form of HRA contributions.

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Health Care Cost Savings Continued...

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Basic cost-reduction strategy: First, switch your health insurance plan to one which greatly reduces your company's premium costs, which of course, means it provides less benefits to employees. Then, return a portion of the savings to employees via the tax-favored HRA arrangement.

Conclusion

Finally, note that employers will face a wide array of responsibilities and requirements under the PPACA. Your employee benefits adviser can help you explore the options available to your business. ■

Succession Planning: ESOP Overview Continued...

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deferred gain simply disappears. The business owner's heirs can then sell the replacement securities and owe little or nothing in capital gains taxes.

Conclusion

In essence, the ESOP stock sale strategy allows qualified family business owners to trade their relatively illiquid company stock for ultra-liquid publicly traded investment securities while postponing or maybe even eliminating the federal income tax bill. Of course, there are a bunch of tax-law hurdles to clear in order to get such great results. These are complicated issues that will probably require professional guidance. ■

State Tax Alerts

PENNSYLVANIA. The state of Pennsylvania's tax amnesty program launched on April 21, 2017. The program will run through June 19, 2017. The 2017 tax amnesty program applies to all taxes administered by the Department that are delinquent as of December 31, 2015, whether known or unknown to the Department. Tax liabilities due after December 31, 2015 are not eligible to be included. Under the program, amnesty will be granted for eligible taxes to taxpayers, and potentially permits 100% waiver of the underlying penalties and 50% waiver of the underlying interest.

TENNESSEE. The Tennessee Department of Revenue now allows taxpayers to annualize their excise tax payments. This is consistent with the federal treatment of estimated taxes.

VIRGINIA. A new law requires the Virginia Department of Taxation to administer a tax amnesty program during the 2017-2018 fiscal year for at least 60 days, but no more than 75 days. The program will generally be open to any taxpayer that is required but has failed to file a return or pay any tax administered by the Department. MHC&S will follow up with additional details once is established. ■

Our Trucking Team

Dan Schwarz, CPA/ABV

Co-Managing Partner

Dan earned as Associate of Applied Science degree from Hawkeye Institute of Technology. In 1990, he joined McGowen, Hurst, Clark & Smith, P.C., and began work in the Business Advisory and Tax Services Division. Dan's area of expertise includes transportation, business valuation, family-held businesses and corporate finance. He has conducted presentations on valuation of closely-held business, business transition and corporate governance.

Dan is an Accredited Business Valuator (ABV). He is a member of the American Institute of Certified Public Accountants and the Iowa Society of Certified Public Accountants. He is a board member of the Iowa Motor Truck Association Allied Division.

Nick Finkenauer, CPA

Senior Manager

Nick graduated from University of Northern Iowa with a Bachelor of Arts degree in Accounting and joined McGowen, Hurst, Clark & Smith, P.C., in 2012. Prior to joining MHC&S in 2012, Nick worked for a Big 4 firm and specialized with closely held companies and state and local taxes. Nick's area of expertise includes corporate and individual taxation, multi-state tax issues and business consulting, providing clients with top quality service to help them reduce their tax liability and achieve their business and personal goals.

Nick is a member of the American Institute of Certified Public Accountants, CPAmerica International, and the Iowa Society of Certified Public Accountants, where he has served on the Taxation Committee. Nick is a past graduate of the West Des Moines Leadership Academy and IMTA Leadership Academy. Nick is also the treasurer of Morsel Combat, a non-profit organization that benefits Meals from the Heartland.

Ashley Sly, CPA

Supervisor

Ashley is a 2009 graduate of Buena Vista University with Bachelor of Arts degrees in both Accounting and Finance. Prior to joining McGowen, Hurst, Clark & Smith, P.C., in 2013, she had three years of experience at a national accounting firm and one year at a large law firm. Ashley is experienced in tax, providing expertise for small to mid-size businesses, especially those with a multi-state presence and in the industries of transportation, manufacturing and distribution.

Ashley is a member of the American Institute of Certified Public Accountants, CPAmerica International, and the Iowa Society of Certified Public Accountants, where she currently chairs the young professionals committee, LEAP.

In addition, Ashley is the current treasurer of the West Des Moines' Library Friends Foundation and a past graduate of the West Des Moines Leadership Academy. Outside of work, she enjoys spending time with her husband and young son.

About McGowen, Hurst, Clark & Smith, P.C.

With offices in West Des Moines and Winterset, McGowen, Hurst, Clark & Smith, P.C. is one of the oldest and largest local firms in Central Iowa. Founded in 1946, we celebrate over 70 years of providing our clients with accounting, auditing and business consulting expertise.

McGowen, Hurst, Clark & Smith is proud to be a member of CPAmerica International, an exclusive association of leading independent accounting firms. CPAmerica offers a wide pool of additional technical expertise to its member firms, allowing us to offer you big firm opportunity with a small firm feel.

Mission: Providing outstanding, professional services while acting as proactive business partners with our clients. Providing a work environment that enables our firm members to achieve their personal and professional goals.

Values: Integrity. Excellence. Respect. Teamwork. Family. Fun.

In Trucking Territory this Quarter...

On Thursday, May 25, **Dan Schwarz**, **Nick Finkenauer** and **Ashley Sly** will be attending the Truck PAC Iowa Spring Golf Outing hosted by the Iowa Motor Truck Association. This outing is the largest fundraiser the IMTA holds for its Political Action Committee. McGowen, Hurst, Clark & Smith is a proud supporter of the IMTA and sponsor of the Truck PAC Spring Golf Outing. We'll see you there!

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