GABLE GOTWALS COUNSEL

Federal Tax Client Alert

Tax Cuts and Jobs Act: Business Tax Reform Changes

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This summary describes some of the business tax reform changes in federal income tax law made by H. R. 1, generally referred to as the Tax Cuts and Jobs Act ("Act") passed by Congress and then signed into law by the President of December 22, 2017.

Tax Cuts and Jobs Act - Business Tax Reform Overview

Tax Cuts and Jobs Act - Key Business Changes

In general, the Act was introduced and enacted to change the federal income tax in a way aimed at achieving what its name indicates, which is to reduce the rate of federal income tax imposed on businesses and business owners, to encourage new business investment and create jobs in the United States.

The Act provides for a permanent change of the graduated corporate income tax rates that have had a top rate of 35% to a flat 21% rate beginning in 2018. The Act provides for this major corporate tax rate reduction to be made along with enactment of a new 20% business income deduction for owners of pass-through entity businesses (such as a partnership, limited liability company (LLC), S corporation, sole proprietorship).

The business tax reform changes made by the Act include immediate deduction of certain business investment costs rather than allowance of depreciation deductions over a period of years, simplification of tax accounting and compliance for small businesses, and repeal of the corporate alternative minimum tax.

The Act provides for the major corporate tax rate reduction and other favorable business tax reform changes to be offset or countered by certain other changes in the law that modify and limit federal income tax deductions and credits previously allowed for businesses.

The Act also provides for a significant reform of federal income taxation of U. S. businesses with international operations that have income in foreign countries. This summary focuses on the Act's domestic business tax reform changes, so persons interested in the international tax reform changes made by the Act should obtain and consider other published summaries or reports that contain an explanation of the international tax reform changes.

The business tax reform changes made by the Act are generally effective for tax years beginning after December 31, 2017. The corporate income tax rate reduction to 21% is permanent. The pass-through entity 20% business income deduction and certain other changes made by the Act are effective for tax years 2018 through 2025.

Important Tax Provisions for Business *Not* Changed by the Tax Cuts and Jobs Act

The Act did not change numerous federal income tax code provisions that are significant for businesses. This is noted to give the context in which the changes made by the Act will take effect and the probable "add-on" favorable results for many businesses that may come from those changes.

For example, the Act did not materially change or directly affect the existing and significant federal income tax law provisions that favorably result in the non-recognition of income upon the organization of a business as a corporation or partnership, or the non-recognition of income in the event of a corporate reorganization in the form of a merger or similar transaction if specified requirements are satisfied.

The Act did not materially limit or change the federal income tax deductions allowed to a business for amounts spent on important employee benefit programs including accident and health plans, and deductions for employer contributions to provide retirement benefits through qualified pension, profit-sharing and 401(k) plans.

Also, while the Act lowered federal income tax rates and significantly improved cost recovery (depreciation) deductions for capital investment for businesses, it did not as a trade-off alter or limit federal income tax deductions for many of the ordinary and necessary expenses that are most often claimed by and allowed to a business, such as deductions for salaries and wages, rents, utilities, insurance, legal expenses, taxes, and transportation and travel expenses.

Tax Cuts and Jobs Act Changes Favorable to Business

Corporate Federal Income Tax Rate Reduced to 21%

Prior Law. The prior tax code provisions applied a four-step graduated tax rate structure with a top corporate income tax rate of 35%. Personal service corporations were required to pay tax on the entire taxable income at the rate of 35%.

Tax Cuts and Jobs Act. For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate. There is no special rate for personal service corporations.

100% Cost Recovery of Qualifying Business Assets

Prior Law. An additional first-year bonus depreciation deduction has been allowed equal to 50% of the adjusted basis of qualified property, the original use of which began with the taxpayer. The 50% bonus depreciation deduction was subject to being phased down.

Tax Cuts and Jobs Act. A 100% of adjusted basis of qualified property first-year bonus depreciation deduction will be allowed for property acquired and placed in service after September 27, 2017, and before January 1, 2023 (and before January 1, 2024, for certain property with longer production periods). The deduction is to be allowed for new and as well as used property acquired by a taxpayer. The deduction is reduced gradually for property placed in service in 2023 through 2026.

Increased Code Section 179 Expensing of Capital Investment

Prior Law. Internal Revenue Code Section 179 has allowed a taxpayer to elect to deduct (or "expense") the cost of qualifying property (tangible personal property), rather than to recover such costs through depreciation deductions. A maximum deduction of $500,000, (inflation indexed to $510,000 in 2017) has been allowed, phased out by the amount the cost of qualifying property exceeds by 2,000,000, (inflation indexed to $2,030,000 in 2017), subject to limitations based on taxable income.

Tax Cuts and Jobs Act. The Act increases the maximum Section 179 expensing deduction to $1,000,000, and the deduction "phase-out" threshold amount is increased to $2,500,000, indexed for inflation, for property placed in service in tax years beginning after December 31, 2017.

Modification of Cost Recovery Rules for Property Used in Farming Business

Prior Law. A taxpayer involved in farming generally must capitalize the cost of property used in trade or business or the production of income and recover such cost over time through annual deductions for depreciation or amortization.

Tax Cuts and Jobs Act. The Act shortened the cost recovery depreciation period for specified machinery or equipment, subject to exceptions, used in a farming business. The modifications for farming business are effective for property placed in service after December 31, 2017, in taxable years ending after that date.

Recovery Periods for Real Property and Qualified Improvement Property

Prior Law. Under the Internal Revenue Code, a taxpayer generally must capitalize the cost of property used in trade or business or the production of income and recover such cost over time through annual deductions for depreciation or amortization. Tangible personal property is generally depreciated under the modified cost recovery system ("MACRS"). Depreciation is allowed for different types of property based on an assigned applicable depreciation method, recovery period, and convention. The recovery periods specified for improvements to real property vary for property classifications such as nonresidential real property, residential rental property, qualified improvement property, leasehold improvements, and qualified leasehold improvement property. An alternative depreciation system ("ADS") is provided and may be elected by a taxpayer.

Tax Cuts and Jobs Act. The Act maintains prior law recovery periods for nonresidential real property, and residential rental property. It provides for elimination of separate definitions of "qualified leasehold," "qualified restaurant, and "qualified retail" improvement property. A general recovery period is provided for qualified improvement property, and shortened ADS recovery period for residential real property and a specified general MACRS recovery period for qualified improvement property.

Depreciation Deduction Limits on Automobiles, Other "Listed Property" Items

Prior Law. The prior law limits cost recovery deductions for certain more expensive passenger automobiles, classified or referred to as "luxury" automobiles, setting maximum amounts for such automobiles. The law also involves limits on deductions through special rules that apply to listed property, including property that is computer or peripheral equipment.

Tax Cuts and Jobs Act. The Act increases the depreciation limits for such luxury passenger automobiles placed in service after December 31, 2017. The Act also removes computer or peripheral equipment from the definition of listed property.

Tax Accounting for Businesses

Prior Law. The federal tax law generally provides that corporations may not use the cash method of accounting, requires accounting for inventories, provides uniform capitalization (UNICAP) rules requiring capitalization of certain costs, and prescribes a method of accounting that must be used for contractors involved in long-term construction contracts. The law has provided exceptions under which taxpayers with average gross receipts of $5,000,000 or less for cash method accounting, and $10,000,000 or less in other cases, do not have to comply with these specified and detailed tax accounting rules.

Tax Cuts and Jobs Act. The Act provides that taxpayers with average gross receipts of less than $25,000,000 (indexed for inflation) are permitted to use the cash method of accounting, are exempt from inventory accounting and the UNICAP rules, and that contractors are exempt from a requirement to use the percentage-of-completion accounting method for long-term construction contracts to be completed within two (2) years.

Corporate Alternative Minimum Tax Repealed

Prior Law. A corporate alternative minimum tax (AMT) has been imposed on a corporation to the extent the corporation's tentative minimum tax exceeds its regular federal income tax, with an exemption amount that was phased out for corporations with income exceeding a specified amount.

Tax Cuts and Jobs Act. The corporate AMT is repealed by the Act, effective for tax years beginning after December 31, 2017.

Conversion of S Corporation to C Corporation

Prior Law. Under the Internal Revenue Code provisions applicable to S corporations, the distributions from a terminated S corporation have been treated as paid from the corporation's accumulated adjustment account if made during the post-termination transition period which ends on the later of one (1) year from the last day the corporation was an S corporation, or the due date for filing the last return of the S corporation (including extensions).

Tax Cuts and Jobs Act. The Act provides that S corporations that revoke an election to be an S corporation during the two (2) year period beginning on the enactment date of the Act and have the same owners on both the enactment date and the revocation date, will have distributions from the terminated S corporation treated as paid from the corporation's accumulated adjustment account and from earnings and profits.

Partnership Termination by Change of Ownership

Prior Law. Under the Internal Revenue Code in prior years a partnership would be treated as terminated for tax purposes if 50% or more of the total interests in partnership capital and profits were sold or exchanged within a twelve (12) month period. This could have burdensome and expensive effects, including the close of the partnership tax year, cessation of partnership-level elections, and change of partnership depreciation recovery periods.

Tax Cuts and Jobs Act. The Act repeals this partnership termination rule for partnerships in tax years beginning after December 31, 2017.

Employer Credit for Family and Medical Leave Pay

Prior Law. A business has generally been allowed to deduct wages and compensation paid to employees as an ordinary and necessary business expense.

Tax Cuts and Jobs Act. The Act provides that an employer that provides paid family and medical leave to all qualifying employees (non-highly compensated) may claim a credit for a percentage of the wages paid while on leave. The credit is allowed if the employer provides at least two (2) weeks family and medical leave with pay of a least 50% or normal wages paid to the employee. The credit is 12.5% of the amount paid and can be up to 25% if the amount is more than 50% of normal wages. The credit is allowed for tax years beginning after December 31, 2017 but terminates and shall not apply to wages paid in taxable years beginning after December 31, 2019.

Qualified Equity Grants

Prior Law. The prior law does not contain a provision for qualified equity grants.

Tax Cuts and Jobs Act. The Act adds a provision that allows an employee to make a special election with respect to qualified stock incentives granted to the employee by an employer that is not a publicly traded company. The provision allows income to be deferred by the employee when the employee becomes or is treated as owner of the stock. For the provision to apply, the employer plan must provide that least 80% of the employees are granted stock options or restricted stock units with the same rights and privileges, and other specified requirements must be satisfied.

Pass-Through Entity Income Deduction

Prior Law. Businesses organized as partnerships, limited liability companies, S corporations and sole proprietorships are generally treated as "pass-through entities" subject to tax at the individual owner or shareholder level rather than the entity level. For individual owners the net income earned by these entities is reported on their individual income tax returns and is subject to ordinary income tax rates.

Tax Cuts and Jobs Act. The Act provides a new 20% deduction for "qualified business income," realized by owners of such pass-through entities that conduct a trade or business within the United States. The allowance of the 20% deduction for pass-through income is subject to a set of specified requirements, limitations and thresholds that relate to character of a pass-through entity's business and its income, as well as the income level of its owners. Because Congress intended to generally limit this deduction to income of owners of who have active ongoing day-to-day business operations, and for it to be focused as a tax incentive primarily for small and start-up businesses, the application of these requirements may be very complex for some pass-through entities and owners. Certain pass-through entity owners may get little or no deduction because of the requirements for and limitations on claiming it. The requirements and limitations must be specifically applied to the facts and circumstances of each pass-through entity and its owners to determine the amount, if any, of the pass-through entity income deduction allowable to the owners. The factors and items that need to be determined, calculated and applied include whether or not the entity is a service type business, the qualified business income of the entity, if and the extent to which it pays W-2 wages and has a tax basis in qualified property used in its business, and the income of the taxpayer who is an owner of the entity and receiving pass-through income from the entity.

The 20% deduction for pass-through income will be allowed for tax years beginning after December 31, 2017, and before January 1, 2026. A more detailed explanation of the new 20% deduction for pass-through entities is at the GableGotwals web site, www.gablelaw.com.

<u>Other Tax Cuts and Jobs Act Changes Affecting Business</u>

Corporate Dividends - Received Deduction Reduced

<u>Prior Law</u>. Under prior law corporations have been allowed a deduction with respect to dividends received from other taxable domestic corporations. A 70% deduction has been generally allowed for the dividends received by a corporation from another corporation; an 80% deduction allowed for dividends received from a 20% owned corporation; and a 100% deduction allowed for dividends received from a corporation that is a member of the same affiliated group, subject to aggregate deduction limits.

<u>Tax Cuts and Jobs Act</u>. The 70% dividends received deduction is reduced to 50%, and the 80% dividends received deduction is reduced to 65%, effective for tax years beginning after December 31, 2017.

Limits on Deduction of Business Interest

<u>Prior Law</u>. Under the Internal Revenue Code interest paid or accrued by a business generally has been deductible in the computation of taxable income of a business. A taxpayer has generally been allowed deduct interest paid or accrued within a tax year on indebtedness incurred in the conduct of a trade or business, depending on the taxpayer's method of accounting. The interest deduction has been subject to a number of special rules.

<u>Tax Cuts and Jobs Act</u>. The Act generally limits the deduction for net interest expenses incurred by a business to the sum of business interest income, thirty percent (30%) of the business's adjusted taxable income, and floor plan financing interest. Disallowed interest will be allowed to be carried forward and deducted in later years. A business's "adjusted taxable income" for purposes of determining the amount of the interest deduction allowed under the limitation has a defined meaning that excludes specified items of income and deduction. As an exception to the general rule limiting a business' deduction of interest, businesses with average annual gross receipts of $25,000,000 or less are exempt from the limit. Special rules will apply in the case of partnerships. Certain real property trades or business and farming businesses may elect not to be subject to the limitation. Also, the limit will not apply to certain regulated public utilities.

Domestic Production Activities Deduction Repealed

<u>Prior Law</u>. The Internal Revenue Code has allowed taxpayers to claim a deduction equal to 9% of the lesser of the taxpayer's "qualified production activities income," which is derived from property that was manufactured, produced, grown, or extracted within the United States, or the taxpayer's taxable income for the tax year.

<u>Tax Cuts and Jobs Act</u>. The Act repeals the domestic production activities deduction for all taxpayers for tax years beginning after December 31, 2017.

Tax-Free Exchange of Like-Kind Property

<u>Prior Law</u>. Under Section 1031 of the Internal Revenue Code no gain or loss has been recognized to the extent that property held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind that also is held for productive use in a trade or business or for investment.

Tax Cuts and Jobs Act. The Act has amended Section 1031 to provide that the non-recognition of gain for like-kind exchanges shall apply to only an exchange of real property that is not held primarily for sale, and not to an exchange of personal property. The Act generally applies to exchanges completed after December 31, 2017, subject to specified transition rules.

Entertainment and Other Expenses

Prior Law. The Internal Revenue Code has provided employers can only deduct expenses associated with entertainment, amusement, or recreational activities if they establish that the activity was directly related to the active conduct of the employer's trade or business or a facility used in connection with such activity. If an employer was entitled to deduct entertainment expenses generally a 50% cap of the amount otherwise deductible applied. No deduction has been allowed for membership dues with respect to any club organized for entertainment purposes.

Tax Cuts and Jobs Act. The Act repeals the exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit to such deductions). Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business (*e.g.* meals consumed by employees on work travel). The provisions of the Act for these changes are generally applicable to amounts paid or incurred after December 31, 2017.

Net Operating Loss (NOL) Deduction

Prior Law. The Internal Revenue Code allows the deduction for a net operating loss (NOL) of a business, resulting from deductions exceeding gross income in a taxable year. An NOL has been allowed to be carried back for two (2) years and carried forward for twenty (20) years.

Tax Cuts and Jobs Act. The Act provides that an NOL arising in tax years beginning after December 31, 2017, is limited to eight percent (80%) of taxable income computed without regard to the NOL deduction. The Act eliminates the NOL carryback and generally allows unused NOLs to be carried forward indefinitely, subject to certain exceptions.

Deduction of Local Lobbying Expenses Disallowed

Prior Law. Under the Internal Revenue Code, a deduction for lobbying expenses has generally been disallowed, with an exception providing that a deduction was allowed for expenses incurred for lobbying on legislation being considered by local government bodies.

Tax Cuts and Jobs Act. The Act eliminates the deduction for lobbying expenses regarding legislation before local government bodies, effective for amounts paid or incurred on or after the date of enactment of the Act.

Exclusion of Contributions to Capital Modified

Prior Law. The Internal Revenue Code has previously provided that gross income of a corporation generally does not include contributions to its capital. Contributions to a corporation to aid in construction and contributions as a customer or potential customer have not been treated as contributions to the capital. An exception has applied to contributions to aid in the construction of a regulated public utility that provides water or sewage disposal services such that they have been considered tax-free contributions to the capital of a corporation.

Tax Cuts and Jobs Act. The Act provides that term "contributions to capital" does not include any contribution in aid of construction or any other contribution as a customer or potential customer, and any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). The changes are generally effective as to contributions made after the date of enactment of the Act, with exceptions.

Limitation on Deduction of Executive Compensation

Prior Law. The Internal Revenue Code provides that no deduction is allowed by a publicly-held corporation for compensation that exceeds $1,000,000 in a year that is paid or accrued with respect to "covered employees" (top executives). As an exception, a publicly-held corporation has been allowed to deduct "performance-based compensation" (including stock options) paid to covered employees, based upon attaining one or more performance goals determined, established, disclosed and approved under specified criteria.

Tax Cuts and Jobs Act. The Act repeals the performance-based compensation exception to the $1,000,000 per year limit on the deduction for compensation paid with respect to a covered employee of a publicly-held corporation. The Act also modifies the definition of "covered employees" whose compensation is subject to the $1,000,000 limit and provides that once an employee qualifies as a covered employee, the deduction limitation applies to that person so long as the corporation pays remuneration to that person (or to any beneficiaries). This change enacted by the Act applies to taxable years beginning after December 31, 2017. However, an exception and transition rule in the Act provides that the changes enacted by the Act shall not apply with respect to a written binding contract in effect on November 2, 2017, that is not modified in any material respect on or after such date.

Rehabilitation Credit

Prior Law. The rehabilitation credit is a one-time credit based on a fixed percentage of rehabilitation costs incurred in connection with the rehabilitation of certain certified historical structures. A credit has been allowed of 20% of qualified rehabilitation expenses for certified historic structures, and 10% of expenses for qualified rehabilitated buildings first placed in service before 1936 (other than certified historic structures).

Tax Cuts and Jobs Act. The Act provides a 20% credit (to be claimed ratably over a five-year period beginning in the tax year when the structure is placed in service) for qualified rehabilitation expenditures with respect to a historic structure. The Act generally is effective for amounts paid or incurred after December 31, 2017, with a transition rule.

Deduction of Fines and Penalties

Prior Law. The Internal Revenue Code provides that no tax deduction is allowed for fines or penalties paid to a government for the violation of any law.

Tax Cuts and Jobs Act. The Act denies a deduction for amounts paid in relation to the violation of a law or investigation into the potential violation of a law, if a government (or similar entity) is a complainant or investigator with respect to the violation or potential violation. The Act provides an exception as to restitution (including remediation of property) that is paid in certain circumstances. This change is effective for amounts paid or incurred on or after the date of enactment of the Act, except for amounts paid under any binding agreement or court order entered before such date.

Re-characterization of Gains on Partnership Profits Interests

Prior Law. Under the Internal Revenue Code and interpretations of it a *profits interest* is the right to receive future profits in a partnership but does not generally include any right to receive any money or property upon liquidation of the partnership. Different federal income tax treatment has been given to the tax effects of receipt of a profits interest and the Internal Revenue Service has issued guidance on this issue. An owner of a profits interest who receives payments for the performance of services has generally been considered to be entitled to long-term gain treatment upon the sale of an interest held for greater than one (1) year. This is sometimes referred to or known as a "carried interest."

Tax Cuts and Jobs Act. Under the Act a three (3) year holding period applies in the case of certain net long-term capital gain with respect to any applicable partnership interest held by a taxpayer. The provision treats as short-term capital gain to be taxed by ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the tax year that exceeds the amount of such gain calculated as if a three (3) year (not one (1) year) holding period applies. An "applicable partnership interest" is defined as a partnership interest transferred to the taxpayer for performance of services in any applicable trade or business. An "applicable trade or business" is defined as any activity that consists in whole or in part of raising or returning capital, and either investing in or disposing of specified assets, or identifying specified assets for investing or disposition, or developing specified assets. For this purpose, "specified assets" means securities, commodities, real estate held for rental or investments, and other comparable and related items.

Conclusion

The Tax Cuts and Jobs Act contains numerous other changes that may have significant effects for a business taxpayer. A detailed review of the new law and all the changes enacted by it is recommended.

If you have questions or would like to discuss the new federal tax law, how it may affect you or any specific business tax issues, please contact any attorney of GableGotwals you know or our Tax Law Practice Group.

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