Business Changes in the "Tax Cuts and Jobs Act"

Alan D. Sobel, CPA
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Alan.sobel@sobelcollc.com
973-994-9494

SOBEL & CO. LLC

Background

- Most significant tax legislation since 1986
- 503 pages of legislation
  - C-Corp tax rate reductions
  - Reduction in individual rates
  - Flow through entity deduction
  - Limitation on deduction of SALT Tax by individuals
  - Immediate write-off of qualified capital expenditures
  - Limitations of interest expense deductions
  - Repeal of 1031 Exchanges for non-real property
- Should we change to a C-Corp?

CORPORATE

Highlights

- Corporate tax rate reduced to a flat 21% rate
- Temporary 100% first year qualifying business asset deduction
- Increase in 179 expensing to $1 million
- Five year write-off period for R&E expenses
- Limitation on the deduction for business interest
- Elimination of the domestic production activities deduction

Tax Rates

Pre-Act Law	New Law

• Corporations are subject to graduated tax rates of 15% (for taxable income of $0-$50,000)
• 25% (for taxable income of $50,001-$75,000)
• 34% (for taxable income of $75,001-$10,000,000)
• 35% (for taxable income over $10,000,000)
• Personal service corporations pay tax on their entire taxable income at the rate of 35%
	• For tax years beginning after Dec. 31, 2017, the corporate tax rate is a flat 21% rate.
	  • $100k = 1.25k savings
	  • $1mil = $118k savings

Dividends-Received Deduction Percentages Reduced

Pre-Act Law	New Law
• Corporations that receive dividends from other corporations are entitled to a deduction for dividends received. • If the corporation owns at least 20% of the stock of another corporation, an 80% dividends received deduction is allowed. • Otherwise, a 70% deduction is allowed.	• For tax years beginning after Dec. 31, 2017, the 80% dividends received deduction is reduced to 65%, and the 70% dividends received deduction is reduced to 50%.

Corp. Alternative Minimum Tax Repealed

Pre-Act Law	New Law
• The corporate alternative minimum tax (AMT) is 20% with an exemption amount of up to $40,000. • Corporations with average gross receipts of less than $7.5 million for the preceding three tax years are exempt from the AMT. • The exemption amount phases out starting at $150,000 of alternative minimum taxable income.	• For tax years beginning after Dec. 31, 2017, the corporate AMT is repealed.

PASS-THROUGHS

New Deduction for Pass-Through Income

Pre-Act Law	New Law
• The net income of pass-through businesses, sole proprietorships, partnerships, limited liability companies (LLCs), and S corporations, was not subject to an entity-level tax and was instead reported by the owners or shareholders on their individual income tax returns. Thus, the income was effectively subject to individual income tax rates.	• Generally for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the Act adds a new section, Code Sec. 199A, "Qualified Business Income," under which a non-corporate taxpayer, including a trust or estate, who has qualified business income (QBI) from a partnership, S corporation, or sole proprietorship is allowed to deduct: • (1) the lesser of: (a) the "combined qualified business income amount" of the taxpayer, or (b) 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; plus • (2) the lesser of: (i) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or (ii) taxable income (reduced by the net capital gain) of the taxpayer for the tax year.

New Deduction for Pass-Through Income (Continued)

Pre-Act Law	New Law
	Limitations For pass-through entities, other than sole proprietorships, the deduction cannot exceed the greater of: • 50% of the W-2 wages with respect to the qualified trade or business ("W-2 wage limit") or • The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property." Qualified property is defined in Code Sec. 199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year.

New Deduction for Pass-Through Income (Continued)

Pre-Act Law	New Law
	Thresholds and Exclusions • The deduction does not apply to specified service businesses, excluding engineering and architecture; and trades or businesses that involve the performance of services that consist of investment-type activities. • The service business limitation begins phasing out in the case of a taxpayer whose taxable income exceeds $315,000 for married individuals filing jointly; $157,500 for other individuals.

Treatment of S Corporation Converted to C Corporation

Pre-Act Law	New Law
• In the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (PTTP), to the extent of the amount in the accumulated adjustment account), are tax-free to the shareholders and reduce the adjusted basis of the stock.	• On the date of enactment, any code section 481 (a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election is taken into account ratably during six-tax year period beginning with the year of change.

Repeal of Partnership Technical Termination

Pre-Act Law	New Law
• A partnership is considered as terminated if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits.	• For partnership tax years beginning after Dec. 31, 2017, the technical termination of a partnership is repealed. The repeal doesn't change the Pre-Act Law rule that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Partnership "Substantial Built-In Loss" Modified

Pre-Act Law	New Law
• A substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.	• For transfers of partnership interests after Dec. 31, 2017, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

Charitable Contributions & Foreign Taxes in Partner's Share Of Loss

Pre-Act Law	New Law
• A partner was allowed to deduct his or her distributive share of partnership loss only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurred. • Loss limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.	• For partnership tax years beginning after Dec. 31, 2017, in determining the amount of a partner's loss, the partner's distributive shares of partnership charitable contributions and taxes paid or accrued to foreign countries or U.S. possessions are taken into account. • In the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

C CORP VS FLOW THROUGH

C-Corp	Flow Through

• Lower entity tax rate
• Double taxation
• Deductibility of SALT
 	
• $1,000,000 Income
  • State Tax = 90,000
  • Federal Tax = 191,100
  • Total Entity = 281,100
  • Dividend tax (F&S)= 208,500
  • Total Tax = $489,600
	• No double taxation
	• Higher level one tax rate
	• Flow through deduction
	• Limited SALT deduction
	
	• $1,000,000 Income
	  • State Tax = 90,000
	  • Federal Tax = 296,000
	  • Total Tax = 386,000
	
	Service Business
	  • Total Tax = 460,000

CAPITAL EXPENDITURES

Increased Code 179 Expensing

Pre-Act Law	New Law
• The maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property placed in service for the tax year. • The $500,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeds $2m. • These amounts were indexed for inflation.	• For property placed in service in tax years beginning after Dec. 31, 2017: • The maximum amount a taxpayer may expense under Code Sec. 179 is increased to $1m • The phase-out threshold amount is increased to $2.5m • "Qualified real property." The definition of Code Sec. 179 property is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. • The definition of qualified real property eligible for Code Sec. 179 expensing is also expanded to include the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Temporary 100% Cost Recovery of Qualifying Business Assets

Pre-Act Law	New Law
• An additional first-year bonus depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property, placed in service before Jan. 1, 2018. The original use of which began with the taxpayer. • 40% for property placed in service after Dec. 31, 2017 and before Jan. 1, 2019. • 30% for property placed in service after Dec. 31, 2018 and before Jan. 1, 2020.	• A 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. • The additional first-year depreciation deduction is allowed for new and used property. • The first-year bonus depreciation deduction phases down. • 80% for property placed in service after Dec. 31, 2022 and before Jan. 1, 2024. • 60% for property placed in service after Dec. 31, 2023 and before Jan. 1, 2025. • 40% for property placed in service after Dec. 31, 2024 and before Jan. 1, 2026. • 20% for property placed in service after Dec. 31, 2025 and before Jan. 1, 2027.

Luxury Automobile Depreciation Limits Increased

Pre-Act Law	New Law
• For passenger autos placed in service in 2017, for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation deduction is $3,160 for the year in which the vehicle is placed in service, $5,100. • For the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period. This limitation is indexed for inflation. • For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000. This amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018 Thus, the Code Sec. 280F increase amount for property placed in service during 2018 is $6,400, and during 2019 is $4,800.	• For passenger automobiles placed in service after Dec. 31, 2017, in tax years ending after that date, for which the additional first-year depreciation deduction under Code Sec. 168(k) is not claimed, the maximum amount of allowable depreciation is increased to $10,000. • For the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. • For passengers autos eligible for bonus first-year depreciation, the maximum first-year depreciation allowance remains at $8,000.

Recovery Period for Real Property Shortened

Pre-Act Law	New Law
• The cost recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. • The straight line depreciation method and mid-month convention are required for such real property. The ADS recovery period for residential rental property is 40 years.	• For property placed in service after Dec. 31, 2017, the ADS recovery period for residential rental property is shortened from 40 years to 30 years.

Recovery Period for Real Property Shortened

Pre-Act Law	New Law
• Qualified leasehold improvement property was an interior building improvement to nonresidential real property, by a landlord, tenant or subtenant, that was placed in service more than three years after the building is placed in service and meets other requirements. • Qualified restaurant property was either (a) a building improvement in a building in which more than 50% of the building's square footage was devoted to the preparation of, and seating for, on-premises consumption of prepared meals (the more-than-50% test), or (b) a building that passed the more-than-50% test. • Qualified retail improvement property was an interior improvement to retail space that was placed in service more than three years after the date the building was first placed in service and that meets other requirements.	• For property placed in service after Dec. 31, 2017, the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property are eliminated, a general 15-year recovery period and straight-line depreciation are provided for qualified improvement property, and a 20-year ADS recovery period is provided for such property.

Recovery Period for Real Property Shortened (Continued)

Pre-Act Law	New Law
• Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. • Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.	

Limits on Deduction of Business Interest

Pre-Act Law	New Law
• Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.	• For tax years beginning after Dec. 31, 2017, every business, regardless of its form, with average annual gross receipts for the three-tax year period ending with the prior taxable year exceed $25 million, is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entitles, which requires the determination to be made at the entity level, for example, at the partnership level instead of the partner level. • For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion and without the former Code Sec. 199 deduction (which is repealed effective Dec. 31, 2017).

Modification of Net Operating Loss Deduction

Pre-Act Law	New Law
• Net operating loss (NOL) may generally be carried back two years and carried over 20 years to offset taxable income in such years.	• For NOLs arising in tax years ending after Dec. 31, 2017, the two-year carryback and the special carryback provisions are repealed, but a two-year carryback applies in the case of certain losses incurred in the trade or business of farming. • For losses arising in tax years beginning after Dec. 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and, except as provided below, NOLs can be carried forward indefinitely.

TAX CREDITS & DEDUCTIONS

Domestic Production Activities Deduction Repealed

Pre-Act Law	New Law
• Taxpayers could claim a domestic production activities deduction (DPAD) equal to 9% of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year.	• For tax years beginning after Dec. 31, 2017, the DPAD is repealed for non-corporate taxpayers. For tax years beginning after Dec. 31, 2018, the DPAD is repealed for C corporations.

Like-Kind Exchange Treatment Limited

Pre-Act Law	New Law
• The like-kind exchange rule provided that no gain or loss was recognized to the extent that property—which included a wide range of property from real estate to tangible personal 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.	• Generally effective for transfers after Dec. 31, 2017, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. • Under a transition rule, the Pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before Dec. 31, 2017.

Five-Year Write-off of Specified R&E Expenses

Pre-Act Law	New Law
• Taxpayers may elect to deduct currently the amount of certain reasonable research or experimentation (R&E) expenses paid or incurred in connection with a trade or business. Alternatively, taxpayers may forgo a current deduction, capitalize their research expenses, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months. Or, they may elect to recover them over a period of 10 years.	• For amounts paid or incurred in tax years beginning after Dec. 31, 2021, "specified R&E expenses" must be capitalized and amortized ratably over a five year period (15 years if conducted outside of the U.S.), beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred. • Specified R&E expenses subject to capitalization include expenses for software development, but not expenses for land or for depreciable or depletable property used in connection with the research or experimentation (but do include the depreciation and depletion allowances of such property).

Employer's Deduction for Fringe Benefit Expenses Limited

Pre-Act Law	New Law
• A taxpayer may deduct up to 50% of expenses relating to meals and entertainment. Housing and meals provided for the convenience of the employer on the business premises of the employer are excluded from the employee's gross income. Various other fringe benefits provided by employers are not included in an employee's gross income, such as qualified transportation fringe benefits.	• For amounts incurred or paid after Dec. 31, 2017, deductions for entertainment expenses are disallowed, eliminating the subjective determination of whether such expenses are sufficiently business related; the current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer; and deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. In addition, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees. • For tax years beginning after Dec. 31, 2025, the Act will disallow an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

Limitation on Excessive Employee Compensation

Pre-Act Law	New Law
• A deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation is limited to no more than $1 million per year. However, under Pre-Act Law, exceptions applied for: (1) commissions; (2) performance-based remuneration, including stock options; (3) payments to a tax-qualified retirement plan; and (4) amounts that are excludable from the executive's gross income.	• For tax years beginning after Dec. 31, 2017, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed. • The definition of "covered employee" is revised to include the principal executive officer, the principal financial officer, and the three other highest paid officers. • If an individual is a covered employee with respect to a corporation for a tax year beginning after Dec. 31, 2016, the individual remains a covered employee for all future years.

Deduction for Local Lobbying Expenses Eliminated

Pre-Act Law	New Law
• Businesses generally may not deduct lobbying and political expenditures with respect to legislation and candidates for office, except for lobbying expenses with respect to legislation before local government bodies.	• For amounts paid or incurred on or after the date of enactment, the deduction for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments) is eliminated.

New Credit for Employer-Paid Family and Medical Leave

Pre-Act Law	New Law
• No credit is provided to employers for compensation paid to employees while on leave.	• For wages paid in tax years beginning after Dec. 31, 2017, but not beginning after Dec. 31, 2019, the Act allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. • The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. • All qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees have to be given a commensurate amount of leave on a pro rata basis).

ACCOUNTING METHOD CHANGES

Accounting for Inventories

Pre-Act Law	New Law

• Businesses that are required to use an inventory method must generally use the accrual accounting method.
• However, the cash method can be used for certain small businesses that meet a gross receipt test with average gross receipts of not more than $1 million
	• For tax years beginning after Dec. 31, 2017, taxpayers that meet the $25 million gross receipts test may use an accounting method for inventories that either:
	  • Treats inventories as non-incidental materials and supplies, or
	  • Conforms to the taxpayer's financial accounting treatment of inventories

Capitalization and Inclusion of Certain Expenses in Inventory Costs

Pre-Act Law	New Law
• A business with average annual gross receipts of $10 million or less in the preceding three years is not subject to the UNICAP rules for personal property acquired for resale.	• For tax years beginning after Dec. 31, 2017, any producer or re-seller that meets the $25 million gross receipts test is exempted from the application of UNICAP Rules. • The exemptions from the UNICAP rules that are not based on a taxpayer's gross receipts are retained. • Use of this provision results is a change in the taxpayer's accounting method for purposes of Code Sec. 481.

QUESTIONS