Tax Reform is Here: A Brief Primer on the Key Business Provisions

By Jason B. Freeman, JD, CPA | Column Editor

Just before the turn of the new year, Congress passed – and the president signed – the Tax Cuts and Jobs Act of 2017 (TCJA). The TCJA represents the most extensive rewrite of the U.S. tax code in over 30 years. The new act contains a number of important provisions that will impact business tax planning for years to come. Below are some highlights from the business-related provisions that practitioners need to know.

21 Percent Corporate Rate. The new act eliminates the progressive corporate tax rate system, which imposed a 35 percent maximum tax rate. In its place, it provides a flat 21 percent corporate rate. This change, which is not set to phase out, will play a significant role in choice-of-entity decisions.

Corporate Alternative Minimum Tax. The new law repeals the corporate Alternative Minimum Tax for tax years beginning after Dec. 31, 2017.

Dividend Received Deduction. The TCJA reduces the general corporate dividends received deduction rates. Existing law generally provides corporate taxpayers with a dividend received deduction equal to 70 percent of dividends received from another corporation; 80 percent of dividends received from a 20 percent owned corporation; and 100 percent of dividends received from a corporation that is a member of the same affiliated group. The new act reduces the general corporate dividends received deduction to 50 percent and reduces the deduction applicable to 20 percent owned corporations to 65 percent.

Cost Recovery. The new act allows for first-year "bonus" depreciation of 100 percent of the cost of qualifying property. The 100 percent bonus depreciation rate is phased down to 80 percent beginning in 2023 and is ultimately phased out by 2027. Notably, under the new act, used property that was not previously used by the taxpayer and that is not acquired from a related party may be eligible for bonus depreciation.

The new act also expands the availability of section 179 expensing, increasing the maximum amount that can be deducted under section 179 to $1 million and raising the dollar-for-dollar phase-out threshold to $2.5 million.

Net Operating Losses. The new law limits future net operating loss deductions to 80 percent of taxable income with respect to losses arising in tax years that begin after Dec. 31, 2017. Existing law generally provides for a two-year carryback and 20-year carryforward for NOLs. The new law, however, does not allow for carrybacks with respect to losses arising after Dec. 31, 2017. Instead, it allows for an indefinite carryforward period. Thus, taxpayers will be required to separately track NOLs from prior periods.

Section 174 Research and Experimentation. The new act provides that research and experimental expenditures incurred in tax years beginning after Dec. 31, 2021, must be capitalized and amortized over a five-year period. These changes mark a significant break from current law, which permits taxpayers to immediately expense, amortize or capitalize such expenditures. In addition, under the new law, certain research and experimental expenditures that are attributable to research conducted outside the United States are required to be capitalized and amortized over a 15-year period.

Accounting Methods. The act expands the availability of the cash method of accounting for corporations with average gross receipts over a three-year period that do not exceed $25 million. It also eliminates the requirement to comply with the inventory tracking rules and the section 263A uniform capitalization rules for producers and resellers that meet the $25 million test.

Limitation on Net Interest Deduction. The new act replaces the "earnings stripping rules" under section 163(j). In their place, it provides a new limitation on deductible interest. The new limitation disallows a deduction for net business interest expense in excess of 30 percent of adjusted taxable income plus floor plan financing interest. However, the new limitation does not apply to taxpayers that have average annual gross receipts of less than $25 million. Certain taxpayers, such as certain real estate businesses and farming businesses, may elect out of the interest expense limitation. Such electing businesses are required to use the alternative depreciation system with respect to certain property.

Excessive Employee Remuneration. The TCJA expands and strengthens the section 162(m) limitation on the deduction of compensation paid by publicly traded corporate employers to covered employees. The act expands the definition of "covered employee" to include both the principal executive officer and principal financial officer, as well as the three most highly compensated officers for the tax year required to be reported on the company's proxy statement. It also adopts a new once-a-covered-employee, always-a-covered-employee rule. Perhaps most notably, the act eliminates the exception for commissions and performance-based compensation.

20 Percent Deduction for Combined Qualified Business Income. The TCJA provides for a deduction, under new code section 199A, of up to 20 percent of certain pass-through income. The deduction is designed to provide relief to owners of pass-through businesses, which include partnerships, S corporations and sole proprietorships. Notably, the deduction phases out after 2025, a consideration that may factor into the choice-of-entity calculus.

The deduction is generally equal to the taxpayer's "combined qualified business income." (Technically, there is fine print and for some taxpayers the calculation is slightly more complicated.) The deduction, however, cannot exceed the taxpayer's taxable income (reduced by net capital gain) for the year. It is not taken into account

to compute adjusted gross income, and is available to both itemizing and non-itemizing taxpayers.

"Combined qualified business income" is generally equal to 20 percent of the taxpayer's qualified business income (QBI) with respect to each qualified trade or business. QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer.

The amount of QBI for each qualified trade or business that is taken into account, however, is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. (These limitations do not apply for taxpayers with taxable income below certain thresholds – $157,500 for single taxpayers and $315,000 for married filing joint taxpayers – and are "phased-in" for taxpayers with taxable income exceeding such thresholds.) The allowable amount must be calculated and added together for each qualified trade or business to determine the taxpayer's "combined qualified business income."

The section 199A deduction is not available with respect to income from a "specified service trade or business" for taxpayers with taxable income over certain thresholds ($207,500 for single and $415,000 for married filing joint taxpayers). A specified service trade or business generally includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

The deduction for such income – income from a "specified service trade or business" – begins to be phased out for single taxpayers with taxable income over $157,500 and married filing joint taxpayers with taxable income over $315,000; it is completely phased out (i.e., unavailable) when such taxpayers reach the thresholds mentioned above ($207,500 for single and $415,000 for married filing joint taxpayers).

Loss Limit. The new law disallows "excess business losses" for non-corporate taxpayers. An "excess business loss" is defined as the amount by which the taxpayer's total deductions attributable to the taxpayer's trades or businesses exceed the total gross income from those trades or businesses plus $250,000 (or $500,000 for married filing joint taxpayers).

Section 1031. The new law scales back the scope of like-kind exchanges under section 1031. It eliminates 1031 deferral for exchanges of tangible personal property and intangible property. Thus, like-kind deferral is limited to exchanges of real property and is not allowed for exchanges of real property held primarily for sale.

Carried Interest. The new law provides for an extended, three-year holding period in order to qualify for long-term capital gain treatment on the sale of certain partnership interests. More particularly, it provides that the sale of certain profits interests in a partnership that were received in exchange for the performance of services constitutes short-term capital gain unless held for three years or longer. The rule applies to interests in partnerships engaged in raising or returning capital and (1) either investing in (or disposing of) certain assets (or identifying certain assets for investing or disposition) or (2) developing certain assets.

TAXPAYERS WILL BE REQUIRED TO SEPARATELY TRACK NOLS FROM PRIOR PERIODS.

International Tax Provisions. The new law fundamentally changes the international tax landscape, marking a shift toward a quasi-territorial system of taxation. The new rules feature a deemed repatriation, which treats "United States shareholders" (as defined in section 951) of specified foreign corporations as receiving a dividend (taxed at special effective rates) equal to their pro rata share of certain unrepatriated and untaxed existing earnings and profits of the foreign corporation, whether they actually receive such funds or not.

The TCJA provides domestic corporations with a new 100 percent deduction for the foreign-source portion of dividends received from specified 10 percent owned foreign corporations when the domestic corporation is a United States shareholder of such foreign corporation. The deemed repatriation and dividends received deduction are designed to remove the "lockout" effect that inhibits the investment of foreign subsidiary earnings back into the United States.

The new law retains the current subpart F regime with some tweaks. It also provides for a new class of income known as global intangible low taxed income (GILTI), requiring United States shareholders of controlled foreign corporations (CFCs) to include their share of the CFC's GILTI in current income in a manner similar to subpart F income. Corporate shareholders, however, are allowed to deduct 50 percent of such income (37.5 percent beginning in 2026).

The new law provides domestic corporations with a reduced effective tax rate (13.125 percent) on foreign derived intangible income, which is defined as a portion of the statutorily defined "intangible" income earned directly by U.S. corporations from serving foreign markets. In addition, the new law contains a number of base erosion and anti-hybrid measures. As a result, taxpayers with international operations will be required to navigate a new and complex array of tax provisions and, for some, to rethink existing structures. ■

Jason B. Freeman, JD, CPA is the managing member of Freeman Law PLLC, based in the DFW Metroplex, and an adjunct professor of law at Southern Methodist University's Dedman School of Law. He can be reached at Jason@freemanlaw-pllc.com.