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Key Tax Provisions in the Tax Cut and Jobs Act

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Tax Reform Seminar | Huron Campus | Endicott, NY
Wednesday, March 7, 2018

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Circular 230

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Pass-Through Businesses

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Code Section 199A - Qualified Business Income (20% Deduction for Qualified Business Income)

- The Section 199A "pass-thru entity" tax cut gives a non-corporate taxpayer, including a trust or estate, who has qualified business income (QBI) a deduction of up to 20% of the qualified business income.

- Pass-through businesses include:
  - Sole-proprietorships (no entity, Schedule C).
  - Real estate investors (no entity, Schedule E).
  - Disregarded entities (single member LLCs).
  - Multi-member LLCs.
  - Any entity taxed as an S corporation.
  - Trusts and estates, REITs and qualified cooperatives.

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Code Section 199A - Qualified Business Income (20% Deduction for Qualified Business Income)

- The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income (similar to the standard deduction).

- Sunset provision.

- The Section 199A deduction formula generally applies the 20% deduction **both to the QBI** from the taxpayer's businesses and **then again to the taxpayer's taxable** income adjusted for any net capital gains and without the adjustment for the Section 199A deduction.

- The taxpayer then **receives a deduction equal to the lesser of the two**.

Example #1

- Tom earns $100,000 of pass-through QBI in a company he operates as an S corporation.

- His taxable income on his Form 1040 equals $110,000.
  - QBI limit: $100,000 x 20% = $20,000.
  - Taxable Income limit: $110,000 x 20% = $22,000.

- He can use the Section 199A deduction in the amount of $20,000 (the lesser of the two).

- So with full utilization of the Section 199A deduction, Tom is effectively paying tax on 80% of the pass-through income at his normal tax rates (assuming no other limitations apply).

Qualified Business Income

- The definition of qualified business income (QBI) includes not just a business or rental property's bottom line or operating income, but also the <u>gains and losses on dispositions of assets used in the business if tax law treats those gains as ordinary income or ordinary losses.</u>

- Capital gains and losses are excluded.

- The income must also be <u>effectively connected with the conduct of a trade or business within the United States.</u>

- QBI also includes the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer.

Qualified Business Income

- If the combined QBI from all of the trades or businesses of the taxpayer for any taxable year **<u>nets to a loss, no Section 199A deduction gets calculated</u>** for that year and the loss carries forward to the next year's QBI calculations.

- Real estate investors treat the net rental income shown on the Schedule E tax form as QBI.
  - These investors also net rental losses against income, including passive suspended losses.

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Example #2

- Martin, a real estate investor, owns three rental properties (Schedule E's on his Form 1040).

- One property generates $10,000 of rental income. Another property generates $20,000 of net rental income. A third property loses $5,000.

- The QBI equals $25,000, calculated as: $10,000 + $20,000 - $5,000.

- The Section 199A deduction equals $5,000 calculated as $25,000 x 20% (assuming no other limitations apply).

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Qualified Business Income

- A partner in a partnership (or shareholder in an S corporation) investing in real estate calculates his or her QBI as his or her **proportional share** of the entity's QBI, which in turn gets calculated using the same principles described for taxpayers directly investing in real estate.

- Pass-through entities will also be required to provide members/shareholders with additional information required to calculate limitations at the individual level.

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Limitations

- There <u>**are basically two limitations**</u> which must be applied where a taxpayer meets certain taxable income thresholds. They are:

  - **W-2 Wage and Property Limitation:**
    - Applies to all taxpayers and all business types where the taxpayer's taxable income exceeds a threshold amount.
    - Limitation is calculated separately for each entity based on the wages and property specific to that entity.

  - **Specified Service Trade or Business Limitation:**
    - Applies only to taxpayers where QBI is generated in a specified service trade or business.
    - Will result in full allowance, partial limitation or total disallowance based on taxable income of taxpayer.

Limitations
Based on Taxable Income Threshold

- The **<u>taxable income thresholds that apply to both</u>** the W-2 Wage and Property Limitation and the Specified Service Business Limitation are, as follows:

  - $315,000 MFJ (full phase-out at $415,000).
    - Phase-out range of $100,000.

  - $157,500 for other taxpayers (full phase-out at $207,500).
    - Phase-out range of $50,000.

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W-2 Wages and Property Limitation

- Applies to all taxpayers with QBI where taxable income exceeds the applicable threshold.
  - Once the threshold is exceeded, the wage and property limitation is imposed.

- For taxpayers with taxable income above the "threshold amount," <u>the deduction cannot exceed the lesser of</u>:
  - 20% of the taxpayer's QBI with respect to the qualified trade or business; or
  - The <u>greater of</u>:
    - 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 <u>**unadjusted basis**</u>, immediately after acquisition, of all "qualified property."

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Definitions

Qualified Property: The term 'qualified property' means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under Section 167:

1. Which is held by, and available for use in, the qualified trade or business at the close of the taxable year;
2. Which is used at any point during the taxable year in the production of QBI; and
3. The **depreciable period** for which has not ended before the close of the taxable year.

Definitions

- **<u>Depreciable Period</u>**<u>:</u> The term ‘depreciable period’ means, with respect to qualified property of a taxpayer, <u>the period beginning on the date the property was first placed in service by the taxpayer and ending on the **later of**:</u>

  1. The date that is <u>ten years</u> after such date; or
  2. The last day of the last full year in the applicable recovery period that would apply to the property under Section 168.

- Accordingly, the cost of any fully depreciated property that was purchased in the prior ten year period by the taxpayer will be included.

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Application of the W-2 Wage and Property Limitation

- Taxable income becomes an important component when dealing with the W-2 Wage and Property Limitation.

- If taxable income is less than $157,500/$315,000, then the 20% deduction is fully available.

- If taxable income is greater than $157,500/$315,000 but less than $207,500/$415,000 then a full deduction, partial deduction or no deduction may be available.
    - Subject to the W-2 Wage/Property Limitation.

- If taxable income is greater than $207,500/$415,000 then a full deduction, partial deduction or no deduction may be available.

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Example #3

- Jim has $500,000 of taxable income, $100,000 of which is from a non-specified service business he operates. The business has no qualified property and pays $30,000 in W-2 wages. As Jim's taxable income exceeds the taxable income threshold, he is subject to the W-2 Wage/Property Limitation.

  - General deduction: $100,000 x .2 = $20,000.

  - W-2 Wage limitation: $30,000 x .5 = $15,000.

- Jim is limited to a QBI deduction of $15,000 from this business.

Application of the W-2 Wage and Property Limitation

- For a taxpayer that falls within the bands of $157,500 to $207,500 and $315,000 to $415,000, a formula is utilized to calculate how much of the Section 199A deduction a taxpayer can utilize.

Example #4

- Joe, a single entrepreneur, has taxable income equal to $182,500 from a business that owns no depreciable property and pays $30,000 in W-2 wages. Taxable income limit = $36,500. W-2 limit = $15,000. The formula then looks at his taxable income of $182,500, sees that this amount rests halfway between $157,500 and $207,500, and then sets the final Section 199A deduction amount to the point that is halfway between the $15,000 “W-2 wages” based value and the $36,500 “20 percent of qualified business income” value, which is $25,750. If the Wage and Property Limitation exceed the 20% calculation, no limit applies and Joe would get the full $36,500 deduction.

Limitations Based on Specified Service Business

- The deduction is also phased out where the income is generated in a ***specified service business*** (i.e., trades or businesses described in *Code Sec. 1202(e)(3)(A)* but excluding engineering and architecture.

  - 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 and trades or businesses that involve the performance of services that consist of investment-type activities.

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Limitations Based on Specified Service Business

- Where the income is generated in a ***specified service business***, 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).

- The benefit of the deduction for income generated in a specified service business is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals).

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Limitations Based on Specified Service Business

- The taxable income becomes a more important component when dealing with income from a **specified service business**.

- If taxable income is less than $157,500/$315,000, then the 20% deduction is fully available.

- If taxable income is greater than $157,500/$315,000, but less than $207,500/$415,000, then a partial or no deduction is available.
  - Subject to the Applicable Percentage and W-2/Property Limitations.

- If taxable income is greater than $207,500/$415,000, **then no deduction is available.**

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Limitations Based on Specified Service Business

- For taxpayers with Specified Service Business income and taxable income between the upper and lower thresholds, the phase-out of the deduction is more aggressive than the phase-out applicable to income from a Non-Specified Service Business.
  - Applicable Percentage Limitation under Code Section 199A(d)(3) applied first.
  - W-2/Property Limitation under Code Section 199A(b) applied next.

Example #5

- Joe, a single taxpayer, earns $100,000 as an actor, which falls into the specified service trade or business category. His taxable income equals $157,500 due to other investment income. He pays $0 wages and owns no property. As his taxable income does not exceed the lower threshold, his deduction equals $20,000, calculated as: $100,000 x 20%.

  - If Joe’s taxable income was $180,000: The QBI deduction would be $6,050.

  - If Joe’s taxable income was $200,000: The QBI deduction would be $450.

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Example #6

- Martha, who files joint with her husband, earned $200,000 from a specified service business. Her allocable share of the W-2 wages paid by the business is $60,000. Their taxable income is $365,000. As the taxable income falls between the $315,000 bottom phase-out limit and the $415,000 full phase-out threshold, Martha's Section 199A deduction is subject to the phase-out rules, as follows:

- Martha’s Section 199A deduction calculates to <u>$17,500</u> under the phase-outs applicable to specified services business income.

- Had Martha's income been from a Non-Specified Service Business, her deduction would have been <u>$35,000.</u>

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Example #7

- John and Mary, married taxpayers filing jointly, together earn $200,000 as owners of a law firm (a specified service business). Their allocable share of W-2 wages is $300,000. Due to interest income from corporate bonds; however, the family's taxable income equals $500,000. John and Mary do not get the Section 199A deduction as their taxable income exceeds the upper threshold of $415,000.

- *If the $200,000 was from a Non-Specified Service Business, the Section 199A deduction would have been $40,000 ($200,000 x 20%).*

Note

- No entity is penalized under the new Tax Law.

- Under the new Tax Law you will not pay any additional taxes over and above what you paid under the old Law but can, depending on the circumstance, pay up to 20% less on certain sources of income.

- This, combined with the lower tax rates, can equate to a sizeable tax savings.

Dealing with Multiple Pass-Through Entities

- If a taxpayer owns several pass-through entities or interests in pass-through entities:
    1. The taxpayer first determines the deductible amount with respect to each qualified trade or business after application of any entity required limitations (W-2/Property Limitation Specified Service Business Limitation).
    2. The taxpayer then combines the individual Section 199A deduction amounts to arrive at the "combined qualified business income amount."
    3. The taxpayer then compares this combined qualified business income amount to the taxable income limitation to determine the allowable deduction.

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Special Rules

- 20% of a taxpayer's qualified REIT dividends and qualified publicly traded partnership income are included in combined qualified business income amount without any limitation.

- In calculating a taxpayer's taxable income limitation (20% x taxable income), the taxpayer's taxable income as reported on the tax return is reduced by the taxpayer's net capital gain income.

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Impact on Self-Employment Tax

- Self-employment taxes will still be calculated on the net business income BEFORE the Section 199A deduction since the deduction is taken “below the line” on Form 1040.

- You could earn $100,000 and deduct $20,000 under Section 199A, but still pay self-employment taxes on $100,000.

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Impact on Alternative Minimum Tax

- The 20% QBI deduction is also allowable in calculating the Alternative Minimum Taxable Income and is not added back.

Planning under Section 199A

- Although the Section 199A deduction first became available January 1, 2018, taxpayers, with the assistance of their tax advisors, should review their personal tax situations and determine if there are any current steps that should be taken to maximize the deduction in 2018.

- Questions to consider are:
  1. Should I change the type of pass-through business entity?
     a. Should I incorporate my sole proprietorship or convert to an LLC?

Example #8

- If Nick operates as a sole proprietor and earns $500,000 but does not pay any W-2 wages, his deduction is the lessor of 50% of the W-2 wages ($0 in this example) or 20% of the $500,000.

- If he paid out $200,000 in wages and had $300,000 in net business income, his Section 199A deduction would be the lessor of 50% of $200,000 or 20% of $300,000.

- Therefore, he would deduct $60,000 ($300,000 x 20%).

- He would want to create an LLC, tax it as an S corporation and pay-out W-2 wages to maximize his Section 199A deduction.

Planning under Section 199A

2. What limitations might I be subject to in 2018 and what can I do?
   a. W-2 Wage Limitation?
      i. Increase owner wages.
      ii. Convert independent contractors to employees.
   b. Depreciable Property Limitation?
      i. Purchase or capital lease vs. equipment rental.
      ii. Improvements paid for and owned in operating company vs. real estate entity.

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Planning under Section 199A

3. Should I adjust the guaranteed payments from the partnership/LLC of which I am a partner/member?
    a. Guaranteed payments to a partner are not considered to be QBI. Accordingly, the classification of your income between ordinary income and guaranteed payments will have an impact of the 20% deduction.

Note

Many partnerships and LLC’s report all income as ordinary income with no allocation to guaranteed payments. Should they now, based on the type of business, make a reasonable allocation to guaranteed payments?

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Example #9

- Partnership A classifies all of Partner X's $100,000 share of the partnership's income as a guaranteed payment and $0 as ordinary income. As guaranteed payments are excluded from the definition of QBI, Partner X will not be entitled to a Section 199A deduction from income passing through from Partnership A.

- If Partnership A were to classify $30,000 of Partner X's allocable share to guaranteed payments (reasonable allocation based on value of services provided to the Partnership) and $70,000 to ordinary income, Partner X would be entitled to a Section 199A deduction of up to $14,000 ($70,000 x 20%).

Partnerships

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Repeal of Partnership Technical Termination

- **Pre-Act Law:** Under a "technical termination," a partnership is considered as terminated if, within any 12 month period if there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

  - A technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.

  - As a result of a technical termination, some of the tax attributes of the old partnership terminated; the partnership's tax year closed; partnership-level elections generally ceased to apply; and the partnership depreciation recovery periods restarted.

- **New Law:** For partnership tax years beginning after December 31, 2017, the Code Section 708(b)(1), (B) rule providing for the technical termination of a partnership is repealed.

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S Corporations

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S Corporations Converted to C Corporations

- **Pre-Act 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 (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.
  - The post-termination transition period is generally the one year period after the S corporation election terminates.
  - Distributions after the post-termination transition period are taken from C E&P and taxed as dividends.

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S Corporations Converted to C Corporations

- **New Law:** A distribution of money by an "Eligible Terminated S Corporation" during the post-termination transition period will be allocated between the accumulated adjustments account (tax-free distribution) and the accumulated earnings and profits (taxable distribution), in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

  - An "Eligible Terminated S Corporation" is a C Corporation that was an S corporation before 12/22/17, revoked its S election within 2 years of 12/22/17, and had the same owners on 12/22/17 and on the S corporation revocation date.

  - Additional guidance is needed to determine if the amount of the C E&P used in determining the ratio is the fixed amount on the date of conversion or will it be adjusted for additional income or losses generated post-conversion.

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C Corporations

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Reduction in C Corporation Tax Rate

- **Pre-Act Law:** C corporations were 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), and 35% (for taxable income over $10,000,000).
  - Personal service corporations pay tax on their entire taxable income at the rate of 35%.

- **New Law:** For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% rate, including personal service corporations.

  - No sunset - permanent.

  - **Note:** This rate will also apply to the S corporations who have recognized built-in-gains in years beginning after December 31, 2017.

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Should I Convert to a C Corporation?

- Many are asking if with the tax rates on C corporations now at 21%, does it make sense to convert their business to a C corporation?

- Although a detailed analysis should be done, the answer in most cases will probably be no.

- Although at a 21% corporate tax rate, wages paid out are still taxed as ordinary income tax rates (and are not eligible for the 20% QBI deduction).

- Dividends paid out of the after-tax income of the corporation are subject to capital gains rates as the corporation does not receive a deduction for the dividends that income will be subject to double taxation with Federal tax rates approaching 37%.

    - (21% Corp Tax + (79% x 20%) Dividend Tax = 37% Total Tax (ignores state tax).

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Corporate Alternative Minimum Tax Repealed

- The corporate alternative minimum tax (AMT) is repealed.

- **Note:** Under pre-Act Law, one of the possible disadvantages of having corporate owned life insurance to fund an entity-purchase buy-sell agreement was the potential taxation of the proceeds under the AMT. This is no longer the case with the repeal of the corporate AMT.

Other Business Provisions

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Increased Section 179 Expensing

- The Act increases the maximum amount a taxpayer may expense under Section 179 to $1,000,000, (from $500,000) and increases the phase-out threshold amount to $2,500,000 (from $2,000,000).

- Effective property placed in service in taxable years beginning after December 31, 2017.

- The $1,000,000 and $2,500,000 amounts, as well as the $25,000 sport utility vehicle limitation, are indexed for inflation for taxable years beginning after 2018.

- The Act expands the definition of Section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.

Increased Section 179 Expensing

- The Act also expands the definition of qualified real property eligible for Section 179 expensing to include any of the following improvements to non-residential real property placed in service 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.

- No sunset provision.

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100% Expensing of Qualified Business Assets (Bonus Depreciation)

- **Pre-Act Law:** An additional first-year depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020.

- **New Law:** Allows 100% expensing for qualified property (generally, depreciable assets other than buildings) that are acquired and **placed in service after September 27, 2017** and before 2023 (before 2024 for “longer production period” property and certain aircraft.

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100% Expensing of Qualified Business Assets (Bonus Depreciation)

- A 20% per year phase-down of full expensing will apply for property placed in service after 2022 and before 2027 (2023 – 80%, 2024 – 60%, 2025 – 40%, 2026 – 20%).

- The Act also removes the requirement that the original use of qualified property must commence with the taxpayer.
  - **<u>Thus, the provision applies to purchases of used, as well as new items</u>**.

- To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction.

- Sunset provision.

Luxury Automobile Depreciation Limits Increased

- For passenger automobiles placed in service after December 31, 2017, in tax years ended after that date, for which the additional first year depreciation deduction under Code Section 168(k) is not claimed, the maximum amount of allowable depreciation is increased to:

  - $10,000 (was $3,160) for the year in which the vehicle is placed in service,
  - $16,000 (was $5,100) for the second year,
  - $9,600 (was $3,050) for the third year, and
  - $5,760 (was $1,875) for the fourth and later years in the recovery period.

- For passenger automobiles placed in service after 2018, the dollar limits will be indexed for inflation.

Luxury Automobile Depreciation Limits Increased

- For **passenger autos eligible for bonus first year depreciation**, the maximum first year additional depreciation allowance remains at $8,000 which when combined with the limitation will allow a first year deduction of $18,000.

- Definition of Listed Property: The new law also removes computer or peripheral equipment from the definition of listed property, and therefore, this property is no longer subject to the heightened substantiation requirements that apply to listed property.

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New Farming Equipment is 5 Year Property

- For property placed in service after December 31, 2017, in tax years ending after that date, the cost recovery period is shortened from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence or other land improvement) used in a farming business, the original use of which commences with the taxpayer.

- In addition, the required use of the 150 percent declining balance depreciation method for property used in a farming business (i.e., for 3, 5, 7, and 10 year property) is repealed.

- The 150 percent declining balance method continues to apply to any 15 year or 20 year property used in the farming business to which the straight-line method does not apply, and to property for which the taxpayer elects the use of the 150 percent declining balance method.

Recovery Period for Real Property Shortened

- The cost recovery periods for most real property are 39 years for non-residential real property and 27.5 years for residential rental property.

- Special rules and shorter depreciable lives did exist for qualified leasehold improvement, qualified restaurant and qualified retail improvement property.

- For property placed in service after December 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**.

- Thus, qualified improvement property is now generally depreciable over 15 years using the straight-line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service or made to a restaurant building.

Limitation on Interest Deductions for Businesses

- **Pre-Act Law:** Businesses were allowed to deduct 100 percent of their business interest expense.

- **New Law:** Interest deductions for businesses with **average annual gross receipts over $25 million** for the 3 prior years generally are limited to 30% of the corporation's adjusted taxable income.

- No sunset provision.

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Limitation on Interest Deductions for Businesses

- **Adjusted Taxable Income:** Defined as the taxpayer's taxable income, computed without regard to:
  - Any item of income, gain, deduction or loss that is not properly allocable to a trade or business;
  - Any business interest expense or business interest income;
  - The amount of any net operating loss (NOL) deduction under Code Section 172;
  - The amount of any QBI deduction allowed under Code Section 199A; and
  - For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.

Example #10

- XYZ Corp has net income of $90,000 after the following deductions, depreciation and amortization - $60,000, business interest expense $100,000. XYZ's average annual gross receipts for the past three years was $30 million.

- XYZ Corp's business interest deduction is limited to $75,000 calculated, as follows:
  - Adjusted taxable income = $250,000 ($90,000 + $60,000 + $100,000).
  - Limitation: $75,000 ($250,000 x 30%).
  - Allowable interest deduction $75,000.
  - Disallowed interest deduction $25,000.
  - Carryover subject to indefinite carryforward.

- After 2021, the business interest limitation would be $57,000 (no addback for depreciation and amortization).

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Limitation on Interest Deductions for Businesses

- Disallowed interest can be carried forward indefinitely.

- Various complicated detailed rules and exceptions apply in determining the interest deduction limitation, but the limitation will be significant.

- Floor plan interest is fully deductible. (Offset - cannot utilize the 100% bonus depreciation expensing provision).

- Electing real property trade of business or electing farming business will not be subject to the limitation <u>but will not be able to utilize the100% bonus depreciation expensing provision</u>.

- Special reporting rules apply to partnerships and S corporations.

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Like-Kind Exchange Limited to Real Property

- **Pre-Act Law:** Like-kind exchanges (LKE's) are permitted for property held for use in a trade or business or for investment.
  - LKE's were permitted for both real property and personal property.

- **New Law:** Like-kind treatment will be limited to real property only.

- **Note:** With the increased Section 179 expensing and the 100% bonus depreciation expensing provisions, the inability to defer the gain recognized on a trade-in will have limited impact as the increased basis of the property acquired can most likely be expensed in full.

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Limitation on Deduction for Entertainment Expense/Fringe Benefits

- No deduction will be allowed for expenses of a trade or business related to entertainment, amusement or recreation activities or for membership dues to any club organized for business, pleasure, recreation or other social purposes.
  - This eliminates the subjective determination of whether such expenses were sufficiently business related.

- **<u>The 50 percent limitation on deductions for meals continues to apply</u>** and is expanded to include meals provided through an in-house cafeteria or otherwise on the premises of the employer.

- The deductions for employee transportation fringe benefits (e.g., parking and mass transit) are no longer allowed and the exclusion from income for such benefits received by an employee is retained.

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Change in Treatment of Net Operating Losses

- **Pre-Act Law:** Generally, with some exceptions, a net operating loss (NOL) could be carried back 2 years and carried over 20 years to offset taxable income in such years.

- **New Law:**
- For NOLs arising in tax years ended after December 31, 2017, the **2 year carryback** and the special carryback provisions are **repealed**.
  - A 2 year carryback continues to apply in the case of certain losses incurred in the trade or business of farming.
- For losses arising in tax years beginning after December 31, 2017, the NOL deduction is **limited to 80 percent of taxable income** (determined without regard to the deduction).
- Carryovers to other years are adjusted to take account of this limitation and **NOLs can be carried forward indefinitely**.
- **Exception:** NOLs of property and casualty insurance companies can be carried back 2 years and carried over 20 years to offset 100 percent of taxable income in such years.

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Five Year Write-Off of Specified R&E Expenses

- **Pre-Act Law:** Taxpayers can 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.

- **New Law:** For amounts paid or incurred in <u>tax years beginning after December 31, 2021,</u> "specified R&E expenses" **<u>must be capitalized and amortized ratably over a 5 year period</u>** (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.

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Five Year Write-Off of Specified R&E Expenses

- 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).
  - Also excluded are exploration expenses incurred for ore or other minerals (including oil and gas).

- In the case of retired, abandoned or disposed property with respect to which specified R&E expenses are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment or disposal, but instead must continue to be amortized over the remaining amortization period.

New Credit for Employer-paid Family and Medical Leave

- Under the Act, for tax years beginning after 12/31/17 and before 1/1/20, businesses can claim a tax 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 if the rate of payment is 50% of the wages normally paid to the employee.

- The credit is increased by .25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

- The amount of family and medical leave that may be taken into account with respect to any employee in determining the credit for any tax year can't exceed 12 weeks.

- The taxpayer's wage deduction must be reduced by the total amount of family and medical leave credits claimed.

- All qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave.

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Accounting Method Changes Taxable Year of Inclusion

- **Pre-Act Law**: In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received. For an accrual basis taxpayer, an amount is included in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (i.e., when the “all events test” is met), unless an exception permits deferral or exclusion.

  - A number of exceptions that exist to permit deferral of income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (e.g., income is recognized as the goods are provided or the services are performed).

- **New Law:** Generally, for tax years beginning after December 31, 2017, a taxpayer is required to recognize income <u>no later than the tax year in which such income is taken into account as income on an applicable financial statement (AFS</u>) or another financial statement under rules specified by IRS (subject to an exception for long-term contract income under Code Section 460).

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Accounting Method Changes - Cash Method of Accounting

- **Pre-Act Law:** A corporation, or a partnership with a corporate partner, may generally only use the cash method of accounting if the corporation or partnership met a gross receipts test (i.e., the average annual gross receipts of the entity for the three tax year period ending with the earlier tax year does not exceed <u>$5 million).</u>

- **New Law.** For tax years beginning after December 31, 2017, the cash method may be used by taxpayers (other than tax shelters) that satisfy a $25 million gross receipts test, regardless of whether the purchase, production or sale of merchandise is an income-producing factor. Under the gross receipts test, taxpayers with annual average gross receipts that do not exceed <u>$25 million</u> (indexed for inflation for tax years beginning after December 31, 2018) for the three prior tax years are allowed to use the cash method.
    - Use of this provision results is a change in the taxpayer's accounting method for purposes of Code Section 481.

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Accounting Method Changes - Inventories

- **Pre-Act 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 ($10 million businesses in certain industries). These businesses account for inventory as non-incidental materials and supplies.

- **New Law:** For tax years beginning after December 31, 2017, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under Code Section 471, but rather may use an accounting method for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories.
  - Use of this provisions results is a change in the taxpayer's accounting method for purposes of Code Section 481.

Accounting Method Changes - UNICAP

- **Pre-Act Law:** The uniform capitalization (UNICAP) rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property. Exception: under pre-Act 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.

- **New Law:** For tax years beginning after December 31, 2017, <u>any producer or re-seller</u> that meets the $25 million gross receipts test is exempted from the application of the Code Section 263A 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 in a change in the taxpayer's accounting method for purposes of Code Section 481.

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Accounting Method Changes – Long-term Contracts

- **Pre-Act Law:** An exception from the requirement to use the percentage-of-completion method (PCM) for long-term contracts was provided for construction companies with average annual gross receipts of $10 million or less in the preceding three years (i.e. they are allowed use other methods such as the completed contract method or an accrual method).

- **New Law:** For contracts entered into after December 31, 2017, in tax years ending after that date, the exception for small construction contracts from the requirement to use the PCM is expanded to apply to contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $25 million gross receipts test.
  - Use of this PCM exception for small construction contracts is applied on a cutoff basis for all similarly classified contracts (so there is no adjustment under Code Section 481(a) for contracts entered into before January 1, 2018).

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Other Miscellaneous Business Provisions

- **No deductions for amounts paid for sexual harassment subject to nondisclosure agreement.**
- **Deduction for local lobbying expenses eliminated.**
- **Changes to the limitation on excessive employee compensation -** the exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed.
- **Domestic production activities deduction repealed.**
- **Repeal of rollover of publicly traded securities gain into specialized SBICs.**
- **Orphan drug credit modified -** credit rate reduced from 50 percent to 25 percent.
- **Rehabilitation credit limited –** The 10 percent credit for qualified rehabilitation expenditures with respect to a pre-'36 building is repealed. The 20% Certified Historic Structure tax credit must now be claimed ratably over a 5-year period beginning with the year the qualified rehabilitated building is placed into service.
- **New tax incentives for investments in qualified opportunity zones.**

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