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Key Business Tax Provisions in the Tax Cuts and Jobs Act

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New Section 199A Deduction

Overview of Section 199A Deduction

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

- 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.

Overview of Section 199A Deduction

- The *Section 199A* 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).
- The QBI 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 QBID.
- The taxpayer then **receives a deduction equal to the lesser of the two**.
- ***Sunset Provision.*** Effective for years beginning after 1/1/17 and before 1/1/26.

Overview of Section 199A Deduction - Example

- Bob earns $120,000 of pass-through QBI in a company he operates as an S corporation which is not an SSB.
- His **taxable income** on his Form 1040 equals $150,000.
  - QBI limit: $120,000 x 20% = $24,000.
  - Taxable Income limit: $150,000 x 20% = $30,000.
- He can use the *Section 199A* deduction in the amount of $24,000 **(the lesser of the two).**
- So with full utilization of the *Section 199A deduction*, Bob is effectively paying tax on 80% of the pass-through income at his normal tax rates (assuming no other limitations apply).

Calculating the Section 199A Deduction

- ***<u>Step 1: Compute QBI for the qualified trade or business</u>.***
  - Calculate QBI for the business.
  - If the individual has multiple businesses, you must first compute the total QBI amount from all trades or businesses to determine if any adjustments need to be made to QBI for each business.
- ***<u>Step 2: Compute the deductible amount (known as the QBI component) for each of the taxpayer's qualified businesses</u>.***
  - This is generally the lesser of (a) QBI as adjusted (if applicable) from Step 1 multiplied by 20% or (b) the wage/investment limit.
  - If any qualified payments were received from a cooperative, this amount is reduced by the lesser of 9% of QBI allocable to cooperative sales or 50% of wages allocable to cooperative sales.
  - If the individual taxpayer's taxable income is less than the threshold amount, then the wage/investment limit does not apply and the deductible amount equals 20% of QBI from Step 1.

Calculating the Section 199A Deduction

- ***Step 3: Combine all the deductible amounts (QBI components) from Step 2.***
  - This is the sum of the amounts computed in Step 2 for each of the taxpayer's qualified businesses
- ***Step 4: Compute the combined QBI amount.***
  - Add 20% of any **qualified REIT dividends** and **qualified PTP income** to the amount computed in Step 3.
- ***Step 5: Apply the taxable income limit.***
  - The amount computed in Step 4 is limited to 20% of the excess of taxable income over the taxpayer's net capital gain for the year.
- ***Step 6: Compute the final deduction.***
  - If applicable, add the DPAD passed through from a cooperative under IRC Sec. 199A(g)(2) to the amount determined in Step 5.
  - This additional amount is limited to the taxpayer's taxable income less the amount determined in Step 5.

Qualified Business Income Definition

- QBI is the net amount of items of income, gain, deduction, and loss from a ***qualified trade or business*** conducted within the U.S. (including Puerto Rico)

- QBI includes gains and losses on dispositions of assets used in the business if the tax law treats such dispositions as **ordinary income or ordinary losses.**

- QBI **does not include investment income** such as **capital gains and losses, dividends, interest income** (unless properly allocable to a trade or business) and **commodity and foreign currency gains**.

- ***Section 481 Adjustment***: Taken in account for QBI if Section 481 Adjustment arises in a taxable year ending after 12/31/17.

Qualified Business Income Definition

- Partners treat **ordinary income** or loss recognized under the *IRC* ***Section 751 "hot asset" rules*** as QBI.
- Previously disallowed losses or deductions (for example, under the at-risk or passive activity loss rules, or due to the limits on partnership or S corporation losses due to lack of basis) are taken into account for computing QBI, **except for losses or deductions that were disallowed, suspended, limited, or carried over from years ending before 2018**.
- Generally, an **NOL deduction** under *IRC Section 172* is **not considered** for computing QBI, but to the extent that the NOL is comprised of amounts disallowed under the new excess business loss rules, it is taken into account.

Qualified Business Income Definition

- The following items are **<u>specifically excluded from QBI</u>**:
  - **<u>Compensation</u>** paid by the business to the taxpayer.
  - **<u>Guaranteed payments</u>** paid by the business to partners.
  - **<u>Payments to partners</u>** outside their capacity as partners.
- ***<u>Partnerships and S Corporations</u>***: A partner in a partnership or shareholder in an S corporation calculates his or her QBI as his or her **<u>proportional share</u>** of the entity's QBI.
  - Pass-through entities will also be required to provide partners/shareholders with additional information (i.e., wages and property info) required to calculate limitations at the individual level.

Dealing with Multiple Pass-Through Entities

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

Qualified Trade or Business Definition

- A ***qualified trade or business*** is defined as any trade or business **other than**:
  - The business of performing **services as an employee**.
    - The proposed regs provide for anti-abuse rules to prevent taxpayers from classifying themselves as independent contractors if they are really employees under the normal Federal tax rules.
  - A ***specified service business (SSB)***.
    - However, in any year that a taxpayer's taxable income is **at or below the taxable income threshold amount** (explained below), that taxpayer can treat an SSB as a qualified trade or business.

Specified Service Business (SSB) Definition

- An SSB is defined as any trade or business:
  - Involving the **performance of services** in the fields of **health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services**, or any business where the principal asset is the **reputation or skill** of one or more of its owners or employees.
    - The definition comes from *IRC Sec. 1202(e)(3)(A)* except **engineering and architecture are specifically excluded.**
  - Any business that participates in investing and investment management, trading, or dealing in securities, partnerships, or commodities.

SSB Definition - Proposed Regs.

- Only the following activities constitute a business whose **principal asset is the reputation or skill of one or more of its owners or employees**:
  - Receiving fees, compensation, or other income for endorsing products or services.
  - Licensing or receiving fees, compensation, or other income for the use of an individual's image, name, signature, etc.
  - Receiving fees, compensation, or other income for appearing at an event or on radio, television, or other media format.
- ***De Minimis Rule:*** A business that **sells both products and performs services is not an SSB** if gross receipts attributable to specified services are **less than**:
  - 10% of total gross receipts (gross receipts are $25MM or less).
  - 5% of total gross receipts (gross receipts are more than $25MM).

SSB Definition - Proposed Regs.

- ***SSB Anti-abuse Provision***: **Curtails the ability to divide a business** into separate entities.
  - Situations where one entity would provide services in an SSB and the other entities would lease property or provide administrative services to the SSB.
- An SSB includes any business with 50% or more common ownership that provides 80% or more of its property or services to an SSB.
  - When determining common ownership, the attribution rules of IRC Secs. 267(b) and 707(b) apply.
  - The planning strategy would be still available if common ownership is kept below the 50% threshold (with attribution).

Rental Real Estate – Proposed Regs.

- QBI includes income from **<u>rental real estate activities</u>** if such activities rise to the level of a **<u>trade or business</u>**.
  - Rental activities are regular and continuous enough to constitute a trade or business.
  - Factors to consider are the taxpayer's intent and involvement with the property (i.e., showing the property for rent, collecting rents, purchasing materials, paying expenses, providing services to the tenants, etc.).
  - There is **<u>no 500-hour safe harbor test</u>** for ***<u>qualified real estate professionals</u>*** like there is under the NIIT regulations.
- ***Self-Rentals:*** The rental or licensing of tangible or intangible property to a commonly controlled trade or business is **<u>treated as a trade or business for QBI purposes</u>**.
  - Same person or group of persons owns (directly or indirectly) 50% or more of the rental activity and trade or business activity.
  - Under the attribution rules, an individual is considered to own an interest in a trade or business held by a spouse, child, grandchild or parent.

Qualified Business Income (Net Loss)

- If the combined QBI from all of the trades or businesses of the taxpayer for any taxable year **nets to a loss, no Section 199A deduction gets calculated** 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.

QBI Net Loss - Example

- Bill, a real estate investor, owns three rental properties (Schedule E's on his Form 1040).
- **Property A** generates $10,000 of net rental income. **Property B** generates $20,000 of net rental income. **Property C** loses $5,000.
- The QBI = $25,000 ($10,000 + $20,000 - $5,000).
- The *Section 199A* deduction = $5,000 ($25,000 x 20%)

QBI Deductible Amount Limitations

- There **are basically two limitations** 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 an SSB.
    - Will result in full allowance, partial limitation or total disallowance based on taxable income of taxpayer.

Taxable Income Threshold

- The **taxable income thresholds that apply to both** the **W-2 Wage and Property Limitation** and the **SSB 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.

W-2 Wages and Property Limitation

- Applies to all taxpayers with QBI where taxable income exceeds the applicable threshold.
  - Once the taxpayer's **taxable income threshold** is exceeded, the wage and property limitation is imposed.
- For taxpayers with **taxable income above the threshold amount**, **the deduction cannot exceed the lesser of**:
  - 20% of the taxpayer's QBI with respect to the qualified trade or business; or
  - 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 of the business's qualified property**.

Qualified Property Definition

- ***Qualified Property***: Defined as depreciable property held by the qualified business at the end of the year to produce QBI and for which the **depreciable period hasn't ended** before the close of the year.
- The **depreciable period** is the **later of**:
  - 10 years from the placed-in-service date, or
  - The last day of the last full year in the MACRs recovery period.
- Accordingly, the cost of any **fully depreciated** property that was purchased in the prior 10-year period by the taxpayer will be included.

Qualified Property Definition - Proposed Regs.

- ***Additions to Qualified Property***: Capitalized improvements to an existing property is treated as a new and separate property addition.
- ***Effect of IRC Section 179 and Bonus Depreciation***:
  - The unadjusted basis of qualified property is determined without regard to the *IRC Section 179* deduction.
  - Bonus depreciation does not affect the applicable recovery period of qualified property.
- ***Partnership Basis Adjustments***: The basis step-up in partnership assets under *IRC Section 754* **is not** treated as qualified property.
- ***Anti-abuse Rule***: Property is excluded from qualified property if it is acquired within 60 days of the end of the tax year and disposed of within 120 days without having been used in the business for at least 45 days.

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.

Wage and Property Limitation – Example 1

- Jim has $500,000 of taxable income, $100,000 of which is from a non-SSB 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 20% = $20,000.
  - W-2 Wage limitation: $30,000 x 50% = $15,000.

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

W-2 Wage and Property Limitation - Example 2

- **For a taxpayer whose taxable income 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.**
- Joe, a single entrepreneur, has **taxable income of $182,500**, **QBI of $150,000** from a business that owns no depreciable property and pays $30,000 in W-2 wages.
- **QBID = $30,000** ($150,000 x 20%). **W-2 wage limit = $15,000** ($30,000 x 50%).
- The formula then looks at his taxable income of $182,500, which 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 $30,000 20% QBI value, which is **$22,500**.
- If the Wage and Property Limitation exceeded the 20% calculation, no limit would apply and Joe would get the full $30,000 deduction.

Limitations Based on an SSB

- Where the income is generated in an ***SSB***, the **SSB** 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 an SSB is **phased out** over the next $100,000 of taxable income for joint filers ($50,000 for other individuals).

Limitations Based on SSB

- The taxable income becomes a more important component when dealing with income from an **SSB**.
- 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**.

Limitations Based on an SSB

- For taxpayers with **SSB** 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-SSB.
  - Applicable Percentage Limitation under *IRC Section 199A(d)(3)* applied first.
  - W-2/Property Limitation under *IRC Section 199A(b)* applied next.

Limitations Based on SSB - Example 1

- Joe, a single taxpayer, earns $100,000 as an actor, which falls into the SSB 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 ($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.

Limitations Based on SSB - Example 2

- Martha, who files joint with her husband, earned $200,000 from an SSB.
- Her allocable share of the W-2 wages paid by the business is $60,000.
- Their taxable income is $365,000.
- As their 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 $17,500 under the phase-outs applicable to SSB income.
- Had Martha's income been from a Non-SSB, her deduction would have been $35,000.

Limitations Based on SSB - Example 3

- John and Mary, married taxpayers filing jointly, together earn $200,000 as owners of a law firm (an SSB).
- Their allocable share of W-2 wages is $300,000.
- Their taxable income is $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-SSB, the *Section 199A* deduction would have been $40,000 ($200,000 x 20%).

Aggregation Rules – Proposed Regs.

- The aggregation rules permit taxpayers **to elect to combine** separate trades or businesses if the following requirements are met:
  - The same person or group of persons owns (directly or indirectly) 50% or more of each business.
  - The items of each business are reported in returns with the same tax year.
  - None of the businesses are an SSB.
  - The businesses satisfy **at least two** of the following factors:
    - They provide products and services that are the same or customarily offered together.
    - They share facilities, personnel, or other business resources.
    - They operate in coordination with, or reliance upon each other.

Aggregation Rules – Proposed Regs.

- When aggregation is allowed, the taxpayer has the option to chose which businesses to aggregate (i.e., can be selective as to which businesses to aggregate).
- The taxpayer calculates QBI, W-2 wages and unadjusted basis of qualified property for each business and then combines these amounts to compute QBI and the wage/property limit for the aggregated businesses.
- The Taxpayer must consistently report the aggregation on his or her return.
- Additional businesses can be added if they are newly established.
- Change in circumstances will allow taxpayers to change prior aggregation if businesses no longer qualify.

Aggregation Rules – Proposed Regs.

- ***Planning Opportunity***: Aggregating businesses can allow an individual with high taxable income to claim a larger QBI deduction when otherwise subject to the wage/property limit.
- For example, aggregating one business with substantial QBI but little or no W-2 wages and another business with minimal QBI but considerable W-2 wages can result in a substantial QBI deduction while keeping them separate could result in a lower QBI deduction or even no QBI deduction.

Aggregation Rules – Proposed Regs.

- **Netting of negative and positive QBI amounts and carryovers**.
  - Businesses with negative QBI amounts are allocated proportionately to businesses with positive QBI amounts.
  - W-2 wages and the unadjusted basis of qualified property of negative QBI businesses are not taken into account in calculating the aggregate wage/property limit.
  - If a taxpayer has an overall negative QBI for the year, the negative amount is treated as a loss from a qualified business in the following year.
- **Examples of businesses eligible for aggregation**:
  - Restaurant and catering business that use same kitchen and staff.
  - Clothing manufacturer and retail store.
  - A group of hardware stores.

Impact on Self-Employment Tax, NITT and AMT

- ***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.

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

- ***Net Investment Income Tax (NIIT):*** The *Section 199A* deduction **does not** reduce net investment income for NIIT purposes.

- The *Section 199A* 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?

Convert to S Corporation – Example

- If Nick operates as a sole proprietor with no employees in a Non-SSB and earns $500,000, his deduction is the lessor of 50% of the W-2 wages ($0 in this example) or 20% of the $500,000.

- He may want to incorporate as an S corporation and pay-out W-2 wages to himself to maximize his *Section 199A* deduction.

- If he paid out $200,000 in wages to himself 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, his Section 199A deduction would be $60,000 ($300,000 x 20%).

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.

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?

Partnership Guaranteed Payment - Example

- 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

Repeal of Partnership Technical Termination

- **Prior 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% 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.
- **TCJA -** For partnership tax years beginning after December 31, 2017, the *IRC Section 708(b)(1)(B)* rule providing for the technical termination of a partnership is repealed.

S Corporations

S Corporations Converted to C Corporations

- **Prior 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.

S Corporations Converted to C Corporations

- **TCJA -** 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.

C Corporations

Reduction in C Corporation Tax Rate

- **Prior 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%.
- **TCJA -** 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.

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 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 23.8%) Dividend Tax = 39.80% Total Tax.
    - Top Tax Rate with QBID (37% x 80%) = 29.60% (ignores state tax).

Corporate Alternative Minimum Tax Repealed

- The corporate alternative minimum tax (AMT) is repealed.
- **Note:** Under TCJA 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

Increased Section 179 Expensing

- The TCJA permanently increases the maximum amount a taxpayer may expense under **Section 179 to $1,000,000** in 2018, (from $510,000 in 2017).
- The phase-out threshold amount increased to $2,500,000 in 2018 (from $2,030,000 in 2017).
  - The phase-out rule applies only if the asset acquisitions eligible for the Section 179 deduction exceed the phase-out threshold.
  - If the they do exceed the threshold, then the maximum Section 179 deduction amount is reduced dollar-for-dollar by the excess over the threshold.
- 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.

Increased Section 179 Expensing

- Beginning in 2018, the TCJA 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 (i.e. furniture, appliances, etc.).
    - Applies to residential rental properties, hotels, etc.

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

Increased Section 179 Expensing

- **Under the TCJA, the Section 179 deductions are now allowed for more real property expenditures.**
- As under prior law, Section 179 deductions can still be claimed for ***qualified real property*** expenditures, up to the maximum Section 179 limit.
  - There is no separate Section 179 deduction for real property.
- Under the TCJA, beginning in 2018, ***qualified real property*** includes any improvement to the interior portion of a nonresidential building after the building was placed in service.

Increased Section 179 Expensing

- ***Qualified real property*** does not include any improvement attributable to the following:
  - The enlargement of the building.
  - Any elevator or escalator.
  - The internal structural framework of the building.
- Under the TCJA, beginning in 2018, the definition ***qualified real property now*** includes:
  - Roofs
  - HVAC equipment
  - Fire protection and alarm system
  - Security systems

Increased Section 179 Expensing

- **Business Taxable Income Limitation (TCJA same as Prior Law)**
  - The Section 179 deduction cannot exceed the taxpayer's aggregate net business income from all sources before the Section 179 deduction.
  - Salaries and wages, as well as self-employment income for taxpayer and spouse count as net business income.

Increased Section 179 Expensing

- **Maximum $25,000 Section 179 deduction for Heavy SUVs (TCJA same as Prior Law).**
  - The Section 179 limit is $25,000 for heavy SUVs with a Gross Vehicle Weight Rating (GVWR) over 6,000 lbs. and less than 14,000 lbs.
  - This $25,000 limit does not apply to heavy non-SUVs which include the following:
    - Vehicles designed to seat more than nine passengers behind the driver's seat (i.e., shuttle vans).
    - Vehicles equipped with a cargo area not readily accessible from the passenger compartment that is at least six feet in length (i.e., many pickups with full-size cargo beds will qualify).
    - Other vehicles meeting other requirements including no seating behind the driver's seat such as most delivery vans.
  - Vehicles with GVWRs above 6,000 lbs. that fall under the above non-SUV exceptions remain eligible for the full Section 179 deduction.

100% Expensing of Qualified Business Assets (Bonus Depreciation)

- **Prior Law -** An additional first-year depreciation deduction was allowed equal to 50% of the adjusted basis of qualified property placed in service before 2020.
- **TCJA -** 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).
  - ***Sunset Provision*** - 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 TCJA also removes the requirement that the ***original use*** of qualified property must commence with the taxpayer.
    - **Thus, the provision applies to purchases of used, as well as new items.**
  - To prevent abuses, the first-year bonus depreciation deduction applies only to property purchased in an arm's-length transaction.

100% Expensing of Qualified Business Assets (Bonus Depreciation)

- To be eligible for bonus depreciation, the property must meet one of the following definitions:
  - Property with a cost recovery period of 20 years or less.
  - Purchased computer software not amortizable under IRC Section 197.
  - ***Qualified improvement property*** placed in service after 2017 (subject to fixing a legislative error explained below).
  - Qualified water utility property.
  - Qualified film, television or theatrical production property.

100% Expensing of Qualified Business Assets (Bonus Depreciation)

- For ***qualified improvement property*** placed in service after 2017, the TCJA was supposed allow such property to qualify for the 100% bonus depreciation.
  - This provision was in the legislative committee reports.
  - However, the law as enacted does not reflect this legislative intent.
  - It is expected that a Technical Corrections bill will fix this drafting error.
  - Until this problem is fixed, ***qualified improvement property*** will not be eligible for the 100% bonus depreciation.

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.

- For ***qualified improvement property*** placed in service after 2017, the TCJA was supposed to permanently install a 15-year cost recovery period .
  - This provision was in the legislative committee reports.
  - However, the law as enacted does not reflect this legislative intent.
  - It is expected that a Technical Corrections bill will fix this drafting error.
  - Until this problem is fixed, qualified improvement property will still be subject to a 39-year cost recovery period.

Luxury Automobile Depreciation Limits Increase

- **TCJA** - For passenger vehicles placed in service after December 31, 2017, 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 vehicles placed in service after 2018, the dollar limits will be indexed for inflation.
- For **passenger vehicles eligible for first-year bonus depreciation**, the maximum first year bonus depreciation allowance remains at $8,000 which when combined with the above depreciation limitation will allow a first-year deduction of $18,000.
- **Definition of Listed Property**: The TCJA also **removes computer or peripheral equipment** from the definition of listed property.
  - Therefore, this property is no longer subject to the heightened substantiation requirements that apply to listed property.

New Farming Equipment is 5 Year Property

- For property placed in service after December 31, 2017, 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.

Limitation on Interest Deductions for Businesses

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

- **TCJA -** For tax years beginning after 2017**, i**nterest 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***.
    - ***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.
    - Disallowed interest can be carried forward indefinitely.
    - Special reporting rules apply to partnerships and S corporations.
    - No sunset provision

Limitation on Interest Deductions for Businesses

Example:

- 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 of $25,000 subject to indefinite carryforward.

- After 2021, the business interest limitation would be $57,000 ($190,000 x 30%)
  - No addback for depreciation and amortization.

Limitation on Interest Deductions for Businesses

Exceptions:

- Employee
  - The performance of services as an employee isn't a trade or business for the business interest limitation.
  - Thus, an employee's wages are not counted in the taxpayer's ***adjusted taxable income*** for purposes of determining the limitation.
- Floor plan financing interest is fully deductible.
  - Applies to debt used to finance motor vehicles, boats and farm machinery for sale or lease.
  - However, such businesses cannot utilize the 100% bonus depreciation expensing provision.

Limitation on Interest Deductions for Businesses

Exceptions:

- A regulated public utility will not be subject to the limitation.
    - However, such businesses cannot utilize the 100% bonus depreciation expensing provision.
- An electing real property trade or business or electing farming business will not be subject to the limitation.
    - However, such businesses must use the Alternative Depreciation System (which doesn't allow for bonus depreciation) to depreciate:
        - Nonresidential real property, residential rental property and qualified improvement property for real property trades or businesses.
        - Property with a recovery period of 10 years or more for farming businesses.

Like-Kind Exchange Limited to Real Property

- **Prior 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.

- **TCJA -** 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.

Meals and Entertainment Expenses

- **Prior Law -** Taxpayers could generally deduct 50% of business-related meal and entertainment expenses incurred before 1/1/18.
    - Taxpayer had to establish that the expenses were directly related to or associated with the business.

- **TCJA -** 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.
    - Some examples include:
        - Tickets to sporting events.
        - Private boxes or license fees for seating rights at sporting events.
        - Theater tickets.
        - Golf club dues.
        - Golf, hunting, fishing, sailing outings, etc. for customers.

Meals and Entertainment Expenses

- This eliminates the subjective determination of whether such expenses were sufficiently business related.
- **The 50 percent limitation on deductions for meals continues to apply** and is expanded to include meals provided through an in-house cafeteria or otherwise on the premises of the employer.
- Effective for amounts paid or incurred after 12/31/17.

Meals and Entertainment Expenses

De minimis Meals

- **Prior Law** – Employer could deduct 100% of meal expenses that were excluded from the recipient employee's income as a *de minimis* fringe benefit. Examples include:
  - Meals or meal money provided to employees on an occasional basis.
  - Meals or meal money provided to employees working overtime.
- **TCJA** – De minimis meals are no longer 100% deductible.
  - The new law *apparently* still allows a 50% deduction for de minimis meals.

Meals and Entertainment Expenses

Convenience of Employer Meals and Lodging

- **Prior Law** – Employer could deduct 100% of meal or lodging expenses provided to an employee (including his or her spouse and dependents) for the convenience of the employer and such expenses were excluded from employee's income if the following requirements were met:
    - ***Business Premises***. The meals or lodging must be furnished on the employer's business premises.
    - ***Convenience of the Employer***. The meals or lodging must be furnished for the convenience of the employer
    - ***Condition of Employment***. In the case of lodging (but not meals), the employee must be required to accept such lodging as a condition of employment.
- **TCJA** – Convenience of employer meals are now only 50% deductible.
    - After 2025, no deductions for such meals will be allowable.

Meals and Entertainment Expenses

Employer-Operated Eating Facility

- **Prior Law** – Employer could deduct 100% of the cost (including facility costs) of providing meals to employees at a qualifying employer-operated eating facility (i.e., company cafeteria). To qualify, the facility had to meet the following requirements:
  - Be owned or leased by the employer.
  - Be operated by the employer (can be through a vendor).
  - Be on or near the employer's business premises.
  - Revenue from the facility must equal or exceed the cost of operating the facility.
  - Meals are served during or immediately before or after working hours.
  - The facility is generally available to all employees.
- **TCJA** – Employer-operated eating facility costs are now only 50% deductible.
  - After 2025, no deductions for such costs will be allowable.

Meals and Entertainment Expenses

Employee Events

- **Prior Law** – Employer could deduct 100% of food, beverages and entertainment expenses incurred for recreational, social, or similar activities primarily for the benefit of employees. Examples include:
  - Company holiday parties or picnics.
- **TCJA** – Same as prior law.
  - Covers applicable entertainment expenses as well.

Meals and Entertainment Expenses

General Public Events

- **Prior Law** – Employer could deduct 100% of food, beverages and entertainment expenses made available to the general public. Examples include:
  - Free snacks at a business showroom.
  - Free food and entertainment at an event open to the public.
- **TCJA** – Same as prior law.
  - Covers applicable entertainment expenses as well.

Meals and Entertainment Expenses

Compensation Meals

- **Prior Law** – Employer could deduct 100% of meal and entertainment expenses that were reported as taxable compensation to recipient employees.
- **TCJA** – Same as prior law.
  - Still applies to entertainment expenses as well.

Meals and Entertainment Expenses

Nonemployee Recipients

- **Prior Law** – Taxpayers could deduct 100% of meals and entertainment expenses that were reported to a nonemployee recipient on a Form 1099. Example includes:
  - Customer or independent contractor wins a trip or entertainment package at a sales event.

- **TCJA** – Same as prior law.
  - Covers applicable entertainment expenses as well.

Meals and Entertainment Expenses

Sold to Customers

- **Prior Law** – Taxpayers could deduct 100% of food, beverages and entertainment expenses sold to customers at full value.
- **TCJA** – Same as prior law.
  - Covers applicable entertainment expenses as well.

Meals and Entertainment Expenses

Fundraising Charitable Sporting Events

- **Prior Law** – Taxpayers could deduct 100% of the cost of tickets to fundraising charitable sporting events if all of the following requirements were met:
  - The event was organized for the benefit of a qualifying charitable organization.
  - 100% of the net proceeds were contributed to the charity.
  - Volunteers did substantially all the work in staging the event.
- **TCJA** – Such expenses are no longer deductible.

Meals and Entertainment Expenses

- IRS clarified in *IRS Notice 2018-76 (10-3-18)* when ***entertainment business meals*** are deductible.

- Per *IRS Notice 2018-76*, businesses can deduct 50% of otherwise allowable business meal expenses (food and beverages) if the following requirements are met:
  - The expense is an ordinary and necessary business expense under *IRC Sec. 162(a)*.
  - The expense is not lavish or extravagant under the circumstances.
  - The taxpayer, or an employee of the taxpayer, is present at the meal.
  - The meals are provided to a current or potential business customer, client, consultant, or similar business contact.
  - The cost of the meals are purchased separately or stated separately on the bill from the cost of the entertainment.
    - This identification provision is a new requirement.

Meals and Entertainment Expenses

- Although not specifically discussed in *IRS Notice 2018-76*, to be an *otherwise allowable* business meal expense:
  - Business must be conducted immediately before, during, or immediately after the event, and
  - The normal substantiation requirements must be met.
- *IRS Notice 2018-76* represents interim guidance until IRS issues proposed regulations.

Fringe Benefits

Transportation Fringe Benefits

- The deductions for employee transportation fringe benefits (e.g., parking and mass transit) are **no longer allowed**.
  - Transportation in a commuter highway vehicle for travel between the employee's residence and place of employment.
  - Transit passes.
  - Qualified parking.
  - Qualified bicycle commuting reimbursement.
- However, the **exclusion from income** for such benefits received by an employee **is retained**.
  - Qualified bicycle commuting reimbursements are taxable to employees under the TCJA.
    - This provision is effective for tax years beginning after 1/1/17 and before 1/1/26.
- Effective for amounts paid or incurred after 12/31/17.

Change in Treatment of Net Operating Losses

- **Prior 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.

- **TCJA -** 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.

Five Year Write-Off of Specified R&E Expenses

- **Prior 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.

- **TCJA -** For amounts paid or incurred in tax years beginning after December 31, 2021, "specified R&E expenses" **must be capitalized and amortized ratably over a 5-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).
  - 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 TCJA, 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.

Accounting Method Changes Taxable Year of Inclusion

- **Prior 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 related 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).

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

Accounting Method Changes - Cash Method

- **Prior 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 $5 million).**

- **TCJA -** 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 $25 million (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.

Accounting Method Changes - Inventories

- **Prior 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.
- **TCJA -** 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

- **Prior 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.

- **TCJA** - 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.

Accounting Method Changes – Long-term Contracts

- **Prior 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).

- **TCJA -** 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).

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% to 25%.
- **Rehabilitation credit limited** - The 10% 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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