THE TAX CUTS AND JOBS ACT OF 2017: *A Business Perspective*

A tax reform update by the Tax, Estates & Business Practice at Morris James LLP

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The Tax Cuts and Jobs Act of 2017 (the "Act") enacted in December is a sweeping tax package with significant impact on both businesses and individuals. While certain of the Act's provisions – such as those curtailing state and local/real estate tax deductions going forward – received quite a bit of press suggesting that the Act might raise the tax bills of many individuals, a number of its changes present new planning opportunities for substantial tax savings.

To highlight these opportunities, we will initially focus on how the new law changes the dynamics for income taxation of both closely-held businesses and professional practices. In a nutshell, some of the major elements of the Act directly impact key aspects of these entities and present new opportunities to make their operations more tax-efficient than ever. For the most part, this affects so-called pass-through entities, such as S corporations and LLCs taxed as partnerships or sole proprietorships. However, it should also be noted that the reduction in the corporate income tax rate for C corporations presents additional planning considerations. In general, the changes outlined in this Section are effective for tax years beginning in 2018:

- ***Corporate tax rates reduced***. The new law cuts the corporate tax rate to a flat 21%. Previously, rates were graduated, starting at 15% for taxable income up to $50,000 and climbing to 35% for taxable income above $10 million. Professional practices – which are almost universally classified under the Code as "personal service corporations" and, therefore, taxed at the highest marginal corporate rate – will now see that rate reduced from 35% to 21%.

- ***New deduction for pass-through income***. The new law provides a deduction from taxable income for 20% of an individual's "qualified business income." Potentially one of the most important changes made by the new law, it can reduce your effective taxable rate on this income by 20% – in other words, convert taxable income that would otherwise be taxed at a rate of 35% into income taxable at 28%. The term "qualified business income" is defined as income from a trade or business conducted within the U.S. by an S corporation, partnership, or sole proprietorship, including an LLC which is taxed as a partnership or sole proprietorship. Investment items, reasonable compensation paid by an S corporation, and guaranteed payments from a partnership are excluded. For taxpayers with *taxable income* (i.e., after all other deductions are taken) above $315,000 (joint filers; all others, $157,500), a limitation is phased in, with relief from that limitation if certain designated wage and capital parameters are met. Notably, while the deduction is phased out for qualified business income from certain service-related trades or businesses – such as health, law, consulting, and financial or brokerage services – those taxpayers with *taxable income* not exceeding the $315,000 joint filer threshold ($157,500 otherwise) remain fully eligible for the 20% deduction, notwithstanding the service-related nature of their business or professional practice. For those taxpayers with qualified business income from a service-related business or professional practice whose individual taxable income exceeds the $315,000 threshold above, but is less than $415,000, a portion of 20% deduction is still available but is reduced proportionately so that it is completely phased out at $415,000.

- ***S corporation conversion to C corporation***. In general, if an S corporation converts to a C corporation within two years following enactment of the Act, adjustments to the corporation's taxable income resulting from a change in accounting method are taken into account ratably during the 6-tax-year period starting with the year of change.

- ***Partnership "technical termination" rule repealed***. Before the new law, partnerships experienced a "technical termination" if, within any 12-month period, there was a sale

or exchange of at least 50% of the total interest in partnership capital and profits. This often imposed unintended burdens and costs on the parties, as some of the tax attributes of the old partnership terminated, its tax year closed, partnership-level elections ceased to apply, and depreciation recovery periods restarted. The Act repeals this rule, and a partnership termination is no longer triggered if there is a sale or exchange of 50% or more of total partnership capital and profits interests within a 12-month period.

- ***Partnership loss limitation rule***. A partner can only deduct his or her share of partnership loss to the extent of the partner's basis in his or her partnership interest as of the end of the partnership tax year in which the loss occurred. The new law addresses issues concerning the deduction of a partner's share of the partnership's charitable contributions and the effect of the foreign tax credit by providing that the rule limiting a partner's losses to the partner's basis in his or her partnership interest is generally applied by reducing the partner's basis by his or her share of partnership charitable contributions and foreign taxes paid.

Next, we will focus on provisions in the Act that encourage capital investment by increasing certain deductions for expensing and depreciation:

- ***Increased Code Sec. 179 expensing***. The new law increases the maximum amount that may be expensed under Code Sec. 179 to $1 million. If more than $2.5 million of property is placed in service during the year, the $1 million limitation is reduced by the excess over $2.5 million. Both the $1 million and the $2.5 million amounts are indexed for inflation after 2018. The expense election has also been expanded to cover certain depreciable tangible personal property and certain improvements to nonresidential real property made after the original property was first placed in service.

- ***Bonus depreciation***. Under the new law, a 100% first-year deduction is allowed for qualified new and used property acquired and placed in service after September 27, 2017 and before 2023. Pre-Act law provides for a 50% allowance, to be phased down for property placed in service after 2017. Under the new law, the 100% allowance is phased down starting after 2023.

- ***Depreciation of qualified improvement property***. The new law provides that qualified improvement property is depreciable using a 15-year recovery period and the straight-line method. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property placed in service after the building was placed in service. There are no longer separate requirements for leasehold improvement property or restaurant property.

- ***Depreciation of farming equipment and machinery***. Under the new law, subject to certain exceptions, the cost recovery period for farming equipment and machinery the original use of which begins with the taxpayer is reduced from 7 to 5 years. Additionally, in general, the 200% declining balance method may be used in place of the 150% declining balance method that was required under pre-Act law.

- ***Luxury auto depreciation limits***. Under the new law, for a passenger automobile for which bonus depreciation (see above) is not claimed, the maximum depreciation allowance is *increased* and the amounts are indexed for inflation after 2018.

- ***Computers and peripheral equipment***. The new law removes computers and peripheral equipment from the definition of listed property. Thus, the heightened substantiation requirements and possibly slower cost recovery for listed property of pre-Act law no longer apply.

Finally, we would like to provide an overview of some of the more significant business tax changes of general application in the new law. While effective dates are for tax years beginning in 2018, you will note some carry expiration provisions:

- ***Alternative minimum tax repealed for corporations***. The corporate alternative minimum tax (AMT) is repealed.

- ***Alternative minimum tax credit***. Corporations are allowed to reduce their regular tax liability by the AMT credit. The credit is refundable but will expire for taxable years after 2021.

- ***Net Operating Loss ("NOL") deduction modified***. In general, the Act provides that NOLs arising in tax years ending after 2017 can only be carried forward, not back. The general two-year carryback rule and other special carryback provisions of pre-ACT law have been repealed. The new law allows NOLs to be carried forward indefinitely, rather than expiring after 20 years. Additionally, under the new law, for losses arising in tax years beginning after 2017, the NOL deduction is limited to 80% of taxable income, determined without regard to the deduction. Carryovers to other years are adjusted to take account of the 80% limitation.

- ***Limit on business interest deduction***. Under the new law, every business, regardless of its form, is limited to a deduction for business interest equal to 30% of its adjusted taxable income. Adjusted taxable income is computed without regard to the repealed domestic production activities deduction and, for tax years beginning after 2017 and before 2022, without regard to deductions for depreciation, amortization, or depletion. Any business interest deduction disallowed under this rule is carried into the following year and, generally, may be carried forward indefinitely. The limitation does not apply to taxpayers (other than tax shelters) with average annual gross receipts of $25 million or less for the three-year period ending with the prior tax year. Real property trades or businesses can elect to have the rule not apply if they elect to use the alternative depreciation system for real property used in their trade or business. Certain additional rules apply to partnerships.

- ***New fringe benefit rules***. The new law eliminates the 50% deduction for business-related entertainment expenses. The pre-ACT 50% limit on deductible business meals is expanded to cover meals provided via an in-house cafeteria or otherwise on the employer's premises. Additionally, the deduction for transportation fringe benefits (e.g., parking and mass transit) is denied to employers, but the exclusion from income for such benefits for employees continues. Finally, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees except as provided for the employee's safety.

- ***Lobbying expenses***. The new law denies deductions for lobbying expenses paid or incurred after the date of enactment with respect to lobbying related to legislation before local governmental bodies (including Indian tribal governments). Under pre-Act law, such expenses were deductible.

- ***Like-kind exchange treatment limited***. Under the new law, the rule allowing the deferral of gain on like-kind exchanges of property held for productive use in a taxpayer's trade or business or for investment purposes is limited to cover only like-kind exchanges of real property not held primarily for sale. Under a transition rule, the pre-ACT law applies to exchanges of personal property if the taxpayer has either disposed of the property given up or obtained the replacement property before 2018.

- ***Penalties and fines***. Under pre-Act law, no deduction is allowed for fines or penalties paid to a government for the violation of any law. Under the Act, deductions are not allowed for any otherwise deductible amount paid to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by the government or entity into the potential violation of any law. An exception may apply to any payment the taxpayer establishes is either restitution (including remediation costs), or an amount required to come into compliance with any law that was violated or involved in the investigation or inquiry. An exception also applies to an amount paid or incurred as taxes due.

- ***Look-through rule on sale of partnership interest***. Under the new law, gain or loss on the sale of a partnership interest is effectively connected with a U.S. business to the extent the selling partner would have had effectively connected gain or loss had the partnership sold all of its assets on the date of sale. Tax

withholding obligations are imposed on the buying partner unless the selling partner certifies that he or she is not a nonresident alien or foreign corporation. This rule applies to transfers on or after November 27, 2017.

- ***Family and medical leave credit***. A new general business credit may be available for tax years beginning in 2018 and 2019 for eligible employers based on the wages they pay to qualifying employees on family and medical leave. Eligible employers are those with a written policy in place allowing qualifying full-time employees at least two weeks of paid family and medical leave a year, and less than full-time employees a pro-rated amount of leave. A qualifying employee is one who has been employed by the employer for one year or more and who, in the preceding year, had compensation not exceeding 60% of the compensation threshold for so-called "key employees." Paid leave provided as vacation leave, personal leave, or other medical or sick leave is not considered family and medical leave.
- ***Qualified rehabilitation credit***. The new law repeals the 10% credit for qualified rehabilitation expenditures for a building that was first placed in service before 1936, and modifies the 20% credit for qualified rehabilitation expenditures for a certified historic structure. The repeal of the 10% credit and modification of the 20% credit take effect starting in 2018 (subject to a transition rule for certain buildings owned or leased at all times after 2017).
- ***Employee achievement awards clarified***. An employee achievement award is tax free to the extent the employer can deduct its cost, generally limited to $400 for one employee or $1,600 for a qualified plan award. An employee achievement award is an item of tangible personal property given to an employee in recognition of length of service or a safety achievement and presented as part of a meaningful presentation. The new law defines "tangible personal property" to exclude cash, cash equivalents, gift cards, gift coupons, gift certificates (other than from an employer pre-selected limited list), vacations, meals, lodging, theater or sports tickets, stocks, bonds, or similar items, and other non-tangible personal property.

In this newsletter we have distilled a number of complex tax law provisions that may apply differently from one taxpayer to another. The above represents only some of the new laws and opportunities that arise under The Tax Cuts and Jobs Act of 2017, and is focused on certain business-related provisions of the Act. You should consult your tax advisors to determine how the new law may affect you. At Morris James, we would be happy to meet with you to review and evaluate your own circumstances in order to determine if additional action is advisable. We look forward to hearing from you.

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