Tax Reform Advisory: Corporate and General Business Provisions

December 29, 2017

On December 22, 2017, the President signed into law H.R. 1, informally known as the **"Tax Cuts and Jobs Act" (the "Act")**, implementing sweeping changes to the United States tax regimes generally applicable to businesses. Most provisions of the **Act will take effect as of January 1, 2018** and (except as noted below) generally will apply to tax years beginning after 2017. Certain highlights of the Act are discussed below.

Changes to Individual and Corporate Tax Rates. The corporate tax rate is reduced to a flat 21%. The highest individual income tax rate is reduced from 39.6% to 37%. As described below, a new deduction available to individuals for certain pass-through business income further reduces the effective maximum tax rate on income qualifying for the deduction to 29.6%.

Pass-Through Deduction. Individuals, trusts, and estates may be eligible for a 20% deduction on certain income earned through a partnership, S corporation or sole proprietorship (including a wholly-owned disregarded LLC), subject to limitations.

Income Eligible for the Deduction. The type of income eligible for the pass-through deduction includes: (1) the net income of a US trade or business (excluding compensation or guaranteed payments to the taxpayer); and (2) dividends from a REIT that are taxable at ordinary income rates. Investment-type income such as dividends and short-term or long-term capital gains (including for this purpose capital gains from the sale of an asset used in the trade or business) are excluded. Interest income is excluded unless it is allocable to the trade or business.

Limitations on the Deduction. There are two principal limitations on the availability of this deduction for income from a trade or business: (1) an exclusion imposed on certain services businesses; and (2) a limit based upon the amount of wages paid by the business and the unadjusted cost basis of the depreciable tangible property of the business. Both of these limitations do not apply to taxpayers with taxable income below $157,500 individually (or $315,000 for joint filers) and are phased in for taxpayers with taxable income above that threshold. These limits do not apply to REIT dividends.

With respect to service businesses, including law firms and accounting firms as well as businesses that provide investment management services, taxpayers whose income is above the applicable thresholds are not able to utilize the pass-through deduction with respect to income from such service businesses. It is not anticipated that real estate sponsors receiving promote payments in their capacity as partners would be treated as earning income from investment management services for this purpose.

The second limitation caps the deduction at the greater of: (1) 50% of the wages paid by the business; or (2) the sum of 25% of the wages paid by the business and 2.5% of the unadjusted cost basis of the depreciable tangible property of the business.

Calculating the Deduction. The deduction is calculated at the individual level, and the net income or loss, and the limitations noted above, are calculated separately for each trade or business. It is not clear whether a trade or business will be grouped by entity, activity, or some combination of the two for purposes of calculating the deduction and the applicable limitations. An individual partner's share of W-2 wages for limitation purposes is determined based upon the partner's allocable share of the partnership's wage expenses. An individual partner's share of unadjusted basis for limitation purposes is determined based upon the partner's allocable share of depreciation. Partnerships will need to provide additional information regarding the allocable shares of such items to their partners to allow their partners to determine their individual deductions. After an individual's tentative net income or loss and limitations are calculated for each trade or business, these amounts are netted such that a net loss from one trade or business may reduce the deduction allowable for a separate trade or business.

Commercial Observations. Real estate businesses, although capital-intensive, are generally not labor intensive. Therefore, many real estate business owners may not see a benefit from this deduction. For example, developers of for-sale condominiums do not generally have a large amount of depreciable tangible property or W-2 wages. The same may be true for long-term owners of appreciated real estate with low unadjusted cost basis. On the other hand, newer investments with lower cap rates may generate a material amount of income that would be deductible under the new provision. Guidance is needed to determine whether partnership basis adjustments allocable to depreciable tangible property would count toward the 2.5% unadjusted cost basis. Because the deduction is calculated at the individual level, partnerships will need to provide additional information to their partners to allow their partners to determine their individual deductions.

Limits and Elections for Interest Deductions. The Act limits the deductibility of interest for every business, regardless of its form, to 30% percent of adjusted taxable income (defined similarly to "EBITDA" by adding back to taxable income interest, any NOL or pass-thru business deduction, and (until 2022 only) depreciation). This limitation does not apply to: (1) taxpayers with less than $25 million of gross receipts; and (2) real property trades or businesses that elect out of the limitation. Real property trades or businesses include any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (including management and operation of lodging facilities). Interest in excess of 30% is carried-forward indefinitely.

Special Rules for Partnerships. The limitation generally applies to partnerships at the partnership level. For partnerships subject to the interest limitation, the interest deductions from a partnership will not be separately stated items, but will flow through to the partners as part of the partnership's non-separately stated income. Individual partners will then make certain adjustments in calculating their own interest deduction limitation to ensure that the limitation at the partner-level takes into account any interest that flows through the partnership. Special rules are provided for partnerships that have excess business interest carryforwards. Partners are allocated a share of the partnership's excess business interest, which they can use in any future year against excess taxable income from the partnership giving rise to the carryforward.

Election Out for Real Estate Businesses. Taxpayers electing to use the real property trade or business exception to the interest limitation will be required to use an alternative depreciation method in which the recovery period for: (1) residential real property is 30 years (instead of the 27.5-year recovery period otherwise available); (2) nonresidential real property is 40 years (instead of the 39-year recovery period otherwise available); and (3) qualified improvement property (e.g., leasehold improvements) is 20 years (instead of the 15-year recovery period otherwise available). Bonus depreciation on such qualified improvement property will also not be available for taxpayers electing out of the interest deduction limitation. It is anticipated most real estate investors who are eligible to elect out of the interest limitations will do so. Further guidance is needed to determine whether such taxpayers will have to take into account excess income as a result of a change to the recovery period of depreciable property. For partnerships, the election out of the limitation must be made at the partnership level.

Carried Interest. Any gain with respect to partnership interests held in connection with the performance of investment or development services (including investing in and developing real estate) will be long-term capital gain only if a three-year holding period is met. An exception is provided for capital interests which provide the taxpayer the right to share in the partnership's capital that is commensurate with the amount of capital contributed by the partner or with the amount taxed to the partner under section 83. It is uncertain whether the holding period applies only to the partnership interest, to assets of the partnership generating capital gain, or to both.

Expensing of Business Assets

Bonus Depreciation. Under the current rules in effect prior to the enactment of the Act, the cost of certain non-structural improvements to the interior of a nonresidential building and of other new tangible property that has a recovery period of 20 years or less is eligible for bonus depreciation in the year the property is placed in service. Under the Act, bonus depreciation is extended to used property purchased by the taxpayer and qualifying property may be fully expensed in the year the property is placed in service if the property is placed in service before 2023. The bonus expensing rate gradually steps down beginning in 2023. This provision does not apply to structural improvements or to taxpayers with a real property business who elect out of the 30% limitation on interest deductions described above.

Section 179 Expense. The amount allowed to be expensed under section 179 is increased from $500,000 to $1 million***.*** The $1 million expense allowance begins to be phased out now at $2.5 million of total acquisition costs of qualifying property, increased from $2 million. The types of property eligible for section 179 expense is expanded to include all qualified improvement property and certain improvements made to nonresidential real property.

Corporate Provisions

Net Operating Losses (NOLs). The net operating loss (NOL) deduction is limited to 80% of taxable income (determined without regard to the deduction) for losses arising in taxable years beginning after December 31, 2017. NOL carrybacks are eliminated (under current law they could be carried back two years) but unused NOLs can be carried forward indefinitely (instead of expiring in 20 years as under current law).

Dividends Received Deduction. For corporations, the Dividends Received deduction is reduced to 65% for dividends from more than 20% owned corporations and 50% for less than 20% owned corporations, from the current percentages of 80% and 70%, respectively. The 100% DRD for 80% owned corporations is not affected.

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

S Corporation Conversions. In apparent anticipation of taxpayers seeking to take advantage of the significantly lower corporate tax rate under the Act, the Act includes new transition rules to ease S corporation conversions to C corporation status occurring within the two-year period following the enactment date. To be eligible for the transition rule the corporation has to have the same owners on the date of enactment and the date of the conversion. Under current law, distributions paid during the one-year post-termination period are treated as tax-free returns of basis to the extent of the accumulated adjustments account (AAA), but distributions made after such one-year period are treated as taxable dividends. Under the new transition rule in the Act, distributions paid after the end of the one-year post-termination period may continue to be treated as paid in part from the AAA account in the same proportion that the balance in the AAA account bears to the post-conversion accumulated earnings and profits. In addition, accounting method change adjustments required under Section 481 attributable to the conversion (e.g., a cash method to accrual basis change) will be accounted for over a six-year period instead of the normal four-year period.

It remains to be seen whether taxpayers will actually convert into C corporation status in significant numbers. The combined effective C corporation and shareholder level tax income tax rates under the Act are approximately 37.8%. (This is comprised of a 21% corporate tax rate plus a 20% tax rate on the qualifying dividends paid from the after-tax earnings of the C Corporation). This combined rate is only slightly higher than the 37% maximum individual rate applicable to individual shareholders of S corporation Some taxpayers may be tempted by the opportunity to defer the shareholder level of dividend tax and reinvest the corporation's earnings inside the corporation. However, lower individual rates apply to long-term capital gains and the nominal 37% individual rate on ordinary income may be reduced by the availability of the new section 199A pass-thru business deduction. In addition, the attractiveness of the C corporation structure is reduced by the potential for a second level of state and local income taxation.

Contributions to Capital. Corporate developers can no longer exclude cash payments or property contributions from governmental or civic entities from taxable income by treating such payments as nontaxable capital contributions. A transition rule provides an exception in the case of certain payments made in connection with master development plans that have already been approved.

Accounting Methods

Cash Method of Accounting. Currently, the cash method of accounting is not available to corporations and partnerships with corporate partners if average gross receipts for the prior three year period are $5 million or more. The Act increases the average gross receipts threshold from $5 million to $25 million.

Inventory. Currently, certain businesses with average gross receipts less than $10 million are permitted to account for inventories as non-incidental materials and supplies. Under the new rules, taxpayers that carry inventories and are otherwise eligible to use the cash method of accounting will be permitted to account for such inventories as costs incurred for non-incidental materials and supplies, increasing the $10 million threshold to $25 million. Inventoriable items that are treated as non-incidental materials and supplies are consumed and used in the year the taxpayer provides the items to a customer. Thus, the cost of such inventoriable items are deductible only in that year, or in the year in which the taxpayer actually pays for the goods, whichever is later.

Also, the UNICAP rules will not be applicable to taxpayers with gross receipts of less than $25 million. The current threshold is $10 million.

Long Term Contracts. The exclusion from the requirement to use the percentage of completion method will be increased from $5 million of average gross receipts to $25 million of average gross receipts for the prior three-year period for contracts entered into after 2017.

Recognition of Certain Advance Payments. In certain circumstances, the "all events" test with respect to any item of gross income would be met no later than the year in which the income is recognized for financial statement purposes.[1] For example, accrual method taxpayers would be required to recognize certain advance payments when received. Additionally, in certain circumstances this rule may supersede the accrual rules generally applicable to debt instruments, such as the market discount and OID rules**.** There is an exception for income earned in connection with mortgage servicing rights, which will continue to be recognized in accordance with the rules of section 451. The new rule does not apply to situations in which the taxpayer uses a special method of accounting under another provision of the Code (other than the rules for debt instruments). Thus, the installment sale method is not affected.

The Act also codifies the current deferred method of accounting for payments for goods and services under Revenue Procedure 2004-34, which allows for the deferral of certain advance payments until the year following receipt, if also deferred for financial accounting purposes.

This provision is effective for tax years beginning after December 31, 2017, with the exception of debt instruments subject to the OID provisions, which will be subject to the provision in tax years beginning after December 31, 2018.

Treatment of Certain Expenditures

Domestic Activities Production Deduction. The deduction for domestic production activities is repealed.

Meals and Entertainment. The Act disallows a deduction for entertainment or amusement activities, social club dues or costs of a facility used in connection with such activities. The Act also disallows a deduction for commuting and transportation costs provided by an employer to employees. Meals provided by an employer on the employer's business premises would be disallowed after December 31, 2025.

Research and Development Expenditures. The research and development credit is preserved in the Act. Certain research expenditures, including software development costs, must be capitalized and amortized over 5 years and applies to expenditures paid or incurred after December 31, 2025.

Deduction for Defending Against Fines and Penalties. Although most fines and penalties are already nondeductible under current law, the Act expands the definition of fines and penalties to include any amount (such as legal fees) paid or incurred in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

Settlements Paid in Connection with Sexual Harassment or Sexual Abuse. Any amount paid for a settlement, payout, or attorney fees in connection with sexual harassment or abuse is not deductible if the payments are subject to a nondisclosure agreement.

Other Business Provisions

Aircraft Management. Certain payments paid by an aircraft owner for aircraft management services and maintenance are exempt from excise taxes imposed on taxable air transportation.

Foreign Beneficiary of an ESBT. Effective January 1, 2018, a nonresident alien is allowed to be a potential current beneficiary of an Electing Small Business Trust (ESBT). This provision would potentially allow a nonresident alien to hold an interest in an S corporation through an ESBT.

Tax Credits. The 20% credit for qualified rehabilitation expenditures with respect to a certified historic structure is amended to spread the credit ratably over the 5-year period beginning with the placed in service date of the rehabilitated building. The 10% credit with respect to pre-1936 buildings is repealed. A special transition rule applies with respect to certified historic structures or pre-1936 buildings owned or leased by the taxpayer at all times after January 1, 2018, if certain other conditions are satisfied.

Miscellaneous Items.

- From the date of enactment, the general disallowance of deductions for lobbying and political expenditures are expanded to include lobbying expenses incurred with respect to local councils or similar governing bodies (including Indian tribal governments).
- The Act repeals the rule allowing for the tax-free roll over of capital gains on publically traded securities to a specialized small business investment company.
- Gain or loss from the sale or exchange of self-created patents, inventions, models or designs (whether or not patented), or a secret formula or process will not receive capital gain treatment.

International Provisions. The Act makes material changes to the US international taxing regime. Below is a high-level summary of certain of the key international features of the Act. For a more fulsome discussion of these provisions and the other international provisions included in the Act, please see our International Provisions Advisory HERE.

New Dividends Received Deduction. The Act moves the United States to a so-called territorial system of international taxation, under which no US federal income tax is imposed on the operations of foreign corporate subsidiaries even when the profits are repatriated back to the United States in the form of dividends.

Transition Rule for Existing E&P. To transition existing offshore earnings into the new territorial regime, US shareholders are subject to a mandatory immediate inclusion of all accumulated earnings and profits (E&P) of a "specified foreign corporation" into gross income for the current taxable year. A special partial dividends received deduction (not limited to domestic corporations) is available. A number of special elections are available to US shareholders subject to a section 965 inclusion. **Individual shareholders may wish to consider transferring their stock in specified foreign corporations to a subchapter S corporation before the end of the year.**

Repeal of Indirect Foreign Tax Credit. The section 902 indirect foreign tax credit (for dividends from foreign subsidiaries, which dividends are now exempt from tax) is repealed.

CFC Changes. The Act expands US Shareholder Status to include 10% non-voting shareholders and expands the ownership attribution rules that apply in determining whether a shareholder is a US shareholder for CFC purposes.

New Tax on Low-Taxed Income of CFCs. The Act adds a new tax on "global intangible low-taxed income" (GILTI). The GILTI tax operates in a manner similar to subpart F requiring US shareholders of a CFC with GILTI income to include their proportionate shares of such income on a current basis.

New Deduction for Foreign Derived Income of Domestic Corporations. The Act add a new deduction equal to 37.5% of a domestic corporation's foreign derived intangible income (FDII) which effectively reduces the tax rate on such income to 13.125%.

Base Erosion Minimum Tax. The Act imposes a new base erosion minimum tax (BEAT) of 10% (5% for 2018) on the modified taxable income of an applicable taxpayer which is calculated by adding back to the taxpayers income any deductions for payments made to related foreign parties and any depreciation claimed for assets purchased from such persons (as well as NOL carryovers attributable to such payments made in prior years).

Additional detail regarding the above items and further discussion of other elements of the Act is available in the following Client Advisories.

- Exempt Organizations
- International Provisions
- Private Client & Trust
- Real Estate Industry

If you have any questions or concerns, we invite you to reach out directly to any member of our Corporate or Tax Groups.

****Mr. Razza is an accountant and not an attorney.***

[1] Financial statements generally must be prepared in accordance with GAAP or IFRS and filed with a regulatory or government body.