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The New Tax Law: Impact on Businesses

On December 22, 2017 President Trump signed H.R. 1, known as the Tax Cuts and Jobs Act, into law making widespread changes to the Internal Revenue Code. These changes went into effect January 1, 2018, and it is no overstatement to say that this mammoth tax bill will have a significant impact on virtually every business and individual.

This newsletter outlines selected changes under the new law that we believe will have the greatest impact on businesses. Please note that each of the changes described in this newsletter have no scheduled sunset date.

Reduction in Corporate Tax Rate

For tax years beginning after 2017, the *New Law* provides for a flat tax rate of 21% (down from a top 35% rate) for regular "C" corporations. "Personal Service Corporations" (PSCs) are also subject to the flat 21% tax rate (down from a 35% flat tax rate). A PSC is generally a "C" corporation that is primarily in the business of providing services in the areas of health, law, accounting, engineering, architecture, actuarial sciences, performing arts, or consulting.

Repeal Of Corporate Alternative Minimum Tax (AMT)

The *New Law* repeals the corporate AMT for tax years beginning after 2017. A corporation will be allowed a refundable credit for each of the tax years beginning in 2018, 2019, and 2020 equal to 50% of unused AMT credit carryovers to those respective years in excess of the regular tax for those years. Any AMT credit carryover amount that remains unused after applying it to the 2021 regular tax is 100% refundable.

NEW 20% DEDUCTION FOR QUALIFYING INCOME

Effective for tax years beginning after 2017, the *New Law* creates a new 20% deduction that is generally provided to non-corporate taxpayers receiving certain qualifying income.

Planning Alert! Although not discussed in detail in this letter, a similar 20% deduction is allowed to certain agricultural and horticultural cooperatives that satisfy specific criteria.

Caution! While most new tax provisions primarily impacting businesses under the *New Law* do not have an expiration date, this 20% deduction does expire after 2025.

Income Qualifying For The 20% Deduction

The following types of income generated by partnerships, S corporations, sole proprietorships, trusts, and estates may qualify for the 20% deduction: "Qualified Business Income," "Qualified Cooperative Dividends," "Qualified REIT Dividends," and "Qualified Publically-Traded Partnership Income." Please note that, of these four types of qualifying income, the most common will, in all likelihood, be "Qualified Business Income" (QBI). Consequently, the remainder of this discussion focuses only on QBI.

"Qualified Business Income"

"Qualified Business Income" (QBI) is generally defined as the net amount of qualified items of income, gain, deduction, and loss with respect to "any" trade or business other than:

1. Certain personal service businesses known as "Specified Service Trade Or Businesses" (described in more detail below), and
2. The trade or business of performing services "as an employee." QBI does not include:
   a) Dividends, investment interest income, short term capital gains, long term capital gains, income from annuities, commodities gains, foreign currency gains, etc.,
   b) Reasonable compensation paid by a qualified trade of business for services rendered to the taxpayer claiming the 20% deduction

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3. Any "guaranteed payment" paid to a partner for services actually rendered to or on behalf of the partnership, or

4. To the extent provided in regulations, any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services rendered to a partnership.

The Amount Of The 20% Deduction

The amount of the 20% deduction with respect to Qualified Business Income is generally the lesser of:

1. 20% of the owner's share of "Qualified Business Income" (QBI) from the owner's interest in each "Qualified Trade or Business," or

2. The owner's share of the W-2 Wage and Capital Limitation (if applicable) for each such trade or business interest.

The aggregate 20% deduction for QBI also cannot exceed 20% of the excess of the taxpayer's "taxable income" over the taxpayer's "net capital gains."

Caution! Although we do not discuss the detailed workings of the "W-2 Wage and Capital Limitation" in this letter, this limitation is generally designed to ensure that the maximum 20% deduction is available only to qualified businesses that have sufficient W-2 wages, sufficient tangible depreciable business property, or both. Also, otherwise qualifying owners of pass-through entities are entirely exempt from the W-2 Wage And Capital Limitation if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed $157,500 or $315,000 (if filing jointly). However, the Wage and Capital Limitation phases in as an owner's taxable income goes from more than $157,500 to $207,500 or more than $315,000 to $415,000 (if filing jointly).

"Specified Service Trade Or Businesses" Generally Do Not Qualify For The 20% Deduction Unless Owner's Taxable Income Less Than $415,000/$207,500.

A "Specified Service Trade or Business" (SSTB) generally does not qualify for the 20% deduction. An SSTB is any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or any trade or business involving the services of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Planning Alert! The 20% deduction is allowed for an owner of an SSTB if the owner's "taxable income" (computed without regard to the 20% deduction) does not exceed $157,500 or $315,000 (if filing jointly). The deduction is phased-out as an owner's taxable income goes from more than $157,500 to $207,500 or from more than $315,000 to $415,000 (if filing jointly).

Other Rules

The 20% deduction:

1. Does not reduce the owner's "self-employment" income for purposes of determining S/E Tax,
2. Does not reduce the owner's "adjusted gross income" (AGI), although it does reduce the owner's "taxable income," and
3. Is available to taxpayers using the standard deduction.

EXPANDED WRITE-OFFS FOR CERTAIN CAPITAL EXPENDITURES

100% First-Year 168(k) Bonus Depreciation Deduction

For the past several years, one of the most popular tax-favored deductions has been the 168(k) Bonus Depreciation deduction. Under prior law, the 168(k) deduction was equal to 50% of the cost of qualifying "new" depreciable assets placed-in-service during 2017, and was scheduled to drop to 40% for 2018.

However, the *New Law* increases the 168(k) Bonus Depreciation deduction to 100% for qualifying new and "used" property acquired and placed-in-service after September 27, 2017 and before January 1, 2023. Therefore, under the *New Law*, property that generally qualifies for the 168(k) Bonus Depreciation includes "new" or "used" business property that has a depreciable life for tax purposes of 20 years or less (e.g., machinery and equipment, furniture and fixtures, sidewalks, roads, landscaping, computers, computer software, farm buildings, and qualified motor fuels facilities).

Business Vehicles

Vehicles used primarily in business generally qualify for the 168(k) Bonus Depreciation. However, there is a dollar cap imposed on business cars and trucks that have a loaded vehicle weight of 6,000 lbs or less. More specifically, vehicles acquired and placed-in-service in 2017 and used 100% for business are generally allowed maximum depreciation (including the Section 179 deduction as discussed below) of $3,160 ($3,560 for trucks and vans) for 2017.

However, these caps are increased by $8,000 (i.e., to $11,160 and $11,560 for trucks and vans) for qualifying vehicles. For qualifying vehicles acquired and placed-in-service after September 27, 2017, the *New Law* retains this $8,000 increase through 2022. Moreover, for qualifying vehicles placed-in-service after 2017, the *New Law* increases the annual depreciation caps (without regard to the $8,000 increase) as follows:

- 1st year 10,000 (up from $3,160 if placed-in-service in 2017);
- 2nd year $16,000 (up from $5,100);
- 3rd year $9,600 (up from $3,050); fourth and subsequent years $5,760 (up from $1,875).

Listed Property

- The limitations are indexed for inflation for passenger automobiles placed in service after 2018
- The Act removes computer or peripheral equipment from the definition of listed property
- Such property is therefore not subject to the heightened substantiation requirements that apply to listed property
- The provision is effective for property placed in service after 12/31/17 in taxable years ending after such date

OTHER DEPRECIATION CHANGES

Applicable Recovery Period for Real Property

- The Act maintains the present law general MACRS recovery periods of 39 and 27.5 years for nonresidential real and residential rental property, respectively
- The Act provides a general 15-year MACRS recovery period for Qualified Improvement Property

“Qualified Improvement Property” is generally an improvement to the interior portion of a commercial building [provided the improvement is not attributable to an enlargement of the building, elevators or escalators, or the internal structural framework of the building], if the improvement is placed in service after the building was first placed in service.

Expansion Of The 179 Deduction

- A taxpayer may elect under §179 to deduct the cost of qualifying property, rather than recover such costs through depreciation deductions, subject to limitation
- Qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business

Effective for property placed-in-service in tax years beginning after 2017, the *New Law* increases the 179 Deduction limitation to $1,000,000 (up from $510,000 for 2017) and increases the phase out threshold to $2,500,000 (up from $2,030,000 for 2017). These caps are to be indexed for inflation after 2018.

Also, the $25,000 cap for SUVs remains, but will be indexed for inflation beginning in 2019.

Moreover, effective for property placed-in-service in tax years beginning after 2017, the *New Law* allows the 179 Deduction for:

1. “Qualified Improvement Property” (as described above), if the improvement is placed in service after the building was first placed in service, and
2. “Specified Improvements To Commercial Real Property” (which generally include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air conditioning property; fire protection and alarm systems; and security systems).
3. The Act expanded the definition of §179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.

OTHER SELECTED MISCELLANEOUS BUSINESS CHANGES

Simplified Accounting For Certain Small Businesses

Generally effective for tax years beginning after 2017, the *New Law* provides the accounting method relief for qualifying businesses.

Qualifying businesses are taxpayers with annual average gross receipts that do not exceed $25 million for the three-prior taxable-year period. (The $25 million amount is indexed for inflation for taxable years beginning after 2018).

The New Law:

1. Increases the average gross receipts (for the past three years) safe harbor for “C” corporations to use the cash method of accounting from $5 million to $25 million,
2. Generally allows businesses with average gross receipts (AVGRs) for the preceding three tax years of $25 million or less to use the cash method even if the business has inventories,
3. Generally allows simplified methods for accounting for inventories for businesses with AVGRs for the preceding three tax years of $25 million or less,
4. Generally exempts businesses with AVGRs for the preceding three tax years of $25 million or less from applying UNICAP, and
5. Liberalizes the availability of the completed contract method for certain businesses with AVGRs for the preceding three tax years of $25 million or less.
6. Contracts within this exception are those contracts for the construction or improvement of real property if the contract:

   - Is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract, and
   - Is performed by a taxpayer that (for the taxable

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year in which the contract was entered into) meets the $25 million gross receipts test.

New Limits On Business Interest

Effective for tax years beginning after 2017, the *New Law* generally provides that businesses may not deduct interest expense for a taxable year in excess of

1. Interest income, plus
2. 30% of the business's adjusted taxable income, plus
3. Floor plan financing interest.
4. Any excess is carried over to subsequent years for an unlimited number of years.

The *New Law* also generally exempts businesses with Average Gross receipts for the preceding three tax years of $25 million or less from this new interest expense deduction limitation.

Modifications To The NOL Deduction

The *New Law* generally makes the following changes to the NOL deduction:

1. For net operating losses (NOLs) arising in tax years beginning after 2017, repeals the prior law 20-year limitation on the number of years to which an NOL could be carried forward;
2. Net operating losses (NOLs) arising in tax years beginning after 2017 and carried to future years will not be allowed to offset more than 80% of taxable income before the NOL deduction; and
3. For net operating losses (NOLs) arising in tax years beginning after 2017, repeals the ability to carry back an NOL to previous years (except for certain farming and insurance companies.

Changes To §1031 Like Kind Exchanges

Generally, effective for exchanges completed after 2017, the *New Law* allows Section 1031 like kind exchanges only with respect to real property that is held in a trade or business or for investment.

Repeal Of Section 199 Deduction For Income Attributable To Domestic Production Activities

The *New Law* generally repeals the deduction for domestic production activities effective for tax years beginning after December 31, 2017.

Research and Experimental Expenses

Pre-TCJA law allowed taxpayers to currently deduct Research & Experimental expenses paid or incurred in connection with a trade or business (IRC Sec.174). Alternatively, taxpayers could capitalize their R&E expenditures and amortize them ratably over the useful life of the research (not to exceed 60 months) or a period of 10 years. For amounts paid or incurred in tax years beginning after 12/31/21, the *New Law* requires specified R&E expenses to be capitalized and amortized ratably over 5 years (15 years if R&E is conducted outside of the U.S.) Specified R&E expenses include costs for software development and exploration for ore and other minerals.

Note that the R&E tax credit is expressly preserved in the *New Law*.

Repeal Of Deductions For Certain Entertainment, Amusement, Recreation Activities, Membership Dues, Etc.

Effective for amounts paid or incurred after 2017, the *New Law* repeals all deductions with respect to:

1. An activity generally considered to be entertainment, amusement or recreation,
2. Membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or
3. A facility or portion of a facility used in connection with any of the above.

Planning Alert! The *New Law* did not repeal the deduction for 50% of food and beverage expenses associated with operating a trade or business (e.g., meals consumed by employees during travel away from home).

Changes For Meals Provided To Employees On Employer's Premises

Under prior law, an employer could generally deduct 100% of the cost of business meals that were excludable from the income of employees because they were provided at an employer operated eating facility for the convenience of the employer. Effective for amounts incurred and paid after 2017 and before 2026, the employer may deduct only 50% (down from 100%) of these employer-provided meals at an employer operated eating facility (after 2025 the *New Law* repeals this deduction altogether).

For more information and to schedule a strategy session to reduce your overall tax liability please call our office at 802.878.1963 (Williston) or 802.775.7132 (Rutland).