

BDO KNOWS:

TAX REFORM



SUBJECT

CORPORATE TAX REFORM – SUMMARY OF NEW LAWS TAKING EFFECT

SUMMARY

Introduced as the Tax Cuts and Jobs Act, the “Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal year 2018,” P.L. 115-97, was signed into law by the President on December 22, 2017. While the individual and pass-through (e.g., S corporation) provisions are generally phased out in less than a decade, the tax cuts for C corporations are permanent changes to the Internal Revenue Code. The reduced tax rate of 21 percent, from 35 percent, is certain to increase the popularity of corporations. The benefits increase the longer earnings are retained and deferred from additional tax (e.g., no dividends or stock dispositions). S-to-C corporation conversions have been made more taxpayer-friendly in an effort to ensure C corporations are not only more competitive internationally under the new law, but also domestically. The key topics in the new law covered below include: 1) corporate tax rate reduction and the alternative minimum tax (AMT) repeal, 2) capital contributions and dividends to corporations, 3) debt versus equity (section 385) and the new limitation on deducting interest expense, 4) corporate net operating losses (NOLs), 5) bonus depreciation and full expensing, 6) section 199A deduction for qualified business income earned from S corporations, 7) electing small business trusts (ESBTs), and 8) S-to-C corporation conversions.

DETAILS

Corporate Tax Rate Reduction and the Alternative Minimum Tax Repeal

The top corporate tax rate has been permanently reduced by 40 percent—from 35 to a flat tax rate of 21 percent. The prior four corporate tax rates, with a top rate applicable to income over \$10 million, have been reduced to a single flat rate thereby converting the corporate progressive tax system into a flat tax system. Personal service corporations (e.g., certain corporations providing health, law, and accounting services), which have historically been subject to some of the highest tax rates and could not benefit from the lower progressive rates, are now taxed at the same rate as other C corporations. The corporate tax rate of 21 percent may increase the relative use of C corporations for certain businesses based on the facts and circumstances of each situation (e.g., the applicability of the new top individual rate of 37 percent, still subject to the individual AMT, and a new deduction for certain pass-through income discussed below). Taxpayers have already begun the difficult task of modeling out specific factors that could impact choice of entity determinations (e.g., temporary vs. permanent rate differences).

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The corporate AMT has generally applied to the extent a corporation's tentative minimum tax, based on a 20 percent rate, exceeds its regular tax, by reducing certain tax incentives and deductions. While the House bill eliminated the corporate AMT, the Senate proposal did not. Ultimately, the Conferees opted to repeal it because retaining the corporate AMT could reduce research and development incentives intended to improve competitiveness and innovation. Further, the historic policy concerns underlying the corporate AMT, with its tax rate threshold of 20 percent, have been greatly diminished as a result of the top corporate tax rate reduction from 35 to 21 percent.

The corporate AMT repeal is effective for taxable years beginning after December 31, 2017. Going forward, any corporate AMT credit may offset the regular tax liability for any taxable year after 2017. The AMT credit is simply the corporation's prior AMT liabilities. In addition, the AMT credit is refundable for any taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent for taxable years beginning in 2021) of the excess credit for the taxable year.

Capital Contributions and Dividends to Corporations

Certain capital contributions from state and local governments will no longer be excluded from income under section 118. Section 108(e)(6), however, will not be altered for computations of cancellation of debt income on certain contributions of debt. And the meaningless gesture doctrine will continue to apply to section 351 exchanges of wholly-owned corporations in which no shares are issued. While section 108(e)(6) and section 351 concerns arose following broad statutory language found in the House proposal, the subsequent Congressional reports eliminated these concerns.

As in the Senate proposal, the 70 and 80 percent dividend received deduction percentages for corporations have been reduced to 50 and 65 percent, respectively, under the new law.

Debt versus Equity and the New Limitation on Deducting Interest Expense

The recent section 385 regulations were identified by the Administration for possible elimination. That elimination determination was put on hold after statements that new statutory provisions may eliminate or mitigate the need for the regulations. As indicated, the new law modifies section 163 with an enhanced limitation on the deduction of interest for any business. The new provision limits the deduction of business interest by any taxpayer to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer; and (3) the floor plan financing interest of the taxpayer for the taxable year. The last element, floor plan financing, applies to dealers of vehicles, boats, farm machinery or construction machinery. For all other taxpayers, the limitation on net interest expense (interest expense less interest income) will be 30 percent of adjusted taxable income. Adjusted taxable income for this purpose is the taxable income of the taxpayer with the exclusion of: (1) any nonbusiness income, gain, deduction or loss, (2) business interest and business interest income, (3) any net operating loss deduction, and (4) any deduction allowable for depreciation, amortization or depletion.

Any amount disallowed under the limitation is treated as business interest paid or accrued in the following tax year. Disallowed interest will have an indefinite carryforward. In addition, the disallowed interest carryforward will be a tax attribute that carries over in certain corporate acquisitions subject to section 381 (such as tax free liquidations under section 332 and most reorganizations under section 368). The bill also modifies section 382 to expand the definition of pre-change loss to include any disallowed interest carryforward, making these carryforwards subject to the section 382 limitation in the same manner as NOL carryforwards.

Special rules apply to account for interests held by partners and S corporation shareholders. Specifically, the partnership must first calculate the limitation on business interest expense at the partnership level. Any excess interest is allocated to each partner in the partnership. The partner can then carryforward the excess, but can only deduct the carryforward to the extent the partnership allocates excess business income to that partner in a future year. Excess business income is the portion of that partnership's taxable income which bears the same ratio to the partnership's adjusted taxable income as the excess of 30 percent of the adjusted taxable income over the amount of net business interest bears to 30 percent of the adjusted taxable income of the partnership. In addition, if a taxpayer is a partner in a partnership, the taxpayer removes all items of income, deduction, gain or loss of the partnership when calculating adjusted taxable income. Instead, the taxpayer only includes the excess taxable income of the partnership in the taxpayer's calculation of adjusted taxable income. S corporations will apply similar rules to that of partnerships.

The following taxpayers are excluded from the application of the new interest limitations: (1) any taxpayer that has annual gross receipts under \$25 million, (2) regulated public utilities, (3) an electing real property trade or business, and (4) an electing farming business.

These new rules generally apply to taxable years beginning after December 31, 2017. The new interest limitations could lead to the repeal of the recent section 385 regulations in whole or in part.

Corporate Net Operating Losses

Under current law, section 172 allows businesses to offset current taxable income by any NOL carryforward or carryback, subject to several limitations. Although no limitation is placed on the use of NOLs under section 172, the AMT as it applies to businesses effectively limits utilization of NOLs to an offset of 90 percent of taxable income. The House bill took the AMT limitation and proposed to incorporate it within section 172, imposing a 90-percent limitation on the use of NOL carryforwards and carrybacks. The House bill also proposed to allow the indefinite carryforward of NOLs, eliminating the current 20-year carryforward limitation, while also eliminating all NOL carrybacks with the narrow exception of certain carrybacks for small businesses and farms in the event of casualty or disaster losses arising in a tax year beginning after 2017. The Senate bill proposed to limit NOL deductions to 90 percent of taxable income, and then 80 percent in tax years beginning after December 31, 2022.

Like the House bill, the Senate bill also proposed the elimination of NOL carrybacks and an indefinite NOL carryforward period. The Conference Committee report and new law adopts the Senate bill approach, with the exception that NOL deductions be limited to 80 percent of taxable income for all years beginning after December 31, 2017.

The 80 percent limitation on NOL deductions applies to losses generated in tax years beginning after December 31, 2017, and the elimination of carrybacks and indefinite extension of carryforwards applies only to NOLs generated in taxable years ending after December 31, 2017. NOLs generated in 2017 and earlier would retain their 20-year life and be available to offset 100 percent of taxable income, subject to certain limitations. The result is that taxpayers will have to track NOLs before and after the effective date separately. While NOLs are expected to increase as a result of the expansion of allowable depreciation deductions (see below), there may be an incentive to defer deductions to a year where they can be deducted 100 percent against taxable income as opposed to generating an NOL which is limited to 80 percent. Taxpayers should also consider any carryforward of disallowed interest under revised section 163, which will be an attribute subject to the same limitations on NOLs (specifically section 382), potentially causing taxpayers in a profitable position to consider change of control impacts.

Bonus Depreciation and Full Expensing

Under current section 168(k), an allowance for 50 percent "bonus" depreciation gives businesses an immediate deduction for half the purchase price of certain qualified property in addition to the first year tax depreciation expense (calculated after the reduction by 50 percent). The House bill proposed an increase of the first year allowance to 100 percent, allowing taxpayers the ability to deduct the full cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The House bill also proposed expanding property treated as qualifying to include used property not used by the taxpayer before acquiring it. The Senate bill proposed full expensing for property placed in service after September 27, 2017, and before January 1, 2023, (2024 for property with longer production periods) with the percentage decreasing by 20 percent for each successive year beginning in 2023 (80 percent allowance in 2023, 60 percent allowance in 2024, etc.) through a total phase out of the allowance for property placed in service on or after January 1, 2027. The new law adopted the Senate proposal and also allows the election for 50 percent bonus depreciation in lieu of the 100 percent available, and repeals the election to claim prior year minimum tax credits in lieu of bonus depreciation. Importantly, the new law expands the definition of qualified property by eliminating the requirement that use of the qualified property commence with the taxpayer.

Section 179 allows a deduction for the full purchase price of certain qualifying property purchased in the tax year. For tax years beginning in 2017, the section 179 deduction is limited at \$510,000, and begins to be reduced dollar-for-dollar when equipment purchases exceed \$2,030,000.

The House bill proposed for tax years beginning in 2018 through 2022 the expense limitation be increased to \$5,000,000, and the phase out amount to \$20,000,000. The Senate bill proposed the expense limitation be increased to \$1,000,000, and the phase out amount to \$2,500,000. The Conference Committee report and new law adopts the Senate approach, increasing the section 179 expense limitation on qualifying property to \$1,000,000, while also increasing the initial phase out amount to \$2,500,000.

As noted above, the expansion of both bonus depreciation and section 179 may increase or accelerate the generation of NOLs. The election to use such deductions will depend on the specific context and whether or not the acceleration will generate an 80 percent limited NOL. Further, the expansion of "qualified" property may increase the desire of buyers to purchase assets as opposed to stock in scenarios where the result is a step up in tax basis based on purchase price which can then be immediately deducted. For the same reason, there may also be an increase in deemed asset sale elections under sections 336(e), 338(g), and 338(h)(10) in scenarios where the structure of the acquisition is a qualified stock disposition or purchase.

Section 199A Qualified Business Income Earned from S Corporations

The new law provides individuals, estates, and trusts with a deduction of up to 20 percent of their domestic qualified business income (QBI), regardless of whether it is attributable to income earned through an S corporation, partnership, sole proprietorship, or disregarded entity.

For taxpayers whose taxable income does not exceed \$157,500 (or \$315,000 in the case of a joint return of a married couple), the deduction is fixed at 20 percent with no limitations. For taxpayers whose taxable income is at least \$207,500 (or \$415,000 in the case of a joint return of a married couple), two additional provisions apply. First, a limitation based on W-2 wages must be applied at the individual level, and thus may reduce the deduction percentage below 20 percent. Second, no deduction may be claimed for income from specified service businesses. For taxpayers whose taxable income is between these two amounts, the W-2 wage limitation and the limitation on specified service businesses are phased in. It is important to note that QBI does not include reasonable compensation paid to the taxpayer for services rendered with respect to the trade or business under new section 199A(c)(4).

A disqualified business includes a "specified service trade or business," which is defined in part as a business described in section 1202(e)(3)(A), ignoring the words engineering and architecture (permissible real estate services). Specifically, a specified service business is one involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities.

The new law also adopts a two-part W-2 wage (e.g., compensation from an S corporation) limitation. Under this provision, the wage limitation is the greater of 50 percent of the W-2 wages paid with respect to the qualified trade or business or the sum of 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis of all qualified property used in the business. The application of this wage limitation may reduce the deduction below 20 percent of the qualified business income, but will never increase the deduction above 20 percent.

The above offers a summary of the changes to section 199A.

An in-depth alert will be issued on the topic on the

[BDO Tax Reform website](#).

Electing Small Business Trusts

The new law modifies two rules applicable to ESBTs. First, a nonresident alien may be a potential current beneficiary of such a trust. Because the tax imposed on the S portion of an ESBT is the final incidence of taxation of such income, there is no further taxation on any amounts distributed to a beneficiary of an ESBT. Second, if an S corporation allocates a charitable contribution to an ESBT, the limitations on that deduction will be computed under the rules for individuals and not under the more restrictive rules for trusts. The rate of tax imposed on the taxable income of the S portion of an ESBT will also be reduced to 37 percent to match the highest rate of tax imposed on trusts.

S-to-C Corporation Conversions

In the event an S corporation and its shareholders determine that it is advantageous, in light of tax law changes or otherwise, to revoke the S corporation election, two new provisions will cushion the impact of the revocation. Both changes apply to an "eligible terminated S corporation," defined as any C corporation that is an S corporation on the day before enactment of the bill, revokes its S corporation election within two years after the date of enactment, and has the same shareholders, in the same proportions, as the corporation had on the date of enactment of the bill.

First, after the expiration of the post-termination transition period (at least one year after termination of the S corporation election), a distribution of money by the corporation is allocated between the accumulated adjustments account (AAA) and the accumulated earnings and profits (AE&P) of the corporation in the same ratio as the amount of the AAA bears to the amount of the AE&P. The portion of the distribution allocated to the corporation's AAA will reduce the shareholder's basis in the stock. The portion of the distribution allocated to AE&P will be a taxable dividend. These transition period provisions allow C corporation shareholders to benefit from historic AAA distributions, as a tax-free return of capital, where distributions would otherwise be entirely includable in income as dividends.

Second, if an eligible terminated S corporation using the cash method is required under section 448 to adopt an accrual method, the resulting section 481(a) adjustment, i.e., the amount necessary to prevent items of income or deduction from being duplicated or omitted, is taken into account ratably over six taxable years beginning with the year of change. Current accounting-method change procedures generally require a positive (taxpayer-unfavorable) section 481(a) adjustment to be taken into account over four taxable years.

Finally, because the tax rate established by sections 1374 (net recognized built-in gains) and 1375 (excess net passive income) are tied to the highest corporate tax rate, the tax rate under these two provisions will also be reduced to 21 percent. These provisions incentivize S-to-C corporation conversions so taxpayers can benefit from the 21 percent corporate tax rate and the accompanying deferral provided to shareholders until they choose to cash out.

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