Tax Bill Requires Prompt Consideration

(Accountants Global Network)

Attached is a summary and of several changes related to the income taxation of businesses and business activity that we have identified to be particularly significant.

Corporate Rate Cut

Effective for taxable years beginning after 2017, the rate of tax for corporations is fixed at 21%.

While the impact on publicly traded corporations is already evident (witness the stock markets), the 21% rate merits a reconsideration of C corporation status for private entities that currently are more often operated as pass-thru entities. For example, without considering the impact of state/local taxes, the rate of tax on the operating income of a pass-thru business, assuming the owner pays tax at the new maximum non-corporate rate of 37% and can take full advantage of the new deduction for qualified business income, is 29.6% [(1 - .2) x .37].[1]

The percentage quickly changes if the owners take distributions from the business, since distributions from a C corporation generally are taxed as qualified dividends at a 20% rate and will result in a combined rate of 36.8% [.21 + ((1 - .21) x .2)]. Further, a taxable sale of the business assets, preferred by the buyer, produces a greater differential, since most of the gain to the pass-thru owner will be taxed at the long- term capital gain rate, which remains at a maximum of 20%.
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20% Deduction for Qualified Business Income of Pass-Thru Entities

As a corollary to the rate relief given to C corporations, owners of pass-thru business entities (tax partnerships, S corporations and sole proprietorships) will be allowed a deduction under Section 199A generally equal to 20% of the combined qualified business income amount passed through to the owners from their pass-thru entities. This provision is effective for taxable years beginning after 2017, but will sunset or cease to apply for taxable years beginning after 2025.

This benefit applies only to the qualified business income of the pass-thru entity, that is, the items of income, gain, deduction and loss attributable to the qualified trade or business, and excludes investment income, e.g., dividends, interest income (other than interest income allocable to the trade or business), and items of short-term capital gain/loss and long-term capital gain/loss. This deduction also does not apply to any foreign source income of the business.

There are significant limitations on the deduction, including:

- Generally, subject to an exception based on the owner's taxable income, specified service businesses, including professional service businesses, do not qualify. This includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset is the reputation or skill of 1 or more of its employees. (Note that the conference committee removed engineering and architecture businesses from the list.)

- Subject to an exception based on the owner's taxable income, the deduction cannot exceed the greater of 2 amounts:

- 50% of the owner's allocable share of the W-2 wages of the business, or
- 25% of the owner's allocable share of the W-2 wages of the business, plus 2.5% of the unadjusted basis of the qualified property of the business (generally tangible property subject to the allowance for depreciation).

This latter limitation that takes into account qualified property of the business is particularly significant. This new limitation was inserted by the conference committee and addresses concerns our firm and others raised that the limitation based solely on W-2 wages unfairly penalized the form of ownership (partnerships and proprietorships) and many industries, including real estate. For example, rental income from commercial real estate should be able to be offset, at least in part, by the Section 199A deduction.

There is an exception to the specified service business limitation and the W-2 wages/qualified property limitation that looks to the taxable income of the business owner. Thus, generally, these limitations do not apply if the owner has taxable income of $157,500 or less ($315,000 or less for a joint return). However, this exception phases out for an owner who has taxable income exceeding $157,500 but less than $207,500 ($415,000 for a joint return). Thus, for owners who have taxable income of $207,500 ($415,000 for a joint return), the specified service business and W-2 wages/qualified property limitations are fully applicable as limitations on the 20% deduction.

The Section 199A deduction is not allowed to C corporations that are owners of a pass-thru business. However, the conference committee changed Section 199A to allow trusts and estates to receive the benefit of the deduction.

It is evident that properly structuring a taxpayer's business entities and their operation will be key to maximizing tax efficiency, particularly the availability of the 20% pass-thru deduction. This will require critical analysis of many issues; for example, segmentation/consolidation of business activity, form of ownership, lease versus ownership of business property, use of contractors versus employees, and payment of wages versus non-wage distributions, to name just a few. Further, since the provision will become effective for most taxpayers beginning January 1, 2018, this analysis should begin immediately.

Full Expensing of Certain Business Assets

In the case of certain property placed in service after 9/27/2017 and before 1/1/2023, the taxpayer may deduct 100% of the adjusted basis of the asset. This deduction phases out before generally ending for property placed in service after 2026.

The full expensing provision generally applies to (1) property to which MACRS applies with a recovery period of 20 years or less, (2) certain computer software, and (3) qualified improvement property. Full expensing will also apply to used property placed in service by the taxpayer, subject to limitations designed to prevent the churning of assets, e.g., acquisition from a related taxpayer.

Assuming passage of the bill, the full expensing provision can be used as a critical tax planning tool not only for taxable years beginning after 2017, but also for the current taxable year, given the 9/28/2017 effective date.

Limitation of Business Interest Deduction

The TCJA significantly limits the ability of taxpayers to deduct business interest for taxable years beginning after 2017. Subject to several important exceptions, the business interest deduction will be limited to the sum of (1) a taxpayer's business interest income, (2) floor plan financing interest, and (3) 30% of the taxpayer's "adjusted taxable income."

The taxpayer's adjusted taxable income generally is the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction or loss which is not properly allocable to a trade or business, (2) any business interest or business interest income, (3) any deduction under Section 199A with respect to qualified business income, (4) any net operating loss deduction, and (5) for taxable years beginning after 2017 and before 2022, any allowable deductions for depreciation, amortization or depletion.

This last provision reflects a compromise between the House and Senate, since the House bill allowed the depreciation addback, while the Senate bill did not provide for a depreciation adjustment. Further, to the extent the deduction of interest is limited, the conference agreement allows the disallowed interest to be carried forward indefinitely.

There are two important exceptions to the interest limitation. First, the limitation does not apply to a taxpayer that meets a $25 million gross receipts test. This generally requires that the taxpayer's average annual gross receipts for the 3-taxable year period ending with the prior taxable year not exceed $25 million. Unfortunately, complex aggregation rules apply to determine whether a taxpayer meets this test. Thus, the gross receipts of certain related taxpayers may have to be taken into account.

Also, certain real estate businesses may elect to avoid the limitation. This election is available to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. One downside of making the real estate business election is that the business must use the alternative depreciation system (ADS) for any nonresidential real property, residential rental property and qualified improvement property. Under the revised ADS rules, nonresidential real property has a recovery period of 40 years, residential rental property, 30 years (shortened from 40 years under current law), and qualified improvement property, 20 years.

The application of revised Section 163(j) is complex. It is applied separately at the partnership or S corporation level and then applied with adjustments at the owner level to make sure that the income limitation is effectively not duplicated or shortchanged.

This interest limitation is likely to affect many businesses. Taxpayers not within the exceptions will need to run calculations to determine how the limitation will affect their taxable income and whether adjustments to the capital structure, or other modifications to the business operation, are necessary.

Like-Kind Exchanges of Real Property

The TCJA generally preserves like-kind exchange treatment for real property used in a trade or business or held for investment. However, it eliminates like-kind exchange treatment for other property (i.e., personal property). This provision generally applies to exchanges completed after 12/31/2017, subject to an exception for an exchange if the relinquished property is disposed of before 1/1/2018, or the replacement property is received before such date.

Carried Interests

New Section 1061 is effective for taxable years beginning after 2017, and will effectively convert certain net long-term capital gain of a partner to short-term capital gain. A taxpayer's net short-term capital gain is taxed at ordinary income rates.

The conversion will occur where the property generating the long-term capital gain has a holding period of more than 1 year but not more than 3 years. This provision applies to "applicable partnership interests," defined as any interest in a partnership transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer (or a related person) in any applicable trade or business. Applicable businesses involve activities that consist of (1) raising or returning capital, and (2) investing in or developing specified assets, including, among others, securities, commodities and real estate held for rental or investment.

The provision does not apply to an interest held by a corporation or to a capital interest in a partnership if that interest provides the taxpayer with a right to share in partnership capital commensurate with the amount of capital contributed.

This provision may impact many real estate developers and promoters, given that most deals are structured to provide some form of carried interest to the developer/promoter. The statutory language of this provision is amorphous. If the developer or promoter does not satisfy the 3-year holding period, this provision will cause a great deal of uncertainty that will make planning around this provision difficult. It will be interesting to see whether Treasury and IRS prioritize guidance on Section 1061, since clarification of the provision may be difficult, and uncertainty of the boundaries not unwelcome by the IRS.

Conclusion

The new tax law is enormous and complex. The government print is 1,079 pages, with 503 pages of statutory language and 560 pages of accompanying explanation. Taxpayers are urged to consult their tax professionals in order to understand and appropriately respond to their own unique situations.