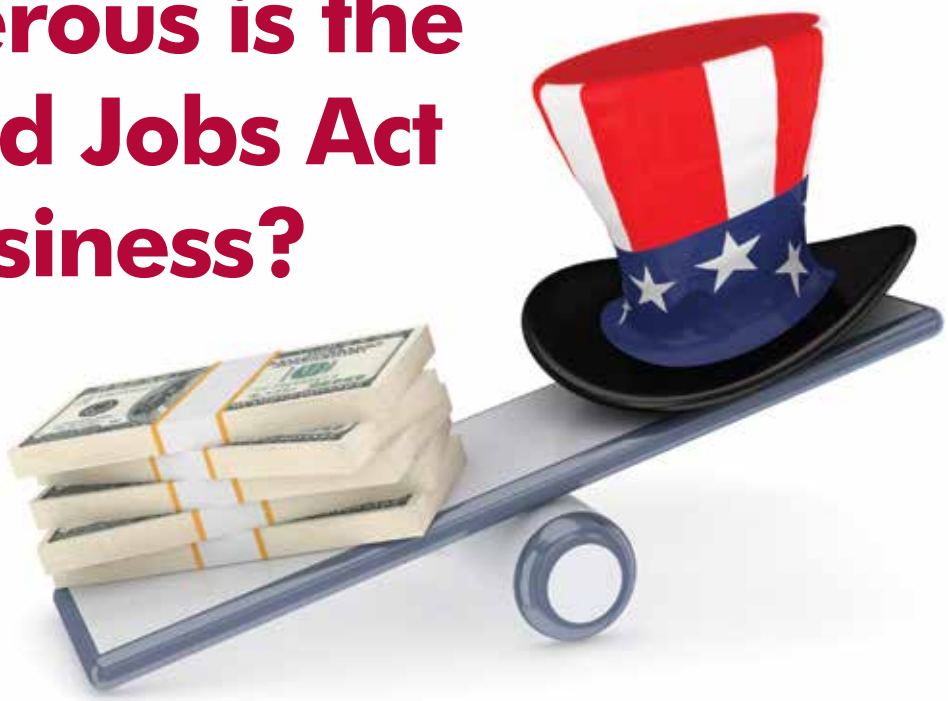
Delaware Banker

Summer 2018
Vol. 14 No. 3

Tax Cuts

How Generous Are They to Your Business?

How Generous is the Tax Cut and Jobs Act to Your Business?



by
Jordon Rosen, CPA, MST, AEP®
Tax Director
Belfint, Lyons & Shuman, P.A.

The centerpiece of the Tax Cuts and Jobs Act (the "Act") is the reduction from the tiered corporate tax rate system with a top rate of 35% to a flat 21% beginning in 2018. Thus, a corporation with taxable income of $335,000 would see a 38% reduction in its tax bill, from $113,900 to $70,350. The story, however, does not end here. The Act contains numerous income recognition and deduction changes that will impact a company's bottom line as well as make the owners and advisors re-think the overall business structure in some cases. This article will provide an overview of those changes and their possible impact.

As noted above, the Act reduced the overall tax rate for C corporations. In response, owners of flow-through businesses such as partnerships, S corporations, and proprietorships cried foul since their business income was reported on their individual tax return and could be taxed as highly as 37% (the new top individual rate from 2018-2025). Congress therefore provided new Section 199A – the **qualified business income (QBI) deduction** which in short, provides for a 20% deduction of qualified business income, thus reducing the overall effective rate for those in the top bracket to 29.6% on their business income. One key here is that the QBI deduction sunsets after 2025, while the corporate rate reduction is permanent. Business owners and advisors will need to evaluate the impact of the QBI deduction to determine its impact as well as determine the best form of entity to be doing business and whether a change in entity is warranted.

Along with the reduction in the top corporate tax rate is a reduction in the corporate **dividends-received deduction** from 70% to 50% and from 80% to 65% if there is at least 20% ownership in the other company. This reduces the rate on corporate dividends received to 10.5% and 7.35%, respectively.

Corporate Alternative Minimum Tax (AMT)

The Act repeals the corporate alternative minimum tax for tax years beginning after 2017. For 2018-2020, the AMT credit is refundable and can offset the regular tax liability equal to 50% of the excess (100% of the excess in 2021 and 2022) of the minimum tax credit for the year over the credit against the regular tax liability.

Depreciation

The Act made several changes to how businesses depreciate fixed assets. First, the **Section 179 expensing** allowance was expanded from $500,000 to $1 million for property placed in service in tax years beginning after 2017, with the $2 million phaseout increased to $2.5 million. The definition of qualified Section 179 property was also expanded to include certain depreciable tangible property used predominantly to furnish lodging and certain nonresidential real property improvements made after the date the property was first placed into service (e.g., roofs, HVAC property, fire protection and alarm systems, and security systems).

In addition, the Act increased the percentage of **bonus depreciation** that can be claimed for qualified property acquired and placed in service after September 27, 2017 through 2022 (note the start date is actually prior to the 12/22/17 enactment date) from 50% to 100% of the adjusted basis of the property. Starting in 2023 the bonus percentage is reduced by 20% each year until it sunsets at the end of 2026.

The Act also shortens the recovery period for certain real property and qualified restaurant improvement to 15 years, using the straight line, mid-year convention.

Finally, the Act significantly increased the luxury automobile depreciation limits. For vehicles placed in service after 2017 in tax years ending after 2017, the first-year depreciation limit increases from $3,160 to $10,000. If bonus depreciation is claimed (limited to $8,000), the first-year deprecation increases from $11,160 to $18,000. Similar increases were made to subsequent years' limits (for example, the second-year limit increases from $5,100 to $16,000!).

Net Operating Losses (NOLs)

A provision that will likely cause some frustration is the change in reporting business NOLs. In the past, an NOL could be carried back 2 years and then carried forward up to 20 years. For NOLs arising after 2017, the 2-year carryback provision is repealed except for farming trade or businesses. Thus, businesses will no longer be able recoup prior years' taxes using NOLs. The 20-year carryforward limit is repealed; thus an NOL can be carried forward indefinitely. In addition, the amount of an NOL that can be used to offset income in a succeeding year is limited to 80% of that year's taxable income.

Limit on Deduction for Business Interest

With certain exceptions, the Act places a 30% of "adjusted taxable income" limit on the deduction of net interest expense for tax years beginning after 2017. For 2018 through 2022, adjusted taxable income is computed as taxable income without regard to deductions for depreciation, amortization, and depletion. Any disallowed interest deduction is carried forward as business interest paid in the succeeding year and can be carried forward indefinitely.

Businesses that meet a $25 million gross receipts test (other than tax shelters) are exempt from the new interest limitation rules. Real property trade or businesses can elect out if they use the alternate depreciation system to depreciate applicable property. Floor plan financing is also exempt from the limitation rules.

There are special rules with respect to the limitation applicable to partnerships. The limitation is first determined at the entity level and then taken into account and allocated as part of non-separately stated taxable income or loss. Any excess interest expense is allocated to partners and reduces that partner's basis in the partnership. Special rules, beyond the scope of this article, address excess capacity amounts also allocated to partners as well as the adjustment to partnership basis in the case of unused excess interest expense upon disposition.

Tax Accounting Changes

The Act made four major changes in the way that businesses can report their income and deductions.

- **Expanding the use of the cash method of accounting** for all taxpayers (except tax shelters) for tax years beginning after 2017 if the prior 3 years' average gross receipts are not more than $25 million. This would apply regardless of whether inventory is an income-producing factor. The use of this provision would result in a change of accounting method under Section 481. Note that the exceptions for qualified personal service corporations and taxpayers other than C corporations is retained.

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• Pre-Act rules allowed only certain businesses with average gross receipts under $1 million ($10 million in certain cases) to use the cash method for **accounting for inventories**. For tax years beginning after 2017, the Act allows businesses meeting the above $25 million average gross receipts test to account for inventories (1) as non-incidental materials and supplies or (2) using a method that conforms to the taxpayer's financial statement treatment of inventories. The use of this provision is a change in accounting method under Section 481.

• For tax years beginning after 2017, the Act exempts producers and resellers of both real and personal property that meet the above $25 million average gross receipts test from the **UNICAP** rules under Section 263A. The exemption does not apply if use of 263A is not otherwise based on gross receipts. Again, this provision is a change in accounting method under Section 481.

• For **long-term contracts** entered into after 2017 and for years beginning after 2017 and except for tax shelters, the exemption from the requirement to use the percentage-of-completion method for reporting long-term contracts is expanded to include those contracts that are expected to be completed within two years from the commencement of the contact, and the taxpayer performing the work is expected to meet the $25 million gross receipts test for the year the contract is entered into.

Employer Deduction for Fringe Benefits

Through 2017, business-related meals and entertainment were 50% deductible (100% prior to the 1986 tax act). For expenses incurred or paid after 2017, the deduction for entertainment is disallowed. This would include items such as golf fees, theater tickets, and sporting events. The 50% deduction for business meals is retained; however, it is anticipated that IRS regulations will clarify that meals incidental to general business entertainment are "tainted" and thus not deductible. Also, after 2025, the deduction for employer-provided meals for the convenience of the employer is disallowed. This would include meals provide for employees working overtime. The deduction for employee transportation fringe benefits is now disallowed (e.g., parking and mass transit), but the benefit to the employee is still tax-free. Finally, no deduction is allowed for transportation expense paid for employee commuting, except for safety reasons.

Other provisions include:

• Repeal of the Domestic Production Activity Deduction for tax years beginning after 2017.
• Repeal of the partnership technical termination rules for partnership tax years beginning after 2017.
• Requirement that research and experimental expenses be capitalized and amortized over 5 years (15 years if conducted outside of the United States), beginning with the mid-point of the year in which the expense was paid or incurred.
• Limits like-kind exchange treatment under Section 1031 for transfers after 2017 to only real property that is not held primarily for sale (thus, it will no longer apply to tangible personal property). There is a transition rule for pre-Act tangible personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before 12/31/17.
• Clarification that tangible personal property given to an employee in recognition of either length of service or safety achievement does not include cash, cash equivalents, gift cards, gift coupons, gift certificates, vacations, meals, lodging, tickets for theater or sporting events, stock, or similar other nontangible property.
• The deduction for lobbying expenses with respect to legislation before local government bodies is eliminated after 12/22/17.
• The tax-free rollover provision of publicly traded securities gains into specialized SBICs under Section 1044 is repealed for sales after 2017.

The above summary of changes only scratches the surface of those made by the Act. Business owners and their advisors need to evaluate the impact of the provisions on their particular business, both from a tax and accounting standpoint. Since the Act was put together so quickly at the end of 2017, many items were not addressed and others are very ambiguous and need clarification. Treasury is expected to address many of these open issues in upcoming regulations.

Finally, the question will be whether states and local jurisdictions will conform to the federal changes or decouple, such as in the case of bonus depreciation and the 20% QBI deduction. This is certainly something that businesses and their advisors need to be monitoring.
For questions or further information, please contact Jordon Rosen at jrosen@belfint.com or 302.573.3911.

Jordon Rosen is a Director and shareholder at BLS and heads the firm's estate and trust practice. Jordon also provides tax consulting and compliance services to the firm's higher net worth clients and business owners. He is the Immediate Past President of the National Association of Estate Planners and Councils (NAEPC) and has served as president of the Delaware Estate Planning Council and the Chester County, PA Estate Planning Council. Jordon also serves as Chair of the Tax Committee of the Delaware State Chamber of Commerce, is a member of the AICPA Trust, Estate and Gift Technical Resource Panel and is a member of the editorial board of Thomson Reuters Focus publication. Jordon is a licensed CPA in Delaware and Pennsylvania and is a member of the Pennsylvania Institute of CPAs, Delaware Society of CPAs and the AICPA Tax Section. He also holds the designation of Accredited Estate Planner and has been recognized multiple years as a 5-Star Wealth Manager by Philadelphia Magazine and Delaware Today.