Journal of Accountancy

How tax overhaul would change business taxes

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December 18, 2017
Updated: December 20, 2017

The tax reform bill that Congress voted to approve Dec. 20 contains numerous changes that will affect businesses large and small. H.R. 1, known as the Tax Cuts and Jobs Act, would make sweeping modifications to the Internal Revenue Code, including a much lower corporate tax rate, changes to credits and deductions, and a move to a territorial system for corporations that have overseas earnings.

Here are many of the bill's business provisions.

Corporate tax rate

The act replaced the prior-law graduated corporate tax rate, which taxed income over $10 million at 35%, with a flat rate of 21%. The House version of the bill had provided for a special 25% rate on personal service corporations, but that special rate did not appear in the final act. The new rate took effect Jan. 1, 2018.

Corporate AMT

The act repealed the corporate AMT.

Depreciation

Bonus depreciation: The act extended and modified bonus depreciation under Sec. 168(k), allowing businesses to immediately deduct 100% of the cost of eligible property in the year it is placed in service, through 2022. The amount of allowable bonus depreciation will then be phased down over four years: 80% will be allowed for property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026. (For certain property with long production periods, the above dates will be pushed out a year.)

The act also removed the rule that made bonus depreciation available only for new property.

Luxury automobile depreciation limits: The act increased the depreciation limits under Sec. 280F that apply to listed property. For passenger automobiles placed in service after 2017 and for which bonus depreciation is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years.

Sec. 179 expensing: The act increased the maximum amount a taxpayer may expense under Sec. 179 to $1 million and increased the phaseout threshold to $2.5 million. These amounts will be indexed for inflation after 2018.

The act also expanded the definition of Sec. 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. It also expanded the definition of qualified real property eligible for Sec. 179 expensing to include any of the following improvements to nonresidential real property: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Accounting methods

Cash method of accounting: The act expanded the list of taxpayers that are eligible to use the cash method of accounting by allowing taxpayers that have average annual gross receipts of $25 million or less in the three prior tax years to use the cash method. The $25 million gross-receipts threshold will be indexed for inflation after 2018. Under the provision, the cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross-receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.

Farming C corporations (or farming partnerships with a C corporation partner) will be allowed to use the cash method if they meet the $25 million gross-receipts test.

The current-law exceptions from the use of the accrual method otherwise remain the same, so qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities continue to be allowed to use the cash method without regard to whether they meet the $25 million gross-receipts test, so long as the use of that method clearly reflects income.

Inventories: Taxpayers that meet the cash-method $25 million gross-receipts test will also not be required to account for inventories under Sec. 471. Instead, they will be allowed to use an accounting method that either treats inventories as nonincidental materials and supplies or conforms to their financial accounting treatment of inventories.

UNICAP: Taxpayers that meet the cash-method $25 million gross-receipts test are exempted from the uniform capitalization rules of Sec. 263A. (The exemptions from the UNICAP rules that are not based on gross receipts are retained in the law.)

Expenses and deductions

Interest deduction limitation: Under the act, the deduction for business interest is limited to the sum of (1) business interest income; (2) 30% of the taxpayer's adjusted taxable income for the tax year; and (3) the taxpayer's floor plan financing interest for the tax year. Any disallowed business interest deduction can be carried forward indefinitely (with certain restrictions for partnerships).

Any taxpayer that meets the $25 million gross-receipts test is exempt from the interest deduction limitation. The limitation will also not apply to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Farming businesses are allowed to elect out of the limitation.

For these purposes, business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the taxpayer's gross income for the tax year that is properly allocable to a trade or business. However, business interest does not include investment interest, and business interest income does not include investment income, within the meaning of Sec. 163(d).

Floor plan financing interest means interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired.

Net operating losses: The act limits the deduction for net operating losses (NOLs) to 80% of taxable income (determined without regard to the deduction) for losses. (Property and casualty insurance companies are exempt from this limitation.)

Taxpayers are allowed to carry NOLs forward indefinitely. The two-year carryback and special NOL carryback provisions were repealed. However, farming businesses are still allowed a two-year NOL carryback.

Like-kind exchanges: Under the act, like-kind exchanges under Sec. 1031 will be limited to exchanges of real property that is not primarily held for sale. This provision generally applies to exchanges completed after Dec. 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange was disposed of on or before Dec. 31, 2017, or the property received by the taxpayer in the exchange was received on or before that date.

Domestic production activities: The act repealed the Sec. 199 domestic production activities deduction.

Entertainment expenses: The act disallows a deduction for (1) an activity generally considered to be entertainment, amusement, or recreation; (2) membership dues for any club organized for business, pleasure, recreation, or other social purposes; or (3) a facility or portion thereof used in connection with any of the above items.

Qualified transportation fringe benefits: The act disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer and, except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

Meals: Under the act, taxpayers are still generally able to deduct 50% of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). For amounts incurred and paid after Dec. 31, 2017, and until Dec. 31, 2025, the act expands this 50% limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer. Such amounts incurred and paid after Dec. 31, 2025, will not be deductible.

Partnership technical terminations: The act repealed the Sec. 708(b)(1)(B) rule providing for technical terminations of partnerships under specified circumstances. The provision does not change the rule of Sec. 708(b)(1)(A) that a partnership is considered to be terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Carried interests: The act provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer. It treats as short-term capital gain taxed at ordinary income rates the amount of a taxpayer's net long-term capital gain with respect to an applicable partnership interest if the partnership interest has been held for less than three years.

The conference report for the act clarified that the three-year holding requirement applies notwithstanding the rules of Sec. 83 or any election in effect under Sec. 83(b).

Amortization of research and experimental expenditures: Under the act, amounts defined as specified research or experimental expenditures must be capitalized and amortized ratably over a five-year period. Specified research or experimental expenditures that are attributable to research that is conducted outside of the United States must be capitalized and amortized ratably over a 15-year period.

Year of inclusion: The act requires accrual-method taxpayers subject to the all-events test to recognize items of gross income for tax purposes in the year in which they recognize the income on their applicable financial statement (or another financial statement under rules to be specified by the IRS). The act provides an exception for taxpayers without an applicable or other specified financial statement.

Business credits

The act modified a number of credits available to businesses. The House version of the act would have repealed a large number of business credits, but the final act generally did not repeal those credits. Changes to business credits in the final act include:

Orphan drug credit: The amount of the Sec. 45C credit for clinical testing expenses for drugs for rare diseases or conditions is reduced to 25% (from the prior 50%).

Rehabilitation credit: The act modified the Sec. 47 rehabilitation credit to repeal the 10% credit for pre-1936 buildings and retain the 20% credit for certified historic structures. However, the credit must be claimed over a five-year period.

Employer credit for paid family or medical leave: The act allows eligible employers to claim a credit equal to 12.5% of the amount of wages paid to a qualifying employee during any period in which the employee is on family and medical leave if the rate of payment under the program is 50% of the wages normally paid to the employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. The maximum amount of family and medical leave that may be taken into account for any employee in any tax year is 12 weeks. However, the credit is only available in 2018 and 2019.

Compensation

Covered employees: Sec. 162(m) limits the deductibility of compensation paid to certain covered employees of publicly traded corporations. Prior law defined a covered employee as the chief executive officer and the four most highly compensated officers (other than the CEO). The act revised the definition of a covered employee under Sec. 162(m) to include both the principal executive officer and the principal financial officer and reduced the number of other officers included to the three most highly compensated officers for the tax year. The act also requires that if an individual is a covered employee for any tax year (after 2016), that individual will remain a covered employee for all future years. The act also removed prior-law exceptions for commissions and performance-based compensation.

The act includes a transition rule so that the changes do not apply to any remuneration under a written binding contract that was in effect on Nov. 2, 2017, and that was not later modified in any material respect.

Qualified equity grants: The act allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion for qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

Taxation of foreign income

The act provides a 100% deduction for the foreign-source portion of dividends received from "specified 10% owned foreign corporations" by domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of Sec. 951(b). The conference report says that the term "dividend received" is intended to be interpreted broadly, consistently with the meaning of the phrases "amount received as dividends" and "dividends received" under Secs. 243 and 245, respectively.

A specified 10%-owned foreign corporation is any foreign corporation (other than a passive foreign investment company (PFIC) that is not also a controlled foreign corporation (CFC)) with respect to which any domestic corporation is a U.S. shareholder.

The deduction is not available for any dividend received by a U.S. shareholder from a CFC if the dividend is a hybrid dividend. A hybrid dividend is an amount received from a CFC for which a deduction would be allowed under this provision and for which the specified 10%-owned foreign corporation received a deduction (or other tax benefit) from any income, war profits, and excess profits taxes imposed by a foreign country.

Foreign tax credit: No foreign tax credit or deduction will be allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction.

Holding period: A domestic corporation will not be permitted a deduction for any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.

Deemed repatriation: The act generally requires that, for the last tax year beginning before Jan. 1, 2018, any U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the accumulated post-1986 deferred foreign income of the corporation. For purposes of this provision, a specified foreign corporation is any foreign corporation in which a U.S. person owns a 10% voting interest. It excludes PFICs that are not also CFCs.

A portion of that pro rata share of foreign earnings is deductible; the amount of the deductible portion depends on whether the deferred earnings are held in cash or other assets. The deduction results in a reduced rate of tax on income from the required inclusion of preeffective date earnings. The reduced rate of tax is 15.5% for cash and cash equivalents and 8% for all other earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. The separate foreign tax credit limitation rules of current-law Sec. 904 apply, with coordinating rules. The increased tax liability generally may be paid over an eight-year period. Special rules are provided for S corporations and real estate investment trusts (REITs).

Foreign intangible income: The act provides domestic C corporations (that are not regulated investment companies or REITs) with a reduced tax rate on "foreign-derived intangible income" (FDII) and "global intangible low-taxed income" (GILTI). FDII is the portion of a domestic corporation's intangible income that is derived from serving foreign markets, using a formula in a new Sec. 250. GILTI would be defined in a new Sec. 951A.

The effective tax rate on FDII will be 13.125% in tax years beginning after 2017 and before 2026 and 16.406% after 2025. The effective tax rate on GILTI will be 10.5% in tax years beginning after 2017 and before 2026 and 13.125% after 2025.

Definition of U.S. shareholder: The act amended the ownership attribution rules of Sec. 958(b) to expand the definition of "U.S. shareholder" to include a U.S. person who owns at least 10% of the value of the shares of the foreign corporation.

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