TAX CUTS AND JOBS ACT

KEY PROVISIONS TO BUSINESS OWNERS

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Tax Cuts and Jobs Act of 2017 (“TCJA”)

- Signed into law on December 22, 2017.
- Sweeping changes to the Internal Revenue Code, including major modifications to taxes for both individuals and businesses.
- IRS has issued limited guidance on how to interpret certain provisions. More comprehensive guidance is expected to be released throughout the year.

Reference Materials

- Text of the bill can be found here:
  - http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf

- Joint explanatory statement from the conference committee managers can be found here:
  - http://docs.house.gov/billsthisweek/20171218/Joint%20Explanatory%20Statement.pdf

New Individual Tax Rates

Single Individuals	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

New Individual Tax Rates

Married Individuals Filing Joint Returns and Surviving Spouses	
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000

Individual AMT

- Temporarily increases both the exemption amount and the exemption amount phase-out thresholds for the individual Alternative Minimum Tax.
- For tax years 2018 through 2025, exemption amount is increased to $109,400 for married taxpayers filing jointly (50% of this amount for each taxpayer that is married filing separately) and to $70,300 for all other taxpayers.
- The phase-out thresholds are increased to $1,000,000 for married taxpayers filing jointly and $500,000 for all other taxpayers.

Taxation of Businesses

C Corporation Taxation

- C corporation income tax rate is 21%
- No graduated rate structure; 21% rate applies at all income levels.
- Starts in tax year 2018 and does not have an expiration.
- Alternative minimum tax for C corporations is repealed.

Pass-through Entity Taxation

- Includes partnerships, S corporations, and sole proprietorships.
- Under prior law, income passed through to taxpayers and taxed at individual tax rates—no general deduction or reduction of tax for business income.
- TCJA introduces a 20% deduction under new Section 199A for income from pass-through business entities.

Section 199A Deduction

- For tax years beginning after December 31, 2017 and before January 1, 2026.
- Taxpayer generally may deduct 20% of “qualified business income” from a partnership, S corporation, or sole proprietorship.
- A limitation based on “W-2 wages” paid or a combination of “W-2 wages” paid and “qualified business property” is phased in above a certain threshold amount of taxable income.

Qualified Business Income

- Qualified Business Income ("QBI") means the net amount of income, gain, deduction, and loss with respect to the business.
- QBI is determined for each qualified trade or business of the taxpayer.
- Does not include specified investment-related income such as: net long-term capital gain, dividends, and interest income not associated with the business.
- Does not include amounts paid to the taxpayer as compensation by an S corporation or other pass-through entity.
- If a business has multiple owners, each owner is allocated a portion of the QBI of the business based on relative ownership.

Deduction Limitation

- Once the taxpayer has taxable income above a certain threshold, a limitation on the amount of the deduction is phased in.
- Married Filing Jointly:
  - Up to $315,000 = full 20% deduction with no limitation
  - Over $315,000 but not over $415,000 = limitation is partially phased in
  - Over $415,000 = limitation is fully phased in
- Single filers:
  - Up to $157,500 = full 20% deduction with no limitation
  - Over $157,500 but not over $207,500 = limitation is partially phased in
  - Over $207,500 = limitation is fully phased in

How does the limitation work?

- 20% deduction is limited to the higher of either of the following limitations:
  - 50% of the "W-2 wages" paid by the business; or
  - 25% of the "W-2 wages" paid by the business plus 2.5% of the unadjusted basis immediately after acquisition (i.e. the purchase price) of all "qualified property."
- "W-2 wages" are the total wages paid by the business to its employees that are subject to wage withholding, elective deferrals, and deferred compensation.
- "Qualified business property" is depreciable property held for use in the business, that the business still holds at the end of the tax year and for which the depreciable period has not ended before the close of the tax year.
- Note: for each taxpayer's calculation of the limitation, they must use their allocable share of W-2 wages or qualified property. For example, a 50% partner would use 50% of the total W-2 wages paid by the partnership to calculate his or her limit for the Section 199A deduction.

Example 1: 50% of W-2 wages

- Taxpayer has $500,000 of QBI and an allocable share of $150,000 in W-2 wages paid by the business.
- 20% deduction of QBI would be $100,000, but it is limited because taxpayer's taxable income is over $415,000.
- Because the taxpayer's allocable share of W-2 wages is $150,000, the deduction is limited to $75,000 (50% of $150,000).
- To take the full $100,000 deduction, taxpayer would need to have allocable W-2 wages of $200,000.

Example 2: W-2 wages + Property

- Taxpayer still has $500,000 of QBI and an allocable share of $150,000 in W-2 wages, but also has an allocable share of $2,000,000 in qualified property used by the business.
- 25% of W-2 wages is $37,500 (25% of $150,000).
- 2.5% of qualified property is $50,000 (2.5% of $2,000,000).
- Under this limitation option, the taxpayer could take a deduction of $87,500 instead of $75,000.

Tax Illustration: C Corp 1

C Corporation with No Distributions to Shareholders	
C Corp Income	$1,000,000
21% Federal Tax	$210,000
Net C Corp Income after Tax	$790,000
Amount distributed to shareholders	$0
Amount retained by C Corp	$790,000
Total Tax*	**$210,000**
Effective Tax Rate	**21%**

*Does not include additional tax to shareholders when income earned by the C corporation is eventually distributed. See next slide for details.

Tax Illustration: C Corp 2

C Corporation Distributing All Income to Shareholders	
C Corp Income	$1,000,000
21% Federal Tax	$210,000
Net C Corp Income after Tax	$790,000
Amount distributed to shareholders	$790,000
23.8% Dividend tax + NII tax	$188,020
Net Income to Shareholders	$601,980
Total Tax	**$398,020**
Effective Tax Rate	**39.8%**

Tax Illustration: Pass-through

Pass-through Entity (S Corp, Partnership, Sole Proprietorship)	
Qualified Business Income (QBI)	$1,000,000
Section 199A Deduction (20%)*	($200,000)
QBI After Section 199A Deduction	$800,000
Tax on QBI (37% max rate)	$296,000
Net QBI after Tax	$704,000
Total Tax	**$296,000**
Effective Tax Rate	**29.6%**

*Assumes sufficient W-2 wages (or W-2 wages and qualified business property) to prevent limitation of deduction.

Advantages of C Corp

- Flat 21% federal tax rate on corporate income.
- Can use fiscal (versus calendar) year.
- Generally favorable rules for participation in retirement plans and fringe benefits.
- Can have multiple classes of stock.
- Can utilize full deduction of state corporate income tax paid (versus $10,000 limit for individuals).

Disadvantages of C Corp

- Tax on undistributed income is deferred, not avoided.
- If shareholders who do not receive salaries need income, dividends will have to be paid.
- If the business is sold as a sale of assets instead of stock, there would be double tax.
- Must use accrual basis of accounting if average gross receipts exceed $25 million.
- Losses do not flow through to owners.
- No preferred tax rate for capital gains.

S Corp to C Corp Conversions

- TCJA provides special conversion rules for any S corporation that becomes taxable as a C corporation during the two year period following its enactment.
- Must have the same owners on the date the new law took effect and on the date the S corporation election is revoked.
- Before TCJA, a C corporation with gross receipts over $5 million must use the accrual method of accounting. TCJA now allows C corporations with gross receipts of up to $25 million to use the cash method of accounting.
- If switching from cash to accrual method as part of conversion, can account for adjustments over 6 tax years beginning with the year of change, instead of 4 tax years.

S Corp to C Corp Conversions

- After an S corporation converts to a C corporation, distributions of cash by the C corporation to its shareholders for the one-year period following conversion are tax-free to the extent of the S corporation's accumulated adjustments account ("AAA").
- After the one-year conversion period, cash distributions by the C corporation are proportionately allocated between the AAA and accumulated C corporation earnings and profits.
- In summary, the TCJA expands tax relief to shareholders of a terminating S corporation beyond the one-year period following conversion.

Conversion Mechanics

- The Corporation revokes its S election by filing a statement with the IRS that is signed by shareholders owning more than 50% of the stock.
- It is effective for the following tax year, except that:
  - The revocation can specify a different effective date during the year of filing that is on or after the date of filing.
  - The revocation can be retroactive to first day of the tax year if it is filed within the first two months and 15 days of the tax year.

Conversion Mechanics

- If effective date of revocation is during the year, the Corporation will have a “short S year” and a “short C year”.
- Generally, the Corporation must begin making estimated tax payments during the short C year.
- Generally, the Corporation cannot elect back into S corporation status for 5 years.

Other Relevant Provisions

Business Interest Expense Deduction

- The deduction for net business interest expense is limited to 30% of the adjusted taxable income of the business.
- For tax years 2018 through 2021, adjusted taxable income will be computed without regard to deductions for depreciation, amortization, and depletion.
- Businesses with average gross receipts of $25 million or less in the 3 prior tax years will be exempt from the business interest deduction limitation.

100% Expensing

- Businesses are eligible for 100% expensing (i.e. 100% “bonus depreciation”) for certain qualified property purchased and placed in service after September 27, 2017 and before January 1, 2023.
- For tax years 2023 through 2027 the applicable first-year expensing amount will be phased down by 20% each year (i.e. 80% for tax year 2023, 60% for tax year 2024, etc.) until it reaches 0%.
- The Conference Agreement applies this new expensing regime to both new and used property acquired by the taxpayer in an applicable tax year.

Section 179 Depreciation

- Taxpayers can expense up to $1,000,000 of the cost of qualifying property placed in service in a taxable year.
- The $1,000,000 allowable expensing limit is reduced dollar for dollar by the amount that the cost of the property placed in service exceeds $2,500,000.
- For example, if a taxpayer places in service $3,000,000 of qualified property in a given tax year, the amount allowable as Section 179 expense would be $500,000 ($1,000,000 minus the amount by which the value of the property exceeds $2,500,000 ($500,000)).

Excess Business Losses

- Applies to pass-through business owners.
- A taxpayer's "excess business loss" for a taxable year is the excess of:
  - (a) the taxpayer's aggregate deductions attributable to his trades or businesses for the year, over
  - (b) the sum of:
    - (i) the taxpayer's aggregate gross income or gain for the year attributable to such trades or businesses, plus
    - (ii) $250,000 (or $500,000 for married couples).
- Essentially limits the amount of pass-through losses that can be used to offset other income to $250,000 (or $500,00 for married couples) per tax year.
- Excess business losses must then be carried forward and used as a Net Operating Loss (NOL) in later tax years.

Excess Business Losses

- Assume H has losses of $500,000 from his pass-through business and W has $300,000 from her pass-through business. They also have $1,000,000 of investment income.

	Prior Law	TCJA
Investment Income	$1,000,000	$1,000,000
H's business loss	($500,000)	($500,000)
W's business loss	($300,000)	($300,000)
Excess Business Loss Limit	N/A	($500,000)
Net Income for 2018	$200,000	$500,000
Loss carried forward to 2019	N/A	($300,000)

Net Operating Losses (NOLs)

- Net operating losses will be limited to 80% of taxable income for each year and may be carried forward indefinitely.
- TCJA repeals the two-year net operating loss carryback (exceptions are granted for certain losses incurred in the business of farming).

Repeal of Section 199

- TCJA repealed the Section 199 deduction for income attributable to domestic production activities.
- Under prior law, deduction was 9% of the lesser of the taxpayer's qualified production activities income or taxable income.
- For C corporations subject to the 35% corporate income tax rate, the 9% deduction effectively reduced the corporate income tax rate to slightly less than 32% on qualified production activities income.
- Repeal is effective for tax years beginning after December 31, 2017.

Modification of 1031 Exchanges

- TCJA repealed like-kind exchange treatment for personal property (e.g., machinery, equipment, aircraft).
- Tax deferred treatment under Section 1031 is now only for exchanges of "real property held for productive use or investment."
- Effective January 1, 2018. However, transition rules allow the completion of an exchange in 2018 if relinquished property was sold or replacement property was acquired by December 31, 2017.

Estate and Gift Exemption

- Increased estate and gift tax unified credit amount of almost $11.2 million per person ($22.4 million for married couples).
- Applies for gifts made and decedents dying from tax year 2018 through 2025.
- Without additional legislation, unified credit amount will return to pre-TCJA levels (adjusted for inflation) in 2026. Credit amount for 2017 was approximately $5.5 million ($11 million for married couples).
- Consider making large gifts to take advantage of the enhanced exemption?

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