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Tax Reform: Key Implications for U.S.-Based Businesses

The massive tax reform legislation enacted in December 2017, commonly referred to as the "Tax Cuts and Jobs Act" (the "Act"), has made extensive changes to the taxation of business entities. This alert summarizes some of the key provisions of the Act of general applicability to domestic corporations, partnerships and their respective U.S.-based shareholders and partners. For purposes of this alert, a "partnership" includes an LLC classified as a partnership for tax purposes, and all references to "Section" numbers are to sections of the Internal Revenue Code of 1986, as amended by the Act. The impact of the Act in any particular situation will require a fact-intensive inquiry and in certain cases may remain uncertain until guidance is received from the IRS or technical corrections are enacted by Congress.

New Corporate Tax Rates: For tax years beginning after December 31, 2017, the tax rates on C corporations are reduced from a top marginal rate of 35% to a flat rate of 21% (without "graduated" rates on lower levels of income as had been the case under prior law). A "blended" tax liability (effectively representing a weighted average of the old and new rates) is calculated for those corporations with fiscal years beginning in 2017 and ending in 2018. The alternative minimum tax (commonly referred to as "AMT") applicable to C corporations has been repealed. Unlike the Act's personal income tax rates – which are scheduled to sunset after 2025 – the reduced 21% corporate rate and repeal of the corporate AMT are permanent in nature.

New Individual Tax Rates: For the 2018-2025 tax years, individual tax rates on ordinary income – including business income recognized indirectly through partnerships and S corporations – are reduced at most levels of taxable income. In particular, the top marginal rate is reduced from 39.6% to 37%. The pre-2018 tax rates spring back into existence in 2026. Although the <u>individual</u> AMT has <u>not</u> been repealed, the exemption amount and level of income at which the exemption "phases out" have both been increased in a manner that, when coupled with revised limitations on certain itemized deductions, makes it less likely that AMT will be relevant for many individuals.

No Change for Long-Term Capital Gains or Qualified Dividends: There has been no change to the preferential tax rates applicable to an individual's long-term capital gain (the top rate remaining at 20% for taxpayers in the new 37% bracket), including long-term capital gain recognized on certain "exit" transactions and sales of business property owned through flow-through entities. Similarly, there has been no change to the top 20% rate for "qualified dividend income" received by an individual – meaning that a C corporation's earnings remain subject to the so-called double tax (consisting of the reduced 21% tax at the corporate level plus the top 20% tax on qualified dividends received by individual shareholders).

No Change for S/E and NII Taxes: There have been no changes to the tax on "net earnings from self-employment" (the "S/E tax") or the 3.8% tax on "net investment income" (the "NII tax"), either of which remains potentially applicable to an individual's income or gain from partnerships and S corporations, in each case on top of regular income tax rates. Both the S/E tax and NII tax continue to be subject to various exceptions and limitations (including, in the case of the NII tax, an exception for individuals who materially participate in the business of a partnership or S corporation). In addition, the NII tax continues to apply automatically to upper-income individuals (without regard to the individual's material participation in the business) who receive C corp. dividends or recognize capital gain on the sale of C corp. stock.

New 20% Deduction for Qualified Business Income from Flow-Through Entities: Under new Section 199A, individuals, trusts and estates are entitled to deduct up to 20% of their "qualified business income" ("QBI") from a partnership, S corporation, or Schedule C business activity (whether directly as a sole proprietorship or indirectly through a single-member LLC classified as a "disregarded entity"). The practical effect of this new provision is to reduce the highest marginal rate on QBI from 37% to 29.6%. Stock in a C corporation does not qualify for this new deduction. The computation of the QBI deduction requires several steps and is subject to numerous exceptions and limitations, which must be evaluated on a case-by-case basis, including the following:

- <u>Qualified Trade or Business</u>. In order to be eligible for the maximum 20% deduction, QBI must be U.S.-source income (generally including Puerto Rico) recognized by a business owner from a "qualified trade or business" ("QTB"). Services rendered by an employee (as opposed to an independent contractor) are specifically excluded from QTB treatment, with the result that W-2 compensation will not count as QBI eligible for the new deduction.

- <u>Exclusion for Specified Service-Oriented Businesses</u>. Of great significance, QTB treatment is not available in the case of a "specified service trade or business" ("SSTB") for business owners above certain taxable income thresholds. The exclusion for SSTBs does not affect business owners with taxable income of less than $157,500 ($315,000 for a joint return), and the exclusion phases in proportionately as the owner's taxable income increases to $207,500 ($415,000 for a joint return), in each case indexed for inflation. SSTBs are defined (unfortunately, without great clarity) as (i) the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, consulting or brokerage services; (ii) any business whose principal asset is the reputation or skill of one or more of its employees or owners; and (iii) the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

- Exclusion for Certain Types of Income. Certain categories of income are specifically excluded from QBI treatment (even if the business is otherwise properly treated as a QTB). Key exclusions include salary-like "guaranteed payments" for services rendered by a partner to a partnership and portfolio income such as dividends, capital gains and non-business interest income.

- Cap Based on W-2 Wages and Qualified Property. Of further significance, if a business owner's taxable income exceeds the threshold noted above, the 20% deduction for each QTB is subject to a formula cap equal to the greater of (i) 50% of the owner's allocable share of W-2 wages paid by the business or (ii) the sum of (A) 25% of the owner's allocable share of W-2 wages paid by the business and (B) 2.5% of the owner's allocable share of the unadjusted basis (i.e., original cost) of certain depreciable property owned by the business.

- Caps Based on Taxable Income. The Section 199A deduction otherwise determined for a business owner under the rules summarized above is then subject to further limitations based on the owner's "ordinary" taxable income (i.e., taxable income determined without regard to net capital gain and qualified dividends).

Choice of Entity Considerations: At first glance, the significantly reduced 21% corporate tax rate might tempt certain business owners to consider the use of a C corporation instead of a flow-through entity, particularly if the corporation plans on retaining most of its earnings in the business. However, for those business entities generating current income that expect to distribute all or substantially all of their after-tax profits to their equity owners, a flow-through entity eligible for the new Section 199A deduction will typically be a more tax-efficient approach than a C corporation subject to the "double tax." On the other hand, there could be other factors in a particular situation that might tilt the scales in favor of a C corporation, including the possibility that a shareholder's stock in a C corporation might be eligible for the Section 1202 capital gain exclusion for "qualified small business stock" held for more than five years. The determination of whether to use a C corporation, S corporation or partnership for a new or existing entity as a result of the Act will be based on numerous factors and is not susceptible to a "one-size-fits-all" solution.

Temporary Bonus Depreciation: The Act generally allows taxpayers to claim immediate deductions for 100% of the cost of certain tangible property used in a trade or business (commonly referred to as "bonus depreciation") – rather than depreciating the property over a specified recovery period – if the property is placed in service after September 27, 2017, and before January 1, 2023. Thereafter, the percentage of the property's cost that may be immediately deducted as bonus depreciation is reduced at the rate of 20% per year until the deduction reaches 20% in 2026 and zero in 2027. This bonus depreciation generally is available for tangible personal property having a recovery period of 20 years or less. In addition, although the Act's legislative history indicates congressional intent to allow bonus depreciation for "qualified improvement property" (defined as real property improvements to the interior portion of a nonresidential building placed in service after the date on which the building itself was first placed in service), these rules were not included in the actual text of the Act and presumably will not be available without technical corrections. Of some significance, the Act eliminates the requirement of prior law that the original use of the property commence with the taxpayer – so that bonus depreciation is now available for used property (subject to an exception for acquisitions from a related party).

- M&A Implications. The foregoing bonus depreciation rules (and the expanded Section 179 expensing rules noted below) may affect corporate M&A transactions by incentivizing buyers to push for asset acquisitions or so-called Section 338(h)(10) transactions (which cause a stock purchase to be deemed a purchase of assets for tax purposes), rather than straightforward purchases of stock.

Increase in Section 179 Expensing: For property placed in service in taxable years beginning after December 31, 2017, the Act increases from $510,000 to $1 million the amount a taxpayer may deduct with respect to "section 179 property" placed in service during such taxable year (subject to a dollar-for-dollar phase-out to the extent that the section 179 property placed in service by the taxpayer exceeds $2.5 million in any year). The term "section 179 property" generally means new or used tangible depreciable property or certain computer software that is acquired by purchase for use in the active conduct of a taxpayer's trade or business, subject to other limitations (including a requirement that the property not be used predominantly outside of the United States). Of particular importance, the Act expands the categories of real property improvements eligible to be expensed as section 179 property to include (i) "qualified improvement property" as defined under the bonus depreciation rules, and (ii) certain improvements made to a structural component of a building, such as roofs; heating, ventilation and air-conditioning property; fire protection and alarm systems; and security systems.

NOLs: The Act makes fundamental changes to the rules for net operating loss ("NOL") carryovers, depending upon when the NOL arises. For NOLs of calendar year taxpayers arising in post-2017 taxable years, (i) the two-year carryback provision of prior law has generally been eliminated, (ii) such NOLs may be carried forward indefinitely (rather than just for 20 years as under prior law) and (iii) the resulting carryforwards will now be permitted to offset only 80% of taxable income in the carryforward year (determined without regard to the NOL carryforward and with certain other adjustments). For NOLs of calendar year taxpayers arising in pre-2018 taxable years, (x) the two-year carryback and 20-year carryforward provisions of prior law have been retained, and (y) such NOLs may continue to be carried back two years and/or carried forward 20 years to offset taxable income without regard to the new 80% of taxable income limitation noted above.

- M&A Implications. The reduced 21% corporate tax rate, when coupled with the new limitations on NOL carryovers, may cause buyers of C corporation stock to attach less value to the target's NOLs for purposes of pricing a particular deal and to rethink the manner in which the parties allocate the tax benefit of any NOL carryforwards (particularly where the NOLs arise from transaction expense deductions incurred by the target).

New Limitation on Excess Business Losses of Individuals: The Act imposes a brand new limitation on an individual's ability to deduct aggregate net business losses in any taxable year – including the individual's share of business losses from flow-through entities – to the extent that such net business losses exceed $250,000 ($500,000 for a joint return) (referred to in the Act as an "excess business loss"). The threshold amounts will be indexed for inflation. Under the Act, an individual's excess business loss (determined after applying existing limitations in the tax law based on the individual's basis, at-risk amount and the passive activity rules) will no longer be deductible against investment income and other non-business income. Instead, the excess business loss will be deemed to give rise to an NOL that is carried forward to future years in accordance with the NOL rules described above. This provision applies to taxable years beginning after December 31, 2017, and sunsets for taxable years beginning after December 31, 2025.

New Limitation on Business Interest Expense: For taxable years beginning after December 31, 2017, the Act enacts a complex new regime that generally disallows a deduction for business interest expense that exceeds the sum of (i) the borrower's business-related interest income (if any), plus (ii) the borrower's interest expense on debt incurred to finance the acquisition of motor vehicles held for sale or lease, plus (iii) 30% of the borrower's "adjusted taxable income." "Adjusted taxable income" is defined in a manner that is similar to EBITDA for taxable years beginning before January 1, 2022 (*i.e.*, for the first four years that the new 30% limitation is in effect), but the definition then changes for subsequent years so that it is more similar to EBIT. Potentially significant exceptions apply for (x) taxpayers with average annual gross receipts of $25 million or less on a rolling three-year lookback basis, and (y) certain real estate businesses that elect out of the new limitation (although a condition to the election out is a stretched-out period of depreciation for the business's real property and the inability to elect bonus depreciation for certain real property improvements). Any business interest that is nondeductible for a particular taxable year is allowed to be carried forward indefinitely. Special rules apply in determining the allowable deduction for partners and S corp. shareholders. Of some significance, there is no grandfather rule for existing loan obligations, so that taxpayers are potentially subject to the new limitations for existing debt as well as new debt. These changes easily could cause certain borrowers to rethink the degree of leverage in their capital structure (including the possibility of giving consideration to preferred equity financing instead of debt, where appropriate).

- <u>M&A Implications</u>. Disallowed interest expense incurred by a C corporation (i) is treated as a tax attribute that is subject to carryover under Section 381 in certain tax-free liquidations and reorganizations and (ii) is potentially subject to limitation upon a change in control of the corporation in accordance with existing Section 382 rules applicable to NOLs. This may create another due diligence item to be taken into account by purchasers of corporate stock.

Like-Kind Exchanges Limited to Real Property: Effective generally for exchange transactions completed after December 31, 2017, nonrecognition treatment for like-kind exchanges is limited to exchanges of real property (subject to the continuing requirement of prior law that the property not be held primarily for sale). The Act repeals the deferral of gain for all other types of property (such as art held for investment, airplanes, or tangible personal property included within an office building, hotel or restaurant). The exclusion of personal property from like-kind exchange treatment may cause more tension between buyers and sellers with respect to purchase price allocations and may also impact a taxpayer's approach to aggressive cost segregation studies.

Carried Interests: The Act requires a three-year holding period (rather than the usual one-year period) as a prerequisite for long-term capital gain treatment for certain categories of partnership interests (commonly referred to as a "profits interest," "carried interest" or "promote") where the partner's economic interest in the partnership is disproportionately high relative to the partner's capital contributions and such economic interest may be viewed (in whole or in part) as economically equivalent to compensation for services rendered. The three-year holding period appears to be written broadly enough to include gain from the sale of a partnership asset flowing through on the Schedule K-1 as well as gain recognized on a sale of the partner's partnership interest. The new rules apply to taxable years beginning after December 31, 2017 (without sunset) and, of some significance, there is no grandfather rule for pre-existing carried interests.

Self-Created Patents and Other IP Not Treated as Capital Assets: The Act expands the list of self-created intellectual property ("IP") not eligible to be treated as "capital assets" under Section 1221(a)(3) or as "property used in the trade or business" under Section 1231(b)(1)(C) to include patents, inventions, models or designs (whether or not patented), and secret formulas or processes. At first blush, this might seem to foreclose the possibility of obtaining long-term capital gain treatment upon the disposition of a self-created patent or other listed IP asset. However, significant ambiguity is presented by the fact that the Act failed to repeal or otherwise amend Section 1235, which is in the nature of a "safe harbor" provision that generally allows certain inventors and investors to obtain long-term capital gain treatment upon the transfer of "all substantial rights" to a patent (even if the transfer might not have qualified for long-term capital gain treatment under the usual rules). It is not clear whether the Act's failure to repeal or amend Section 1235 was a technical drafting error or if Congress specifically intended long-term capital gain treatment to continue to be available for dispositions of patents complying with Section 1235, even though such dispositions will no longer be eligible for long-term capital gain treatment under the usual rules.

Miscellaneous Business-Related Changes:

- <u>Deductibility of Expenses for Entertainment, Meals and Entertainment, and Other Fringe Benefits</u>. For taxable years beginning after December 31, 2017, no deduction is allowed for (i) entertainment, amusement, or recreation expenses, (ii) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes or (iii) expenses associated with providing employee transportation fringe benefits. The Act retains the deduction for 50% of food and beverage expenses associated with operating a trade or business (e.g., meals consumed by employees on work or travel).

- Accounting Method Changes. The Act includes several provisions that simplify accounting method requirements for "small" businesses – defined generally as taxpayers with average annual gross receipts of less than $25 million on a rolling three-year lookback basis – including expanded availability of the cash method, exemption from the requirement to maintain inventories, relief from certain capitalization requirements and relief from using the percentage-of-completion method. In addition, the Act changes certain rules relating to the timing of income inclusion, including a new rule for accrual method taxpayers that generally requires an item to be included in income no later than when it is taken into account in an "applicable financial statement" (such as a Form 10-K or certain other certified financial statements used for credit purposes or other substantial nontax purposes), but generally not before a realization event has occurred for tax purposes.

- Taxation of Certain Capital Contributions. Under prior law, capital contributions to a corporation by a non-shareholder were ordinarily nontaxable to the recipient corporation. However, under the Act, capital contributions made by a governmental entity or civic group in a non-shareholder capacity will now be taxable to the corporation. As a result, governmental grants of cash or interests in real property intended to encourage corporations to relocate or develop property in a particular location will no longer be considered tax-free. The new provision is effective for transactions entered into after the date of enactment (December 22, 2017), subject to a grandfather rule for certain pre-enactment master development plans.

- Dividends Received Deduction. The "dividends received deduction" ("DRD") for dividends received by one corporation from another corporation has been reduced from 70% to 50% (for a corporation that owns less than 20% of the payor) and from 80% to 65% (for a corporation that owns 20% or more but less than 100% of the payor). The 100% DRD generally available for dividends received from a wholly owned corporate subsidiary has not been changed.

- Conversion of S Corp. to C Corp. The Act adds two somewhat technical provisions that may make it less costly for certain S corporations to convert to C corp. status. First, the Act expands the circumstances in which cash distributions by a former S corporation can be treated as a tax-free return of previously taxed S corp. earnings (rather than as a taxable C corp. dividend). Second, if the corporation is required to switch from the cash method of accounting to the accrual method of accounting as a result of its new status as a C corp., the Act allows any resulting income inclusion to be spread over six years rather than four years as under prior law. This new tax relief is available for any S corp. that revokes its S election within two years after December 22, 2017, provided that there are no changes in the corporation's stock ownership during that time.

- Repeal of Partnership Technical Termination Rule. The Act repeals the provision of prior law under which a partnership would be "terminated" for federal income tax purposes if 50% or more of its capital and profits interests were sold or exchanged within a 12-month period (even though the partnership continued to exist under applicable state law). However, the Act did not change the provision of existing law under which a partnership is deemed to terminate for tax purposes if 100% of its partnership interests are acquired by a single buyer (a situation that is commonly presented in certain LLC/partnership M&A transactions).

- Other Changes. The Act includes several industry-specific provisions that are not addressed in this alert (*e.g.*, changes relating to life insurance companies and energy sector-specific changes for power and utility companies, mining and metals companies, oil and gas companies, and the renewable and alternatives energy market). In addition, this alert does not address numerous other business-related changes in highly specialized areas of the tax law, including executive compensation, employee benefit plans, tax-exempt bonds, excise taxes, income tax credits, cross-border transactions and exempt organizations.

We would be happy to speak with you about the impact of the Act on your particular situation and the opportunities it may present for you. Questions about this alert or tax reform generally can be directed to:

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