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Summary of Significant Changes under the Tax Cuts and Jobs Act of 2017

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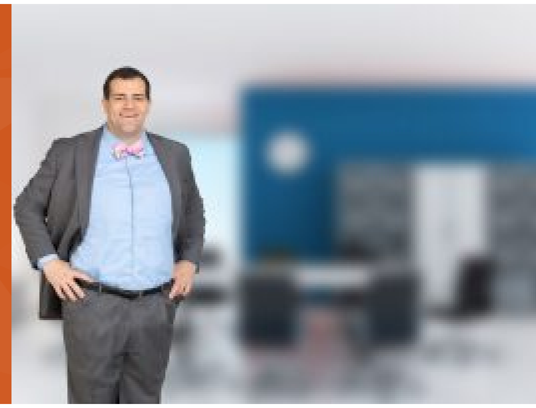

On December 22, 2017, President Trump signed into law a sweeping tax reform bill known as the Tax Cuts and Jobs Act of 2017 ("TCJA") that introduced significant changes for individuals, corporations, and pass-through entities.[1] This article summarizes some of the more significant changes made by the TCJA affecting U.S. corporations and pass-through entities.

1. Corporations.

a. Lower Corporate Tax Rate.

The TCJA permanently lowers the federal corporate income tax rate from 35% to 21% effective for tax years beginning after December 31, 2017. Personal service corporations (e.g., certain corporations providing legal, accounting, and health services) are now taxed at the same rate as other C corporations, effectively converting the historically progressive federal corporate income tax rate into a flat tax system. This new federal corporate income tax rate is significantly lower than before the TCJA and may have a serious impact on choice of entity decisions (e.g., whether to form a business as a corporation or pass-through entity).

b. Repeal of Corporate AMT.

The TCJA permanently repeals the corporate alternative minimum tax ("AMT") for taxable years beginning after December 31, 2017. Moving forward, corporations that were previously subject to corporate AMT are eligible for refundable credits against their regular tax liability, subject to certain limitations and thresholds. Generally, a corporation's AMT was the excess of its tentative minimum tax for the tax year over its regular tax. Originally intended to prevent perceived abuses by certain high-income corporate taxpayers, the historic policy concerns are greatly diminished as a result of the TCJA which reduced the federal corporate income tax rate to 21%.

c. Interest Deductibility.

The TCJA modifies the Internal Revenue Code (the "Code"), limiting the deduction of business interest by any corporate taxpayer to 30% of adjusted taxable income, subject to certain restrictions and limitations, for tax years beginning after December 31, 2017. Any amounts disallowed under this limitation can be carried forward indefinitely. Certain taxpayers are specifically excluded from the limitation on interest deductibility, specifically (i) any corporation with less than $25 million of annual gross receipts; (ii) any regulated public utility; (iii) any electing real property trade or business; and (iv) any electing farming business. This new limitation on interest deductibility could make debt-financed acquisitions (e.g., leveraged buyouts) less attractive; however, the permanent reduction in the federal corporate income tax rate to 21% may alleviate any potential impact.

d. Net Operating Losses.

Prior to the TCJA, corporations could carry their net operating losses ("NOLs") back up to two years and forward twenty years. The TCJA amends the Code to disallow carry backs and allow for NOLs arising in a taxable year ending after December 31, 2017 to carry forward indefinitely; however, future NOL deductions are limited to 80% of taxable income. As a result, the 80% NOL deduction limitation only applies to losses generated in tax years beginning after December 31, 2017, which means that corporate taxpayers will have to separately track NOLs arising before and after the effective date.

e. Bonus Depreciation.

Prior to the TCJA, the Code allowed corporate and pass-through businesses to immediately deduct an additional 50% of the purchase price of certain qualified property above and beyond first year tax depreciation expense. As a result of the TCJA, corporate and pass-through businesses can deduct 100% of the cost of certain "qualified property" business assets acquired and placed in service after September 27, 2017, and before January 1, 2023. The first-year bonus depreciation deduction phases out completely for property acquired and placed in service after December 31, 2026. In particular, the TCJA expands the definition of qualified property by eliminating the requirement that use of the qualified property commence with the taxpayer in question. The impact of the expansion of the definition of qualified property may, among other things, increase the desire for buyers in M&A transactions to pursue asset acquisitions versus stock acquisitions to account for a step up in the tax basis of purchased assets that can be immediately deducted, including deemed asset acquisitions under Code Sections 336(e), 336(g), and 338(h)(10).

2. Pass-through Entities.

a. Pass-through Income.

In general, a pass-through entity (an S corporation, partnership or sole proprietorship) is not subject to federal income tax. Rather, owners of the entity report their shares of the entity's income or loss on their individual income tax returns with the character passing through as well (as if the owners had realized or incurred the items of income or loss directly) and without regard to the amounts of distributions they receive from the entity. The TCJA reduced tax rates applicable to a U.S. individual's ordinary income, with the top marginal tax rate falling from 39.6% to 37%, and continued to subject pass-through entities to those now-reduced rates but with the potential benefit of the deduction described below.

i. Pass-through Deduction.

In general, the pass-through deduction available to an individual (or other non-corporate) owner of an interest in a pass-through entity is limited to the lesser of (i) 20% of the qualified business income ("QBI") allocated to the owner or (ii) the greater of (a) 50% of the owner's share of the "W-2 wages" paid by the entity for the year or (b) 25% of the owner's share of the "W-2 wages" paid by the entity for the year plus 2.5% of the owner's share of the unadjusted basis of all "qualified property" of the entity. The deduction can reduce the rate applicable to pass-through income to as low as 29.6%.

ii. Qualified Business Income.

QBI is the net amount of qualified items of income, gain, deduction and loss with respect to any "qualified trade or business" of the taxpayer to the extent effectively connected with the conduct of a U.S. trade or business and included or allowed in determining taxable income, but with exceptions for, among other things, (i) capital gains and losses (both short- and long-term), (ii) dividends, (iii) interest income not allocable to a trade or business, and (iv) deductions and losses allocable to excluded income. QBI also excludes reasonable compensation for services and "guaranteed payments" to partners for services rendered to their partnerships.

iii. Qualified Trade or Business.

In general, a qualified trade or business is any trade or business other than a "specified service trade or business" or the trade or business of performing services as an employee.

iv. Specified Service Trade or Business.

In general, a "specified service trade or business" is any trade or business involving the performance of services (i) in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services or where the principal asset of the business is the reputation or skill of one or more of its employees (but with a specific exception for architectural and engineering services), or (ii) that consist of investing and investment management, trading, or dealing in securities, partnership interests or commodities.

v. Threshold Considerations.

The pass-through deduction of 20% of QBI is generally available to those taxpayers with taxable income below a threshold amount – initially $157,500 for individuals and $315,000 for married taxpayers filing jointly – regardless of whether their income is derived from a "specified service trade or business" or whether they satisfy the W-2 wage requirements discussed above. A phase out begins as income from the "specified service trade or business" exceeds the "threshold amount" and is completely eliminated at levels of taxable income of $207,500 for individuals and $415,000 for married taxpayers filing jointly.

vi. Final Considerations.

The rules governing the QBI deduction applicable to pass-through entities are extremely complex and will depend on the facts and circumstances of each situation. While higher-income individuals who conduct "specified service trades or businesses" may not benefit from the new pass-through deduction, other pass-through entities may see a significant benefit as a result of the TCJA.

b. Carried Interest.

Prior to the TCJA, an owner of a partnership interest received in connection with the performance of services was generally entitled to long-term capital gain treatment upon the sale of the partnership interest if the interest were held for a period greater than one year. The TCJA retains the existing carried interest provision; however, it extends the required holding period for partnership interests issued in connection with the performance of services in the business of raising or returning capital or investing in or disposing of certain assets, such as securities, commodities, real estate held for rent or investment, cash and cash equivalents, options, and derivatives in reference to the foregoing items. For tax years beginning after December 31, 2017, the TCJA increases the holding period for these types of interests to three years in order to achieve long-term capital gain tax treatment. Where these types of partnership interests that would otherwise result in carried interest are not held for at least three years, the TCJA would subject the interests to taxation at short-term capital gains at a top marginal rate of 37%.

c. Excess Business Losses.

The 2008 Farm Bill[2] introduced a unique tax provision that limited annual farm losses for non-C corporation farms which received Commodity Credit Corporation loans or similar payments to the greater of (i) $300,000 or (ii) cumulative farm income during the past five years beginning in 2010. Excess farm losses for a particular year were disallowed as a deduction and could be carried forward to the next tax year and treated as a deduction from that year. The TCJA extends the "excess farm loss" rule to non-corporate owners of interests in all businesses conducted by pass-through entities by introducing a new Code Section which disallows any "excess business loss" of a non-corporate owner for any year and treats it as an NOL carry forward of the owner to the following year. An owner's "excess business loss" for any year is currently the excess of (i) the owner's aggregate deductions for the year from trade or businesses of the owner over (ii) the sum of (a) the owner's aggregate gross income or gain attributable to such trades or businesses plus (b) $250,000 ($500,000 in the case of a taxpayer filing a joint return), indexed for inflation. In the case of a pass-through entity, the "excess business loss" limitation is applied at the owner level, and, in the case of passive business owners, applies after the application of the passive loss rules. This new "excess business loss" limitation may have a disparate impact on entrepreneurs with substantial capital investments who have losses in any given tax year that exceed the threshold amount; however, it is important to note that the provision expires after December 31, 2025.

Looking ahead, taxpayers will undoubtedly require additional guidance from the Internal Revenue Service, the Department of the Treasury, as well as Congress with respect to the issuance of notices, Treasury Regulations, and technical corrections legislation. Please contact a member of our **Tax Practice Group** to learn more.

Footnotes.

1. P.L. 115-97, officially "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

2. P.L. 110-234, officially "The Food, Conservation and Energy Act of 2008."