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Tax Cuts and Jobs Act

1. Deduction For Qualified Business Income – IRC §199A

- **a.** The Tax Cuts and Jobs Act permits pass-through business owners, including partners of partnerships, S corporation shareholders and sole proprietorships, to deduct the 20% of qualified business income not to exceed taxable income for the year. The deduction is also available to a trust, which has the interest in a pass-thru entity. The deduction can lower the highest marginal tax rate on business income from 37% to 29.6%.
- **b.** The amount of qualified business income is generally net income earned by business less capital gains, dividends and interest income.
- **c.** The deduction is subject to limitations that phase in over specific taxable income thresholds and is based on whether the business is a qualifying business on and the amount of wages paid by the business or, if greater, a combination of wages paid and the adjusted tax basis of depreciable property.
- **d.** Qualified business income does not include wages or guaranteed payments for services under IRC §707(c) and certain non-partner capacity payments under IRC §707(a) paid to the taxpayer for services rendered with respect to the qualified trade or business.
- **e.** A qualified business does not include: (a) a business involving the performance of services in the fields of health, law, consulting, athletics, financial services or brokerage services; (b) a business the principal asset of which is the reputation or skill of one or more employees or owners; (c) a business involving the performance of services consisting of investing and investment management or trading or dealing in securities, partnership interests or commodities.
- **f.** The service business limitation applies only to taxpayers whose taxable income exceeds specific thresholds. For 2018 these thresholds are $315,000 for joint return or $157,000 for single return. Below the threshold amounts, the service business limitation does not apply. Above these amounts, the qualified business deduction phases out for service business until taxable income equal or exceeds the $415,000 for a joint return or $207,500 for a single return. A contribution to a qualified plan lowers the taxable income and hence maximizing contributions to a qualified plan can increase the amount of the qualified business deduction.

g. The deduction is subject to limitations that phase in over specific taxable income thresholds and is based on whether the business is a qualifying business on and the amount of wages paid by the business or, if greater, a combination of wages paid and the adjusted tax basis of depreciable property.

h. To maximize the wage or property limitation, the business could increase wages or purchase additional property used in the business to a point at which 20% of qualified business income equals 50% of wages paid or if more 25% of wages plus 2.5% of unadjusted tax basis of depreciable property. If 20% of qualified business income is more than the limit, the cap of the wage and property limitations limit the deduction.

i. If the business had no material amount of depreciable property, the maximum deduction will be achieved when wages equal $^{2}/_{7}$ of the business income, net of expenses other than wages. Once this $^{2}/_{7}$ amount is crossed, the qualified business deduction decreases to the extent that additional wages are paid. For example, if all the business income of an S corporation were paid out as wages, there would be no qualified as income deduction.

j. When a business does not have a significant payroll, an S corporation has an advantage. This is because the S corporation can pay the owners a wage while payments by an entity classified as a partnership to a member can never be a wage.

k. Payments made to independent contractors do not count in the wage of limitation.

l. An unknown question is whether employees of professional employer organizations or staffing firms who are outsourced to a business are treated as employees of the business for this purpose or are treated as employees of the professional employer organization or staffing firm.

m. An additional unknown is whether related businesses or even the same business housed in different legal entities can be aggregated. This is particularly important for those businesses that house all their employees in one affiliate and then charge sister business entities for services.

2. Deductibility Of Business Interest

- **a.** New §163(j) provides that a taxpayer is prohibited from deducting business interest expense exceeding the sum of (a) the business interest income plus (b) 30% of adjusted taxable income. For taxable years beginning after 2017 and before 2022, adjusted taxable income is defined as taxable income other than (a) items not allocable to a business, (b) business interest income and business interest deductions, (c) depreciation, amortization and depletion, (d) the 20% deduction for qualified business income, and (e) net operating loss carry forwards. For taxable years beginning after 2021 depreciation and amortization and depletion must be deducted in determining adjusted taxable income.
- **b.** Any disallowed interest may be carried forward.
- **c.** The limitation does not apply if the average annual gross receipts for the three taxable years which precede the current year does not exceed $25 million.
- **d.** If the taxpayer is engaged in a real property trade or business, the person or entity may elect out of the new interest limitations. A real property trade or business is defined as any real property development, redevelop-ment, construction, reconstruction, acquisition, rental operation, management, leasing, or brokerage business. The election once made is irrevocable. If the taxpayer makes this election, the taxpayer must depreciate nonresidential real property, residential real property and qualified improvement property using the slower alternate recovery period. However, it does appear that this election does not prohibit a Section 179 deduction. Section 179 permits immediate expensing of certain items subject to limitations.
- **e.** In the case of a partnership, the limitation applies at the partnership level by reference to the partnership's business interest income and 30% of the partnership's adjusted taxable income. Business interest deductions that are allowed are taken into account in determining the non-separately stated taxable income or loss of the partnership that flows through to the partner. The excess business interest is allocated to the partners and reduces the partners' adjusted basis. The excess business interest may be deducted in later years only to extent of excess taxable income allocated by that partnership to the partners. Excess taxable income allocated to the partners by a partnership that is not used to deduct previously disallowed excess business interest allocated by that partnership may be used to deduct other business interest incurred directly by the partner.
- **f.** Excess business interest is the amount of business interest not allowed as a deduction on the partnership tax return for that year. As indicated above, excess business interest is allocated to the partner and carried forward. Excess taxable income represents the partnership's excess capacity to deduct interest that is

passed through to the partners. This excess taxable income allows the partners to deduct directly incurred business interest or the previously disallowed excess business interest deduction allocated from the partnership. Excess taxable income is first used by a partner to allow the deduction of previously disallowed excess business interest allocated to the partner by the partnership. After the excess business interest has been fully offset, excess taxable income may be used to offset other business interest deductions directly incurred by the partner.

g. Other than the allocation of excess taxable income, for the purposes of computing the interest deduction limitation at the partner level, the partner's share of income, gain, loss and deduction from the partnership is ignored.

h. In a case of a partnership, guaranteed payments for use of capital under IRC §707(c) are not considered interest and preferred returns are not considered interest. Accordingly, where the interest limitation is likely to apply one might consider bringing in capital through preferred partnership interest or LLC interests that are given either a guaranteed payment or a preferred return.

3. Net Excess Business Loss Limitation

a. The Tax Cuts and Jobs Act creates an additional loss limitation. Under IRC §461(l) for taxpayers other than a "C" corporation excess business losses will not be allowed as a deduction in the current year. Instead the loss will be carried over as part of the taxpayer's net operating loss carried forward.

b. The excess business loss for a married taxpayer filing a joint return equals (a) the aggregate deductions of the taxpayer attributable to all trades or business over (b) all income and gain of the taxpayer plus $500,000, (adjusted for inflation). In the case of a separate return $500,000 is $250,000. The impact of the new IRS §461(l) is that it limits the ability of taxpayers other than a "C" corporations to deduct business losses exceeding $500,000 against other forms of income such as wages and investment income. By including the disallowed excess business loss in the taxpayer's net operating loss carry forward, the losses become subject to the new 80% of taxable income limitation applicable to net operating loss carry forwards.

c. For taxpayers in pass-through entities if some of the entities run at a loss, it is important to limit the amount of wages paid to the taxpayer and limit the amount of interest and dividends received by the taxpayer. For example if the taxpayer takes out $1 million in salary but has losses coming through pass-through entities of $1 million, the taxpayer will still pay tax on a portion of the wages even though the wages would otherwise be fully offset by losses from the pass-through entities.

4. Choice Of Entity – "C" Corporation Or Pass-Through

a. Effective for taxable years beginning after 2017, the federal tax rate for a C corporation is fixed at 21%. This 21% rate does not expire. The tax liability changes if the owner takes distributions from the business. Generally, distributions from a C corporation are qualified dividends taxed at 20%. In addition, the qualified dividends generally would be subject to an additional tax at 3.8% under IRC §1411. This results in a combined federal tax rate of 39.6%. If the additional tax of 3.8% under IRC §1411 doesn't apply, the combined rate is 35.8%.

b. If the full 20% IRC §199A deduction is available, the owners of a sole proprietorship or pass-through entity are taxed at a rate not greater than 29.6%. The IRC §199A deduction does not apply to self-employment taxes or the Medicare surcharge.

c. The greatest benefit of the corporate rate as compared with the individual rates is most apparent where the entity is likely to retain virtually all of its earnings or the owners do not qualify for the IRC §199A deduction either due to the nature of the business or the application of the limitations. In the case where IRC §199A does not apply, the taxpayer faces a marginal rate between 37% and 40.8%. Operating as a C corporation is least advantageous for businesses that qualify for the §199A deduction or where the business intends to distribute most if not all of the profit.

d. Under new IRC §164(b)(6)(B), the aggregate deductions for state and local taxes that may be taken into account by an individual is $10,000; $5,000 in the case of a married individual filing a separate return. These limitations do not apply to foreign income taxes, and state and local property taxes paid or incurred to carry on a trade or business or an activity conducted for profit. The state and local income taxes that an individual incurs on account of ownership of a pass-through entity do not qualify for the trade or business/ investment property exception and are subject to the $10,000 aggregate limit. There is no state and local tax deduction limitations for a C corporation. It is expected that when guidance is issued, taxes imposed at the entity level on a pass-through entity, such as business taxes imposed at the entity level, will be treated as a Section 162 deduction at the entity level.

e. Owners of pass-through entities have more flexibility in structuring a sale of the business. Buyers prefer a transaction pursuant to which the buyer receives a step up in basis. In the case of a C corporation, a sale of assets produces a double tax which is why owners of C corporations generally try to negotiate a stock sale.

5. Section 179 Expensing And Section 168(k) – Bonus Depreciation

- **a.** Under IRC §179, a taxpayer can elect to expense up to $1,000,000 of Section 179 Property placed in service. The $1,000,000 sum is an annual figure, and it is subject to two limitations. The $1,000,000 is reduced dollar for dollar by expenditures for Section 179 Property that exceed $2,500,000. The $1,000,000 is totally eliminated when the expenditures are $3,500,000 or more. The $1,000,000 is limited to the taxpayer's taxable income computed prior to the Section 179 expenses. Any amount in excess of taxable income is carried forward.
- **b.** Section 179 property now includes both new and used property. It also includes off-the-shelf software. It includes tangible personal property used in a business that is otherwise depreciable. Section 179 Property now includes "qualified real property" if elected by the taxpayer. Qualified real property includes improvements to the interior portion of non-residential real estate if the improvements are placed in service after the building is placed in service, but not enlargements, elevators or escalators or the structural framework of the building. It now includes certain improvements to non-residential real estate placed in service after the building is placed in service, such as roofs, heating and air conditioning systems, fire protection and security systems. Section 179 Property does not include intangibles such as patents and goodwill and except for "qualified" real property generally does not include real property.
- **c.** Under IRC 198(k) for qualified property placed in service before January 1, 2023, taxpayers can elect to deduct 100% of the property's adjusted basis in the year placed in service. After January 1, 2023, bonus depreciation phases down and is eliminated after 2027.
- **d.** Qualified property includes new and used property, off-the-shelf software and tangible personal property with a recovery period of 20 years or less.
- **e.** Qualified property does not include property that must be depreciated under the alternate depreciation system including property used outside the U.S. and real property businesses where the taxpayer has elected out of the 30% limitation on business interest expense.
- **f.** There are certain instances where Section 179 applies but Section 168(k) bonus depreciation is not permitted where the taxpayers elected out of 30% limitation on business interests.
- **g.** There are certain instances where Section 168(k) bonus depreciation is allowed but Section 179 does not apply. These include income producing property that is not used in business.

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6. Advance Payments Received By Accrual Basis Taxpayers

a. Under the accrual method of accounting, income is included when all events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. Generally, all events that fix the right to receive payment occur when (a) payment is earned through performance, (b) payment is due, or (c) payment is received by the taxpayer, whichever occurs first.

b. For an accrual method taxpayer, new Section 451(b)(1)(A)(i) provides that the all events test for any item of gross income shall not be treated as met any later than the year the item is taken into account as revenue on the taxpayer's applicable financial statements. New Section 451(c)(1)(A) now provides that an accrual method taxpayer must include an advance payment in gross income in the taxable year receipt. However, under new Section 451(c)(1)(B), an accrual method taxpayer may elect to defer the recognition of all or any portion of an advance payment to the taxable year following the taxable year in which payment is received, except for any portion of the advance payment that is required to be included in income under IRC §451(b) because, the item of income is taken into account as revenue on the applicable financial statements.

c. An accrual basis taxpayer cannot delay including the item in income, and at the same time record the item as income on applicable financial statements. If deferral is elected, reporting the income cannot extend beyond the taxable year following the taxable year in which payment is received.

d. To some extent these new rules follow existing rule provided in Revenue Procedure 2014-34. IRS Notice 2018-35 provides that until new guidance is issued, taxpayers may continue to rely on the rules of Revenue Procedure 2004-34 for treatment of advance payments.

e. Since there is now permissible deferral of up to one year, taxpayers should carefully consider their business practices regarding advance payments. Of course, a cash basis taxpayer must include an advance payment into income in the year received.

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