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Tax Cuts and Jobs Act

IN-DEPTH COMMENTARY of the Tax Bill

IV. Business-Related Changes

Reduction in Corporate Tax Rate

The Tax Bill eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 21 percent. It also eliminates the special tax rate for personal service corporations.

The Tax Bill proposals would be effective for taxable years beginning after December 31, 2017.

Reduction of Dividends Received Deductions to Reflect Lower Corporate Tax Rate

The Tax Bill reduces the 70 percent dividends received deduction available to corporations who receive a dividend from another taxable domestic corporation to 50 percent. It also reduces the 80 percent dividends received deduction for dividends received from a 20-percent owned corporation to 65 percent.

The Tax Bill proposals would be effective for taxable years beginning after December 31, 2018.

Corporate Alternative Minimum Tax (AMT)

The Tax Bill repeals the Corporate AMT. In the case of a corporation, the Tax Bill allows the AMT credit to offset the regular tax liability for any taxable year. In addition, the AMT credit is refundable for any taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, the full amount of the minimum tax credit would be allowed in taxable years beginning before 2022.

The Tax Bill provisions would be effective for taxable years beginning after December 31, 2017.

Enhanced Expensing Through Bonus Depreciation

The Tax Bill extends and modifies the additional first-year (i.e., "bonus") depreciation deduction through 2026. Under the Tax Bill, the 50-percent additional depreciation allowance is increased to 100 percent for property placed in service after September 27, 2017, and before January 1, 2023

The 100-percent allowance is phased down by 20 percent per calendar year for property placed in service. Thus, for property placed in service after December 31, 2022, and before January 1, 2024, the bonus percentage is 80 percent; for property placed in service after December 31, 2023, and before January 1, 2025, the bonus percentage is 60 percent; for property placed in service after December 31, 2024, and before January 1, 2026, the bonus percentage is 40 percent; for property placed in service after December 31, 2025, and before January 1, 2027, the bonus percentage is 20 percent.

Observation: Under current law, the bonus depreciation is scheduled to end for qualified property acquired and placed in service before January 1, 2020 and the 50-percent bonus depreciation amount is scheduled to be phased down for property placed in service after December 31, 2017. Thus, the Tax Bill repeals the current-law phase-down of the additional first-year depreciation deduction for property placed in service after December 31, 2017.

Observation: The Tax Bill maintains the bonus depreciation increase amount of $8,000 for luxury passenger automobiles placed in service after December 31, 2017. Under current law, the $8,000 increase in depreciation for luxury passenger automobiles (as defined in Code Sec. 280F(d)(5)) was scheduled to be phased down to $6,400 and $4,800 for property placed in service in 2018 and 2019, respectively.

Qualified Property. The Tax Bill removes the requirement that, in order to qualify for bonus depreciation, the original use of qualified property must begin with the taxpayer. Thus, the provision applies to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent. In the case of trade-ins, like-kind exchanges, or involuntary conversions, it applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property. It does not apply to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in Code Sec. 267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer.

The Tax Bill proposals would generally apply to property placed in service after September 27, 2017, in taxable years ending after such date.

Enhanced Expensing Through Section 179 Expense Deductions

Expansion of Code Section 179 Expensing. The Tax Bill increases the maximum amount a taxpayer may expense under Code Sec. 179 to $1,000,000, and increases the phase-out threshold amount to $2,500,000. Thus, the proposal provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2017, is $1,000,000 of the cost of qualifying property placed in service for the taxable year. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000. The $1,000,000 and $2,500,000 amounts, as well as the $25,000 sport utility vehicle limitation, are indexed for inflation for taxable years beginning after 2018.

Observation: The Tax Bill also expands the definition of qualified real property eligible for Code Sec. 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

The Tax Bill proposals would apply to property placed in service in taxable years beginning after December 31, 2017.

Modification of Net Operating Loss (NOL) Deduction

The Tax Bill limits the NOL deduction to 80 percent of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely.

The proposal repeals the two-year carryback and the special carryback provisions in current law, but provides a two-year carryback in the case of certain losses incurred in the trade or business of farming.

The Tax Bill provision would apply to losses arising in taxable years beginning after December 31, 2017.

Modification of Like-Kind Exchange Rules

The Tax Bill modifies the provision providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale.

The Tax Bill proposal would generally apply to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

No Modification of Depreciation Recovery Period for NonResidential or Residential Rental Property

Observation: The Senate Bill had shortened the recovery period for determining the depreciation deduction with respect to nonresidential real property from 39 years to 25 years and for residential rental property from 27.5 years to 25 years. However, this provision was eliminated in the Tax Bill.

Elimination of Separate Definitions Relating to Qualified Leasehold Improvements, Qualified Restaurant, and Qualified Retail Improvement Property

The Tax Bill eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 15-year recovery period for qualified improvement property. Thus, for example, qualified improvement property placed in service after December 31, 2017, is generally depreciable over 15 years using the straight line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is depreciable over 39 years as nonresidential real property, using the straight line method and the mid-month convention.

As a conforming amendment, the Tax Bill replaces the references in Code Sec. 179(f) to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property with a reference to qualified improvement property.

The Tax Bill proposals would be effective for property placed in service after December 31, 2017.

Small Business Cash Accounting Method Reform and Simplification

The Tax Bill expands the universe of taxpayers that may use the cash method of accounting. Under the provision, the cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy a gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period (the "$25 million gross receipts test") to use the cash method. The $25 million amount is indexed for inflation for taxable years beginning after 2018.

The Tax Bill retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other passthrough entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of such method clearly reflects income.

The Tax Bill provisions to expand the universe of taxpayers eligible to use the cash method apply to taxable years beginning after December 31, 2017. The change to the cash method is a change in the taxpayer's method of accounting for purposes of Code Sec. 481

Modification of Inventory Classification Rules for Small Businesses

The Tax Bill exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under Code Sec. 471, but rather may use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories.

Changes to Interest Deduction Rules

Under the Tax Bill, in the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. There is an exception to this limitation, however, for floor plan financing, which is a specialized type of financing used by car dealerships and certain regulated utilities.

The Tax Bill also exempts from the limitation taxpayers with average annual gross receipts for the three-taxable year period ending with the prior taxable year that do not exceed $25 million.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses

The amount of any interest not allowed as a deduction for any taxable year may be carried forward indefinitely. The limitation applies at the taxpayer level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the proposal. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of Code Sec. 163(d).

By including business interest income in the limitation, the rule operates to limit the deduction for net interest expense to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income. To the extent that business interest exceeds business interest income, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.

Application to pass-through entities. In the case of any partnership, the limitation is applied at the partnership level. Any deduction for business interest is taken into account in determining the nonseparately stated taxable income or loss of the partnership. Similar rules apply with respect to any S corporation and its shareholders.

Carryforward of disallowed business interest. The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely.

The Tax Bill proposal would apply to taxable years beginning after December 31, 2017.

Repeal of Domestic Activities Production Deduction

Under the Tax Bill, the deduction in Code Sec. 199 for domestic production activities is repealed.

The Tax Bill provision applies to taxable years beginning after December 31, 2017.

Limitation on Deduction by Employers of Expenses for Fringe Benefits

The Tax Bill provides that no deduction is allowed with respect to -

(1) an activity generally considered to be entertainment, amusement or recreation;

(2) membership dues with respect to 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.

Thus, the proposal repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions). The Tax Bill also 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.

Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel).

The Tax Bill proposal generally applies to amounts paid or incurred after December 31, 2017.

Change in Determination of Cost Basis of Specified Securities

The Tax Bill does not include a controversial provision in the Senate Bill which would have required that the cost of any specified security sold, exchanged, or otherwise disposed of on or after January 1, 2018, generally be determined on a first-in first-out basis except to the extent the average basis method is otherwise allowed (as in the case of stock of a regulated investment company).

Deductibility of Penalties and Fines for Federal Income Tax Purposes

The Tax Bill denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance.

The proposal applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law. An exception also applies to any amount paid or incurred as taxes due.

VI. Retirement Plan-Related Changes

Partial Repeal of Special Rule Permitting Recharacterization of IRA Contributions

The Tax Bill partially repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Under the provision, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA.

An individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization.

The provision is effective for taxable years beginning after December 31, 2017.

Extended Rollover Period for the Rollover of Plan Loan Offset Amounts in Certain Cases

Under the Tax Bill, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. Under the provision, a qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a Code Sec. 403(b) plan or a governmental Code Sec. 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's separation from service, whether due to layoff, cessation of business, termination of employment, or otherwise. As under present law, a loan offset amount under the provision is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan. The provision applies to taxable years beginning after December 31, 2017.