

Overview of the Tax Cuts and Jobs Act

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On December 27th, 2017 President Trump signed into law what is the most consequential tax reform in thirty years, by signing the Tax Cuts and Jobs Act (the "Act"). Most business changes took effect after December 31, 2017, some changes were effective immediately and others, like expensing of capital expenditures, had specialized retroactive effective dates. The following is an overview of the Act:

Individual Income and Transfer Taxes

For individuals, the new law reduces tax brackets, curbs the effect of the Alternative Minimum Tax, alters some tax credits, simplifies many returns by increasing the standard deduction, and increases the amount of property that can pass free of the estate, gift and generation skipping transfer tax. One area untouched by the new law is the adjustment to tax basis for capital assets upon death, allowing for "step-up" or "step-down" depending upon the cost basis vs. the value at date of death. Please see the following summary explanations:

- **Rates.** Beginning in 2018, the highest individual income tax rate was reduced from 39.6% to 37%. Other rate adjustments are illustrated in this table:

Rate	Unmarried Individuals, Taxable Income Over	Married Individuals Filing Jointly, Taxable Income Over	Heads of Households, Taxable Income Over
10%	\$0	\$0	\$0
12%	\$9,525	\$19,050	\$13,600
22%	\$38,700	\$77,400	\$51,800
24%	\$82,500	\$165,000	\$82,500
32%	\$157,500	\$315,000	\$157,500
35%	\$200,000	\$400,000	\$200,000

37%	\$500,000	\$600,000	\$500,000
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- **Standard Deduction and Personal Exemptions.** Beginning in 2018, the doubling of the standard deduction and curtailment of state and local taxes and mortgage interest deductions have the effect of simplifying many returns by eliminating the complexity associated with the preparation of Schedule A. Elimination of personal exemptions and limits on deductions for those who itemize will dramatically change the benefit to individuals of the deductions for mortgage interest, state income and property taxes and charitable contributions.
- **Credits.** The new legislation creates a patch-work quilt of how many tax credits are treated. For example, the American Opportunities Tax Credit for education remained untouched, but other credits were modified.
- **Alternative Minimum Tax.** Fewer individual taxpayers will be subject to this tax as a result of the increase of the exemption to just over \$109,000 (indexed).
- **Estate, Gift and Generation Skipping Tax Exemptions.** Beginning in 2018 and through 2025, these exemptions have been doubled to \$11.2 million per person, and indexed to inflation.

Basis Adjustment at Death. This adjustment, often mistakenly referred to as "step-up basis", remains unchanged. Property owned at death will be afforded a new basis equal to the value of such property at date of death. Adjusting the basis at date of death may mean the basis is increased, but can also result in a decrease in basis as happened for some deaths occurring during our last recession.

Provisions of Tax Cuts and Jobs Act Affecting Businesses

In addition to the changes impacting individual taxpayers, the Act included a substantial revision to the tax laws governing businesses. These changes begin with a reduction of the corporate tax rate to a flat 21% (down from a maximum of 35%) and permit unlimited expensing of capital expenditures, repeal the corporate Alternative Minimum Tax and change the deductions available to businesses. A substantial difference between the individual and business tax law changes is that some of the business changes are permanent (i.e. corporate tax rate), while others are temporary (immediate expense treatment for capital expenditures).

- **Tax Rate.** The new law creates a flat 21% income tax rate for C Corporations to replace the marginal rate bracket system which had imposed tax rates between 15% and 35%.
- **Corporate Dividends.** The dividends received deduction which allowed a C corporation to deduct 70 or 80 percent of dividends received from another C corporation has been reduced to a deduction of either 50 or 65 percent (the higher rate is available where the stock of the dividend paying corporation is owned at least 20% by the corporation receiving the dividend).
- **AMT.** The corporate Alternative Minimum Tax has been repealed for tax years beginning after December 31, 2017.
- **Section 179 Expensing Business Capital Assets.** Internal Revenue Code Section 179 allows a business to deduct the cost of certain "qualifying property" in the year of purchase in lieu of depreciating the expense over time. The Act allows a year of purchase deduction of up to an inflation indexed \$1 million (increased from \$500,000) with a total capital investment limitation of \$2.5 million. While these changes provide businesses with increased deductions, they have little meaning given the new 100% year of purchase deduction for capital expenditures available under amended Code Section 168(k).
- **Section 168(k) Accelerated Depreciation.** The Act allows a 100% deduction of the basis of "qualifying property" acquired and placed in service after September 27, 2017 and before January 1, 2023. Qualifying property generally includes depreciable tangible property with a cost recovery period of 20 years or less, computer software not acquired upon purchase of a business and nonresidential leasehold improvements.

The bonus depreciation deduction is then reduced to 80% in 2023 and drops by an additional 20% after each subsequent two year period until disappearing entirely for periods beginning January 1, 2027. The allowed deduction percentages are applied on a slightly extended time frame for certain property with longer production periods. In addition to increasing the available deduction, the Act also allows used property to qualify for the deduction. After a phase-out beginning in 2023, this provision lapses after December 31, 2026.

- **Business Interest.** Net business interest will not be deductible in excess of 30% of the "adjusted taxable income" of a business. For 2018 through 2021, adjusted taxable income will be determined without consideration of depreciation, amortization, depletion or the 20% qualified business income deductions. In 2022 and thereafter, the 30% limit will be applied to taxable income after deductions for depreciation and amortization. An exemption from the 30% limitation exists for taxpayers with annual gross receipts (determined by reference to the three preceding years) of \$25 million or less. Disallowed business interest can be carried forward indefinitely. If a taxpayer's full 30% adjusted taxable income limit is not met with respect to one business, the unused limitation amount can be applied to another business of the taxpayer which otherwise would have excess interest that is nondeductible after application of the 30% adjusted taxable income limit to that business.
- **Net Operating Losses.** Generally, the two year NOL carryback has been repealed. While the losses can be carried forward indefinitely, the deduction will generally be limited to 80% of taxable income.
- **Other.**
 - Domestic Production Activities Deduction has been repealed.
 - Like Kind Exchanges are limited to real property.
 - Fringe Benefits. Entertainment expenses and transportation fringe benefits (including parking) are no longer deductible. The 50% meals expense deduction is expanded to include on premises cafeterias of employers.
 - Penalties and Fines. Certain specifically identified restitution payments may be deductible.
 - Sexual Harassment Payments. No deduction will be allowed for amounts paid for or in connection with settlement of sexual harassment or abuse claims if such payments are subject to nondisclosure agreements.

Provisions of Tax Cuts and Jobs Act Affecting Pass-Through Entities and Sole Proprietorships

Before the Act passed, the pass-through of business income from a partnership or S corporation meant a lower overall tax rate would be paid on company income (compared to C corporations) as such income was not subject to double taxation and a lower overall income tax rate generally applied. However, with the reduction of the corporate income tax rate to a flat 21%, and individual rates that reach up to 37%, pass-through entities and sole proprietorships could face a higher tax burden than their C corporation counterparts.

To address the disparate effects of the flat 21% C corporation income tax rate, the Act allows owners of pass-through entities and sole proprietorships a deduction equal to 20% of their "qualified business income" subject to certain limitations. The calculation of what constitutes the qualified business income deduction amount is complex as are the applicable limitations. For example, upon sale of substantially all of the assets of a business, it is likely the 20% qualified business deduction will be significantly limited. Going forward, an analysis of the comparative tax savings as a C corporation or a pass-through entity will be appropriate for all businesses looking to maximize tax savings.

One further complication of the 20% qualified business deduction is that it is currently not applicable in calculating the state tax liability of most businesses. For example, the 20% deduction is currently inapplicable to the state income tax liabilities of Wisconsin businesses.

Family Owned Businesses

With the higher estate and gift tax exemptions and retention of the basis adjustment at death provisions of the tax law, the transfer of family owned businesses will need to re-focus, as follows:

- Entrepreneurial families may prioritize family governance issues over estate tax issues for many businesses in transition. The changes to the valuation rules from August of 2016 have now been neutralized, and higher exemptions allow more effective estate tax freeze types of transactions.
- Changes to how pass-through entities are taxed will re-position family businesses to place more emphasis on leasing entities, intellectual property licensing and real estate rental arrangements.
- With corporate income tax rates reduced, the resurgence of a "management company" or "family office" may take center stage to house key employees who desire different classes of equity and debt ownership, unique compensation arrangements and generous employee benefits. However, IRS rules regarding how management agreements are negotiated and operate will need to be addressed before venturing into this area.

Buying and Selling Businesses

For those clients engaged in buying or selling businesses, the most powerful aspects of the bill have to do with changes to how capital expenditures are taxed, the loss of state and local tax deductions (individuals) and the lower corporate tax rates. We are making the following general observations on the effect of the new law on business sale transactions:

- Even after the so-called "double tax" stigma associated with the regular corporate tax regime, when all aspects are considered, pass through entities are less attractive for many buyers and sellers. For example, a C corporation can deduct state and local taxes, while shareholders of S corporations, non-corporate owners of LLCs and individual sole proprietors cannot. This negative consequence is amplified by the fact that the 20% qualified business income deduction will not be available for state income tax purposes in most states, including Wisconsin.
- Because many business valuations are based on income streams that do not consider taxes, those valuations do not reflect the effect of the now lower income tax rates for those businesses. However, lower tax rates should result in more cash flow to the buyers of those businesses, thereby increasing their internal rate of return on invested capital. The result will be that higher valuations will apply in the future because of the tax benefits of the new tax law.
- Under the new law, buyers of tangible business assets, certain software and leasehold improvements can deduct their cost, in full, in the year of purchase. This means capital intensive businesses will enjoy significantly reduced effective tax rates and, therefore, higher values than previously applicable. More important, however, is that the buyer of a business can fully deduct the cost of all tangible assets in the year of purchase. The result will be that buyers of substantially all of the assets of a business will likely have little taxable income (and therefore less tax liability) for several years after the purchase of the business.
- As a result of the 100% deduction of tangible assets purchased on the sale of a business and the lack of any changes to the capital gain and qualifying dividend tax rates, we believe that asset purchases will become more beneficial than stock purchases to buyers who seek to minimize transactional taxes, while stock sales will be more beneficial to sellers.
- The new tax law limits the deductibility of business interest to 30% of adjusted taxable income. This means buyers using debt financing may not be able to fully deduct interest on the debt used to purchase a business. As a rule of thumb, the interest limitation will become applicable whenever the debt to cash flow ratio is higher than the ratio of the effective interest rate to 30%. Note that starting in 2022, the 30% limitation is applied to adjusted taxable income after deducting depreciation and amortization. Therefore, if you are going to buy a business, the time to do it is before the 30% limit becomes more stringent in 2022.

Compensation and Benefits Changes in the Tax Cuts and Jobs Act

- **Section 162(m).** Internal Revenue Code Section 162(m) imposes a \$1 million cap on the deduction for compensation paid to certain officers of public companies. Before the Act, there was an exception to the deduction limit for compensation that was "performance-based" if certain conditions were met. The Act eliminates the exception for performance-based compensation. Performance-based compensation paid pursuant to a written binding contract in effect on November 2, 2017 will continue to be outside of the \$1 million deductibility cap, if the contract is not materially modified on or after that date.
- **Excise Tax on Excess Compensation for Executives of Tax-Exempt Organizations.** The Act imposes a new excise tax on "excessive" compensation paid to certain employees of certain tax-exempt organizations. The excise tax is 21% of the sum of:
 - any excess parachute payment paid to a covered employee; and
 - remuneration (other than an excess parachute payment) in excess of \$1 million paid to a covered employee for a taxable year (remuneration is treated as paid when there is no longer a substantial risk of forfeiture).

Covered employees are the five highest compensated employees for the year, and any other person who was a covered employee for any prior tax year beginning after 2016. Certain payments to licensed nurses, doctors and veterinarians are excluded.

A "parachute payment" is a payment that is contingent on the employee's separation from service, the present value of which is at least three times the "base amount" (i.e., average annual compensation includible in the employee's gross income for five years ending before the employee's separation from employment). If a parachute payment is paid, the excise tax applies to the amount of the payment that exceeds the base amount.

- **Extended Rollover Deadline for "Qualified Plan Loan Offsets."** Prior to the Act, a participant in a qualified retirement plan who wanted to roll over a "plan loan offset" (an offset to his or her plan account due to a default on a loan taken from the account) to another plan or IRA had only 60 days to do so. The Act gives a longer period of time to roll over a "qualified plan loan offset," which is a plan loan offset that occurs solely because of the termination of the plan or failure to make payments due to severance from employment. Participants will have until the due date of the tax return for the year in which the qualified plan loan offset occurs.
- **Reduction of Individual Mandate Penalty.** The Affordable Care Act generally imposes a penalty (the "individual shared responsibility payment") on all individuals who can afford health insurance but who do not have coverage. The Act reduces the amount of the individual shared responsibility payment to \$0, effective January 1, 2019.
- **Section 83(i) – Taxation of Qualified Stock.** The Act adds a new Section 83(i) to allow certain employees of non-publicly traded companies to defer the tax that would otherwise apply with respect to "qualified stock." Qualified stock is stock issued in connection with the exercise of an option or in settlement of a Restricted Stock Unit ("RSU"), if the options or RSUs were granted during a calendar year in which the corporation was an "eligible corporation." An eligible corporation is a non-publicly traded company with a written plan under which at least 80% of its U.S. employees are granted options or RSUs with the same rights and privileges. Certain employees, including any current or former CEO or CFO, and anyone who is (or was in the prior 10 years) a 1% owner or one of the four highest paid officers of the company, are excluded from the ability to elect a Section 83(i) deferral.

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