BPM

Tax Reform Legislation Becomes the Law—Impact of the Legislation on Corporate Taxpayers

The House and Senate approved, and President Trump signed into law, an amended version of the Conference Agreement to the "Tax Cuts and Jobs Act" (also known as "H.R. 1" or the "Act") on December 22, 2017. As the most significant federal tax law reform in over 30 years, the Act lowered business and individual tax rates, and changed U.S. international tax rules.

The following information focuses on the initial observations and a number of important business highlights of the Act affecting C corporations.

Change in the Corporate Tax Rate

The top corporate tax rate of 35% is reduced permanently to 21% for tax years beginning after 2017. The Act eliminates the special corporate tax rate on personal service corporations and the progressive corporate tax rate structure, replacing it with a flat tax system.

Lowering the corporate tax rate to 21% is an historic legislative accomplishment given that the U.S. currently has the highest corporate rate among industrialized world economies. Presently, the U.S. corporate tax rate, combined with the national average state and local corporate tax rates, is approximately 38.9%. Because of the Act, the combined corporate tax rate will drop to approximately 25.8%. The new U.S. federal statutory corporate tax rate is closer to the Organization for Economic Co-operation and Development average rate of approximately 23.4%.

The overall reduction in the corporate tax rate will make the U.S. corporate tax rate more competitive, including making C corporations a more attractive option for certain taxpayers.

Hot Topic

Tax entity choice decisions will continue to depend on the entity's facts and circumstances. In making determinations, taxpayers should consider the reduced corporate rate and the impact of other tax code changes under the Act, and current tax law provisions, such as the accumulated earnings and personal holding of company taxes.

Corporate taxpayers must also consider financial statement (e.g. ASC 740) and shareholders' income tax implications.

Corporate Alternative Minimum Tax

The Act repeals the corporate alternative minimum tax (AMT) effective for tax years beginning after 2017. The Act permits the full use of the credits to:

1. Reduce or eliminate regular tax liability, and
2. Obtain tax refunds to the extent the AMT credit carryover exceeds regular tax liability.

Taxpayers with a minimum tax credit carryover can claim a refund of 50% of the remaining credits to the extent the credits exceed regular tax, as reduced by certain other tax credits, in tax years beginning in 2018, 2019, and 2020. (*Note: a proration rule with respect to short tax years applies.*) For any unused minimum credit carryover after 2020, a corporate taxpayer can claim a tax refund for all such credits beginning in tax year 2021.

Dividends Received Deduction

Under the current tax law, corporations that receive qualified dividends from other corporations are generally entitled to a deduction for dividends received or dividends received deduction (DRD). If a corporation owns at least 20% of the stock of another corporation, an 80% DRD generally applies. A 70% DRD applies for less than 20% owned corporate stock.

The Act reduces DRD for tax years beginning after December 31, 2017 from 80% to 65% and from 70% to 50%, respectively.

Modified Net Operating Loss Deduction

Under the current tax law, corporate taxpayers can carryforward their federal net operating loss (NOL) for 20 years. The current law also provides a two year carryback provision.

The Act repeals the 20 year carryover and two year carryback provision period for NOLs originating in tax years ending after December, 31, 2017, and certain carryback rules for specific categories of losses (e.g. specified liability losses that may be carried back in ten years).

For losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of the taxable income. Carryovers to other years are adjusted for this limitation (e.g. any amount subject to 80% limitation is carried over). This limitation is similar to, but more restrictive than, 90% limitation for NOLs in the corporate AMT regime, which is repealed by the new law.

Hot Topic

The change in the NOL carryover under the Act may have significant impact on financial statements treatment of loss carryovers in future tax years.

Revisions to Treatment of Capital Contributions

The Act modifies Section 118, which provides exclusion from gross income for contributions to the capital of a corporation. It also provides that contributions to capital do not include any contributions:

1. In aid of construction or any other contribution as a customer or potential customer, and
2. By any governmental entity or civic group, other than a contribution made by a shareholder in its capacity, as such.

The amendments to Section 118 generally would apply to contributions made after the date of enactment. Taxpayers that are expected to receive federal or state funds through certain government stimulus programs should be evaluating whether or not the payments fall under Section 118 exclusion.

The provisions of Section 118 apply to contributions made after the date of enactment, unless the contribution is made by a government entity pursuant to a master development plan that is approved prior to the effective date by a government entity.

Increased Section 179 Deduction

Under the Act, for property placed in service for tax years beginning after December 31, 2017, the maximum amount of deduction is increased to $1 million from $500,000 and the phase-out threshold is increased to $2.5 million from $2 million.

The definition of qualified real property under Section 179 is expanded to include certain improvements to non-residential real property after the date such property was placed in service. This includes roofs, heating, ventilation, air conditioning property, fire protection, alarm systems and security systems.

> **Hot Topic**
>
> H.R. 1 provides significant modification of rules for expensing depreciable business assets.

Temporary Expensing of Depreciable Property—100% Cost Recovery of Qualified Business Assets

The Act temporarily makes expensing the principal capital cost recovery regime by increasing Section 168(k), the bonus first-year depreciation deduction, to 100% and allowing taxpayers to write off the cost of acquisitions (plant, property, and equipment) immediately.

This expensing new regime goes further than current law bonus depreciation by applying to both new and used property. The 100% bonus depreciation rule applies through 2022, and then ratably phases down over the succeeding five years.

The Act also allows taxpayers immediate expense of certain depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023 (e.g. 100% deduction), including additional years for certain aircraft and longer production period property. For qualified property placed in service in calendar years 2023, 2024, 2025 and 2026, the applicable percentage is reduced to 80%, 60%, 40% and 20% respectively. The first year bonus depreciation sunsets after 2026.

> **Hot Topic**
>
> Many state or local jurisdictions are expected not to conform to significant modification of rules for expensing depreciable business assets. States, such as California, will likely decouple from the Section 179 deduction increase and first year bonus depreciation provided by the Act.

Under the Act, the definition of qualified property is expanded and the original use requirement is repealed. Going forward, qualified property will include used property as long as such property had not been used by the taxpayer at any time prior to acquisition and meets other requirements under Section 168. Furthermore, qualified property definition includes qualified film, television and live theatrical productions property, and excludes property used in trade or business of certain regulated public utilities as defined by the code.

It is important to note that if the property is placed in service after September 27, 2017, certain phase-down percentages under the current tax law will be applicable. Taxpayers have an option to elect out of the bonus depreciation for property placed in service before and after September 27, 2017.

Real Property Recovery Periods

For property placed in service after 2017, the Act eliminates separate definitions of qualified leasehold improvement, qualified restaurant and qualified retail improvement property. The Act also provides a general 15 year MACRS recovery period for qualified improvement property and a 20 year alternative depreciation system (ADS) recovery period for such property. The Act shortens the ADS recovery period from 40 to 30 years for residential rental property.

Unfortunately, the legislative text appears to have a technical glitch, which leaves applicable recovery periods (e.g. MACRS and ADS) for qualified improvement property uncertain, including whether qualified improvements of any type are eligible for the benefits of shorter life and bonus depreciation.

Hot Topic

The Act makes a number of significant changes to corporate deductions and exclusions which include a number of revenue raising provisions to partially offset the costs of other beneficial provisions.

Domestic Production Activities Deduction Repeal

Under the current law, qualified taxpayers are allowed to claim a domestic production activities deduction under Section 199. The deduction is generally equal to 9% of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income for the tax year.

Under the Act, the deduction for domestic production activities provided under Section 199 is repealed for tax years beginning after December 31, 2017 (e.g. beginning in 2018).

Modification of Like-Kind Exchanges Rules

The Act limits the availability of Section 1031, Like-Kind Exchange, to real property only. Previously, the Like-Kind Exchange was available for certain personal property.

Deferral under section 1031 is not allowed for an exchange of real property held primarily for sale. In addition, real property located in the United States is not considered like-kind to real property located outside the United States. Modified Section 1031 rules apply to exchanges completed after December 31, 2017. The Act provides a transition rule. Under the new Section 1031 transition regime, the new rules do not apply to any exchange in which the taxpayer disposed of relinquished property, or received replacement property, on or before December 31, 2017.

Net Business Interest Expense

The Act amends Section 163(j) to disallow a deduction for net business interest expense of any taxpayer, including C corporations in excess of 30% of a business adjusted taxable income, plus floor plan financing interest of the taxpayer for the taxable year.

Business interest is defined as any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for tax purposes is treated as "interest" for purposes of this provision. The term "business interest" does not include investment interest within the meaning of Section 163(d).

"Floor plan financing interest" is interest paid or accrued for "floor plan financing indebtedness," which means indebtedness used to finance the acquisition of motor vehicles held for sale or lease. The term "motor vehicle" means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road; boat; or farm machinery or equipment.

The Act allows any disallowed business interest to be carried forward indefinitely for tax years beginning after 2017. The new limitation does not apply to certain qualified small businesses. Specifically, this exception to the limitation applies to taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed $25 million.

The Conference Agreement provides that any disallowed interest carryforward is treated as a "pre-change loss" subject to limitation under Section 382 for transactions described in Section 381(a), which generally include tax-free liquidations and asset reorganizations.

Self-Created Property

The Act no longer treats gain or loss arising from the sale, exchange, or other disposition of a self-created patent, invention, model or design, secret formula or process as a capital. That is self-created property, whether or not patented, would no longer be considered capital asset effective for dispositions of such property after 2017.

Entertainment and Certain Fringe Benefits

The Act repeals deductions for entertainment, amusement, and recreation that are directly related to the conduct of a taxpayer's trade or business. No deduction is allowed for:

1. An activity considered entertainment, amusement or recreation,

2. Membership dues for any club organized for business, pleasure, recreation or other social purposes, or

3. A facility or portion of a facility used in connection with any of the above.

It is important to note that the Act retains the 50% deduction for food and beverage expenses associated with a trade or business after the effective date. However, the new law provides 50% limitation to certain meals that are currently 100% deductible.

The Act expanded the 50% limitation to food and beverages provided to employees as de minimis fringe benefits, including meals provided at an eating facility that meets the requirements for an on premise dining facility, and to meals provided on premise to employees under Section 119 for the convenience of the employer. It is important to note that the 50% deduction limit applies for tax years after 2017 and before 2026. The provision would, therefore, sunset in 2026 and Section 119 meals will then be subject to 100% disallowance.

Finally, the Act disallows any deduction expenses associated with providing qualified transportation fringe and any expense to provide transportation for commuting between the employee's residence and place of employment. This includes vanpools, subway or transit cards, and qualified parking expenses. The Act does provide a limited commuting benefit exception where safety of employees is impacted.

Hot Topic

The Act effectively provides the employers with a choice to include entertainment and certain fringe benefit amounts in taxable income and take a 100% tax deduction or exclude the amounts and take a lesser deduction.

Employers will need to consider:

1. Changing/updating meals and entertainment (M&E), fringe benefits, and expensing and tracking practices, including M&E policies.
2. Modification of general ledger accounts.

Local Lobbying Activities

The Act disallows the deduction for lobbying expenses with respect to legislation before local government bodies, including Indian tribal governments. The provision is effective for amounts paid or incurred on or after the date of enactment.

Sexual Harassment and Sexual Abuse Settlements

Under the Act, no deduction would be allowed for any settlement or payment related to sexual harassment or abuse if subject to a nondisclosure agreement. Specifically, any settlement, payout, or attorney fees related to sexual harassment or sexual abuse, if such payments are subject to a nondisclosure agreement, are no longer deductible. The provision is effective for amounts paid or incurred on or after the date of enactment.

Executive Compensation

The Act repeals the exceptions to Section 162(m) - $1 million deduction limitation for commissions and performance-based compensations. The new law clarifies and expands the definition of “covered employee” to include the principal executive officer, principal financial officer, and the three other highest paid officers. In addition, the Act provides that once an employee is treated as a covered employee, the individual remains a covered employee for all future years, including with respect to payments made after the death of a covered employee. Finally, an individual who is a covered employee in a tax year after December 31, 2016 remains a covered employee for future years.

The Act also expands the definition of a publicly held corporation. The definition includes all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. Under the explanatory statement, the definition of a public company may include some corporations that are not publicly traded, such as large private C or S corporations.

Equity Compensation

The Act allows certain qualified employees, not including certain top executives, to elect to defer income recognition for up to five years for stock of a privately held corporation received upon the exercise of nonqualified stock options or upon settlement of restricted stock units. The election, however, must be made no later than 30 days after the vesting date and would only be available for qualified stock. An employer has federal income tax withholding and Form W-2 reporting obligations following the deferral period.

There are a number of considerations with respect to implementing the election. These considerations include the written plan requirements, identification of eligible employees, employee notice, participation levels, whether or not the corporation purchased any of its outstanding stock in the preceding year, FICA tax and its timing, and coordination with statutory stock options.

Business Credits

Orphan Drug Credit
The Act limits the orphan drug credit to 25% of qualified clinical testing expenses for the tax year, and allows an election of reduced credit under Section 280C. The provision is effective for amounts paid or incurred in tax years beginning after 2017.

Rehabilitation Credit
The Act repeals the 10% credit for pre-1936 buildings and makes a modification to the 20% credit for certified historic structures, generally for amounts paid or incurred after 2017. Specifically, the credit for certified historic structures will remain at 20%, but must be claimed ratably over a five-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service. The new law provides transition rules for certain phased rehabilitations.

Other Credits
The Conference Agreement retained the research and experimentation (R&E) credit, the low-income housing credit, the work opportunity tax credit, and the new markets tax credits. It left unchanged certain energy tax credits prevalent in the power and utility industry, including Section 45 - Production Tax Credit and Section 48 - Investment Tax Credit.

Research or Experimental Expenditures

The Act provides that specified R&E expenditures under Section 174, paid or incurred in tax years beginning after December 31, 2021, should be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the tax year in which the specified R&E expenditures were paid or incurred.

Specified R&E expenditures which are attributable to research that is conducted outside of the U.S. would be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the tax year in which such expenditures are paid or incurred. Specified R&E expenditures subject to capitalization include expenditures for software development.

Multinational Entity Taxation

The Act makes fundamental changes to the taxation of multinational entities. Generally, the new tax law shifts from the current system of worldwide taxation with deferral to a participation exemption regime with current taxation of certain foreign income. As a result, the Act includes the following:

- A 100% deduction for dividends received form 10%-owned foreign corporations
- A minimum tax on “global intangible low-taxed income”
- As a transition to the new regime, deemed repatriation of previously untaxed “old earnings.” A 15.5% rate applies to earnings attributable to liquid assets and an 8% rate applies to earnings attributable to illiquid assets.

In addition, the Act includes significant additional anti-base erosion measures. Particularly, the law includes a “Base Erosion Anti- Abuse Tax” (BEAT). The BEAT generally imposes a minimum tax on certain deductible payments made to a foreign affiliate, including payments such as royalties and management fees, but excluding cost of goods sold. The BEAT generally applies to certain payments paid or accrued in tax years beginning after December 31, 2017.

The Act also includes several other provisions targeted at cross-border transactions, including revised treatment of hybrids, a new special deduction for certain foreign-derived intangible income, and rules for outbound transfers of intangibles.

BPM is Here to Assist You

The Tax Cuts and Jobs Act will have a significant impact on C corporations. We encourage you to work with your BPM tax professional to understand how these changes specifically impact your company. For additional questions regarding the legislative tax matters, please contact a member of our Corporate Tax team.

Tom Garigliano, CPA
Tax Practice Group Leader
(707) 524-6535
tgarigliano@bpmcpa.com

Julie West, CPA
Corporate Tax Chair
(650) 855-6881
jwest@bpmcpa.com

Dmitri Alexeev, CPA
Tax Director
(415) 299-0157
dalexeev@bpmcpa.com

Yung Ling, CPA
Tax Partner
(408) 961-5565
yling@bpmcpa.com

Doug Wright, JD, LLM
International Tax Partner
(925) 296-1044
dwright@bpmcpa.com

Carl Hu, CPA
Tax Director
(408) 961-6346
chu@bpmcpa.com

Robert Houston, CPA
Tax Partner
(415) 288-6238
rhouston@bpmcpa.com

Alex Waniek, JD, LLM
International Tax Partner
(408) 961-6367
awaniek@bpmcpa.com

Sanny Ryan, CPA
Tax Director
(415) 677-3302
sryan@bpmcpa.com