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Practice Update

Tax Reform: Sweeping Changes to Federal Tax Law and the Impact on Businesses and Individuals

January 12, 2018

On December 22, 2017, President Trump signed into law what is commonly referred to as the "Tax Cuts and Jobs Act" (the "Act"). The Act makes significant changes to the Internal Revenue Code (the "Code") and affects a broad array of businesses and individuals. This Practice Update will highlight some of the salient changes affecting various taxpayer groups. Unless otherwise specified, the laws discussed herein take effect beginning in 2018. Sunset provisions (i.e., expiration dates) are noted where applicable.

The below sections are hyperlinked to facilitate navigation of this update.

Corporations

The Act made various changes that apply to entities taxable as corporations, or "C" corporations. Some of

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the main changes applicable to such corporations are summarized below.

Reduced Tax Rate and Elimination of Corporate AMT

The federal corporate income tax rate applicable to corporations was lowered to a flat 21% rate. Previously, corporations were subject to tax at graduated rates of up to 35%. The Act did not change state corporate income tax rates, which will continue to apply.

Corporations are also no longer subject to the alternative minimum tax ("AMT"). This should simplify corporate tax return preparation and planning.

Akerman Insights:

- *Entity choice*. In light of the reduction of the corporate federal income tax rate, taxpayers may want to review current entity structures to determine whether corporate status or 'flow-through' status is preferable. For an entity which plans on reinvesting its profits in the business, corporate status may be more attractive in light of the lower corporate federal income tax rate. The corporate double-tax regime still applies, however, and shareholders generally remain subject to another level of tax on distributions received from corporations and on capital gains on disposition of stock. When the effects of double taxation are fully factored in, flow-through status might still prove to be preferable.
- *Value of deductions*. The value of tax deductions is now generally lower as a result of the lower corporate tax rate and, likewise, so is the value of a step-up in tax basis of assets upon an acquisition. The after-tax cost of deductible payments has accordingly increased.
- *Financial accounting considerations*. While the lower rate may ultimately result in lower corporate taxes in the long run, for financial

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reporting purposes the decrease may result in some corporations recording charges to reflect decreases in the value of deferred tax assets. Conversely, reductions in deferred tax liabilities might reduce charges for income taxes.

Lower Dividends Received Deductions

The amount of certain corporate dividends received deductions has been reduced under the Act. Under the new law, a corporation that receives a dividend from another corporation will generally be entitled to a deduction equal to 50% of the amount of the dividends received, and in the case of a dividend received from a 20% (or greater) owned corporation, the deduction is now 65%. Under prior law, the deduction percentages for these dividends were 70% and 80%, respectively. The 100% dividends received deduction for certain intercorporate dividends from an 80% (or greater) owned corporation remains unchanged.

Akerman Insights:

- As a result of the changes, the effective federal corporate income tax rate on dividends received by corporations (not including taxes paid by the corporation paying the dividend) is generally 10.5%[1] for less than 20%-owned corporations, 7.35%[2] in the case of a 20%-owned corporation, and zero for an 80%-owned corporation.

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General Business Tax Changes for C Corporations and Other Taxpayers

Code § 168 Bonus Depreciation

In general, for certain property acquired and placed in service after September 27, 2017, and before January 1, 2023, a 100% first-year deduction is allowed for the adjusted basis of the property. The

100% deduction is reduced by 20% in each year after 2022 and sunsets after 2026.

Code § 179 Expensing

The amount that a taxpayer may expense under Code § 179 is also increased to $1 million (up from $500,000), the types of property eligible for the increased deduction are expanded, and the phase-out threshold amount is increased to $2.5 million (up from $2 million).

Akerman Insights:

- The increased Code § 179 expense may be of limited use until the beginning of 2023, as taxpayers can qualify for 100% bonus depreciation until then.

Recovery Periods for Certain Real Property

The depreciation recovery periods for certain real property have also changed. For example, the alternative depreciation system recovery period for residential rental property is lowered from 40 years to 30 years. For more details on how the Act affects real estate taxation, see upcoming editions of Akerman Perspectives.

Net Interest Expense

For every business, regardless of form, the deduction for net interest expense will be effectively capped at 30% of its adjusted taxable income (generally, earnings before interest, taxes, depreciation, and amortization). Interest deductions disallowed under the new rules are treated as business interest paid or accrued in the succeeding year and may be carried forward indefinitely. The foregoing limitation only applies to taxpayers with average annual gross receipts exceeding $25 million over a three-year period. Additionally, certain businesses, including certain real property trades or businesses, may elect out of the new regime if certain conditions are met. For more details on how the Act affects real estate taxation, see upcoming editions of Akerman Perspectives.

The 30% limitation applies to partnerships at the partnership level, and the deduction for business interest is taken into account when determining the partnership's nonseparately stated items. Similar rules apply to S corporations.

For taxable years beginning on or after January 1, 2022, the manner in which a taxpayer's adjusted taxable income is calculated will become more restrictive, which would have the effect of changing how the deduction amount is calculated.

Akerman Insights:

- Planning to 'strip out' the earnings of a business through interest payments is now more limited, as taxpayers may not receive a full deduction for the related interest expense.
- Because there are no 'grandfather' rules for existing debt, existing capital structures may need to be reconsidered, especially in highly leveraged situations.

Net Operating Losses

A net operating loss ("NOL") can no longer be carried back, and can now be carried forward indefinitely. In addition, the NOL carryforward deduction is now generally limited to 80% of taxable income in a given year, and the amount of NOL carryforwards which cannot be used in a year because of the 80% limitation are to be carried forward to subsequent years until fully used. Under prior law, NOLs could be carried back for two years and forward for 20 years, and there was no limitation on the percentage of taxable income against which the NOLs could be applied (subject to limits under the alternative minimum tax).

Lobbying Expenses

For amounts paid or incurred on or after December 22, 2017, taxpayers no longer receive a deduction for lobbying expenses with respect to legislation before local government bodies.

Entertainment Expenses

Business deductions for entertainment expenses are also now generally eliminated; however, the 50% deduction for food and beverages associated with business activities remains in effect.

Fines and Penalties

For amounts paid or incurred on or after December 22, 2017, a deduction is no longer available for any otherwise deductible amounts paid to a government or specified nongovernmental entity in relation to the violation of a law or a related investigation. Fines were already non-deductible under prior law, but the new law also disallows deductions for other amounts paid in relation to legal violations. The disallowances do not apply to certain restitution and remediation costs.

Confidential Sexual Harassment Settlements

Effective for amounts paid or incurred after December 22, 2017, there is no longer a deduction available for any payout, settlement, or attorney's fees related to sexual abuse or sexual harassment, if such payments are subject to a nondisclosure agreement.

Akerman Insights:

- Company policies regarding nondisclosure agreements and litigation settlements may need to be reconsidered. Please review our more detailed update on this topic, *New Act Eliminates Deduction for Settlement of Sexual Harassment Claims Subject to a Confidentiality Agreement*, available on Akerman.com.

Amortization of Research and Experimental Costs

For amounts paid or incurred in tax years beginning after December 31, 2021, taxpayers must capitalize research and experimental costs and amortize them ratably over a five-year period (increased to fifteen years if the expenditures are attributable to activities conducted outside of the United States). Under prior law, taxpayers could elect to currently deduct the amount of reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.

Certain Self-Created Intangible Property not a Capital Asset

Certain self-created property such as patents, inventions, and secret formulas have been added to the list of assets that are excluded from the definition of a "capital asset." Accordingly, gains and losses on disposition of these assets are to be treated as ordinary income or losses. The election to treat musical compositions and copyrights in musical works as capital assets, however, has been retained.

Like-Kind Exchanges

For exchanges entered into after December 31, 2017, Code § 1031 like-kind exchange treatment is available only for real property that is not held primarily for sale. For more details on how the Act affects real estate taxation, see upcoming editions of Akerman Perspectives.

Akerman Insights:

- Personal property is no longer eligible for like-kind exchange treatment under Code § 1031. Accordingly, exchanges of equipment, vehicles, machinery, artwork, collectibles, and intangible assets do not qualify for nonrecognition of gain or loss as like-kind exchanges.
- Although like-kind treatment is no longer available for exchanges of tangible personal

property, the cost of acquiring such replacement property may now qualify for 100% expensing, as described above under “Code § 168 Bonus Depreciation.”

<u>20% Deduction for Pass-Throughs and Individuals</u>

Under the newly enacted Code § 199A, for taxable years beginning after December 31, 2017 and before January 1, 2026, noncorporate taxpayers can receive a deduction of up to 20% of their “qualified business income.” Qualified business income generally means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer, but does not include certain investment income such as interest and dividends, and reasonable compensation paid to the taxpayer for services rendered. As described below, special limitations apply to taxpayers in specified service trades or businesses.

For taxpayers with taxable income below certain threshold amounts ($315,000 for married taxpayers who file jointly; $157,500 in the case of all other filers), the deduction is 20% of the qualifying income. For taxpayers with taxable income above a ‘fully-phased-in amount’ ($415,000 for married taxpayers who file jointly; $207,500 for all other filers), two limits apply: (1) for taxpayers not in a specified service trade or business, the deduction cannot exceed the greater of (a) 50% of their share of W-2 wages paid with respect to the qualified business income or (b) 25% of their share of the W-2 wages paid plus 2.5% of the unadjusted basis of certain qualified property; (2) for taxpayers in a specified service trade or business (e.g., a trade or business involving the performance of services in the fields of health, law, or accounting, and other services businesses), the deduction is denied altogether. For taxpayers in between the thresholds (i.e., taxable income between $315,000 and $415,000 for married taxpayers who file jointly, and between $157,500 and $207,500 for all other filers), the foregoing limitations are phased-in.

Akerman Insights:

- In the most favorable circumstances (i.e., a full 20% deduction), noncorporate taxpayers will be taxed on their qualified business income at a top federal effective rate of 29.6%.
- Business owners will need to weigh the benefits of the deduction for certain income of pass-through entities vs. the lower tax rates applicable to C corporations to determine which entity classification makes the most sense for their business operations.
- For pass-through entities that plan to distribute most of their profits to their owners, converting to a C corporation may not make sense despite the lower corporate tax rate due to the double taxation that would still occur when profits are distributed. Instead, these companies may wish to consider how to maximize the new Code § 199A deduction.
- The new deduction may also lead individuals to consider working as independent contractors rather than employees. In considering such a strategy, taxpayers should consider the extent to which the § 199A deduction would be available under an independent contractor approach and the increased self-employment taxes that may arise as a result, as well as the potential loss of non-taxable employee benefits. The negative ramifications of misclassifying workers should also be considered.
- The deduction is not permanent like the reduction in corporate tax rate and is scheduled to expire after 2025. Accordingly, entity choice decisions which are based in whole or in part on the availability of the 20% deduction should take into account the scheduled sunset of the provision.
- Taxpayers whose entire income is W-2 income will not see any benefit from the new 20% deduction.

<u>Excess Business Losses</u>

Non-corporate taxpayers operating an active trade or business must treat their excess business losses as NOL carryforwards. An excess business loss is essentially the excess of a taxpayer's deductions attributable to trades or businesses over the aggregate gross income from those trades or businesses, plus a threshold. The foregoing rules expire after December 31, 2025. For partnerships and S corporations, the limitation applies at the partner or shareholder level.

Akerman Insights:

- The new law effectively limits the ability of a non-corporate taxpayer to use business losses to offset other streams of income, such as salaries and interest.
- Due to the threshold amounts, the practical effect of the new rules is that a non-corporate taxpayer can offset up to $500,000 (for married couples filing jointly), or $250,000 (for all other filers), of non-business income with business losses.
- The existing rules regarding passive activity losses still apply.

<u>Carried Interests</u>

The income tax treatment of profits interests (sometimes referred to as carried interests) is also modified. Newly enacted Code § 1061 effectively imposes a three-year holding period in order to receive long-term capital gains tax treatment with respect to an "applicable partnership interest." An applicable partnership interest is generally an interest in a partnership transferred in connection with the performance of services in relation to certain trades or business involving raising or returning capital and investing in or developing specified assets (such as securities, commodities, real estate held for rental or investment, cash, etc.). The new rule does not apply to the extent a partnership interest held by a taxpayer is commensurate with capital invested by the taxpayer or the amount of taxable income incurred by the taxpayer in connection with the issuance of the partnership interest.

Akerman Insights:

- These provisions are meant to close perceived loopholes under previous law that effectively allowed for capital gains tax treatment on gains that may have been viewed by policymakers as compensation for services rendered.
- Hedge fund managers who typically invest for shorter periods should take the new rules into account with respect to interests that may not satisfy the three-year holding period requirement in order to obtain preferential long-term capital gains tax treatment.

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Withholding Requirements on Acquisitions of Partnership/LLC Interests

The Act contains many sections which affect the international tax provisions of the Code. A discussion of those provisions is outside the scope of this Practice Update; however, one provision is particularly noteworthy in connection with acquisitions of interests in LLCs or partnerships with U.S. assets or activities.

Effective for sales and exchanges on or after November 27, 2017, income from the sale or exchange of a partnership interest by a foreign partner is treated as income effectively connected with the conduct of a U.S. trade or business (“ECI”) to the extent a sale of the underlying partnership assets would have given rise to ECI. This rule effectively adopts the IRS’s long-standing position on the subject, even though such position was recently struck down by the Tax Court in *Grecian Magnesite*, 149 TC No. 3 (2017).

In addition to the foregoing tax treatment, new withholding rules generally apply to dispositions occurring after December 31, 2017. In particular, if any gain from the sale or exchange of a partnership interest would be treated as ECI under the foregoing rules, the transferee must withhold 10% of the amount realized on the disposition, unless the transferor furnishes an affidavit to the transferee which states under penalty of perjury that the transferor is not a foreign person and provides the transferor's U.S. tax ID number.

Akerman Insights:

- All buyers (domestic and foreign) of interests in partnerships (including interests in LLCs) with U.S. assets/activities should obtain a non-foreign affidavit from the sellers pursuant to applicable rules in order to avoid withholding tax liability.
- The 10% withholding amount applies against the amount realized by the seller, which includes the seller's share of the underlying liabilities of the partnership or LLC under applicable partnership tax rules.

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Compensation & Benefits

A detailed discussion of the Act's provisions governing compensation and benefits is outside the scope of this Practice Update; however, some notable provisions are mentioned, below. For a more thorough discussion of the Act's impact on provisions governing compensation & benefits, see *Tax Reform: New Law Delivers a Bundle of Executive Compensation and Employee Benefits Changes for the Holidays,* available on the Akerman website.

Expansion of Code Section 162(m) Deduction Limits

The rules governing excessive employee compensation have been changed. Under previous law, a publicly traded company could only deduct up to $1 million of compensation to certain covered employees; however, exceptions existed for common types of executive compensation, such as performance-based compensation and commissions. The Act eliminates these exceptions and expands the list of covered employees to include a company's CEO, CFO, and the three highest paid officers at any point in any taxable year beginning after December 31, 2016 (with an exception for written, binding contracts that were in effect as of November 2, 2017, and which are not materially modified thereafter).

Akerman Insights:

- Public company employers may need to examine their current compensation structures and benefits packages to determine if such arrangements are still tax efficient.

<u>Elimination of the Affordable Care Act Individual Mandate – But Retention of Employer Mandate and Additional Taxes</u>

Although the Affordable Care Act's individual mandate was eliminated, the Affordable Care Act's employer mandate (which requires large employers to offer affordable and minimum value health coverage to full-time employees and their dependents) as well as the 3.8% net investment income tax and the 0.9% additional Medicare tax remain in effect.

Akerman Insights:

- Employers may see health insurance costs rise as younger and healthier employees drop coverage.
- High-income earners will still be subject to additional income taxes on certain income.

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Individuals

A number of provisions applicable to individuals have been modified. In general, the following changes are effective for tax years after December 31, 2017, and before January 1, 2026.

New Federal Income Tax Rates and Brackets

The tax rates and brackets applicable to individuals have changed. The new rates range from 10% to 37%, and the top 37% rate applies to single filers with taxable income over $500,000, married couples who file separately with taxable income over $300,000, and married couples who file jointly with taxable income over $600,000. Under previous law, the top rate was 39.6%. The maximum long-term capital gains tax rate remains at 20%. While the alternative minimum tax (AMT) may have been repealed for corporations, it remains in place for individuals; however, the AMT exemption amounts are increased.

Personal Deductions, Miscellaneous Deductions, and Mortgage Interest Deduction

The standard deduction is increased to $24,000 for married couples who file jointly, $28,000 for head-of-household filers, and $12,000 for all other filers. Deductions for personal exemptions are no longer available. All miscellaneous itemized deductions that are subject to the 2% floor are suspended, as is the overall limitation on itemized deductions that was imposed under previous law. The deduction previously available for interest on home equity indebtedness is not available, and the deduction for mortgage interest is limited to indebtedness of up to $750,000 (down from the previous amount of $1,000,000). This new lower $750,000 amount does not apply to debt incurred before December 15, 2017. The itemized deduction for charitable contributions is generally still available under the Act.

Many other deductions previously available to taxpayers have also been modified or eliminated under the new law. A full discussion of such changes is outside the scope of this Practice Update.

Akerman Insights:

- Given the reductions in tax rates and new limits on tax deductions, the overall effects of the new law on individual taxpayers will depend on their particular circumstances.

- The increased standard deduction, coupled with the elimination of many deductions, may result in taxpayers no longer 'itemizing' deductions on their federal tax returns.

State and Local Tax Deduction

The state and local tax deduction (commonly referred to as the "SALT" deduction) has also been generally limited to $10,000 for state and local income and property taxes not incurred in a trade or business. For property taxes paid or accrued in carrying on a trade or business, however, the $10,000 limit does not apply. C Corporations, unlike individuals, are not subject to the $10,000 limitation and may still deduct state and local income and property taxes.

Akerman Insights:

- The limitation on the SALT deduction could have the biggest impact on individuals living in states that impose a high state income tax, such as New York and California.

- Although property taxes may be exempt from the $10,000 limit in the case of taxes paid or accrued in a trade or business, state and local income taxes are not exempt from the $10,000 limit, even if associated with a trade or business of the individual or trade or business income allocated to an individual by a partnership or S corporation.

Increased Estate, Gift, and Generation-Skipping Transfer Tax Exemption Amounts

The Act retains the estate, gift, and generation-skipping transfer ("GST") taxes; however, both the exemption amount for the estate and gift tax and for the GST tax is doubled to $10 million (indexed annually for inflation). In 2018, individuals have an exemption amount of $11.2 million ($22.4 million for married couples). The exemption amounts will return to its previous base level of $5 million in 2026 if not extended by future legislation.

The increased exemption amount against the estate tax only applies to U.S. taxpayers, however, as foreign taxpayers still generally only receive a $60,000 exemption against U.S. estate tax.

Akerman Insights:

- Clients should review their existing estate plans in light of the new law.

- With the larger amount that is exempt from estate, gift, and GST tax, planning objectives for many married couples should shift away from removing assets from the gross estate toward basis planning to maximize the benefit of the "step-up" in the income tax basis of the assets at the death of each spouse. This can be achieved by designing the estate plan to take advantage of the portability rules while securing all other important tax benefits.

- Building in flexibility to existing estate plans will be key, as the increased exemption amounts are not permanent.

Life Insurance Transfer for Value Rules

The Act adds new Code § 101(a)(3), which provides that the certain exceptions to the transfer for value rule do not apply to "reportable policy sales," which means that a portion of the death benefit payable under such a contract may be includable in the recipient's gross income.

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[1] 50% of 21%.

[2] 35% of 21%.

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