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Today's Discussion

Changes We Will Cover that Impact:

- Corporations
- Items Effecting all Business Entity Types
- Partnerships
- Individuals
- Estate Tax
- Foreign Activities and Operations

Corporations

Corporate tax rates reduced to a flat 21%

- No graduated rates.

Corporate alternative minimum tax repealed

- The corporate AMT is repealed.

Corporations - Tax Rates and Attributes

Tax Rates

- A reduction in the tax rate reduces the value of tax attributes (NOLs, Depreciable Basis, etc.).
  - $1 of NOL carryover is worth (no more than) $0.35 if the rate of tax is 35%.
  - The TCJA reduced the corporate tax rate to 21%; meaning the value of a $1 NOL carryover falls to (no more than) $0.21.

- However, attributes that reduce tax liability directly (e.g., credits) are not directly impacted by rate changes, as they still maintain their full value.

Corporations - Tax Rates and IRC Section 15

TCJA

- On the surface of the new tax law, non-calendar year-end companies might conclude that the 21% corporate tax rate would be effective in the first taxable year beginning on or after January 1st, 2018.

IRC Section 15

- However, existing tax law, which was not amended by the TCJA, requires a blended rate for non-calendar year end companies.
- Taxes should be calculated by applying a blended rate to the taxable income for the year.
- To compute the blended rate, the weighted average tax rate based on the ratio of days in the fiscal year prior to and after enactment.

Corporations – Section 15 Example

Example excerpt from IRS Notice 2018-38:

- C Corporation with a June 30th, 2018 year-end
- $1,000,000 taxable income
- Tax rate for July 1 – December 31: 34%, 184 days
- Tax rate for January 1 – June 30: 21%, 181 days

Corporations – Section 15 Example (cont.)

Example excerpt from IRS Notice 2018-38:

• 1. Taxable Income	$1,000,000
• 2. Tax using pre-enactment rate of 34%	$340,000
• 3. Number of days in tax year before Jan. 1	184
• 4. Line 2 times line 3	$62,560,000
• 5. Tax using post-enactment rate of 21%	$210,000
• 6. Number of days in tax year after Dec. 31	181
• 7. Line 5 times line 6	$38,010,000
• 8. Divide line 4 by total days in tax year (365)	$171,397
• 9. Divide line 7 by total days in tax year (365)	$104,137
• **10. Sum of line 8 and line 9: total tax**	**$275,534**

Corporations – Repeal of AMT

- The TCJA repealed the AMT on corporations
- Is it really gone?
  - A number of AMT type provisions now apply for regular tax purposes on a go forward.
    - NOL Limitations
    - R&D Activities required to be capitalized (starting in 2021).
- Prior to the TCJA, a taxpayer who was subject to the AMT in an earlier year may be entitled to carryforward a “minimum tax credit” (MTC) (also called the “AMT credit”), against the taxpayer's regular tax.

Corporations – Repeal of AMT

- The TCJA also allows corporations to offset regular tax liability by any minimum tax credit they may have for any tax year.

- The MTC is also now refundable:
  – Corporation's Minimum Tax Credit (MTC) is refundable for any tax year beginning after 2017 and before 2022 in an amount equal to 50% (100% for tax years beginning in 2021) of the excess MTC for the tax year, over the amount of the credit allowable for the year against regular tax liability.
  – Thus, the full amount of the corporation's MTC will be allowed in tax years beginning before 2022.

Business – Repeal of DPAD Section 199

IRC Section 199 Domestic Production Activities Deduction (DPAD) repealed

- 9% tax deduction for certain domestic income from items manufactured, produced, grown, within the U.S.

- New Section 199 pass-through deduction enacted (detailed in later presentation)

- Repealed after Dec. 31, 2017

Business – Entertainment Expense

Employer deductions for entertainment expense

- Entertainment expenses related to business are no longer deductible (such as amusement, sporting events and activities, clubs, etc.)
- Employer-operated eating facilities are only 50% deductible through 2025 and non-deductible thereafter. These expenses were previously 100% deductible.
- Effective for tax years beginning after 2017 and not a suspension.

Business – Fringe Benefits

Employer deductions for fringe benefits

- Employers can no longer deduct the cost of providing qualified transportation fringe benefits (such as transit passes, qualified parking and commuter vehicles).
- Employers can still offer these benefits on a taxable basis and claim a deduction
- UBTI Warning: tax-exempt organizations will now trigger UBTI by participating in qualified transportation fringe benefit program
- Effective for tax years beginning after 2017

Business – Excess Business Loss

New "Excess Business Loss" Limitation – IRC Section 461(l)

New Law: Certain business losses are no longer allowed to be deducted in full and subject to limitation. Prevents excess business losses from being used against other sources of income (such as salaries, interest, dividends, capital gains, retirement distributions, etc.)

Excess Business Loss is:

- Aggregate tax loss from all trades or businesses
- Less: Amount of allowed loss
- Equals Excess Business Loss

- Amount of allowed loss: $500,000 for married filing jointly taxpayers and $250,000 for single

- An excess business loss is disallowed and carried over as a net operating loss to the following year with no carry back allowed.
- Only applies to pass-through entities (S Corp, partnership/LLC and sole proprietor) and limitation applied at the partner or S corporation shareholder level.
- Effective for tax years beginning after 2017 and not a suspension.

Business – Net Operating Losses (NOLs)

Net Operating Loss Modifications

- The NOL deduction is limited to 80% of taxable income
- 2-year carryback repealed (except for some farming losses that are still allowed to be carried back)
- NOLs can be carried forward indefinitely
- Effective for tax years beginning after 2017 and not a suspension

Business – NOLs (cont.)

Net Operating Loss Modifications

- Ordering rule of IRC § 172(b)(2) generally requires full use of pre-2018 NOLs to offset income prior to use of any "limited" post-2017 NOLs.

- Effective date for elimination of carryback has an error in it's current form.
  - Fiscal-year taxpayers seeking technical correction.

- NOLs can be carried forward indefinitely

- Effective for tax years beginning after 2017 and not a suspension

Business – Interest Deduction Limits

Limits on deduction of business interest

- The TCJA completely revised IRC § 163(j).
  - Formerly applied only to payments by leveraged corporations to related persons.
- New IRC § 163(j) creates a 30% cap on deductibility of interest.
  - Cap is 30% of a calculation that closely resembles EBITDA for tax years beginning before 2022;
  - 30% of roughly EBIT after 2022.
    - Determined without regard to payer's leverage or whether recipient is a related person.
    - Unlimited carryover of disallowed interest deductions
    - Existing debt is subject to new rule. **No grandfathering.**

Business - Interest Deduction Limits (cont.)

Limits on deduction of business interest

- Exceptions to new cap:
  - To offset business interest income
  - For certain interest (i.e., motor vehicle fleet financing)
  - For certain taxpayers:
    - Certain small businesses
    - Regulated utilities
    - Electing farm businesses
    - Electing real property businesses

Business - Interest Deduction Limits (cont.)

Limits on deduction of business interest

- Adjusted Taxable Income: Taxable income without regard to interest expense, depreciation, amortization, depletion, NOLs and 20% qualified business deduction (new section 199A).

- Tax deferred tax provision considerations of interest carryovers?

- Section 382 considerations?

Business - Interest Deduction Limits (cont.)

Limits on deduction of business interest

- Exception - Does not apply to taxpayers:
  - If the average annual gross receipts for the three prior tax years does not exceed $25 million.
  - Real property and farming businesses can elect out if using certain depreciation methods
- Disallowed interest is carried forward to the following tax year.
- Effective for tax years beginning after 2017 and not a suspension.

Business – NOLs and Interest Limits

Example of NOL and deduction of business interest

- In 2018, Corporation (A) has $100 of disallowed interest deductions and $400 of NOL, both of which are carried over to 2019.
- In 2019, A has $1,000 of gross income, as well as:
  - $300 of operating expenses;
  - $100 of current interest expenses and
  - $200 of depreciation deductions.
- In 2019, A is able to utilize its disallowed interest and some NOL carryovers
  - A's 30% disallowed interest cap is $210 (($1,000-$300)*30%), and current interest expense is only $100, so T can use its entire $100 disallowed interest carryover.
  - A's 80% cap on its NOL carryovers is $320 (($1,000-$600)*80%).
  - A can use $320 of it's NOL Carryforward.

Business – Research Expenses

Amortization of Research and Experimentation (R&E) Expenses after year 2021

- Currently R&E expenses are allowed to be deducted when paid or incurred or elected to be capitalized and amortized.
- New Rules: R&E expenses paid or incurred must be capitalized and amortized over a 5-year period (15 years if conducted outside of the U.S.)
- Unamortized R&E expenses that are retired, abandoned, or disposed may not be recovered in the year of retirement, abandonment, or disposal, and must continue to be amortized over the remaining amortization period.
- Does not look to impact existing research and development credit
- Effective for tax years beginning after 2021 (unless repealed first)

Business – Hobby Loss

Revision to hobby loss rules

- Income from hobbies has always been taxable, and expenses to the extent of that income used to be deductible under the old law
- While income from a hobby is still taxable, expenses are no longer deductible
- Expenses used to be included in 2% AGI-limited miscellaneous itemized deductions, which has been repealed
- Effective for tax years beginning after 2017 and before 2026

Individuals – Mortgage Interest Deduction

Mortgage interest deduction limited

- Old Rules:
  - Mortgage interest deduction limited to interest on $1,000,000 of home acquisition debt on first and second residences.
  - Additional mortgage interest allowed of up to $100,000 of home equity debt

- New Rules:
  - For mortgage debt incurred after December 15th, 2017, limited to $750,000 (MFJ) of qualified mortgage interest.
  - Home equity interest is nondeductible

Individuals – Mortgage Interest Deduction (cont.)

- Potential for using interest tracing to re-categorize as business interest under Reg. 1.163-8T
  - Debt is allocated by tracing the loan disbursements to specific expenditures
  - Interest is then allocated in the same manner

- Notice 89-35: 30-day rule allows a taxpayer to treat any expenditure from *any* account *or* cash as being made from the debt proceeds if done within 30 days before or after the debt proceeds are deposited

- No law change for this, just more incentive due to increased limits on mortgage interest
- Effective for tax years beginning after 2017 and before 2026

Estate & Gift

- Estate & gift tax retained at top federal rate
- Estate & gift tax exemption doubled from $5M to $10M (indexed for inflation beginning in 2012).
- Presumed exemption of $11.2M in 2018 ($22.4M per married couple)
- Applies to decedents dying and gifts made in 2018 - 2025
- Sunsets in 2026, so opportunity for gifting before the exemption goes back down by half

1031 – Like Kind Exchanges

- Section 1031 exchanges other than for real property are eliminated.
- Could pose issues with exchanges of other types of property included in like kind exchanges (1245, businesses with cost segregation studies, etc.).
- What appear to be real estate exchanges could be taxable once you dig down into other business assets included in the exchange.
- This eliminates the possibility of deferring gain on cryptocurrency through like kind exchanges.
- Effective for tax years beginning after 2017

IRC Section 1221 – Capital Asset Change

- Prior to the TCJA Code Sec. 1221(a)(3) excluded certain self-created intangibles such as copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property from the definition of a capital asset if the asset is held either by the taxpayer who created the property, or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced.

- The TJCA revised this to *also* include a patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created), from the definition of a capital asset.

IRC Section 1221 – Capital Asset Change (cont.)

- The TCJA expanded items excluded from capital asset treatment.

- It should be noted that though patents are excluded from the definition of a capital asset under Code Sec. 1221(a)(3), certain transfers of patents by inventors and certain financial backers are treated as sales or exchange of long-term capital assets under Code Sec. 1235

Carried Interest

- Profits Interests, aka “carried interests,” are usually received in exchange for providing substantial services to a partnership
- This is one of the main reasons some consider the carried interest laws to have a “loophole,” since it allows income essentially received for services to be taxed at capital gains rates
- Starting in 2018, carried interest must now be held **more than three years**, instead of the normal one year, in order to qualify for LTCG treatment
- This attempts to remedy the above issue with preferential treatment of carried interests (does it work?)

Qualified Equity Grants – Section 83(i)

- Section 83(i)
  - Allows a deferral of taxes owed on qualified equity grants.
    - “qualified employee” may elect to defer the income attributable to a stock option or RSU received in connection with the performance of services for up to five years if the corporation’s stock is an “eligible corporation.”
  - If the election is made, the employee is subject to tax at:
    - The date the qualified stock is transferrable;
    - The date the employee becomes an “excluded employee”;
    - The date on which any stock of the employer becomes publicly traded;
    - Five years after the employee’s right to the stock is substantially vested; or
    - The date the employee revokes the election.

Qualified Equity Grants – Section 83(i) (cont.)

- An "excluded employee" includes:
  - An individual who becomes a 1 percent owner during the taxable year;
  - A 1 percent owner of the corporation at any time during the 10 preceding calendar years;
  - The current or former chief executive officer or chief financial officer of the corporation (or an individual acting in either capacity);
  - A family member of an individual described above;
  - One of the four highest-compensated officers of the corporation during the taxable year; or
  - The four highest-compensated officers of the corporation for any of the 10 preceding taxable years.

Qualified Equity Grants – Section 83(i) (cont.)

- A corporation is an "eligible corporation" if:
  - no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year.
  - has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any US possession) are granted stock options or RSUs with the same rights and privileges to receive qualified stock (the "80-percent requirement").
    - This test must be met with respect to options only or RSUs only, not a combination of the two.

Qualified Equity Grants – Section 83(i) (cont.)

- Corporations that are members of the same controlled group are treated as one corporation.

- With respect to the corporations deduction, if an employee makes a deferral election, the employer's deduction is also deferred until the employer's taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee's income.
  - The deferral election affects only the deferral of income tax and does not affect the timing of FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act).

Qualified Equity Grants – Section 83(i) (cont.)

- An employer that transfers qualified stock to a qualified employee must provide written notice that:
  - the employee can elect to defer income inclusion with respect to the stock;
  - If the employee makes an inclusion deferral election, the income inclusion amount at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, regardless of value declining; and
  - the amount of income to be included at the end of the deferral period will be subject to withholding.

Foreign

- Key provisions under new modified territorial tax system:
  - Transition (Repatriation) Tax
  - Dividends Received Deduction (Participation Exemption)
  - Global Intangible Low-Tax Income (GILTI) deduction
  - Foreign Derived Intangible Income (FDII) deduction
  - Base Erosion Anti-Abuse Tax (BEAT)

Foreign

Transition (Repatriation) Tax

- Tax to transition out of old deferral tax system
- Old system: U.S. generally taxed foreign earnings only upon receipt of a dividend by U.S. entity (deferral system)
- New system: A significant portion of foreign earnings will be taxed currently on a U.S. tax return.
- Deemed repatriation of foreign earnings and profits (E&P)

Foreign

Transition (Repatriation) Tax

- Applies to U.S. Shareholder of a “specified foreign corporation” with untaxed post-1986 E&P
- Specified foreign corporation:
  - Controlled Foreign Corporation (CFC) - expanded definition
  - Any US shareholder owning more than 10% of a foreign subsidiary, excluding PFICs
- U.S. Shareholder can be an individual or a corporation
- Special rules for S corporation shareholders and REITs

Foreign

Transition (Repatriation) Tax

- Tax on pro-rata share of untaxed E&P of the corporation
- E&P is netted across all specified foreign corporations
- E&P is determined as of 11/2/17 or the close of the last taxable year beginning before 1/1/18, whichever is greater
- E&P is taxed at reduced rates:
  - 15.5% to the extent of cash and other liquid assets, and
  - 8% on all remaining earnings
- Cash position determined at close of last taxable year beginning before 1/1/18 or average as of 11/2/17 and close of year, whichever is greater

Foreign

Transition (Repatriation) Tax

- Retrospective: Applies for the last taxable year of the taxpayer beginning before 1/1/18
- Foreign tax credit allowed for the foreign taxes attributable to the foreign corporate earnings
- Election available to pay in increasing installments over 8 years
- IRS regulations forthcoming

Foreign

Global Intangible Low-Taxed Income (GILTI)

- GILTI is the income of Controlled Foreign Corporation included in U.S. shareholder's taxable income
- Applies to tax years beginning after 12/31/17
- Complicated calculation with many new terms and definitions
- Included income is the aggregate net income earned by CFCs that exceeds the "net deemed tangible income return" (i.e. 10% return on tax basis of depreciable tangible property)
  - Less foreign income subject to U.S. tax if there are more tangible assets abroad
- Individuals are not allowed any deductions against this income and are taxed at ordinary rates, with no foreign tax credits available for offset

Foreign

Global Intangible Low-Taxed Income (GILTI)

- Addition provisions that apply C-Corporations only:
  - GILTI Deduction equal to 50% of the GILTI income
    - Deduction will decrease to 21.875% after 12/31/2025
  - Foreign tax credits allowed up to 80% of the foreign income taxes paid
- Effective US tax rate on GILTI income of 10.5% (half the federal rate of 21%)
- The minimum foreign tax rate at which no U.S. residual tax for GILTI owed is 13.125% (i.e. 80% of 13.125% = 10.5%)

Entity Selection

- Change in rates and new deductions call for re-evaluation
- Federal effective tax rates:
  - C-Corporations: 39.8%
    - Double taxation still applies (21% + (79% * 23.8%)
    - Consider added benefit of C-Corp only deductions, such as FDII, GILTI deduction and DRD
  - S-Corporation:
    - 199A Qualified Business: 29.6%
    - Specified Service Business: 37%
      - After 2025, back to 39.6%
    - Transition tax deferral BUT no other foreign income deductions allowed

State Tax Ramifications

- The State of California does not automatically conform to the provisions of the Tax Cuts and Jobs Act.
- California income and resulting tax begins with federal income and is modified for changes / nonconformity.
- California nonconformity differences currently include (among others):
  - Real and personal property tax deduction limitation
  - Mortgage interest limitation: $750k limit and no deductibility of home equity and second home mortgage interest
  - Miscellaneous itemized deductions
  - AMT revisions

State Tax Ramifications

- States / California will feel budget pressure because state tax is no longer partially subsidized by federal government through the SALT (State and Local Tax) deduction.
- The States of CA and NY are considering changes that will circumvent the repeal of the SALT deduction.
- Stay tuned.

Final Comments and Take Aways

- Provisions of TCJA are complex and unclear in some areas:
  - Some provisions require technical corrections to fix errors
  - Some provisions require IRS guidance to apply
  - There are many questions that practitioners are asking
  - We expect some clarity over the coming months

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