NEW JERSEY STATE BAR ASSOCIATION 1899

Business Law Section Newsletter

Vol. 42, No. 1 — August 2018

Significant Provisions of the Tax Cuts and Jobs Act Affecting Closely Held Businesses and Their Owners

by Gerald A. Shanker

Significant Provisions of the Tax Cuts and Jobs Act Affecting Closely Held Businesses and Their Owners

by Gerald A. Shanker

The Tax Cuts and Jobs Act[1] (TCJA) made significant changes to the Internal Revenue Code of 1986, affecting individuals, U.S. businesses, and international taxpayers. This article will discuss selected business provisions of the TCJA, and certain individual provisions affecting owners of pass-through entities.

Three significant TCJA provisions affecting closely held businesses and their owners are:

- Reduction of corporation and individual tax rates
- Introduction of Section 199A, which provides for a tax deduction of 20 percent of qualified business income, subject to limitations and exclusions
- $10,000 annual limit on deduction of real estate taxes and state and local income taxes

Corporate Tax Rates

Under pre-TCJA law, corporations were taxed at graduated rates of 15 percent on taxable income of $0 to $50,000, 25 percent for taxable income of $50,001 to $75,000, 34 percent for taxable income of $75,001 to $10,000,000, and 35 percent for taxable income over $10,000,000. Personal service corporations (defined in Section 448(d)(2)) did not have the advantage of graduated rates and were taxed at a flat 35 percent rate, on all income.

For tax years beginning after Dec. 31, 2017, the corporate tax rate now is a flat 21 percent rate.[2] This rate also applies to personal service corporations.

Because of this decrease in corporation tax rates, many S corporation owners and their advisors are considering revocation of the S election, and partners, limited liability company (LLC) members, and sole proprietors are considering changing their form of organization to a C corporation. However, to avoid potential pitfalls, the consequences of such a change must be analyzed.

In situations where the business may be sold in the future, the tax savings from the immediate rate reduction may be significantly less than the additional tax on the sale of the business assets and distribution of the after corporate tax sales proceeds to the shareholders. In a business sale transaction, purchasers typically favor structuring the transaction as an asset purchase rather than a stock purchase. When an S corporation or partnership sells its assets, the gain on the sale is passed through to the shareholders/partners, who pay a single tax (personal income tax) on the transaction. When assets are sold by a C corporation, the corporation pays tax on the gain and distributes remaining cash to its shareholders, who are then taxed on the distribution.

As shown in the following example, the total tax paid by a C corporation is almost double the tax paid by pass-through entities.

		C Corp	Pass Through
Selling price	$	100.00	100.00
Basis		–	–
Gain		100.00	100.00
Corporate tax at 21%		21.00	–
Available for distribution		79.00	100.00
Personal tax at 20%		15.80	20.00
Net to shareholders/partners		63.20	80.00
Total tax	**$**	**36.80**	**20.00**

As shown in this example, the total on a $100 gain is $36.80 for a C corporation and $20 for an S corporation or partnership. Although conversion from a pass-through entity to C corporation may result in immediate tax savings equal to the difference between the shareholders'/partners' personal tax rates and 21 percent, these saving will not offset the additional tax on a sale of the business. It should be noted that this example ignores the effect of Section 1411 net investment income tax and state income taxes, and assumes all assets qualify for long-term capital gain treatment.

Other factors to consider in determining whether to convert from a pass-through entity to a C corporation include, but are not limited to:

- **Distribution vs. Reinvestment—**Entities that reinvest income in the business rather than distribute to owners may find it advantageous to pay tax on such income at 21 percent rather than the owners' personal tax rate.
- **Debt Service—**Entities using taxable income to repay significant debt principal will benefit by paying 21 percent tax on this income, leaving more funds available for debt repayment and/or operations.
- **State Income Taxes—**As will be discussed later in this article, the TCJA has effectively eliminated the federal tax deduction for state income taxes paid. As pass-through entity owners are generally responsible for paying federal and state income tax on their share of taxable income, state taxes are paid on business income with no federal tax benefit. Since C corporations are subject to state income taxes, and there is no limitation on the deductibility of state income taxes by C corporations, the full tax benefit of paying state income taxes will be realized by the C corporation.
- **Other Nondeductible Expenses—**Entities that pay nondeductible expenses such as entertainment, life insurance, penalties and fines, and business meals (50 percent nondeductible) will pay 21 percent tax on these items rather than at the owners' personal tax rate.

Individual Tax Rates

Under pre-TCJA law, individual income tax rates ranged from 10 to 39.6 percent. The 39.6 percent rate was applicable to all taxable income in excess of $418,400 for single individuals and $470,700 for married filing jointly. The TCJA lowers the top rate to 37 percent and applies this rate to income over $500,000 for single individuals and $600,000 for married filing jointly.[3]

Section 199A Deduction

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the TCJA adds Section 199A, under which a taxpayer that has qualified business income from a partnership, S corporation, or sole proprietorship may generally deduct, subject to limitations, 20 percent of the combined qualified business income for the tax year.[4] The effect of this provision is a tax rate reduction from 37 to 29.6 percent on qualified business income.

The 20 percent deduction is not allowed in computing adjusted gross income but is allowed as a deduction in reducing taxable income. For taxpayers with taxable income below the threshold amount of $315,000 for married filing jointly and $157,500 for others, the limitations and exclusions do not apply. The threshold amounts are phased out for taxable income between $315,000 and $415,000 for joint filers and $157,500 and $207,500 for others. For taxpayers with qualified business income and whose taxable income exceeds the threshold amount, the following limitations apply:

1. 50 percent of the W-2 wages with respect to the qualified trade or business, or
2. The sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all 'qualified property.' Qualified property is tangible, depreciable property that is held and available for use in the qualified trade or business at the close of the taxable year, which is used at any point during the tax year in the production of qualified business income, and the property's depreciable life has not ended before the close of the tax year.

The second limitation was added to benefit the real estate industry, where low wages and high-cost depreciable property are common.

The deduction does not apply to specified service trade or business. A specified service trade or business is a business involving the performance of services described in Section 1202(e)(3)(A), including health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Although this code section includes engineering and architecture in the list of service professions, the TCJA excludes these professions from the definition of specified service trade or business.

When owner(s) of a specified service trade or business's taxable income exceeds the thresholds, the Section 199A deduction is reduced or eliminated.

Many such owners and their tax advisors are exploring ways to qualify for this deduction. For example, a law firm might bifurcate its activities into separate entities, consisting of an entity that performs non-qualifying specified services, and an entity that performs other functions. The following activities are some that may be structured to generate taxable income that may qualify for the 199A deduction:

- Office lease(s)
- Equipment leases
- Word processing
- Document printing and production
- Non-professional staffing
- Information technology
- Bookkeeping
- Firm management

The Internal Revenue Service (IRS) has yet to issue regulations or guidance on Section 199A. When issued, it is possible that regulations will render business restructuring ineffective in qualifying for the 199A deduction if the restructured businesses share direct or attributed ownership, or the commonly owned businesses provide the majority of their products or services to a specified service trade or business.

Limitation on Tax Deductions by Individuals

The TCJA imposes a new $10,000 annual limitation on the deduction of real estate and state and local income taxes by individual taxpayers, regardless of the source of the income giving rise to the taxes.[5] Since the majority of closely held businesses are operated as pass-through entities, this limitation effectively eliminates the federal tax deduction for state and local income taxes paid on business income.

The Connecticut General Assembly has enacted, and Governor Dannel Malloy is expected to sign (and New York and New Jersey have proposed), legislation to impose entity-level taxes on the income of pass-through entities, with an accompanying credit for these taxes to be utilized by the owners of the pass-through entities on their state personal income tax returns. Since entity-level taxes are legal obligations of the business, they should be deductible expenses on the entity's federal tax return, just as they would be if the entity were a C corporation.

In addition to the significant provisions identified at the beginning of this article, the following other TCJA provisions may affect closely held businesses and their owners.

New Limitations on Excess Business Loss

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026, a noncorporate taxpayer's 'excess business loss' is disallowed.[6] Under the new rule, excess business losses are not allowed for the tax year but are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent tax years. The effect of this provision is that business losses in exceeding threshold amounts may no longer be used to offset interest, dividend and capital gain income. This limitation applies after the application of the passive activity loss rules set forth by Internal Revenue Code Section 469.[7]

An excess business loss for the year is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses, over the aggregate gross income or gain of the taxpayer, plus a threshold amount. The threshold amount for a tax year is $500,000 for married taxpayers filing jointly and $250,000 for other individuals, with both amounts indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's or shareholder's share of items of income, gain, deduction, or loss of the pass-through entity is taken into account in applying the limitation for the tax year of the partner or shareholder.

New Holding Period Required for 'Carried Interest'

In general, the receipt of a capital interest for services provided to a partnership results in taxable compensation to the recipient. However, under a safe harbor rule the receipt of a profits interest in exchange for services provided is not a taxable event to the recipient if the profits interest entitles the holder to share only in gains and profits generated after the date of issuance. This provision was effectively employed by hedge fund managers, who receive performance fees as compensation for their services. These performance fees typically consist of a percentage of total fund assets and a percentage of the fund's earnings. The earnings component is often carried over from year to year, until a cash payment is made, usually following the closing out of an investment. This is known as a carried interest. Under pre-TCJA law, carried interests were taxed at favorable capital gains rates instead of as ordinary income.

Effective for years beginning after Dec. 31, 2017, the

TCJA imposes a three-year holding period requirement for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain.[8] If the three-year holding period is not met, the gain will be treated as short-term gain taxed at ordinary income rates.[9]

Certain Self-Created Property Not Treated as Capital Asset

Under prior TCJA-law, Section 1221 specifically excluded certain assets from the definition of capital asset, including inventory, depreciable property, and certain self-created intangibles such as copyrights and musical compositions.

Effective for dispositions after Dec. 31, 2017, the TCJA expands this capital asset exclusion to include patents, inventions, models or designs, and secret formulas, which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who created the property.[10]

Dividends Received Deduction Percentages Reduced

Under pre-TCJA law, corporations that receive dividends from other corporations were entitled to a deduction for dividends received. If the corporation owns at least 20 percent of the stock of the payor corporation, an 80 percent deduction was allowed. Otherwise, a 70 percent deduction was allowed.

For tax years beginning after Dec. 31, 2017, the 80 percent dividends received deduction is reduced to 65 percent, and the 70 percent dividends received deduction is reduced to 50 percent.[11]

Corporate Alternative Minimum Tax Repealed

For years beginning after Dec. 31, 2017, the corporate alternative minimum tax (AMT) is repealed. For taxpayers with AMT credits, the credits may be used to offset regular tax liability and is partially refundable for years 2018 through 2020 and fully refundable beginning in 2021 for AMT credits exceeding regular tax liability.[12]

Expensing, Depreciation, and Capitalization

Section 179 Expense

Under Section 179, a taxpayer may elect to deduct the cost of qualifying property, rather than recover the cost through depreciation deductions. Under pre-TCJA law, the maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property. The $500,000 was reduced by the amount by which the cost of qualifying property placed in service during the year exceeds $2 million.

For property placed in service in tax years beginning after Dec. 31, 2017, the maximum amount a taxpayer may expense under Section 179 is increased to $1 million and the phase-out threshold amount is increased to $2.5 million.[13]

The definition of Section 179 property has been expanded to include certain depreciable personal property used to furnish lodging or in connection with furnishing lodging. The definition of qualified real property eligible for Section 179 expensing is also expanded to include the following improvements to nonresidential real property: roofs; heating, ventilation and air conditioning; fire protection and alarm systems; and security systems.

It is important to note that New Jersey law limits the annual Section 179 expense deduction to $25,000. For New Jersey tax purposes, the cost of property placed in service exceeding this $25,000 limitation is recovered through depreciation deductions.

Bonus Depreciation

Under pre-TCJA law, an additional first-year bonus depreciation deduction was allowed equal to 50 percent of the adjusted basis of qualified property, the original use of which began with the taxpayer. Under the new law, a 100 percent first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023.[14] The additional first-year deduction is allowed for new and used property. This deduction is phased out at the rate of 20 percent per year, starting with property placed in service after Dec. 31, 2022, and will be eliminated after 2026.

New Jersey does not allow any deduction for bonus depreciation.

Cash Method of Accounting

Under pre-TCJA law, a corporation, or a partnership with a corporate partner, was not permitted to use the cash method of accounting if its three-year average annual gross receipts exceeded $5 million. For years beginning after Dec. 31, 2017, the $5 million average annual gross receipts test has been increased to $25 million, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.[15]

The exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations are retained, allowing these entities to use the cash method of accounting without regard to the $25 million gross receipts test, so long as the use of the method clearly reflects income.

Business Deductions, Exclusions and Credits

Limits on Deduction of Business Interest

Under pre-TCJA law, interest paid or accrued by a business is generally deductible in the computation of taxable income.

For tax years beginning after Dec. 31, 2017, every business is generally subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business's adjusted taxable income.[16] The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entities, which requires the determination to be made at the entity level.

For tax years beginning after Dec. 31, 2017, and before Jan. 1, 2022, adjusted taxable income is computed without regard to deductions for depreciation, amortization, or depletion. After Dec. 31, 2021, these deductions are included in the computation, effectively lowering the interest deduction limitation.

The amount of interest not allowed as a deduction for any taxable year is treated as interest paid or accrued on the succeeding taxable year, and may be carried forward indefinitely.

Taxpayers with average annual gross receipts for the three-year tax period ending with the prior tax year that do not exceed $25 million are exempt from this interest deduction limitation. Real property businesses can elect out of this provision if they use the alternative depreciation system to depreciate applicable real property used in the trade or business.

Partnerships are subject to an increased limitation, the computation of which is beyond the scope of this article. Any business interest that is not allowed as a deduction to the partnership is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. The partner may deduct its share of the excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership, the activities of which gave rise to the excess business interest carryforward.

When excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced by the amount of the allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest.

In the event the partner disposes of a partnership interest, the basis of which has been reduced, the partner's basis is increased, immediately before such disposition, by the amount of interest carryforward allocated to the partner, and not deducted.

Modification of Net Operating Loss Deduction

Under prior law, a net operating loss (NOL) could be carried back two years and carried forward 20 years, to offset taxable income in those years. For NOLs arising in tax years ending after Dec. 31, 2017, the two-year carryback provision is repealed and the NOL deduction is limited to 80 percent of taxable income.[17]

Domestic Production Activities Deduction Repealed

Under prior law and subject to certain limitations, a taxpayer could claim a domestic production activities deduction equal to nine percent (six percent for oil and gas) of the lesser of the taxpayer's qualified production activities income or taxable income for the year. For tax years beginning after Dec. 31, 2017, the domestic production activities deduction is repealed.[18]

Like Kind Exchange Treatment Limited

Under prior tax law, like kind exchange nonrecognition treatment was available for a wide range of property, including real estate and tangible personal property held for productive use in the taxpayer's trade or business, or property held for investment purposes.

Effective for transfers after Dec. 31, 2017, the rule allowing deferral of gain on like kind exchanges is modified to allow for like kind exchanges only for real property that is not held primarily for sale.[19]

Employer's Deduction for Fringe Benefit Expenses Limited

For expenses incurred after Dec. 31, 2017, deduction for entertainment expenses is disallowed and the current 50 percent limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer. For years beginning after 2025, the TCJA disallows the employer's deduction for expenses incurred for meals provided for the convenience of the employer on the employer's business premises. Deductions for employee transportation fringe benefits, such as parking and mass transit, are denied, but the exclusion from income for those benefits received by an employee is retained. No deduction is allowed for transportation expenses that are the equivalent of commuting for the employee, except as provided for the safety of the employee.[20]

Credit for Employer-Paid Family and Medical Leave

For wages paid in tax years beginning after Dec. 31, 2017, and before Jan. 1, 2020, the TCJA allows businesses to claim a general business credit equal to 12.5 percent of wages paid to qualifying employees during any period in which those employees are on family and medical leave, if the rate of payment is at least 50 percent of the wages normally paid to an employee. The credit is increased to as much as 25 percent for wages where the rate of payment exceeds 50 percent. To qualify for the credit, all qualifying full-time employees must be given at least two weeks of annual paid family and medical leave.[21]

Hastily enacted, the TCJA contains many provisions requiring clarification. This article was intended to provide a general overview of its significant provisions. Before taking any action, a tax advisor should be consulted to determine the best course of action based on the taxpayer's specific fact pattern and the applicability of the TCJA. ■

Gerald A. Shanker, CPA/ABV, CFF, is a member of KRS, LLC, an accounting and consulting firm in Paramus.

Endnotes

1. Public Law 115-97 (12/22/2017).
2. §11(b)
3. §1(i).
4. §199A(a).
5. §164(b)6.
6. §461(l)(3).
7. §461(l).
8. §1061(a).
9. §1061.
10. §1221(a)(3).
11. §243.
12. §55.
13. §179.
14. §168(k)
15. §448.
16. §163(j).
17. §172.
18. §199.
19. §1031
20. §274.
21. §45S.