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U.S. Tax Reform – Selected Domestic Corporate Tax Provisions

On December 22, 2017, President Trump signed into law the 2017 U.S. tax reform bill "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*," Public Law 115-97 (the "**Act**"), formerly known as the "*Tax Cuts & Jobs Act*." Most of the Act's provisions are effective January 1, 2018. The over 500 pages of legislation include provisions that have possibly unintended or ambiguous results that are subject to interpretation. The Department of Treasury and the Internal Revenue Service ("**IRS**") may take years to provide the necessary guidance. In the meantime, taxpayers and their tax advisors will be forced to interpret complex legislative language, creating challenges and planning opportunities.

The Act introduces the most significant changes to the U.S. tax system since 1986. This Tax Alert sets forth preliminary observations about selected provisions of the Act affecting domestic corporate taxpayers. What follows is not an exhaustive discussion of every domestic corporate tax provision in the Act. For those clients wishing a more specific analysis, interpretation and calculation of the impact of the Act, we are available to answer your questions.

Below is a brief snapshot of the provisions analyzed in this Tax Alert (with more detail immediately below).

1. Corporate Tax Rate and Alternative Minimum Tax ("AMT"). The Act replaces the corporate tax rate with a flat 21% rate, and eliminates the corporate AMT.

2. Depreciation. The Act liberalizes the bonus depreciation rule by allowing full expensing and applies to both new and used property. The Act makes several other less significant depreciation changes.

3. Deductions. The Act substantially limits key business deductions and, in particular, adds a new deduction limitation with respect to interest expenses.

4. Tax Accounting Provisions. The Act limits the ability of accrual taxpayers to defer income recognition beyond the year when income is recognized in financial statements, but contains some accounting method relief for smaller businesses.

5. Other Provisions. The Act contains other provisions important for our clients, including income inclusion for corporations receiving contributions to capital by governmental entities.

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DETAILED EXPLANATION AND INTERPRETATION

1. Corporate Tax Rate and Alternative Minimum Tax

The Act amends Internal Revenue Code ("**IRC**") §11 and replaces the prior-law system of graduated corporate tax rates (the top marginal rate being 35%), with a new flat rate of 21%. There is no sunset provision. The overwhelming majority of corporations are therefore the real beneficiaries of the Act.

Taxpayers with a fiscal year different from the calendar year will need to consider the implications of IRC §15(a), requiring taxpayers to prorate their tax liability for tax rate changes that are effective in the middle of the year.

The Act also eliminates the corporate AMT. However, see the new limitation on net operating losses below which acts similar to an AMT.

Effective Date - These provisions are effective for taxable years beginning after December 31, 2017.

2. Depreciation

2.A. Bonus Depreciation

The Act extends and modifies the bonus depreciation provisions under IRC §168(k), allowing businesses to immediately deduct 100% of the cost of qualified property (e.g., excluding real estate) acquired and placed in service after September 27, 2017, and before January 1, 2023. Expensing for property placed into service beginning January 1, 2023 is phased down by 20% per year for four years starting in 2023.

The Act also removes the requirement that the original use of qualified property must commence with the taxpayer. Thus the provision applies to purchases of used as well as new items, subject to certain anti-abuse provisions.

Effective Date – This provision is generally effective for property acquired and placed in service after September 27, 2017.

2.B. Section 179 Expensing

The Act increases from $500,000 to $1 million the maximum amount of an immediate expense deduction that a taxpayer may take under IRC §179 for purchases of depreciable business property instead of capitalizing and depreciating the asset.

If the total amount of property placed in service exceeds a threshold amount, the benefits of the immediate expense deduction begins to phase-out. The Act increases the threshold amount to $2.5 million from $2 million, for property placed in service in tax years beginning after 2017. These amounts will be indexed for inflation after 2018.

In addition, the Act expands the definition of IRC §179 property to include certain nonresidential real property improvements and certain depreciable tangible personal property related to lodgings.

Effective Date – This provision is effective for property placed in service in taxable years beginning after December 31, 2017.

2.C. Real Estate

The Act eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 15-year Modified Accelerated Cost Recovery System ("**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 for residential property from 40 years to 30 years.

A real property trade or business electing out of the limitation on the deduction for interest (discussed below) must use ADS to depreciate any of its nonresidential real property, residential property and qualified improvement property. This means that for any real property business that elects not to be subject to the interest expense limitation described below, the depreciation recovery period for nonresidential real property (other than land) is 40 years (as opposed to 39 years under MACRS), the recovery period for residential property is 39 years (as opposed to 27.5 years under MACRS) and the recovery period for qualified improvement property is 20 years (as opposed to 15 years under MACRS)

Effective Date - This provision is effective for property placed in service after December 31, 2017.

3. Deductions

3.A. Interest Expense Deduction Limitation

The most significant change to the deduction provisions is the new limitation on interest expense deductions. The so-called "earning stripping rules" under IRC §163(j) applicable to interest payments from U.S. corporations to foreign related parties are repealed and replaced with a new IRC §163(j). The new IRC §163(j), however, does not apply to taxpayers with average annual gross receipts of $25 million or less during a 3-year look-back period.

The new IRC §163(j) provides that the deduction for business interest is limited to the sum of:

- The taxpayer's business interest income;
- 30% of the taxpayer's "adjusted taxable income" for the taxable year; and
- the taxpayer's "floor plan financing interest" for the taxable year.

"Business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business. However, business interest does not include investment interest, and business interest income does not include investment income within the meaning of IRC §163(d).

"Adjusted taxable income" is generally defined as EBITDA (earnings before income tax, depreciation and amortization) for taxable years beginning after December 31, 2017 and before January 1, 2022, and EBIT (earnings before income tax) thereafter.

"Floor plan financing interest" means interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired.

Any disallowed business interest deduction can be carried forward indefinitely (with special rules applying to partnerships).

Real estate firms may elect out of new IRC §163(j) by making an irrevocable election in a time and manner as prescribed by the Treasury Secretary. As noted above, an electing real property trade or business must use the ADS method of depreciation under IRC §168(g).

Effective Date - This provision is effective for tax years beginning after December 31, 2017.

3.B. Deduction for Net Operating Losses ("NOLs")

The Act generally limits the deduction for NOLs under IRC §172 to 80% of taxable income (determined without regard to the NOL deduction). Although the Act claims to eliminate the corporate AMT, the NOL limitation is "in effect" a virtual AMT.

The two-year carryback and special NOL carryback provisions were generally repealed. Taxpayers are allowed to carry NOLs forward indefinitely.

Effective Date - This provision is effective for losses arising in tax years beginning after December 31, 2017. This is significant since it means the 80% limitation does not apply to NOLs incurred prior to December 31, 2017. It also means that NOLs that carry forward indefinitely are only those that occur after December 31, 2017 (i.e., those NOLs incurred prior to December 31, 2017 only carry forward 20 years).

Action Steps - Any entity that had an NOL in 2016 or 2017 and was considering carrying it forward instead of carrying it back should reconsider the carryback, which could be significantly more

advantageous, to the extent taxable income in the carryback year was subject to a tax rate higher than 21%.

3.C. Dividends Received Deduction Limitation

Under IRC §245 corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. Under the Act, however, a corporation is only able to deduct 65% (down from 80%) of the amount of such dividends in which the receiving corporation owned 20% or more of the stock. A corporation is only able to deduct 50% (down from 70%) of the amount of such dividends received from other domestic corporations. For the dividends received deduction for dividends from foreign corporations refer to the Tax Alert, "U.S. Tax Reform – International Corporate Tax Provisions: *The Good, the Bad and the Extremely Complex*."

Effective Date - This provision is effective for taxable years beginning after December 31, 2017.

3.D. Miscellaneous Deduction Limitations

The Act contains numerous other deduction limitations, including:

Domestic production activities deduction: IRC §199 generally provides a deduction from taxable income that is equal to 9% of the lesser of the taxpayer's qualified production activities income or taxable income. The Act repeals the domestic production activities deduction under IRC §199. This provision is effective for C corporations for taxable years beginning after December 31, 2017.

Business entertainment expense deduction: IRC §274 generally provides a deduction of 50% with respect to certain entertainment expenses directly related to or associated with the active conduct of a trade or business. The Act repeals the 50% deduction under IRC §274 for those business entertainment expenses. This provision generally applies to amounts paid or incurred after December 31, 2017.

Qualified transportation fringe benefit deduction: IRC §274 generally provides a deduction for expenses associated with providing qualified transportation fringe benefits (e.g., transit passes) to the taxpayer's employees. The Act disallows the deduction under IRC §274 for such expenses. This provision generally applies to amounts paid or incurred after December 31, 2017.

Fines and penalty deduction: The Act expands the scope of IRC §162(f) by disallowing **all** amounts paid to or incurred at the direction of a governmental or specific nongovernmental regulatory entity for the violation or potential violation of any law. Certain exceptions continue to apply (e.g., with respect to restitution amounts) but such amounts must be specifically identified in the underlying court order or settlement agreement. The provision would generally apply to amounts paid or incurred after December 22, 2017, the Act's enactment date, except with respect to amounts paid or incurred under a binding court order or agreement entered into before that date.

4. Tax Accounting Provisions

4.A. Taxable Year of Inclusion

"All Events Test"

The Act requires accrual basis taxpayers to recognize items of gross income for tax purposes no later than the taxable year in which they recognize the income on their "applicable financial statement" (or another financial statement under rules to be specified by the IRS). The Act provides an exception for taxpayers without an applicable or other specified financial statement.

This rule applies notwithstanding that the "all events test" has not yet been met (i.e., when all events have occurred that fix the right to receive such income and the amounts therefore can be determined with reasonable accuracy). Thus, per the legislative history, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income as revenue in an applicable financial statement or another financial statement specified by the Treasury Secretary.

The Act provides a list of "applicable financial statements" which include, among others: (i) a Form 10-K; (ii) an audited financial statement of the taxpayer which is used for credit purposes, reporting to shareholders, etc.; and (iii) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government equivalent to the United States Securities and Exchange Commission.

Deferral Method – Gift Cards

The Act also codifies the current deferral method of accounting for advance payment of goods, services, and other specified items provided under Revenue Procedure 2004-34. According to the legislative history, the provision is intended to override the deferral method provided by Treasury Regulations §1.451-5 for advance payment received for goods. Thus, for instance, revenue from the sale of gift cards can no longer be deferred longer than one tax year. A taxpayer is required to elect the deferred recognition of advance payments at such time and in such form and manner as the Treasury Secretary provides and such election shall be effective for all subsequent taxable years unless the Treasury Secretary agrees to revoke the election.

The application of the above rules is a change in the taxpayer's method of accounting for purposes of IRC 481. In the case of any taxpayer required by this provision to change its method of accounting for its first taxable year beginning after December, 31, 2017, such change is treated as initiated by the taxpayer and made with the Treasury Secretary's consent.

Effective Date - These provisions are generally effective for taxable years beginning after December 31, 2017.

4.B. Small Business Accounting Method Relief

The Act also contains simplified accounting for certain small businesses as follows:

Cash method of accounting: The Act permits certain taxpayers that meet the annual average gross receipts test of $25 million or less for the three prior taxable-year-period (the "**$25 million GRT"**) to use the cash method of accounting even if the business has inventories. In contrast, under current law, the cash method can generally be used for certain small businesses with gross receipts of not more than $1 million (or $5 million for all prior years). This provision is generally effective for taxable years beginning after December 31, 2017.

Accounting for inventories relief: For Federal income tax purposes, taxpayers must generally account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer. Under current law an exception for inventory accounting exists for small taxpayers with gross receipts of not more than $1 million, and to small taxpayers in certain industries with gross receipts of not more than $10 million. The Act liberalizes the exceptions by allowing taxpayers meeting the $25 million GRT defined above to avoid the method of tax accounting under IRC §471 for inventories and instead use a method of accounting for inventories that either (i) treats inventories as non-incidental materials and supplies or (ii) conforms to the taxpayer's financial accounting treatment of inventory. This provision is generally effective for taxable years beginning after December 31, 2017.

Uniform capitalization relief: The uniform capitalization (**"UNICAP"**) rules under IRC §263 require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable. The Act liberalizes an exception under current law applicable to small resellers. Under the Act, producers or resellers that meet the $25 million GRT defined above are exempt from IRC §263A. This provision is generally effective for taxable years beginning after December 31, 2017.

Long-term contract relief: For long-term contracts, the taxable income from the contract is determined under the percentage-of-completion (**"POC"**) method. Under the POC method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (i) the gross contract price and (ii) the percentage of the contract completed during the taxable year. Under current law, the POC method is not required for certain real estate contracts if (i) the contract is expected to be completed within two years of the contract commencement and (ii) is performed by a taxpayer with gross receipts that do not exceed $10 million. The Act liberalizes the gross receipts limitation of the exception by increasing it to the $25 million GRT defined above. This provision generally applies to contracts entered into after December 31, 2017, in taxable years ending after such date.

5. Other Provisions

5.A. Form 5472 Penalty Increases to $25,000

The international tax changes include a new tax which won't apply to most clients (the "Base Erosion and Anti Abuse Tax" or **BEAT**).[1] However, along with additional reporting requirements included with the BEAT is an increase in the penalty for failure to file a substantially complete Form 5472 from the current $10,000 to $25,000.

Effective Date - This provision is effective for taxable years beginning after December 31, 2017.

5.B. Like-Kind Exchanges

Like-kind exchanges of the same class or kind of certain personal or real property can qualify under current law for nonrecognition treatment under §1031. The Act, however, limits the application of the IRC §1031 like kind exchange rules to only like-kind exchanges of real property. Thus, for instance, exchanges of a broadcast license with another broadcast license would no longer qualify for nonrecognition treatment. The legislative history states that it is intended that real property eligible for like-kind exchange treatment under current law will continue to be eligible for like-kind exchange treatment under the new provision.

Effective Date - This provision is effective for exchanges completed after December 31, 2017. A transition rule would allow for like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired replacement property on or before December 31, 2017.

5.C. Contributions to Capital

The Acts adds a new category of contributions to capital to which tax-free treatment under IRC §118 does not apply: any contribution by any governmental entity or civic group (other than a contribution made by a shareholder in its capacity as such). Thus a contribution of municipal land by a municipality to a corporation, not in exchange for such corporation's stock, would now be included in the income of the corporation.

Effective Date - This provision applies to contributions made after December 22, 2017, the date of enactment. However, the provision does not apply to any contribution made after the date of enactment by a governmental entity pursuant to a master development plan that has been approved prior to such date by a governmental entity.

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[1] For a discussion of BEAT, refer to the Tax Alert, "U.S. Tax Reform – International Corporate Tax Provisions: *The Good, the Bad and the Extremely Complex*."

5.C. Research and Experimental ("R&E") Expenditures

For tax years beginning after 2021, the Act would repeal the expensing of R&E expenditures, including software development costs, permitted under current IRC §174 and require instead that such expenditures be capitalized and amortized over a 5-year period. R&E expenditures that are attributable to research that is conducted outside the United States would be capitalized and amortized over a 15-year period.

Effective Date - This provision is effective for amounts paid or incurred in taxable years after December 31, 2021.

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