# Gettry Marcus CPA, P.C.

## 2017 TAX LEGISLATION

## Q & A: Tax Cuts & Jobs Act

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# INTRODUCTION

The 2017 Tax Cuts and Jobs Act provides for the most significant changes to the Internal Revenue Code in decades that will affect almost every taxpayer. At the same time, it presents challenges in its interpretation and implementation, having been enacted only ten days before most of its changes took effect after a very short legislative process. While many of its provisions are straightforward, there are several areas that are marked by ambiguity and which will require technical guidance from the Treasury Department.

This guide is an overview of the most significant topics in question-and-answer format. As the aforementioned technical guidance becomes available, we will provide relevant updates. Please feel free to contact your Gettry Marcus professional for more information, and to learn how these changes affect you and your business.

# 1. PERSONAL INCOME TAX CHANGES

**Q:** What are the changes in personal income taxes pursuant to the Tax Cuts and Jobs Act of 2017?

**A:** The changes below generally apply for the years 2018 through 2025. See the different sections for a discussion of the changes.

### *PERSONAL INCOME TAX RATES & ITEMIZED DEDUCTIONS*

Tax brackets change effective for years beginning after 12/31/2017, and revert back to pre-law rates for years beginning after 12/31/2025. The brackets are reduced in number, the top rate drops from 39.6% to 37%, and the measure for inflation adjustment is changed from the cost-of-living for urban consumers to the chained cost-of-living for urban consumers. This change results in smaller inflation adjustments. Inflation adjustments start in 2019.[1]

**Married filing jointly and surviving spouses**

| **2017 brackets** | | | **2018 brackets** | |
|---|---|---|---|---|
| Not over $18,650 | 10% of the taxable income | | Not over $19,050 | 10% of taxable income |
| Over $18,650 but not over $75,900 | $1,865 plus 15% of the excess over $18,650 | | Over $19,050 but not over $77,400 | $1,905, plus 12% of the excess over $19,050. |
| Over $75,900 but not over $153,100 | $10,452.50 plus 25% of the excess over $75,900 | | Over $77,400 but not over $165,000 | $8,907, plus 22% of the excess over $77,400. |
| Over $153,100 but not over $233,350 | $29,752.50 plus 28% of the excess over $153,100 | | Over $165,000 but not over $315,000 | $28,179, plus 24% of the excess over $165,000 |

[1] Code §1(j) as amended by the Tax Cuts and Jobs Act §11001.

| | | | | |
|---|---|---|---|---|
| Over $233,350 but not over $416,700 | $52,222.50 plus 33% of the excess over $233,350 | | Over $315,000 but not over $400,000 | $64,179, plus 32% of the excess over $315,000. |
| Over $416,700 but not over $470,700 | $112,728 plus 35% of the excess over $416,700 | | Over $400,000 but not over $600,000 | $91,379, plus 35% of the excess over $400,000. |
| Over $470,700 | $131,628 plus 39.6% of the excess over $470,700 | | Over $600,000 | $161,379, plus 37% of the excess over $600,000. |

## Heads of households

| 2017 brackets | | | 2018 brackets | |
|---|---|---|---|---|
| Not over $13,350 | 10% of the taxable income | | Not over $13,600 | 10% of taxable income. |
| Over $13,350 but not over $50,800 | $1,335 plus 15% of the excess over $13,350 | | Over $13,600 but not over $51,800 | $1,360, plus 12% of the excess over $13,600. |
| Over $50,800 but not over $131,200 | $27,052.50 plus 28% of the excess over $131,200 | | Over $51,800 but not over $82,500 | $5,944, plus 22% of the excess over $51,800. |
| Over $131,200 but not over $212,500 | $6,952.50 plus 25% of the excess over $50,800 | | Over $82,500 but not over $157,500 | $12,698, plus 24% of the excess over $82,500. |
| Over $212,500 but not over $416,700 | $49,816.50 plus 33% of the excess over $212,500 | | Over $157,500 but not over $200,000 | $30,698, plus 32% of the excess over $157,500. |
| Over $416,700 but not over $444,550 | $117,202.50 plus 35% of the excess over $416,700 | | Over $200,000 but not over $500,000 | $44,298, plus 35% of the excess over $200,000. |
| Over $444,550 | $126,950 plus 39.6% of the excess over $444,550 | | Over $500,000 | $149,298, plus 37% of the excess over $500,000. |

## Married filing separately

| 2017 brackets | | | 2018 brackets | |
|---|---|---|---|---|
| Not over $9,325 | 10% of the taxable income | | Not over $9,525 | 10% of taxable income. |
| Over $9,325 but not over $37,950 | $932.50 plus 15% of the excess over $9,325 | | Over $9,525 but not over $38,700 | $952.50, plus 12% of the excess over $9,525. |
| Over $37,950 but not over $76,550 | $5,226.25 plus 25% of the excess over $37,950 | | Over $38,700 but not over $82,500 | $4,453.50, plus 22% of the excess over $38,700. |

| | | | | |
|---|---|---|---|---|
| Over $76,550 but not over $116,675 | $14,876.25 plus 28% of the excess over $76,550 | | Over $82,500 but not over $157,500 | $14,089.50, plus 24% of the excess over $82,500 |
| Over $116,675 but not over $208,350 | $26,111.25 plus 33% of the excess over $116,675 | | Over $157,500 but not over $200,000 | $32,089.50, plus 32% of the excess over $157,500 |
| Over $208,350 but not over $235,350 | $56,364 plus 35% of the excess over $208,350 | | Over $200,000 but not over $300,000 | $45,689.50, plus 35% of the excess over $200,000 |
| Over $235,350 | $65,814 plus 39.6% of the excess over $235,350 | | Over $300,000 | $80,689.50, plus 37% of the excess over $300,000 |

## Single

| 2017 brackets | | | 2018 brackets | |
|---|---|---|---|---|
| Not over $9,325 | 10% of the taxable income | | Not over $9,525 | 10% of taxable income. |
| Over $9,325 but not over $37,950 | $932.50 plus 15% of the excess over $9,325 | | Over $9,525 but not over $38,700 | $952.50, plus 12% of the excess over $9,525. |
| Over $37,950 but not over $91,900 | $5,226.25 plus 25% of the excess over $37,950 | | Over $38,700 but not over $82,500 | $4,453.50, plus 22% of the excess over $38,700. |
| Over $91,900 but not over $191,650 | $18,713.75 plus 28% of the excess over $91,900 | | Over $82,500 but not over $157,500 | $14,089.50, plus 24% of the excess over $82,500. |
| Over $191,650 but not over $416,700 | $46,643.75 plus 33% of the excess over $191,650 | | Over $157,500 but not over $200,000 | $32,089.50, plus 32% of the excess over $157,500. |
| Over $416,700 but not over $418,400 | $120,910.25 plus 35% of the excess over $416,700 | | Over $200,000 but not over $500,000 | $45,689.50, plus 35% of the excess over $200,000. |
| Over $418,400 | $121,505.25 plus 39.6% of the excess over $418,400 | | Over $500,000 | $150,689.50, plus 37% of the excess over $500,000 |

## Estates and trusts

| 2017 brackets | | | 2018 brackets | |
|---|---|---|---|---|
| Not over $2,550 | 15% of the taxable income | | Not over $2,550 | 10% of taxable income. |
| Over $2,550 but not over $6,000 | $382.50 plus 25% of the excess over $2,550 | | Over $2,550 but not over $9,150 | $255, plus 24% of the excess over $2,550. |
| Over $6,000 but not over $9,150 | $1,245 plus 28% of the excess over $6,000 | | Over $9,150 but not over $12,500 | $1,839, plus 35% of the excess over $9,150. |

| | | | | |
|---|---|---|---|---|
| Over $9,150 but not over $12,500 | $2,127 plus 33% of the excess over $9,150 | | Over $12,500 | $3,011.50, plus 37% of the excess over $12,500. |
| Over $12,500 | $3,232.50 plus 39.6% of the excess over $12,500 | | | |

### *KIDDIE TAX*

Net unearned income is taxed using the brackets that apply to estates and trusts.[2] The child's tax is no longer computed with reference to the parent's tax brackets or the child's siblings. The age limits – age 19 or full-time student under 24 – are unchanged.[3]

### *CAPITAL GAINS*

Capital gains rates are unchanged, at 15% and 20%, however, the threshold amounts have changed.[4]

| Filing status | Tax rate zero | Tax rate 15% | Tax rate 20% |
|---|---|---|---|
| Joint return or surviving spouse | up to $77,200 | up to $479,000 | over $479,000 |
| Head of Household | up to $51,700 | up to $452,400 | over $452,400 |
| Single or married filing separately | up to $38,600 | up to $425,800 | over $425,800 |
| Estate or trust | up to $2,600 | up to $12,700 | over $12,700 |

The thresholds will be adjusted for inflation beginning in 2019 and using 2017 as the base year.[5] Inflation adjustments, as mentioned above, will be based on the chained cost-of-living adjustment.[6]

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[2] Code §1(j)(4) as amended by the Tax Cuts and Jobs Act §11001.

[3] Conference Committee Report, p. 197, 200.

[4] Conference Committee Report p. 198, 200; Code §1(j)(5) as amended by the Tax Cuts and Jobs Act §11001.

[5] Code §1(j)(5)(C) as amended by the Tax Cuts and Jobs Act §11001.

[6] Code §1(f)(3), as amended by the Tax Cuts and Jobs Act §11002(a).

### *ITEMIZED DEDUCTIONS*

Like the other changes, these apply for the years 2018 through 2025.

The cut back of itemized deductions is suspended.[7] However, many previously allowed itemized deductions have been eliminated:

- The miscellaneous itemized deductions;[8]
- State and local income taxes, state and local property taxes, and state and local sales taxes, where the aggregate exceeds $10,000 (i.e., the maximum deduction allowed is $10,000 for the total of these taxes, and the sales tax deduction is only allowed as an election in lieu of state and local income taxes);[9]
- Mortgage interest deduction has been trimmed back for interest on $1 million of indebtedness to $750,000 of indebtedness for debt incurred after December 15, 2017.[10]
- Casualty losses are only allowed for federally declared disaster zones, or to the extent of casualty involuntary conversion gains.[11]
- The limitation on cash contributions to a charity is increased from 50% of AGI to 60% of AGI.[12]

### *ABOVE THE LINE DEDUCTIONS*

The alimony deduction by the payor and inclusion by the recipient has been repealed, effective for divorce or separation instruments executed after 2018.[13]

The above the line treatment of moving expenses has also been changed: the moving expense deduction is suspended,[14] as is the exclusion of moving expense reimbursement.[15] However, active duty military personnel who move pursuant to a military order are not affected by the suspension: they still get the benefit of prior law.[16]

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[7] Code §68(f), as amended by the Tax Cuts and Jobs Act §11046(a).

[8] Code §67(g), as amended by the Tax Cuts and Jobs Act §11045(a).

[9] Code §164(b) as amended by the Tax Cuts and Jobs Act §11042; Conference Committee Report p. 260.

[10] Code §163(h)(3), as amended by the Tax Cuts and Jobs Act §11043(a).

[11] Code §165(h), as amended by the Tax Cuts and Jobs Act §11044(a).

[12] Code §170(b), as amended by the Tax Cuts and Jobs Act §11023(a).

[13] Tax Cuts and Jobs Act §11051.

[14] Code §217(k), as amended by the Tax Cuts and Jobs Act §11049(a).

[15] Code §132(g), as amended by the Tax Cuts and Jobs Act §11048(a).

[16] *Ibid.*

### *STANDARD DEDUCTION*

The new standard deductions are $24,000 for married filing jointly or surviving spouses, $18,000 for head-of-household, and $12,000 for married filing separately or single.[17] There is no change to the additional amounts allowed for over 65 or blind.[18]

### *PERSONAL EXEMPTION*

The personal exemption is suspended for the years 2018 through 2025.[19]

## 2. ESTATE AND GIFT TAX

**Q:** What are the changes in estate and gift taxes pursuant to the Tax Cuts and Jobs Act of 2017?

**A:** The basic exclusion amount is doubled from $5 million to $10 million.[20] This amount is adjusted for inflation after 2011 – and that provision was not changed. Using the prior law $5 million limit, the inflation adjusted amount for 2018 was scheduled to be $5.6 million.[21] Therefore, the inflation adjusted amount for 2018, under the new law, should be $11.2 million.

The change applies for the years 2018 through 2025.[22]

There is no change to the gift tax annual exclusion, which is scheduled to be $15,000 in 2018.[23]

The new law leaves open the issue of how to compute the estate tax if a taxpayer makes gifts between 2018 and 2025, taking advantage of the higher exclusion amount, but then dies during a year when the unadjusted exclusion amount has snapped back to $5 million (adjusted for inflation). The problem arises because lifetime gifts must be added to the estate to determine total transfers. For example, a taxpayer could make a gift of $11 million in 2018 and it would be exempt from gift tax. However, if taxpayer dies in 2026 and the inflation-adjusted exclusion amount is then $6 million, taxpayer has total transfers of $5 million over the exclusion amount – the estate would be subject to an estate tax, and it might not even have sufficient assets to pay the estate tax. The general rule is that the estate tax shall be computed using the exclusion amount and rates in

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[17] Code §63(c)(7), as amended by the Tax Cuts and Jobs Act §11021(a).

[18] Code §63(f) (unchanged); Conference Committee Report p. 202.

[19] Code §151(d)(5), as amended by the Tax Cuts and Jobs Act §11041(a).

[20] Code §2010(c)(3)(C), as amended by the Tax Cuts and Jobs Act §11061(a).

[21] Surkin, Dean L., "Recent Developments in Taxation Law and Procedure," slide 19 – presentation for the NYSSCPAs, Westchester Chapter, December 4, 2017.

[22] Code §2010(c)(3)(C), as amended by the Tax Cuts and Jobs Act §11061(a).

[23] Surkin, Dean L., *op cit.*

effect at the decedent's death, and the Treasury Department has been directed to issue regulations implementing these rules.[24]

Note that there have been no corresponding changes to New York estate tax. The New York estate tax exemption amount for 2018 is $5,250,000.[25]

## 3. CAPITAL GAIN PROPERTY TAX CHANGES

**Q:** What changes have been made with respect to certain capital gain property?

**A:** The exclusion from the definition of capital assets for certain self-created intangibles has been expanded; and a new holding period for long-term gains attributable to "carried interests" has been created.

### *SELF-CREATED INTANGIBLES*

Under prior law, the Code 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 was 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. In addition, gains were treated as ordinary in the hands of a transferee with substituted or transferred basis from the creator of the asset.

Effective for dispositions after December 31, 2017 the exclusion is expanded to 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).

Note that even though patents are excluded from the definition of a capital asset, Section 1235 provides that certain transfers of patents by inventors and certain financial backers are treated as sales or exchange of long-term capital assets.

### *3-YEAR HOLDING PERIOD FOR CAPITAL GAINS FROM CARRIED INTERESTS*

In general, the receipt of a partnership 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. Profits interests are commonly used in private investment funds and are often referred to as "carried interest". If a partnership recognizes gain from the sale of a capital asset that it has held for more than one year, an individual partner who is allocated a share of the partnership's long-term capital gain will be taxed on that share at long-term capital gain rates.

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[24] Code §2001(g), as amended by the Tax Cuts and Jobs Act §11061(a).

[25] https://tax.ny.gov/pit/estate/etidx.htm, retrieved January 12, 2018.

Effective for tax years beginning after December 31, 2017, the tax treatment of gains with respect to an “applicable partnership interest” where the holding period is 3 years or less will be treated as short-term capital gain. An “applicable partnership interest” is any activity conducted on a regular, continuous, and substantial basis which consists (in whole or part) of raising or returning capital, and either investing in (or disposing of) or developing “specified assets.”

“Specified assets “include securities, commodities, rental or investment real estate, and certain other investment-type assets.

The fact that an individual may have included an amount in income upon acquisition of an applicable partnership interest, or that an individual may have made a Code Sec. 83(b) election with respect to an applicable partnership interest, doesn't change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

## 4. CHANGES IN PARTNERSHIP PROVISIONS

**Q:** What changes have been made to rules specifically affecting partnerships under the 2017 Tax Cuts and Jobs Act?

**A:** The technical termination rule has been eliminated and the basis reduction provisions for charitable contributions has been amended

### *TECHNICAL TERMINATIONS*

Under prior law, a partnership was considered terminated for tax purposes if, within any 12-month period, there was a sale or exchange of 50% or more of the total interest in partnership capital and profits (a Section 708(b)(1)(B) technical termination).

As a result of a technical termination, (1) some of the tax attributes of the old partnership terminated, (2) the partnership's taxable year closed, potentially resulting in short tax years, (3) partnership-level elections generally ceased to apply and, (4) the partnership depreciation recovery periods restarted.

Effective for partnership tax years beginning after December 31, 2017 the technical termination rule is eliminated. Note that a partnership will still be deemed terminated when the business is no longer carried on in partnership form, e.g., only one partner remains.

Example 1: Joker Novelties, LLC, which is treated as a calendar-year partnership for tax purposes, has three members with interests in profits and capital as follows: Chuckle, 50%; Snicker, 30%, and Guffaw, 20%. On April 30, 2017 Guffaw purchases Chuckle’s entire interest, and one-third of Snicker’s interest. After the transaction, Guffaw owns 80% and Snicker 20%, and Chuckle is no longer a member. Because more than 50% of the partnership’s interest in profits and capital was transferred, Joker is considered terminated. It must file two returns for 2017, one for the period ending on April 30, and one for the period beginning May 1 and ending on December

31, 2017. All of Joker's tax elections are no longer in effect and it must restart depreciating its fixed assets over their full recovery periods.

Example 2: Same as above, except the transfer occurred on April 30, 2018. Joker will file one return for calendar year 2018 without any changes to its tax elections or depreciation (other than a potential basis step-up due to a Section 754 election).

### *ADJUSTMENT TO PARTNERS' BASIS FOR CHARITABLE CONTRIBUTIONS AND FOREIGN TAXES*

A partner is allowed to deduct his or her distributive share of partnership loss only to the extent of the adjusted basis of the partner's interest in the partnership at the end of the partnership year in which such loss occurs. Regulations issued in connection with this rule implied that the limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions or foreign taxes.

Effective for partnership tax years beginning after Dec. 31, 2017, the Internal Revenue Code clarifies that in determining the amount of a partner's loss, his or her share of partnership charitable contributions and taxes paid or accrued to foreign countries or U.S. possessions are taken into account. However, in the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

## 5. BUSINESS TAX CHANGES

### Q's:

1. What are the changes in business interest deductions pursuant to the Tax Cuts and Jobs Act of 2017?
2. What are the changes to business and meal expenses pursuant to the Tax Cuts and Jobs Act of 2017?
3. What are the changes in accounting methods pursuant to the Tax Cuts and Jobs Act of 2017?

### A's:

1. Unlike under prior law, business interest deductions for taxpayers with more than $25 million average gross receipts are now subject to a limit, generally 30% of income (but subject to modifications discussed below).
2. Business meals and entertainment deductions are generally eliminated as discussed below.
3. The cash method may be used by taxpayers with up to $25 million of average gross receipts.

## *BUSINESS INTEREST EXPENSE LIMITATION*

Business interest was not limited under pre-2018 law. The new law limits the business interest deduction to the sum of:

- Business interest income; plus
- 30% of adjusted taxable income (but not below zero); plus
- Floor plan financing interest.[26]

The limitation applies at the partnership level, such that the partnership's ordinary income or loss includes the allowable deduction for business interest.[27] To prevent double counting and potentially increasing the allowable limit for business interest,[28] the adjusted taxable income for a partner does not include the pass-through income from the partnership.[29] However, if the partnership has not met the limit – in other words, if it has not deducted interest up to the maximum amount of 30% of adjusted taxable income – the unused portion, called excess taxable income, may be used by the partners to compute their adjusted taxable income.[30]

### Exclusions from the limitation

The limit does not apply to small taxpayers, defined by reference to the same threshold that determines which taxpayers may use the cash method.[31] For years after 2017, that threshold is $25 million.[32] The limit also does not apply to utilities or an electing farming business, or an electing real property trade or business.[33]

The Treasury Department will issue Regulations specifying how to make the election for a real property trade or business[34] or a farming business.[35]

### Definitions

Business interest is interest incurred in a trade or business and does not include investment interest.[36]

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[26] Code §163(j), as amended by the Tax Cuts and Jobs Act §13301(a).

[27] Code §163(j)(4), as amended by the Tax Cuts and Jobs Act §13301(a).

[28] Conference Committee Report p. 388.

[29] Code §163(j)(4)(A)(ii), as amended by the Tax Cuts and Jobs Act §13301(a).

[30] Code §163(j)(4)(B)(ii), as amended by the Tax Cuts and Jobs Act §13301(a); Conference Committee Report p. 388.

[31] Code §163(j)(3), as amended by the Tax Cuts and Jobs Act §13301(a).

[32] Conference Committee Report p. 389.

[33] Code §163(j)(7), as amended by the Tax Cuts and Jobs Act §13301(a).

[34] Code §163(j)(7)(B), as amended by the Tax Cuts and Jobs Act §13301(a).

[35] Code §163(j)(7)(C), as amended by the Tax Cuts and Jobs Act §13301(a).

[36] Code §163(j)(5), as amended by the Tax Cuts and Jobs Act §13301(a).

Adjusted taxable income is taxable income computed without regard to:

- Non-business income, gain, deduction or loss;
- Business interest;
- NOL; and
- Pass-through deduction (under new Code §199A);
- For the years between 2018 and 2021, adjusted taxable income is also computed without regard to depreciation amortization, or depletion.[37]

Floor plan financing interest means interest on a debt used to acquire motor vehicles for sale or lease.[38] The purpose of including floor plan financing in the limit is to ensure that motor vehicle dealers can deduct the interest they pay to acquire inventory.[39]

Interest over the limit is carried forward indefinitely.[40] If there is a change in control of a corporation that would trigger a limitation on NOL carryover under Code §381, the business interest carryover is treated, and limited, just as an NOL carryover would be.[41]

### *MEALS AND ENTERTAINMENT EXPENSES*

The deduction for business entertainment has been repealed.[42] Similarly, no membership dues in recreation or social clubs are deductible. The deduction for business meals provided to employees at employer-operated eating facilities (i.e., as a *de minimus* fringe benefit) remains at 50%.[43] However, meals provided at the convenience of the employer will be nondeductible after December 31, 2025.[44]

### *ACCOUNTING METHODS*

A C corporation or partnership that has a C corporation as a partner may use the cash method if its average annual gross receipts for the prior three taxable years is less than or equal to $25 million.[45] The threshold amount will be adjusted for inflation beginning in 2019.[46]

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[37] Code §163(j)(8) as amended by the Tax Cuts and Jobs Act §13301(a).

[38] Code §163(j)(9) as amended by the Tax Cuts and Jobs Act §13301(a).

[39] Conference Committee Report p. 387.

[40] Code §163(j)(2) as amended by the Tax Cuts and Jobs Act §13301(a).

[41] Code §381(c)(20) as amended by the Tax Cuts and Jobs Act §13301(b).

[42] Code §274(a) as amended by the Tax Cuts and Jobs Act §13304(a).

[43] Code §274(n) as amended by the Tax Cuts and Jobs Act §13304(a).

[44] Code §274(o) as amended by the Tax Cuts and Jobs Act §13304(d), (e).

[45] Code §448(c) as amended by the Tax Cuts and Jobs Act §13102(a).

[46] Code §448(c)(4) as amended by the Tax Cuts and Jobs Act §13102(a).

A qualifying taxpayer may change to the cash method of accounting with automatic consent from the IRS.[47] Once a qualifying taxpayer begins using the cash method, it does not have to use the inventory method[48] (for example, it can expense inventory costs as supplies[49]) and is exempt from the uniform capitalization rules of code §263A.[50] Producers and resellers are also exempt from the uniform capitalization rules.[51]

A taxpayer that meets the $25 million test does not have to use the percentage-of-completion method for small construction contracts. A small construction contract is a contract expected to be completed within two years of commencement, and taxpayer meets the $25 million test for year it entered into the contract.[52]

## 6. CHANGES IN C CORP TAX RATES

**Q:** What changes have been made to corporate tax rates under the 2017 Tax Cuts and Jobs Act?

**A:** The graduated rates have been replaced by a lower flat rate and the Alternative Minimum Tax (AMT) has been repealed

Under prior law, C corporations were subject to graduated tax rates ranging from 15% for the first $50,000 of taxable income to 35% for taxable income more than $10,000,000. The graduated rates were phased out so that taxable income between $335,000 and $10,000,000 was subject to a flat rate of 34% and income over $18,333,333 was subject to a flat rate of 35%. In addition, personal service corporations did not have the advantage of the lower rates and were taxed at a flat 35% rate.

Effective for tax years beginning after December 31, 2017 the corporate tax rate is reduced to a flat 21%. It appears that corporations with fiscal years ending after Dec. 31, 2017 would be subject to a blended rate based on a weighted average of two hypothetical tax calculations.

Example 1: Pluto Plumbing Inc. has taxable income of $400,000 for both calendar year 2017 and 2018. Pluto's federal income tax for 2017 is $136,000 ($400,000 X 34%) and 2018 tax is $84,000 ($400,000 X 21%), resulting in a tax cut under the new law of $52,000.

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[47] Code §448(d)(7) as amended by the Tax Cuts and Jobs Act §13102(a).

[48] Code §263A(j) as amended by the Tax Cuts and Jobs Act §13102(b).

[49] Conference Committee Report p. 380.

[50] Code §471(c) as amended by the Tax Cuts and Jobs Act §13102(c).

[51] Conference Committee Report p. 380

[52] Code §460(e)(1)(B) as amended by the Tax Cuts and Jobs Act §13102(d).

Example 2: Venus Vending Corp. has taxable income of $50,000 for both calendar year 2017 and 2018. Venus's federal income tax for 2017 is $7,500 ($50,000 X 15%) and 2018 tax is $10,500 ($50,000 X 21%), resulting in a tax *increase* under the new law of $3,000.

Example 3: Mercury Marshmallow Ltd. Has taxable income of $600,000 for the fiscal year ended March 31, 2018. Mercury's federal income tax is $184,767, calculated as follows:

Tax based on old rates = $600,000 X 34% = $204,000 X 275/365 = $153,699; Tax based on new rate = $600,000 X 21% = $126,000 X 90/365 = $31,068; 153,699 + $31,068 = $184,767.

### *REPEAL OF CORPORATE AMT*

Under prior law, AMT was imposed on a corporation to the extent that the corporation's "tentative minimum tax" (TMT) exceeded its regular income tax for the tax year. TMT was equal to 20% of the corporation's "alternative minimum taxable income" (AMTI) in excess of the exemption amount ($40,000, subject to phase out when AMTI exceeded $150,000.) AMTI was computed by adding or subtracting certain adjustment and preference items (such as accelerated depreciation on certain assets), and the AMT net operating loss deduction could not reduce AMTI by more than 90%. Corporations whose average annual gross receipts for the prior three years did not exceed $7.5 million were not subject to AMT.

Taxpayers subject to the AMT were entitled to a nonrefundable minimum tax credit (MTC) that could be carried forward indefinitely and reduce the corporation's regular tax to the extent it exceeded the TMT for the year.

Effective for tax years beginning after December 31, 2017, the corporate AMT is repealed, and the MTC may offset regular tax liability without limitations. For any tax year beginning after 2017 and before 2022, 50% of the excess MTC over the amount of the credit used to reduce the regular tax for the year is refundable; for tax years beginning in 2021, 100% is refundable.

Example: Saturn Salt Mine Corp. has an MTC carryover to 2018 of $70,000. Saturn's tax liability before credits is zero for 2018-2019, $30,000 for 2020, and $5,000 for 2021. Saturn utilizes $30,000 of the MTC to reduce its 2020 tax to zero and receives a refund of $20,000 ($70,000 - $30,000 = $40,000 /2). In 2021, the remaining MTC of $20,000 reduces Saturn's tax to zero and 100% of the remaining balance ($15,000) is refunded.

## 7. CHANGES TO TAX DEPRECIATION RULES

**Q:** What changes were made with respect to depreciation and cost recovery under the 2017 Tax Cuts and Jobs Act?

**A:** Several changes were made that will result in acceleration of depreciation deductions

### *SECTION 179 EXPENSE*

Under prior law, a taxpayer's annually allowable Code Sec. 179 expense couldn't exceed $500,000 as adjusted for inflation. In addition, there was a phasedown of the allowable amount when the cost of section eligible property placed in service by the taxpayer during the tax year exceeded 2,000,000, adjusted for inflation. At the election of the taxpayer, qualified leasehold improvements, qualified restaurant property and qualified retail improvement property were eligible for expensing.

Effective for property placed in service *in years beginning* after 2017, the above-referenced amounts are each increased by $500,000, to $1,000,000 and $2,500,000, respectively. They will continue to be adjusted for inflation.

Furthermore, the type of property eligible for Section 179 expensing is expanded to include all qualified improvement property, as well as personal property used in connection with lodging facilities that previously did not qualify.

### *BONUS DEPRECIATION*

Under prior law, newly acquired depreciable property was eligible for additional first-year (“bonus”) depreciation of 50% of the basis. This was set to phase down and completely expire after 2019. In addition, the original use of qualified property had to begin with the taxpayer.

Effective for property *acquired and placed in service after September 27, 2017* (unless subject to a written binding contract to acquire before September 28, 2017), property is eligible for 100% bonus depreciation. There is a scheduled phase-down to 80% starting in 2023 and ending at 20% in 2026, after which the provision is set to expire. In addition, used property now qualifies if it was not previously used by the taxpayer or a related party.

### *LUXURY AUTO LIMITATION*

Under prior law, there were caps on the depreciation deductions that can be claimed with respect to passenger automobiles, as follows:

- $3,160 for the first tax year in its recovery period*;
- $5,100 for the second tax year in its recovery period;
- $3,050 for the third tax year in its recovery period;
- $1,875 for each succeeding tax year in its recovery period

Effective for property placed in service after Dec. 31, 2017 in a tax year that ends after Dec. 31, 2017, the depreciation caps for a passenger automobile are as follows:

- $10,000 for the year that a vehicle is placed in service, *
- $16,000 for the second year in the recovery period,
- $9,600 for the third year in the recovery period,
- $5,760 for the fourth, fifth and sixth year in the recovery period,
- $5,760 for any years after the recovery period

*For vehicles that are qualifying property for which bonus depreciation is allowed, $8,000 is added to the otherwise-applicable placed-in-service year limit under both prior and new law.

## 8. NEW LIMITATIONS ON BUSINESS LOSSES

**Q:** What new limitations on the tax benefits of net losses from businesses were created by the 2017 Tax Cuts and Jobs Act?

**A:** There are three major changes affecting taxpayers:

### *ELIMINATION OF NET OPERATING LOSS (NOL) CARRYBACKS*

Under prior law, an NOL incurred by a C corporation, individual, estate or trust for any tax year was generally carried back two years, and then carried forward 20 years. An election to waive the carryback and carry the entire NOL forward could be made with the return of the loss year.

Effective for losses incurred in years *ending* after 2017, NOL's may no longer be carried back. However, these losses may now be carried forward indefinitely.

### *TAXABLE INCOME LIMITATION*

Under prior law, the NOL deduction wasn't subject to a limitation based on taxable income for regular tax purposes.

Effective for losses incurred in years *beginning* after 2017, the NOL deduction is limited to 80% of taxable income, determined without regard to the NOL deduction itself. Carryovers to other years are adjusted to take account of the 80% limitation.

Example: In 2018, XYZ Inc., a calendar-year C corporation, has a $90,000 NOL and no other NOL carryovers. XYZ's loss is carried to 2019, when it has tentative taxable income of $100,000. The 2019 NOL deduction is limited to 80% of $100,000, or $80,000. The remaining $10,000 can't be deducted in 2019, but can be carried forward indefinitely.

### *EXCESS BUSINESS LOSS DISALLOWANCE*

Under prior law, net losses from business incurred by noncorporate taxpayers (after applying passive activity limitations, etc.) could be deducted and offset all other sources of income in the loss year without limitation.

Effective for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, a taxpayer's "excess business loss" (EBL) is disallowed. EBL is equal to the pre-limitation aggregate deductions for the tax year that are attributable to the taxpayer's trades or businesses over gross income or gain from said businesses plus $250,000 ($500,00 for a joint return). Any disallowed EBL is treated as an NOL carryover to the following tax year (subject to the 80% limitation discussed above).

For partnerships and S corporations, EBL rules are determined at the partner/shareholder level.

Example 1: Susie Green receives a K-1 from CYE, LLC reflecting a business loss of $300,000 for 2018. The loss is non-passive and there is no basis or at-risk limitation, and Susie has no other trade or business income. Her EBL is $50,000 ($300,000 –$250,000). The $50,000 excess business loss is treated as part of the Susie's NOL carryfoward in later years.

Example 2: Same as above, except Susie files a joint return with her husband, Jeff. She doesn't have an excess business loss because the business loss ($300,000) doesn't exceed the $500,000 threshold for joint filers.

For years beginning after 2018, the $250,000/$500,000 thresholds will be indexed for inflation.

## 9. NEW RESTRICTIONS IN LIKE-KIND EXCHANGES

**Q:** What new limitations apply to like-kind (Section 1031) exchanges under the 2017 Tax Cuts and Jobs Act?

**A:** Only real property will qualify for tax-free exchange treatment

Under prior law, property eligible to be exchanged in a tax-free like-kind exchange included real property and personal property, including intangible personal property such as patents and other intellectual property.

Effective for exchanges completed after 2017, Section 1031 tax-free treatment is limited to exchanges of real property not held primarily for sale; no gain or loss is recognized on the exchange of only real property held for productive use in a trade or business or for investment if it is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

Example: On March 1, 2018 ABC Gum Co. LLC trades in a truck used in its business for a new truck. The adjusted basis of the old truck is $5,000 and the fair market value (i.e., purchase price) of the new vehicle is $30,000. The dealer gives ABC a trade-in allowance of $6,500 for the old truck and they pay $23,500 in cash.

Under prior law, this was a like-kind exchange and no gain or loss would be recognized; ABC would have a basis in the new truck of $23,500 plus $5,000 = $28,500. Under the new law, it is a fully taxable transaction; ABC is treated as having sold the old truck for $30,000 and its tax basis in property and cash is $28,500, resulting in a gain of $1,500.

### *TRANSITIONAL RULES*

The changes do not apply to any exchange if the property:

1. disposed of by the taxpayer in the exchange is disposed of before Jan. 1, 2018, or
2. received by the taxpayer in the exchange is received before Jan. 1, 2018.

by the taxpayer in the exchange is received before Jan. 1, 2018.

# 10. QBI DEDUCTION GENERAL RULES

**Q:** What are the general rules with respect to the new deduction for 20% of Qualified Business Income?

**A:** For tax years after 2017 and before 2026, individuals, estates and trusts can deduct up to 20% of qualified business income ("QBI") from a partnership, S corporation, or sole proprietorship.

Income from specified service trades or businesses is not eligible for the deduction (with an exception for taxpayers meeting a low-income threshold, discussed below.) These include any trade or business in the fields of accounting, health, law, consulting, athletics, performing arts, financial services, brokerage services, or any business where the principal asset of the business is the reputation or skill of one or more of its employees or owners.

QBI and the related deduction are calculated for each business, and the deduction is applied at the owner level. The income must be effectively connected with the conduct of a trade or business within the United States, and does not include specified investment-type income, including capital gains from the sale of business assets. It also does not include an S corporation shareholder's reasonable compensation, a partner's guaranteed payments, or—to the extent provided in regulations—payments to a partner who is acting in a capacity other than his or her capacity as a partner.

A limitation on the QBI deduction is based on wages; it's limited to 50% of the taxpayer's share of W-2 wages paid with respect to the business. Alternatively, capital-intensive businesses may yield a higher benefit under a rule that takes into consideration 25% of wages paid plus 2.5% of the business's original basis in its depreciable assets. This limitation also does not apply if the taxpayer's taxable income without regard to the QBI deduction is below the threshold discussed below.

Example: H and W file a joint return for 2018. W has an importing business organized as a single-member limited liability company which is treated as a sole proprietorship. Her net income from the business is $850,000. The business paid W-2 wages of $240,000 and has an unadjusted basis in depreciable property of $600,000. Her QBI deduction before limitation is $850,000 X 20% or $170,000.; Her W-2 wages limitation is 50% of $240,000 or $120,000; her wages plus property basis limitation is ($240,000 X 25% = $60,000) plus ($600,000 X 2.5% = 15,000) or $75,000. Therefore, her QBI deduction is $120,000, her regular W-2 wages limitation.

The taxable income threshold for both the specified services limitation and the W-2 wages limitation is $157,500 or $315,000 in the case of a joint return. These benefits phase out fully as taxable income is $50,000 (or $100,000 for a joint return) in excess of the aforementioned threshold.

The QBI deduction does not reduce the taxpayer's adjusted gross income, self-employment income, or income subject to the 3.8% net investment income tax. It is applied directly to taxable income, i.e. adjusted gross income minus itemized deductions.

# 11. QBI DEDUCTION FOR RENTAL REAL ESTATE ACTIVITY

**Q:** How would the new 20% deduction for pass-through income benefit the owners of a profitable rental property?

**A:** Assuming that a rental real estate activity is considered a trade or business (this is believed to be the case for most rental activities), the owners (other than C corporations) can deduct 20% of the net profit in arriving at taxable income. However, there is a limitation based on 50% of W-2 wages paid to employees or, if larger, 25% of wages plus 2.5% of the unadjusted basis of depreciable property at the end of the year. For this purpose, depreciable property that has been held at least 10 years and beyond the asset's regular depreciation period is not included. Furthermore, the percentage of wages and property limitations do not apply to taxpayers whose taxable income (before the QBI deduction) is under a threshold amount — $157,500 ($315,000 for joint filers).

Example #1: Joe owns a 50% membership interest in PJ LLC, which is taxed as a partnership; there are no special allocations. For the year 2018, PJ has net rental income of $1,200,000. The property is managed by a real estate management company, so PJ has no W-2 wages other than $60,000 paid to a superintendent. The building was acquired in 2004 for $7 million and has a MACRS life of 27.5 years. There is $40,000 of equipment that was acquired in 2007 and is fully depreciated and $30,000 of equipment acquired in 2010 that is also fully depreciated. Joe files a joint return and his tentative taxable income from all sources is $700,000.

Joe's QBI deduction is calculated as follows:

Maximum amount = $600,000 share of net income X 20% = $120,000
50% W-2 wages limit = $30,000 share of wages X 50% = $15,000

Or

25% of $30,000 = $7,500; plus share of building basis ($3,500,000) plus share of equipment held less than 10 years ($15,000) = $3,515,000 X 2.5% = $87,875
$7,500 + $87,875 = $95,375.

Joe's deduction is limited to $95,375, which will reduce his taxable income to $604,625.

Example #2: Same as above, except the property is self-managed by the LLC so W-2 wages are $400,000, and Joe's share is $200,000. His 50% of wages limitation is $100,000; wages plus basis limitation is ($200,000 X 25%)= $50,000 plus $87,875 = $137,875. His deduction is the maximum amount of $120,000.

Example #3: Same as #1, but due to losses and deductions from other sources, Joe's tentative joint taxable income is only $310,000. Joe can take the maximum $120,000 deduction without regard to the wages/property basis limitations.

# 12. MISCELLANEOUS BUSINESS TAX CHANGES

**Q:** What miscellaneous changes have been made to rules affecting business taxpayers?

**A:** The dividend received deduction for C corporations has been reduced; the rules for deducting research expenses has been changed; and the domestic production activities deduction (DPAD) has been repealed.

### *DIVIDENDS RECEIVED DEDUCTION*

Under prior law, a C corporation was allowed a deduction with respect to dividends received from other taxable domestic corporations. The amount was generally equal to 70 percent of the dividend received. In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction was equal to 80 percent of the dividend received. For corporations subject to the maximum tax rate of 35 percent, this resulted in an effective tax rate on qualifying dividends of 10.5 percent and 7 percent, respectively.

Effective for tax years beginning after December 31, 2017 the 70 percent deduction is reduced to 50 percent and the 80 percent deduction is reduced to 65 percent. Coupled with the new 20 percent corporate tax rate, this results in an effective rate on dividends of 10.5 percent and 7.35 percent, respectively.

### *RESEARCH AND EXPERIMENTAL EXPENSES*

Under current law, taxpayers could elect to deduct currently the amount of certain reasonable research or experimentation (R & E) expenditures paid or incurred in connection with a trade or business. Alternatively, they could capitalize R & E expenditures and amortize them ratably over the useful life of the research, but in no case over a period of less than 60 months (deferred expense election), or over a period of 10 years to avoid AMT preferences and adjustments.

Effective for R & E expenditures incurred in tax years beginning after Dec. 31, *2021* taxpayers must capitalize the expenditures and will be allowed an amortization deduction ratably over the five-year period beginning with the midpoint of the tax year in which the expenditures are paid or incurred. A 15-year period will apply in the case of any specified R & E expenditures which are attributable to foreign research.

Specified R & E expenditures will not include expenditures for land or for depreciable or depletable property used in connection with the research and experimentation, but do include the depreciation and depletion allowances of the property.

### *REPEAL OF DPAD*

Under prior law, the domestic production activities deduction (“DPAD”), which was allowed for certain qualifying U.S.-based activities, was equal to 9% of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income (determined without regard to the DPAD) for the tax year.

Effective for tax years beginning after December 31, 2017 the DPAD is repealed.

## 13. MISCELLANEOUS INDIVIDUAL TAX CHANGES

**Q:** What miscellaneous changes have been made to rules affecting individual taxpayers?

**A:** Rules allowing recharacterization of IRA contributions have been limited; the alternative minimum tax ("AMT") exemption has been increased; 529 plans have been modified.

### *IRA RECHARACTERIZATIONS*

Under prior law, if an individual made a contribution to an IRA (traditional or Roth) for a taxable year, he or she was permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer before the due date of the individual's income tax return for that year. Both regular contributions and conversion contributions to a Roth IRA could be recharacterized as having been made to a traditional IRA.

Effective for tax years beginning after December 31, 2017 the provision allowing taxpayers to recharacterize Roth IRA contributions and traditional IRA contributions does not apply to a conversion contribution to a Roth IRA. For example, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion). However, the provision does not preclude an individual from making a contribution to a traditional IRA and converting the traditional IRA to a Roth IRA.

### *AMT EXEMPTION AMOUNTS FOR INDIVIDUALS INCREASED*

Under prior law, the AMT exemption amounts for individuals (as adjusted for inflation) were:

a. $84,500 for married filing jointly and surviving spouses;
b. $54,300 for other unmarried individuals;
c. 50% of the married filing jointly amount for married filing separately, i.e., $42,250; &
d. $24,100 for estates and trusts.

Those exemption amounts were reduced (phased out) by an amount equal to 25% of the amount by which the individual's AMTI exceeded:

a) $160,900 for married filing jointly and surviving spouses;
b) $120,700 for unmarried individuals; and
c) 50% of the married filing jointly amount for married filing separately, or an estate or trust, i.e., $80,450.

Effective for tax years beginning after Dec. 31, 2017 *and before January 1, 2026*, the exemption amounts are increased to:

a) $109,400 for married filing jointly and surviving spouses
b) $70,300 for single or head of household
c) $54,700 for married filing separately

Those exemption amounts are reduced (phased out) by an amount equal to 25% of the amount by which the individual's AMTI exceeds:

a) $1,000,000 for married filing jointly/surviving spouses
b) $500,000 for all other taxpayers

These changes do not apply to estates and trusts.

Note that the elimination of the deduction for all but $10,000 of state and local income and property taxes as well as the elimination of miscellaneous itemized deductions will result in far fewer individuals being subject to the AMT.

### *529 PLANS*

Under prior law, a distribution from a Section 529 plan was tax-free if used to pay "qualified higher education expenses" of the beneficiary student. Qualified higher education expenses did not include tuition and other expenses for elementary and secondary schools.

Effective for post-2017 distributions, qualified education expenses now include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. However, the amount of cash distributions from all 529 plans per single beneficiary during any tax year can't, when combined, include more than $10,000 for elementary school and secondary school tuition incurred during the tax year.

## 14. INTERNATIONAL PROVISIONS

**Q:** What are the changes to the overall conception of U.S. taxation of international operations?

**A:** Historically, the U.S. has taxed U.S. persons (the term includes individuals and all entities) on their world-wide income. To abide by treaty provisions preventing double taxation, there is a foreign tax credit. Most other countries do not offer a foreign tax credit, but instead exempt foreign-source income.[53] Effective 2018, the U.S. uses a modified territorial system. The devil is in the details, as described below.

### *DIVIDEND RECEIVED DEDUCTION*

A domestic corporation may deduct the foreign-source portion of any dividend received from certain foreign corporations that meet these requirements:

- The payor corporation must be a specified 10-percent owned foreign corporation;
- The recipient corporation must be a U.S. shareholder with respect to the payor corporation;[54] and

[53] http://www.taxpolicycenter.org/briefing-book/how-does-current-system-international-taxation-work, retrieved 01/15/2018.

[54] Code §245A(a), as amended by the Tax Cuts and Jobs Act §14101(a).

- The recipient corporation must meet a holding period requirement (see below).

The deduction doesn't apply to dividends from a passive foreign investment company.[55] The deduction does apply to deemed dividends on the sale of Subpart F stock.[56]

The foreign-source portion of a dividend is what intuition says it would be[57]:

$$dividend * \frac{undistributed\ foreign\ earnings}{total\ undistributed\ earnings}$$

The recipient corporation may not take a foreign tax credit nor a deduction for the foreign taxes paid on the foreign-source portion of the dividend.[58] Nor may the recipient count the foreign-source portion of the dividend as foreign-source income for computing the income limits on the foreign tax credit.[59] This makes sense, because the ability to deduct the foreign-source income takes the place of the foreign tax credit or foreign tax deduction in assuring that the U.S. complies with the treaty provisions concerning double taxation.

The holding period is 365 days out of the 731-day period beginning 365 days before the dividend date.[60] This means that the testing period extends one year before the dividend date to one year after the dividend date. It seems possible to me that a U.S. corporation could purchase stock one day before the dividend date, get the benefit of the foreign-source dividends-received deduction, hold the stock for a year, and then dispose of the stock. I have not yet seen any articles that address this issue.

If the recipient corporation later sells the foreign corporation stock at a loss, it must reduce the basis in the stock by the amount of dividends-received deduction it took under these new rules.[61]

### *PREVIOUSLY ACCUMULATED FOREIGN INCOME*

Congress has wrestled with the issue of U.S. corporations leaving unrepatriated income overseas, beyond the reach of U.S. taxation. The new law treats the deferred foreign income as if it were Subpart F income for the last year that begins before January 1, 2018.[62] Thus, the tax is imposed on the 2017 tax year.

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[55] Code §215A(b)(2), as amended by the Tax Cuts and Jobs Act §14101(a).

[56] Code §964(e)(4)(A), as amended by the Tax Cuts and Jobs Act §14102(c).

[57] Code §245A(c)(1), as amended by the Tax Cuts and Jobs Act §14101(a).

[58] Code §245A(d), as amended by the Tax Cuts and Jobs Act §14101(a).

[59] Code §904(b)(5), as amended by the Tax Cuts and Jobs Act §14101(d).

[60] Code §246(c)(5), as amended by the Tax Cuts and Jobs Act §14101(b).

[61] Code §961(d), as amended by the Tax Cuts and Jobs Act §14102(b).

[62] Code §965(a), as amended by the Tax Cuts and Jobs Act §14103(a).

Subpart F income is generally investment income, not operating business income,[63] so the new tax law imposes a one-shot extension of the scope of Subpart F. Deferred foreign income means the amount accumulated post-1986. To minimize abusive tax planning, the Code ignores any tax planning a taxpayer did after the proposal was made public. It does this by specifying that the taxpayer must use the greater of deferred foreign income as of November 2, 2017 or December 31, 2017.[64]

The provision applies to controlled foreign corporations and any foreign corporation that has a U.S. corporation as a shareholder.[65] A controlled foreign corporation is a corporation more than 10% owned by U.S. persons, whether the U.S. persons are individuals or entities. A foreign corporation that has a U.S. corporation as a shareholder is brought under these provisions whether or not it meets the threshold to be a controlled foreign corporation.[66]

These mandatory inclusion rules may result in a previously unanticipated tax liability. To reduce the impact, a taxpayer may elect installment payments over eight years for the tax liability resulting from the mandatory inclusion[67] The installments are not equal, but increase gradually over time. They are 8% of the net tax liability for each of the first five years, 15% for the sixth year, 20% for the seventh year, and 25% in the eighth year. The installments are due on the due date of the tax return, beginning with the taxable year of the mandatory inclusion.[68]

S corporation shareholders may elect to defer their share of S corporation deferred foreign income until the S corporation has a triggering event. Triggering events include terminating S status, liquidation or ceasing business, or a stock transfer (including a transfer by reason of death).[69] A triggering event is determined from the shareholder's perspective,[70] so a stock transfer is only a triggering event for the particular shareholder who made the transfer, not for the corporation as a whole.

An S corporation shareholder may elect to pay the tax liability in eight installments, but needs IRS consent if the triggering event was liquidation or ceasing business.[71] The corporation is jointly and severally liable for the unpaid tax.[72]

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[63] Code §952.

[64] Code §965(a), as amended by the Tax Cuts and Jobs Act §14103(a).

[65] Code §965(e)(1), as amended by the Tax Cuts and Jobs Act §14103(a).

[66] Conference Committee Report, p. 618.

[67] Code §965(h)(1) as amended by the Tax Cuts and Jobs Act §14103(a).

[68] Code §965(h)(2) as amended by the Tax Cuts and Jobs Act §14103(a).

[69] Code §965(i)(2) as amended by the Tax Cuts and Jobs Act §14103(a).

[70] Conference Committee Report, p. 612.

[71] Code §965(i)(4) as amended by the Tax Cuts and Jobs Act §14103(a).

[72] Code §965(i)(5) as amended by the Tax Cuts and Jobs Act §14103(a).

### Calculating the tax on the mandatory inclusion

The language of the new Code provisions is dense, even by Code standards.[73] The Code creates layered deductions pursuant to a few algebraic formulas that, using the 2017 tax rates, reduce the tax on the mandatory inclusion. The net tax will be "8 percent on illiquid assets and 15.5 percent on cash and cash equivalents…"[74] Congress intends that imposing a tax on the mandatory inclusion would obviate the advantage of keeping profits offshore, and that many companies will decide to repatriate their earnings to the U.S. since there is no longer a tax detriment to doing so.[75]

## *SUBPART F CHANGES*

### Subpart F

Subpart F is the mechanism under which U.S. shareholders report investment income of foreign corporations, whether or not it is distributed. Subpart F applies to U.S. persons who hold at least 10% of the stock of foreign corporations – controlled foreign corporations, or CFCs.

The new law increases Subpart F income by including global intangible low-taxed income (GILTI).[76] GILTI is a deemed income amount, derived from a formula. It starts with the net deemed tangible income return, which equals the excess of 10% of qualified business asset investment over interest expense not used to calculate net CFC tested income. Tested income or loss generally is business operations income or loss.[77]

### Domestic corporation deduction and credit

A U.S. corporation may deduct:

- 37.5% of foreign-derived intangible income, plus
- 50% of the GILTI that Subpart F causes to be taxed to the U.S. corporation.[78]

GILTI, being a deemed item of income, may or may not have been subject to foreign tax. Nevertheless, a U.S. corporation is deemed to have paid foreign taxes equal to 80% of the product of the corporation's inclusion percentage multiplied by aggregate tested foreign income taxes paid or accrued by CFCs.[79]

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[73] Code §965(c) as amended by the Tax Cuts and Jobs Act §14103(a).

[74] https://www.reuters.com/article/us-usa-tax-provisions-factbox/whats-in-the-final-republican-tax-bill-idUSKBN1ED27K, retrieved 01/15/2018.

[75] https://www.bloomberg.com/news/articles/2017-12-16/gop-tax-plan-sets-higher-rate-than-expected-on-offshore-earnings, retrieved 01/15/2018.

[76] Code §951A(a) as amended by the Tax Cuts and Jobs Act §14201(a).

[77] Code §951A(c) as amended by the Tax Cuts and Jobs Act §14201(a).

[78] Code §250(a) as amended by the Tax Cuts and Jobs Act §14201(a).

[79] Code §960 as amended by the Tax Cuts and Jobs Act §14201(a).

The term "tested foreign income taxes" refers to foreign income taxes paid with respect to tested income (defined above).[80] The inclusion percentage is the ratio of GILTI to total tested income.[81]

Previously, there have been two baskets for the foreign tax credit: general and passive (e.g., portfolio or investment). The new law adds a third basket for the GILTI credit (and a fourth basket for foreign branch income).[82]

### *PREVENTING BASE EROSION AND PROFIT-SHIFTING*

Base erosion and profit-shifting (BEPS) refers to steps taken by multinational taxpayers to shift their income from one country to another. There are anti-BEPS provisions in income tax treaties, and 72 countries have signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting.[83] The United States has not signed the convention,[84] and takes independent steps to minimize BEPS.

One technique for diverting income from the U.S. has been to make payments to related foreign corporations for services or intangible assets (e.g., having a foreign corporation own valuable trademarks and patent rights). This is sometimes referred to as income stripping. The new law tackles this issue by imposing the base erosion minimum tax.[85]

The rate starts at 5% in 2018, increasing to 10% in 2019 and 12.5% in 2025.[86] The tax is computed by a multiply-layered formula, and I do not think I can simplify it without omitting a potentially important part. It equals the excess of[87]:

- The rate (5%, 10%, or 12.5%, depending on the year) times the modified taxable income, over
- The regular tax liability reduced by the excess of all tax credits over the sum of:
  - the research credit plus
  - the lesser of 80% of business credits or the base erosion minimum tax amount.

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[80] Code §960(d)(3) as amended by the Tax Cuts and Jobs Act §14201(a).

[81] Code §960(d)(2) as amended by the Tax Cuts and Jobs Act §14201(a).

[82] Code §904(d)(1) as amended by the Tax Cuts and Jobs Act §14201(a).

[83] http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm, retrieved 01/15/2018.

[84] http://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf, retrieved 01/15/2018.

[85] Code §59A(a), as amended by the Tax Cuts and Jobs Act §14401(a).

[86] Code §59A(b), as amended by the Tax Cuts and Jobs Act §14401(a).

[87] *Ibid.*

### *MISCELLANEOUS PROVISIONS*

In 2017, the Tax Court had held that a foreign corporation's gain on sale of a partnership interest was a sale of an intangible asset – the capital gain not being subject to U.S. tax.[88] The new law effectively overturns that ruling, providing that the gain or loss on the sale of the partnership interest is gain or loss effectively connected with the conduct of a business in the U.S.[89]

Inventory sales under prior law were sourced part to the place they were produced and part to the place they were sold. The new law changes the allocation: inventory sales are allocated solely on the basis of production activities.[90]

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[88] Grecian Magnesite Mining, Industrial & Shipping Co. v. Comm'r, 149 T.C. No. 3 (2017).

[89] Code §864(c)(8)(a) as amended by the Tax Cuts and Jobs Act §13501(a).

[90] Code §863(b), as amended by the Tax Cuts and Jobs Act §14303(a).