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Corporate Tax Changes in New Tax Law

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Public Law 115-97, the "tax reform" legislation enacted last December, effected major changes to Federal income tax law. While many of the changes are of relevance specifically to individuals, others affect all businesses, regardless of their form of organization, and some are particularly relevant to corporate taxpayers. Changes summarized below are likely to be of concern to the broadest range of "C corporations" (that is, corporations other than those that have elected "S corporation" status under the applicable rules of the Internal Revenue Code (the "Code")). Except as otherwise indicated, changes were effective for taxable years beginning after December 31, 2017.

Corporate tax rate. The graduated corporate income tax rate schedule of prior law, with a top stated rate of 35%, has been replaced with a flat tax rate of 21% of taxable income.

Dividends received deduction. The dividends received deduction ("DRD") is generally applicable to dividends received from a domestic corporation and is intended to mitigate the effects of double taxation as earnings are passed from one taxable corporation to another. In the case of such a dividend, other than a dividend received from a corporation 20% or more of the stock of which (by vote and by value) is owned by the recipient of the dividend, the deduction has been reduced from 70% to 50% of the dividend. This results in an effective tax rate of 50% x 21%, or 10.5%, unchanged from the prior effective rate with respect to such dividends. The DRD with respect to dividends received from a 20% owned corporation was reduced from 80% to 65%.

Expensing of certain depreciable assets under Code section 179. The amount of tangible property acquired during any taxable year that may be expensed under section 179 (as opposed to being capitalized and depreciated) was increased from $500,000 to $1,000,000. However, the $1,000,000 limit is subject to reduction to the extent that the corporation's section 179 property placed in service during the year exceeds $2,500,000. These dollar amounts will be adjusted for inflation for taxable years beginning after 2018. In a significant change from prior law, property eligible for expensing now includes certain improvements to real property.

Full expensing of certain business assets. The cost of certain qualified property (limited, generally, to property otherwise subject to depreciation with a recovery period of not more than 20 years) placed in service after September 27, 2017, and before January 1, 2023, may now be claimed as an expense in the year in which the property is placed in service. This expensing applies to property in excess of the section 179 limits. In another significant change from prior law, used property newly acquired by the taxpayer is now eligible for this treatment; previously, only new property qualified.

This expensing rule phases out at the rate of 20% per year in the case of property placed in service after December 31, 2022, such that additional deductions will generally no longer be available under this provision after 2026. Special effective date rules apply with respect to, for example, property acquired after September 27, 2017, under a binding contract entered into on or before that date.

Alternative minimum tax. The alternative minimum tax of Code section 55 is no longer imposed on corporations.

Limitation on deductibility of interest. Prior to the 2017 Act, section 163(j) of the Code limited a corporation's ability to deduct interest in the case of certain related party transactions. The section 163(j) limitation has now been expanded. In general, the amount allowed as a deduction for "business interest" expense of any taxpayer cannot exceed the sum of (i) the taxpayer's business interest income plus (ii) 30% of the taxpayer's "adjusted taxable income." (A special rule applies to "floor plan financing expense" (relating to the acquisition of motor vehicles held for sale or lease).) Business interest expense disallowed under section 163(j) can be carried forward to succeeding taxable years.

"Business interest" means interest on debt allocable to a trade or business. "Adjusted taxable income" means, generally, the taxpayer's taxable income as determined without regard to: any item

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not attributable to a trade or business; business interest or business interest income; net operating loss deductions; and, for years beginning before 2022, deductions for depreciation, amortization, or depletion. For years beginning on or after January 1, 2022, depreciation, amortization, and depletion will be subtracted in determining adjusted taxable income, with the effect that the limitation will become significantly more onerous.

The expanded limitation on the deductibility of interest does not apply to certain businesses, including: certain "small" businesses with average annual gross receipts over a three-year period of not more than $25 million (subject to an "aggregation" rule in the case of related businesses); certain regulated electrical, gas, water, and other utility businesses; and electing real property and farming businesses. Real property and farming businesses that do elect to be exempt from the section 163(j) rules are subject to a "toll charge"—they must compute depreciation deductions under generally less favorable depreciation rules of the "alternative depreciation system," and they are denied many of the "expensing" benefits described above.

Net operating losses. Net operating losses attributable to taxable years ending after 2017 generally cannot be carried back, but can be carried forward indefinitely (superseding the 2-year carryback and 20-year carryforward rules that were previously generally applicable). In addition, the use of net operating losses arising in taxable years beginning after 2017 is now limited to 80% of the taxpayer's taxable income for the year to which the losses are carried. This imposes an effective minimum tax of 4.2% of the current income of the carryover year.

Deduction of compensation expense. The Code's $1,000,000 per year limitation on deduction of compensation expense for each "covered employee" of publicly held corporations has been made more stringent in several respects. The definition of "publicly held corporation" has been expanded to apparently include, for example a corporation any securities of which are required to be registered under Section 12 of the Securities Exchange Act of 1934 (such as, for example, a closely held corporation with publicly traded debt securities).

The term "covered employee" now includes any person who serves at any time during a taxable year beginning after 2016 as the principal executive officer (CEO), principal financial officer (CFO), or any of the three highest compensated officers other than the CEO or CFO. A person who becomes a covered employee of a publicly held corporation retains that status indefinitely (even after retirement). In addition, the exceptions from the $1 million ceiling for commissions and certain "performance-based" compensation have been eliminated. These changes are effective for taxable years beginning after 2017, subject to grandfathering relief for remuneration provided pursuant to a written binding contract that was in effect on November 2, 2017, and not materially modified after that date.

Foreign source income. Numerous changes were made with respect to the taxation of income attributable to so-called "controlled foreign corporations" ("CFCs") and other foreign-source income, in an apparent effort to encourage US corporations with earnings accumulated in foreign subsidiaries to cause those earnings to be distributed to the U.S. parent corporation. U.S. tax is now imposed on certain additional categories of foreign income, whether or not distributed to a U.S. person.

These changes, far too complex to be summarized in detail here, included the following: A 100% dividends received deduction is allowed with respect to the foreign-source portion of dividends received by a U.S. corporation from 10% owned foreign corporations. A one-time requirement is imposed with respect to CFCs, and foreign corporations other than CFCs, under which a U.S. corporation that owned a 10% stock interest in such a corporation must include in income post-1986 accumulated earnings and profits in existence at the end of the last taxable year of the foreign corporation beginning before 2018. This amount is subject to tax at an effective rate (with respect to a domestic C corporation) of either 8% or 15.5%, depending on the composition of the assets of the foreign corporation (with the higher rate being applicable to the extent of the foreign corporation's "cash position," as defined), and the tax is payable, generally, over an eight-year period.

In addition, a lower effective rate of tax has been provided with respect to "foreign-derived intangible income." Conversely, "global intangible low-taxed income" is now taxed on a current basis.

Observations

Owners of businesses that have heretofore been conducted as sole proprietorships, as partnerships, and as S corporations (the income of which is generally not subject to Federal tax at the corporate level), are evaluating whether or not classification as a C corporation may be preferable to their current tax structures, taking into account the lower income tax rate now applicable to the income of C corporations and the other changes made. Each situation has to be evaluated based on its particular circumstances.

Circumstances that should be considered before a decision to incorporate a business as a C corporation is made include, without limitation, whether and to what extent income from the business, if continued in non-corporate form or as an S corporation, will be eligible for the new deduction of up to 20% of income under Code Section 199A, or to taxation under more favorable tax rates of prior law that remain in effect for certain categories of income, such as those applicable to long-term capital gains.

Also relevant are: the likelihood of earnings being accumulated at the entity level rather than being distributed on a current basis (and thereby subject to tax at the shareholder level as dividends or otherwise); state and local tax considerations, including state and local income taxes imposed on corporations, and the almost complete repeal of the deduction by individuals of state and local income taxes (subject to an exception permitting the deduction of up to $10,000 per year of certain state and local taxes); the likelihood of the business being sold in the near future, with the potential for two levels of tax if the transaction is structured as a sale of assets for tax purposes; and provisions of prior law that remain in effect and that are intended to discourage the accumulation of income at the corporate level, including the potential for "accumulated earnings tax" under Code section 531 or "personal holding company tax" under Code section 541. Finally, there is of course the potential for further change in the tax laws that may cause a hasty decision to incorporate to be regretted later.