



Morgan Lewis

# NAVIGATING US TAX REFORM: WHAT BUSINESSES NEED TO KNOW

## General Business Implications

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# Agenda

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# **CORPORATE RATE CUT**

# Corporate Rate Cut

## In General:

- Flat 21% rate.
- Repeals corporate alternative minimum tax (“AMT”).
  - AMT credit carryovers may be utilized to the extent of the taxpayer’s regular tax liability.
  - For tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability, 50% of the excess AMT credit carryovers are refundable.
  - Any remaining AMT credits will be fully refundable in 2021.

## Effective Date:

- Taxable years beginning after December 31, 2017.

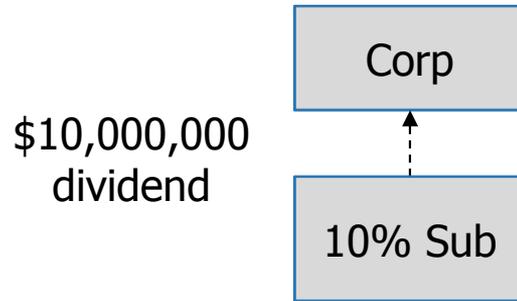
# **DIVIDENDS RECEIVED DEDUCTION (DRD)**

# Dividends Received Deduction (DRD)

- Available to corporate stockholders with respect to dividends received from other domestic corporations
- Amount of the DRD depends on ownership:

Ownership	Prior DRD	Effective Rate	New DRD	Effective Rate	Change
Less than 20%	70%	10.5%	50%	10.5%	-
20% to less than 80%	80%	7%	65%	7.35%	+ 0.35%
80% or more	100%	0%	100%	0%	-

# Dividends Received Deduction – State Impact



Assume 10% State Income Tax with 100% Dividend Apportioned to Corp's State

- *Rolling Conformity:* \$5,000,000      DRD = \$500,000 state tax.
- *Static Conformity:* \$7,000,000      DRD = \$300,000 state tax.

# **PASS-THROUGH DEDUCTION**

# Section 199A Overview

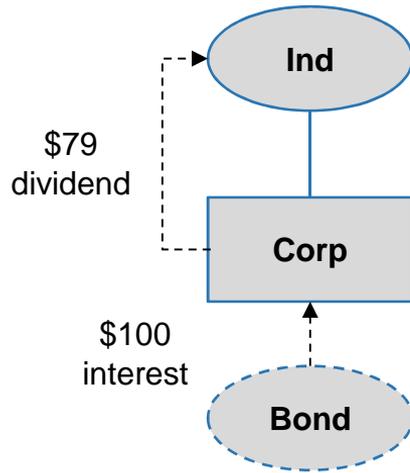
- Deduction equal to 20% of:
  - (1) “qualified business income,” *plus*
  - (2) qualified REIT dividends, cooperative dividends, and publicly traded partnership income
- Excludes most investment income, capital gains and losses, etc.
- Special limitations for most service businesses.
- Limited based on the taxpayer’s share of the business’s W-2 wages, plus 2.5% of the taxpayer’s unadjusted basis in certain tangible property (in some cases).
- Applied at individual level to income received as sole proprietor or allocated as a partner or S corporation shareholder.
- Expires after 2025.

# Section 199A: Qualified Business Income

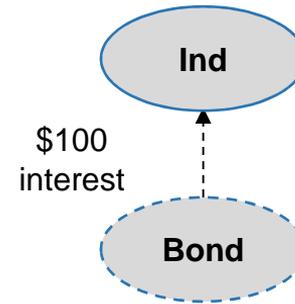
- “Qualified business income” is reduced by:
  - “reasonable compensation” paid to the taxpayer,
  - section 707(c) guaranteed payments made for services, and
  - under regulations, any section 707(a) payments for services.
- Reduction for “reasonable compensation” apparently limited to S corporations.
- Potential IRS challenge to impute compensation to S corporation shareholder(s).
- Potential for IRS to recast allocations of partnership income under Prop. Reg. § 1.707-2 (recharacterizing distributive share as either 707(a) compensation or 707(c) guaranteed payment).

# **CHOICE OF ENTITY**

# Corporate "Stuffing" Example 1

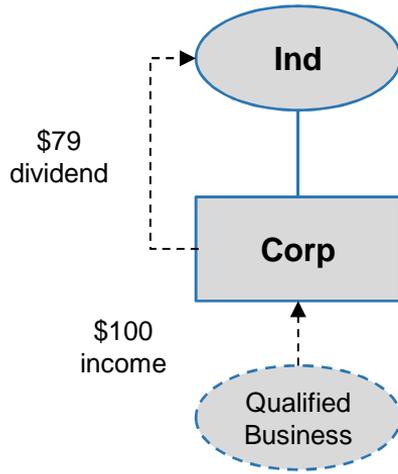


- Corp pays 21% tax = \$21.
- Corp distributes \$79 to Ind.
- Ind pays 23.8% tax (20% individual + 3.8% net investment) = \$18.80.
- Ind retains \$60.20.
- Combined rate = 39.8%

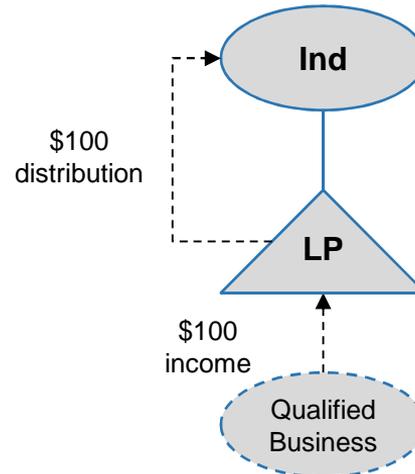


- Ind pays 40.8% tax (37% individual + 3.8% net investment) = \$40.80.
- Ind retains \$59.20.

# Corporate "Stuffing" Example 2



- Corp pays 21% tax = \$21.
- Corp distributes \$79 to Ind.
- Ind pays 23.8% tax (20% individual + 3.8% net investment) = \$18.80.
- Ind retains \$60.20.
- Combined rate = 39.8%



- Ind pays 33.4% tax (37% individual on \$80 (after 20% QBI deduction of \$20) + 3.8% net investment on \$100) = \$33.40.
- Ind retains \$66.60.

# Personal Holding Company Tax

## In General:

- The personal holding company provisions of sections 541-47 impose an additional corporate-level tax of 20% on any “undistributed personal holding company income” of a “personal holding company.”

## Personal Holding Company Tests:

- *Ownership Test* – 50% or more (by value) of the stock of a corporation is owned by five or fewer individuals, applying constructive ownership rules.
- *Income Test* – 60% or more of the corporation’s “adjusted ordinary gross income” is from “personal holding company income” (“PHCI”).
  - “Adjusted ordinary gross income” – gross income, other than gains from the sale of capital or section 1231 assets, reduced by certain deductions (e.g., depreciation and certain other expenses incurred in owning rental property).
  - “PHCI” – Includes dividends, interest, royalties, income received from contract for the performance of personal services by a 25% shareholder.
  - Excludes certain bank, life insurance, and active lending or finance businesses.

# Accumulated Earnings Tax

## In General:

- The accumulated earnings tax provisions of sections 531-37 impose an additional 20% corporate-level tax on a corporation formed or availed of to avoid shareholder-level tax.
- Determination based on whether corporation retains earnings “beyond the reasonable needs of the business.”

## What are a Corporation's Reasonable Needs?

- Question of fact; no bright-line rules.
- Current v. future needs.
- Working capital v. long-term debts.
- Anticipated acquisitions and expansions.

## Accumulated Taxable Income:

- Taxable income less dividends paid (or consent dividends if not distributed).

# LIMITATION ON NOLS

# Limitations on NOLs

## NOL deduction limited to 80% of taxable income

- Exception for property and casualty (P&C) insurance company losses.
- Effective for NOLs arising in taxable years beginning after December 31, 2017.

## 2-year carryback period eliminated

- Exception for farming losses and P&C insurance company losses.
- Effective for NOLs arising in taxable years ending after December 31, 2017.

## 20-year carryover period amended to an indefinite NOL carryover

- Exception for P&C insurance company losses.
- Effective for NOLs arising in taxable years ending after December 31, 2017.

# Limitations on NOLs: Effective Date Issues

## Conference Report Effective Date

- The provision allowing indefinite carryovers and modifying carrybacks applies to losses arising in **taxable years beginning after December 31, 2017**.
- The provision limiting the NOL deduction applies to losses arising in **taxable years beginning after December 31, 2017**.

## Statutory Text Effective Date

- Net Operating Loss Limitation: The amendments made by subsections (a) and (d)(2) shall apply to losses arising in **taxable years beginning after December 31, 2017**.
  - Subsection (a) relates to the 80% limitation
- Carryforwards and Carrybacks: The amendments made by subsections (b), (c), and (d)(1) shall apply to net operating losses arising in **taxable years ending after December 31, 2017**.
  - Subsection (b) relates to the repeal of NOL carryback and indefinite carryforward

# Limitations on NOLs: Effective Date Example

Calendar-Year Taxpayer		
	12/31/16	12/31/17
Taxable Income	300	(200)
NOL Carryback	(200)	
Taxable Income	100	0

Fiscal-Year Taxpayer		
	6/30/17	6/30/18
Taxable Income	300	(200)
NOL Carryback	<del>(200)</del>	
Taxable Income	300	(200)

- Calendar-year taxpayer can carryback NOL for the year ended 12/31/17 to the year ended 12/31/16 and obtain \$70 refund (35% x \$200).
- Under statutory effective date, fiscal-year taxpayer cannot carryback NOL for the year ended 6/30/18 and would carryforward NOL to offset income at 21%, worth only \$42 (21% x \$200).
- Congressional staff and Treasury aware of issue.

**EXPENSING**

# Section 168(k) Expensing

## In General:

- Bonus depreciation percentage is increased from 50% to 100% for property acquired and placed in service after September 27, 2017, and before 2023.
- Phases down 20 percent per year through 2026 (2027 for longer production period property and certain aircraft).
- Property that is acquired prior to September 28, 2017, but placed in service after September 27, 2017, remains subject to the bonus depreciation percentages under prior law.

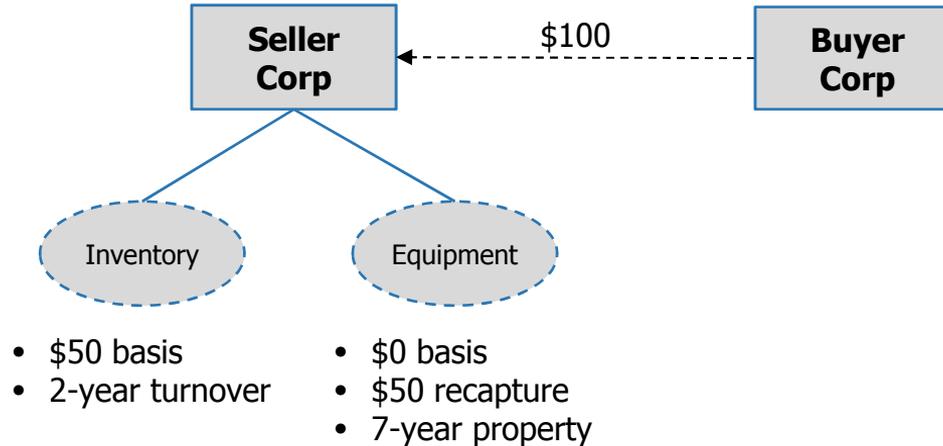
## Used Property:

- Removes the requirement that the original use of qualified property must commence with the taxpayer.

## Exceptions:

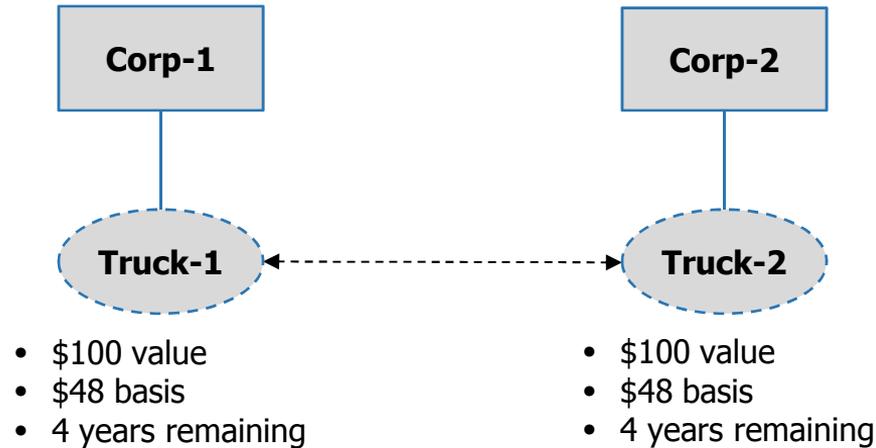
- Excludes certain public utility and electric cooperative property, and certain property used in a business with floor plan financing.

# Expensing: Interaction with § 1060 Asset Acquisitions



- Prior Law – Buyer incentive to allocate basis to inventory.
- New Law – Buyer incentive to allocate basis to equipment (qualified property) and fully expense.

# Expensing: Interaction with Section 1031



- Prior Law – Section 1031 like-kind exchange with exchanged basis.
- New Law – Section 1031 only applies to exchanges of real property. Expensing effectively allows immediate deduction of remaining basis.

# **LIMITATIONS ON INTEREST DEDUCTIONS**

# Deductibility of Business Interest

- Prior Law
  - Section 163(j) limited deductions for interest paid by corporations to related tax-exempt persons and, in certain cases, to unrelated tax-exempt persons.
- New Law
  - Replaces old section 163(j) with new and expanded version.
- Unlike prior law, new section 163(j) –
  - Applies to noncorporate taxpayers;
  - Applies regardless of tax status of payee or payee's relationship to taxpayer;
  - Applies regardless of taxpayer's debt:equity ratio; and
  - Applies only to "business interest."

# Definition of Business Interest

- Section 163(j)(5) defines “business interest” as “any interest paid or accrued on indebtedness *properly allocable* to a trade or business.”
- Section 163(j)(5) excludes “investment interest” (as defined in section 163(d)) from definition of “business interest.”
  - Although the 163(d) limitation on deductibility of investment interest applies only to noncorporate taxpayers, the definition of “investment interest” is not restricted to corporations.
  - The passive loss rules distinguish between a closely held C corporation’s “active income” and its portfolio income, including interest expense “properly allocable” to portfolio income “not derived in the ordinary course of a trade or business.” See Sections 469(e)(1), (2).

# Calculation of the Limitation

- Limits deduction for “business interest” to the sum of
  - Business interest income,
  - 30% of taxpayer’s “adjusted taxable income” (ATI), plus
  - “floor plan financing interest.”
- Any excess business interest expense is suspended but may be carried forward indefinitely.
- Unlike its predecessor, new section 163(j) does not permit a taxpayer that has excess capacity (i.e., whose interest expense is less than 30% of ATI) to carry that excess capacity to the following year.

# Definition of Business Interest Income

- Section 163(j)(6) defines “business interest income” as interest includible in taxpayer’s gross income that is “properly allocable” to a trade or business.
- “Investment income” (as defined in section 163(d)) is excluded from business interest income.
  - The section 163(d) definition of “investment income” incorporates, through a series of cross references, section 469(e)(1)(A)(i)(I) (“gross income from interest . . . not derived in the ordinary course of a trade or business”).
  - Section 469(e)(2) treats income on working capital as not derived in the ordinary course of business.
  - Under the section 469 regulations, interest income is *not* “derived in the ordinary course of a trade or business” unless it falls within one of six enumerated cases or is described in other guidance issued by the Service. Reg. § 1.469-2T(c)(3)(ii).

# Definition of Business Interest Income

- *Example.* Taxpayer has two businesses. It sells one business for \$5,000 cash and a \$10,000 nonnegotiable note bearing interest at 10%. To finance the expansion of its remaining business, Taxpayer borrows \$10,000 from Bank, also at 10%.
  - Under the section 469 regulations, the interest income Taxpayer receives from the purchaser is investment interest.
- Recasting the taxpayer's interest income as investment (non-business) interest has two implications:
  - The income cannot be netted against the business interest expense;
  - The income is eliminated from the computation of ATI.

# Definition of ATI

- Section 163(j)(8) defines ATI as taxable income computed without regard to –
  - Any item not “properly allocable to a trade or business”;
  - Business interest or business income;
  - NOL deductions under section 172;
  - The section 199A deduction; and
  - For taxable years beginning before 2022, depreciation and amortization
- For 2018 – 2021, ATI is essentially an EBITDA computation (earnings before interest, taxes, depreciation and amortization), and beginning in 2022 becomes an EBIT computation.
  - The reduction in ATI will correspond to the phase-down of expensing under section 168(k)

# Exclusions from Section 163(j)

- Exclusions from section 163(j) –
  - businesses with less than \$25M in gross receipts
  - the performance of services as an employee
  - an “electing real property trade or business”
    - Any business described in section 469(c)(7)(C) (any “real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business”) that elects out of section 163(j).
  - an “electing farming business”
  - certain regulated utility businesses

# Consequences of Exclusions

- In case of electing real property trade or business, electing farming business, and utility business, the price of avoiding section 163(j) is inability to expense acquisitions of tangible personal property under section 168(k)
- By excluding excepted activities from the definition of “trade or business,” section 163(j) will create potential allocation issues for taxpayers engaged in multiple lines of businesses, such as a taxpayer that has an electing real property business and a non-real estate activity.

# Properly Allocable – A “know it when you see it” standard?

- Section 163(j)(5) defines “business interest” as “any interest paid or accrued on indebtedness *properly allocable* to a trade or business.”
  - Statute and legislative history are silent on the meaning of “properly allocable.”
- “Properly allocable” appears in other interest-related provisions:
  - Section 163(d)(1) defines “investment interest” as interest on debt “properly allocable” to property held for investment.
  - Section 163(h)(2)(A) excludes interest on debt “properly allocable to a trade or business” from definition of “personal interest.”
  - Section 469(e)(1)(A)(i)(III) excludes from the computation of passive income or loss interest expense “properly allocable to” gross income from interest, dividends, annuities or royalties not derived in the ordinary course of a trade or business.

# Properly Allocable – Is Tracing Permissible?

- Is tracing relevant in determining “properly allocable”?
  - Reg. § 1.163-8T(a)(3): “In general, interest expense . . . is allocated in the same manner as the debt . . . . Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures.”
  - Reg. § 1.163-8T(a)(4)(i)(A) provides for tracing of debt to a trade or business for purposes of applying the “properly allocable” standard of section 163(h)(2)(A).
  - Tracing is susceptible to manipulation.
- What about asset-based apportionment under Reg. § 1.861-9T?
  - Allocation of debt in proportion to asset basis can give rise to distortions.
  - *Example:* taxpayer elects out of 163(j) for its rental real estate business while applying section 163(j) to its capital-intensive business, which under 168(k) has artificially low tax basis in its assets.

# Application to Consolidated Groups

- Former section 163(j)(6)(C) provided: “All members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as 1 taxpayer.”
- New section 163(j) is silent on treatment of affiliated groups, but the legislative history states that if an affiliated group files a consolidated return, “the limitation applies at the consolidated tax return filing level.”
- Is there a difference between treating members of a group as “one taxpayer” and applying the limitation at the group level?
  - *Example* : Parent incurs debt to purchase stock of Target, which conducts an active business.
    - Is Parent’s debt “properly allocable” to Target’s trade or business?
    - Is Parent’s debt properly allocable to Target stock, making it “investment interest”?
    - If debt is allocated according to asset basis, is the relevant basis Parent’s basis in Target stock or Target’s basis in its assets?
  - *Example* : Parent owns two subsidiaries, X and Y. X is engaged in a 163(j) business, but Y is engaged in highly leveraged real estate activities, leading it to elect out of section 163(j). Parent funds X and Y through a combination of third-party debt and retained earnings.

# Application to Consolidated Groups

- Presumably, a consolidated group must determine its “business interest income,” “business interest expense,” and “adjusted taxable income” at the group level and then allocate any suspended interest deductions among the members who have net business interest expense.
- Thus, losses incurred by one member could affect the deductibility of interest expense paid or accrued by another member.
- It may be necessary to revisit existing tax sharing agreements to ensure they reach appropriate results in such cases.

# Application to Pass-through Entities

- Former section 163(j) used aggregate principles to apply interest deduction limitations to corporate partners.
- New section 163(j) adopts an entity approach:
  - If a partnership's business interest exceeds 30% of its ATI, the excess business interest is treated as a nondeductible expense that is allocated to the partners currently.
  - Partners may deduct the excess interest expense only to the extent they receive an allocation of ATI from the *same partnership* in a future tax year.
  - If a partnership's business interest is less than 30% of its ATI, partners may use their shares of the "excess" ATI in computing their deduction for business interest incurred outside of the partnership.
  - Otherwise, partnership income is not taken into account in computing partners' ATI.
- Similar rules apply to S corporations.

# Application to Pass-through Entities

- These rules create significant differences between the results of entity-level debt and owner-level debt:
  - Example:
    - A is a 50% shareholder in AB Corp, an S corporation, which has \$60,000 in debt. AB's ATI is \$10,000 and its interest expense on its debt is \$6,000. A is also a member of the AC partnership, which generates \$10,000 of ATI and has \$0 of interest expense. A materially participates in both businesses.
      - AB has \$3,000 of deductible interest; the remainder is disallowed. A's share of AB's taxable income is \$3,500 (50% x [\$10,000 - \$3,000]). A also receives an allocation of \$1,500 of nondeductible interest.
      - A's total taxable income from AB Corp. and the AC partnership is \$8,500 (\$3,500 from AB and \$5,000 from AC). A cannot use her share of AC income to absorb any of the \$1,500 of suspended interest deductions from AB.
  - Example:
    - Assume instead that AB is funded entirely by equity, and that A borrows \$30,000 at 10% interest to fund her contribution to AB.
      - A will be allocated \$5,000 of "excess" ATI from each of AB and AC, giving her \$10,000 of total ATI.
      - A can deduct her entire \$3,000 of business interest expense.

# Application to Pass-through Entities

- The anomalous treatment of pass-through entities creates potential benefits for taxpayers:
  - Under section 163(J)(4)(a)(ii), a member of a partnership computes its ATI without regard to any items of partnership income, gain, loss or deduction except to the extent the partnership has “excess taxable income” (i.e., if 30% of its ATI exceeds its business interest expense).
  - Example: X and Y are members of the P consolidated group and are the sole members of partnership. X and Y fund the partnership through capital contributions financed by P-level debt. The partnership generates substantial losses that are absorbed currently on P’s consolidated return. However, those losses are ignored in computing the P group’s ATI.

# Application to Pass-through Entities

- The anomalous treatment of pass-through entities can also have unexpected detrimental results.
- Example:
  - X and Y, members of the P group, are the sole members of the Z partnership. The P group has \$1,000 of ATI from third parties, and P pays \$300 of interest on third-party debt.
  - Assume that P also pays \$100 of interest to Z, and that Z has no other items of income or deduction.
  - The payment of interest to Z increases the P group's business interest expense by \$100, but the allocation of Z's income to X and Y increases the P group's section 163(j) limitation by no more than \$30 (30% x \$100).

# **ACCOUNTING METHODS**

# Book Conformity for “All Events” Test

## In General:

- New section 451(b) requires accrual method taxpayers subject to the “all events test” to recognize gross income no later than the year in which such income is taken into account as revenue in an “applicable financial statement.”
- Transaction price for contract with multiple performance obligations is allocated in accordance with allocation in the applicable financial statement.

## Applicable Financial Statement:

- Includes (1) Forms 10-K, (2) audited financial statement used for credit purposes, reporting to shareholders or partners, or any other substantial nontax purpose; (3) filed by the taxpayer with a Federal agency for nontax purposes; or (4) IFRS statements filed with a foreign equivalent of the SEC.
- Applies on a group-wide basis.

## Effective Date:

- Taxable years beginning after December 31, 2017.

# Codification of Special Rule for Advance Payments

## In General:

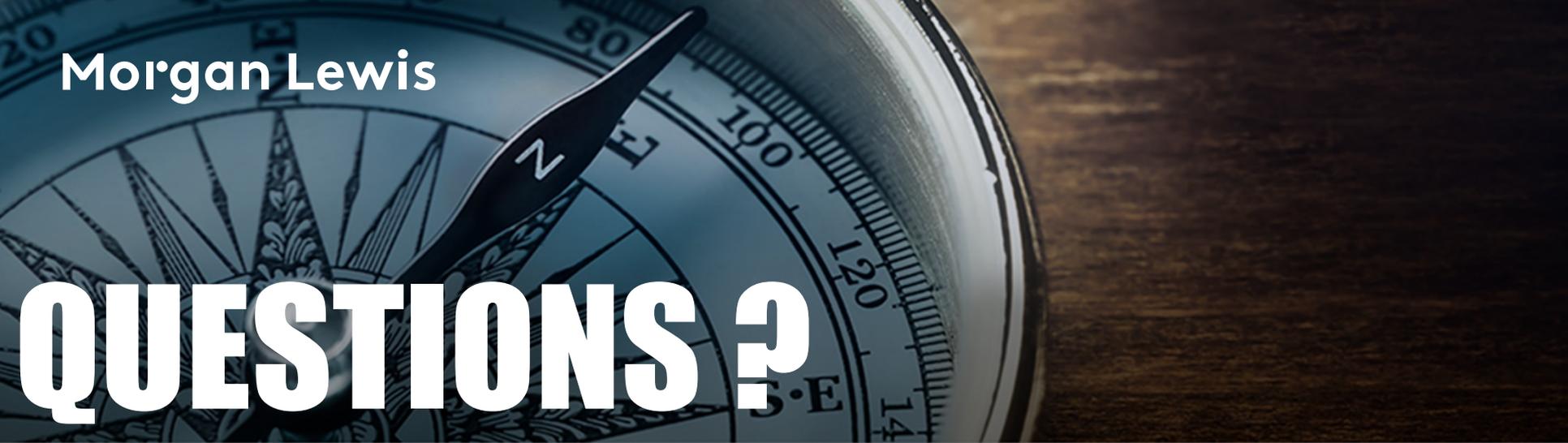
- New section 451(b) codifies the current one-year deferral for advance payments for goods or services provided under Rev. Proc. 2004-34.
- Allows accrual method taxpayers to elect to defer the inclusion of income associated with advance payments to the end of the tax year following the tax year of receipt *if* such income also is deferred for financial statement purposes.

## Exclusions:

- “Goods or services” does not include (1) rent, (2) insurance premiums, (3) payments with respect to financial instruments, (4) warranty or guarantee payments, (5) payments subject to withholding under section 871(a), 881, 1441, or 1442, or (6) payments in property subject to section 83.

## Other Provisions:

- Does not affect Reg. § 1.451-5 (deferral for advance payments for inventory goods); section 455 (prepaid subscriptions); or section 456 (prepaid dues).



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# QUESTIONS?

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# Biography



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Josh Brady's practice encompasses a broad range of corporate tax issues involving corporations, partnerships, and their owners and investors. He is widely recognized for his work on mergers and acquisitions, distributions, financings, restructurings, and corporations filing consolidated returns.

Josh advises both public and private clients on a number of sophisticated acquisition and disposition structures, including tax-free mergers, tender offers, going-private transactions, and cross-border joint ventures. He represents public corporations in large spin-offs and split-offs, including spin-offs attendant to mergers, joint ventures, private equity investments, and cash-rich split-offs. He also represents taxpayers before the Internal Revenue Service on audits, appeals, and obtaining IRS private letter rulings on transactions. Josh also represents clients before the Treasury Department and Congress on matters involving proposed legislation and regulations.

# Biography



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Jim Bridgeman's practice encompasses a broad range of business tax issues, including partnerships and joint ventures, mergers and acquisitions, internal restructurings, and structured finance and other financial transactions. His clients include publicly traded and large privately held businesses in the energy, financial services, and real estate sectors. He also represents clients in audits and appeals before the Internal Revenue Service and in tax litigation in the US Tax Court, the US District Courts and the US Circuit Courts of Appeals.

Jim previously served as an attorney-adviser in the Office of Tax Legislative Counsel at the US Treasury Department, where he participated in developing the Tax Reform Act of 1986. He also served in two high-ranking positions at the Internal Revenue Service—special assistant to the chief counsel and deputy associate chief counsel (technical)—where he participated actively in the issuance of regulations and rulings implementing the Tax Reform Act of 1986.

## Our Global Reach

Africa  
Asia Pacific  
Europe  
Latin America  
Middle East  
North America

## Our Locations

Almaty	Chicago	Houston	Orange County	Shanghai*
Astana	Dallas	London	Paris	Silicon Valley
Beijing*	Dubai	Los Angeles	Philadelphia	Singapore
Boston	Frankfurt	Miami	Pittsburgh	Tokyo
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