2018 Tax Cuts and Jobs Act

BUSINESS IMPACTS

(Unless otherwise noted, the changes are effective beginning in 2018)

New Deduction for "Qualified Business Income"

Starting in 2018, taxpayers are allowed a deduction equal to 20 percent of "qualified business income," otherwise known as "pass-through" income, i.e., income from partnerships, S corporations, LLCs, and sole proprietorships. The income must be from a trade or business within the U.S. Investment income does not qualify, nor do amounts received from an S corporation as reasonable compensation or from a partnership as a guaranteed payment for services provided to the trade or business. The deduction is not used in computing adjusted gross income, just taxable income. For taxpayers with taxable income above $157,500 ($315,000 for joint filers), (1) a limitation based on W-2 wages paid by the business and depreciable tangible property used in the business is phased in, and (2) income from the following trades or businesses is phased out of qualified business income: health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.

No Entertainment Expenses

Entertainment expenses are no longer deductible, even if it is directly related to the taxpayer's active trade or business. This includes as golf outings, fishing trips, tickets to the theatre or professional sporting events, to name a few. Only meals are allowed as deductible expenses, and are still limited to a 50% limitation.

Cash Method of Accounting

The new law provides that taxpayers with average gross receipts up to $25 million (up from $10 million) are not required to account for cost of goods sold using inventories, but rather may use a method of accounting consistent with treating inventory purchases (1) as non-incidental materials and supplies, or (2) that conforms with their financial method of accounting for inventories.

Repeal of the Deduction for Domestic Production Activities

The Domestic Production Activities deduction is repealed for years after December 31, 2017.

Increased Bonus Depreciation

The Act provides for full and immediate expensing of 100% of the cost of qualified property that is acquired and placed in service after September 27, 2017 through December 31, 2022 as bonus depreciation, and reduced amounts after that. It is allowable for new and used property. (Previously it was 50%, and for only new property.)

Increased Section 179 Expensing

Section 179 expensing for small businesses is expanded by increasing the limitation to $1 million, and increases the phase-out threshold to $2.5 million for property placed in service after December 31, 2017. Also, nonresidential real property improvements are now eligible for expensing provided they are placed in service after the original building is already in operation; such as roofs, HVAC property, fire protection, alarm and security systems.

Interest Expense Limitation

For taxpayers with average gross receipts exceeding $25 million, the deduction allowed for interest expense is limited to generally 30% of the adjusted taxable income for the year.

Employer-Provided Meals

From 2018 through 2025, *de minimis* fringe meals that are provided for the convenience of the employer are 50% deductible. After 2025, there is no deduction. However, there will still be a 50% deduction of meals for business operations, such as incurred by an employee on work travel.

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C Corporations – Reduction in Tax Rates

The Act creates a flat corporate tax rate of 21%, and eliminates the higher tax rate for personal service corporations. Note however, prior to enactment, many small corporations paid an effective tax rate lower than 21%, because of graduated tax rates (with 15% being the lowest rate).

C Corporations – AMT Repealed

The alternative minimum tax for C corporations is permanently repealed.

Partnerships – Technical Termination

Before the new law, partnerships experienced a "technical termination" if, within any 12-month period, there was a sale or exchange of at least 50% of the total interest in partnership capital and profits. This often imposed unintended burdens and costs on the parties. The new law repeals this rule. A partnership termination is no longer triggered if within a 12-month period, there is a sale or exchange of 50% or more of total partnership capital and profits interests. A partnership termination will still occur only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Net Operating Losses

There are new rules for the utilization of net operating losses ("NOL") generated in 2018, going forward. These losses may be carried forward indefinitely, but may not be carried back to previous tax years for a refund of prior taxes paid. Also, the NOL is limited to 80% of the taxpayer's taxable income. For losses that were generated in 2017 and earlier, the NOL may be carried back two years, and expires after a 20-year carryforward period.

Research and Development Expenses

In general, the Tax Act kept R&D credits unchanged. However, beginning in 2022, research or experimental expenses must be capitalized and amortized over a 5-year period (15-years for research conducted outside the U.S.).

Harassment Lawsuits

Under the new law, no deduction is allowed for any settlement, payout, or attorney fees related to a sexual harassment or abuse if such payments are subject to a nondisclosure agreement. Under previous law, such expenses were fully deductible as ordinary and necessary business expenses.

Credit for Employer-Provided Family Leave

The law provides a new tax credit for employer-provided family leave on wages paid in 2018 and 2019. The credit is calculated as 12.5% of wages paid to qualifying employees that are on family or medical leave, if the rate of pay is at least 50% of their normal wages. The credit is increased up to 25% if the rate of pay exceeds 50% of normal wages. A written policy, meeting certain requirements, must be in place to take the credit.

Increased Penalties

The federal penalties for filing late information returns (1099, W-2, W-3, etc.) have increased, to $260 per form in 2018 and $270 in 2019). The penalties are lower if you fix it by the 30th day following the due date, and are greater if the failure is intentional. CA imposes late filing penalties as well, ranging from $30 to $100 per form.

NOTE

Given the extent of the tax law changes, now may be a good time to consider a change of entity for your business – to or from a sole proprietorship, S corporation, C corporation, partnership or LLC. Please discuss it with your CPA.

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