

Tax Notes

C Corporations Find New Life under the Tax Cuts and Jobs Act

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Much has been written on the provisions of the tax legislation which was signed by President Trump on December 22, 2017. Individuals will see a different landscape to their taxes starting in 2018 not only with reduced income tax rates but larger standard deductions, expanded child credits, curtailed state and local tax deductions and limited home mortgage interest deductions just to name a few. Businesses operating as partnerships and/or S corporations can generate a new “pass-through” deduction which may help lower the overall effective tax rate of partners and shareholders.

But what about the C corporation? Often thought of as the entity of choice used by large, publicly-held companies or businesses with an eye toward raising capital, the C corporation might see a rebirth of those choosing to set up a new business or change an existing business to this structure after analyzing the generous provisions of the Tax Cuts and Jobs Act (TCJA) geared toward lowering the income tax burden of C corporations. The matter of double taxation will continue to exist for C corporations and their shareholders, albeit at a lesser bite than under prior tax law. There are also a few givebacks as presented later which will help to pay for the other generous provisions included in the legislation.

This article will discuss the major provisions of the new tax law that will impact businesses operating as C corporations.

Income Tax Rate Reduction

The centerpiece of the TCJA is the reduction of the income tax rates applicable to C corporations. Prior to this legislation, C corps were subject to four graduated income tax rates ranging from 15% of the first \$50,000 of taxable income to 35% of taxable income in excess of \$10 million.

These income rates placed U.S. corporations at the high end of other developed countries in the world. The average corporate income tax rate of nations in the Organization for Economic Co-operation and Development (OECD) is 22.5%. U.S. corporations were at a competitive disadvantage and many moved their operations overseas to lower their tax burden. Once the profits were earned and received overseas there was also a “toll” that was required to be paid when those dollars were brought back into the United States thus limiting spending and employment opportunities at home.

Under the new law, C corporations will pay income tax at a flat 21% rate effective for taxable years beginning after December 31, 2017. This should provide a significant boost to the bottom lines of these corporations. In fact, stories have already hit the press about companies awarding unplanned bonuses to all employees or making plans to significantly increase capital spending as a result of this new tax law.

Repeal of Corporate Alternative Minimum Tax

The corporate alternative minimum tax (AMT) is repealed for tax years beginning after 2017. As with the AMT for individuals, this tax was meant to ensure that corporations who took advantage of certain deductions in computing their regular tax would pay some amount of tax under the AMT. AMT was computed based on the excess of a corporate taxpayer's tentative minimum tax over their regular tax liability. The tentative minimum tax is 20% of the taxpayer's alternative minimum taxable income (AMTI). An exclusion from corporate AMT was in place for small corporations (average annual gross receipts of

\$7.5 million or less for the previous three tax years.) The AMT will still exist for individuals, estates and trusts after 2017.

Corporations subject to AMT in any year were eligible to claim a “minimum tax credit” against their regular tax liability for AMT paid in previous tax years. Any unused minimum tax credit can be used to offset the regular tax liability for any year. Some of the unused minimum tax credit can be refunded in 2018 through 2021. The amount refundable is 50% of any excess minimum tax for the year over any credit allowable against regular tax for the year. The refund percentage increases to 100% in 2021.

Incentives to Increase Capital Expenditures

In a change that will most certainly spur capital spending, bonus depreciation will increase from 50% to 100% of the cost of property acquired and placed in service after September 27, 2017 and before January 1, 2023. After 2023, the bonus depreciation percentage will decline by 20% each year until it reaches zero (expires) for assets placed in service after December 31, 2027. Used property will now also qualify for bonus depreciation under the new law (prior bonus depreciation was eligible only for new property).

Section 179 expensing of new or used property will get a boost through an increase in the dollar limitation from \$500,000 to \$1 million. The investment limitation also rises from \$2 million to \$2.5 million. Both changes are effective for tax years beginning after December 31, 2017.

Net Operating Loss Carrybacks and Carryovers

The new law makes changes to the rules for net operating loss (NOL) usage. Under prior law, corporations could carryback an NOL two years and carryforward any remaining NOL for a period of up to 20 years. Longer carryback periods were available for NOLs arising from casualty losses and farming businesses.

The new law eliminates the carryback of NOLs arising in tax years ending after 2017 (other than for farm losses and certain insurance companies) while allowing such NOLs to be carried forward indefinitely. The NOL deduction for those NOLs arising in tax years beginning after 2017 is limited to the lesser of the aggregate of the NOL carryforwards to the tax year OR 80% of taxable income computed without regard to the NOL.

For fiscal year 2017/2018, special attention should be given to these new provisions. An NOL arising in this fiscal year cannot be carried back because it arose in a tax year ending after 2017. That same NOL will NOT be subject to the 80% of taxable income limitation because the NOL did not arise in a tax year **beginning** after 2017.

Meals and Entertainment Deductions Reduced and Eliminated

Businesses were permitted to deduct 50% of meals and entertainment expenses in prior years. The new tax law puts an end to the deduction of entertainment expenses by eliminating in full any deduction for those expenses paid or incurred after 2017. This will end any business deductions for taking your clients to night clubs, theaters, country clubs, sporting events, hunting/fishing trips and other similar types of client entertainment.

Expenses for meals incurred after 2017 (previously 50% deductible) are also not deductible with some exceptions. The 50% deduction for expenses of food, beverages and related facilities furnished on business premises primarily for employees (such as company cafeterias or executive dining rooms) will continue. Meals provided to employees on the employer’s premises for the convenience of the employer (i.e., dinners provided during busy periods) will continue to be deductible at 50% and will become nondeductible after 2025 barring future action by Congress.

Limitation on Deduction of Business Interest Expense

For tax years beginning after 2017, the deduction for business interest expense will be subject to an annual computation. This limitation applies to *all taxpayers* regardless of how the business is organized (partnership, corporation or sole proprietorship). The amount of deductible business interest is limited in any tax year to the sum of:

- Business interest income of the taxpayer for the tax year;

- 30% of the taxpayer's adjusted taxable income for the year, including any increases in adjusted taxable income as a result of a distributive share in a partnership or S corporation, but not below zero, and
- Floor plan financing interest for the tax year (applicable to financing vehicles for sale or lease to retail customers).

Adjusted taxable income equals the taxable income of the taxpayer computed without regard to any item of income, gain, deduction or loss not properly allocable to a trade or business, any business interest or business interest income, any NOL deduction, the 20% deduction for pass-through business income under new section 199A, and, for tax years beginning before January 1, 2022, the allowable deduction for depreciation, amortization or depletion.

There is a small business exception to this limitation available to any taxpayer whose average annual gross receipts for the three tax years ending with the prior year do not exceed \$25 million (to be adjusted for inflation after 2018). The small business exception is applied to taxpayers who are not corporations or partnerships in the same manner as if they were a corporation or partnership.

Business interest for purposes of this limitation is the amount of interest expense paid or accrued on debt that is properly allocable to a trade or business of the taxpayer. Investment interest expense or investment interest income is not included as business interest expense or in the computation of the amount of the limitation.

Any business interest expense not deducted as a result of these rules may be carried forward indefinitely.

The limitation on the deduction for business interest is applied at the entity level for partnerships and S corporations and the deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership or S corporation. The partners or shareholders who have business interest expense not from the partnership or S corporation will compute their own adjusted taxable income limitation without regard to the distributive share of income passed through to them.

New Definitions Expand Limitation on Public Company Excessive Employee Compensation

A publicly-traded corporation cannot deduct employee compensation in excess of \$1 million paid to any "covered employee" during the tax year.

Effective for tax years beginning after December 31, 2017:

A **covered employee** of a corporation:

- is the principal executive officer (PEO) of the corporation (or an individual acting in such capacity) at any time during the tax year;
- is the principal financial officer (PFO) of the corporation (or an individual acting in such capacity) at any time during the tax year;
- is among the three highest compensated officers for the tax year (other than the PEO or the PFO); or
- was a covered employee of the corporation (or any predecessor) for any prior tax year beginning on or after January 1, 2017.

Compensation to a covered employee included in the cap:

- taxable wages
- any cash and noncash benefits paid for services
- commissions and performance-based compensation

Compensation to a covered employee excluded from the cap:

- income from specified employee trusts, annuity plans, or pensions
- any benefit that is reasonably anticipated to be tax free under the Code
- income payable under a written binding contract which was in effect on February 17, 1993
- compensation paid before a corporation became publicly held

The reach of the limitation on the deduction for excess compensation now extends to compensation paid to the employee's estate, a beneficiary of the employee's estate or to a former spouse. Compensation paid pursuant to a written binding contract which was in effect on November 2, 2017 (and not modified in any material respect on or after such date) is not subject to the new provisions discussed herein.

Observations

The significant reduction in the corporate income tax rate, along with the repeal of the corporate Alternative Minimum Tax and greatly enhanced current write-offs for capital expenditures, should for many taxpayers offset any of the impact of the revenue raisers such as the changes to deductibility of meals and entertainment, the limitation on the deduction of business interest and the broadened scope of excessive compensation limitations.

Contact Us

Should your business be impacted by one or all of the changes discussed above, we are here to help you navigate and assist you in determining the impact of these major changes to the taxation of C corporations. Contact your PKF O'Connor Davies tax professional with any questions or for any additional information.

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