Business Tax Planning for 2017 Tax Reform

Dear Client,

As you may be aware, major tax reform legislation may be passed this year and could mean sweeping changes to the tax code for the first time in about 30 years. Although the bill has only recently been proposed and the timing of its passage is uncertain, businesses should be aware of the bill that has been released.

The corporate rate cuts would be significant. The bill proposes a 20% corporate tax rate for most corporations with a 25% corporate tax rate for personal service corporations. The bill also significantly alters the treatment of income from passthrough entities. Businesses conducted as sole proprietorships, partnerships, or S corporations would be subject to a special passthrough maximum rate of 25% for business income. The bill includes methods to combat classification of compensation into business income.

The bill aims to broaden the corporate tax base by partially limiting interest expenses (except for businesses with gross receipts of less than $25 million), modifying the net operating loss deduction, revising treatment of contributions to capital, and repealing various deductions and credits, among other changes.

The bill significantly reforms international rules by exempting offshore profits upon repatriation. Foreign subsidiary dividends (of which the U.S. parent owns at least 10%) will be exempt from U.S. tax. However, the bill limits losses with respect to foreign subsidiaries by requiring the U.S. parent to reduce its basis in stock of the foreign subsidiary by the amount of exempt dividends received, but only for purposes of determining loss (not gain) from the sale of stock of the foreign subsidiary. In order to transition to this new system, accumulated earnings stored offshore will be deemed repatriated.

The bill provides us with a vision for what might be. This has made planning difficult, particularly for businesses that must consider the impact of international tax rules.

The following are highlights of the changes proposed in the recently released bill:

Business Deductions and Credits

- *Section 179 Expensing:* For years 2018 through 2022, the expensing limitation would increase to $5 million and the phase out amount to $20 million. The new limitations would be adjusted for inflation.

- *Research and Development Credit:* Preserved.

- *Deductions for Income Attributable to Domestic Production Activities:* Beginning in 2018, would be repealed.

- *Entertainments Expenses Deductions:* Beginning in 2018, would disallow deductions for entertainment, amusement

• *Interest Expense Deduction:* Beginning in 2018, would limit the deduction for net interest expenses incurred by a business in excess of 30% of the business's adjusted taxable income.

• *Small Business Exception from Limitation on Deduction of Business Interest:* Beginning in 2018, businesses with average gross receipts of $25 million or less would be exempt from the interest limitation rules.

• *NOL Deduction:* Would allow a taxpayer to deduct an NOL carryover or carryback of up to 90% of the taxpayer's taxable income. The provision generally would be effective for losses arising in tax years beginning in 2018.

Method of Accounting

• *Cash Method of Accounting:* The $5 million average gross receipts threshold for corporations and partnerships with corporate partners that are not allowed to use the cash method of accounting would be increased to $25 million (indexed for inflation) and would be extended to farm corporations and farm partnership with a corporate partner, as well as family farm corporations) for tax years beginning after 2017. The requirement that such businesses satisfy the requirement for all prior years would be repealed. Exemption from UNICAP for such business entities would apply to real and personal property acquired or manufactured by such businesses.

Corporations

• *Corporate Tax Rate:* Beginning in 2018, 20% flat corporate tax rate; 25% flat rate for personal service corporations.

• *Alternative Minimum Tax:* Beginning in 2018, would repeal alternative minimum tax. In 2019, 2020, and 2021, if taxpayer would have AMT credit carryforward, taxpayer would be able to claim a refund of 50% of remaining credits (to extent credits exceed regular tax for year). For 2022, taxpayer would be able to claim a refund of all remaining credits.

• *Accounting for Long-term Contracts:* The $5 million average gross receipts threshold for corporations and partnerships with corporate partners that are not allowed to use the cash method of accounting would be increased to $25 million (indexed for inflation) and would be extended to farm corporations and farm partnership with a corporate partner, as well as family farm corporations) for tax years beginning after 2017. The requirement that such businesses satisfy the requirement for all prior years would be repealed. Exemption from UNICAP for such business entities would apply to real and personal property acquired or manufactured by such business. The $10 million average gross receipts exception to the requirement to use the percentage-of-completion accounting method for long-term contracts would be increased to $25 million for tax years beginning in 2018, and businesses that meet such exception would be permitted to use the completed-contract method (or any other permissible exempt contract method).

• *Contributions to Capital:* Beginning with date of enactment, contributions to capital of a corporation would be included in corporation's gross income unless exchanged for stock. Contributions in excess of fair market value of stock issued would be included in gross income. Basis in property contributed to capital would be greater of either basis of transferor increased by gain recognized, or amount included in gross income.

Pass-Through Entities

• *Pass-Through Tax Rate:* Beginning in 2018, 25% maximum tax rate on portion of pass-through entity distributions treated as business income (remaining portion of distributions treated as wage income subject to individual income tax rates). Owners or shareholders receiving distributions from active business activities would be able to elect to:

(1) treat 30% as business income and 70% as wage income, or (2) determine ratio of business income to wage income based on capital investment. Owners or shareholders receiving distributions from passive business activities would be able to treat 100% as business income. Transition rules would apply.

• *Contributions to Capital:* Beginning with date of enactment, contributions to capital of partnership would be included in partnership's gross income unless exchanged for interest in partnership. Contributions in excess of fair market value of interest received would be included in gross income.

• *Technical Termination of Partnership:* Beginning in 2018, technical termination rule would be repealed. A partnership would be treated as continuing even if more than 50% of the total capital and profit interest of partnership were sold or exchanged, and new elections would not be required or permitted.

International

• *100% Deduction for Foreign-Source Portion of Dividends & Repatriation:* 100% deduction for foreign-source portion of dividends received from "specified 10-percent owned foreign corporations" by U.S. shareholders. Accumulated foreign earnings held in cash or cash equivalents and in illiquid assets deemed repatriated and taxed at 12% and 5% respectively. Taxpayer would be able to elect to pay resulting liability over 8-year period in equal annual installments of 12.5% of the total tax liability due.

• *Foreign Tax Credit*: Repeal of indirect foreign tax credit under §902. No foreign tax credit or deduction permitted for taxes paid or accrued with respect to exempt dividends. Income from sale of inventory sourced based solely on basis of production activities.

• *Subpart F:* Repeal of current taxation of previously excluded qualified investments. Repeal of foreign base company oil related income as subpart F income. Inflation adjustment of de minimis exception threshold for foreign base company income. CFC look-through exception made permanent. Stock attribution rules for determining CFC status modified to treat U.S. corporations as constructively owning stock held by its foreign shareholder.

• *Base Erosion:* U.S. shareholders of CFCs subject to current U.S. taxation on 50% of "foreign high return amounts." Deductible net interest expense of a U.S. corporation that is a member of an "international financial reporting group" limited based on U.S. corporation's share of group's Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Excise tax of 20% imposed on certain payments made by a U.S. corporation to a related foreign corporation, unless U.S. corporation elects to treat the payments as effectively connected income. Payments (other than interest) that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset subject to the 20% excise tax.

Please contact your tax accountant at 256.533.1040 to discuss tax planning opportunities in preparation for the possibility of comprehensive tax reform.

Sincerely,

Anglin Reichmann Snellgrove & Armstrong P.C.