US Tax Reform – Key Considerations

On December 20, 2017, Congress passed the Tax Cuts and Jobs Act (P.L. 115-97).

A vote in the House followed, and President Trump signed the bill into law on December 22, 2017.

The Tax Cuts and Jobs Act represents the most significant overhaul of the Internal Revenue Code in more than 30 years. It provides significant reductions in tax rates for individuals, corporations, and small businesses, reforms the U.S. taxation of international transactions and businesses, eliminates dozens of individual and business tax deductions, enhances many tax credits and deductions, as well as many other changes. Every U.S. taxpayer, foreign or domestic, individual or business, high-income or low-income, is impacted by the provisions of the act.

- Section 199A 20% deduction on passthrough income
- Choice of entity
- Meal & Entertainment and fringe benefits
- Section 163(j) business interest expense limitations
- Section 162(m) limitation on deduction for compensation paid to covered employees

Overview of section 199A and the proposed regulations
Background

- Section 199A generally provides a deduction of up to 20 percent of qualified business income from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust, or estate, subject to certain significant limitations (the "section 199A deduction"). This provision applies to taxable years beginning after 2017 and before 2026.

Overview of section 199A and the proposed regulations

Combined qualified business income (QBI)

- Under section 199A, an individual, estate or trust taxpayer generally may deduct the sum of -
  - An amount for each trade or business, equal to the lesser of –
    - 20 percent of the taxpayer's **QBI** with respect to the trade or business, or
    - The greater of the following limitations –
      - 50 percent of the **W–2 wages** with respect to the **trade or business**, or
      - the sum of 25 percent of the W–2 wages with respect to the **qualified trade or business**, plus 2.5 percent of the **UBIA of qualified property**.
  - 20 percent of aggregate **qualified REIT dividends** and **qualified publicly traded partnership (PTP) income**.
- However, the section 199A deduction is limited to 20% of the amount by which taxable income exceeds net capital gain (the "overall limitation").

Specified service trade or business

General definitions

- Unless a taxpayer’s income is below the threshold amount, a qualified trade or business does not include a specified service trade or business (SSTB). The proposed regulations provide additional guidance on definitions for SSTBs.
- An **SSTB** means any trade or business involving the performance of services in one of more of the SSTB fields provided by the proposed regulations.
- If a trade or business conducted by a relevant passthrough entity (RPE) is an SSTB, this limitation applies to any direct or indirect individual owners of the business, regardless of whether the owner is passive or participated in any specified service activity.
- **NOTE**: performing services as an employee is not a qualified trade or business for purposes of section 199A.

Specified service trade or business

Definition of SSTB fields

The proposed regulations provide a separate definition for each of the following SSTB fields:

- Health
- Law
- Accounting
- Consulting
- Performing arts
- Athletics
- Trading
- Financial services
- Actuarial science
- Investing and investment management
- Brokerage services
- Dealing in securities, partnership interests, or commodities
- Any trade or business where the principal asset is the "reputation or skill" of employees or owners [1]

[1] The proposed regulations adopt a narrow interpretation of the "reputation or skill" category that generally only includes income received based directly on the taxpayer's fame (*e.g.*, endorsement, appearances, licensing the use of likeness, etc.).

Specified service trade or business

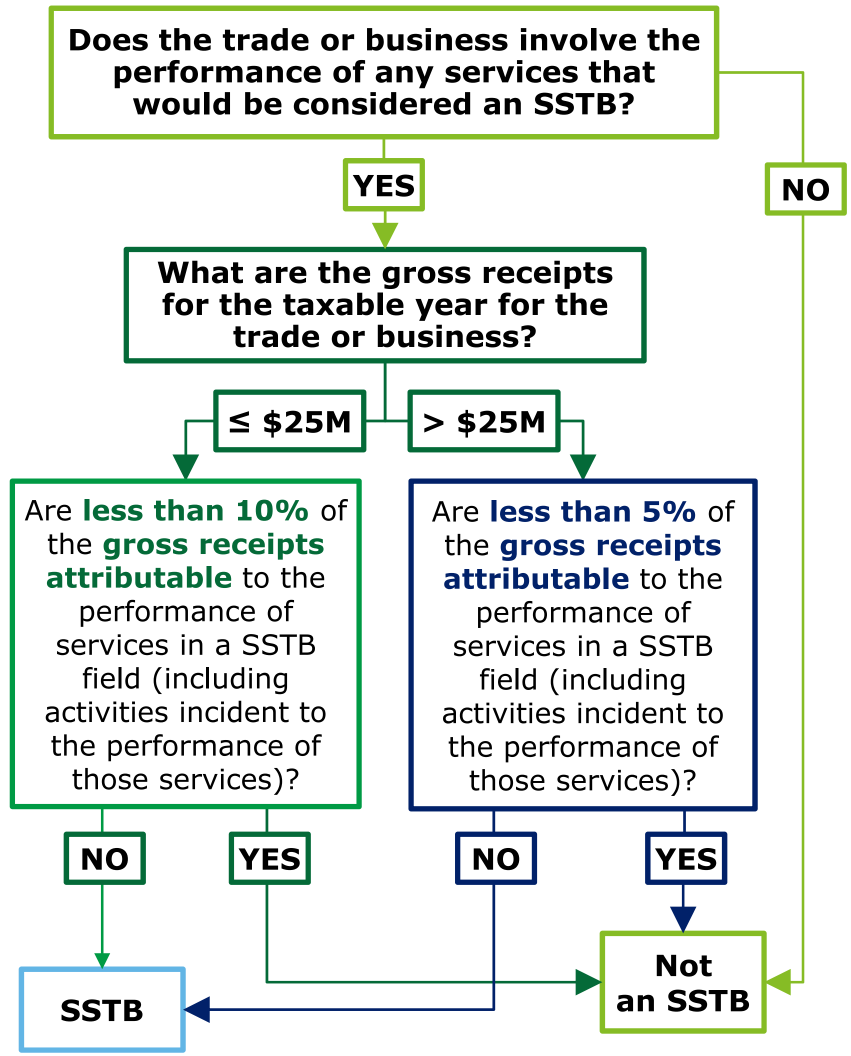
Specific guidance provided by the proposed regulations

QTB	SSTB
architecture or engineering services	legal services
pharmaceuticals or medical devices	medical services
health clubs & spas	actuarial services
broadcasting or disseminating video or audio of professional sports or performing arts	accounting services
insurance brokerage	ticket sales for professional sports or performing arts
payment processing & billing services	dealing in securities, commodities, or partnership interests
consulting that is embedded or ancillary to the sale of goods	stock brokerage
real estate brokerage	financial services
direct real property management	consulting services
retail banking	investment banking
	investment management

The “*de minimis* rule”

A trade or business (determined *before* the application of the aggregation rules) is NOT an SSTB if:

- Its gross receipts in a taxable year are **$25M or less** and **less than 10%** of its gross receipts is attributable to the performance of services in an SSTB, or
- Its gross receipts in a taxable year are **more than $25M** and **less than 5%** of its gross receipts is attributable to the performance of services in an SSTB.



QTB and SSTB threshold application

Threshold amount*
- $157,500 (single/ other filers) or
- $315,000 (married filing jointly (MFJ))

End of phase-in
- $207,500 (single/ other filers) or
- $415,000 (MFJ)

QTB

Deduction available subject to overall limit	Phase-in wage and basis limit, and overall limit also applies	Deduction available subject to wage and basis limit and overall limit

$ - Taxable income as determined without regard to the deduction → $$$

SSTB

Deduction available subject to overall limit	Phase-in SSTB limit, wage and basis limit, and overall limit also applies	Deduction NOT available

Threshold amount*
- $157,500 (single/ other filers) or
- $315,000 (MFJ)

End of phase-in
- $207,500 (single/ other filers) or
- $415,000 (MFJ)

* For taxable years beginning after 2018, the threshold amount will be adjusted for inflation (using a section 1(f)(3) cost-of-living adjustment).

Entity conversion considerations. Why now?

Tax considerations only

- Corporate rate reduction
- Limitations of the pass-through (section 199A) deduction
- Limitation of state and local income and property taxes for individuals (limited to $10,000)
- International provisions

Key take-away:

Pass-through entities should consider the implications of tax reform and the impact of converting to a corporation for the future after tax cash of the business and its owners. Modeling is required.

Key considerations

	Remain a Pass-Through	Convert to a C Corporation
Corporate rate reduction from tax reform		X
Ability to claim full pass-through deduction benefit	X	
Partnership/S corporation distributions limited to tax distributions		X
Exit strategy	X	
ROI of business > ROI on cash distributed		X
Depending on state footprint - significant state taxes on business income	X	X

Pass-through considerations

Choice of entity–Rate differences

Prior Law	
C Corporation Shareholder	**50.47%**
Partner/S Corporation Shareholder	**43.40%**
Post Passage of 2017 Tax Act	
C Corporation Shareholder	**39.80%**
Partner/S Corporation Shareholder **(with no 199A deduction)** (Individual Rate (37%) + NII (3.8%)/(Individual Rate (37%))	**40.80%/37%**
Partner/ S Corporation Shareholder **(with 20% 199A deduction)** (Individual Rate (37%*(1-20%)) + NII (3.8%)/(Individual Rate (37%*(1-20%)))	**33.40%/29.6%**

- *For corporate scenarios, assumes that all after tax earnings are distributed*
- *For simplicity, the employment tax rate is assumed to be 3.8% and payroll tax deductions are ignored*
- *Does not factor in compensation paid*
- *Does not factor in active vs. passive ownership (assumes either 3.8% self-employment tax or 3.8% net investment income tax applies to all income)*
- *Does not include state tax implications*

Pass-through deduction limitations

- Limited to US sourced trade or business income
- Exclusion of Specified Service Trade or Business income
- W-2 wage and basis limitation
- Carryover of losses of qualified business income to offset future income

Key take-away:

- **Assess the potential limitations of section 199A that may limit the pass-through deduction to less than a 20% benefit**
- **The ability to recognize this deduction is a significant consideration when assessing a conversion to a C corporation.**

Distributions and growth

- Current distributions (tax and non-tax distributions)
- Future distributions
- Projected rate of return on assets held in the entity
- Projected rate of growth of distributed cash

Key take-away:

- **The amount of annual distributions impacts the benefit of a conversion (*i.e.,* less distributions favor a corporate entity)**
- **Consider the comparison between the projected growth of maintaining assets in the entity choice vs. in the hands of the owners**

State tax implications

- Impact of state sourcing on income taxes
- State tax footprint of the entity
- State tax footprint of the owners
- Different apportionment rules for partnerships vs. corporations
- Deductibility of state taxes for corporations vs. individuals
- Compliance costs

Exit strategies

- Sale of partnership interest
- Stock vs. asset deal of C corporation and S corporation
- Holding period upon exit
- Benefit of basis build-up vs. deferral of gain in corporation

Key take-away:

- **Important to look at exit and tax/cash flow implications in each scenario**

Character of income recognized

- Long-term capital gains and qualified dividends
- Section 1231
- Portfolio deductions
- US sourced vs. non-US sourced income
- Foreign tax credit utilization

Key take-away:

- **Evaluate the character and types of income generated by the pass-though entity**
- **Consider the impact of whether portfolio deductions would be deductible at the individual level vs. deducting them in a corporation**

Other

- International structure/foreign tax credits
- Historical and future estate planning strategies
- Flexibility in entity structure to reach to potential future changes in tax law
- Built-in gains tax

Key take-away:

- **A lot to still consider that may be very fact specific**

Tax Reform Impact Summary – Meals & Entertainment

Type of M&E Expenditure	Old Law Deductibility	New Law Deductibility
Non-employee entertainment	50% deductible	100% non-deductible
Entertainment tickets	50% deductible up to face value; excess 100% non-deductible	100% non-deductible
Non-employee meals	50% deductible	Mix of 50% and 100% non-deductible
Employee recreation	Mix of 100% and 50% deductible	Mix of 100% deductible and 100% non-deductible
Deminimis food & beverage	Mix of 100% deductible and 50% deductible	50% deductible
Overtime meals	Mix of 100% deductible and income inclusion	Mix of 50% deductible and income inclusion
Transportation fringe provided by employer	Mix of 100% deductible and income inclusion	Mix of 100% non-deductible and income inclusion
Cafeteria subsidy	Mix of 100% deductible and income inclusion	Mix of 50% deductible and income inclusion
Skyboxes & suites	Mix of 50% and 100% non-deductible	100% non-deductible

Entertainment Ticket/Skybox Examples

Type of M&E Expenditure	Old Law Deductibility	New Law Deductibility
Skybox tickets	50% deductible	100% non-deductible
Food/beverage in skybox	50% deductible	100% non-deductible or 50% non-deductible
Sporting tickets	50% deductible	100% non-deductible
Food/beverage at sporting event	50% deductible	100% non-deductible or 50% non-deductible
Concert tickets	50% deductible	100% non-deductible
Food/beverage at concert	50% deductible	100% non-deductible or 50% non-deductible

Definition of entertainment – see Treasury Regulation 1.274-2

Food and beverage may be 50% deductible with proper documentation and substantiation – See IRS Notice 2018-76

Non-Employee Entertainment Examples

Type of M&E Expenditure	Old Law Deductibility	New Law Deductibility
Outing with non-employees (e.g. golf outing)	50% deductible	100% non-deductible
Food and beverage at outing	50% deductible	100% non-deductible or 50% non-deductible

Food and beverage at outing may be 50% deductible with proper documentation and substantiation – See IRS Notice 2018-76

Transportation Fringe Benefits

Pre-Tax Transportation

- **Old Law:** Employer could deduct pre-tax transportation benefit not subject to tax by employee (e.g. up to $260/month for parking and mass transit for 2018).
- **New Law:** Employer cannot deduct pre-tax transportation benefit not subject to tax by employee.
- **Notes**:
  - Any benefits that are imputed into income of the employee are still deductible by employer.
  - Certain states mandate providing pre-tax transportation benefits to employees.

Parking Included in Facility Owned or Leased by Employer

- **Old Law:** Employer costs associated with providing parking to employees in a facility owned or leased by employer were deductible to employer.
- **New Law:** These costs may be considered employer provided commuting and therefore non-deductible to employer.

Qualified Parking – Notice 2018-99 Update

On December 10, 2018, the IRS issued Notice 2018-99, providing interim guidance on the determination of the amount of Parking Expenses subject to disallowance under IRC Section 274(a)(4).

Highlights –

- The amount of disallowed deductions for an employer is not determined in relation to the value of the Qualified Parking provided to employees, but instead on the expenses associated with providing the Qualified Parking
- For employers that pay on a "per parking spot" basis, all amounts paid for employees parking is disallowed.
- For employers that either lease or own a parking facility where parking is provided to employees must determine the Total Parking Expense associated with the facility and allocate those costs to the employee usage under any reasonable method.
- The IRS has provided a Four Step process that will be deemed to be a reasonable method.
- The Notice clarifies that Depreciation associated with a parking facility owned by an employer is not considered a component of Total Parking Expenses.

Qualified Parking – Notice 2018-99 Update (continued)

Total Parking Expenses Defined for Purposes of the Notice –

- If a taxpayer pays a third party an amount so that its employees may park at the third party's parking lot or garage, the § 274(a)(4) disallowance generally is calculated as the taxpayer's total annual cost of employee parking paid to the third party, except for the amounts included as compensation to the employee.
- For Parking Facilities that are Owned or Leased by an Employer - "Total Parking Expenses"
  - Include, but are not limited to, repairs, maintenance, utility costs, insurance, property taxes, interest, snow and ice removal, leaf removal, trash removal, cleaning, landscape costs, parking lot attendant expenses, security, and rent or lease payments or a portion of a rent or lease payment (if not broken out separately).
  - Does not include deduction for an allowance for depreciation on a parking structure owned by a taxpayer and used for parking by the taxpayer's employees is an allowance for the exhaustion, wear and tear, and obsolescence of property, and not a parking expense for purposes of this notice
  - Does not include Expenses paid for items not located on or in the parking facility, including items related to property next to the parking facility, such as landscaping or lighting

Qualified Parking – Notice 2018-99 Update (continued)

Additional Guidance from Notice 2018-99

General Public Use –

- IRC Section 274(e)(7) has provided for an exception from deductibility limitations under Section 274(a) for expenses for goods, services, and facilities made available by the taxpayer to the general public. A taxpayer's customers and potential customers are members of the general public for purposes of Section 274(e)(7)
- Treasury Department and the IRS have determined that expenses for parking made available to the general public are within this exception.

Qualified Parking – Notice 2018-99 Update: Four Step Process

IRS has provided a four step process that is deemed to be a reasonable method for allocating Total Parking Expenses as follows:

1. Calculate the disallowance for Reserved Employee Spots. These spots can be reserved by a variety of methods, including (but not limited to) specific signage ("Employee Only Parking") or a separate facility or portion of a facility segregated by a barrier to entry or limited by terms of access
2. Determine the Primary Use of Remaining Spots. Taxpayer must determine if the remaining spots have greater than 50% of actual or estimated usage by the general public. If general public is greater than 50%, no additional costs are disallowed. If not, the taxpayer proceeds to Step 3.
3. Calculate the Allowance for Reserved Nonemployee Spots. Taxpayer may identify the number of spots in the parking facility exclusively reserved for nonemployees (visitors, customers, etc) and exclude the allocated costs for these spots from disallowance.
4. Remaining Use - taxpayer must reasonably determine the employee use of the remaining parking spots during normal business hours on a typical business day. Unused, unreserved spots are determined to not be for employee use.

Business Interest Expense Limitations Overview

- New section 163(j) applies to every business – regardless of its form – and disallows the deduction for business interest expense in excess the sum of (i) "Business Interest Income", (ii) 30% of the business's "adjusted taxable income" ("ATI"), and (iii) floor plan financing interest expense (generally auto dealers).
  - Business Interest Income is defined as any interest income "properly allocable to a trade or business" and does not include investment income. Similarly, business interest expense does not include investment interest expense.
  - ATI is defined as the taxable income of the taxpayer, excluding (i) items of income, gain, deduction, or loss not properly allocable to a trade or business, (ii) business interest expense or income, (iii) net operating loss deductions under section 172, (iv) deductions allowed under section 199A, and (v) only for tax years beginning before January 1, 2022, depreciation, amortization, or depletion deductions.
  - Any deductions disallowed can be carried forward indefinitely.
  - Limitation is determined at the entity level, with special rules for partnerships consolidated groups and controlled foreign corporations.
  - Exceptions for certain businesses including electing real property trades or businesses, regulated utilities, farming businesses etc.
  - Many items not traditionally considered interest are now interest for 163(j) purposes.

Overview of section 162(m) & Tax Reform implications

The 1993 Tax Act added section 162(m) to the Internal Revenue Code (herein after referred to as "the Code"). The proposed regulations were issued subsequently in the same year offering clarification and transition guidance. Aimed at limiting the deduction for compensation paid to certain top-paid executives, section 162(m) provided an explicit limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than $1 million per year.

Prior to passage of tax reform legislation formally known as An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 ("the Act") on December 20, 2017, the $1 million dollar limitation extended to all types of compensation, but with certain exceptions. Most notably, the $1 million dollar exception did not apply to certain performance-based compensation and commissions.

Effective for tax years beginning after December 31, 2017, the Act modified the Code to repeal the performance-based compensation and commission exceptions to the section 162(m) $1 million deduction limitation, expand the definition of an applicable employer and revise the definition of covered employee.

Companies should be considering the impact of new section 162(m) rules on deductibility of compensation payments as well as the impact to cumulative and future deferred tax asset related to covered employee compensation arrangements.

Pre-Act and Post-Act Considerations

US Tax Reform has changed the impact of 162(m) for the following:

Compensation

Pre-Act

The $1 million deduction limitation did not apply to certain performance-based compensation and commissions.

Post-Act*

The performance-based compensation and commission exceptions to the section 162(m) $1 million deduction limitation have been repealed. Only compensation up to $1 million is deductible.

Applicable Employer

Pre-Act

Applicable employers were only entities that were issuers of securities that are subject to the registration requirements of section 12 of the Securities and Exchange (SEC) Act of 1934.

Post-Act*

Expand the definition of an applicable employer to include entities that are issuers required to file reports under section 15(d) of the SEC Act.

*Effective for tax years beginning after December 31, 2017

Pre-Act and Post-Act Considerations

US Tax Reform has changed the impact of 162(m) for the following:

Covered Employees

Before tax reform legislation

- Covered employees included the principal executive officer and next three highest-paid employees, as disclosed in SEC filings, as of the last day of the employer's taxable year.
- The principal financial officer (i.e., chief financial officer) was excluded from the definition of a covered employee.
- Status as a covered employee was a discrete determination for each taxable year.

After tax reform legislation*

Revised the definition of a "covered employee" as follows:

- The principal financial officer is now a covered employee;
- An individual serving as principal executive officer or principal financial officer at any time during the taxable year is a covered employee;
- Covered employees include officers whose compensation is required to be disclosed to shareholders as one of three highest-paid officers (other than the principal executive officer or principal financial officer). This is not an operational change; and
- For a "publicly held corporation" that is not required to file a proxy statement, covered employees are determined as if these rules applied.
- An individual who is a covered employee for any taxable year beginning after December 31, 2016 will continue to be a covered employee for all subsequent taxable years, including years after termination of employment or death.

**Effective for tax years beginning after December 31, 2017*