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Client Alert: “Tax Reform” Changes Will Take Immediate Effect

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The Tax Cuts and Jobs Act (the “**Act**”) was signed into law on December 22. The Act brings about immediate, sweeping changes to the federal income tax laws, affecting businesses and business owners across all industries. Most provisions of the Act are effective for taxable years beginning after December 31, 2017. Certain provisions, however, are retroactive to September or November of 2017.

Highlights of the Act relating generally to U.S. businesses and business owners are described below. Given the extensive nature of the changes and complexities of the Act, the ultimate impact of tax reform on each taxpayer is highly individualized. In addition, many provisions of the Act have particular application to real estate businesses. (Look for an upcoming Vorys Client Alert next week discussing Act highlights with a focus on application to real estate businesses.)

Taxpayers are encouraged to discuss with their tax advisors the impact of the new tax reform law on their business structure and operations.

Federal Income Tax Rates

Flat Corporate Rate. Beginning in 2018, all C corporations will be subject to a 21% federal tax rate on net income, regardless of income level. This new rate is set to continue indefinitely.

Graduated Individual Rates. Beginning in 2018, the seven tax brackets applicable to individuals will shift in scope and the rates applicable to these brackets will be somewhat lower than current rates, with a 37% maximum rate (down from the current 39.6% maximum rate). Qualified dividends and capital gains will continue to be subject to tax at a maximum rate of 20%. These new graduated individual rates are set to expire after 2025.

20% Deduction for Qualified Business Income of Individuals

Beginning in 2018, an individual taxpayer generally may deduct 20% of his or her share of net income from a U.S. trade or business operated through a partnership, S corporation, sole proprietorship, or LLC treated as a partnership or disregarded entity for federal income tax purposes. For individuals with income above \$156,500 (\$315,000 for married filing jointly) the amount of this deduction is subject to possible limitation, based upon the amount of wages and capital expenditures of the trade or business. In addition, for “specified service trades or businesses,” this deduction begins to be phased out for individuals with income above \$156,000 (\$315,000 for married filing jointly) and is completely unavailable for individuals with income of at least \$207,500 (\$415,000 married filing jointly).

A “specified service trade or business” is a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such business is the reputation or skill of one or more of its employees (other than trades or businesses involving the performance of services in engineering or architecture).

The 20% deduction for qualified business income is set to expire after 2025.

Look for an upcoming Vorys Client Alert next week including a more detailed discussion of this deduction.

Business Interest Deduction Limitation

Beginning in 2018, the deduction for interest expense available to most businesses for a taxable year will be limited to 30% of the adjusted gross taxable income of the business for such year, computed without reduction for interest, taxes, depreciation, amortization or depletion. Beginning in 2022, this limit will be further reduced by taking into account depreciation, amortization and depletion (though not interest or taxes) in the computation of adjusted gross taxable income. Interest expense deductions that are disallowed as a result of the limitation described above could be carried forward indefinitely.

Certain small businesses are exempt from the limitation on deduction of business interest. A business is “small” if its average annual items of gross receipts for the immediately-preceding 3-year period is not greater than \$25,000,000. Additionally, certain real estate companies that use the alternative depreciation system may elect not to be subject to this limitation. Other special rules or exceptions may apply with respect to farming businesses, regulated public utilities and electric cooperatives and businesses that use floor plan financing arrangements. The business interest deduction limitation is set to continue indefinitely.

Modification of the Net Operating Loss Deduction

Currently, net operating losses (“**NOLs**”) generated by a business in a taxable year may be carried back 2 years and carried forward 20 years. NOLs generated in taxable years ending after December 31, 2017 generally may not be carried back, but may be carried forward indefinitely. In addition, the Act limits the available deduction for such NOLs to 80% of taxable income in the year of deduction (computed before the NOL deduction). Special rules apply to farming businesses and insurance companies. These changes are set to continue indefinitely.

Limitation on State and Local Tax Deduction for Individuals

Beginning in 2018, the Act generally limits an individual's ability to claim federal itemized deductions for state and local (and certain foreign) taxes. The Act provides that, for any taxable year, an individual may claim an itemized deduction of up to a maximum amount of \$10,000 for aggregate state and local personal property taxes, real property taxes, and income taxes (and certain foreign and sales taxes) paid or accrued during that year. The limit for a married individual filing separately is \$5,000 per year.

The limitation does not apply to state, local, or foreign property taxes, or to state or local sales taxes, in each case that are paid or accrued in carrying on a trade or business or for the production of income. Such property taxes and sales taxes generally are allowed as a deduction and will not be included in the \$10,000 aggregate limit. The limitation does, however, apply to state and local *income* taxes paid or accrued in carrying on a trade or business or for the production of income.

The limitation on state and local tax deduction is set to expire after 2025.

Temporary 100% Expensing of Certain Business Assets

The Act temporarily expands the "bonus depreciation" provisions to allow for full expensing of qualified property. Businesses generally will be able to expense 100% of the cost of qualified improvement property and other tangible, personal property used in the trade or business, which property is acquired and placed into service after September 27, 2017 and before January 1, 2023. The expensing allowance decreases by 20% per year after 2022, and is completely eliminated after 2026. Certain property with longer production periods (including transportation property and aircraft) may be eligible for an additional year of 100% expensing, which allowance then decreases by 20% per year after 2023, and is completely eliminated after 2027. Generally, used property acquired and placed in service after September 27, 2017 will be eligible for 100% expensing. In addition, property that was acquired (but not placed in service) prior to September 27, 2017 may be eligible for a reduced percentage of expensing, depending on when it is ultimately placed in service.

The Act excludes certain public utility property from the definition of qualified property. Businesses that use floor plan financing arrangements may be subject to different rules.

Expanded Section 179 Expensing

Beginning in 2018, the Act increases from \$500,000 to \$1,000,000 (subject to adjustment for inflation) the amount that certain businesses may immediately expense for the cost of "Section 179 property" placed in service during a taxable year. If the business places in service more than \$2,500,000 (subject to adjustment for inflation) of Section 179 property in a taxable year (up from \$2,000,000), then the amount available for immediate expensing is reduced by the amount by which the cost of such property exceeds \$2,500,000. The Act also expands the definition of "Section 179 property" to include tangible business assets as well as qualified improvement property and certain other improvements (specifically, roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems) made to nonresidential real property.

Like-Kind Exchanges

Beginning in 2018, Section 1031 like-kind exchanges of personal property no longer will be permitted. However, like-kind exchanges will remain available for domestic real estate.

Conclusion

The Act changes the federal income taxation of businesses in many material respects. Contact your Vorys attorney if you have any questions about the application of the Act to your business, or if you would like assistance in adapting your business to these changes.