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No Business Left Behind - New Tax Bill Ushers in Significant Changes for All Companies

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Long a priority of the Republican Party, the final tax cut bill includes significant simplification and lowering of the taxes paid by corporations. The bill eliminates the corporate Alternative Minimum Tax, creates a new tax rate for certain types of pass-through income and, most importantly, permanently lowers the corporate tax rate.

Effective for taxable years beginning on or after January 1, 2018, the tax rates for C corporations will be reduced from 35 to 21 percent. The top rate for other taxpayers, including owners of pass-through businesses, such as partnerships, LLCs and S corporations, will be reduced from 39.6 to 37 percent. However, the 37 percent top rate for income from a pass-through business may effectively be reduced in many cases to 29.6 percent through a new deduction under Section 199A of the Code of up to 20 percent of qualified business income. The Section 199A deduction may be limited for business owners at higher income levels in the case of many businesses providing professional services and in the case of other businesses which do not pay significant amounts of employee wages. The changes in the tax rates and the availability of the new Section 199A deduction may cause the present organizational structure of many businesses to no longer be optimal. In general, pass-through tax entities that intend to retain most profits for reinvestment in the business should consider converting to a C corporation to take advantage of the 21 percent tax rate. In addition, this may also provide the opportunity to make dividend distributions which may ultimately result in a lower effective tax rate notwithstanding two levels of taxation. Pass-through entities that intend to distribute most profits to the owners should likely not convert to C corporations and should focus on maximizing the Section 199A deduction to achieve an effective top tax rate of 29.6 percent. These are matters that will need to be closely analyzed.

Another significant change is to cap the net interest expense deduction of businesses at 30 percent of adjusted taxable income (taxable income before interest, depreciation, amortization and the Section 199A deduction). Businesses involved in real estate development, operation, rental and management may elect out of the limitation. Small businesses with average gross receipts of less than $25 million are generally exempt from this provision. Restrictions may apply to pass-through businesses to prevent an owner from organizing multiple small businesses entitled to exemption or from avoiding the limitation by incurring business interest expense at both the owner level and the entity level.

Other changes affecting many businesses include more generous expensing of capital expenditures, the elimination of net operating loss carrybacks, allowing net operating loss carryovers to offset no more than 80 percent of taxable income and limiting like-kind exchanges to real property.

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