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Tax Cuts and Jobs Act: Impact on Businesses

The Tax Cuts and Jobs Act, a $1.5 trillion tax cut package, was signed into law on December 22, 2017. The centerpiece of the legislation is a permanent reduction of the corporate income tax rate. The corporate rate change and some of the other major provisions that affect businesses and business income are summarized below. Provisions take effect in tax year 2018 unless otherwise stated.

Corporate tax rates

- Instead of the previous graduated corporate tax structure with four rate brackets (15%, 25%, 34%, and 35%), the new legislation establishes a single flat corporate rate of 21%.
- The Act reduces the dividends-received deduction (corporations are allowed a deduction for dividends received from other domestic corporations) from 70% to 50%. If the corporation owns 20% or more of the company paying the dividend, the percentage is now 65%, down from 80%.
- The Act permanently repeals the corporate alternative minimum tax (AMT).

Pass-through business income deduction

Individuals who receive business income from pass-through entities (e.g., sole proprietors, partners) generally report that business income on their individual income tax returns, paying tax at individual rates.

For tax years 2018 through 2025, a new deduction is available equal to 20% of qualified business income from partnerships, S corporations, and sole proprietorships.

For those with taxable incomes exceeding certain thresholds, the deduction may be limited or phased out altogether, depending on two broad factors:

- The deduction is generally limited to the greater of 50% of the W-2 wages reported by the business, or 25% of the W-2 wages plus 2.5% of the value of qualifying depreciable property held and used by the business to produce income.
- The deduction is not allowed for certain businesses that involve the performance of services in fields including health, law, accounting, actuarial science, performing arts, consulting, athletics, and financial services.

For those with taxable incomes not exceeding $157,500 ($315,000 if married filing jointly), neither of the two factors above will apply (i.e., the full deduction amount can be claimed). Those with taxable incomes between $157,500 and $207,500 (between $315,000 and $415,000 if married filing jointly) may be able to claim a partial deduction.

"Bonus" depreciation

The cost of tangible property used in a trade or business, or held for the production of income, generally must be recovered over time through annual depreciation deductions. For most qualified property acquired and placed in service before 2020, special rules allowed an up-front additional "bonus" amount to be deducted. For property placed in service in 2017, the additional first-year depreciation amount was 50% of the adjusted basis of the property (40% for property placed in service in 2018, 30% if placed in service in 2019).

The Act extends and expands first-year additional ("bonus") depreciation rules. Bonus depreciation is extended to cover qualified property placed in service before January 1, 2027. For qualified property that's both acquired and placed in service after September 27, 2017, 100% of the adjusted basis of the property can be deducted in the year the property is first placed in service. The first-year 100% bonus depreciation percentage amount is reduced by 20% each year starting in 2023 (i.e., the first-year bonus percentage amount will be 80% in 2023, 60% in 2024, 40% in 2025, and 20% in 2026) until bonus depreciation is eliminated altogether beginning in 2027.

For qualified property acquired before September 28, 2017, prior bonus depreciation limits apply — if placed in service in 2017, a 50% limit applies; the limit drops to 40% if the property is placed in service in 2018, and to 30% if placed in service in 2019.

Note that the timelines and percentages are slightly different for certain aircraft and property with longer production periods.

Internal Revenue Code (IRC) Section 179 expensing

Small businesses may elect under IRC Section 179 to expense the cost of qualified property, rather than recover such costs through depreciation deductions. The Tax Cuts and Jobs Act increases the maximum amount that can be expensed in 2018 from $520,000 to $1,000,000, and the threshold at which the maximum deduction begins to phase out from $2,070,000 to $2,500,000. Both the $1,000,000 and $2,500,000 amounts will be increased to reflect inflation in years after 2018. The new law also expands the range of property eligible for expensing.

Foreign income

Under pre-existing corporate tax rules, U.S. companies were taxed on worldwide profits, with a credit available for foreign taxes paid. If a U.S. corporation earned profit through a foreign subsidiary, however, no U.S. tax was typically due until the earnings were returned to the United States, generally in the form of dividends paid. This system contributed to some domestic corporations moving production overseas, and may have led some multinational companies to keep profits outside the United States.

The new law fundamentally changes the way multinational companies are taxed, making a shift from worldwide taxation of income to a more territorial approach. Under the new rules, qualifying dividends from foreign subsidiaries are effectively exempted from U.S. tax. This is accomplished by allowing domestic C corporations that own 10% or more of a foreign corporation to claim a 100% deduction for dividends received from that foreign corporation, to the extent the dividends are considered to represent foreign earnings.

The new law also forces corporations to pay U.S. tax on prior-year foreign earnings that have accumulated outside the United States in foreign subsidiaries, through a one-time "deemed repatriation" of the accumulated foreign earnings. U.S. shareholders owning at least 10% of a specified foreign corporation* may be subject to a one-time tax on their share of accumulated untaxed deferred foreign income; deferred income that represents cash will be taxed at an effective rate of 15.5%, other earnings at an effective rate of 8%; the resulting tax can be paid in installments. The tax applies for the foreign corporation's last tax year that begins before 2018. The one-time tax is also not limited to C corporations; it can apply to all U.S. shareholders, including individuals (special rules apply to S corporations and REITs). After paying the one-time deemed repatriation payment, foreign earnings can be brought back to the United States without paying any additional tax.

* Includes controlled foreign corporations (CFCs) and non-CFC foreign corporations (other than passive foreign investment companies, or PFICs) if there is at least one 10% shareholder that is a U.S. corporation.
