**SUPPLEMENT TO ACCOMPANY**

**CORPORATE, PARTNERSHIP, ESTATE AND GIFT TAXATION**

**2018 EDITION**

**Pratt and Kulsrud**

**Changes introduced by the**

**Tax Cuts and Jobs Act of 2017**

**Pratt-Kulsrud Tax Series**

**Van-Griner**

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**INTRODUCTION**

On December 22, 2017, President Trump signed into law the *Tax Cuts and Jobs Act* (the Act or TCJA) that represents the most comprehensive overhaul of the tax law in over 30 years. The Act extends to virtually every area of the law, impacting not only individuals but businesses as well. As discussed in this supplement, the Act eliminates or changes many rules that have long been a part of the tax landscape, and, at the same time, adds many new provisions.

This supplement updates the text for these revisions as well as other items of note since publication. The changes are reflected in the following pages and are referenced to the 2018 edition by chapter and page.

In order to comply with budget rules, Congress made most changes effective for tax years beginning after December 31, 2017 and before January 1, 2026. In effect, existing law is suspended until 2026. However, it is anticipated that the suspension is merely temporary and the changes ultimately will become permanent. For this reason, the supplement does not make the distinction and assumes the changes are permanent unless otherwise noted. Note that the highlights of the Act below includes changes relating to individual taxpayers that may not be covered in this textbook (see other books in this series, *Individual Taxation* or *Federal Taxation*).

Highlights of the *Tax Cuts and Jobs Act*

(P.L. 115-97, 12/22/2017)

* The Act reduces the tax rates for all taxpayers, both individuals and businesses.
* The new law retains seven marginal tax rates for individuals. However, these individual rates are reduced and the spreads of the tax brackets are wider.

**2017**: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%   
 **2018**: 10%, 12%, 22%, 24%, 32%, 35%, 37.0%

* The graduated rates for all C corporations are eliminated and replaced by a single flat rate of 21%, down from the top rate of 35%.
* To address the disparity between the rates for C corporations and flow-thru businesses (partnerships, S corporations, self-employed individuals and certain rental activities),   
  flow-throughs are entitled to a special deduction generally equal to 20% of their “qualified business income.”
* The tax rates for dividends and capital gains remain at 0%, 15% and 20%.
* The deduction for personal and dependent exemptions is eliminated. Trusts also lose their exemption deduction of $300 for a simple trust and $100 for a complex trust. Nevertheless, the rules for identifying dependents are retained to be used for other purposes of the law (e.g., child tax credit, head of household, surviving spouse).
* The child tax credit is doubled from $1,000 to $2,000 and up to $1,400 is refundable.
* The standard deduction (shown below) is increased substantially, reducing the number of taxpayers that will itemize deductions.

2018 2017  
Individuals $12,000 $ 6,350  
Joint returns 24,000 12,700  
Head of household 18,000 9,350

* The increases to the standard deduction for the elderly and blind are maintained.
* The phase-out for itemized deductions is eliminated.
* Under the revised kiddie tax rules, the child’s tax on unearned income (including dividend and long-term capital gains) is computed using the tax rates for estates and trusts rather than those of his or her parents.
* For divorces after 2018, alimony is no longer deductible and is not taxable to the recipient.
* The deduction for moving expenses is eliminated. Reimbursements for an employee’s moving expenses would be considered taxable income with no offsetting deduction.
* The deduction for qualified tuition and related expenses expired for tax years after 2017 and was not extended.
* The floor at which unreimbursed medical expenses are not deductible drops from 10% to 7.5% of AGI.
* The itemized deductions for real and personal property taxes as well as state and local income and sales taxes are now combined and limited to a maximum of $10,000. Up to $10,000 will be added back for alternative minimum tax purposes.
* Foreign real property taxes may not be deducted.
* The mortgage interest deduction continues for both a principal and a second residence but is limited to the interest on total mortgage loans not greater than $750,000 (down from $1,000,000, although the $1,000,000 amount continues for home mortgages obtained before December 15, 2017).
* The deduction for interest on home equity loans is eliminated. Interest on existing home equity loans was not grandfathered and is nondeductible.
* The charitable contribution deduction was retained and the limitation on the total deductible contributions was increased from 50% to 60% of adjusted gross income. Amounts paid to colleges and universities for athletic seating rights no longer qualify as a charitable contribution deduction.
* The Act eliminates the 50% deduction for the costs of entertainment directly related to or associated with business (e.g., tickets to a ballgame or other event). As under prior law, food or beverage expenses associated with operating a business, such as meals consumed by employees while traveling for business purposes are still deductible subject to the 50% disallowance rule.
* Under the new law, only 50% of the costs of food and beverages for employees at a corporate snack bar or an in-house cafeteria are deductible.
* The Act clarifies that employee achievement awards shall not include cash, cash equivalents gift cards or gift certificates (unless redeemable for tangible personal property from a limited array of pre-approved items by the employer) nor vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.
* Under the new law, employers may not deduct any expense incurred for providing transportation or any payment or reimbursement to an employee for commuting except as necessary for ensuring the safety of the employee.
* Individuals generally can no longer deduct casualty losses unless they occurred in a federally declared disaster area.
* Deductions for all expenses classified as miscellaneous itemized deductions including unreimbursed employee business expenses and such items as home office expenses, investment advisory expenses and tax preparation expenses are eliminated.
* The alternative minimum tax is maintained for individuals (with higher exemptions) but eliminated for C corporations.
* Under the amended bonus depreciation rules, most businesses can immediately expense 100% of the cost of qualified property. The new law eliminates the rule that bonus depreciation is available only if the “original use” of the property began with the taxpayer. So now both new and used property can be expensed.
* The amount of depreciable tangible personal property that can be expensed in the year of acquisition under § 179 is increased to $1,000,000 and begins its dollar for dollar phase-out at $2,500,000. The Act also extends the use of § 179 to certain building improvements.
* The annual depreciation limits on passenger automobiles are increased.
* Net operating loss (NOL) carryovers or carrybacks are deductible only to the extent of 80% of the taxpayer's taxable income. NOLs normally can only be carried forward and the carryover period is unlimited.
* The amount of net business losses of a sole proprietorship, partnership, or S corporation that can be deducted on an owner’s return is limited to $500,000 (joint return) or $250,000 (all other returns).
* Funds in a § 529 college savings account can now be used for elementary and high school expenses (e.g., home schooling, private or religious school tuition)
* The Act restricts the use of the like-kind exchange rules solely to exchanges of real property and not tangible personal property (e.g., vehicles and equipment). To the extent of any trade-in value, a taxable exchange would result. However, this increased basis (i.e., not just any boot paid, but the trade-in value of the now taxable exchange) could be offset by either § 179 expensing or bonus depreciation on the newly-acquired property.
* The deduction under § 199 related to domestic production and manufacturing activities is eliminated.
* The estate tax exemption is doubled and after appropriate inflation adjustments for 2018, is expected to be about $11,200,000 million (effectively is $22,400,000 for a married couple).
* The gift tax exclusion was increased under the normal inflation adjustment rules to $15,000.
* Proposed changes relating to the following items were not made and, therefore, the treatment remains the same as under prior law: child and dependent care credit; deduction for student loan interest; exclusion for employer provided education assistance and employer provided housing; educational credits (American Opportunity Tax Credit (the Hope Scholarship Credit) and the Lifetime Learning Credit); gain on the sale of personal residence, adoption exclusion and credit.

**Individual Tax Rate Schedules (2018 rates as revised by the TCJA)**

**2018 Single**

If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$ 0 $ 9,525 $ 0.00 10% $ 0  
 9,525 38,700 952.50 12% 9,525  
 38,700 82,500 4,453.50 22% 38,700  
 82,500 157,500 14,089.50 24% 82,500  
 157,500 200,000 32,089.50 32% 157,500  
 200,000 500,000 45,689.50 35% 200,000  
 500,000 150,689.50 37% 500,000

# **2018 Married Filing Jointly and Surviving Spouses**

If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$ 0 $ 19,050 $ 0.00 10% $ 0  
 19,050 77,400 1,905.00 12% 19,050  
 77,400 165,000 8,907.00 22% 77,400  
 165,000 315,000 28,179.00 24% 165,000  
 315,000 400,000 64,179.00 32% 315,000  
 400,000 600,000 91,379.00 35% 400,000  
 600,000 161,379.00 37% 600,000

# **2018 Head of Household**

If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$ 0 $ 13,600 $ 0.00 10% $ 0  
 13,600 51,800 1,360.00 12% 13,600  
 51,800 82,500 5,944.00 22% 51,800  
 82,500 157,500 12,698.00 24% 82,500  
 157,500 200,000 30,698.00 32% 157,500  
 200,000 500,000 44,298.00 35% 200,000  
 500,000 149,298.00 37% 500,000

# **2018 Married Filing Separately**

If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$ 0 $ 9,525 $ 0.00 10% $ 0  
 9,525 38,700 952.50 12% 9,525  
 38,700 82,500 4,453.50 22% 38,700  
 82,500 157,500 14,089.50 24% 82,500  
 157,500 200,000 32,089.50 32% 157,500  
 200,000 300,000 45,689.50 35% 200,000  
 300,000 80,689.50 37% 300,000

**2018 Estates and Trusts** If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$0 $ 2,550 $ 0.00 10% $ 0  
 2,550 9,150 225.00 24% 2,550  
 9,150 12,500 1,839.00 35% 9,150  
 12,500 3,011.50 37% 12,500

CHAPTER 1: INCOME TAXATION OF CORPORATIONS

**Page 1-4 Choice of Entity**

**Qualified Business Income Deduction**

As the previous discussion in the text explains, for tax purposes, there are two types of organizations: (1) C corporations that are treated as separate taxable entities and (2) pass-through entities (PTEs), including partnerships, S corporations, sole proprietorships (self-employed individuals) and owner-operated rental activities where the income flows through and is taxed to the owner(s). For the business owner, the obvious question is which form is better for tax purposes?

At first glance, it appears that C corporations would be the least preferable since their income is potentially taxed twice, first at the corporate level and again when it is distributed to an owner as a nondeductible dividend. Recognize, however, that this second tax can be avoided to the extent that the distribution from the corporation is characterized as a deductible salary (or the dividend is taxed at a 0% rate). In fact, if all of the corporation’s income were to be distributed as deductible salaries, the corporation would not pay any tax and the tax burden would be shifted to the individual. However, most business owners recognize that mere survival as well as long-term success, requires steady sustained growth. For this reason alone, they usually reinvest a large share of the entity’s profits in the business. In that case, the analysis becomes a bit different. If the owner’s objective is to maximize the amount that can be reinvested after-taxes, what form of business is best?

Under the Act, the taxable income of C corporations is taxed at a flat rate of 21 percent. In contrast, the income of pass-through entities potentially can be taxed at the highest individual rate of 37 percent. Assuming all of the income that the entity produces is taxed at the highest rate and is reinvested in the business, C corporations would appear to have a significant tax advantage. On the margin, the corporate rate is 16% lower (37% - 21% = 16%). While there is much more to the analysis, it appears that the tax playing field is significantly tilted toward C corporations.

When Congress reduced the corporate tax rate, it recognized the disparity in the rates between corporations and PTEs. As a result, it made a noble attempt to fix what is almost an insurmountable problem given the current structure of the U.S. tax laws. Generally, the Act introduces new rules that reduce the effective rate at which the income of PTEs is taxed. This is done operationally by allowing the owners of PTEs to claim a deduction equal to 20% of the net income that flows through or which is allocated to them. In a simple world, if the PTE produces $100 of income, only 80% or $80 is ultimately taxed to the owner. Unfortunately, as might be expected, it’s not that easy. Moreover, the new rules also try to prevent PTEs from recharacterizing wage income into favorably taxed business income.

As seen below, the calculation of the deduction is incredibly complex, full of never before heard of terms requiring lengthy definitions, as well as a handful of acronyms, limitations and more. Some of the complexity is directly attributable to Congress’ preference for capital-intensive businesses—those that earn by investing in machinery, equipment and other tangible assets—over service businesses. For this reason, the law provides benefits to those that can manufacture, build and produce products. Simply put, providing goods is better than providing services. This bias runs throughout § 199A. For this reason:

* The 20% deduction generally is not available where the PTE’s business primarily involves the performance of services (e.g., accountants, lawyers, doctors, financial advisors) but there are exceptions for small service businesses.
* The deduction is based on the PTE’s business income and not investment income; and
* The deduction is limited based upon how much the PTE pays in wages or invests in machinery, equipment, and other tangible property. But again, there are exceptions for small businesses.

The QBI deduction is neither a deduction for AGI nor an itemized deduction but rather a deduction from taxable income. It does not reduce the owner’s self-employment income or the income from the business reported on Schedule C, E or F. Note also that the owner need not be active in the business to qualify for the deduction.

The QBI deduction also includes 20% of qualified dividends from REITs (real estate investment trusts) and 20% of income from a publicly traded partnership income. These situations are not covered in this discussion.

**Qualified Business Income Deduction (§ 199A)**

**The Rule.** New § 199A generally allows owners of PTEs to claim a deduction equal to 20% of the owner’s qualified business income (QBI). QBI is normally the ordinary net income of PTE that is allocated or flows through to the owner from a qualified trade or business (QTB). In this regard, QBI includes rental income but does not include interest, dividends and capital gains or losses. Note that a single taxpayer could own one or more QTBs (e.g., interests in several partnerships).

The deductible amount for each QTB of the taxpayer is the *lesser* of (§ 199A(b)(2)):

1. 20% of QBI (qualified business income) or $xxx,xxx
2. The greater of (a) or (b)**\***(a) 50% of (total W-2 wages paid by the business)$ yyyy

(b) 25% of share W-2 of wages $x,xxx  
 + 2.5% of share of unadjusted basis of tangible depreciable property xxx

Total $x,xxx  
 Greater of (a) or (b) $ yyyy

\* Note that the items below, 2(a) and 2(b), serve as potential limitations of the basic 20% deduction. For purposes of discussion, item (a) will be referred to as the wage limitation and item (b) as the property limitation (no doubt the regulations will create something more appropriate). Both of these limitations contained in item 2 above are ignored if the owner’s taxable income does not exceed $315,000 for joint returns and $157,500 for all other returns (§ 199A(b)(3)).

As seen above, § 199A starts by granting a PTE owner a deduction equal to 20% of the net income that flows through to the owner (20% of QBI). However, that tentative deduction may be reduced by the limitations based on the amount of W-2 wages paid by the PTE and the amount the PTE has invested in tangible depreciable property (e.g., plant, property and equipment but not land). Observe that if the company’s payroll and investment in fixed assets are substantial enough, these potential limitations would not be applicable.

**Example 1.** T is single. He owns 30% of the stock in an S corporation that produced ordinary income of $3,000,000. His share is $900,000. His tentative QBI deduction is $180,000 (20% x $900,000). The next step is to consider the limitations. His total taxable income from all sources exceed the $157,500 safe harbor threshold for single taxpayers so the potential limitations apply. The S corporation paid total W-2 wages of $1,000,000 and the total unadjusted basis of property held by the corporation is $100,000. T is allocated 30% of these items. What is T’s QBI deduction?

As shown below, T’s QBI deduction is $150,000. It is the lesser of: (1) the tentative QBI deduction of $180,000 (20% x his share of QBI of $900,000) or (2) the greater of the wage limitation, $150,000 (50% x wages of $300,000), or the limitation related to wages and property $75,750 [(25% x wages of $300,000 = $75,000) + (2.5% x unadjusted basis of property of $30,000 = $750). Note that the deduction is *not* the lesser of the three quantities.

Total T’s share (30%) Total  
Lesser of (1) or (2):  
  
1. QBI (20%) $3,000,000 $900,000 $180,000

2. Greater of

(a) W-2 wages $1,000,000 $300,000 x 50% $150,000 $150,000  
  
(b) W-2 wages $1,000,000 300,000 x 25% $75,000  
 Property $100,000 30,000 x 2.5% 750  
 Total $75,750

As noted above, as long as the owner’s taxable income from all sources is less than certain thresholds ($315,000 for joint returns and $157,500 for all others), the wage and property limitations are ignored completely (i.e., 2(a) or (b) above). In such case, the deduction is simply 20% of QBI. However, if total taxable income from all sources exceeds these thresholds, the limitation is no longer zero. Instead, the limitation phases in over $100,000 of taxable income for joint returns and $50,000 for others. Thus if taxable income exceeds the $315,000 threshold by $100,000, 100% ($100,000 excess/$100,000), the full limitation applies. If taxable income is less, the calculation is more complex as illustrated below (see § 199A(b)(3)).

**Example 2.** H and W are married. H owns a 20% interest in an S corporation. His share of the S corporation’s income is $300,000. His allocable share of W-2 wages paid by the S corporation is $40,000 and his share of the unadjusted basis of qualified property held by the S corporation is $0. Assume the couple’s total taxable income is $375,000 ($300,000 of from the S Corporation). Since H’s income from an S corporation is $300,000 his tentative QBI deduction is $60,000 (20% x $300,000) before any possible reductions.

His tentative wage limitation is $20,000 (50% x $40,000 wages), causing a potential drop in his QBI deduction from $60,000 to $20,000 or a $40,000 decrease. However, had the couple’s taxable income been $315,000 or less, none of the $40,000 decrease would have occurred and QBI deduction would have been $60,000. Instead of applying the decrease in one fell swoop and to avoid a cliff effect, this $40,000 *decrease* is spread over $100,000 or 40% for every dollar over $315,000. Since their taxable income is $375,000 or $60,000 more than the $315,000 threshold there is a $24,000 decrease (40% x $60,000) and the QBI deduction is $36,000.

1. QBI deduction before limitations ($300,000 x 20%) $60,000  
2. Greater of (a) or (b) (a) Normal wage limit = Wages x 50% = $40,000 x 50% = $20,000   
 (b) Property limitation =   
 Wages x 25% = $40,000 x 25% $10,000  
 + 2.5% x $0 unadjusted basis of property 0  
 Property limitation $10,000  
   
QBI deduction if full wage limitation above applied (greater of (a) or (b)) $20,000   
  
Tentative QBI deduction $60,000  
-Excess amount\* (potential decrease in QBI deduction = $60,000 - $20,000 = $40,000)   
-Ignore both limitations if taxable income < $315,000 but taxable income is $375,000  
-Taxable income in excess of threshold ($375,000 - $315,000 = $60,000)   
-Phase in of limitation range $100,000  
-Percentage disallowed 60% ($60,000/$100,000) of $40,000 benefit = $24,000 (24,000)  
QBI deduction $36,000

\*Name of defined quantity per § 199A(b)(3)(ii)

**Qualified Business and Specified Service Trade or Businesses (§ 199A(d)).**  The 20% deduction is only allowed for a qualified trade or business (QTB). A QTB means any trade or business other than that of being an employee (generally employees are considered in the business of being an employee) and a “specified service trade or business.” The specified service businesses that do qualify include any business involving the performance of services in the following fields (generally § 1202(e)(3)(A)

* Health
* Law
* Accounting
* Consulting
* Financial services, brokerage services, investing, investment management or trading or dealing in securities
* Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees,

However, a business that involves the performance of engineering or architectural services is blessed and is considered a QTB.

Most importantly for small businesses, under §199A(d)(3) the exclusion of specified service businesses does not apply if the business’ taxable income is less than the safe harbor thresholds mentioned above: taxable income less that $315,000 for joint filers ($100,000 phase-in to $415,000) and $157,500 ($50,000 phase-in to $207,500) for all other taxpayers. In other words, if a service business has taxable income that does not exceed these thresholds, it can claim the QBI deduction.

Note also that the QBI deduction is based only on the net business income of the PTE that flows through to the owner; it does not apply to any amount paid by the PTE to the taxpayer in respect of any services rendered by the owner to the PTE (e.g., salaries or guaranteed payments to partners).

**Example 3.** B, a CPA, is partner in a regional accounting firm. She is married, and the couple has taxable income of $600,000. Her distributive share of the income from the accounting firm is $500,000. Her allocable share of the W-2 wages of the law firm is $100,000, and her allocable share of the unadjusted basis of the assets of the business is $20,000. B is not entitled to a QBI deduction, because a law firm is a specified service business and B's personal taxable income exceeds the $415,000 safe harbor, meaning she is completely phased-out of any possible deduction.

**Example 4.** Same as above, except B is a partner of a local accounting firm and has taxable income is $300,000. Her share of the income of the accounting is $200,000, her share of the W-2 wages is $60,000, and her share of the assets of the partnership is $40,000. Even though B makes her living providing services, she is blessed. She may take the QBI deduction because her taxable income is below $315,000, the start of the phase-in threshold. As a result, B can take a deduction of 20% of $200,000, or $40,000 and is taxed on $160,000 rather than $200,000. Note also that the 50% of wages limitation and the property limitation of 25% of wages + 2.5% of unadjusted basis do not apply since B’s taxable income is less that $315,000 for joint filers.

If the specified service business has taxable income over the threshold levels, phase-in rules similar to the ones discussed above apply. Remember the key number here is the PTE’s taxable income and not the owner’s taxable income

**Property Limitation.** For purposes of the 2.5% property limitation, the computation uses the unadjusted basis, meaning the asset’s original cost before any depreciation. In addition, only “qualified property” is included. To be considered qualified under § 199A(b)(6) and included in the computation, the property

1. Must be tangible depreciable property subject to depreciation.
2. Must be owned at the end of the year.
3. Must be used at any point of the year in the production QBI.
4. Must be held within its depreciable period, which begins when the asset is placed in service and ends at the later of 10 years or the last day of the last full year in the asset’s regular (not ADS) depreciation period. For example, if the taxpayer purchased 5-year property, its depreciable period would occur in year 10.

For an excellent discussion of § 199A see the articles in *Forbes* by Tony Nitti <https://www.forbes.com/sites/anthonynitti/2017/12/26/tax-geek-tuesday-making-sense-of-the-new-20-qualified-business-income-deduction/#c67dee044fda>

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**Exhibit 1-2.** For individual taxpayers, the Act eliminates the deduction for personal and dependency exemptions and substantially increases the standard deduction amounts.

**Deductions and Credits**

**Note: Several of the following topics are not specifically discussed in the text but are relevant concerns in computing a business’ taxable income. They generally apply to all businesses and not just C corporations.**

**Reasonable Compensation for Highly Compensated Employees**. Although not discussed in the text, under current law, a deduction for compensation paid or accrued with respect to a “covered employee” of a publicly traded corporation is limited to no more than $1 million per year. However, current law contained exceptions for: (1) commissions; (2) performance-based remuneration, including stock options; (3) payments to a tax-qualified retirement plan; and (4) amounts that are excludible from the executive’s gross income.

While it may pay to be the boss, apparently Congress wants no share in the cost. Under the new law, the $1,000,000 cap is retained but the exceptions for commissions and performance-based compensation are repealed. Therefore, under the new law, Apple would not have been able to deduct most of CEO Tim Cook’s 2016 salary of about $10 million (excluding stock awards). In addition, the definition of “covered employee” is expanded to include the principal executive officer, the principal financial officer (anyone who holds these positions at any time during the year), and the three other highest-paid officers. If an individual is a “covered employee” with respect to a corporation for a tax year beginning after Dec. 31, 2016, the individual remains a covered employee for all future years. Finally, some suggest that the revised definition of publicly held corporation may extend to large private C or S corporations (that are not publicly held).

According to some, there is a bright side to the change. Even though the excess compensation will no longer be deductible, such employers will no longer need to comply with the strict rules that were necessary to maintain qualified performance-based compensation arrangements.

**Limited Expensing.** For tax years beginning after 2017, the maximum amount that can be expensed under § 179 is increased to $1,000,000. However, this amount begins to phase-out once $2,500,000 of qualifying assets are placed in service. In addition, the definition of eligible property has been expanded. Section 179 makes the following types of building improvements eligible for the immediate write-off:

* Roofs
* Heating, ventilation, and air-conditioning property
* Fire protection and alarm systems; security systems

**Bonus Depreciation.** The Act modifies bonus depreciation. Taxpayers will be able to immediately expense 100% of the cost of qualified property acquired and placed in service after Sept. 27, 2017. This is up from the 50% allowed under prior law. In addition, the original use requirement no longer applies (§ 162(k)(2)(A)(ii) and (E)(ii)). However, this deduction is not available for any property used in a real property trade or business (e.g., a rental activity and real property businesses to be identified; see House Report on p. 187 in Conference Committee Report). Nevertheless, § 179, as noted above now allows immediate expensing for assets “used in connection with lodging.”

**Qualified Property.** The new law modifies the definition of qualified property that is eligible for bonus depreciation (see § 168(k)(2)(A)). Obviously, the definition is significant since it determines whether a business is allowed to immediately expense an asset or depreciate it over some longer life. Below are the changes.

* Qualified improvement property is removed from the list (see revised rules above)
* Qualified film, television, and live theatric productions are now eligible
* Businesses that furnish or sell various types of energy are not eligible (e.g. utility companies that provide electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline)
* Businesses with floor-plan financing (e.g., auto dealers) cannot use if the floor-plan financing interest is deducted in full.

**Section 280F Depreciation Limits for Autos.**  The Act amends § 280F significantly increases the annual depreciation limits on passenger autos. The new limits are:

First year of service . . . . . . . . . $10,000 (+ $8,000 with bonus depreciation for total $18,000)

Second year of service . . . . . . . . 16,000

Third year of service . . . . . . . . . 9,600

Thereafter . . . . . . . . . . . . . . . . . . 5,760

**Nontaxable Exchanges.** Under the new law, the nonrecognition treatment for like kind exchanges is allowed solely for real property. Tangible personal property such as cars (personal vehicles as well as those of rental car companies), trucks, airplanes, machinery, construction equipment, art, currency, and coins are no longer eligible for like kind exchange treatment.

For business taxpayers that purchase a new car or truck and trade in their old one, their trade-in would be a taxable exchange. Taxpayers would be treated as if they sold their car for the amount of the trade-in value. For businesses, any gain would be taxable (probably § 1231 gain except to the depreciation recapture under § 1245) and any loss normally would be considered a deductible ordinary loss (§ 1231 loss). For businesses, any increase in basis (i.e., notjust any boot paid, but the trade-in value of the now taxable exchange) could be offset by either Sec. 179 or bonus depreciation on the newly-acquired property.

**Exceptions to Inventory Requirement.** Another important issue related to corporations and all businesses concerns the accounting for inventories. In a step toward simplification, the Act generally exempts taxpayers whose average annual gross receipts are less than $25 million from the requirement to keep inventories. Instead, they must use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies (as discussed in the text), or (2) conforms to the taxpayer's financial accounting treatment of inventories.

**UNICAP**. The Act expands the exception for small taxpayers from the UNICAP rules. Under the new rules, for any taxpayer (other than certain tax shelters) whose average annual gross receipts are less than $25 million, the UNICAP rules do not apply for that tax year.

**Qualified Production Activities Deduction.** The Act eliminates the qualified production activities deduction and § 199.

**Limitation on Deduction of Interest of Businesses.**  While the new tax law might be characterized as pro business, not everything is roses. One of the new unfavorable rules is a limitation on the deduction of interest expense. However, the limitation affects only businesses with average annual gross receipts that exceed $25 million. It is also important to note that this limitation applies not only to corporations but also to all types of businesses, regardless of form.

The limitation may have been sparked by Congress’ concerned with the growth in the amount of debt issued by businesses. For example, large corporations have borrowed heavily to buy back their own stock and have been able to deduct the interest expense. According to estimates, corporations bought back roughly $250 billion of stock in the first half of 2017 and many of these buybacks were done with borrowed money. Congress has also worried about the increase in leveraged buyouts that create high levels of debt on which the interest is deductible.

Regardless of the reason, Congress acted. Under revised § 163(j), a deduction generally is denied for net interest expense (interest expense in excess of interest income) that exceeds 30 percent of the business’ taxable income (technically, 30% of adjusted taxable income or ATI). Any interest amounts disallowed are carried forward to the succeeding five tax years.

From 2018 through 2021, the computation of ATI should approximately reflect a business’ earnings before interest, taxes, depreciation, and amortization (EBITDA). Thereafter, the definition of ATI changes to approximate earnings before interest and taxes (EBIT) because the deductions for depreciation, interest and amortization will not be excluded from ATI.

The limitations do not apply in several situations.

* Real property trades or businesses can avoid the interest expense limitation if they elect to use ADS to depreciate “applicable real property” used in the business.
* Farming businesses can escape the limitation if they choose to use ADS to depreciate any property used in the farming business with a recovery period of 10 years or more.
* Interest related to “floor plan financing” is exempt (i.e., financing for the acquisition of motor vehicles including RVs, boats or farm machinery for sale or lease and secured by such inventory).

**Amounts Paid For Sexual Harassment Subject to Non-Disclosure Agreement.** Recently, the news has been filled with stories about sexual abuse claims against powerful actors, journalists politicians and executives (e.g., [Hollywood](http://www.chicagotribune.com/topic/south-florida/hollywood-SFL00012-topic.html) mogul [Harvey Weinstein](http://www.chicagotribune.com/topic/entertainment/movies/harvey-weinstein-PECLB005319-topic.html), former Fox News host Bill O’Reilly, Congressman Al Franken). These stories often mention payments—hush money—that either the perpetrators or their employers made to silence the victims who accused them of misconduct. These settlements normally require alleged victims to sign a nondisclosure agreement — essentially a pledge of secrecy — in exchange for a cash payment. In one report, Bill O’Reilly was said to have paid $32 million of hush money in a sexual harassment settlement.

Apparently, these payments are sufficiently related to the company’s or celebrity’s business that they are deductible as ordinary and necessary business expenses. However, the new law eliminates this possibility. Under the Act, new § 162(q)(2) provides that no deduction is allowed for any settlement or payment related to sexual harassment or sexual abuse.

Note that this is one of several situations where what otherwise might be considered a business expense is not deductible. Other “business” expenses that are specifically disallowed include any illegal bribe, illegal kickback, or other illegal payment; certain lobbying and political expenses; any fine or similar penalty paid to a government for the violation of any law; and two-thirds of treble damage payments under the antitrust laws.

**Local Lobbying Expenses.** Section 162(e) currently allows a deduction for lobbying expenses only if they are incurred for the purpose of influencing legislation at the local level. But that all came to a halt with the enactment of the new law. Under the Act, the deduction for local lobbying expenses (including the lobbying of Indian tribal governments) is eliminated.

**Business Meals and Entertainment.** The Act took dead aim at the deduction for business meals and entertainment expenses. Entertainment took a direct hit while, for the most part, 50% of the meals survived.

As discussed in the text, under prior law, entertainment expenses could be deducted only if they were “*directly related*” or *“associated with*” the taxpayer’s business. That generally meant that a deduction (think tickets to a game or a play) was allowed as long as business was discussed before, during or after the entertainment activity.

The new law no longer cares whether business was discussed before, after or during the ball game, in the golf cart or at dinner. The Act, specifically revised § 274(a), simply says no deduction shall be allowed for any “activity” which is of a “type generally considered to constitute entertainment, amusement, or recreation.” With the slash of a pen, Congress put an end to the deduction for the costs of tickets to sporting events, Broadway plays, and the like.

Under prior law, a deduction also was allowed for membership dues to clubs but only if the taxpayer could establish that the facility was used primarily for the furtherance of the taxpayer's trade or business. As a practical matter, that did not prove difficult. For years, these clubs, with their deep red carpets, oak-paneled rooms and portraits of board members dating to 19th century, were a place where business was discussed and deals were sealed. Membership was required and the dues were deductible. Despite their apparent necessity, the Act eliminated the deduction.

However, as under prior law, food or beverage expenses associated with operating a business, such as meals consumed by employees while traveling for business purposes are still deductible subject to the 50% disallowance rule. “Free food” that many companies provide their workers—coffee and donuts, the snack bar or in-house company cafeteria—is still tax-free to employees but the employer deduction is now restricted to 50% of the cost. In addition, as noted on page 8-40 of the text, § 274(e) provides that the restrictions on entertainment expenses do not apply to a number of “innocent” situations. To summarize:

|  |  |  |
| --- | --- | --- |
| Type | 2017 Expenses (Old Rules) | 2018 Expenses (New Rules) |
| Office holiday parties, golf outings, annual picnic, primarily for employees | 100% deductible | 100% deductible |
| Entertaining clients | 50% deductible | Meals – 50% deductible |
| Event tickets, 50% deductible | No deduction for entertainment |
| Tickets to qualified charitable events |
| Employee travel meals | 50% deductible | 50% deductible |
| Meals provided for the convenience of the employer | 100% deductible if excludible from employee’s gross income as de minimis fringe; otherwise 50% deductible | 50% deductible |
| Entertainment and meals for employees included in W-2 | 100% deductible | 100% deductible |

**Employer Credit for Paid Family and Medical Leave**. The federal Family and Medical Leave Act (FMLA) guarantees employees up to 12 weeks of job-protected leave annually. Under the law, employees can leave work without fear of losing their jobs if the leave is required to care for a new baby or ill family member, or when they themselves are unable to work because of a serious health condition. The law does not require employers to pay the employee while on leave. At present, the law applies only to companies with 50 or more employees. The Act aims to encourage more employers to create such programs as well as offer paid leave by providing a credit for wages paid during the employee’s absence.

New § 45S allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid if certain criteria are met.

* The wages must be paid to qualifying employees.
* Wages are to be paid during any period in which such employees are on family and medical leave.
* Wages qualify as long as the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.
* The maximum family leave to be taken into account for a taxable year is 12 weeks.

A “qualifying employee” is any employee who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.

Employers can claim the credit only if they have a policy providing a minimum of two weeks of paid leave for family and medical leave per year for all qualifying full-time employees and provide a commensurate amount of leave for part time employees on a pro-rata basis.

The credit is for wages paid after Dec. 31, 2017, but *not* beginning after Dec. 31, 2019,

**Page 1-8**

**Corporate Dividends Received Deduction.** The Act reduces the dividends received deduction as follows:

Dividends Received Deduction

Stock Ownership Previous law **New law**

< 20% 70% 65%  
 > 20% & < 80% 80% 50%  
 > 80% 100% 100%

**Page 1-15**

**Net Operating Losses.** The Act makes several changes to the use of an NOL. Beginning in 2018:

* The 2-year carryback period (except for farming businesses) is eliminated. Therefore, NOLs can only be carried forward.
* The 20-year carryover period is eliminated. NOLs are carried forward indefinitely.
* The NOL deduction is limited to 80% of taxable income, determined without regard to the NOL deduction itself.  However, NOLs existing prior to 2018 are not subject to the 80% limit.

**Page 1-16**

**Payment Date for Contributions.** Consistent with the revised due date of corporate returns, the contribution must be paid by 15th day of fourth month following the close of the taxable year or April 15 for calendar year corporations.

**Example 15.**  Correction to **Note**: had the donation been paid after *April 15*, the contribution deduction would not be allowed until 2018.

**Page 1-22**

**Corporate Tax Rates.** Under the new law, the tax rates for corporations have been reduced from a top rate of 35% to a single rate of 21 percent.

**Personal Service Corporation Tax Rates.** Historically, personal service corporations used the highest corporate tax in computing their tax liability (previously 35 percent). Under the new law, that rate becomes 21 percent. As a result, whether a corporation is a PSC becomes less significant.

**Page 1-24**

**Controlled Groups.** Under the new law, there is only a single tax rate of 21 percent. For this reason, much of the tax planning to avoid being treated as a controlled group to take advantage of the lower tax rates is eliminated. However, the controlled group rules are used by other sections of the Code so they remain relevant.

**Page 1-29 through 1-33**

**Alternative Minimum Tax (AMT).** In a move welcome by most everyone, the Act repeals the AMT for corporations. The new law continues to allow the prior year minimum tax credit to offset the taxpayer’s regular tax liability for any tax year. For tax years beginning after 2017 and before 2022, the prior year minimum tax credit is refundable in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the credit for the tax year over the amount of the credit allowable for the year against regular tax.

**Page 1-33**

**Accounting Methods: Cash Method.** The new law substantially increases the number of taxpayers eligible to use the cash method of accounting. Beginning in 2018, the cash method may be used by all taxpayers whose average annual gross receipts do not exceed $25,000,000—up from $5,000,000 (adjusted annually for inflation). In addition, prior law required corporations to meet the gross receipts test for all prior years. Under the Act, businesses need only meet the test for the three-year testing period that precedes the year of change and not all prior years.

**Accounting for Long Term Contracts.** Effective for contracts entered into after December 31, 2017, taxpayers with average gross receipts of less than $25 million (indexed for inflation) for the prior three taxable years are exempt from the requirement to use the percentage-of-completion accounting method for long-term construction contracts to be completed within two years, regardless of entity structure. Taxpayers that meet such exception would be permitted to use the completed-contract method (or any other permissible exempt contract method).

**Prepaid Service Income and Advance Payments.**  The Act generally codifies the treatment of advance payments prescribed by Rev. Proc. 2004-34. As a result, taxpayers that use the accrual method and actually receive an advance payment have two options: report the entire payment in the year received; or report for the first year the amount that it reports for financial accounting purposes and report the balance of the payment in the following year.

For accrual basis taxpayers, revised § 451(b) limits the possibilities for deferral with a global approach. Under the new rule, accrual basis taxpayers must recognize income no later than the tax year in which the income is taken into account on (1) an applicable financial statement (AFS) or (2) another financial statement to be specified by the IRS. For this purpose, an AFS is generally a financial statement which has been audited and is certified as being prepared in accordance with generally accepted accounting principles (§ 451(b)(3)). Note that the rule does not apply to a taxpayer (e.g., small businesses) that does not have a financial statement which meets the criteria set forth in § 451.

CHAPTER 2: CORPORATE FORMATION AND CAPITAL STRUCTURE

**Page 2-24**

**Nonshareholder Contributions to Capital.**

Under the new law, § 118 is effectively repealed. All contributions to capital by a non-owner (e.g., governmental entity or civic group) would be taxable. Moreover, it would not matter whether these contributions were made to a corporate or noncorporate entity (e.g., partnerships, sole proprietorships). Commentary on this change suggests that this may have a significant impact on certain state and local incentives such as cash grants, no-cost land, equipment, infrastructure improvements or reimbursements and similar transfers. For example, Connecticut's “First Five Plus Program” offers grants to projects that are expected to create at least 200 new jobs and require an investment of $25 million. Since 2012, total grants under this program have ranged between $8.5 to $48 million to various businesses, including manufacturing, media, and financial service companies. Under the new legislation, grants under the First Five Plus Program may give rise to taxable income. That said, from the corporation’s perspective, this may be a small cost to receiving what may be a huge benefit.

CHAPTER 6: PENALTIES ON CORPORATE ACCUMULATIONS

**Page 6-1**

By substantially reducing the corporate tax rate (35% to 21%), the new law makes the corporate form more attractive than ever. By way of comparison, the top corporate rate is now 21% while the top individual rate is 37%, 16 percentage points higher! Although the qualified business deduction tries to level the playing field, it may be insufficient. For this reason, more businesses may think that using a C corporation is more beneficial than a pass-through entity. But before they leap, they need to be aware of the potential obstacles, specifically, the accumulated earnings tax and the personal holding company tax.

For many, many years there has been little incentive for small, closely held businesses to become a C corporation since individual rates usually were lower than corporate rates. For this reason (and the potential for double taxation), the vast majority of small businesses became S corporations or partnerships where the income would flow through to be taxed only once at the lower individual rates. However, under the new law, this is not necessarily a foregone conclusion.

Business owners now may want to become a C corporation. By so doing, they could have their business income taxed at the lower rate and accumulate their earnings, distributing them only when necessary. By distributing the earnings in some type of deductible form such as salaries, double taxation would be avoided. Moreover, the earnings on the reinvested capital could be taxed at the lower corporate rates and, arguably, accumulate more quickly. However, this plan does not come without risks. Since the inception of the tax law, Congress has given the government two weapons to fight taxpayers who want to use C corporations to shield themselves from individual tax rates. These weapons, the accumulated earnings tax and personal holding company tax, may now have new life under the new tax law. Taxpayers thinking about abandoning their S corporation or partnership need to be aware of the two penalty taxes discussed in this chapter.

See pages 6-2 and 6-15 for a complete discussion of the typical schemes that these two penalty taxes originally were designed to prevent.

**Page 6-10**

**Accumulated Earnings Tax Rate.** The accumulated earnings tax rate remains at 20%.

**Page 6-10**

**Personal Holding Company Tax Rate.** The personal holding company tax rate remains at 20%.

CHAPTER 9: TAXATION OF PARTNERSHIPS AND PARTNERS

**Page 9-35 Qualified Business Income Deduction.** No doubt, one of the biggest changes in the tax law was the reduction of the corporate tax rate from 35 percent to a flat 21 percent. To address the disparity in the tax rates between C corporations and pass-through entities, Congress created the qualified business income deduction. In short, owners of a pass-through entity (partnership, S corporation, sole proprietorship and certain owner-operated rental activities) are entitled to a deduction equal to 20% of the net business income that passes through to them. For a complete discussion of this deduction, see Chapter 1, page 4 of this supplement.

**Page 9-35**

**New Limitation on Excess Business Losses.** The Act creates an additional limitation on the deduction for so-called excess business losses (§ 461(l)). The effect is to limit the amount of net business losses (e.g., losses from a sole proprietorship, S corporation or partnership) that active owners—in contrast to passive owners—can deduct. The new provision creates one more hurdle that owners must clear before a loss is deductible. The gauntlet of limitations includes:

* Basis limitation (i.e., adjusted basis in partnership interest or S corporation stock)
* At-risk limitations
* Passive loss limitations
* Excess business loss limitations

According to the new excess business loss rule, the maximum loss allowed is $500,000 for joint returns and $250,000 for others. The loss in excess of the allowed amount (the excess loss) becomes part of the taxpayer’s NOL and would be carried forward indefinitely under the Act.

An excess business loss for the year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer, over the sum of aggregate gross income or gain of the taxpayer from those trades or business plus the threshold amount ($500,000 or $250,000). The $500,000 and $250,000 are adjusted annually for inflation. The computation is shown below.

Business losses  
 (Business income + $250,000/$500,000)  
 Excess business losses (to NOL)

The excess business loss rules are not as oppressive as the passive activity loss rules. Losses from passive activities can be used only to offset income from other passive activities. Unused losses are carried forward until the taxpayer has passive income or the taxpayer sells the investment or he or she dies, which allows the taxpayer to use any suspended loss. In contrast, the excess business loss rules for active businesses allow what some would believe is a reasonable loss amount ($250,000 or $500,000), and the excess is an NOL carryover, which is more useful and valuable than a suspended passive loss. Note that the excess business loss rules are applied after the passive loss rules.

**Example.**  Last year, Sam Callum, single, took a sabbatical leave from his position as a professor of computer science to develop a new technology to replace conventional passwords. At a recent IT conference, he met a potential investor in his project, Maggie Baker. Maggie is married and she and her husband have done well, together earning more than $700,000 a year from their technology jobs. Maggie and her husband believed that Sam had a good idea and decided to join forces. To this end, Sam and Maggie formed a partnership. Unfortunately, the partnership, like many start-ups, did not do as well as expected. In the first year of operations, 2018, it suffered a net loss of $800,000. Sam and Maggie each reported their respective shares of the loss, $400,000, on their 2018 individual tax returns (Schedule E).

The excess business loss rule limits the amount of loss that Sam can use to offset his other income to $250,000. The remaining loss of $150,000 ($400,000 - $250,000 threshold for single taxpayers) is considered an excess business loss and becomes an NOL. It would be combined with any of the $250,000 loss that Sam might not able to use for 2018. Under prior law, Sam could have carried the NOL back to offset his professorial salary. However, under the new law, the NOL must be carried forward, most likely to years where Sam may have little, if any, income. Consequently, he obtains little immediate benefit from the operating loss.

The story for Maggie has a much better ending. The excess business loss rule does not apply to her since her share of the loss, $400,000, is less than the $500,000 threshold for joint returns. She can use the entire loss to offset the income of her and her husband.

CHAPTER 11: S CORPORATIONS

**Page 11-21. Qualified Production Activities Deduction.** This deduction granted by § 199 was repealed for all taxpayers.

**Page 11-22. Qualified Business Income Deduction.** As mentioned in Chapter 9 of this supplement relating to partnerships (page 9-35), one of the most dramatic changes made by the Act was the reduction of the corporate tax rate from 35 percent to a flat 21 percent. To address the disparity in the tax rates between C corporations and pass-through entities, Congress created the qualified business income deduction. In short, owners of a pass-through entity (partnership, S corporation, sole proprietorship and certain owner-operated rental activities) are entitled to a deduction equal to 20% of the net business income that passes through to them. For a complete discussion of this deduction, see Chapter 1, page 4 of this supplement.

**Page 11-33. New Limitation on Excess Business Losses.** As mentioned in Chapter 9 of this supplement relating to partnerships (page 9-35 of this supplement), the Act creates an additional limitation on the deduction of so-called excess business losses (§ 461(l)). The effect is to limit the amount of net business losses (e.g., losses from a sole proprietorship, S corporation or partnership) that can be deducted from an active—in contrast to passive—owner’s return. This is yet another barrier partners or S shareholders must navigate before they can deduct any losses that flow through. See a complete discussion for partnerships on page 9-35 of this supplement.

CHAPTER 13: INTERNATIONAL TAXATION

**Page 13-1**

Perhaps the most controversial changes found in the Act involve its international tax provisions. As a general rule, under prior law, businesses were taxed on their worldwide income. This created the potential for double taxation if the country in which the corporation operated also taxed the income. The foreign tax credit was one way to address and reduce this burden.

In contrast to worldwide taxation, a territorial system taxes business only on income earned within a country’s borders. It applies to all businesses that operate within a country’s boundaries, whether that business is headquartered in that country or another. One of the goals of the Act was to move away from a worldwide system of taxation to a territorial system. Several provisions were included to achieve this goal.

Only six other countries in the Organization for Economic Cooperation and Development (OECD), a group of the 34 most highly developed nations in the world (including the U.S.), employ a worldwide system for taxing their multinational businesses: Chile, Greece, Ireland, Israel, South Korea, and Mexico. The other 27 have mostly territorial systems. Nevertheless, the move is not without controversy.

* **Dividends Received Deduction for Foreign-Source Portion of Dividends.** The new law essentially exempts certain income earned by foreign subsidiaries from U.S. taxation. This is accomplished by granting a corporation a 100% deduction for the foreign-source portion of dividends received from any 10%-owned foreign corporations. In other words, when a U.S. corporation receives a dividend from a subsidiary in Ireland that represents income of the subsidiary that was earned in Ireland, the U.S. corporation does not pay tax on the dividend. In theory, the only tax that would have been paid by the subsidiary would have been the tax it paid to Ireland. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction. The deduction is available only to C corporations and applies to distributions made after December 31, 2017.
* **Deemed Repatriation of Foreign Earnings and Profits.** To transition to a new territorial system, the Act imposes a deemed repatriation tax. This requires U.S. shareholders (e.g., Apple) owning at least 10% of a foreign subsidiary to include in income their pro-rata share of the subsidiary's post-1986 earnings and profits. The portion of earnings and profits attributable to cash or cash equivalents is taxed at 15.5%, while that attributable to noncash assets (for example, property, plant and equipment) are taxed at 8%. The U.S. shareholder may elect to pay the deemed repatriation tax over eight years. Note that a foreign subsidiary need not actually pay the dividend (i.e., transfer cash to the U.S. parent) but it will be treated as having done so.
* **Minimum Tax on Passive and Mobile Income of Controlled Foreign Corporations (CFCs).** Under new § 951A, U.S. shareholders of a CFC will be taxed currently on global intangible low-taxed income (GILTI), defined as a CFC’s net income less a deemed 10% return on the CFC’s basis in depreciable tangible property. After a 50% deduction, the income is effectively taxed at a rate of 10.5%. Likewise, in new § 250, the Act creates a new category of income – foreign-derived intangible income or FDII – along with a new 37.5% deduction resulting in an effective tax rate of 13.125%. FDII is essentially intangible income derived from selling in non-U.S. markets.
* **Base Erosion Minimum Tax.** Operating like a minimum tax, a corporation with excess base erosion payments must pay a tax equal to 10% (5% in 2018) of its modified taxable income over its regular tax liability. Base erosion payments are payments made to related foreign entities by a U.S. corporation – for example, deductible interest payments on intercompany loans or royalty payments to affiliated companies.

**Page 13-17**

* **Modifications Related to Foreign Tax Credits**. The Act adds a new “foreign branch income” basket to the general and passive baskets under prior law.

**Page 13-21**

* **Change in Definition of U.S. Shareholder**. For purposes of defining a CFC, the definition of a U.S. shareholder is expanded to include a U.S. person who owns 10% or more of the value (rather than just voting power) of the stock of a foreign corporation.

CHAPTER 15: ESTATE AND GIFT TAXATION

**Page 15-2. Increased Exemption.** For purposes of computing the estate and gift tax, the Act increases the exemption amount for 2018 to $11,200,000 (effectively $22,400,000 for married couples). In light of the increased exemption, only the wealthiest of Americans will pay the tax.

**Page 15-9. Gift Tax Exclusion.** The annual gift tax exclusion is adjusted annually for inflation and rises to $15,000 in 2018.

**Page 15-12. Exemption.** The Act increases the unified credit to $4,425,800, which effectively shelters $11,200,000 from the estate and gift tax as well as the generation skipping transfer tax. It is important to note that the estate and gift tax are structured such that any exemption used during life is not available at death. The rules prevent a taxpayer from getting two exemptions. However, a married couple effectively receives two exemptions allowing them to shelter approximately $22,400,000 under the new law.

**Page 15-28**

**State Death Taxes.**  States that impose an estate tax normally have an exemption much like the federal estate tax. In light of the increase in the Federal exemption, it remains to be seen how states will respond.

CHAPTER 16: INCOME TAXATION OF ESTATES AND TRUSTS

**Page 16-8**

The Act not only cut the tax rates of individuals and corporations, it also reduced them for estates and trusts.

**Exhibit 16-2.** The new tax rates for estates and trusts are shown below.

**2018 Estates and Trusts** If taxable income is % on Of the   
Over But not over The tax is + Excess Amount over

$0 $ 2,550 $ 0.00 10% $ 0  
 2,550 9,150 225.00 24% 2,550  
 9,150 12,500 1,839.00 35% 9,150  
 12,500 3,011.50 37% 12,500

**Personal Exemption.** The new law not only eliminated the deduction for personal and dependent exemptions for individuals but also repealed them for trusts and estates. Note that estates and trusts are not entitled to a standard deduction so they will not benefit by the significant increase in the standard deduction for individuals.

**Page 16-10**

**Qualified Business Income Deduction.** This special deduction for the owners of pass-through entities (partnerships, S corporations, including sole proprietorships and owner-operated rental activities (for a complete discussion see Chapter 1, page 4 of this supplement) is also available to trusts and estates who own such interests. In addition, individual beneficiaries that receive distributions from an estate or trust that include pass-through business income would likewise be entitled to this new deduction. However, it is not clear whether Electing Small Business Trusts (ESBTs) holding S-corporation stock will be entitled to the new deduction in view of the unique tax regime applicable to these ESBTs.

**Limitation on Miscellaneous Itemized Deductions.** The treatment of these deductions for estates and trusts is not clear. Under § 67(e), certain fiduciary specific expenses like trustee fees are not subject to the 2% floor but not excluded from the classification of miscellaneous itemized deductions. Expenses that may or may not be deductible include trustee and executor fees, tax preparation expenses, legal fees related to administration of a trust or estate, accounting and appraisal fees. Presumably, regulations will provide clarification. On the other hand, certain expenses are clearly not deductible, including investment management fees as well as trustee or executor fees related to investment management.

**State and Local Tax Deduction.** Another area requiring clarification is the treatment of the $10,000 limitation on the deduction for state and local taxes. The Act provides three exceptions to this cap: (1) foreign taxes claimed in lieu of foreign tax credit, (2) personal and real property taxes that are incurred in a trade or business (i.e., those taxes that are deductible on Schedule C, Schedule E or Schedule F) and (3) personal and real property taxes incurred for an activity engaged in for profit (e.g., investment assets). Many trusts and estates hold assets for investment. For this reason, it would appear that the cap on the deduction for state and local taxes might have limited impact on trusts and estates who pay personal taxes or real property taxes. If all of the activities of a trust can be characterized as for the production of taxable income, then under this exception, the state personal and real property taxes should still be deductible.

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