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CERTIFIED PUBLIC ACCOUNTANTS

2017
Year-End Tax Planning & Tax Reform Legislation Update For Businesses

Year-End Planning in Light of Pending Tax Reform - Businesses

As Congress's tax reform package, the Tax Cuts and Jobs Bill (HR 1), moves forward to likely passage, taxpayers need to consider what advantages might be gained by utilizing certain year-end tax strategies to take advantage of possible new tax benefits in 2018, as well as the loss of certain benefits, while continuing to sit on the fence until the last moment in case legislation does not move forward. This update takes a look at some of the year-end planning that might be considered by businesses in anticipation of final tax reform legislation that would follow the existing House and/or Senate bills.

Bonus Depreciation - The House and Senate would increase bonus depreciation to 100 percent. Under current law, it is being phased out at 40 percent in 2018 (from 50 percent in 2017 and down to 30 percent in 2019). In addition, under the Senate bill, qualifying property no longer needs to be new; it can be used, although it must be the taxpayer's first use. Any property used in a real property trade or business would be excluded. The property must be acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for property with a longer production period and a four-year phasedown period after 2023). Property acquired prior to September 28, 2017 but not placed in service until after September 27, 2017, appears only eligible for 50-percent bonus depreciation. The Senate bill also adds qualified film, television and live theatrical productions as qualifying property, with placed-in-service determined when first commercially made available to an audience. Further, the Senate bill removes computer or peripheral equipment from the definition of listed property, which would be otherwise subject to heightened substantiation requirements.

Planning Considerations - Purchasing equipment and placing it in service at year-end 2017 is a "win-win" in several respects. If tax reform does not pass, the taxpayer gets a 50-percent bonus depreciation rate, which, under current law, would be lowered to 40 percent starting January 1, 2018. Next, if the tax reform is approved and bonus depreciation is included, the 100-percent deduction for year-end 2017 purchases will be applied to 2017 income, which is taxed at higher rates than in 2018 in most cases. Finally, bonus depreciation is elective, so a decision on whether to take it is not necessary until 2017 returns are filed.

Luxury Auto Caps - The Senate bill carves out increased expensing ceilings for depreciation limitations on so-called "luxury" automobiles, which better reflect the cost of an average vehicle. The provision, effective starting in 2018, would increase maximum first-year depreciation from $3,160 to $10,000; second year from $5,100 to $16,000, third year from $3,050 to $9,600, and fourth and subsequent year depreciation from $1,875 to $5, 760 until the cost of the vehicle is recovered. It is unclear at this time, however, whether first-year bonus depreciation (now at $8,000) would continue to be allowed.

Planning Considerations - Delaying the purchase of a business-use vehicle until 2018 would make sense in most cases. Even without additional bonus depreciation, the combined first- and second-year write-offs of $26,000 would more than make up for an immediate $11,160 deduction for a 2017 purchase.

Real Property Recovery Period - Most non-residential real property under current law must be recovered over 39 years; residential real property over 27.5 years, with both using straight-line depreciation. The Senate bill would shorten the recovery period for both to 25 years, for property placed in service after December 31, 2017. Further, adopted in the Senate's modified mark, the alternative depreciation system (ADS) recovery period for residential rental property is shorten from 40 years to 30 years.

Planning Considerations - Taxpayers should consider delaying placing buildings and other real property into service until January 1, 2018, if possible, to gain the shortened recovery period.

Year-End Planning in Light of Pending Tax Reform - Businesses (Cont)

Section 179 Expensing - The House bill would increase the thresholds for full expensing under Code Sec. 179, raising them from the current $500,000 level with a $2-million phase-out starting point to $5-million and $20-million thresholds, respectively. The Senate version would increase the maximum Code Sec. 179 expensing to $1 million, with a $2.5-million phase-out threshold. Qualified energy efficient heating and air-conditioning property would qualify if acquired and placed in service after November 2, 2017. Other property would have a January 1, 2018 start date, and sunset at the end of 2022.

Although the differences between bonus depreciation and Code Sec. 179 expensing after 2017 would now be narrowed if both offer 100-percent write-offs for new or used property, some advantages and disadvantages for each would remain. For example, Code Sec. 179 property is subject to recapture if business use of the property during a tax year falls to 50 percent or less; but Code Sec. 179 allows a taxpayer to elect to expense only particular qualifying assets within any asset class.

Planning Considerations - Purchasing qualifying Code Sec. 179 property before year-end 2017 up to the current $500,000 and $2 million caps will allow a deduction against business income that will be taxed earlier (that is, within the 2017 tax year) and, if a tax-reform bill passes, at a higher tax rate than in 2018. If a business reaches the $500,000/$2 million cap, however, additional purchases of Code Sec. 179 property should be deferred into 2018 in most situations.

Meals & Entertainment - The Senate bill would bar the business deduction of all entertainment expenses, which are currently allowed up to 50 percent. In addition, the current 50-percent limitation on deductions for meals provided to employees for the convenience of the employer would be expanded to include in-house cafeterias. Further, any employee transportation fringe benefit would no longer be deductible by the employer. For tax years beginning after December 31, 2025, the Senate bill also provides that no deduction would be allowed for employer-provided meals on or near the employer’s business premises.

Planning Considerations - Seats at sporting events, as well as certain other venues, must often be purchased well in advance or risk being "sold out." Cash-basis businesses might consider nailing down those tickets in December and, therefore, allocating them as a 2017 expense, especially if the invitations to business clients are also made in advance before tax-year 2017 ends to better support an "all-events" test. Among other requirements, to be deductible, business must be discussed at the event, which means that the taxpayer must eventually attend. "Luxury" boxes have additional restrictions under current regulations.

Employers might reconsider subsidies to in-house employee cafeterias or at least budget for a limited 50-percent tax deduction. The additional cost to the employer of not getting a deduction for providing employee transportation fringe benefits starting in 2018 should also be considered in any commitments made to employees at this time.

Interest deductions - Both the House bill and Senate bill would cap the deduction for net interest expenses generally at 30 percent of a taxpayer's adjusted taxable income, among other criteria. Exceptions would exist for small businesses, with the House bill exempting from the rules businesses with average gross receipts of $25 million or less and the Senate setting the exemption at average gross receipts of less than $15 million during the three preceding years. Although the net interest expense disallowance would generally be determined at the "tax filer" level, special rules would apply to pass-through entities that would make the determination at the entity level; for example, at the partnership level instead of the partner level.

Year-End Planning in Light of Pending Tax Reform - Businesses (Cont)

Planning Considerations - This provision is an attempt to "level the playing field" between businesses that capitalize through equity and those that borrow. Businesses that would be over the new limits for interest deductions might consider gradually reducing debt. Any debt financing that would be undertaken before year -end 2017 might be reconsidered in favor of equity offerings.

Pass-Through Businesses - Currently, owners of partnerships, S corporations, and sole proprietorships, as "pass-through" entities, pay tax at the individual rates, with the highest rate at 39.6 percent. The House GOP bill proposes a 25-percent tax rate for certain pass-through income after 2017, with a 9-percent rate for certain small businesses. The Senate bill generally would allow a temporary deduction in an amount equal to 23 percent of qualified income of pass-through entities, subject to a number of limitations and qualifications. In both bills, the remaining portion of net business income, subject to a variety of anti-abuse rules, directed at service providers and others, would be treated as compensation subject to ordinary individual income tax rates. The rules regarding this tax rate reduction for pass-through's for both the House and Senate versions of the bill, as well as, the calculations and the anti-abuse provisions are very dense and complex and will require significant time to navigate if they are enacted.

Planning Considerations - Most small business owners who operate through pass-through entities would come out ahead under tax reform, although arguably some more than others. Until a final bill is written, however, owners should consider basic year-end strategies. For those business owners feeling "bullish" on some form of tax reform favorable to pass-through's likely, deferring the recognition of business income into 2018 and accelerating deductions and credits into 2017, especially those deductions and credits set for repeal or cutback, should be considered.

Considering a switch to a C corporation solely to benefit from the 20-percent rate, rather than as a partnership or S corporation subject to the new pass-through regime, probably should be postponed until more information is available. C corporate dividends from a C corporation will continue to be taxed again at either the 20 or 15-percent capital gains/dividends rate if distributed. Both entities are required to pay reasonable compensation, for the C corporation before dividends are paid and for S corporations under new anti-abuse rules.

Sunsetting Tax Benefits - To find the revenues to balance out some of the tax cuts provided in the pending tax reform package, bill drafters had to repeal or significantly cut back on a variety of beneficial tax provisions now in the Tax Code. The following list highlights some of these provisions as they relate to businesses. Taxpayers should consider taking action either to accelerate the benefit from these targeted tax breaks for tax year 2017 before being foreclosed from doing so by tax reform in 2018, or to make plans now not to commit to these expenses for 2018. Some of these provisions, among others, include:

- Repeal of like-kind exchanges (except real estate);
- Repeal of the Code Sec. 199 domestic production activities deduction;
- Modification of the limit on excessive employee remuneration;
- Limitations on the exclusion for employer-provided housing;
- Changes to the employer-provided child care credit; and
- Changes to the deduction for employee achievement awards of cash or gift cards.

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