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STUDENT SUPPLEMENTAL UPDATE MEMORANDUM

to

FUNDAMENTALS OF CORPORATE TAXATION

Cases and Materials

Ninth Edition

By

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PREFACE

This January 2018 Student Supplemental Update Memorandum brings the 2017 Student Update Memorandum to the Ninth Edition of *Fundamentals of Corporate Taxation* up to date by summarizing the relevant provisions of the tax reform legislation popularly known as the Tax Cuts and Jobs Act and enacted into law on December 22, 2017 under the title, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub. L. No. 115-97 (hereinafter "the Act"). The Update Memorandum is organized to parallel the text, with cross references to chapter and topic headings and page numbers. The discussion includes citations to sections of the Act and, selectively, to the affected provisions of the Internal Revenue Code.

The discussion in this Update Memorandum is intended to be a general summary of the major provisions of the Act affecting corporations and their shareholders, and a preview of some of the Act's implications. There is more to digest, and expanded coverage can be expected in the Summer 2018 Update Memorandum to be published in July.

Instructors who have adopted the text for classroom use may provide electronic or paper copies of all or part of the Update Memorandum to their students.

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January 2018

PART ONE: INTRODUCTION

CHAPTER 1. AN OVERVIEW OF THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

A. INTRODUCTION

1. TAXATION OF BUSINESS ENTITIES

Page 4, footnote 5:

The Act reduces the 70 percent dividends received deduction to 50 percent and the 80 percent dividends received deduction to 65 percent. The 100 percent deduction, when applicable, is unchanged.

2. INFLUENTIAL POLICIES

Page 6:

Impact of the 2017 Act on Influential Policies and Choice of Entity. The core infrastructure of Subchapter C (Sections 301-385) of the Internal Revenue Code – the provisions governing the tax consequences of transactions between C corporations and their shareholders – were left relatively untouched by the Tax Cuts and Jobs Act. But many of the influential policies previewed at pages 6 to 12 of the text, and how they relate to one another, have changed dramatically, with profound implications on the choice of entity for a business, capital structure, compensation policy, and much more. This update provides an overview of the highlights and some initial observations on how they may influence taxpayer behavior.

Congress rejected the radical step of eliminating the double tax regime of Subchapter C and instead moderated its bite by lowering the corporate income tax rate to 21 percent – a 40 percent decrease from the 35 percent top rate that has been in place for many years. As enacted, this rate cut is permanent, but of course nothing is ever "permanent" in the Code especially with the shifting of political winds. The top individual rate fell only slightly, from 39.6 to 37 percent, and the individual tax cuts are "temporary" (they are scheduled to expire in 2026 unless they are extended or made permanent). The 20 percent maximum rate on long-term capital gains and qualified dividends also was left unchanged and the 3.8 percent tax on net investment income for taxpayers above certain thresholds was retained. The end result of all this is that for the first time in over thirty years, the corporate rate is significantly lower than the highest individual marginal rates. Business taxpayers also will be allowed to deduct 100 percent of the cost of both new and used equipment (this temporary change phases out gradually beginning in 2023). But, in a rough justice trade-off, taxpayers are now subject to a limit on the deduction of net business interest expense. Finally, to level the playing field between C corporations and pass-through business entities that are not taxed at the entity level (partnerships, limited liability companies, S corporations and sole proprietorships), Section 199A of the Code allows individual taxpayers, trusts and estates to deduct 20 percent of their share of "qualified business income." For those who qualify for this deduction, their business income is effectively taxed at a top rate of 29.6 percent instead of 37 percent (29.6 percent is 37 percent multiplied by the 80 percent of taxable qualified business income after the deduction). This represents a 25 percent reduction from the pre-2018 top rate of 39.6 percent – much less than the corporate rate reduction but considerably more than the small rate cut for wage earners. The bad news is that the 20 percent deduction is subject to a nasty web of special rules and limitations that are previewed later in this chapter in connection with S corporations and in more depth in the update to Chapter 15.

At page 11 of the text, we summarized the influential policies relating to corporate and individual rates as follows:

> For now, the conventional wisdom is that, in most cases, the modest increase in tax rates for high income individuals [i.e., raising the top marginal rate back up to 39.6 percent in 2013] is not sufficient to tip the scales toward conducting business as a C corporation for the majority of closely held businesses that are not planning to "go public" at a later time. But a reduction in the statutory corporate tax rates could alter the analysis and revive the use of C corporations as an attractive refuge from the more onerous individual tax rates unless that reduction is coupled with tax relief for pass-through entities, as some have proposed under the banner of protecting small businesses.

As predicted, the Act has once again tinkered with tax rates and, in so doing, altered these influential policies. A major takeaway is that closely held businesses that previously chose to operate as sole proprietorships or pass-through entities to avoid the double tax may want to reconsider using C corporations because of the dramatically lower corporate tax rate. As in the good old days, corporations may be "an attractive refuge" as long as strategies can be employed to minimize, defer or, where possible, completely avoid a second layer of tax at the shareholder level. The ideal tax plan would be to leave the earnings in the corporation to compound at the preferential rate until the business is sold or liquidated. Better still, shareholders should wait until they die, when their stock basis is stepped up to fair market value, completely eliminating any shareholder-level tax on the unrealized appreciation up to the date of death. The choice of entity decision is far more nuanced, however, involving many other variables such as the type of business, whether a shareholder also works for the company and is (or should be) paid reasonable compensation, employment tax issues, the shareholder's need to withdraw earnings to pay for personal consumption, the availability of business deductions and credits that may reduce a C corporation's tax liability, other opportunities for tax savings through tax-preferred fringe benefits and deferred compensation planning, the impact of state and local taxes, and myriad of other considerations unique to special situations. The new 20 percent deduction on qualified business income also must be evaluated for those who qualify for it, and it may tip the scales back toward use of a pass-through entity for all or part of the business.

Page 12:

The International Dimension. The text summarized possible approaches to U.S. international tax reform, including reducing the corporate income tax rate to make U.S. companies more competitive in the global economy, moving to a territorial system, ending the incentives to defer U.S. tax on foreign profits by keeping them offshore, and a repatriation tax holiday. The Act did not disappoint. Major changes were made to the taxation of foreign income earned by U.S. corporations by the adoption of a modified territorial system of taxation and imposing a mandatory repatriation tax on previously untaxed foreign earnings. These and numerous other changes are beyond the scope of coverage of this text.

B. THE CORPORATION AS A SEPARATE TAXABLE ENTITY

1. THE CORPORATE INCOME TAX

Pages 18-24:

Rates. Section 13001 of the Act replaces the graduated corporate income tax rate structure with a flat 21 percent rate for all C corporations, including personal service corporations. I.R.C. § 11(b). The lower rate, which is permanent (until Congress changes it again), is effective for tax years beginning after December 31, 2017.

Determination of Taxable Income. The Act makes numerous changes to the determination of taxable income. Highlights include: (1) the maximum corporate tax rate on net capital gain in Section 1201 of the Code is repealed as obsolete, with the result that all corporate capital gains (short or long-term) will be taxed at 21 percent (Act § 13001; I.R.C. § 11(b)); (2) the generally applicable 70 percent dividends received deduction is reduced to 50 percent and the 80 percent dividends received deduction is reduced to 65 percent (Act § 13002; I.R.C. §243); (3) business taxpayers may expense 100 percent of the costs of acquiring both new and used equipment placed in service after September 17, 2017 and before January 1, 2023 (this benefit will be gradually phased down after 2022) (Act §13201; I.R.C. §168(k)); (4) new limits are imposed on the deduction of business interest expense (Act §13301; I.R.C. § 163(j) (see the update to Chapter 3); (5) deductions for most forms of business entertainment and certain employee fringe benefits, such as qualified parking, are eliminated (Act § 13304; I.R.C. § 274); (6) the $1 million limitation on the deductibility of compensation paid by public companies to their top executives is broadened to encompass performance-based pay, such as stock options, and private companies with publicly traded debt are now subject to the compensation deduction cap (Act § 13601; I.R.C. § 162(m); and (7) the business deduction for local lobbying expenses is eliminated (Act § 13308; I.R.C. § 162(e)), as are deductions for certain fines, penalties, and settlement payments for sexual harassments or abuse that are subject to nondisclosure agreements (Act §§ 13306; 13307; I.R.C. §§ 162(f), (q)).

Deduction for Domestic Production Activities. Section 13305 of the Act repeals the deduction provided by Section 199 of the Code for income attributable to domestic production activities, effective for tax years beginning after December 31, 2017.

Taxable Year and Accounting Period. Section 13102 of the Act reforms and simplifies accounting methods for small businesses by expanding the availability of the cash method to C corporations (other than certain "tax shelters," as defined) with average annual gross receipts for the three-year period preceding the taxable year that do not exceed $25 million (up from $5 million). I.R.C. § 448(c). Other more specialized amendments exempt certain small businesses from the inventory accounting requirements and broaden the exception from the uniform capitalization rules in Section 263A of the Code.

Credits. The Act generally preserves most business tax credits except in a few specialized situations where credits are subject to new limitations. Section 13403 of the Act adds a new employer credit for paid family and medical leave. I.R.C. § 45S.

2. THE CORPORATE ALTERNATIVE MINIMUM TAX

Page 24:

Section 12001 of the Act repeals the corporate alternative minimum tax, effective for tax years beginning after December 31, 2017. Transitional rules are provided for corporations with AMT credits (Act § 12202; I.R.C. § 53(e)).

4. THE S CORPORATION ALTERNATIVE

Page 28:

Deduction for Qualified Business Income of Pass-Through Entities: An Overview of New Section 199A. As previewed in the Introduction, Section 199A confers a new deduction from taxable income (through 2025) to individuals, trusts and estates in an amount equal to 20 percent of their share of domestic-sourced "qualified business income" ("QBI") from pass-through entities (including S corporations). The effect of this deduction is to reduce the tax rate on QBI for the highest income taxpayers from 37 to 29.6 percent.

Very generally, QBI is the net income passing through to the taxpayer from an active trade or business conducted by a pass-through entity, whether or not the taxpayer "materially participates" in the qualified trade or business. Amounts paid by an S corporation to an owner-employee as compensation or by a partnership or LLC as a "guaranteed payment" and traditional forms of investment income, such as interest, dividends and capital gains, do not qualify for the deduction.

The QBI deduction is subject to several different limitations which vary depending on whether the taxpayer's taxable income exceeds certain threshold amounts and, if so, by how much. First, the deduction generally is not available for income derived from certain specified service businesses. This disfavored category includes doctors, lawyers, accountants, entertainers, consultants, investment advisors, entertainers and athletes (among others) but not engineers and architects. This limitation does not apply, however, to married couples filing jointly with taxable income of $315,000 or less ($157,000 for single taxpayers), and the limitation is phased in for taxpayers with income above those thresholds.

A second more general limitation, which also does not apply to taxpayers below the taxable income thresholds and is phased in as a taxpayer's income exceeds those thresholds, caps the 20 percent deduction at the greater of: (1) 50 percent of the taxpayer's pro rata share of the "W-2 wages" paid by the QTB or (2) 25 percent of those W-2 wages, plus 2.5 percent of the taxpayer's share of the unadjusted basis immediately after acquisition of all tangible depreciable property (including real estate) used in the qualified trade or business that has not been fully depreciated prior to the close of the taxable year. In all events, the deduction may not exceed 20 percent of the taxpayer's total taxable income reduced by net capital gain.

For now (it's still early), all these details and others not included in this preview are less important than simply being aware that the new Section 199A deduction is important enough to be added to the list of policies influencing taxpayer behavior and, in time, identifying those taxpayers who will benefit from the deduction.

Page 31:

PROBLEM

Consider how the answers to this problem have changed as a result of the Act. For this purposes, take into account the new 21% corporate income tax rate under § 11 and continue to assume the individual rates are 40% on ordinary income and 20% on qualified dividends and long-term capital gains. Assume further that the ACRS depreciation was in connection with the purchase of equipment that Boots, Inc. acquired during the taxable year and fully expensed under § 168(k).

For part (b), assume Boots distributes $395,000 each to Emil and Betty as qualified dividends. Has the effectiveness of this strategy changed as a result of the 2017 Act?

For part (c), in evaluating other strategies to mitigate the impact of the "double tax," consider very generally the advantage, if any, of operating as a pass-through entity, such as an S corporation, partnership or limited liability company and the impact of new § 199A.

E. TAX POLICY ISSUES

2. OTHER CORPORATE TAX REFORM OPTIONS

Page 50:

Tax Reform Update. As discussed in the text, the meandering tax reform discussion continued for many years prior to and during the 2016 election campaign. The prospects for tax legislation were raised after the Republican party assumed control of the White House and both houses of Congress, but little progress had been made at the time the 2017 Update Memorandum was published in mid-summer. So we concluded then, as many times before, with the familiar refrain "stay tuned." Now, at last, with the enactment of a major tax bill, we can say something else, such as "elections have consequences" and "be careful what you ask for."

The Act did not adopt any of the corporate integration approaches discussed at pages 43 to 50 of the text. Instead, Congress took a more conventional route by permanently reducing the corporate income tax rate (although not as low as the 15 percent promised by President Trump in his campaign platform) but it did so without the base broadening necessary to make the legislation revenue neutral. Instead, many business tax expenditures were left in place (individual taxpayers were not as fortunate), and significant "incentives" were added, such as 100 percent expensing of most capital expenditures for equipment and tax relief for owners of pass-through entities. Some revenue will be raised by a new limit on deductibility of net business interest expense, and desirable simplification was achieved by the repeal of the corporate alternative minimum tax and the deduction under Section 199 for income from domestic production activities. Overall, however, the Act adds more complexity than it removes, and many of its provisions are temporary and will sunset within eight years. As for the deficit, it is projected to grow considerably unless, as proponents of the Act have promised, the stimulus provided by the lower rates and other incentives lead to a sustained period of economic growth, more jobs, and enough future revenue to balance the budget.

PART TWO: TAXATION OF C CORPORATIONS

CHAPTER 2. FORMATION OF A CORPORATION

F. COLLATERAL ISSUES

1. CONTRIBUTIONS TO CAPITAL

Page 110:

Effective for contributions made after December 22, 2017 (the date of enactment), Section 13312 of the Act provides that for purposes of Section 118 of the Code the term "contribution to capital" does not include: (1) any contribution (such as contributions received by certain public utilities) or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). As a result, these types of contributions will be included in a corporation's gross income. This change was made to eliminate what Congress believed to be a federal tax subsidy for financial incentives that some corporations were receiving from public entities and customers to locate operations within a particular municipality or general location. The Conference report makes it clear that Section 118, as so modified, applies only to corporations, a position long held by the I.R.S.

CHAPTER 3. CAPITAL STRUCTURE

A. INTRODUCTION

Page 115:

The tax bias in favor of debt has been further eroded by the new limitation on deductibility of business interest discussed below. The 1989 excerpt from the Joint Committee on Taxation report at page 117 of the text continues to raise policy issues that have not been fully addressed, but its assumptions regarding rates and the full deductibility of interest expense are out of date.

Page 122:

Limitation on Deduction of Business Interest. Section 13301 of the Act amends Section 163(j) of the Code to limit the deduction for "business interest" for any taxable year. The deduction cap is the sum of: (1) business interest income for the taxable year; (2) 30 percent of the taxpayer's "adjusted taxable income;" and (3) the taxpayer's "floor financing interest" (a specialized category for retail car dealers). I.R.C. § 163(j)(1). Business interest disallowed under this provision may be carried forward indefinitely. I.R.C. § 163(j)(2). The new limitation applies to all business taxpayers, not just corporations, and it is applied after any other limitations, such as those requiring deferral or capitalization of interest expense in certain situations. Special rules, not directly relevant to C corporations, apply to pass-through entities. I.R.C. § 163(j)(4).

"Business interest" is any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include "investment interest," which continues to be subject to its own set of limitations under Section 163(d). Business interest income is interest income allocable to a trade or business. I.R.C. § 163(j)(5), (6). In the case of a C corporation, virtually all interest income and expense will be allocable to its trade or business activities.

The key measure for the deduction cap is "adjusted taxable income" ("ATI"), which is defined as the taxpayer's taxable income computed without regard to: (1) tax items not properly allocable to a trade or business; (2) any business interest expense or business interest income; (3) the amount of any net operating loss deduction; (4) the 20 percent deduction provided by Section 199A for certain "qualified business income" from pass-through entities; and (5) for tax years beginning before January 1, 2022, deductions for depreciation, amortization or depletion (this category would include any costs expensed under Sections 168(k) or 179). I.R.C. § 163(j)(8). ATI is thus conceptually similar to what is known as EBITDA (earnings before interest, taxes, depreciation and amortization), a metric used by financial analysts to measure a company's operating performance without regard to its capital structure, taxes, or cost recovery deductions. Beginning in 2022, ATI is determined without adding back depreciation and amortization so that it resembles EBIT (earnings before interest and taxes) and, in most cases, the impact of this change is that the ceiling will be lower (the cap will be 30 percent of a lower number), further limiting the deduction for business interest. The combination of immediate expensing for equipment and the harsher post-2021 cap has the odd effect of punishing companies that increase their capital investment. This future change in the formula presumably was made to increase the revenue estimates for the "out years" of the relevant budget window rather than for any discernable policy reasons. Thus, there is at least some possibility that the post-2021 change in the ATI formula may be repealed.

Relief from the limitation is provided for "small businesses," which generally are taxpayers with average annual gross receipts not exceeding $25 million for the three-year period ending with the prior taxable year. I.R.C. § 163(j)(3). An exception also is available, at the taxpayer's election, to a real property trade or business, as broadly defined in Section 469(c)(7)(C) to encompass real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, brokerage trade or business, and (according to the legislative history) operation or management of a lodging facility. I.R.C. § 163(j)(7)(A)(ii), (B). The trade-off for taxpayers who make this election is that they must use the slightly slower alternative depreciation system under Section 168(g), which requires straight line cost recovery over 30 years for residential rental property (instead of 27.5 years) and 40 year for commercial property (instead of 39 years). Real estate businesses will need to do a cost/benefit analysis in deciding whether or not to make this election. Similarly, at the taxpayer's election, any farming business and certain agricultural or horticultural cooperatives, will not be subject to the interest deduction limitation. I.R.C. § 163(j)(7)(A)(iii), (C). Regulated public utilities also are exempted. I.R.C. § 163(j)(7)(A)(iv).

The implications of the new interest deduction limitation will vary depending on a corporation's capital structure. Industries that typically rely more on debt, or particular companies that are highly leveraged, will take a bigger hit. For those C corporations that historically have enjoyed the tax benefits from debt-financing for operations, dividend payments, and stock buybacks, the stakes will change. At this point, it seems fairly certain that the interest limitation, coupled with the reduced corporate income tax rate, will increase the cost of issuing debt, causing a ripple effect on the corporate bond market.

CHAPTER 4. NONLIQUIDATING DISTRIBUTIONS

A. INTRODUCTION

2. QUALIFIED DIVIDENDS

Page 154:

The Act does not change either the 20 percent top rate for qualified dividends or the 3.8 percent tax on net investment income imposed on high-income taxpayers.

B. EARNINGS AND PROFITS

Page 161:

Problems. The facts should be changed to assume that the cost of the equipment is $7,000 and it was fully expensed under Section 168(k) in the year it was acquired.

E. CONSTRUCTIVE DISTRIBUTIONS

Page 176:

Some of the assumptions and calculations in the Note are now out of date as a result of the reduction of the corporate income tax rate to 21 percent and several other changes made by the Act.

F. Anti-Avoidance Limitations on the Dividends Received Deduction

1. In General

Page 177:

Section 13302 of the Act lowers the generally applicable 70 percent dividends received deduction to 50 percent and the 80 percent dividends received deduction (for dividends from 20 percent or more owned corporations) to 65 percent, effective for tax years beginning after 2017. The effect of these changes is that eligible dividends will be taxed at a maximum rate of 10.5 percent or 7.35 percent, respectively. The Act did not change the 100 percent deduction for dividends received from 80 percent or more owned corporations.

2. Special Holding Period Requirements

Page 178:

The illustrations in the text should be changed to reflect the 21 percent corporate income tax rate and the reduction of the 70 percent dividends received deduction to 50 percent.

3. Extraordinary Dividends: Basis Reduction

Page 179:

The illustration from the Committee report in the text does not reflect the 21 percent corporate income tax rate and the 50 percent dividends received deduction.

4. Debt-Financed Portfolio Stock

Page 181:

Although the Act left Section 264A unchanged, the illustrations in the text do not reflect: (1) the lower corporate income tax rate; (2) the now 50 percent dividends received deduction; and (3) the impact of the limitation on deduction of business interest expense.

Chapter 5. Redemptions and Partial Liquidations

H. Redemptions to Pay Death Taxes

Page 292:

Section 303 was not changed by the Act but its importance is somewhat reduced by the doubling of the gift, estate and generation-skipping tax exemptions, which increase to $11.2 million per person in 2018 and will continue to be indexed annually. In 2026, the exemption is scheduled to revert back to $5 million per person.

Page 294:

Problems. To make this problem relevant in light of the increased wealth transfer tax exemption amounts, all the numbers should be doubled.

CHAPTER 8. TAXABLE CORPORATE ACQUISITIONS

C. ASSET ACQUISITIONS

1. TAX CONSEQUENCES TO THE PARTIES

Page 357:

The illustrations of basic asset acquisition transactions in the text are affected by the reduction of the corporate income tax rate to 21 percent and, to a lesser extent, by the reduction of the top marginal individual rate to 37 percent. For illustrative purposes and computational convenience, it now should be assumed that C corporations are taxed at a flat 20 percent rate, with individuals still taxed at 40 percent on ordinary income and 20 percent on long-term capital gains. Using these revised assumptions, the 20 percent corporate tax on a liquidating distribution or sale of Gainacre is reduced from $140,000 to $80,000. A recognizes $220,000 long-term capital gain on the distribution ($400,000 distribution less $80,000 corporate tax less A's $100,000 basis in the T stock), and A incurs a shareholder-level tax at capital gains rates of $44,000 (20% x $220,000). The combined corporate and shareholder tax on the liquidation and sale is $124,000 (down from $172,000), leaving a happier and wealthier A with $276,000.

2. ALLOCATION OF PURCHASE PRICE

Page 358:

The pricing of taxable acquisitions and allocation of the purchase price may be affected by the Act's temporary extension of 100 percent expensing for purchases of "used" property. See I.R.C. §§ 168(k)(2)(A)(ii); 168(k)(2)(E)(ii). Buyers will be able to immediately deduct the portion of the purchase price allocated to qualified property. It remains to be seen whether lowering the corporate tax rate from 35 to 21 percent, coupled with 100 percent expensing, will lead to a greater use of actual or deemed asset acquisitions.

Page 380:

Problems. To bring the assumptions closer to the current rate structure, assume (if your instructor requests specific computations) that C corporations are taxed at a flat rate of 20 percent and individuals are taxed at a flat 40 percent on ordinary income and a 20 percent rate on long-term capital gains.

F. POLICY ISSUES: CORPORATION ACQUISITIONS AND THE PROBLEM OF EXCESSIVE DEBT

Page 386:

The lower corporate income tax rate and the new limitation on deduction of business interest alter the stakes and policy issues discussed in the text, and render much of the discussion in the text obsolete, albeit not totally irrelevant. For example, future investment returns from leveraged buyouts fueled with excessive debt would appear to be negatively affected by these changes, but the resourceful private equity business is likely to adapt and continue to prosper by adjusting their deal structure.

CHAPTER 12. CARRYOVERS OF CORPORATE TAX ATTRIBUTES

B. SECTION 381 CARRYOVER RULES

Page 564:

General Carryover Rules. Section 13301(b) of the Act adds "carryforward of disallowed business interest" to the list of carryover tax items in Section 381. I.R.C. § 381(c)(20).

C. LIMITATIONS ON NET OPERATING LOSS CARRYFORWARDS: SECTION 382

1. INTRODUCTION

Page 568:

Modified Net Operating Loss Deduction. Section 13302 of the Act modifies the net operating loss deduction by limiting it to 80 percent of the taxable income for the taxable year, effective for losses arising in tax years beginning after December 31, 2017. The NOL two-year carryback rules are repealed for tax years ending after 2017 (except for certain farming losses and in other specialized situations), and carryforwards will be indefinite, rather than expiring after 20 years, for NOLs arising in tax years after 2017. I.R.C. § 172(a), (b). Corporate capital loss carrybacks and carryovers are not affected. This change means that financially distressed companies will not be able to carry back NOLs to receive refunds for taxes paid in the two previous years.

CHAPTER 13. AFFILIATED CORPORATIONS

A. RESTRICTIONS ON AFFILIATED CORPORATIONS

2. LIMITATIONS ON MULTIPLE TAX BENEFITS

Page 599:

Section 1561. Section 13001(b)(6)(A) of the Act modifies Section 1561 by limiting its reach to the limitation of the accumulated earnings credit and removing as obsolete the limitations related to the repealed lower corporate income rates in Section 11(b) and the corporate alternative minimum tax exemption. The illustrations at pages 600-601 of the text also have been rendered obsolete for tax years beginning after December 31, 2017.

CHAPTER 14. ANTI-AVOIDANCE RULES

A. INTRODUCTION

Page 623:

The reduction of the corporate income tax rate to 21 percent, when compared with the top individual rate of 37 percent on ordinary income, may breathe new life into the accumulated earnings and personal holding company taxes. It remains to be seen whether these venerable anti-avoidance rules will rise again to prevent the gaming of the system that many have already predicted will become rampant as a result of the new business tax rate regime.

C. THE ACCUMULATED EARNINGS TAX

Page 639:

As previewed above, beginning in 2018 the differential between the top corporate and individual rates described in the text has widened considerably (21 percent corporate vs. 37 percent individual), although it is not as wide as in the good old days when the accumulated earnings tax was first added to the Code. As noted in the update to Chapter 1, it is likely that in some situations C corporations will be more widely used to take advantage of the lower rates on business income while avoiding distributions that will result in another level of tax. The accumulated earnings tax was designed to patrol against this type of strategy, but its many available defenses (e.g., accumulation for the reasonable needs of the business) reduce its effectiveness.

D. THE PERSONAL HOLDING COMPANY TAX

1. INTRODUCTION

Page 656:

The reduction of the corporate income tax rate to 21 percent also may breathe new life into the mostly dormant personal holding company rules, which were designed to prevent taxpayers from using C corporations to circumvent the steeper individual marginal rates (when they were higher). Under the current rate structure, with most dividends and long-term capital gains taxed at 20 percent (23.8 percent for taxpayers subject to the 3.8 percent tax on net investment income), there is nothing to be gained by incorporating a stock portfolio. Interest income, however, is still taxed at the highest individual marginal rates, as are most forms of compensation. This raises the possibility that corporations will re-emerge as tax shelters for those forms of more highly taxed income.

PART THREE: TAXATION OF S CORPORATIONS

CHAPTER 15. S CORPORATIONS

B. ELIGIBILITY FOR S CORPORATION STATUS

Page 676:

Electing Small Business Trusts. Section 13541 of the Act amends the Code to permit electing small business trusts to have nonresident alien beneficiaries, expanding the ESBT's role in international estate planning. I.R.C. § 1361(c)(2)(B)(v). Section 13542 of the Act provides that the charitable contributions deduction for the portion of an ESBT holding S corporation stock is determined under the rules in Section 170 (e.g., percentage limitations and carryovers) applicable to individuals rather than the rules in Section 642(c) applicable to trusts. I.R.C. § 641(c)(2)(E). This amendment addresses an arcane technical issue beyond the coverage in the text but, for those who are interested, its effect is generally favorable to ESBTs that make distributions to charitable beneficiaries.

D. TREATMENT OF THE SHAREHOLDERS

2. LOSS LIMITATIONS

A. IN GENERAL

Page 689:

Limitation on Excess Business Losses. S corporation shareholders who materially participate in a business activity that operates at a loss will now be impacted by new Section 461(*l*) (added by Section 11012 of the Act), which disallows a current deduction for "excess business losses" of noncorporate taxpayers. An "excess business loss" is the aggregate deductions of the taxpayer attributable to all of the taxpayer's trades or businesses (determined without regard to this limitation) reduced by the sum of: (1) the aggregate gross income or gain of the taxpayer for the taxable year which is attributable to such trades or businesses, and (2) a threshold amount that in 2018 is $500,000 for married filing jointly taxpayers and $250,000 for all others (the threshold amounts are indexed for inflation beginning in 2019). I.R.C. § 461(*l*)(3). For S corporations, the loss limitation applies at the shareholder level to the shareholder's pro rata share of all tax items from trades or businesses attributable to the corporation. I.R.C. § 461(*l*)(4). Any disallowed excess business loss is carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years, subject to the new rule allowing NOLs only up to 80 percent of taxable income. I.R.C. § 461(*l*)(2).

Section 461(*l*) applies to taxable years beginning after December 31, 2017 and before January 1, 2026. I.R.C. § 461(*l*)(1).

Page 699:

After the carryover paragraph, insert the following new section and redesignate the topic heading that follows it as "4. SALE OF S CORPORATION STOCK":

3. DEDUCTION FOR QUALIFIED BUSINESS INCOME

Code: § 199A (selectively)

Introduction. While the Tax Cuts and Jobs Act of 2017 is headlined by the reduction of the top corporate income tax rate from 35 to 21 percent, lawmakers who favored significant tax reductions for business taxpayers were concerned about providing relief for public companies and other businesses organized as C corporations to the exclusion of "small businesses," which often are conducted by sole proprietorships, partnerships, LLCs, or S corporations. To level the playing field, Section 11011(a) of the Act adds to the Code new Section 199A, which provides a temporary (through taxable years beginning before 2026) income tax deduction to individuals, trusts and estates of 20 percent of the "qualified business income" from these pass-through vehicles. In all cases, the deduction may not exceed 20 percent of the taxpayer's taxable income (determined without the Section 199A deduction) reduced by net capital gain. I.R.C. § 199A(a)(1)(B), (e)(1). When fully available, the deduction effectively lowers the tax rate applicable to this income from 37 to 29.6 percent for the highest income taxpayers. This deduction is not allowed in computing adjusted gross income and thus does not affect limitations based on AGI, but it is available to taxpayers who do not otherwise itemize deductions. I.R.C. §§ 62(a); 63(b)(3).

At its most basic level, Section 199A permits an individual to deduct 20 percent of the qualified business income generated through a sole proprietorship, a partnership, or an S corporation. I.R.C. § 199A(a)(1)(A), (b)(1)(A), (b)(2)(A). As will quickly become apparent, the "qualified" modifier is ubiquitous in Section 199A. In particular, qualified business income consists of the net amount of qualified items of income, gain, deduction and loss with respect to each qualified business of the taxpayer. I.R.C. § 199A(c)(1).

Qualified Business Income Defined. As a starting point, "qualified business income" ("QBI") is the net amount of qualified items of income, gain, deduction and loss that are effectively connected with the conduct of a trade or business within the United States and which are included or allowed in determining taxable income for the relevant year. I.R.C. § 199A(c)(3)(A). Consistent with the intention to limit the deduction to operating income, the definition excludes a broad range of investment income: capital gains or losses, dividend income (or payments in lieu of dividends), interest income, net gains from commodities transactions, net foreign currency gains, net income from notional principal contracts, and annuity income. I.R.C. § 199A(c)(3)(B). Furthermore, the definition does not extend to compensation or similar payments an individual receives from a business. Hence, qualified income under Section 199A does not include reasonable compensation paid to the taxpayer from a qualified business for services rendered or, in the context of a partnership or LLC, it does not extend to any guaranteed payment made to the taxpayer under Section 707(c) in connection with the provision of services. I.R.C. § 199A(c)(4).

Qualified Trade or Business. For taxpayers who fall below critical taxable income thresholds established under Section 199A (discussed below), the scope of a qualified trade or business is remarkably broad. It includes any trade or business other than a trade or business of providing services as an employee. I.R.C. § 199A(d)(1)(B). Accordingly, an employee in her capacity as such cannot benefit from the Section 199A deduction. Rather, the deduction is limited to independent contractors, sole proprietors, and owners of S corporations, partnerships, and LLCs. But, as discussed below, this otherwise broad reach is restricted considerably for high-income taxpayers who are engaged in trades or businesses involving the performance of services in certain specified fields.

To illustrate a straightforward application of Section 199A, assume A, a single taxpayer who does not itemize deductions, practices law as a solo practitioner. Over the course of the year, her practice generates $140,000 of legal fees and $2,000 of interest income from her business deposits. A incurs $40,000 of deductible expenses attributable to her practice and she has no other sources of income. In this case, A is engaged in a qualified trade or business under Section 199A, as she is not providing services in an employee capacity. While her net income from the practice totals $102,000, only $100,000 constitutes QBI because the $2,000 of interest income is excluded from the definition. A's taxable income (without the Section 199A deduction) would be $90,000 ($102,000 less a $12,000 standard deduction). Accordingly, A may deduct 20 percent of the lesser of: (1) her $100,000 of QBI from the law practice, or (2) the $90,000 taxable income amount. Thus, A's Section 199A deduction is $18,000, reducing her final taxable income to $72,000. The $18,000 deduction has the effect of reducing A's average tax rate on the income from her law practice. Note that if A were an associate in a law firm and her wages as an employee were $100,000, she would not be entitled to any deduction under Section 199A.

Income-Based Thresholds: In General. The basic application of Section 199A becomes considerably more complex once a taxpayer reaches certain taxable income thresholds. Those thresholds – determined without reference to the deduction otherwise provided by Section 199A – are $157,500 for a single taxpayer and $315,000 for married taxpayers filing jointly, with each figure being indexed for inflation after 2018. Once these thresholds are reached, Section 199A imposes two independent limitations: (1) it excludes certain specified service-predominant activities from the definition of a qualified trade or business, and (2) it imposes a cap on the amount otherwise deductible under Section 199A, determined by reference to a percentage of the W-2 wages paid by the business (i.e., wages paid to its employees) or by references to a lesser percentage of W-2 wages paid and the cost of its depreciable property used in the production of QBI. These limitations, addressed in more detail below, are fully phased in when taxable income reaches $50,000 above the threshold amount for single taxpayers (that is, $207,500 in 2018) and $100,000 above the threshold amount for married taxpayers filing jointly (that is, $415,000 in 2018). Within the phase-in range, the limitations are each applied based on the ratio by which the taxable income of the taxpayer over the threshold amount bears to $50,000 for single taxpayers, or $100,000 for married taxpayers filing jointly. I.R.C. § 199A(b)(3)(B). For purposes of simplicity, the discussion below will refer to the limitations as applied in their fully phased-in form to "high-income taxpayers."

Limitation for Specified Service Businesses. For high-income taxpayers, Section 199A excludes any "specified service trade or business" from the definition of a qualified trade or business. I.R.C. § 199A(d)(1)(A), (3). A specified service trade or business for this purpose includes any 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, and any trade or business the principal asset of which is the reputation or skill of one or more of its employees or owners. I.R.C. § 199A(d)(2); see also I.R.C. § 1202(e)(3)(A). Investment managers and traders in securities are also included in the "specified service trade or business" category, and architects and engineers are excluded. I.R.C. § 199A(d)(2). As explained in the legislative history of the Act, the taxable income thresholds at which the exclusion for a specified service trade or business applies was intended by Congress "to deter high-income taxpayers from a attempting to convert wages or other compensation for personal services to income eligible for the 20 percent deduction under the provision." The exclusion, however, applies without regard to the taxpayer's subjective motivation. For instance, returning to the basic example above, if A were married and filed a joint return with her husband B who earned $350,000 in salary as an employee, A's law practice would no longer constitute a qualified trade or business for purposes of Section 199A.

W-2 and Qualified Property Limitations. In addition to limitations on the type of activities that will constitute a qualified trade or business, high-income taxpayers are subject to a cap on the amount that can be deducted under Section 199A. Although the deduction is generally equal to 20 percent of QBI, for high-income taxpayers that amount is limited to the greater of: (1) 50 percent of the "W-2 wages" with respect to the qualified trade or business, or (2) the sum of 25 percent of the "W-2 wages" with respect to the trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property" used in the trade or business. I.R.C. § 199A(b)(2)(B).

The scope of "W-2 wages" for purposes of this limitation includes the total amount of wages subject to income tax withholding, compensation paid into qualified retirement accounts, and certain other forms of deferred compensation paid to the employees of the business. I.R.C. § 199A(b)(4). For labor-intensive businesses, the figure determined by 50% of W-2 wages paid by the business likely will serve as the relevant cap on the amount deductible from that trade or business for purposes of Section 199A.

For capital-intensive businesses (e.g., real estate), however, an alternate cap exists. It starts with 25 percent of W-2 wages paid by the trade or business and adds to this amount 2.5 percent of the unadjusted basis (immediately after acquisition) of "qualified property." Qualified property for this purpose encompasses tangible property—real or personal—of a character subject to depreciation (hence, not land) that is held by and available for use in a qualified trade or business at the close of the taxable year, which is used in the production of qualified business income, and for which the depreciable period of the property has not ended before the close of the taxable year. I.R.C. § 199A(b)(6)(A). In light of the legislation's introduction of broad-based expensing of equipment purchases, the depreciable period of property for purposes of Section 199A ends upon the later of (a) 10 years after the date the property is placed in service, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under Section 168. I.R.C. § 199A(b)(6)(B).

Special Apportionment Rules. The application of the Section 199A to sole proprietors is fairly straightforward, as there can exist only one owner of such business. Accordingly, references to the qualified income, W-2 wages, and qualified property of the trade or business include all such amounts generated by the trade or business. However, for pass-through entities, such as S corporations that have more than one owner, these amounts must be apportioned among the respective owners. Section 199A provides special rules for this purpose. See I.R.C. § 199A(f). Each partner or shareholder takes into account only her "allocable share" of each item of income, gain, deduction and loss from the qualified trade or business. I.R.C. § 199A(f)(1)(A)(ii). The allocable share of a shareholder in an S corporation will be based on pro-rata stock ownership (different rules apply to partners). With respect to determining the cap applicable to taxpayer's deduction under 199A, those amounts too will be determined by reference to the shareholder's allocable share of the W-2 wages and unadjusted basis of qualified property in the trade or business. Again, the allocable shares of S corporation shareholders will be based on pro-rata stock ownership.

Examples. The examples below illustrate the operation of Section 199A in two basic situations.

Example 1. C holds a 25 percent ownership interest in an S corporation that operates a restaurant, and C's allocable share of net operating income from the corporation totals $100,000 for the year. C also earns has $200,000 of taxable income from sources unrelated to the business, subjecting him to the high-income limitations imposed by Section 199A. The corporation pays its employees $120,000 in wages over the course of the year, and the restaurant (which leases its building) has a $400,000 of unadjusted basis in restaurant equipment and furnishings used in the business for which the recovery period under Section 168 remains unexpired.

C's deduction under Section 199A is equal to the lesser of: (1) 20 percent of C's allocable share of qualified income from the trade or business (note that it is not a specified service trade or business), or (2) the greater of: (a) 50 percent of the C's allocable share of the W-2 wages paid by the corporation or (b) 25 percent of C's allocable share of the W-2 wages paid by the corporation plus 2.5 percent of the unadjusted basis of qualified property used in the corporation's trade or business. Keeping in mind that C's pro rata share of all tax items from the business is based on his 25 percent ownership, the starting point for calculating C's deduction under Section 199A is 20 percent of $100,000, or $20,000. However, this amount is capped by the greater of the following two amounts: 50 percent of

C's $30,000 share of W-2 wages paid by the corporation ($15,000) or 25 percent of C's $30,000 share of W-2 wages paid by the corporation ($7,500) plus 2.5 percent of C's $100,000 share of the unadjusted basis of qualified property held by the corporation ($2,500). Accordingly, C's deduction under Section 199A is capped at the higher of these two amounts, which is $15,000.

Example 2. D owns a 10 percent interest in an S corporation that owns and operates a commercial office building purchased for $550 million, $50 million of which was allocated to the underlying land. The corporation generates $50 million of net rental income for the year, and it pays its employees W-2 wages of $500,000. In the absence of any cap, D's deduction under Section 199A would equal 20 percent of his $5 million allocable share of net rental income, or $1 million. If this amount were capped at 50 percent of D's $50,000 allocable share of W-2 wages paid by the corporation, the deduction would be reduced significantly to $25,000. However, the alternate cap of 25 percent of D's 50,000 allocable share of W-2 wages ($12,500) when added to 2.5 percent of D's $50 million allocable share of the unadjusted basis of the commercial office building ($1.25 million) produces a cap on D's Section 199A deduction of $1,262,500. Accordingly, D's $1 million deduction under Section 199A based on 20 percent of his qualified income from the corporation and is not subject to the limitation.

E. DISTRIBUTIONS TO SHAREHOLDERS

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Distributions after Conversion from S to C Corporation Status. As described in the text, distributions from S corporations generally are treated as coming first from the corporation's accumulated adjustments account ("AAA") and, when relevant, any excess is treated as coming from earnings and profits generated by the corporation when it was a C corporation or carried over under Section 381 as a result of a tax-free transaction such as a merger. I.R.C. § 1368. If an S corporation's S election terminates, causing it to become a C corporation, the Code provides special rules for cash distributions made during a post-termination transition period ("PTTP"), which generally is one year. I.R.C. § 1377(b). A cash distribution during the PTTP is treated as a reduction of basis to the extent it does not exceed the S corporation's AAA, but after the PTTP expires, distributions are treated as coming first from earnings and profits and taxed as a dividend to that extent. I.R.C. § 1371(e)(2).

Section 13543(b) of the Act provides additional relief in the S to C corporation conversion scenario by providing that, for cash distributions made after the expiration of the PTTP, the AAA shall be allocated to the distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the AAA bears to the amount of the accumulated E & P. To qualify for this relief provision, the corporation must: (1) have been an S corporation on December 21, 2017 (the day before the date of enactment of the Act); (2) revoke its S election within the two-year period beginning on the date of enactment; and (3) have the same owners on the date its S election is revoked and in the same proportions as on the date of enactment. I.R.C. §§ 1371(f); 481(d)(2).

F. Taxation of the S Corporation

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Tax on Certain Built-in Gains. Effective for taxable years beginning after December 31, 2017, the reduction to the highest corporate income tax rate results in a corresponding reduction of the Section 1374 tax rate from 35 to 21 percent.

Page 708:

Tax on Passive Investment Income. Effective for taxable years beginning after December 31, 2017, the reduction of the highest corporate income tax rate results in a corresponding reduction of the Section 1375 tax rate from 35 to 21 percent. In the illustration at pages 709-710 of the text, X's liability will be reduced from $1,750 to $1,050 ($5,000 x 21%).

G. Coordination with Other Income Tax Provisions

1. Subchapter C

Page 718:

Change of Accounting Method on Conversion of S Corporation to C Corporation. With the corporate income tax rate reduced to 21 percent, some S corporations may choose to revoke their S elections and become C corporations. Since C corporations generally are required to use the accrual method of accounting, the conversion may require the corporation to change from the cash to the accrual method, triggering certain adjustments under Section 481 in computing taxable income. To provide relief in this situation, Section 13543 of the Act permits any such Section 481 adjustments arising from a change in accounting method caused by an S to C conversion to be taken into account ratably over six tax years. I.R.C. § 481(d).