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Legal Alert: The Tax Cuts and Jobs Act, Take One: A Methods-Based Overview of the Initial Draft of the House Tax Bill

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In the Tax Cuts and Jobs Act (the Act) released by the House Ways & Means Committee on Thursday, November 2, 2017, a number of reforms were proposed that would have a direct and substantial impact on American businesses. Republicans are targeting the end of the year as the deadline to pass a tax bill, and the introduction of the Act is a significant step toward that goal. As is the case with all significant legislation, the Act is likely to undergo further revision before it is voted on by the full House. In addition, it is expected that the Senate Finance Committee will release its own tax reform bill this week. While the Administration's Unified Framework, released September 27, 2017, was intended to guide both Congressional tax-writing committees, the Senate bill could differ from the House's Act in meaningful ways (for example, the corporate integration plan favored by Chairman Orin Hatch was not included the Act). In light of the significant changes contemplated by the Act, businesses will need to carefully follow (and consider steps to mitigate) the potential impact of expected changes in the Internal Revenue Code.

With respect to issues that fall within the umbrella of income tax accounting and accounting methods, full expensing, the expansion of section 179 expensing, and the elimination of the section 199 domestic production activities deduction are particularly significant. In consideration of the entire Act, there are also a number of accounting method opportunities that taxpayers should consider in light of the major changes to the corporate tax system as well as opportunities to take advantage of the proposed reduction in the corporate tax rate. All taxpayers should review their treatment of items of income and expense to ensure they are capturing the greatest value of deductions in 2017 before rates are reduced, and deferring income to the extent possible into future years with the reduced rate.

Five-Year Period of Full Expensing

Section 3101 of the Act provides for taxpayers to be able to fully expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (with an additional year for certain qualified property with a longer production period). This provision follows closely 100% bonus depreciation, which was effective in 2011, and provides taxpayers with immediate expensing of capital purchases for a five-year period. This temporary window of immediate expensing differs significantly from the current bonus depreciation regime, which affords taxpayers a much smaller deduction for additional depreciation. More specifically, the current rules provide taxpayers with 50%, 40%, and 30% additional amounts of depreciation for property placed in service during the 2017-2019 tax years. By replacing this current phased-out approach with a five-year period of immediate recovery, the Act aims to incentivize capital investment by American companies and spur economic growth.

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The provision expands the scope of property eligible for immediate expensing by repealing the requirement that the original use of the property begin with the taxpayer. As proposed, qualified property eliminates the requirement that the original use of the property begin with the taxpayer, which current bonus depreciation provisions require. As such, there is less of a distinction between bonus depreciation and section 179 than existed previously. Currently, bonus depreciation applies exclusively to new equipment, while section 179 applies to both new and used equipment (as long as the equipment is new to the taxpayer). The repeal of the original use requirement for bonus depreciation should be a significant benefit to industries that routinely acquire used and not necessarily new equipment. This expanded definition of qualified property could also affect corporate transactions. If enacted, the full expensing provision could be used to deduct consideration paid for assets acquired in applicable asset acquisitions. Although such costs are generally capitalized and then allocated to the assets acquired, to the extent that these amounts are properly allocable to qualified property, it appears that these amounts would be available for immediate expensing.

One limitation of the proposal is the exclusion of any property used by a regulated public utility company or any property used in a real property trade or business from classifying as qualified property. With respect to the types of trades or business engaged in by a regulated public utility company that are excluded under this provision, this includes the trade or business of the furnishing or sale of: (1) electrical energy, water, or sewer disposal services; (2) gas or steam through a local distribution system; or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by any agency of instrumentality of the United States, or by a public service or public utility commission or other similar governing body; with respect to property used in a real property trade or business, this includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Historically, qualified property eligible for bonus depreciation was defined as tangible personal property with a MACRS recovery period of 20 years or less, certain off-the-shelf computer software, water utility property, and qualified improvement property. It will be interesting to see how the exclusion of this full expensing provision impacts those industries possessing property excluded from the provision. Other limitations include property acquired in nontaxable exchanges, property acquired from a related party as defined in section 267, as well as transfers from a person who controls, is controlled by, or is under the common control of the taxpayer.

Further, a taxpayer's election to use AMT credits in lieu of additional depreciation would be repealed. This contrasts with the current law that allows taxpayer to elect to accelerate their use of AMT credits in lieu of additional depreciation. Due to the more significant repeal of the AMT in section 2001 of the Act, this elimination of a taxpayer's ability to use AMT credits in lieu of bonus depreciation should be no surprise. If enacted, 2017 would be the last tax year

for which this election would be available. For this reason, taxpayers may need to consider whether to recover AMT credits with a 2017 election or recover these amounts through the proposed transition rule, which allows recovery of unused credits in subsequent years.

It is important to note that not all companies will benefit from this provision as many new and growing companies often operate from a loss position. Additionally, certain capital intensive companies are in a position of net operating loss (NOL) as a result of taking advantage of bonus depreciation since its original enactment in 2001. To the extent a company is growing, investing in new equipment, but operating at a loss, this full expensing provision may not provide any immediate benefit, and in fact, might negatively affect a company's bottom line. This result is further complicated by the changes in the NOL provisions (discussed below), which reduce the available NOLs and also eliminate carrying the NOL back. For this reason, it is anticipated that any final legislation would retain provisions that are part of the current bonus depreciation regime, which include, an annual election permitting companies to forgo bonus depreciation. The annual election provides limited flexibility to companies that may not benefit from full expensing.

Expansion of Section 179 Expensing

Section 179 was originally enacted to provide small businesses a current year deduction for the full purchase price of financed or leased equipment and qualifying off-the-shelf software. Intended for small businesses, section 179 placed a cap on the possible total amount written off ($500,000 for 2017) and limits to the total amount of the equipment purchased ($2,000,000 in 2017). The deduction begins to phase out dollar-for-dollar after $2,000,000 is spent by a given business, thereby making it a true small and medium-sized business deduction. The immediate expensing provision essentially eliminates the benefits of section 179; however, for property outside the scope of the full expensing provision, the changes to section 179 may offer significant opportunity.

Section 3201 of the Act increases the expensing limitation to $5 million and the phase-out amount to $20 million, with both caps indexed for inflation. Similar to the five-year period for full expensing discussed above, the expansion of section 179 would be available for tax years 2018-2022. In addition to increasing the section 179 caps on expensing and the correlating phase out, Section 3201 also modifies the definition of section 179 property to include qualified energy-efficient heating and air-conditioning property, in addition to the historic definition, which included tangible personal property with a MACRS recovery period of 20 years or less, certain off-the-shelf computer software, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Repeal of the Domestic Production Activities Deduction

Section 3306 of the Act repeals the domestic production activities deduction (DPAD) provided for in section 199 of the Code. The repeal would be effective for tax years beginning after 2017; therefore, taxpayers seeking to take advantage of the deduction for the 2017 tax year still have time to review their treatment of such costs and maximize any available benefit.

Currently, section 199 allows taxpayers to claim a deduction equal to 9% (6% in the case of certain oil and gas activities) of the lesser of the taxpayer's qualified production activities income (QPAI) or the taxpayer's taxable income for the tax year. The deduction is limited to 50% of the W-2 wages paid by the taxpayer during the calendar year. QPAI is equal to domestic production gross receipts (DPGR) less the cost of goods sold and expenses properly allocable to such receipts. Qualifying receipts are derived from property that was manufactured, produced, grown, or extracted (MGPE) within the United States; qualified film productions; production of electricity, natural gas, or potable water; construction activities performed in the United States; and certain engineering or architectural services. Qualifying receipts do not include gross receipts derived from the sale of food or beverages prepared at a retail establishment; the transmission or distribution of electricity, gas, and potable water; or the disposition of land.

Although the section 199 deduction was designed to incentivize businesses to operate and make and sell their goods in the United States, the Administration has stated the deduction, as well as many others that are being repealed in the Act, are no longer necessary in light of the significant reduction in the corporate tax rate. Because the section could now be repealed, taxpayers with activities eligible for the deduction should consider whether to file amended returns to ensure that they are claiming the full amounts of the section 199 deduction that is currently available. If enacted as proposed, companies will need to consider a claim on an amended return for open tax years beginning before January 1, 2018.

Reduction in Amount of NOLs and Repeal of Most NOL Carrybacks

Section 3302 reduces the potential amount of taxpayers' net operating loss (NOL) deductions to 90% of the taxpayer's taxable income; currently, NOL deductions are not limited in such a way. Additionally, section 3302 eliminates all NOL carrybacks, but for a special one-year carryback for small business and farms in the case of certain casualty and disaster losses. This change is rather significant as currently NOLs may be carried back two years generally, although there are much larger carryback periods for certain kinds of NOLs: five-year carryback for NOLs arising from a farming loss, certain bad debts of commercial banks, and disaster relief; ten-year carrybacks for specified liability losses; and, five-year carryback for losses incurred in 2008 and 2009, and NOLs incurred by certain electric utility companies from 2003 to 2005.

It will be important for taxpayers when evaluating how to assess the impact of this change to pay attention to the timing of such losses, as the changes vary depending on the type and timing of the NOL. The Act generally would be

effective only for losses arising in tax years beginning after 2017. Additionally, any NOL, specified liability loss, excess interest loss, or eligible loss carrybacks would be permitted in a tax year beginning in 2017 as long as the NOL is not attributable to the increased expensing provided in the Act. As with other provisions in the bill, NOLs arising in tax years beginning after 2017 and that are carried forward would be increased by an interest factor to preserve their value.

Further, NOLs are captured on a company's balance sheet as deferred tax assets. To the extent the corporate tax rate is 35%, every dollar of a net operating loss results in a 35-cent deferred tax asset on that company's financial statements. Under the Act, the value of that deferred tax asset is decreased dramatically as the corporate tax rate is reduced, dropping the value of such deferred tax assets from 35% to 20% of any existing net operating losses.

Simplification of Tax Accounting Requirements for Small Business Taxpayers

Section 3202 of the Act provides welcome simplification to small business taxpayers with respect to their accounting methods practice and accounting for inventory. Currently, sole proprietorships, partnerships (without a corporate partner), S corporations, and corporations and partnerships with corporate partners with average gross receipts less than $5 million may use the cash method of accounting to recognize income and deduct expenses. The Act increases the gross receipts threshold for corporations and partnerships with a corporate partner from $5 million to $25 million in order to qualify to use the cash method of accounting. The increased threshold would also be extended to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations, all of whom currently have much more restrictive thresholds that prevent them from using the cash method of accounting.

In addition to increasing the thresholds for corporations and partnerships with corporate partners to qualify to use the cash method of accounting, section 3202 also allows businesses with average gross receipts less than $25 million that maintain inventories to use the cash method of accounting. If choosing to use the cash method of accounting, qualifying taxpayers may account for inventory as non-incidental materials and supplies. Currently, businesses are required to use an inventory method if maintaining inventory is a material income-producing factor to the business, and such taxpayers are required to use the accrual method of accounting for tax purposes. There is currently an exception for small business with average gross receipts of not more than $1 million, and business in certain identified industries whose annual gross receipts don't exceed $10 million, but the new legislation clearly raises the thresholds for all, providing administrative relief to a number of taxpayers currently maintaining inventories as part of their business.

Lastly, section 3202 raises the average gross receipts threshold for taxpayers exempt from the uniform capitalization (UNICAP) rules and the percentage-of-completion method for long-term contracts from $10 million to $25 million. Currently, a business with less than $10 million of average annual gross receipts

is not subject to the UNICAP rules with respect to personal property acquired for resale, but the legislation raises that threshold to $25 million and expands the exemption to personal *and* real property acquired or manufactured by such business, in addition to personal property acquired for resale. As for the increased threshold with respect to taxpayers with long-term contracts, in order to be exempt from the requirement to use the percentage-of-completion method (as opposed to the completed contract method), taxpayers now must have average annual gross receipts of less than $25 million, as opposed to the current, more restrictive $10 million threshold.

Section 3202 not only provides a greater number of taxpayers with access to the more administratively feasible cash method of accounting, but it also provides a number of simplifying accounting method rules to such taxpayers. Furthermore, the threshold standard for each of these conventions is aligned to the same dollar amount, $25 million, to facilitate easier compliance.

Other Notable Changes

Similar to the strategy used with respect to individual income tax deductions, the Act either repeals or modifies a number of business tax deductions and benefits. Section 3305 repeals deductions for lobbying expenses with respect to legislation before local government bodies; currently, there was an exception for local lobbying expenses from the general rule that expenses for lobbying and political expenditures with respect to legislation and candidates for office were non-deductible. The Act likely eliminated this exception to reduce the administrative complexity of compliance.

Section 3307 eliminates the deduction for entertainment, amusement or recreation activities, facilities, or membership dues relating to such activities or other social purposes. Additionally, there would be no deduction available for transportation fringe benefits, benefits in the form of on-premises gyms and other athletic facilities, or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business, except to the extent that such benefits are treated as taxable compensation to an employee. Currently, to the extent a taxpayer demonstrates that the item is directly related to the active conduct of the taxpayer's trade or business, a taxpayer may deduct up to 50% of such expenses. As indicated above, the Act would limit the 50% limitation to expenses for food and beverage and qualifying business meals, with no deduction available any longer for any amount of entertainment expenses.

Section 3309 also makes a significant change to the treatment of FDIC premiums to certain large depository institutions. Currently, amounts paid by insured depository institutions pursuant to an FDIC assessment to support the Deposit Insurance Fund (DIF) are deductible. The Act would limit the deductibility of a percentage of such assessments for institutions with total consolidated assets greater than $10 billion. While this change may not simplify the treatment of such expenses by certain institutions, it is intended to correct

the current negative impact the deductibility of such payments have on the FDIC General Fund.

Lastly, Section 3311 would treat the gain or loss from the disposition of *all* self-created property as ordinary in character. Currently, a self-created patent invention, model or design, or secret formula or process is treated as a capital asset, while only the following self-created property are not: copyrights; literary, musical or artistic compositions; and letters or memoranda. This change would certainly streamline the treatment of all self-created property, although resulting in not-necessarily taxpayer-favorable treatment of any related gain or loss.

Corporate Tax Rate Reduction

Section 3001 of the Act reduces the corporate tax rates to a flat rate of 20%, effective in 2018. Companies should consider accounting method planning now in anticipation of the rate change. Planning that accelerates deductions to the current (and higher) 35% federal tax rate or that defers income recognition to the future (and expected lower rate) will reduce cash taxes. Further, because of the anticipated rate change, such planning may also result in permanent tax benefits planning that reduces deferred tax assets (DTAs) by the amount of book expense when DTAs must be written down from 35% to 20%. Similarly, planning that creates or increases deferred tax liabilities (DTLs) will result in book income when DTLs are written down from 35% to 20%.

In reviewing their current methods practice and deciding whether to make accounting method changes or other planning in response to the Act, taxpayers should pay particular attention to whether such accounting method changes are available on an automatic or non-automatic basis. While automatic accounting method changes can be attached to a company’s 2017 return, for calendar-year taxpayers, October 15, 2017, non-automatic accounting method changes must be filed by the end of the tax year, for calendar-year taxpayers, December 31, 2017. With these issues in mind, it is essential for taxpayers to review the list of automatic accounting method changes available in Rev. Proc. 2017-30 to determine whether a potential change is automatic or not, and, subsequently, the appropriate deadline for filing.

Additionally, taxpayers should consider whether certain changes can be effected without an accounting method change. With respect to certain items, changes may be available with a change in underlying facts (change in contracts or business practice), for example, change regarding year-end accrual of bonus payment liabilities. Changes may also be effected for certain items through an amended return (correcting section 199 deductions, carryback claim while NOLs may be carried back to earlier tax years) or late elections that may be available through a section 9100 request. Because the Act is generally effective for tax years beginning after 2017, these issues should be carefully considered in the event that action is required before December 31, 2017.

Please see our Tax Reform Law blog for more information, including the text of the Act, the House Ways and Means Committee Summary, the Joint Committee on Taxation Explanation, and more in-depth analysis on other sections of the Act.

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