The United States recently enacted a host of changes to its income tax rules. This FAQ addresses the most significant changes to the business income tax rules.

by Joe Mandarino

Is it true that because of the new tax law I should run my business in a corporation rather than a pass-through entity?

The new U.S. tax act reduces the federal corporate income tax rate from 35% to 21%. For pass-through entities, the federal income tax rate will vary from 41% to 30%. At first glance, it would seem more efficient to operate a business in a corporation rather than a pass-through entity. However, even though it has a lower tax rate, a corporation may not be appropriate if the net cash flow of the business is distributed out to the owners frequently, or if there is a desire to sell the assets of the business in the future. The correct choice for a given business will depend on its operational model and exit strategy.

Will the new tax law have any effect on the state income tax treatment of my business?

Because federal tax rates have decreased, there will be more pressure to optimize state tax rates. For example, on the corporate side, the high federal tax rate meant that state taxes were subsidized by 35%. That subsidy has decreased by 40% under the new U.S. tax act. In some jurisdictions, the state tax burden can approach half or more of the federal tax rate. Businesses with high state tax burdens may need to restructure operations to compete with more tax-efficient businesses.
I understand that the new tax law cut the tax rates for corporations, but I operate a business in a pass-through. Does the new tax law provide any incentives for me?

In an effort to reduce taxes on pass-through entities, the new U.S. tax act contains a special tax benefit for partnerships, trusts, and sole proprietorships. Rather than creating a special tax rate just for pass-through income, the new U.S. tax act eliminates 20% of such income in calculating the owner’s ultimate taxes. For individual members of an LLC, for instance, this reduces the top tax rate from 37% to 29.6%. (Or from 40.8% to 33.4% if the 3.8% Affordable Care Act applies.) This tax benefit is subject to several limitations:

- Income from certain service activities is excluded (the “service limitation”).
- Income from businesses without sufficient W-2 wages or assets is excluded (the “wage/property limitation”).
- Income and losses from all qualifying businesses are netted and any net loss carries forward to the next year (the “netting limitation”).

Significantly, the service and wage/property limitations do not apply to taxpayers who are under certain income thresholds. The threshold is taxable income no greater than $157,500 ($315,000 for joint filers).

For taxpayers with taxable income in excess of $207,500 ($415,000 for joint filers), the limitations apply fully. For taxpayers with taxable income within those bounds, only a ratable portion of the benefit is permitted. For business owners who cannot utilize the income threshold, it will be extremely important to meet the service and wage/property limitations. A business may have to be reorganized so that some or all of its income can qualify for the pass-through tax benefit.

Does the new tax law provide incentives for the purchase of used assets?

The new U.S. tax act provides a liberalized regime for expensing of tangible assets. This regime also applies to used assets acquired from unrelated parties in certain types of asset transactions. In the context of an asset acquisition, this format will generate pressure to allocate more value to tangible assets and less to intangible assets, such as goodwill.

My business includes significant foreign operations and/or foreign ownership. Does the new tax law impact how I should conduct operations?

The new U.S. tax act imposes a minimum tax on certain earnings of foreign affiliates, typically those in low-tax or no-tax jurisdictions. It also disallows some deductions for payments by a U.S. corporation to a foreign affiliate (e.g., royalties to a foreign parent). Although on balance the new rules appear to be more beneficial than not, they contain traps for the unwary and rely on nonsubstantive legal formalities. U.S. companies with foreign operations and/or a foreign parent should consider changes to their operations and capital structures to best navigate these new rules.

Does the new tax law have incentives to keep royalty income in the U.S.?

The new U.S. tax act incentivizes U.S. corporations that earn “foreign-derived intangible income” – this is taxed at about 10% rather than the standard 21%. In certain circumstances, it may make sense to house intellectual property in the U.S. and license it to foreign affiliates. U.S. companies with foreign subsidiaries and/or a foreign parent need to carefully examine the new U.S. tax act to determine the best structure for developing, holding and licensing intangible property going forward.

My business holds significant offshore earnings in foreign subsidiaries. Will the new tax law impact those holdings?

In the long term, U.S. companies with foreign subsidiaries may benefit significantly from the new U.S. tax act. For example, dividends from foreign subsidiaries are now generally exempt from U.S. tax. In contrast, the accumulated overseas income of any foreign subsidiaries prior to the new U.S. tax act is deemed repatriated. The repatriation income amount is generally taxed at a rate of 15% for cash items and 8% on all other assets. The resulting tax liability can be spread out over eight years without an interest charge. In some cases, the repatriation income may be covered by a foreign tax treaty and, with careful cash flow management, may have zero net effect on worldwide tax expenses. U.S. companies with accumulated offshore earnings should carefully manage the calculation and payment of the repatriation tax.

My business has a lot of interest expense. Is it true that the new tax law restricts how much I can deduct?

Generally, the new U.S. tax act limits the deduction for net interest expense to 30% of the taxpayer’s EBITDA (starting in 2022, the limitation drops to 30% of EBIT). There is no transition relief – interest deductions on existing loans are limited just as for new loans. For businesses that have large amounts of net interest expense, alternatives to debt treatment may be available to fill the gap. For example, a sale-leaseback can generate equivalent rental deductions that are not subject to the interest limitation. A business with significant net interest expense may need to change its operations and/or capital structure to mitigate the loss of this tax benefit.

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