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Tax Act: Key Issues for Corporate Taxpayers, Including Changes in Rules Related to Net Operating Losses and Interest Deductions

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In an effort to be competitive with other nations, the Tax Act provides comprehensive reform of the taxation of corporations. In particular, the Tax Act reduces the corporate tax rate from 35% to 21% and repeals the alternative minimum tax for corporations, in each case for taxable years beginning after December 31, 2017, while broadening the base of income on which corporations are taxed. Significant changes impacting the taxation of corporations are described below.

Net operating losses. The Tax Act limits the amount of the net operating loss ("NOL") deduction to which a corporation is entitled in a taxable year to 80% of the taxable income of the corporation for such year (computed without regard to the NOL deduction). The 80% limitation applies to losses arising in taxable years beginning after December 31, 2017. Prior to the Tax Act, an NOL from a taxable year was first carried back to the prior two taxable years of the corporation and then carried forward to the following twenty taxable years. Under the Tax Act, NOLs are no longer permitted to be carried back but shall be carried forward indefinitely. The changes to the carryforward and carryback period apply to NOLs arising in taxable years ending after December 31, 2017. Special rules apply for property and casualty insurance companies.

Limitations on deduction for interest. The Tax Act limits the amount a corporation is entitled to deduct as business interest in any taxable year beginning after December 31, 2017. The business interest deducted generally shall not exceed the sum of (i) the business interest income of the corporation for such taxable year plus (ii) 30% of the adjusted taxable income of the corporation for such taxable year.[1] Adjusted taxable income means the taxable income of the corporation without regard to (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, (ii) any business interest expense or business interest income, (iii) the amount of any net operating loss deduction, and (iv) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. For purposes of these rules, a consolidated group will be treated as one corporation.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest includible in the gross income of the corporation for the taxable year which is properly allocable to a trade or business. For this purpose, trade or business does not include certain specified trades or businesses, such as an electing real property trade or business.

The amount of any business interest not allowed as a deduction for any taxable year shall be treated as business interest paid or accrued in the succeeding taxable year. Section 381 of the Code was amended to provide that the carryforward of business interest deductions shall transfer to the acquiring corporation in certain corporate transactions, and Section 382 of the Code was amended to provide that such carryforwards will be treated as pre-change losses subject to limitation under Section 382 in the event of an ownership change of a corporation.

The limitation does not apply to a corporation for a taxable year if the corporation's average annual gross receipts for the prior three taxable years does not exceed $25 million.

Bonus depreciation. The Tax Act amends the Code to provide an increased first-year depreciation deduction for qualified property. Under the Tax Act, a corporation is entitled to deduct 100% of the cost of qualified property acquired and placed in service after September 17, 2017, and before January 1, 2023. For the following four years, the percentage of the cost permitted to be deducted decreases from 80% to 20%. The periods are one year longer for certain longer-production property. Qualified property is generally tangible property to which the modified accelerated cost recovery system for depreciation applies with an applicable recovery period of 20 years or less, and computer software. The bonus depreciation rules are broadened under the Tax Act to apply to used property acquired from an unrelated taxpayer as well as new property. For the first taxable year ending after September 27, 2017, a corporation may elect to depreciate 50% of its cost instead of 100% of its cost.

Research and experimental expenditures. Prior to the Tax Act, research and development expenditures (including software development expenses) were deductible in full in the year they were incurred (although a corporation could elect to treat such expenditures as deferred expenses and amortize the costs over a period of not less than sixty months). Under the Tax Act, expenditures paid or incurred after December 31, 2021 must be capitalized and amortized over a five-year period (or a fifteen-year period if the expenditures are attributable to research conducted outside the United States).

Section 179 expensing. Under Section 179 of the Code, a corporation may elect to deduct the cost of certain depreciable property rather than recover such costs through depreciation deductions, subject to limitation and phase-out. The Tax Act increases the limitation from $500,000 to $1,000,000 and increases the phase-out threshold amount to $2,500,000. Therefore, the $1,000,000 amount is reduced by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000. The Tax Act also expands the type of property to which Section 179 applies.

Contributions by governmental entities. Under Section 118 of the Code, gross income does not include any contribution to the capital of a corporation. Under the Tax Act, Section 118 was amended to provide that a capital contribution shall not include (i) any contribution in aid of construction or any other contribution as a customer or potential customer and (ii) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). Such amendment generally applies to contributions made after the date of enactment of the Tax Act.

Taxable year of inclusion. The Tax Act amends Section 451 of the Code to provide generally that in the case of an accrual method taxpayer, an item of gross income shall be included in income no later than when such item is taken into account as revenue in an applicable financial statement of the taxpayer. The Tax Act also includes special rules for advance payments for goods, services, and other items identified by the Secretary.

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[1] The limit also may be increased by floor plan financing interest, which is interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease and secured by the inventory so acquired.

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