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Legislative Update | Tax Cuts and Jobs Act

Business tax highlights

Table of contents

Overview……………………....1

C corporation changes...... 2

Pass-through entity deduction…………………...... 3

Executive compensation... 7

Planning opportunities….. 7

On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (P.L. 115-97). Highlights of many key business provisions are outlined below. We'll continue to provide additional information and analysis as we move forward in 2018.

When will these provisions go into effect? Unless noted, the provisions became effective for tax years beginning after **December 31, 2017**.

Business taxation overview

Provision	2017 Law	New Law	Analysis
Income taxation of C corporations IRC Section 11(b)	C corporations were subject to graduated rates as follows: $0 - $50K 15% $50K - $75K 25% $75K - $10M 34% Over $10M 35%	All C corporations (including personal service corporations) are subject to a flat income tax rate of 21%, for tax years beginning after December 31, 2017.	C corporation owners are subject to taxation both at the entity level and the individual level. The 21% flat tax rate has no scheduled expiration date.
Repeal of corporate alternative minimum tax IRC Sections 53, 55-59	Larger C corporations were subject to an alternative minimum tax, to the extent that their tentative minimum tax exceeded their regular tax.	The corporate alternative minimum tax is repealed.	The corporate alternative minimum tax generally applied only to larger C corporations (generally defined as having average annual gross receipts of $7,500,000 over three-year period). See page 2 for further analysis.

Provision	2017 Law	New Law	Analysis
Income taxation of pass-through entities and sole proprietorships New IRC Section 199A	Income passed through to owners of S corporations, partnerships, sole proprietorships and most LLCs was taxed at the individual's top marginal rate.	An income tax deduction of up to 20% of "qualified business income" is available to many owners of pass-through businesses. Income and other limits apply.	This deduction will effectively lower the income tax liability of many pass-through business owners. This change is scheduled to expire after December 31, 2025.
Executive compensation deduction limitation IRC Section 162(m)	Limits deductibility for compensation more than $1M for public company's covered executives.	Expands definition of public company and covered executives. Expands compensation definition to include performance-based compensation and commissions.	This new definition applies to public companies and companies that have registered debt offerings (Sec. 15(d)). Covered employees include CEO, CFO and next 3 highest compensated officers.
Executive compensation and tax-exempt organizations New IRC Section 4960	Tax-exempt organizations were generally not subject to compensation limitations. May be limited by private inurement rules under IRC Sec. 4598 if compensation is excessive.	Imposes an annual 21% excise tax to any applicable tax-exempt organization on compensation more than $1M on any covered employee. Covered employees include the organization's 5 highest paid employees.	The $1M compensation includes wages and parachute payments. The statute does not include a control group rule so several questions remain unanswered.

C corporation tax changes

The graduated tax rates that were previously in effect for C corporations have been replaced with a flat rate of 21% for all C corporations. This includes personal service corporations, which were previously subject to a flat rate of 35%.

For profitable C corporations, employers will have additional after-tax income for company expansion, company protection and key employee retention. As was the case under prior law, C corporation owners are generally taxed on corporate distributions, which creates two levels of taxation.

The repeal of the corporate alternative minimum tax (AMT) is favorable for C corporations that own life insurance. Under prior law, a portion of a life insurance death benefit paid to a C corporation subject to AMT would be considered a tax adjustment item subject to the AMT calculation. A portion of cash value growth for a corporate-owned policy might also be considered a tax adjustment item. The repeal of the corporate AMT will mean life insurance death proceeds to the corporation will generally be income tax-free.

Personal holding company tax

With lower tax rates and the appeal of accumulating funds in a C corporation, the penalty for personal holding companies (PHCs) could become a concern for some business owners. This 20% penalty (paid at the company level) is triggered by certain types of undistributed passive-type income from PHCs (as defined by the Code) that are not distributed to business owners. S corporations are generally not subject to the PHC tax.

Business owners should carefully monitor their C corporation for possible PHC status if much of business income comes from passive sources. If the company is classified as a PHC (as defined by the Code), care should be exercised to distribute passive-type income to business owners during the taxable year, notwithstanding the likely dividend income tax treatment at the personal level.

Accumulated earnings tax

If a C corporation retains earnings over a certain level (generally $250,000 or $150,000 for personal service corporations) without a reasonable business purpose, the income may be subject to a 20% accumulated earnings penalty tax. This would be paid at the corporate level, in addition to the corporate income tax. (The same income will not be subject to both PHC tax and accumulated earnings tax.)

No change was made in this potential tax under the Act. This means business owners should exercise care that substantial accumulations of earnings are retained for reasonable business purposes.

What are examples of reasonable business purposes? Key person life insurance funded with permanent life insurance might be one. Informal company funding of nonqualified deferred compensation might be another example. And, planned business expansion might be a third.

Pass-through business deduction

A new deduction has been created for owners of pass-through entities, designed to reduce the income tax rates of certain business owners.[1] The deduction is available for up to 20% of qualified business income (QBI) of certain business owners, subject to limitations. The deduction is applied at the individual level, not the business level. The availability of the deduction depends in part on the individual business owner's taxable income, as follows:

For individuals with taxable income below $157,500 (single) or $315,000 (married filing jointly): the deduction is 20% of QBI.

For individuals with taxable income $157,500 - $207,500 (single) or $315,000 - $415,000 (married filing jointly): the 20% deduction is subject to phaseout, as well as a special reduction for service business owners.

For individuals with taxable income exceeding $207,500 (single) or $415,000 (married filing jointly): the deduction is available only for owners of businesses other than a "specified service trade or business," as defined on page 6. The deduction for those individuals may be less than 20%.

Pass-through business owner's taxable income level	Specified service business[2]	Nonservice businesses[3]
Owner with taxable income **below threshold** ($157,500 single, $315,000 married filing jointly)	20% deduction	20% deduction
Owner with taxable income **in phaseout range** ($157,500 - $207,500 single, $315,000 - $415,000 married filing jointly)	Deduction is subject to both a phaseout and a reduction (see "Service business reduction" on page 6)	Part or all of deduction may be phased out, depending on results of the wage/basis calculation amount (see "Phaseout calculation" on page 5)
Owner with taxable income **exceeding phaseout range** ($207,500 single, $415,000 married filing jointly)	No deduction	Deduction is the lesser of the 20% amount or the WBC amount (described below)

Qualified business income deduction examples

Example 1: Phil has an S corporation that passes through $100,000 of income to him. Phil is married filing jointly, with taxable income of $225,000. Phil receives a deduction in the amount of $20,000 (20% x $100,000), regardless of the nature of the business.

Example 2: Patti is the owner of Patti's Wine Shop, which passes through $200,000 of income to her. Patti is married filing jointly, with taxable income of $365,000. Patti's initial 20% calculation amount is $40,000, but since her income is above the $315,000 threshold, the deduction will be reduced (see examples 4 and 6 below, for details).

Example 3: Lance has a law practice and Lance's Pizza Café that each pass through $200,000 of income to him. Lance is married filing jointly, with taxable income of $500,000. Lance does not receive a deduction for the income from his law practice, because it's a specified service business and his income is above the phaseout range. However, he might be eligible to take a deduction for a portion of the income from the pizza café, depending on the results of a second calculation involving wages and his basis (explained below).

W-2 wages and basis calculation (WBC)

For owners of businesses whose taxable income exceeds the thresholds described above, there's an additional stage to calculating the deduction.[4] The W-2 wages and basis calculation (we'll call it WBC) determines the greater of: (a) 50% of the owner's allocable share of the business's W-2 wages, or (b) 25% of the share of the W-2 wages plus 2.5% of the unadjusted basis of all qualified property (defined on page 7).

Example 4: Returning to Patti's Wine Shop above: in addition to the facts in Example 2, Patti's unadjusted basis in her shop is $100,000, and Patti's allocable share of wages is $50,000.[5] The WBC calculation amount is $25,000. This is the greater of (a) $25,000 (50% of her allocable share of wages), or (b) $15,000 (25% of wages ($12,500), plus 2.5% of basis ($2,500)). The WBC amount is necessary to calculate Patti's phaseout, as explained below.

In 2018, the phaseout range for single individuals is $157,500 - $207,500. For married individuals filing jointly, the range is $315,000 - $415,000. The phaseout calculation is explained below.

For individuals above the phaseout range (such as Lance in Example 3, above), the deductible amount for the owner of a nonservice business, such as Lance's Pizza Café, is the lesser of (a) 20% of qualified business income, or (b) the WBC amount.[6]

> Example 5: Assume that Lance's Pizza Café, in Example 3, happens to have the same WBC calculation just described for Patti. So his basis is $100,000 and his share of wages is $50,000. This means his WBC amount is $25,000 (the same as Patti's). Lance's deduction will be limited to $25,000. This is because he's outside the phaseout range, meaning that his deduction is limited to the lesser of the 20% amount ($200,000 x 20%, or $40,000) or the WBC amount ($25,000).

Phaseout calculation

For taxpayers whose income is in the phaseout range (like Patti, above), it's necessary to determine the amount of the deduction that's phased out. (No phaseout applies to business owners with taxable income below the phaseout thresholds.)

For business owners in the phaseout range, the phaseout is calculated by multiplying the excess, if any, of (a) the 20% amount (20% of QBI), over (b) the WBC amount, by a fraction.[7] The numerator for the fraction is the amount by which the taxable income of the owner exceeds the phaseout threshold. The denominator is the $50,000 (single) or $100,000 (married filing jointly) phaseout range amount. This fraction produces the phaseout percentage.

> Example 6: Patti's Wine Shop: Using the facts in Examples 2 and 4, the calculation of Patti's phaseout is as follows:

- Patti's taxable income is $365,000. This exceeds the phaseout threshold (of $315,000 for married filing jointly) by $50,000.
- The fraction is $50,000 excess/$100,000 phaseout range amount. So the phaseout percentage is 50%.
- The difference between Patti's initial 20% amount ($40,000) and WBC amount ($25,000) is $15,000.
- That difference of $15,000 is multiplied by the 50% phaseout percentage: $15,000 x 50% = $7,500.
- Patti's initial 20% amount is reduced by $7,500, meaning that her **deduction amount is $32,500** ($40,000 - $7,500).

Service business reduction – Service business owners whose taxable income is in the phaseout range must apply an additional reduction to the components of the previous calculation,[8] as shown here:

Example 7: Assume all the same information as in Example 6, but instead of a wine shop, Patti has a CPA business. Patti's taxable income, filing status and phaseout percentage of 50% are the same as in Example 6. But, because she has a service business (and taxable income in the phaseout range), Patti must also reduce each component of the calculation by her 50% phaseout percentage, as follows:

- Reduced pass-through income ($200,000) x 50% phaseout percentage = $100,000. So, 20% of adjusted pass-through income is **$20,000**.
- Reduced unadjusted basis ($100,000) x 50% phaseout percentage = $50,000. (2.5% of this reduced unadjusted basis = $1,250.)
- Reduced wages ($50,000) x 50% phaseout percentage = $25,000. (50% of this is $12,500, and 25% of it is $6,125.)
- 20% of reduced pass-through income = **$20,000**.
- WBC calculation based on the reduced numbers is the greater of:
  - 50% of reduced wages ($25,000) or **$12,500**.
    OR
  - 25% of reduced wages ($6,250) plus 2.5% of reduced unadjusted basis ($1,250) = **$7,500.** The reduced WBC is the greater of these, or **$12,500**.
  - The service business reduction reduces Patti's deduction by 50% of the difference between $20,000 and $12,500 (50% x $7,500), or $3,750. Patti's reduced and partially phased out deduction is $20,000 - $3,750, or **$16,250**.

Definitions

A specified service trade or business – Services in the fields of health, law, accounting, actuarial science, performing arts, consulting, and athletics. Plus, services that consist of investing and investment management, trading, or dealing in securities interests or commodities. It generally means a trade or business in which the principal asset is the reputation or skill of one or more of its employees. Engineering and architecture are excluded from this definition.

Taxable income – The taxable income of the individual owner, determined before the QBI deduction. The QBI deduction is taken after the determination of adjusted gross income, but it's not an itemized deduction, meaning that taxpayers who take the standard deduction will still have the availability of the QBI deduction as well.

Qualified business income – The net amount of qualified items of income, gain, deduction and loss that are connected with the conduct of the qualified trade or business.[9] Investment items of capital gain or loss, dividends, and annuity income received by the business are excluded from this amount. It also doesn't include reasonable compensation paid to the owner, or guaranteed payments to a partner, for services rendered.

W-2 wages –Includes all wages paid by the business as taxable compensation, including the compensation to the owner, as well as elective deferrals (such as salary contributed to a 401(k) plan). Wages do not include owner distributions. An owner's share of W-2 wages is his or her share based on the partnership allocations, or on the pro rata share of the owner in an S corporation.

Qualified property – For purposes of the unadjusted basis calculation, this generally means tangible property used in the trade or business that's depreciable, but has not reached the end of its depreciation recovery period.

Executive compensation

For-profit companies

The executive compensation deduction limitation expands the $1 million compensation definition limitation to include performance-based compensation and commissions. This provision applies to publicly traded companies and certain closely held businesses that have registered debt offerings (Section 15(d)).

Covered executives include the CEO, CFO, and the next three highest paid employees. It also includes any individual who was once a covered employee, regardless of whether job duties have changed or the individual has separated from service.

The section includes a transition rule that would exempt any compensation paid, "pursuant to a written binding contract [that] was in effect on November 2, 2017, and [that] was not modified in any material respect on or after such date." This transition rule closely follows Section 162(m) regulations.

Tax-exempt organizations

A new annual 21% excise tax is imposed on applicable tax-exempt organizations on compensation more than $1M on any covered employee. This limitation for tax-exempt organizations is imposed by newly created Section 4960.

For this purpose, a covered employee is one of the organization's top five highly paid employees for the taxable year, and any employee who was a covered employee for any preceding taxable year beginning after December 31, 2016. Covered employee status is not limited to just the organization's officers.

There's an exception for certain types of compensation. Any "remuneration" received by a licensed medical professional for performing medical services is not included in the compensation calculation. Wages that some medical professionals would receive for administrative services (not medical services), would be included in the compensation calculation.

Planning opportunities

Choice of entity

Choice of entity depends upon tax and nontax factors. All such factors should be considered when deciding which type of entity is most advantageous.

From an income tax law standpoint, the new 21% flat tax on C corporations is attractive. For some business owners, the first instinct might be to change to C corporation status. However, profits of C corporations are still subject to double taxation when distributed to shareholders. Also, if the C corporation sells most or all of its assets to an outside party (often referred to as an "asset sale"), the sale may be subject to double taxation.

Business owners of pass-through entities are subject to one level of taxation based on individual tax rates with a possible 20% tax deduction against their pass-through income. However, the 20% tax deduction may be reduced or eliminated based on individual taxable income and other factors. The possible reduction or elimination of the 20% tax deduction for pass-through income would be an important factor to consider, particularly for business owners of profitable S service corporations.

If an S corporation converts to a C corporation, no immediate gain or loss is generally realized upon conversion. Once the S election is revoked or terminated, however, the corporation cannot elect S status again for five years without IRS approval.

Business planning and life insurance

In larger C corporations that were previously subject to the alternative minimum tax, cash value life insurance may be more attractive in the absence of that tax.

For some business owners, an executive bonus to a key employee that increases deductible wages may result in a higher qualified business income deduction by raising the wage portion of the calculation. This may increase the appeal of an executive bonus or restricted bonus plan.

With a lower business tax bracket, some business owners may revisit their qualified plans if these plans are the primary vehicle for their retirement funds. With the sunset provision for lower individual income tax rates, business owners may be receiving qualified retirement distributions in a higher tax bracket. A simple nonqualified bonus plan funded with life insurance may be attractive as a supplement to qualified plan benefits.

Personal planning for business owners

Since the new deduction for qualified business income is applied on the basis of an individual owner's taxable income, taxpayers who own a pass-through business may wish to consider planning steps at the personal level. These may include making charitable gifts, deferring income, and accelerating deductions to manage taxable income levels. A business owner whose spouse has high earnings or income even from an unrelated business may be subject to phaseout of the deduction based on the taxable income on their joint return.

Cross purchase buy-sell arrangements

Many small business owners, particularly in businesses with two or three owners, may prefer to own the policies on themselves that are used to fund a cross purchase agreement, but may have been advised against it. This is due to (a) possible estate inclusion of both the business and the life insurance death benefit, (b) the need for a split dollar agreement and yearly inclusion of the value of the economic benefit, and (c) possible "transfer for value" concerns which may cause a portion of the life insurance death benefit to be considered taxable income to the beneficiary of the proceeds. With the increase in the estate exemption to over $11 million, more owners might find owning the policies themselves more appealing (assuming there's no "transfer for value" problem).

Key employee retention and retirement

The underlying reasons for these arrangements — to recruit, reward, retain and retire top employees — are unchanged. Bonus plans, nonqualified deferred compensation plans, and split dollar arrangements are commonly used to achieve these goals. The reduced taxes mean that more funds may be available for these plans.

Summary

The changing tax environment is a great time to look at business planning goals, such as succession planning, business protection, employee retention, and protection of business owners' families and lifestyles. The income tax reductions may make more funds available for meeting these goals. In addition, business owners might find that a bonus arrangement or other change in wage structure could offer a more favorable outcome for the new qualified business income deduction.

While many of the benefits of the Tax Cuts and Jobs Act are set to sunset after 2025, the basics and benefits of planning never expire. As with all business planning strategies, it's vital that businesses consult with local counsel for detailed tax and legal advice.

[1] Pass-through entities include S corporations, partnerships, sole proprietorships, and LLCs that are taxed as any of these pass-through entity types

[2] See the definitions section for the meaning of "specified service trade or business." Examples include accountants, attorneys, doctors and dentists.

[3] Examples include manufacturing, construction and retail businesses.

[4] For taxpayers below the threshold amounts, the WBC is disregarded. See IRC Sec. 199A(b)(3)(A).

[5] If Patti's pro rata share of wages is $50,000, that could mean, for example, that (a) she is the 100% owner and total wages paid to all Wine Shop employees (including herself) was $50,000, or (b) Patti is a 50% owner and the total wages paid to all employees was $100,000, or (c) Patti is a 20% owner and the total wages paid to all employees was $250,000, and so on. The amount of W-2 wages allocable to an owner is not measured solely by the owner's compensation.

[6] See IRC Sec. 199A(b)(2).

[7] See IRC Sec. 199A(b)(3). If the WBC equals or exceeds the 20%, this phaseout does not apply. IRC Sec. 199A(b)(3)(A).

[8] See IRC Sec. 199A(d)(3).

[9] Qualified business income does not include a reasonable salary paid to the owner. The term also does not include qualified real estate investment trust (REIT) dividends, qualified cooperative dividends or qualified publicly traded partnership income, but those items are treated separately and may trigger the deduction separately.

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