CREDITS AND INCENTIVES

The Effects of Tax Reform on Economic Development

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After long debate, the President and Congress have passed the Tax Cuts and Jobs Act. The historic measure changes tax structure for both individuals and businesses. Most individuals will now be in a lower tax bracket, while there are fewer deductions and credits. On the corporate side, the corporate tax rate has been slashed as additional provisions in Tax Reform have been added to encourage businesses to invest their profits and expand in the U.S.

In December 2017, the Tax Cuts and Jobs Act (AKA Tax Reform or the Act) was placed into law in historic fashion. Effectively, the Act reduced the corporate income tax rate from 35% to 21%, a decrease of 14 percentage points. This historic change to the tax structure in the United States has both significant corporate and individual implications. The Act includes many changes to existing federal programs that encourage reinvestment into the U.S. economy. Some of these programs include the Orphan Drug Credit, Rehabilitation Credit, Family and Medical Leave Credit, Opportunity Zones and Foreign Derived Intangible Income. For businesses, tax reform has many positive implications that can lead to increased cash flow from reduced tax liability, which will provide opportunities for funding reinvestment into the United States.

In effect, the changes in the corporate tax rate allow U.S. businesses to be more competitive with foreign companies that pay a majority of their taxes outside of the U.S. The 15.5% Mandatory Toll Charge on Foreign Earnings/ Transition Tax has been designed to encourage companies to repatriate their foreign cash and other liquid assets back the U.S., which hopefully, in turn, will yield increased capital investment and on shoring in the U.S. This was evidenced, by Apple's announcement in January to plan to repatriate $252 billion and pay about $39 billion in taxes for its stockpile of cash that it plans to bring back to the U.S.

There are a number of changes and new opportunities as part of the legislation that are briefly outlined below.

Bonus Depreciation

New qualified property placed in service between September 27, 2017, and January 1, 2023, can be expensed up to 100% (100% bonus depreciation). Generally, property placed in service after December 31, 2022, and before January 1, 2024, can be expensed at 80%; property placed in service after December 31, 2023, and before January 1, 2025, can be expensed at 60%; property placed in service after December 31, 2024, and before January 1, 2026, can be expensed at 40%; and property placed in service after December 31, 2025, and before January 1, 2027, can be expensed at 20%. In addition, used property purchased by a company now qualifies for bonus depreciation.

Orphan Drug Credit

In Section 13401 of the Act, The Orphan Drug Credit has been reduced from its previous 50% to 25% of qualified clinical testing expenses. Clinical testing must be related to a rare disease or condition. The credit does not apply to testing by American companies outside of the U.S. unless there is an insufficient amount of subjects for testing in the U.S.

Historic Tax Credit

In Section 13402 of the Act, the non-Historic Tax Credit of 10% has been eliminated in the Act, but the Certified Historic Structure Rehabilitation Credit has been updated. A 20% credit for structure rehabilitation will now be taken over a 5-year period instead of claiming it when the structure was put into service. There are also special transition rules companies should pay attention to for property owned on January 1, 2018.

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Family and Medical Leave

In Section 13403 of the Act, the Family and Medical Leave Credit provides a 12.5% credit for wages paid to qualifying employees on FMLA. In order to participate, employers must have a policy in place that pays at least 50% of the normal wages for Family and Medical Leave for all employees, including part-time employees. Eligible employees must have worked for the company for at least one year in order to qualify. The credit can increase by 0.25% for every 1% above the 50% of normal wages paid by the employer. The credit is capped at 12 weeks for paid Family and Medical Leave. The credit is available for 2018 and 2019, but could be included in a future Extenders package. Companies are encouraged to review their existing policies and operations to take advantage of these programs.

Opportunity Zones

In Section 13823 of the Act, an additional program created as a part of Tax Reform is the Opportunity Zone Program. The Opportunity Zone Program has been created to spur investment in low-income and less developed areas in all states. Governors are designating their respective qualified areas. Businesses can invest their unrealized capital gains into an Opportunity Fund, which is a private sector financial vehicle that designates 90% of their funds to Opportunity Zone programs. The businesses that invest in Opportunity Funds can receive deferred capital gains for their interest in improving investment in low-income and less developed areas. More details about the Opportunity Zone Program will be shared in next month's newsletter.

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Taxation of Certain Incentives

In Section 13312 of the Act, Section 118 ("Certain Contributions By Governmental Entities Not Treated as Contributions to Capital") was updated to remove the exclusion from income of certain incentives. We have heard many economic developers ask what we think of the fact that incentives are now taxable. What they don't realize, is that most incentives were previously taxable. Under the new law, for example, if a jurisdiction provides land or buildings as an "incentive," the company would need to treat the contribution as income based on the fair market value of the property.

Research and Experimentation Impact

Although the Research and Experimentation (R&E) credit itself was left unchanged, starting in 2022, companies will need to amortize their R&E expenditures over five years rather than taking a current deduction. This will also include software development costs. With the reduced corporate tax rate, the benefit of the R&E credit will be greater given that the missed deduction for the R&E expenditure impact will only be 21% rather than 35%, which would bring the overall benefit to 79% rather than 65% (i.e., 100% less 21% instead of 100% less 35%).

Foreign Derived Intangible Income

In Section 14202 of the Act, the new Foreign Derived Intangible Income "FDII" regime is a new tax incentive for U.S. corporations who sell products or provide services to third parties abroad. The earnings related to the foreign sales or services, above a 10% rate of return on the company's depreciable tangible assets, are considered FDII and eligible for the incentive. The FDII provision allows a U.S. corporation to deduct from its taxable base 37.5 percent of such corporation's qualified FDII profits. The net result of the incentive is that a U.S. corporation would only be subject to a 13.125% tax rate on its FDII profits. Note that starting in 2026, the deduction percentage is reduced to 21.875%, making the effective tax rate on FDII 16.406%.

Unlike FDII, the new GILTI regime imposes a minimum tax on a U.S. shareholder on their share of "global intangible low-taxed income" earned by its foreign subsidiaries. Such tax is an anti-deferral mechanism comparable to that of the subpart F. In general, income of a foreign subsidiary in excess of a 10% return on depreciable tangible assets, that is not considered Subpart F income, is deemed to be GILTI. The full amount is includable in a U.S. shareholder's taxable income. However, corporate U.S. shareholders may deduct 50% of their GILTI for 2018 through 2025 (the deduction amount is decreased to 37.5% beginning in 2026). As a result, the effective tax rate on GILTI to a U.S. corporation is 10.5% prior to 2026, and 13.125% thereafter. The U.S. tax on a U.S. corporation's GILTI income may be offset by a portion of the taxes paid in the foreign jurisdiction.

With a lower corporate tax rate and additional credits and allowances for corporations, it is yet to be seen how many companies will seize the opportunity to invest in the U.S. and repatriate cash and operations like Apple plans to do. Here's hoping that this proves to be a boon to the economy over the next several years. Next month, we will elaborate more on the Opportunity Zone opportunity as states begin to designate their zones.