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TAX CUTS & JOBS ACT OVERVIEW

Biggest tax bill in 30+ years redefines tax landscape

On December 22, 2017, the most sweeping tax legislation since the Tax Reform Act of 1986 was signed into law. The Tax Cuts and Jobs Act of 2017 (TCJA) makes small reductions to income tax rates for most individual tax brackets and significantly reduces the income tax rate for corporations. It also provides a large new tax deduction for owners of pass-through entities and significantly increases individual alternative minimum tax (AMT) and estate tax exemptions. And it makes major changes related to the taxation of foreign income.

It's not all good news for taxpayers, however. The TCJA also eliminates or limits many tax breaks, and much of the tax relief is only temporary.

Here is an overview of some of the key changes affecting individual and business taxpayers.

INDIVIDUALS

The TCJA includes significant changes for individual taxpayers, most of which take effect for 2018 and expire after 2025. Here are some of the most notable changes.

Tax rates, brackets and inflation adjustments

The TCJA maintains seven income tax brackets but temporarily adjusts the tax rates as follows:

| 2017 | 2018–2025 |
|-------|-----------|
| 10% | 10% |
| 15% | 12% |
| 25% | 22% |
| 28% | 24% |
| 33% | 32% |
| 35% | 35% |
| 39.6% | 37% |



The top rates, which for 2017 kick in at \$418,400 of taxable income for single filers and \$470,700 for joint filers, for 2018 take effect at \$500,000 and \$600,000, respectively. The brackets will continue to be adjusted for inflation.

Be aware, however, that the TCJA calls for annual inflation adjustments to be calculated using the chained consumer price index (also known as C-CPI-U). This will increase tax bracket thresholds at a slower rate than is the case with the consumer price index previously used. C-CPI-U also will apply to the standard deduction, certain exemptions and other figures.

The change could potentially push taxpayers into higher tax brackets more quickly and make various breaks worth less over time. The law adopts the C-CPI-U on a permanent basis.

Personal exemptions and standard deduction

For 2017, taxpayers can claim a personal exemption of \$4,050 each for themselves, their spouses and any dependents. In addition, they can either itemize deductions or take a standard deduction based on their filing status: \$6,350 for singles and married couples filing separately, \$9,350 for head of household filers, and \$12,700 for married couples filing jointly.

For 2018–2025, the TCJA suspends personal exemptions but roughly doubles the standard deduction amounts to \$12,000 for singles and separate filers, \$18,000 for heads of households, and \$24,000 for joint filers. The standard deduction amounts will be adjusted for inflation beginning in 2019.

For some taxpayers, the increased standard deduction could compensate for the elimination of the exemptions, and perhaps even provide some additional tax savings. But for those with many dependents or who itemize deductions, these changes might result in a higher tax bill — depending in part on the extent to which they can benefit from the family tax credits.

Family tax credits

Tax credits are especially valuable because they reduce your tax bill dollar-for-dollar, rather than just reducing the amount of income subject to tax like deductions do. Beginning in 2018, the TCJA doubles the child credit to \$2,000 per child under age 17. The maximum amount refundable (because a taxpayer's credits exceed his or her tax liability) is limited to \$1,400 per child.

The TCJA also makes the child credit available to more families than in the past. Under the new law, the credit doesn't begin to phase out until adjusted gross income exceeds \$400,000 for married couples or \$200,000 for all other filers, compared with the 2017 phaseout thresholds of \$110,000 and \$75,000. The thresholds won't be indexed for inflation, though, meaning the credit will lose value over time.

The TCJA also includes, beginning in 2018, a \$500 nonrefundable credit for qualifying dependents other than qualifying children (for example, a taxpayer's 17-year-old child or elderly parent).

These provisions all expire after 2025.

Above-the-line deductions

Above-the-line deductions are deductions you can take even if you don't itemize. They're subtracted from your income to determine your adjusted gross income (AGI). AGI affects eligibility for many tax breaks and can trigger certain taxes. The TCJA makes some significant changes to two above-the-line deductions:



1. Moving expenses. The deduction for work-related moving expenses is suspended for 2018–2025, except for active-duty members of the Armed Forces (and their spouses or dependents) who move because of a military order that calls for a permanent change of station. (For 2018–2025, the exclusion from gross income and wages for qualified moving expense reimbursements is also suspended, again except for active-duty members of the Armed Forces who move pursuant to a military order.)

2. Alimony payments. For divorce agreements executed (or, in some cases, modified) after December 31, 2018, alimony payments won't be deductible — and will be excluded from the recipient's taxable income. Because the recipient spouse would typically pay income taxes at a rate lower than that of the paying spouse, the overall tax bite will likely be larger under this new tax treatment. This change is permanent.

Itemized deductions

When you file your tax return, you can either claim the standard deduction or you can itemize deductions. The TCJA limits or suspends many itemized deductions. Itemizing saves tax only if your total itemized deductions exceed your standard deduction. With the TCJA's near doubling of the standard deduction for 2018 and reduction of itemized deduction benefits overall, many taxpayers who've typically itemized may no longer benefit from itemizing.

Here's a closer look at the TCJA changes to itemized deductions:

State and local tax deduction. The deduction for state and local taxes had been proposed for elimination under tax reform. It survived but has been scaled back substantially. For 2018–2025, taxpayers can claim a deduction of no more than \$10,000 for the aggregate of state and local property taxes and either income or sales taxes.

Mortgage interest deduction. The TCJA tightens limits on the deduction for home mortgage interest. For 2018–2025, it generally allows a taxpayer to deduct interest only on mortgage debt of up to \$750,000. However, the limit remains at \$1 million for mortgage debt incurred before December 15, 2017, which will significantly reduce the number of taxpayers affected.

Home equity interest deduction. The new law suspends the deduction for interest on home equity debt for 2018–2025. However, home equity debt interest might still be deductible if the funds are used for a purpose where interest otherwise may be deductible, such as for home-improvement, investment or business purposes. The rules are complex and the new law is still being interpreted.

Medical expense deduction. Qualified medical expenses are deductible only to the extent they exceed the applicable AGI threshold. The TCJA reduces the threshold from 10% of AGI to 7.5% for all taxpayers for both regular and AMT purposes in 2017 and 2018.

Miscellaneous itemized deductions subject to the 2% floor. This deduction for expenses such as certain professional fees, investment expenses and unreimbursed employee business expenses is suspended for 2018–2025. If you're an employee and work from home, this includes the home office deduction.

Personal casualty and theft loss deduction. For 2018–2025, this deduction is suspended except if the loss was due to an event officially declared a disaster by the President.

Charitable contribution deduction. For 2018–2025, the limit on the deduction for cash donations to public charities is raised to 60% of AGI from 50%. However, charitable deductions for payments made in exchange for college athletic event seating rights are eliminated.



Elimination of the AGI-based reduction of certain itemized deductions. Under pre-TCJA law, if your AGI exceeded the applicable threshold, certain deductions were reduced by 3% of the AGI amount over the threshold (not to exceed 80% of otherwise allowable deductions). For 2018–2025, the reduction is suspended.

AMT

The AMT is a separate tax system that limits some deductions, disallows others and treats certain income items differently. The top AMT rate of 28% is lower than the top regular income tax rate, but it typically applies to a higher taxable income base. If your AMT liability exceeds your regular tax liability, you must pay the AMT.

The TCJA temporarily reduces the number of taxpayers who'll have to pay the AMT by increasing both the AMT exemption amount (to \$109,400 for married couples, \$70,300 for singles and heads of households, and \$54,700 for separate filers) and the AMT exemption phaseout thresholds (to \$1 million for married couples and \$500,000 for all other taxpayers other than estates and trusts). These amounts apply for 2018 and will be annually adjusted for inflation until the provision expires after 2025.

“Kiddie” tax

One popular tax planning technique is to transfer investments or other income-producing assets to family members in lower tax brackets to take advantage of their lower rates. The kiddie tax makes this difficult to do.

Under pre-TCJA law, when the kiddie tax applies, all but a small portion of a child's unearned income is taxed at the *parents'* marginal rate (if higher), defeating the purpose of income shifting. The kiddie tax generally applies to children age 18 or younger, as well as to full-time students age 19 to 23 (with some exceptions).

The TCJA makes the kiddie tax even harsher by taxing a child's unearned income according to the tax brackets used for trusts and estates, which are taxed at the highest marginal rate (37% for 2018) once 2018 taxable income reaches \$12,500. In contrast, for a married couple filing jointly, the highest rate doesn't kick in until their 2018 taxable income tops \$600,000. In other words, in many cases, children's unearned income will be taxed at *higher* rates than their parents' income.

Other important changes

Here are some other TCJA changes affecting individuals:

Roth conversions. Beginning after December 31, 2017, the TCJA prohibits taxpayers who convert a pretax traditional IRA into a posttax Roth IRA from later “recharacterizing” (that is, reversing) the conversion. Recharacterization is still an option for other contributions, though. For example, an individual can make a contribution to a Roth IRA and subsequently recharacterize it as a contribution to a traditional IRA (before the applicable deadline).

529 savings plans. 529 plan distributions used to pay qualifying education expenses are generally tax-free. For distributions made after December 31, 2017, the definition of qualified education expenses has been expanded to include not just postsecondary school expenses but also primary and secondary school expenses.



Individual mandate. The TCJA eliminates the individual mandate under the Affordable Care Act requiring taxpayers not covered by a qualifying health plan to pay a penalty, effective for months beginning after December 31, 2018.

Impact on your estate plan

One thing the TCJA *doesn't* do is repeal the federal gift and estate tax, as originally proposed. It does, however, temporarily reduce the potential impact of these taxes.

For the estates of persons dying, and gifts made, after December 31, 2017, and before January 1, 2026, the gift and estate tax exemption and the generation-skipping transfer (GST) tax exemption amounts increase to an inflation-adjusted \$10 million, or \$20 million for married couples with proper planning (expected to be around \$11.2 million and \$22.4 million, respectively, for 2018).

Just because the possibility of federal estate tax liability sounds remote for most families, it doesn't mean the end of estate planning as we know it. For one thing, there are many nontax issues to consider, such as asset protection, guardianship of minor children and family business succession. Plus, it's not clear how states will respond to the federal tax law changes. If you live in a state that imposes significant state estate taxes, many traditional tax-reduction strategies will continue to be relevant.

It's also important to keep in mind that the exemptions are scheduled to revert to their previous levels in 2026 — and there's no guarantee that a future Congress won't reduce the exemption amounts even further. However, the currently high exemptions increase planning opportunities that can help you shield your wealth against tax law changes down the road.

BUSINESSES

Overall, most companies and their owners will come out ahead under the TCJA, but there are a number of tax breaks that have been reduced or eliminated to make room for tax cuts and other beneficial revisions. Here are some important changes in the new law that will affect businesses and their owners.

Changes for corporations

The TCJA will substantially impact corporations, mostly to their benefit:

New 21% corporate tax rate. Under pre-TCJA law, C corporations pay federal income tax at graduated rates of 15% on taxable income of \$0 to \$50,000; 25% on taxable income of \$50,001 to \$75,000; 34% on taxable income of \$75,001 to \$10 million; and 35% on taxable income over \$10 million. Personal service corporations (PSCs) pay a flat 35% rate. For tax years beginning in 2018 or later, the TCJA establishes a flat 21% corporate rate, and that rate also applies to PSCs.

Corporate AMT repealed. Prior to the TCJA, the corporate AMT was imposed at a 20% rate. However, corporations with average annual gross receipts of less than \$7.5 million for the preceding three tax years were exempt. For tax years beginning in 2018 or later, the new law repeals the corporate AMT. For corporations that paid the corporate AMT in earlier years, an AMT credit was allowed under prior law. The new law allows corporations to fully use their AMT credit carryovers in their 2018–2021 tax years.

Reduced corporate dividends deduction. Under pre-TCJA law, C corporations that received dividends from other corporations are entitled to partially deduct those dividends. If the corporation owns at least 20% of the stock of another corporation, an 80% deduction applies. Otherwise, the deduction is 70% of dividends received. For tax years beginning in 2018 or later, the TCJA reduces the 80% deduction to 65% and the 70% deduction to 50%.



New deduction for pass-through businesses

Under pre-TCJA law, net taxable income from pass-through business entities (such as sole proprietorships, partnerships, S corporations and LLCs that are treated as sole proprietorships or as partnerships for tax purposes) was simply passed through to owners. It was then taxed at the owners' standard rates. In other words, no special treatment applied to pass-through income recognized by business owners.

For tax years beginning in 2018 through 2025, the TCJA establishes a new deduction based on a noncorporate owner's qualified business income (QBI). This break is available to individuals, estates and trusts that own interests in pass-through business entities. The deduction generally equals 20% of QBI, subject to restrictions that can apply at higher income levels.

QBI is generally defined as the net amount of qualified items of income, gain, deduction and loss from any qualified business of the noncorporate owner. For this purpose, qualified items are income, gain, deduction and loss that are effectively connected with the conduct of a U.S. business. QBI doesn't include certain investment items, reasonable compensation paid to an owner for services rendered to the business or any guaranteed payments to a partner or LLC member treated as a partner for services rendered to the partnership or LLC.

The QBI deduction isn't allowed in calculating the owner's AGI, but it reduces taxable income. In effect, it's treated the same as an allowable itemized deduction.

W-2 wage limitation. For pass-through entities other than sole proprietorships, the QBI deduction generally can't exceed the greater of the owner's share of:

- 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or
- The sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

Qualified property is the depreciable tangible property (including real estate) owned by a qualified business as of year end and used by the business at any point during the tax year for the production of qualified business income.

Under an exception, the W-2 wage limitation doesn't apply until an individual owner's taxable income exceeds \$157,500 (\$315,000 for joint filers). Above those income levels, the W-2 wage limitation is phased in over a \$50,000 range (\$100,000 range for joint filers).

Service business limitation. The QBI deduction generally isn't available for income from specified service businesses (such as most professional practices other than engineering and architecture and businesses that involve investment-type services such as brokerage and investment advisory services). Under an exception, the service business limitation doesn't apply until an individual owner's taxable income exceeds \$157,500 (\$315,000 for joint filers). Above those income levels, the service business limitation is phased in over a \$50,000 phase-in range (\$100,000 range for joint filers).

Business interest deductions

Subject to some restrictions and exceptions, under pre-TCJA law interest paid or accrued by a business generally is fully deductible. Under the TCJA, for tax years that begin in 2018 or later, businesses generally can't deduct interest expenses in excess of 30% of "adjusted taxable income." For S corporations, partnerships and LLCs that are treated as partnerships for tax purposes, this limit is applied at the entity level rather than at the owner level.



For tax years beginning in 2018 through 2021, adjusted taxable income is calculated by adding back allowable deductions for depreciation, amortization and depletion. After that, these amounts aren't added back in calculating adjusted taxable income.

Business interest expense that's disallowed under this limitation is treated as business interest arising in the following taxable year. Amounts that cannot be deducted in the current year can generally be carried forward indefinitely.

Taxpayers (other than tax shelters) with average annual gross receipts of \$25 million or less for the three previous tax years are exempt from the interest deduction limitation. Some other taxpayers are also exempt.

For example, real property businesses can elect to continue to fully deduct their interest, but then would be required to use the alternative depreciation system for real property used in the business. Interest expense from dealer floor-plan financing (for example, financing by dealers to acquire motor vehicles, boats or farm machinery that will be sold or leased to customers) is also still fully deductible.

Bonus depreciation

Under pre-TCJA law, for qualified *new* assets that your business placed in service in 2017, you can claim a 50% first-year bonus depreciation deduction. Used assets don't qualify. This tax break is available for the cost of new computer systems, purchased software, vehicles, machinery, equipment, office furniture and so forth. In addition, 50% bonus depreciation can be claimed for qualified improvement property.

Bonus depreciation improves significantly under the TCJA: For qualified property placed in service between September 28, 2017, and December 31, 2022 (or by December 31, 2023, for certain property with longer production periods), the first-year bonus depreciation percentage is increased to 100%. In addition, the 100% deduction is allowed for both *new and used* qualifying property. The new law also allows 100% bonus depreciation for qualified film, television and live theatrical productions placed in service on or after September 28, 2017.

In later years, bonus depreciation is scheduled to be reduced as follows:

- 80% for property placed in service in 2023,
- 60% for property placed in service in 2024,
- 40% for property placed in service in 2025, and
- 20% for property placed in service in 2026.

For certain property with longer production periods, the preceding reductions are delayed by one year. For example, 80% bonus depreciation will apply to long-production-period property placed in service in 2024.

Also be aware that, under the TCJA, in some cases a business may not be eligible for bonus depreciation beginning in 2018. Examples include real estate businesses that elect to deduct 100% of their business interest and dealerships with floor-plan financing if they have average annual gross receipts of more than \$25 million for the three previous tax years.

Section 179 deduction

When 100% first-year bonus depreciation isn't available, the Sec. 179 tax break can provide similar benefits. Sec. 179 allows eligible taxpayers to deduct the entire cost of qualifying new or used depreciable property, most software and qualified real property improvement in Year 1, subject to various limitations.



Under pre-TCJA law, for tax years that began in 2017, the maximum Sec. 179 depreciation deduction is \$510,000. The maximum deduction is phased out dollar-for-dollar to the extent the cost of eligible property placed in service during the tax year exceeds the phaseout threshold of \$2.03 million.

The TCJA permanently enhances the Sec. 179 deduction. Under the new law, for qualifying property placed in service in tax years beginning in 2018, the maximum Sec. 179 deduction is increased to \$1 million, and the phaseout threshold amount is increased to \$2.5 million. For later tax years, these amounts will be adjusted for inflation.

The new law also expands the definition of eligible property to include certain depreciable tangible personal property used predominantly to furnish lodging. The definition of qualified real property eligible for the Sec. 179 deduction is also expanded to include the following improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems.

Deductions for business passenger vehicles

For *new or used* passenger vehicles that are placed in service in 2018 and used more than 50% for business, the maximum annual depreciation deductions under the TCJA are as follows:

- \$10,000 for Year 1,
- \$16,000 for Year 2,
- \$9,600 for Year 3, and
- \$5,760 for Year 4 and thereafter until the vehicle is fully depreciated.

For years after 2018, these amounts will be adjusted for inflation.

While the maximum amount that can be deducted in Year 1 under pre-TCJA law may be higher, the TCJA allows much faster depreciation overall. For example, under pre-TCJA law, the 2017 limit for a passenger car is \$11,160 for Year 1 (if the car is new and the elected bonus is included; it's \$3,160 for a used car), and for subsequent years for *new and used* cars, the limits are \$5,100 for Year 2, \$3,050 for Year 3, and \$1,875 for Year 4 and thereafter. Slightly higher limits apply to light trucks and light vans.

Meals, entertainment and transportation

Prior to the TCJA, taxpayers generally could deduct 50% of expenses for business-related meals and entertainment. Meals provided to an employee for the convenience of the employer on the employer's business premises were 100% deductible by the employer and tax-free to the recipient employee. Various other employer-provided fringe benefits were also deductible by the employer and tax-free to the recipient employee.

Under the new law, for amounts paid or incurred after December 31, 2017, business-related entertainment expenses are no longer deductible. Meal expenses incurred while traveling on business are still 50% deductible, but the 50% disallowance rule will now also apply to meals provided via an on-premises cafeteria or otherwise on the employer's premises for the convenience of the employer. After 2025, the cost of meals provided through an on-premises cafeteria or otherwise on the employer's premises will be nondeductible.

The new law also disallows employer deductions for the cost of providing commuting transportation to an employee (such as hiring a car service), unless the transportation is necessary for the employee's safety. It also eliminates employer deductions for the cost of providing qualified employee transportation fringe benefits (for example, parking allowances, mass transit passes and van pooling), but those benefits are still tax-free to recipient employees.



Other important changes

Here are some of the other business-related changes in the TCJA:

- The Section 199 deduction, also commonly referred to as the domestic production activities deduction or manufacturers' deduction, is eliminated for tax years beginning after December 31, 2017, for noncorporate taxpayers and for tax years beginning after December 31, 2018, for C corporation taxpayers.
- For business net operating losses (NOLs) that arise in tax years *ending* after December 31, 2017, the maximum amount of taxable income that can be offset with NOL deductions is generally reduced from 100% to 80%. In addition, NOLs incurred in those years can no longer be carried back to an earlier tax year (except for certain farming losses). Affected NOLs can be carried forward indefinitely.
- A new limitation applies to deductions for "excess business losses" incurred by noncorporate taxpayers. Losses that are disallowed under this rule are carried forward to later tax years and can then be deducted under the rules that apply to NOLs. This new limit kicks in after applying the passive activity loss rules. However, it applies to an individual taxpayer only if the excess business loss exceeds the applicable threshold.
- The eligibility rules to use the more-flexible cash method of accounting are liberalized to make them available to many more medium-size businesses. Also, eligible businesses are excused from the chore of doing inventory accounting for tax purposes.
- The Section 1031 rules that allow tax-deferred exchanges of appreciated like-kind property is allowed only for real estate exchanges completed after December 31, 2017. Beginning in 2018, there are no more like-kind exchanges for personal property assets. However, the prior-law rules still apply if one leg of an exchange has been completed as of December 31, 2017, but one leg remains open on that date.
- Compensation deductions for amounts paid to principal executive officers generally cannot exceed \$1 million per year, subject to a transition rule for amounts paid under binding contracts that were in effect as of November 2, 2017.
- Specified research and development (R&D) expenses must be capitalized and amortized over five years, or 15 years if the R&D is conducted outside the United States instead of being deducted currently. This goes into effect for tax years beginning after December 31, 2021.

The TCJA also includes a bevy of changes that will affect taxpayers who conduct foreign operations. In conjunction with the reduced corporate tax rate, the changes are intended to encourage multinational companies to conduct more operations in the United States, with the resulting increased investments and job creation in this country.

TIME FOR PLANNING

We've only briefly covered some of the most significant TCJA provisions here. There are additional rules and limits that apply, and the law includes additional provisions. As with any piece of massive legislation, many questions about implementation and impact linger unanswered. We'll keep you apprised as more information becomes clear about how the TCJA will affect individual and business taxpayers.

In the meantime, please contact us if you have questions about how the TCJA may affect you or your business. As the largest overhaul of the tax code in more than three decades, the TCJA requires proper planning to minimize any negative impact and maximize available tax benefits.