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Tax Update Focusing on the Tax Cuts and Jobs Act of 2017

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Summary of Presentation

- Our focus will be on the changes brought about by the recently passed Federal Tax Cuts and Jobs Act of 2017. We will cover the key business and individual aspects of this legislation.
- Due to the size of this tax bill, our discussion will be general in nature.
- Please bear in mind that almost all of these provisions do not take effect until 2018.
- Tax returns for 2017 will generally be done under the "old rules".

Key Business Tax Changes

- Tax rate reduction for C Corporations and elimination of corporate AMT
- Qualified Business Income (QBI), which is the new extra deduction for pass-through business income.
- Expansion of Bonus Depreciation and Section 179 expensing of equipment and improvements
- Business interest deduction limitation
- Modification of net operating loss deduction and new limitation on "excess business losses".

Key Business Tax Changes - Continued

- Accounting method reforms for businesses with average gross receipts under $25 million per year.
- Repeal of domestic production activities deduction.
- Elimination of business entertainment deduction.
- Restriction of like-kind exchanges to real property only.
- New tax credit for paid family leave.

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Reduction in C Corporation Tax Rates

- For tax years beginning after 2017, the tax rate for C corporations is a flat 21%. This is a reduction from the former maximum rate of 35%. Also, the corporate alternative minimum tax (AMT) has been repealed.
- A "C" corporation is a traditional corporation that pays its own taxes. Publicly traded corporations all tend to be C corporations, so this tax reduction should be very beneficial to them, and it should put our country on a more competitive footing internationally because we had one of the highest corporate tax rates in the developed world.
- However, the rate reduction will not have such a beneficial effect on closely held businesses.

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Reduction in C Corporation Tax Rates

- Remember that the double tax regime still exists for C corporations, so the effective C corporation tax rate at maximum rates on $100 of taxable income will be as follows:
  - $100 times the 21% corporate tax rate equals $21 of corporate taxes. Now we have $79 left to pay to owner.
  - $79 remainder that is paid out as a dividend is taxed at the 23.8% combined maximum individual capital gains rate (20%) plus the net investment income tax rate (3.8%) equals $19 of individual taxes.
  - This gives us an effective maximum tax rate of 40%. ($21 plus $19 equals $40 of taxes on the $100 of taxable income.)

Reduction in C Corporation Tax Rates

- Closely held businesses have more choices than publicly traded companies as to the entity form in which they can operate. They generally can operate as "pass-through entities" that have only one level of taxation: S corporations, partnerships or even sole proprietorships. A pass-through entity typically does not pay its own taxes. The taxable income flows down to the owner who generally pays the taxes at individual rates.
- We will see that the new 20% deduction on "Qualified Business Income" of certain pass-through entities can bring the maximum effective income tax rate on those entities down to a substantially lower percentage than C corporations.

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New 20% Deduction on Qualified Business Income (QBI)

- There is a lot of excitement and confusion about this new deduction set forth in Section 199A of the IRC. It is very complicated to calculate, so we will discuss it from a broad perspective.
- The idea behind this QBI provision is that individuals, trusts or estates may get an extra 20% deduction on their share of "qualified business income" which effectively lowers the tax rate on this income. We will discuss this deduction as it applies to individuals.
- QBI is the individual's share of income from qualified trades or businesses, which are typically pass-through entities or sole proprietorships. (A rental activity can be a qualified trade or business.)
- QBI does <u>not</u> include any wages earned as an employee or any investment income such as interest, dividends or capital gains.
- Also, C corporations and their owners generally do not benefit from this QBI deduction.

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New 20% Deduction on Qualified Business Income

- Example: Sam Spade is the 100% owner of a excavation business which he operates as an S corporation, Dig It, Inc. The taxable income of this business is reported on Schedule E of his individual income tax return. The net taxable income of Dig It, Inc. for 2018 is $100,000. Sam's business had a payroll of $250,000 in 2018.
- So Sam gets a preliminary deduction for the lesser of 20% of the income from his excavation business ($100,000 x 20% = $20,000) or half of his share of the wages paid by his business ($250,000 x 50% = $125,000).
- So as long as Sam has at least $100,000 of taxable income on his Form 1040 before the QBI deduction, he gets the $20,000 deduction. If his taxable income is less than $100,000, then the deduction is limited to 20% of his taxable income. (There are other adjustments to taxable income that are beyond the scope of this discussion).
- There is another way of calculating the limitation on the QBI deduction that could enable an entity with no wages to get at least a partial deduction. That limitation is beyond the scope of our discussion today.

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New 20% Deduction on Qualified Business Income.

- Income from certain “specified services” is not eligible for the QBI deduction. These unlucky professions are such fields as law, health care, accounting, consulting, athletics, performing arts, financial services, etc.
- However, there is a very big exception to this specified services exclusion and to the 50% of wages limitation.
- If an individual’s taxable income before the QBI deduction is low enough, the specified services rule and the 50% wage limitation do not apply.
- The specified services rule and wage limitation do not apply if the individual’s taxable income is $315,000 or less for married filing jointly and $157,500 or less for other filers. These benefits phase out at $415,000 for married filing jointly and $207,500 for other filers.

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New 20% Deduction on Qualified Business Income

- Example: Larry Litigious, Esq. is a 50% partner in a law firm, and his share of income from the law firm for 2018 is $200,000. Larry is married, and he and his wife have $310,000 of taxable income in 2018. The law firm's total wages paid in 2018 are $100,000, so Larry's share of the wages is $50,000 and his wage limitation is $50,000 x 50% = $25,000.
- Larry gets a $40,000 QBI deduction for 2018 ($200,000 x 20%) even though he is a lawyer and even though his wage limitation is $25,000.

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New 20% Deduction on Qualified Business Income

- The maximum Federal income tax rate on QBI is as follows, computed on $100:
  - $100 x 20% = $80 x 37% = $30 (rounded)
  - So the maximum income tax rate on QBI is 30%. Note that the maximum income tax rate on C corporation income is 40% as we calculated earlier. So there can be a 10% advantage in being a pass-through entity if you are not in a specified service business.
- Profitable C corporations that are not specified service businesses should seriously consider making an S corporation election to take advantage of the QBI deduction, i.e., manufacturers, wholesalers, etc.

Expansion of Bonus Depreciation

- Property placed in service after September 27, 2017 and before January 1, 2023 qualifies for 100% bonus depreciation. The bonus depreciation percentage was 50% prior to the law change. This means we can now use bonus depreciation to write off the entire cost of an eligible equipment, furniture, certain vehicles and certain improvements.
- To qualify for bonus depreciation, the fixed asset must have a depreciable life of 20 years or less. It no longer has to be new as long as it is the taxpayer's first use of the property.
- Qualified improvement property (QIP) is an important category—it is improvement of the interior of a commercial building that does not expand the size of the building and is not construction or improvement of elevators or escalators. The improvement must be placed in service after the building is first placed in service. Congress has decreased the depreciable life of QIP from 39 to 15 years. Formerly, only 50% of QIP was eligible for bonus depreciation.

Expansion of Section 179

- The limit on Section 179 equipment expensing has increased to $1,000,000 on purchases up to $2,500,000 effective for tax years beginning after 2017.
- Qualified improvement property is also eligible for Section 179. These are improvements to the interior of a building as discussed previously.
- Certain other specified improvements to a commercial building are also eligible for Section 179 expensing (but not bonus depreciation): Heating, ventilation and air-conditioning property, fire protection and alarm systems, and security systems. These improvements must also be placed in service after the building is first placed in service. Bear in mind that if you use this provision, the price is ordinary income recapture on disposition of the building.

Comparison of Bonus Depreciation and Section 179

- Often States do not allow bonus depreciation. For example, Connecticut does not allow bonus depreciation for C corporations but does allow Section 179. So look at the rules for the state where you are placing the asset in service.
- Bonus depreciation can be used to create a loss whereas Section 179 has an income limitation.
- This year there is an important distinction between the effective date of the changes in bonus depreciation and Section 179.
- Since it does not have a purchase limitation, bonus depreciation can be used by large businesses while Section 179 generally would phase out.

Business Interest Expense Limitation

- The business interest deduction is limited to 30% of adjusted taxable income for tax years beginning after 2017. Adjusted taxable income is generally the net taxable income of the business adding back interest expense, depreciation and amortization and any net operating loss deduction. Any excess can be carried over to subsequent years indefinitely.
- Businesses with average gross receipts of $25 million or less are exempt from this limitation.
- Certain real property trades or businesses can elect out of this limitation: real property development, rental, construction, etc.
- The price of electing out is that the company must use the alternative depreciation system (ADS) for any nonresidential real property, residential real property or qualified improvement property acquired by the business. This is generally straight line depreciation over a 40 year life.
- The limitation does not apply to “floor plan financing interest”, i.e., interest on motor vehicle inventory.

Change in Rules on NOL Deduction

- For losses arising in tax years beginning after 2017, the net operating loss deduction is limited to 80% of taxable income. Also, the carryback provision is repealed (formerly a 2 year carryback of NOLs was allowed). In its place, an unlimited carryforward of NOLs is now allowed instead of 20 years.

New Excess Loss Limitation

- Here is a surprise that snuck into the tax bill. There is a new level of loss limitations called excess business losses. The limitation applies to taxpayers other than corporations.
- Excess business losses are calculated as the aggregate gross income and gain of the taxpayer minus any business losses plus $500,000 on a joint return or $250,000 on other returns.
- Any excess business losses are not deducted in the current year. Instead, they are added to the taxpayer's net operating losses and carried forward.
- This is the last level of loss limitations after passive losses.

Accounting Method Changes

- For tax years beginning after 2017, the following accounting method changes are available for businesses with average gross receipts of $25 million or less in the prior three tax years:
  - May use the cash method of accounting even if they have inventories.
  - May account for inventories as non-incidental materials and supplies or use the accounting method reflected in its books and records.
  - No more Unicap adjustment for inventories.
  - Switch from percentage of completion method to completed contract method is allowed.
  - All of these will be automatic accounting method changes but Form 3115 must still be filed.

Additional Business Changes

- The 9% domestic production activities deduction has been repealed for tax years beginning after 2017. This was an extra deduction available to manufacturers and other producers of property such as construction companies.
- Business entertainment expenses are no longer deductible and meals provided to employees for the convenience of the employer are now only 50% deductible. Presumably, business meals are still 50% deductible.

Additional Business Changes

- For any exchanges completed after 2017, like-kind exchanges are only allowed for real property. Formerly, they were allowed for other property held for business or investment such as artwork, airplanes and autos.
- New credit for family and medical leave. Eligible employers can take a credit for 12.5% of wages paid to qualifying employees when they are on family and medical leave as long as employer pays at least 50% of their regular wage. Credit can increase if employer pays above 50%.

Additional Business Changes

- Family and medical leave credit, continued:
  - Employer must have a policy of providing at least 2 weeks a year of paid medical and family leave.
  - Qualifying employee must be employed one year or more and make 60% or less of the threshold for highly compensated employees.
  - If the employer provides paid vacation or personal time, using that time cannot be counted as family and medical leave.
  - New credit will no longer be offered on wages paid after 12-31-19, and it begins with wages paid after 12-31-17.

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Intermission

5 Minute Break

Key Individual Tax Changes

- Tax rate changes on regular income
- No change in capital gains rates
- Change in the "kiddie tax"
- Repeal of personal exemptions
- Increased child tax credit and new family tax credit
- Increase in AMT exemptions
- Additional standard deduction
- Improvement in medical expense deduction
- Limitation on deduction of state income & property taxes
- Additional limitations on deduction of mortgage interest
- Repeal of 2% miscellaneous itemized deductions.

Key Individual Tax Changes

- No personal casualty or theft losses except in Presidentially Declared Disaster Zones.
- No deduction or exclusion for moving expenses
- Ability to use Section 529 plans for elementary and secondary school
- No more alimony deduction or inclusion after 2018
- Elimination of "shared responsibility" payment or penalty for individuals after 2018. Most other Affordable Care Act provisions remain in place, including the 3.8% net investment income tax.

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Individual Tax Rates

- Comparative tax rates applicable to single taxpayers for calendar year 2018:

	New Rate	New Law-Ordinary Taxable Income	Old Rate	Old Law-Ordinary Taxable Income
a)	10%	$0-9,525	10%	$0-9,525
b)	12%	$9,526-38,700	15%	$9,526-38,700
c)	22%	$38,701-82,500	25%	$38,701-93,700
d)	24%	$82,501-157,500	28%	$93,701-195,450
e)	32%	$157,501-200,000	33%	$195,451-424,950
f)	35%	$200,001-500,000	35%	$424,951-426,700
g)	37%	Over $500,000	39.6%	Over $426,700

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Individual Tax Rates

- Comparative tax rates applicable to married taxpayers for calendar year 2018:

	New Rate	New Law-Ordinary Taxable Income	Old Rate	Old Law-Ordinary Taxable Income .
a)	10%	$0-19,050	10%	$0-$19,050
b)	12%	$19,051-77,400	15%	$19,051-77,400
c)	22%	$77,401-165,000	25%	$77,401-156,150
d)	24%	$165,001-315,000	28%	$156,151-237,950
e)	32%	$315,001-400,000	33%	$237,951-$424,950
f)	35%	$400,001-600,000	35%	$424,951-480,050
g)	37%	Over $600,000	39.6%	Over $480,050

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Capital Gains Tax Rates

- No change to capital gain structures under the Act. Short-term capital gains are still taxed as ordinary income.
- The 3.8% net investment income tax did not go away.
- Long-term capital gains still taxed at 0%, 15% and 20% which are applied for 2018 as follows:

Capital Gains Tax Rates

	Rate	Single	Married Joint
i.	0%	$0 - $38,600	$0 – 77,200
ii.	15%	$38,601-$425,800	$77,200-479,000
iii.	20%	Over $425,800	Over $479,000

- The 0% tax rate on long-term capital gains will basically apply to taxpayers in the 10% and 12% tax brackets.
- The 20% tax rate on long-term capital gains applies at about the same level where the old 39.6% rate used to kick in. Congress did not tie it to the new 37% rate because that would have been an additional tax break for high income taxpayers.
- Everyone else will be at the 15% rate.

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Alternative Minimum Tax (AMT)

- AMT did not go away. Under the new law, the number of taxpayers to be in the AMT zone will drop dramatically.
- Under the Act, the phase-out of exemption amount begins at $1,000,000 of taxable income for married, up from $160,900 (for 2017); and, $500,000 of taxable income for single, up from $120,700 (for 2017).
- Many taxpayers making between $200,000 and $1M will now get to take full advantage of the exemption levels.
- The exemption increased to $109,400 for married taxpayers and $70,300 for single taxpayers.
- Pre-reform AMT exemptions for 2018 set to be $86,200 for married taxpayers and $55,400 for single taxpayers and the phase out of the exemption began at much lower levels.

Standard Deduction and Personal Exemption

- Standard deductions for 2018 are:

	New law	Old law
For married taxpayers	$24,000	$13,000
For head of household	$18,000	$ 9,350
For single taxpayers	$12,000	$ 6,500

- No changes made to additional standard deduction for the elderly and blind under the current law
- Personal exemptions were suspended at all income levels between 2018 and 2025

Kiddie Tax

Kiddie Tax on Unearned Income over $2,100

- Beginning after December 31, 2017, the child's taxable income attributable to earned income will be taxed under the rates for single taxpayers (no change in this rule).
- This rule applies to children under the age of 19 and college students under the age of 24.
- The child's taxable income attributable to net unearned income will be taxed according to tax brackets applicable to trust and estates. This is the change!!!
- Child's tax is not affected by the parents or siblings' tax situation.
- This is a temporary provision which applies to taxable years from 2018 through 2025.

Kiddie Tax

- Tax brackets for estates and trusts are very compressed as you can see below

	Rate	Taxable Income
1.	10%	$0 - $2,550
2.	24%	$2,551 - $9,150
3.	35%	$9,151 - $12,500
4.	37%	Over $12,500

Itemized Deductions

- Individual deduction for state and local taxes is limited in the aggregate to $10,000 for married and single filers and $5,000 for married filing separately.
- Property taxes and sales taxes incurred for a trade or business or for the production of income continue to be deductible in full.
- Deduction for foreign real property taxes is eliminated unless paid or accrued in carrying on a trade or business.

Itemized Deductions

- Medical expense deductions will be subject to 7.5% of the taxpayers' adjusted gross income for calendar years 2017 and 2018

<u>Mortgage Interest</u>:

- Under the new law, most taxpayers will be allowed an itemized deduction for the interest on acquisition indebtedness on principal residence and second residence mortgages up to a combined total of $750,000. The limit for married filing separately is $375,000.
- The old limit was $1,000,000 for most taxpayers and $500,000 for married filing separately.

Itemized Deductions

<u>Mortgage Interest - Continued</u>

- Pre December 16, 2017 mortgages are grandfathered and new mortgages may be grandfathered if the purchase contract is dated before December 16, 2017 and other requirements are met.
- Refinancing of grandfathered mortgages is grandfathered, but not beyond the original terms and amount at the time of the refinancing.
- Interest on Home Equity Line of Credit (HELOC) is no longer deductible. Under the old law, borrowers could deduct home equity interest on loans up to $100,000. However, the interest paid on HELOC may still be deductible if the “acquisition indebtedness” requirement is met.

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Itemized Deductions

Mortgage Interest - Continued

- **Acquisition Indebtedness** basically means the amount of debt incurred in acquiring or improving the primary or second residence. This debt must be secured by the residence that was acquired or improved.

Itemized Deductions

Charitable deductions

- Charitable donations deduction limit increased to 60% of the taxpayer's adjusted gross income.
- The 80% charitable deduction for university athletic seating rights is repealed.

Miscellaneous deductions subject to 2%

- Miscellaneous itemized deductions subject to the 2% of adjusted gross income floor will be suspended for calendar years 2018 through 2025.
- Miscellaneous itemized deductions include unreimbursed employee business expenses. It is now even more important to try to get employee business expenses reimbursed under an accountable plan.

Itemized Deductions

- Planning opportunity-bunching:

Standard deduction for married individuals $24,000

	2018	2019
State & local taxes	$10,000	$10,000
Mortgage interest	$10,000	$10,000
Donations	$ 4,000	$ 4,000
Total	$24,000	$24,000
Defer donations	(4,000)	$ 4,000
Itemized deductions	$20,000	**$28,000**

- We still get the $24,000 standard deduction in 2018, but we can itemize in 2019 and get additional deductions.

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Other Suspensions (2018 – 2025)

- The Act temporarily suspended the deduction for moving expenses.
- The suspension for deducting moving expenses does not apply to members of Armed Forces on active duty that move pursuant to a military order and incident to a permanent change of station.
- The rules for exclusions for qualified moving expense reimbursements remain in effect for members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station.

New Family Credit and Enhanced Child Tax Credit (2018 – 2025)

Child Tax Credit

- Child tax credit increased to $2,000 per qualifying child of which $1,400 is a refundable credit.
- The phase-out level of the credit is the same as the family credit – much improved.
- A qualifying child must be under the age of 17 during the calendar year.
- No child tax credit is allowed with respect to a qualifying child without the child's Social Security number.

New Family Credit and Enhanced Child Tax Credit (2018 – 2025)

New Family Credit

- The Act included a New Family Credit which will provide a $500 non-refundable credit to taxpayers for certain dependents (e.g. elderly or disabled dependents or children over 16).
- This credit is subject to income eligibility thresholds and will phase out beginning at $400,000 of adjusted gross income for married joint filers and $200,000 for all other filers.

Child and Dependent Care Credit

- No changes were made to the Child and Dependent Care Credit which relates to child care expenses.
- This credit allows parents to deduct qualified child care expenses which can be worth $1,050 for one child.
- In addition, taxpayers can still contribute up to $5,000 to a dependent care flexible spending account on a pre-tax basis and use the funds to pay for child care expenses.

Casualty or Theft Losses

- Under the Act, there will be no itemized deductions for personal casualty or theft losses between 2018 and 2025.
- Only personal casualty losses incurred in a Federal declared disaster will be allowed.
- Taxpayers affected by hurricanes that occurred in 2017 (Harvey, Irma and Maria) qualify for the personal casualty losses. The net casualty loss from these hurricanes do not need to exceed 10% of the taxpayer's adjusted gross income for the deduction, but the $100 limit per casualty is increased to $500.
- If a taxpayer has a personal casualty gain, the loss suspension will not apply to the extent that such loss does not exceed the gain.

New Uses for 529 Plans

529 Plan Distributions

- The Act extends to taxpayers the opportunity to use up to $10,000 in 529 plan distributions per year for elementary and secondary school expenses
- $10,000 can be used for qualified tuition programs per year for each beneficiary
- It includes secondary public, private and religious schools
- The new uses for 529 Plan does not expire in 2025

Alimony

- Alimony payments will no longer be deductible by the payor nor taxable to the recipient under the new tax law
- The treatment of child support did not change
- The new tax treatment for alimony will be effective after December 31, 2018
- Taxpayers currently negotiating the terms of the divorce agreement have until December 31, 2018 to grandfather into the existing (old) law.

Alimony

- If the divorce instrument is executed by 12/31/2018 and modified on or after 1/1/2019, the alimony payments will still be deductible by the party making the payments and taxable to the recipient unless the modification **expressly provides** that the changes made to the divorce instrument are under the new law.
- In Audubon v Shufeldt, 181 U.S. S., Sup Ct. 735, 736 (45 L.Ed. 1009) the Court said "alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on a contract, express or implied, but on the natural and legal duty of the husband to support the wife".

Health Insurance Mandate

- Under the Affordable Care Act (ACA) or Obamacare Act, taxpayers are required to have health insurance, or pay a penalty.
- Taxpayers are still required to have health insurance through calendar year 2018.
- The new Act, eliminates the penalty or the "shared responsibility" payment after 2018.
- The elimination of the penalty does not expire in 2025.
- Most other Affordable Care Act provisions remain in place.

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