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## Highlights of Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (TCJA) was enacted into law on December 22, 2017, containing significant tax law changes taking effect in 2018 and affecting all taxpayers, businesses and even tax-exempt organizations. This overview concentrates on those provisions under the new law affecting individuals and small businesses.

## Individual Taxpayers

**New Income Tax Rates and Brackets** – for tax years beginning after December 31, 2017 and before January 1, 2026, seven tax rates apply for individuals. To put into perspective the changes in the applicable tax rates for individual taxpayers, provided below is a comparison of the tax rate brackets for tax years 2017 and 2018 for each filing status, as follows:

**Single Individuals**

| Tax Year 2017 | | | Tax Year 2018 | | |
|---|---|---|---|---|---|
| Marginal Tax Rate | Over | To | Marginal Tax Rate | Over | To |
| 10% | $ - | $ 9,325 | 10% | $ - | $ 9,525 |
| 15% | $ 9,325 | $ 37,950 | 12% | $ 9,525 | $ 38,700 |
| 25% | $ 37,950 | $ 91,900 | 22% | $ 38,700 | $ 82,500 |
| 28% | $ 91,900 | $ 191,650 | 24% | $ 82,500 | $ 157,500 |
| 33% | $ 191,650 | $ 416,700 | 32% | $ 157,500 | $ 200,000 |
| 35% | $ 416,700 | $ 418,400 | 35% | $ 200,000 | $ 500,000 |
| 39.6% | $ 418,400 | -- | 37% | $ 500,000 | -- |

**Married Filing Jointly**

| Tax Year 2017 | | | Tax Year 2018 | | |
|---|---|---|---|---|---|
| Marginal Tax Rate | Over | To | Marginal Tax Rate | Over | To |
| 10% | $ - | $ 18,650 | 10% | $ - | $ 19,050 |
| 15% | $ 18,650 | $ 75,900 | 12% | $ 19,050 | $ 77,400 |
| 25% | $ 75,900 | $ 153,100 | 22% | $ 77,400 | $ 165,000 |
| 28% | $ 153,100 | $ 233,350 | 24% | $ 165,000 | $ 315,000 |
| 33% | $ 233,350 | $ 416,700 | 32% | $ 315,000 | $ 400,000 |
| 35% | $ 416,700 | $ 470,700 | 35% | $ 400,000 | $ 600,000 |
| 39.6% | $ 470,700 | -- | 37% | $ 600,000 | -- |

**Married Filing Separate**

| Tax Year 2017 | | | Tax Year 2018 | | |
|---|---|---|---|---|---|
| Marginal Tax Rate | Over | To | Marginal Tax Rate | Over | To |
| 10% | $ - | $ 9,325 | 10% | $ - | $ 9,525 |
| 15% | $ 9,325 | $ 37,950 | 12% | $ 9,525 | $ 38,700 |
| 25% | $ 37,950 | $ 76,550 | 22% | $ 38,700 | $ 82,500 |
| 28% | $ 76,550 | $ 116,675 | 24% | $ 82,500 | $ 157,500 |
| 33% | $ 116,675 | $ 208,350 | 32% | $ 157,500 | $ 200,000 |
| 35% | $ 208,350 | $ 235,350 | 35% | $ 200,000 | $ 300,000 |
| 39.6% | $ 235,350 | -- | 37% | $ 300,000 | -- |

**Head of Household**

| Tax Year 2017 | | | Tax Year 2018 | | |
|---|---|---|---|---|---|
| Marginal Tax Rate | Over | To | Marginal Tax Rate | Over | To |
| 10% | $ - | $ 13,350 | 10% | $ - | $ 13,600 |
| 15% | $ 13,350 | $ 50,800 | 12% | $ 13,600 | $ 51,800 |
| 25% | $ 50,800 | $ 131,200 | 22% | $ 51,800 | $ 82,500 |
| 28% | $ 131,200 | $ 212,500 | 24% | $ 82,500 | $ 157,500 |
| 33% | $ 212,500 | $ 416,700 | 32% | $ 157,500 | $ 200,000 |
| 35% | $ 416,700 | $ 444,550 | 35% | $ 200,000 | $ 500,000 |
| 39.6% | $ 444,550 | -- | 37% | $ 500,000 | -- |

**Standard Deduction Increased** – beginning January 1, 2018 and before January 1, 2026, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers. No changes are made to the current-law additional standard deduction for the elderly or blind.

**Personal Exemptions Suspended** – beginning January 1, 2018 and before January 1, 2026, the deduction for personal and dependency exemptions is disallowed.

**Capital Gains and Qualified Dividends Tax Rate** – effective January 1, 2018 there is no longer a 15% tax rate bracket; however, the Act retains present-law maximum rates on net capital gains and qualified dividends based on fixed-dollar breakpoints, which are indexed for inflation. A comparison of the 0%, 15%, and 20% applicable capital gains tax rate breakpoints for tax years 2017 and 2018 are as follows:

| | 2017 | 2018 |
|---|---|---|
| ***0% applicable rate*** | | |
| MFJ | $ 75,900 | $ 77,200 |
| Single | $ 37,950 | $ 38,600 |
| Head of Household | $ 50,800 | $ 51,700 |
| ***15% applicable rate*** | | |
| Applied up to maximum tax rate for all taxpayers | | |
| ***20% applicable rate*** | | |
| MFJ | $ 470,700 | $ 479,000 |
| Single | $ 418,400 | $ 425,800 |
| Head of Household | $ 444,450 | $ 452,400 |

**Child Tax Credit Increased** – for tax years beginning after December 31, 2017 and before January 1, 2026, the child tax credit increases to $2,000, and other changes were made to phase-outs and refundable portions of the child tax credit during the same period. To put the new tax law into perspective, the 2017 and 2018 child tax credit and applicable Adjusted Gross Income (AGI) phase-outs are as follows:

| | 2017 | 2018 |
|---|---|---|
| *Qualifiying child under age 17 by year-end* | | |
| Maximum credit | $ 1,000 | $ 2,000 |
| Refundable portion of credit | $ 1,000 | $ 1,400 |
| *AGI phase-outs* | | |
| MFJ | $ 110,000 | $ 400,000 |
| Single & Head of Household | $ 75,000 | $ 200,000 |
| *Partial credit for other dependents* | | |
| Other than qualifying child (non-refundable) | $ - | $ 500 |
| *Children over age 17 and other dependents* | | |

As shown in the table above, the Act also provides a $500 nonrefundable credit for certain non-child dependents.

**State and Local Taxes Deduction Limited** – for tax years beginning after December 31, 2017 and before January 1, 2026, individual taxpayers who itemize deductions will be limited to deducting up to $10,000 for the total of state and local property taxes, state and local income taxes, or sales taxes. Foreign real estate taxes are no longer deductible.

**Mortgage and Home Equity Indebtedness Interest Deduction Limited** – for tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for home equity indebtedness is disallowed, and the deduction for mortgage interest is limited to home acquisition indebtedness of up to $750,000.

The new lower limit doesn't apply to any home acquisition indebtedness that was incurred before December 15, 2017.

For any indebtedness that's incurred to refinance indebtedness, the refinanced indebtedness it treated, for purposes of the special rule above for debt incurred on or before December 15, 2017 (which is limited to $1 million for acquisition indebtedness) as incurred on the date the original indebtedness was incurred, to the extent the amount of the indebtedness resulting from the refinancing doesn't exceed the amount of refinanced indebtedness.

**Medical Expense Deduction Threshold Reduced** – for tax years 2017 and 2018 only, the threshold on medical expense deductions is reduced from 10% to 7.5% of Adjusted Gross Income (AGI) for all taxpayers.

**Charitable Contribution Deduction Limitation Increased** – for tax years beginning after December 31, 2017 and before January 1, 2026, the 50% AGI limit for cash contributions to public charities is increased to 60%. Contributions exceeding 60% of AGI can be carried forward and deducted for up to five years, subject to the new ceiling.

**Alimony** – under the Act, for any divorce or separation agreement executed after December 31, 2018, or executed before that date but modified after it, alimony and separate maintenance payments are not deductible by the payor spouse and are not included in the income of the payee spouse.

**Miscellaneous Itemized Deductions Suspended** – for tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for miscellaneous itemized deductions, including tax preparation fees are no longer deductible.

**Moving Expenses Deduction and Exclusion for Moving Expense Reimbursements Suspended** – for tax years beginning after December 31, 2017 and before January 1, 2026, the above-the-line deduction for moving expenses are disallowed, except for members of the Armed Forces on active duty. In addition, the exclusion from gross income for qualified moving expense reimbursements is disallowed, except for members of the Armed Forces on active duty.

**Repeal of Affordable Care Act Individual Mandate** – under the Act, beginning after December 31, 2018, the amount of the individual health care shared responsibility payment or penalty tax for not having coverage for any month during the year is reduced to zero.

**Alternative Minimum Tax Higher Exemption Amounts** – the Act retained Alternative Minimum Tax (AMT) for individual taxpayers, but increased the exemption and Alternative Minimum Taxable Income (AMTI) phase-outs, for tax years beginning after December 31, 2017 and before January 1, 2026. To put into perspective the changes made under the new tax law, the applicable AMT exemptions and AMTI phase-outs for tax years 2017 and 2018 are as follows:

| | 2017 | 2018 |
|---|---|---|
| **AMT Exemption** | | |
| Married Joint | $ 84,500 | $ 109,400 |
| Unmarried Individuals | $ 54,300 | $ 70,300 |
| Married Separate | $ 42,250 | $ 54,700 |
| Estates and Trusts | $ 24,100 | $ 24,100 |
| **AMTI Exemption Phase-Outs** | | |
| Married Joint | $ 160,900 | $ 1,000,000 |
| Unmarried Individuals | $ 120,700 | $ 500,000 |
| Married Separate | $ 80,450 | $ 500,000 |
| Estates and Trusts | $ 80,450 | $ 80,450 |
| Applicable AMT Rate | 26% to 28% | 26% to 28% |

**Estate and Gift Tax Increased Exemption Amount** – for estates of decedents dying and gifts made after December 31, 2017 and before January 1, 2026, the base estate and gift tax exemption amount effectively doubles. Since the exemption amount is indexed for inflation, in 2018 the exemption amount is expected to be approximately $11.2 million ($22.4 million per married couple).

The annual gift tax exclusion for 2018 is $15,000 per donee.

The highlights above, relating to individual taxpayers, are temporary and are due to expire after tax year ending December 31, 2025. In the next section, pertaining to small business taxpayers, the provisions under the Act were made permanent, with certain noted exceptions.

## Small Business Taxpayers

**Increased Section 179 Expensing** – for property placed in service in tax years beginning after December 31, 2017, the maximum amount a taxpayer may expense under (Code Section 179) is increased to $1 million, and the phase-out threshold amount is increased to $2.5 million. For tax years after 2018, these amounts are indexed for inflation.

In addition, the definition of (Code Section 179) qualified real property was expanded to include improvements to nonresidential real property for: roofs, heating, ventilation and air-conditioning property, fire protection and alarm systems and security systems.

**First-Year Bonus Depreciation** – under the Act, a 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. <u>The additional first-year depreciation deduction is allowed for new and used property</u>.

In later years, the first-year bonus depreciation deduction phases down, as follows:

- 80% for property placed in service after Dec 31, 2022 and before Jan 1, 2024
- 60% for property placed in service after Dec 31, 2023 and before Jan 1, 2025
- 40% for property placed in service after Dec 31, 2024 and before Jan 1, 2026
- 20% for property placed in service after Dec 31, 2025 and before Jan 1, 2027

After 2026, the first-year bonus depreciation deduction expires.

**Luxury Automobile Depreciation Limits Increased** – for passenger automobiles (including light-duty trucks and vans) placed in service after December 31, 2017, for which the additional first-year depreciation deduction is not claimed, the maximum amount of allowable depreciation is increased to: $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and late years in the recovery period. After 2018, these amounts are indexed for inflation.

**Recovery Period for Qualified Improvement Real Property Shortened** – for qualified real property improvements placed in service after December 31, 2017, the depreciable period and convention is 15 years using the straight-line method and half-year convention, without regard to whether the improvements are property subject to lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building.

"Qualified improvement property" is any improvement to an interior portion of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service, *except* for any improvement for which the expenditure is attributed to (1) enlargement of the building, (2) any elevator or escalator, or (3) the internal structural framework of the building.

**Modification of Net Operating Loss (NOL) Deduction** – for NOLs arising in tax years ending after December 31, 2017, a NOL can no longer be carried back and can be carried over indefinitely. For NOLs arising after this effective date, the NOL deduction is limited to 80% of the taxable income (without regard to the NOL deduction). Carryovers to other years are adjusted to take into account this limitation.

The effective date, for tax years ending after December 31, 2017, means that NOLs that arose in tax years that began before January 1, 2018 won't be subject to the 80%-of-taxable-income limit. Taxpayers will need to track and distinguish the two types of losses when computing the NOL deduction.

**Business Entertainment Deduction Denied** – under the Act, amounts incurred or paid after December 31, 2017 for business entertainment expenses can no longer be deducted. This includes amounts paid for entertainment, amusement, recreation, or for a facility used in connection with such an activity (e.g. boats), etc.

However, if a non-highly compensated employee incurs such expenses on behalf of an employer under a reimbursement or allowance arrangement, requiring the employee to account to the employer of such expenses incurred, then such deduction will be allowed. Also, expenses for recreational, social or similar activities (including related facilities) primarily for the benefit of the taxpayer's employees, other than highly-compensated employees (HCEs), will be deductible.

In short, entertainment expenses are completely nondeductible, regardless of whether they are directly related to or associated with the taxpayer's business, unless they are the type for expenses incurred by employees on behalf of the employer under an accountable reimbursement plan or for the benefit of the taxpayer's non-highly compensated employees.

As under pre-Tax Cuts and Jobs Act law, taxpayers can still generally deduct 50% of the food and beverage expenses associated with their trade or business, such as meals consumed by employees on work travel.

**Employer-Operated Eating Facilities Expenses** – under the Act, effective January 1, 2018 a 50% limit on deducting food or beverage expenses applies to an employer's expenses for providing food and beverages to employees at an eating facility that qualifies as a *de minimis* fringe benefit. The employee is exempt under the de minimis rules from including the value of such food or beverage as income.

Amounts incurred or paid after December 31, 2025 will no longer be deductible. This includes amounts for employee business meals incurred related to work travel and any expense for an employer-operated eating facility.

**Like-Kind Exchanges Limited to Real Property** – effective for exchanges completed after December 31, 2017, the like-kind exchange (LKE) rules only apply to exchanges of real property.

**Domestic Production Activity Deduction Repealed** – under pre-Act rules, the domestic production activities deduction (DPAD), which was allowed for certain qualifying U.S.- based activities, was 9% of the lesser of the taxpayer's qualified production activities income or the taxpayer's taxable income. Under the Tax Cuts and Jobs Act of 2017, for tax years beginning after December 31, 2017, the DPAD is repealed.

**New 20% Deduction for Qualified Business Income** – effective for tax years beginning after December 31, 2017 and before January 1, 2026, the Act provides for a new deduction for noncorporate business taxpayers, e.g., sole-proprietors, single-member LLCs, partnerships, and S Corporations, commonly referred to as "pass-through" income.

This new deduction is the most complicated provision included under the Act and affects all small businesses that are not corporate taxpayers. The rules provide for determining the deduction and then the deductible limit.

The deduction applies at the individual income tax level. Accordingly, partnerships and S Corporations will have to provide the allocable portions of qualifying business income and related amounts on Schedule K-1s to its partners and shareholders.

The deduction isn't taken into account in determining AGI; however, the deduction can be taken by taxpayers who don't itemize their deductions.

The amount of the deduction is equal to the sum of:

1. The lesser of (i) the combined "qualified business income" for the year (see definition below) of (ii) the sum of 20% of the excess (if any) of the taxpayer's taxable income for the tax year (determined without regard to this deduction) over the sum of the taxpayer's net capital gain (see below) for the tax year, plus

2. The lesser of the taxpayer's taxable income (minus the taxpayer's net capital gain) for the tax year.

*The above provision includes amounts for qualified cooperative dividends, but most of our clientele do no receive such sources of revenue. Accordingly, reference to them in the above determination of the deduction is excluded in this summary.*

However, the total deduction cannot exceed the taxpayer's taxable income (minus the taxpayer's net capital gain) for the tax year.

***"Qualified Business Income"*** – the definition of "qualified business income for a tax year" is the net amount of qualified items of income, gain, deduction, and loss relating to any qualified trade or business of the taxpayer. It does not include any qualified REIT dividends, qualified cooperative dividends or qualified publicly traded partnership income.

If the net amount of qualified income, gain, deduction, and loss relating to a qualified trade or businesses of the taxpayer for any tax year is less than zero, the amount is carried over as a loss from a qualified trade or business in the succeeding tax year.

Qualified items of income, gain, deduction, and loss are items of income, gain, deduction, and loss to the extent these items are effectively connected with the conduct of a trade or business within the U.S. and included or allowed in determining taxable income for the year.

However, certain investment items are not taken into account as a qualified item of income, gain, deduction, or loss:

- Any item of short-term or long-term capital gain or loss
- Any dividend income
- Any interest income
- Any item of deduction or loss properly allocable to an amount described in any of the preceding items above

In addition, qualified business income doesn't include:

- Reasonable compensation paid to the taxpayer by a qualified trade or business of the taxpayer for services rendered for the trade or business, and
- Guaranteed payment paid to a partner for services rendered for the trade or business

For this purpose, a qualified trade or business is any trade or business other than a specified service trade or business or the business of performing services as an employee.

A specified service trade or business is:

a) Any trade or business involving the performance of services described in Code Sec. 1202(e)(3)(A), in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, financial services, brokerage services or any trade or business where the principal asset of such business is the reputation or skill of 1 or more of its employees, and

b) Which involve performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

However, if for any tax year, the taxable income of any taxpayer is less than the sum of the $157,500 ($315,000 in the case of a joint return) threshold amount (explained below) plus $50,000 ($100,000 in the case of a joint return), the exclusion for specified service trades or businesses of the taxpayer for the tax year will not apply.

Instead, the qualified items of income, gain, deduction, loss, W-2 wages, and the unadjusted basis immediately after the acquisition of qualified property of the taxpayer (explained in more detail below) allocable to the specified service trades or businesses will be taken into account in computing the qualified business income, W-2 wages, and unadjusted basis of the taxpayer for the tax year, but only to the extent of the applicable percentage of the qualified items of income, gain, deduction, loss, W-2 wages, and unadjusted basis of the taxpayer allocable to the specified service trades or businesses.

The applicable percentage for any tax year is 100% reduced (but not below zero) by the percentage equal to (i) the taxable income of the taxpayer for the tax year in excess of the threshold amount divided by (ii) $50,000 ($100,000 in the case of a joint return).

A taxpayer's <u>combined</u> qualified business income amount for a tax year is equal to:

- The sum of the deductible amounts determined below for each qualified trade or business carried on by the taxpayer, plus
- 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

A qualified REIT dividend is any dividend from a real estate investment trust received during the year that is not a capital gain dividend or qualified dividend income.

Qualified publicly traded partnership income for any qualified trade or business of the taxpayer is the sum of:

- The net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (after excluding reasonable compensation, guaranteed payments and other payments for services), and
- Any gain recognized by the taxpayer upon the disposition of its interest in such a partnership to the extent that the gain is treated as amount realize from a sale or exchange of property other than a capital asset.

**<u>The deductible amount for a qualified trade or business is the lesser of</u>**:

a) 20% of the taxpayer's qualified business income from the qualified trade or business, or
b) The greater of (I) 50% of the W-2 wages relating to the qualified trade or business or (II) the sum of (i) 25% of the W-2 wages relating to the qualified trade or business and (ii) 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

A person's W-2 wages for the tax year is the total of wages and elective deferrals, but only for amounts properly allocable to qualified business income.

"Qualified property" relating to a qualified trade or business for a tax year is tangible property subject to depreciation that is held by and available for use in, the qualified trade or business at the close of the tax year, used in the production of qualified business income.

The above-mentioned wage limitation doesn't apply for taxpayers below the threshold amount of $157,500 ($315,000 in the case of a joint return). For tax years after 2018 the threshold amounts are increased for inflation.

If the taxable income of a taxpayer for any tax year exceeds the threshold amount, by less than $50,000 ($100,000 in the case of a joint return) and the amount in item (b) above is less than 20% of the taxpayer's qualified business income from the qualified trade or business, then the then the item (b) limitation above will not apply.

Instead, the 20% of the taxpayer's qualified business income from the qualified trade or business amount will be reduced by (1) 20% of the taxpayer's qualified business income minus (2) the amount in item (b) above (excess amount) multiplied by (A) the amount by which the taxpayer's taxable income for the tax year exceeds the threshold amount and divided by (B) $50,000 ($100,000 in the case of a joint return).

The deduction allowed applies only for income tax purposes.

It appears that a "trade or business" would be defined by reference to Code Section 162, as distinguished from an investment activity. For example, a sole-proprietor's business activity reported on Schedule C, Form 1040, as opposed to rental activities, reported on Schedule E, Part I, Form 1040.

The IRS is directed to prescribe regulations that are necessary to carryout the purposes of the deduction, including regulations requiring or restricting the allocation of items of wages for purposes of the deduction, requiring reporting as the IRS determines and applying the deduction in the case of tiered entities.

As mentioned earlier, this specific provision under the Act is complicated and affects all small business taxpayers. Due to the complexity and pending regulations to be issued by the Internal Revenue Service, all small business clients; sole-proprietorships, partnerships, and S Corporation, can expect professional fees for preparation of their tax returns to be significantly greater than in prior years.

The Act contains other provisions not summarized in these highlights. We will be informing our clients of all significant law changes affecting their 2018 and future returns at the time we prepare their 2017 returns. Due to the timing of the enactment of the Act, we anticipate it will take longer than usual to compute estimated tax liabilities for tax year 2018 and software application providers may need more time to provide resources for our firm to provide reliable tax estimates.