A Primer on the Tax Cuts and Jobs Act of 2017

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Introduction

- The Tax Cuts and Jobs Act (the "Act") was signed into law by President Trump on December 22, 2017.
- This legislation contains many changes in taxation for businesses, individuals, and foreign business entities and their United States ("U.S.") owners

INDIVIDUAL TAX CHANGES

Tax Rates

- For the tax years 2018-2025, individuals' taxable income will be in seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. After 2025, earlier rates will be in effect.

- The highest rate is for individuals with taxable income at $500,000 and above, and for married couples filing jointly at $600,000 and above.

Tax Tables

Personal Exemption

- Under pre-Act law, a personal exemption (in addition to numerous personal deductions) was allowed, with the personal exemption being $4,050 in the 2017 tax year.

- Under the Act, both the personal exemption and certain itemized deductions have been suspended.

Capital Gains

- The basic capital gains structure has remained the same, with long-term capital gains at the 0%, 15%, and 20% brackets, while short-term gains are taxed as ordinary income.

- Additionally, the 3.8% net investment income tax is still in place.

Alternative Minimum Tax ("AMT")

- The AMT exemption amount has been increased to $109,400 (joint filers; for single filers, the new amount is $70,300) from $84,500.
- There is an exemption phase-out at 25% of the excess income over $1 million.
- This increase sunsets after 2025.

Standard Deduction

For tax years beginning after December 31, 2017 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, adjusted for inflation in tax years beginning after 2018.

Also, for the above period, the deduction for miscellaneous itemized deductions that are subject to the 2% floor (which includes the deduction for tax preparation expenses, investment advisory fees, license and regulatory fees, and malpractice insurance fees, among many others) is suspended.

Casualty Losses

- For tax years beginning after December 31, 2017 and before January 1, 2026, the personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a federally-declared disaster.

Child Tax Credit

- For tax years beginning after December 31, 2017 and before January 1, 2026, the child tax credit is increased to $2,000.

- The income levels at which the credit phases out are increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers), an amount which is not indexed for inflation. In addition, a $500 nonrefundable credit is provided for certain non-child dependents.

- The amount of the credit that is refundable is increased to $1,400 per qualifying child, and this amount is indexed for inflation, up to the base $2,000 base credit amount. The earned income threshold for the refundable portion of the credit is decreased from $3,000 to $2,500.

State and Local Taxes

- For tax years beginning after December 31, 2017 and before January 1, 2026, state, local, and foreign property taxes, and state and local sales taxes, are deductible only when paid or accrued in carrying on a trade or business or an activity performed for the production of income.

- State and local income taxes are not allowable as a deduction.

- However, a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married taxpayer filing a separate return) for the aggregate of: (i) state and local property taxes not paid or accrued in carrying on a trade or business or activity for the production of income; and (ii) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income taxes) paid or accrued in the tax year. Foreign real property taxes may not be deducted.

- Importantly, for tax years beginning after December 31, 2016, in the case of an amount paid in a tax year beginning before January 1, 2018 with respect to a state or local income tax imposed for a tax year beginning after December 31, 2017, the payment will be treated as paid on the last day of the tax year for which such tax is so imposed for purposes of applying the above limits. In other words, a taxpayer who, in 2017, pays an income tax that is imposed for a tax year after 2017, cannot claim an itemized deduction in 2017 for that prepaid income tax.

Mortgage Interest

- For tax years beginning after December 31, 2017 and before January 1, 2026, the deduction for interest on home equity indebtedness is suspended, and the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately).

- For tax years after December 31, 2025, the prior $1 million/$500,000 limitations are restored, and a taxpayer may treat up to these amounts as acquisition indebtedness regardless of when the indebtedness was incurred. The suspension for home equity indebtedness also ends for tax years beginning after December 31, 2025.

- The new lower limit does not apply to any acquisition indebtedness incurred before December 15, 2017. Moreover, a taxpayer who has entered into a binding written contract before December 15, 2017 to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to incur acquisition indebtedness prior to December 15, 2017.

- The pre-Act $1 million/$500,000 limitations continue to apply to taxpayers who refinance existing qualified residence indebtedness that was incurred before December 15, 2017, so long as the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness.

Charitable Contributions

- The percentage limit of adjusted gross income for charitable contributions is increased from 50% (in connection with donations to public charities and private foundations) to 60%.

- Under pre-Act law, no charitable deduction was allowed for contributions of $250 or more unless the donor substantiates the contribution by a contemporaneous written acknowledgment from the donee organization. Pursuant to §170(f)(8)(D) of the Internal Revenue Code of 1986, as amended (the "Code"), the IRS is authorized to issue regulations that exempt donors from this substantiation requirement if the donee organization files a return that contains the same required information. However, the IRS has, as of yet, not issued such regulations.

- Additionally, for contributions made in tax years beginning after December 31, 2016, the Code §170(f)(8)(D) provision is repealed. Consequently, contemporaneous written acknowledgements continue to be required.

Affordable Care Act (“ACA”) Payments

- For months beginning after December 31, 2018, the amount of the individual shared responsibility payment is reduced to zero. This repeal is permanent.

- The Act retains the 3.8% net investment income tax and the 0.9% additional Medicare tax, both enacted by the ACA.

Alimony

- For any divorce or separation agreement executed after December 31, 2018, or executed before that date but modified after it (if the modification expressly provides that the new amendments apply), alimony and separate maintenance payments are not deductible by the payor spouse and are not included in the income of the payee spouse.

- Instead, income used for alimony is taxed at the rates applicable to the payor spouse.

Use of §529 Accounts

- Currently, the funds in a Code §529 college savings account can only be used for qualified higher education expenses. If funds are withdrawn from the account for other purposes, each withdrawal is treated as containing a pro-rata portion of earnings and principal. The earnings portion of a nonqualified withdrawal was taxable as ordinary income and subject to a 10% additional tax unless an exception applied.

- "Qualified higher education expenses" include tuition, fees, books, supplies, and required equipment, as well as reasonable room and board if the student was enrolled at least half-time. Eligible schools included colleges, universities, vocational schools, or other post-secondary schools eligible to participate in a student aid program of the U.S. Department of Education. This included nearly all accredited public, nonprofit, and proprietary (for-profit) postsecondary institutions.

- For distributions after December 31, 2017, "qualified higher education expenses" include tuition at an elementary or secondary public, private, or religious schools, and various expenses associated with home schooling, up to a $10,000 limit per tax year.

Estate Tax

- For estates of decedents dying and gifts made after December 31, 2017 and before January 1, 2026, the Act doubles the base estate and gift tax exemption amount from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011 and is expected to be approximately $11.2 million in 2018, or $22.4 million per married couple.

- Although the language in the Act does not mention generation-skipping transfers, because the generation-skipping transfer tax exemption amount is based on the basic exclusion amount, generation skipping transfers should also see an increased exclusion amount.

BUSINESS TAX CHANGES

Rate Changes and Deductions

- The former graduated rate structure for corporations is now a flat 21% rate.
- The corporate AMT is eliminated, and AMT credits can be utilized to obtain refunds.
- Up to $1 million of property (subject to a $2.5 million threshold) can be expensed under Code §179.
- Bonus depreciation for 100% of new and used (i.e., the first taxable use does not need to begin with the taxpayer) “qualifying property” is provided, with a phase down through 2026.
- For tax years beginning after December 31, 2025, an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises.

Excess Business Losses

- In determining their taxable income for a taxable year, the shareholders of an S corporation and the partners of a partnership are allocated their share of the pass-through entity's losses for such year. However, there are a number of rules that limit the ability of these owners to deduct these losses (e.g., basis limitation, at-risk, etc.).

- The Act provides an additional one, namely that the excess business losses of a non-corporate taxpayer are disallowed.

- A taxpayer's "excess business loss" for a taxable year is the excess of: (a) the taxpayer's aggregate deductions attributable to his trades or businesses for the year; over (b) the sum of (i) the taxpayer's aggregate gross income or gain for the year attributable to such trades or businesses, plus $250,000 (or $500,000 in the case of a joint return).

- In the case of a partnership or S corporation, this provision is applied at the partner or shareholder level. Each partner's and each S corporation shareholder's share of the pass-through entity's items of income, gain, deduction, or loss are taken into account in applying the limitation for the taxable year of the partner or S corporation shareholder.

- The non-corporate taxpayer's excess business loss for a taxable year is carried forward and treated as part of the taxpayer's net operating loss ("NOL") carryforward in subsequent taxable years.

Other Important Provisions

- NOLs arising in tax years ending after December 31, 2017, the two-year carryback and the special carryback provisions are repealed, and for losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and, NOLs can generally be carried forward indefinitely.

- Effective for transfers after December 31, 2017, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. However, under a transition rule, the pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

- Net interest expense is limited to 30% of adjusted taxable income, and a carryforward is permitted. Real estate businesses using the alternative depreciation system can elect out of this limitation. Also, an exemption from this limitation applies for taxpayers (other than tax shelters) with average annual gross receipts for the three-tax year period ending with the prior tax year that do not exceed $25 million. The limitation also does not apply to certain regulated public utilities and electric cooperatives.

Qualified Business Income ("QBI") Deduction

A non-corporate taxpayer, including a trust or estate, who has qualified QBI from a partnership, S corporation, or sole proprietorship is allowed to deduct:

- (i) the lesser of the "combined qualified business income amount" of the taxpayer, or 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; plus

- (ii) the lesser of: 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or taxable income (reduced by the net capital gain) of the taxpayer for the tax year.

QBI: General

- The "combined qualified business income amount" means, for any tax year, an amount equal to: (i) the deductible amount for each qualified trade or business of the taxpayer (defined as 20% of the taxpayer's QBI subject to the W-2 wage limitation);

- plus (ii) 20% of the aggregate amount of qualified real estate investment trust dividends and qualified publicly traded partnership income of the taxpayer for the tax year.

QBI: General

- QBI does not include certain investment items, reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business, any guaranteed payment to a partner for services to the business under Code §707(c), or a payment under Code§707(a) to a partner for services rendered with respect to the trade or business.

- For pass-through entities, and in respect of the limitation, the deduction cannot exceed the greater of:

  - (i) 50% of the W-2 wages with respect to the qualified trade or business (the "W-2 wage limit"); or

  - (ii) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property" (defined in Code §199A(b)(6) as meaning tangible, depreciable property which is held by and available for use in the qualified trade or business at the close of the tax year, which is used at any point during the tax year in the production of qualified business income, and the depreciable period for which has not ended before the close of the tax year).

QBI: General

- For a partnership or S corporation, each partner or shareholder is treated as having W-2 wages for the tax year in an amount equal to his or her allocable share of the W-2 wages of the entity for the tax year. A partner or shareholder's allocable share of W-2 wages is determined in the same way as the partner or shareholder's allocable share of wage expenses. For an S corporation, an allocable share is the shareholder's pro rata share of an item. However, the W-2 wage limit begins phasing out in the case of a taxpayer with taxable income exceeding $315,000 for married individuals filing jointly ($157,500 for other individuals).

- The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for single filers).

QBI: General

- The QBI deduction does not apply to "specified service" trades or businesses (i.e., generally, the white collar professions, such as consulting, financial advisory, medicine, law, accounting, etc., but also athletics, performing arts, and fundamentally any trade or business where the principal asset is the reputation or skill of one or more employees).

- Engineering and architectural services are excluded from the above definition.

- The service business limitation begins phasing out in the case of a taxpayer whose taxable income exceeds $315,000 for married individuals filing jointly ($157,500 for other individuals), both indexed for inflation after 2018. The benefit of the deduction for service businesses is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals). The deduction also does not apply to the trade or business of being an employee.

QBI: Basic Examples

- Tom earns $100,000 in a law firm that he operates as a single-member LLC. His taxable income equals $100,000.
- Mitch has $500,000 in taxable income working as a neurosurgeon in a medical partnership.
- Natasha earns $200,000 from her sole proprietorship, but has $50,000 of deductions.
- Erica earns $200,000 as a sole proprietor, $100,000 of long-term capital gains, and has $150,000 of deductions.

QBI: A Bit More Complex

- Dan operates a widget factory and has $100,000 of QBI, and his taxable income is $1,000,000. The factory pays $30,000 in wages.

- Same facts, but the factory also has equipment with an original cost of $400,000.

QBI: A Bit More Complex (cont'd)

- Dan's tentative deduction would be $20,000 (20% of $100,000), but the factory only pays $30,000 of wages, which supports merely a $15,000 deduction (50% of $30,000; remember, it's the lesser of the 20% QBI deduction or the greater of the 50% W-2 limitation/25% W-2 plus 2.5% depreciable property basis limitation).

- The equipment, however, supports a $10,000 deduction (2.5% of $400,000), which when added to $7,500 (25% of $30,000), yields a final deduction of $17,500 (which is less than $20,000).

Summary of QBI Rules

- If your taxable income is equal to or less than $157,500, or $315,000 for a married couple filing jointly (adjusted annually), your QBI deduction is equal to 20% of your share of trade or business income from partnerships, limited liability companies, taxed as partnerships, or S corporations.

- Between the above thresholds and an additional $50,000 cap, or a $100,000 cap in the case of a married couple filing jointly, special rules phase out amounts that would otherwise qualify for the QBI deduction.

Summary of QBI Rules (cont'd)

- If your taxable income exceeds the applicable threshold and corresponding cap, then the QBI deduction only applies to qualified trade or business income (i.e., non-service business income; if below the threshold and cap, the deduction is available to all businesses).

- If your taxable income exceeds the applicable threshold and corresponding cap, then the QBI deduction is limited to the lesser of: (i) 20% of QBI, or (ii) the greater of 50% of W-2 wages paid by the business, or the sum of 25% of such W-2 wages plus 2.5% of the cost of certain property used in the business.

- If your taxable income exceeds the applicable threshold but not the corresponding cap, then the 20% QBI deduction is reduced by a pro rata amount. This applies to service businesses as well.

A Touch of International Tax

- Under the Act, 10% U.S. shareholders of controlled foreign corporations ("CFCs") or foreign corporations that are not CFCs but have at least one U.S. corporation as a 10% shareholder are deemed to repatriate cash and illiquid assets (based on earnings and profits) of the foreign entity for their most recent taxable year beginning before January 1, 2018.

- Through a complex deduction mechanism, the resulting tax rate on the repatriation will be 15.5% on cash and 8% on everything else.

- Although payable in 8 installments, the first outlay will be due for some taxpayers by April 15, 2018.

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