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SPECIAL REPORT

Tax Law Essentials

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Game-changing tax package

The recently enacted Tax Cuts and Jobs Act (TCJA) is a sweeping, game-changing tax package. Here's a look at some of the more important elements of the new law. Unless otherwise noted, the changes are effective for tax years beginning in 2018 through 2025.

Provisions that have an impact on individuals:

1. **Tax rates:**
   The new law imposes a new tax rate structure with seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate was reduced from 39.6% to 37%, and applies to taxable income above $500,000 for single taxpayers, and $600,000 for married couples filing jointly. The rates applicable to net capital gains and qualified dividends were not changed. The "kiddie tax" rules were simplified. The net unearned income of a child subject to the rules will be taxed at the capital gain and ordinary income rates that apply to trusts and estates. Thus, the child's tax is unaffected by the parent's tax situation or the unearned income of any siblings.

2. **Standard deduction:**
   The new law increases the standard deduction to $24,000 for joint filers, $18,000 for heads of households, and $12,000 for singles and married taxpayers filing separately. Given these increases, many taxpayers will no longer be itemizing deductions. These figures will be indexed for inflation after 2018.

3. **Exemptions:**
   The new law suspends the deduction for personal exemptions. Thus, starting in 2018, taxpayers can no longer claim personal or dependency exemptions. The rules for withholding income tax on wages will be adjusted to reflect this change, but IRS was given the discretion to leave the withholding unchanged for 2018.

4. **New deduction for "qualified" business income:**
   Starting in 2018, taxpayers are allowed a deduction equal to 20% of "qualified business income," otherwise known as "pass-through" income, i.e. income from partnerships, S corporations, LLCs, and sole proprietorships. The income must be from a trade or business within the United States. Investment income does not qualify, nor do amounts received from an S corporation as reasonable compensation or from a partnership as a guaranteed payment for services provided to the trade or business. The deduction is not used in computing adjusted gross income, just taxable income. For taxpayers with taxable income above $157,500 ($315,000 for joint filers), (1) a limitation based on W-2 wages paid by the business and depreciable tangible property used in the business is phased in, and (2) income from the following trades or businesses is phased out of qualified business income: health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.

5. **Child and family tax credit:**
   The new law increases the credit for qualifying children (i.e. children under 17) to $2,000 from $1,000, and increases to $1,400 the refundable portion of the credit. It also introduces a new (nonrefundable) $500 credit for a taxpayer's dependents who are not qualifying children. The adjusted gross income level at which the credits begin to be phased out has been increased to $200,000 ($400,000 for joint filers).

6. **State and local taxes:**
   The itemized deduction for state and local income and property taxes is limited to a total of $10,000 starting in 2018.

7. **Mortgage interest:**
   Under the new law, mortgage interest on loans used to acquire a principal residence and a second home is only deductible on debt up to $750,000 (down from $1 million), starting with loans taken out in 2018. And there is no longer any deduction for interest on home equity loans, regardless of when the debt was incurred.

Provisions that have an impact on individuals (continued)

8. **Miscellaneous itemized deductions:**
   There is no longer a deduction for miscellaneous itemized deductions which were formerly deductible to the extent they exceeded 2% of adjusted gross income. This category included items such as tax preparation costs, investment expenses, union dues, and unreimbursed employee expenses.

9. **Medical expenses:**
   Under the new law, for 2017 and 2018, medical expenses are deductible to the extent they exceed 7.5% of adjusted gross income for all taxpayers. Previously, the AGI "floor" was 10% for most taxpayers.

10. **Casualty and theft losses:**
    The itemized deduction for casualty and theft losses has been suspended except for losses incurred in a federally declared disaster.

11. **Overall limitation on itemized deductions:**
    The new law suspends the overall limitation on itemized deductions that formerly applied to taxpayers whose adjusted gross income exceeded specified thresholds. The itemized deductions of such taxpayers were reduced by 3% of the amount by which AGI exceeded the applicable threshold, but the reduction could not exceed 80% of the total itemized deductions, and certain items were exempt from the limitation.

12. **Moving expenses:**
    The deduction for job-related moving expenses has been eliminated, except for certain military personnel. The exclusion for moving expense reimbursements has also been suspended.

13. **Alimony:**
    For post-2018 divorce decrees and separation agreements, alimony will not be deductible by the paying spouse and will not be taxable to the receiving spouse.

14. **Healthcare "individual" mandate:**
    Starting in 2019, there is no longer a penalty for individuals who fail to obtain minimum essential health coverage.

15. **Estate and gift tax exemption:**
    Effective for decedents dying, and gifts made, in 2018, the estate and gift tax exemption has been increased to roughly $11.2 million ($22.4 million for married couples).

16. **Alternative minimum tax (AMT) exemption:**
    The AMT has been retained for individuals by the new law but the exemption has been increased to $109,400 for joint filers ($54,700 for married taxpayers filing separately), and $70,300 for unmarried taxpayers. The exemption is phased out for taxpayers with alternative minimum taxable income over $1 million for joint filers, and over $500,000 for all others.

17. **Recharacterization of IRA contributions:**
    An individual who makes a contribution to a regular or Roth IRA can recharacterize it as made to the other type of IRA via a trustee-to-trustee transfer before the due date of the return for the contribution year. Under the new law, however, once a contribution to a regular IRA has been converted into a contribution to a Roth IRA, it can no longer be converted back into a contribution to a regular IRA, i.e. a recharacterization cannot be used to "unwind" a Roth conversion. For any conversions made by taxpayers to a Roth IRA during 2017, there is uncertainty about whether the effective date of this provision (tax years after 2017) refers to the tax year of the recharacterization, or the tax year of the unwinding. Thus, there is a need for a clarification by IRS.

Provisions that impact businesses:

1. **Corporate tax rates reduced:**
   One of the more significant new law provisions cuts the corporate tax rate to a flat 21%. Before the new law, rates were graduated, starting at 15% for taxable income up to $50,000, with rates at 25% for income between 50,001 and $75,000, 34% for income between $75,001 and $10 million, and 35% for income above $10 million.

2. **Net Operating Loss ("NOL") deduction modified:**
   Under the new law, generally, NOLs arising in tax years ending after 2017 can only be carried forward, not back. The general two-year carryback rule, and other special carryback provisions, have been repealed. However, a two-year carryback for certain farming losses is allowed. These NOLs can be carried forward indefinitely, rather than expiring after 20 years. Additionally, under the new law, for losses arising in tax years beginning after 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 the 80% limitation.

3. **Limit on business interest deduction:**
   Under the new law, every business, regardless of its form, is limited to a deduction for business interest equal to 30% of its adjusted taxable income. For pass-through entities such as partnerships and S corporations, the determination is made at the entity, i.e. partnership or S corporation, level. Adjusted taxable income is computed without regard to the repealed domestic production activities deduction and, for tax years beginning after 2017 and before 2022, without regard to deductions for depreciation, amortization, or depletion. Any business interest disallowed under this rule is carried into the following year, and, generally, may be carried forward indefinitely. The limitation does not apply to taxpayers (other than tax shelters) with average annual gross receipts of $25 million or less for the three-year period ending with the prior tax year. Real property trades or businesses can elect to have the rule not apply if they elect to use the alternative depreciation system for real property used in their trade or business. Certain additional rules apply to partnerships.

4. **Domestic production activities deduction ("DPAD") repealed:**
   The new law repeals the DPAD for tax years beginning after 2017. The DPAD formerly allowed taxpayers to deduct 9% (6% for certain oil and gas activities) of the lesser of the taxpayer's (1) qualified production activities income ("QPAI") or (2) taxable income for the year, limited to 50% of the W-2 wages paid by the taxpayer for the year. QPAI was the taxpayer's receipts, minus expenses allocable to the receipts, from property manufactured, produced, grown, or extracted within the U.S.; qualified film productions; production of electricity, natural gas, or potable water; construction activities performed in the U.S.; and certain engineering or architectural services.

5. **Increased Code Sec. 179 expensing:**
   Increased Code Sec. 179 expensing. The new law increases the maximum amount that may be expensed under Code Sec. 179 to $1 million. If more than $2.5 million of property is placed in service during the year, the $1 million limitation is reduced by the excess over $2.5 million. Both the $1 million and the $2.5 million amounts are indexed for inflation after 2018. The expense election has also been expanded to cover (1) certain depreciable tangible personal property used mostly to furnish lodging or in connection with furnishing lodging, and (2) the following improvements to nonresidential real property made after it was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; security systems; and any other building improvements that aren't elevators or escalators, don't enlarge the building, and aren't attributable to internal structural framework.

6. **Bonus depreciation:**
   Bonus depreciation. Under the new law, a 100% first-year deduction is allowed for qualified new and used property acquired and placed in service after September 27, 2017 and before 2023. Pre-Act law provided for a 50% allowance, to be phased down for property placed in service after 2017. Under the new law, the 100% allowance is phased down starting after 2023.

Provisions that impact businesses: (continued)

7. **Depreciation of qualified improvement property:** Depreciation of qualified improvement property. The new law provides that qualified improvement property is depreciable using a 15-year recovery period and the straight-line method. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property placed in service after the building was placed in service. It does not include expenses related to the enlargement of the building, any elevator or escalator, or the internal structural framework. There are no longer separate requirements for leasehold improvement property or restaurant property.

8. **Luxury auto depreciation limits:** Luxury auto depreciation limits. Under the new law, for a passenger automobile for which bonus depreciation (see above) is not claimed, the maximum depreciation allowance is increased to $10,000 for the year it is placed in service, $16,000 for the second year, $9,000 for the third year, and $5,760 for the fourth and later years in the recovery period. These amounts are indexed for inflation after 2018. For passenger autos eligible for bonus first year depreciation, the maximum additional first year depreciation allowance remains at $8,000 as under pre-Act law.

9. **Like-kind exchange treatment limited:** Like-kind exchange treatment limited. Under the new law, the rule allowing the deferral of gain on like-kind exchanges of property held for productive use in a taxpayer's trade or business or for investment purposes is limited to cover only like-kind exchanges of real property not held primarily for sale. Under a transition rule, the pre-TCJA law applies to exchanges of personal property if the taxpayer has either disposed of the property given up or obtained the replacement property before 2018.

10. **Excessive employee compensation:** Excessive employee compensation. Under pre-Act law, a deduction for compensation paid or accrued with respect to a covered employee of a publicly traded corporation is deductible only up to $1 million per year. Exceptions applied for commissions, performance-based pay, including stock options, payments to a qualified retirement plan, and amounts excludable from the employee's gross income. The new law repealed the exceptions for commissions and performance-based pay. The definition of "covered employee" is revised to include the principal executive officer, principal financial officer, and the three highest-paid officers. An individual who is a covered employee for a tax year beginning after 2016 remains a covered employee for all future years.

11. **Partnership "technical termination" rule repealed:** Partnership "technical termination" rule repealed. Before the new law, partnerships experienced a "technical termination" if, within any 12-month period, there was a sale or exchange of at least 50% of the total interest in partnership capital and profits. This resulted in a deemed contribution of all partnership assets and liabilities to a new partnership in exchange for an interest in it, followed by a deemed distribution of interests in the new partnership to the purchasing partners and continuing partners from the terminated partnership. Some of the tax attributes of the old partnership terminated, its tax year closed, partnership-level elections ceased to apply, and depreciation recovery periods restarted. Often, this imposed unintended burdens and costs on the parties. The new law repeals this rule. A partnership termination is no longer triggered if within a 12-month period, there is a sale or exchange of 50% or more of total partnership capital and profits interests. A partnership termination will still occur only if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

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