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OVERVIEW OF TAX CUTS AND JOBS ACT OF 2017 (TCJA)

Dear Client:

On December 22, the President signed into law the Tax Cuts and Jobs Act of 2017 (TCJA). TCJA is the largest tax overhaul since the 1986 Tax Reform Act and it will affect almost every individual and business in the United States. Generally, the new law goes into effect in 2018, with many of the provisions relating to individuals expiring at the end of 2025.

I'm writing to give you a brief rundown of what's in the new law and how it might affect you.

Overview of TCJA Changes Affecting Individuals

The following is a brief overview of TCJA's key changes (and non-changes) affecting individuals.

Tax Rates and Brackets. TCJA provides seven tax brackets, with most rates being two to three points lower than the ones under present law (the top rate goes from 39.6 percent to 37 percent). The top rate kicks in at $600,000 of taxable income for joint filers, $300,000 for married taxpayers filing separately and $400,000 for all other individual taxpayers.

> **Observation:** While applicable rates at any given level of income generally go down by two to three points, some go up. For example, the rate for single individuals with taxable income between $200,000 and $400,000 goes from 33 percent to 35 percent.

Capital Gain Rates and Net Investment Income Tax. Tax rates on capital gains and the 3.8 percent net investment income tax (NIIT) are unchanged by TCJA.

Personal Exemptions and Standard Deduction. TCJA repeals the personal exemption deductions, but nearly doubles the standard deduction amounts to $24,000 for joint filers and surviving spouses, $18,000 for heads of household, and $12,000 for single individuals and married filing separately (additional amounts for the elderly and blind are retained).

> **Observation:** The fact that the standard deduction has nearly doubled may create the misleading impression that you'll reap a large tax benefit from the change. But, because the increase in the standard deduction was coupled with the repeal of the

deduction for personal exemption ($4,150, per exemption in 2018); the actual benefit is fairly modest. For example, the overall amount of income that is exempt from tax will increase by $2,700 for joint filers - a nice increase, but nowhere near double the $13,000 standard deduction under prior law.

Because the standard deduction is generally claimed only when its amount exceeds available itemized deductions, the increases will not benefit you if you itemize (the repeal of personal exemptions, by contrast, will affect you whether you itemize or not).

Exemption for Dependents and Child Tax Credit. As part of the repeal of personal exemption deductions, TCJA repealed exemptions for dependents. To compensate, TCJA increases the child tax credit to $2,000 ($1,400 is refundable), up from $1,000 (fully refundable) under present law. The modified adjusted gross income threshold where the credit phases out is $400,000 for joint filers and $200,000 for all others (up from $230,000 and $115,000, respectively). The maximum age for a child eligible for the credit remains 16 (at the end of the tax year).

TCJA also provides a $500 nonrefundable tax credit for dependent children over age 16 and all other dependents. Most families with non-child dependents will lose some ground here, as the $500 credit will generally be less valuable than the $4,150 exemption deduction it replaces.

Other Tax Breaks for Families Unchanged. The child and dependent care expenses credit, the adoption credit, and the exclusions for dependent care assistance and adoption assistance under employer plans are all unchanged by TCJA.

Passthrough Tax Break. TCJA creates a new 20 percent deduction for qualified business income from sole proprietorships, S corporations, partnerships, and LLCs taxed as partnerships. The deduction, which is available to both itemizers and nonitemizers, is claimed by individuals on their personal tax returns as a reduction to taxable income. The new tax break is subject to some complicated restrictions and limitations, but the rules that apply to individuals with taxable income at or below $157,500 ($315,000 for joint filers) are simpler and more permissive than the ones that apply above those thresholds.

Example: In 2018, Joe receives a salary of $100,000 from his job at XYZ Corporation and $50,000 of qualified business income from a side business that he runs as a sole proprietorship. Joe has no other items of income or loss. Joe's deduction for qualified business income in 2018 is $10,000 (20 percent of $50,000).

Observation: The effective marginal tax rate on qualified business income for individuals in the top 37-percent tax bracket who are able to fully apply the new deduction will be 29.6 percent - fully 10 points lower than the top rate under current law.

Deduction for State and Local Taxes (SALT). TCJA imposes a $10,000 limit on the deduction for state and local taxes, which can be used for both property taxes and income taxes (or sales taxes in lieu of income taxes) and repeals the deduction for foreign property taxes. There is no limit on the amount of the SALT deduction under present law.

Mortgage Interest Deduction. TJCA reduces to $750,000 (from $1 million) the limit on the loan amount for which a mortgage interest deduction can be claimed by individuals,

with existing loans grandfathered. TCJA also repeals the deduction for interest on home equity loans.

Deduction for Medical Expenses. An early version of the tax overhaul passed by the House would have repealed the deduction for unreimbursed medical expenses. TCJA retains that deduction and enhances it for 2017 and 2018 by lowering the adjusted gross income (AGI) floor for claiming the deduction from 10 percent to 7.5 percent for all taxpayers.

Deduction for Casualty and Theft Losses. TCJA repeals the deduction for casualty and theft losses, except for losses incurred in presidentially declared disaster areas.

> **Observation:** The new law does, however, provide enhanced relief for victims in federally declared disaster areas in 2016 and 2017.

Deduction for Charitable Contributions. TCJA retains the charitable contribution deduction and increases the maximum contribution percentage limit from 50 percent of a taxpayer's contribution base to 60 percent for cash contributions to public charities.

Deduction for Certain Miscellaneous Expenses. TCJA repeals the deduction for any miscellaneous itemized deductions subject to 2-percent of AGI floor.

Repeal of Alimony Deduction. TCJA repeals the deduction for alimony paid and also the corresponding inclusion in income by the recipient, effective for tax years beginning in 2019. Alimony paid under separation agreements entered into prior to 2019 will generally be grandfathered under the old rules.

Education-Related Tax Breaks Preserved. TCJA retains deductions for student loan interest and educator expenses, and also exclusions for graduate student tuition waivers and employer educational assistance programs.

Alternative Minimum Tax. TCJA increases alternative minimum tax (AMT) exemption amounts by 27 percent, and sharply increases the income level where the exemption is phased out. Combined with the effects of other TCJA changes, many individuals who are currently subject AMT in 2017, will not be in 2018 and beyond.

Expanded Uses for 529 Plan Distributions. TCJA allows up to $10,000 in aggregate 529 distributions per year to be used for elementary and secondary school tuition. Under present law, 529 distributions can only be used for higher education expenses.

Repeal of Individual Healthcare Mandate. TCJA repeals the tax penalty on individuals who fail to carry health insurance enacted as part of the Affordable Care Act (ACA).

Estate and Gift Tax Exclusion. TCJA permanently doubles the basic exclusion amount for estate and gift tax purposes from $5.6 to $11.2 million. A provision fully repealing the estate tax beginning in 2025 was passed by the House, but didn't make it into TCJA, so the estate tax will remain in effect with the higher exclusion amount.

Overview of TCJA Changes Affecting Businesses

The following is a summary of some of the more significant changes under the new tax law that may affect your business.

Reduction in Corporate Tax Rate and Dividends Received Deduction

TCJA eliminates the graduated corporate tax rate structure and instead taxes corporate taxable income at 21 percent. It also eliminates the special tax rate for personal service corporations and repeals the maximum corporate tax rate on net capital gain as obsolete.

A corresponding change reduces the 70 percent dividends received deduction available to corporations that receive a dividend from another taxable domestic corporation to 50 percent, and the 80 percent dividends received deduction for dividends received from a 20 percent owned corporation to 65 percent.

Corporate Alternative Minimum Tax (AMT) Eliminated

TCJA repeals the corporate AMT. It also allows the AMT credit to offset the regular tax liability for any taxable year. In addition, the AMT credit is refundable for any taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability.

Enhanced Bonus Depreciation Deduction

TCJA extends and modifies the additional first-year (i.e., "bonus") depreciation deduction, which had generally been scheduled to end in 2019, through 2026 (through 2027 for longer production period property and certain aircraft). Under the new law, the 50-percent additional depreciation allowance is increased to 100 percent for property placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before January 1, 2023.

The 100-percent allowance is phased down by 20 percent per calendar year for property placed in service, and specified plants planted or grafted, in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft).

TCJA also maintains the bonus depreciation increase amount of $8,000 for luxury passenger automobiles placed in service after December 31, 2017, that had been scheduled to be phased down in 2018 and 2019.

TCJA also removes the requirement that, in order to qualify for bonus depreciation, the original use of qualified property must begin with the taxpayer. Thus, the provision applies to purchases of used as well as new items.

TCJA also expands the definition of qualified property eligible for the additional first-year depreciation allowance to include qualified film, television and live theatrical productions, effective for productions placed in service after September 27, 2017, and before January 1, 2023.

Enhanced Section 179 Expensing

TCJA increases the maximum amount a taxpayer may expense under Code Sec. 179 to $1,000,000, and increases the phase-out threshold amount to $2,500,000. Thus, the maximum amount you may expense, for taxable years beginning after 2017, is $1,000,000 of the cost of qualifying property you place in service during the tax year. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000.

In addition, TCJA expands the definition of Code Sec. 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.

TCJA also expands the definition of qualified real property eligible for Code Sec. 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property

TCJA increases the depreciation limitations that apply to listed property, such as luxury automobiles. For passenger automobiles that qualify as luxury automobiles (i.e., gross unloaded weight of 6,000 lbs or more) placed in service after December 31, 2017, and for which the additional first-year depreciation deduction is not claimed, the maximum amount of allowable depreciation is $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 later years in the recovery period. The limitations are indexed for inflation for luxury passenger automobiles placed in service after 2018.

In addition, TCJA removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

Modification of Like-Kind Exchange Rules

TCJA modifies the rule for like-kind exchanges by limiting its application to real property that is not held primarily for sale. While the provision generally applies to exchanges completed after December 31, 2017, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

Other Changes Relating to Cost Recovery and Property Transactions

TCJA makes the following additional changes with respect to cost recovery and property transactions:

> (1) allows for expensing of certain costs of replanting citrus plants lost by reason of casualty;

(2) shortens the alternative depreciation system (ADS) recovery period for residential rental property from 40 to 30 years;

(3) allows an electing real property trade or business to use the ADS recovery period in depreciating real and qualified improvement property;

(4) shortens the recovery period from 7 to 5 years for certain machinery or equipment used in a farming business;

(5) repeals the required use of the 150-percent declining balance method for depreciating property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property);

(6) excludes various types of self-created property from the definition of a "capital asset", including: patents, inventions, models or designs (whether or not patented), and secret formula and processes;

(7) specifies situations in which a contribution to the capital of a corporation is includable in the gross income of a corporation (i.e., contributions by a customer or potential customer, and contributions by governmental entities and civic groups); and

(8) tweaks the carried interest rule to provide that a profits interest must be held for three years, rather than one year, in order to receive favorable long-term capital gain treatment.

Repeal of Domestic Activities Production Deduction

TCJA repeals the deduction for domestic production activities.

New Deduction for Qualified Business Income

If you are a sole proprietor, a partner in a partnership, a member in an LLC taxed as a partnership (hereafter, "partner"), or a shareholder in an S corporation, TCJA provides a new deduction for qualified business income for taxable years beginning after December 31, 2017, and before January 1, 2026. Trusts and estates are also eligible for this deduction.

The amount of the deduction is generally 20 percent of the taxpayer's qualifying business income from a qualified trade or business.

> **Example:** In 2018, Joe receives $100,000 in salary from his job at XYZ Corporation and $50,000 of qualified business income from a side business that he runs as a sole proprietorship. Joe's deduction for qualified business income in 2018 is $10,000 (20 percent x $50,000).

The deduction for qualified business income is claimed by individual taxpayers on their personal tax returns. The deduction reduces taxable income. The deduction is not used in computing adjusted gross income. Thus, it does not affect limitations based on adjusted gross income.

The deduction is subject to several restrictions and limitations, discussed below.

Qualified Trade or Business. A qualified trade or business means any trade or business other than (1) a specified service trade or business, or (2) the trade or business of being an employee. A "specified service trade or business" is defined as any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. Engineering and architecture services are specifically excluded from the definition of a specified service trade or business.

Special Rule Where Taxpayer's Income is Below a Specified Threshold. The rule disqualifying specified service trades or businesses from being considered a qualified trade or business does not apply to individuals with taxable income of less than $157,500 ($315,000 for joint filers). After an individual reaches the threshold amount, the restriction is phased in over a range of $50,000 in taxable income ($100,000 for joint filers). If an individual's income falls within the range, he or she is allowed a partial deduction. Once the end of the range is reached, the deduction is completely disallowed.

"Domestic" Business Income Requirement. Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.

Qualified Business Income. Qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer, or any guaranteed payment (or other payment) to a partner for services rendered with respect to the trade or business. Qualified items do not include specified investment-related income, deductions, or losses, such as capital gains and losses, dividends and dividend equivalents, interest income other than that which is properly allocable to a trade or business, and similar items.

Loss Carryovers. If the net amount of qualified business income from all qualified trades or businesses during the tax year is a loss, it is carried forward as a loss from a qualified trade or business in the next tax year (and reduces the qualified business income for that year).

W-2 Wage Limitation. The deductible amount for each qualified trade or business is the lesser of:

(1) 20 percent of the taxpayer's qualified business income with respect to the trade or business; or

(2) the greater of: (a) 50 percent of the W-2 wages with respect to the trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (generally all depreciable property still within its depreciable period at the end of the tax year).

Example: Susan owns and operates a sole proprietorship that sells cupcakes. The cupcake business pays $100,000 in W-2 wages and has $350,000 in qualified business income. For the sake of simplicity, assume the business had no qualified property and that the variation of the limitation involving the unadjusted basis of

such property isn't relevant. Susan's deduction for qualified business income is $50,000, which is the lesser of (a) 20 percent of $350,000 in qualified business income ($70,000), or (b) the 50 percent of W-2 wages ($50,000).

The W-2 wage limitation does not apply to individuals with taxable income of less than $157,500 ($315,000 for joint filers). After an individual reaches the threshold amount, the W-2 limitation is phased in over a range of $50,000 in taxable income ($100,000 for joint filers).

Allocation of Partnership and S Corporations Items. In the case of a partnership or S corporation, the business income deduction applies at the partner or shareholder level. Each partner in a partnership takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. Similarly, each shareholder in an S corporation takes into account the shareholder's pro rata share of each qualified item and W-2 wages.

Additional Limitations on the Deduction for Qualified Business Income. This deduction for qualified business income is subject to some overriding limitations relating to taxable income, net capital gains, and other items which are beyond the scope of this letter and will not affect the amount of the deduction in most situations.

Carryover of Business Losses

TCJA provides that, for taxable years beginning after December 31, 2017, and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. Instead, if you incur such losses, you must carry them forward and treat them as part of your net operating loss (NOL) carryforward in subsequent taxable years. Thus, TCJA generally repeals the two-year carryback and the special carryback provisions under prior law; however, it does provide a two-year carryback in the case of certain losses incurred in the trade or business of farming. NOL carryovers generally are allowed for a taxable year up to the lesser of your carryover amount or 80 percent of your taxable income determined without regard to the deduction for NOLs.

Relaxed Gross Receipts Test for Various Accounting Methods

TCJA expands the universe of taxpayers who can use various accounting methods by increasing the gross receipts threshold ("gross receipts test") under which those methods may be used. TCJA increases the limit for the gross receipts test to $25 million for using the cash method of accounting (including the use by farming C corporations and farming partnerships with a C corporation partner).

The new law also increases the limit for the gross receipts test to $25 million for exemption from the following accounting requirements/methods:

(1) uniform capitalization rules;

(2) the requirement to keep inventories (allowing taxpayers to treat inventories as non-incidental materials and supplies, or in another manner conforming with the taxpayer's financial accounting treatment of inventories); and

(3) the requirement to use the percentage-of-completion method for certain long-term contracts (allowing the use of the more favorable completed-contract method, or any other permissible exempt contract method).

Additional requirements and restrictions apply to the use of the above-mentioned accounting methods. For most, only the dollar limit for the gross receipts test has been relaxed.

Accounting Method Rules Relating to Income Recognition Modified

TCJA revises the rules associated with the recognition of income. Specifically, the new law requires a taxpayer subject to the all events test for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as income on an applicable financial statement or another financial statement under rules specified by the Secretary, but provides an exception for long-term contract income to which Code Sec. 460 applies.

TCJA also codifies the current deferral method of accounting for advance payments for goods and services provided by the IRS under Rev. Proc. 2004-34. That is, the law allows taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.

Interest Deduction Rules Changed for Certain Taxpayers

Under TCJA, a taxpayer's deduction for business interest is limited to the sum of business interest income plus 30 percent of adjusted taxable income for the taxable year. There is an exception to this limitation, however, for certain small taxpayers, certain real estate businesses that make an election to be exempt from this rule, and businesses with floor plan financing, which is a specialized type of financing used by car dealerships, and for certain regulated utilities.

For smaller taxpayers, TCJA exempts from the interest limitation taxpayers with average annual gross receipts for the three-taxable year period ending with the prior taxable year that do not exceed $25 million. Further, at the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

Limitation on Deduction by Employers of Expenses for Fringe Benefits

TCJA provides that no deduction is allowed with respect to:

(1) an activity generally considered to be entertainment, amusement or recreation;

(2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes; or

(3) a facility or portion thereof used in connection with any of the above items.

Thus, the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions) is repealed.

TCJA also disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

A business may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees during work travel). For amounts incurred and paid after December 31, 2017, and until December 31, 2025, this 50 percent limitation is expanded to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025 are not deductible.

Employer Credit for Paid Family and Medical Leave

For 2018 and 2019, TCJA allows eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent.

> **Observation:** An employer must have a written policy in place that provides family and medical leave to all employees on a non-discriminatory basis in order to qualify for the credit. Given the cost of implementing such a policy and complying with yet-to-be-announced reporting requirements, the credit may be impractical for many employers to pursue during the short period it's available. For companies that already have a qualifying family and medical leave plan in place, however, the credit may provide a nice windfall.

Partnership Rule Changes

Several changes were made to the partnership tax rules.

First, gain or loss from the sale or exchange of a partnership interest is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

Second, the transferee of a partnership interest must withhold 10 percent of the amount realized on the sale or exchange of the partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

Third, TCJA modifies the definition of a substantial built-in loss such that a substantial built-in loss is considered to exist if the transferee of a partnership interest would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

Fourth, TCJA modifies the basis limitation on partner losses to provide that a partner's distributive share of items that are not deductible in computing the partnership's taxable income, and not properly chargeable to capital account, are allowed only to the extent of the partner's adjusted basis in its partnership interest at the end of the partnership taxable year in which an expenditure occurs. Thus, the basis limitation on partner losses applies to a partner's distributive share of charitable contributions and foreign taxes. Lastly, TCJA repeals the rule providing for technical terminations of partnerships. Under that rule, a partnership's existence did not necessarily end; rather, it resulted in the termination of some tax attributes and the possibly early closing of the tax year.

S Corporation Changes

TCJA makes several changes to the tax rules involving S corporations. First, it provides that income that must be taken into account when an S corporation revokes its election is taken into account ratably over six years, rather than the four years under prior law. Second, it allows a nonresident alien individual to be a potential current beneficiary of an electing small business trust (ESBT). Third, it provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

International Tax Changes

TCJA makes sweeping changes to the Unites States' international tax regime through a series of highly complex provisions that are beyond the scope of this letter.

Concluding Thoughts

As you can see, the provisions in the TCJA are quite extensive and also quite complicated.

Please call me at your convenience so we can discuss how these changes will impact your tax situation, and what kind of strategies we can adopt to ensure that you get the best possible outcomes under the new rules.

Sincerely,

D. McMillen, Chartered

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