SUMMARY OF TAX CHANGES

The enacted Tax Cuts and Jobs Act (TCJA) is a sweeping 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.

INDIVIDUAL TAX CHANGES

General Changes

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 long-term 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.

Standard deduction. The new law increases the standard deduction to $24,000 for joint filers, $18,000 for heads of household, 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. Also, for individuals over the age of 65 or blind, there is an additional deduction of up to $2,600 for joint filers and $1,600 for unmarried filers.

Exemptions. The new law suspends the deduction for personal exemptions. Thus, starting in 2018, taxpayers can no longer claim personal or dependency exemptions.

New Form 1040. The 2018 Form 1040 reflects changes made by the TCJA, and the "postcard" draft form is about half the size of the prior version and contains far fewer lines than its predecessor. What's more, the Form 1040 is designed using a “building block” approach so that taxpayers without complicated returns will need only file the Form 1040 and no schedules, while taxpayers with more complicated returns (for example, that claim certain deductions or credits or owe additional taxes), will also need to complete one or more of six new Form 1040 schedules.

Qualified Business Income (“QBI”) Deduction (also known as 199A Deduction)

New deduction for “qualified business income.” Starting in 2018, taxpayers are allowed a deduction equal to 20 percent of “qualified business income,” otherwise known as “pass-through” income, i.e., income from partnerships, S corporations, LLCs, and sole proprietorships. The income <u>must be from a trade or business within the U.S.</u> 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. The 20% deduction for QBI does not reduce net earnings from self-employment or net investment income under the rules for the 3.8% surtax on net investment income. At this time, we expect that information needed to calculate any limitations will be provided on the Schedule K-1 received from each pass-through entity.

Itemized Deductions

State and local taxes. The itemized deduction for state and local income and property taxes on personal-use property is limited to a total of $10,000 starting in 2018. Property taxes paid on business property are not affected by this new limitation.

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.

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

Medical expenses. Under the new law, for 2018, medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income for all taxpayers. Previously, the AGI "floor" was 10% for most taxpayers and will return to 10% in 2019. Some taxpayers may be able to work around the new reality by applying a "bunching strategy" to pull or push discretionary medical expenses and charitable contributions into the year where they will do some tax good. For example, if a taxpayer knows he or she will be able to itemize deductions this year but not next year, the taxpayer may be able to make two years' worth of charitable contributions this year, instead of spreading out donations over 2018 and 2019.

Casualty and theft losses. The itemized deduction for casualty and theft losses has been suspended <u>except</u> for losses incurred in a federally declared disaster. At this time, the losses resulting from the Central Texas October flooding are not deductible because a the flooding was not declared a federal disaster.

No 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.

Other Credit, Deductions, and Changes

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).

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.

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. This does not apply to divorce decrees signed before 2018.

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

Estate and gift tax exemption. Effective for decedents dying, and gifts made, in 2018, the estate and gift tax exemption has been increased to $11.18 million ($22.36 million for married couples).

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. The above mentioned changes to itemized deductions will also reduce the impact of AMT for most taxpayers.

529 Plans. The TCJA provides that qualified higher education expenses now include expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. Thus, tax-free distributions from 529 plans can now be received by beneficiaries who pay these expenses, effective for distributions from 529 plans after 2017. The amount of cash distributions from all 529 plans per single beneficiary during any tax year can't, when combined, include more than $10,000 for elementary school and secondary school tuition incurred during the tax year.

BUSINESS TAX CHANGES

Meals and Entertainment

The TCJA provides that—starting Jan. 1, 2018—entertainment, amusement or recreation expenses for clients and business associates are no longer allowed as business deductions. IRS has issued guidance providing that certain business meals aren't considered "entertainment, amusement or recreation," and are still 50% deductible. Historically, these two expenses have been lumped together but going forward we will need a separate total for meals and a total for entertainment. This will likely involve a revision to your chart of accounts if you use an electronic accounting program. Please contact us if you need assistance with your chart of accounts or reclassifying transaction within QuickBooks.

Bonus Depreciation

Whether or not you have in the past claimed it, you are probably familiar with 50% bonus depreciation—an immediate deduction of 50% of the cost of eligible business or other income producing property, followed by depreciation deductions for the remaining 50% of the cost over the regular depreciation period. By accelerating the tax savings from depreciation deductions for machinery, equipment, most software and certain real property, 50% bonus depreciation deduction was available to lower the true economic cost of these assets.

You are probably also aware that late-2017 legislation replaced 50% bonus depreciation with 100% bonus depreciation, an even more powerful cost cutting tool.

Below are some important points about 100% bonus depreciation and about bonus depreciation in general as changed by the legislation TCJA. Note that generally 100% bonus depreciation and any other changes made to bonus depreciation by the TCJA apply only to property that is *both* placed in service *and* acquired after Sept. 27, 2017. Property doesn't meet the acquisition requirement if it is acquired under a written binding contract entered into before Sept. 28, 2017.

Bonus depreciation is scheduled for phase out. The TCJA deferred but didn't end the phaseout of bonus depreciation. For property to which the changes made by the TCJA apply, 100% bonus depreciation will be phased out in steps for property placed in service in calendar years 2023 through 2027. Thus, an 80% rate will apply to property placed in service in 2023, 60% in 2024, 40% in 2025, and 20% in 2026, and a zero % rate will apply in 2027 and later years.

*Bonus depreciation is available for new and most **used** property.* Before the TCJA one of the requirements of bonus depreciation eligibility was that property be new. But now used property qualifies unless the taxpayer both (1) previously used the property and (2) the property was acquired in certain forbidden transactions (generally acquisitions that are tax free or from a related person or entity).

Taxpayers should sometimes make the election to turn down bonus depreciation. Even before the change from 50% to 100% bonus depreciation, taxpayers could elect to reject bonus depreciation for one or more classes of property (an “election-out”).

One of the uses of the election has been eliminated by the TCJA because the act allows net operating losses to be carried forward indefinitely. Thus, there is no reason to decelerate deductions to avoid adding to expiring NOLs. However, another important use remains. Sole proprietorships and entities taxed under the rules for partnerships and S corporations still want to make sure that they don't “waste” depreciation deductions by applying them against lower-bracket income in the year property was placed in service where there is an opportunity to apply them against higher bracket income in later years. (Under the TCJA, entities taxed as “regular” corporations–i.e., non-S corporations–are taxed at a flat rate).

Bonus depreciation is no longer available for any building improvements. Before the TCJA bonus depreciation was available for two types of real property: (1) land improvements other than buildings, for example fencing and parking lots, and (2) “qualified improvement property,” a broad category of improvements made to non-residential buildings after the buildings are placed in service. However, the TCJA inadvertently eliminated bonus depreciation for qualified improvement property. Legislation to retroactively restore bonus depreciation for qualified improvement property is possible but not certain.

100% bonus depreciation has reduced the importance of “section 179 expensing.” If you are a smaller business you have surely benefited from “section 179 expensing.” Section 179 expensing is an elective benefit that subject to dollar limits, allows an immediate deduction of the cost of equipment, machinery, “off-the-shelf” computer software, and some building improvements. Section 179 expensing has in fact been enhanced by the TCJA, but the availability of 100% bonus depreciation is economically equivalent and thus has greatly reduced the cases in which section 179 expensing is useful.

The above discussion only touches on some major aspects of bonus depreciation. The TCJA made several narrower but still significant changes to bonus depreciation, and even without amendment, TCJA bonus depreciation is a complicated area with tax implications for transactions other than simple asset acquisitions.

Business Loss Limitations

New limitation on “excess business loss.” The Act provides that excess business losses aren't allowed for the tax year but are instead carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent tax years. A taxpayer has an excess business loss if the taxpayer's losses from all trades or businesses exceeds income from the trades or businesses by more than $250,000 ($500,000 for taxpayers who file joint returns). The $250,000/$500,000 amount is adjusted for inflation in years after 2018.

Net Operating Losses (NOL).

Carryback periods. For losses arising after 2017, NOLs, generally, cannot be carried back to previous years. But there is an exception for farming losses, which can be carried back to each of the two tax years preceding the tax year of the loss. A taxpayer entitled to a two-year carryback of a farming loss may elect to forego the carryback.

Carryforward periods. For losses arising after 2017, NOLs, generally, can be carried forward indefinitely.

NOL limit. For NOLs arising in tax years ending after 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the NOL deduction itself). Carryovers to other years are adjusted to take account of the 80% limitation.