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The recently 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 that have an impact on individuals and a significant new tax deduction for individuals with "qualified business income," from a partnership, S corporation, LLC, or sole proprietorship sometimes referred to as "pass-through income." Unless otherwise noted, the changes are effective for tax years beginning in 2018 through 2025.

INDIVIDUALS

- **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.
- **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.
- **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.
- **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 must be from a trade or business within the U.S. 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.

- **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).
- **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.
- **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 tax preparation costs, investment expenses, union dues, and unreimbursed employee expenses.
- **Medical expenses.** Under the new law, for 2017 and 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.
- **Casualty and theft losses.** The itemized deduction for casualty and theft losses has been suspended except for losses incurred in a federally declared disaster.
- **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.

- **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.
- **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 roughly \$11.2 million (\$22.4 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.

INDIVIDUAL WITH QUALIFIED BUSINESS INCOME (QBI)

The deduction is 20% of your "qualified business income (QBI)" from a partnership, S corporation, or sole proprietorship, defined as the net amount of items of income, gain, deduction, and loss with respect to your trade or business. The business must be conducted within the U.S. to qualify, and specified investment-related items are not included, e.g., capital gains or losses, dividends, and interest income (unless the interest is properly allocable to the business). The trade or business of being an employee does not qualify. Also, QBI does not include reasonable compensation received from an S corporation, or a guaranteed payment received from a partnership for services provided to a partnership's business.

The deduction is taken "below the line," i.e., it reduces your taxable income but not your adjusted gross income. But it is available regardless of whether you itemize deductions or take the standard deduction.

In general, the deduction cannot exceed 20% of the excess of your taxable income over net capital gain. If QBI is less than zero it is treated as a loss from a qualified business in the following year.

Rules are in place (discussed below) to deter high-income taxpayers from attempting to convert wages or other compensation for personal services into income eligible for the deduction.

For taxpayers with taxable income above \$157,500 (\$315,000 for joint filers), an exclusion from QBI of income from "specified service" trades or businesses is phased in. These are trades or businesses involving the performance of services in the fields of 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. Here's how the phase-in works: If your taxable income is at least \$50,000 above the threshold, i.e., \$207,500 (\$157,500 + \$50,000), all of the net income from the specified service trade or business is excluded from QBI. (Joint filers would use an amount \$100,000 above the \$315,000 threshold, viz., \$415,000.) If your taxable income is between \$157,500 and \$207,500, you would exclude only that percentage of income derived from a fraction the numerator of which is the excess of taxable income over \$157,500 and the denominator of which is \$50,000. So, e.g., if taxable income is \$167,500 (\$10,000 above \$157,500), only 20% of the specified service income would be excluded from QBI ($\$10,000/\$50,000$). (For joint filers, the same operation would apply using the \$315,000 threshold, and a \$100,000 phase-out range.)

Additionally, for taxpayers with taxable income more than the above thresholds, a limitation on the amount of the deduction is phased in based either on wages paid or wages paid plus a capital element. Here's how it works: If your taxable income is at least \$50,000 above the threshold, i.e., \$207,500 (\$157,500 + \$50,000), your deduction for QBI cannot exceed the greater of (1) 50% of taxpayer's allocable share of the W-2 wages paid with respect to the qualified trade or business, or (2) the sum of 25% of such wages plus 2.5% of the unadjusted basis immediately after acquisition of tangible depreciable property used in the business (including real estate). So if your QBI were \$100,000, leading to a deduction of \$20,000 (20% of \$100,000), but the greater of (1) or (2) above were only \$16,000, your deduction would be limited to \$16,000, i.e., it would be reduced by \$4,000. And if your taxable income were between \$157,500 and \$207,500, you would only incur a percentage of the \$4,000 reduction, with the percentage worked out via the fraction discussed in the preceding paragraph. (For joint filers, the same operations would apply using the \$315,000 threshold, and a \$100,000 phase-out

range.)

Other limitations may apply in certain circumstances, e.g., for taxpayers with qualified cooperative dividends, qualified real estate investment trust (REIT) dividends, or income from publicly traded partnerships.

As you can see from this overview, the new law affects many areas of taxation. The complexities surrounding this substantial new deduction can be formidable, especially if your taxable income exceeds the threshold discussed above. If you wish discuss the impact of the law or work through the mechanics of the deduction with me, with particular attention to the impact it can have on your specific situation, please give me a call.

Very truly yours,

A handwritten signature in black ink, appearing to read "Bruce F. Malott". The signature is fluid and cursive, with the first name "Bruce" being the most prominent.

Bruce F. Malott, CPA, CFF
Managing Principal