2017 Tax Reform White Paper

On December 20, 2017, the U.S. House of Representatives and U.S. Senate passed the reconciled tax reform bill, H.R. 1, *Tax Cuts and Jobs Act.* The bill was sent to President Trump who signed the landmark legislation into law on December 22, 2017.

The passage of H.R. 1, *Tax Cuts and Jobs* Act, has put tax reform center-stage. What are the implications for you as a small business owner? What changes will impact your business and your employees?

This white paper, provided by CFOAdvantage, provides a high-level summary of the relevant provisions of the *Tax Cuts and Jobs Act* for individuals and small businesses.

All provisions are effective 1/1/2018 unless otherwise noted.

A. Individual provisions

- The following provision affecting individual taxpayers are temporary and are <u>scheduled to expire after December 31, 2025</u>.
    - The new law retains 7 tax brackets but makes adjustment to the income levels and tax rates applicable to each bracket. (The new tax brackets and rates are detailed in Appendix 1 below.)
    - The new law retains the current rates for net capital gains and qualified dividends (0%, 15% and 20%).
    - The standard deduction is increased to $24,000 (Married Filing Jointly and Surviving Spouse), $18,000 (Head of Household) and $12,000 (all others). The elderly, blind and disabled are able to take an additional standard deduction of $1,600 (single/head of household) and $1,300 (MFJ/surviving spouse).
    - The personal exemption is suspended through December 31, 2025.
    - The child tax credit is increased to $2,000 with a maximum refundable amount of $1,400. The new law provides an additional $500 nonrefundable credit for dependents other than qualifying children. The credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (MFJ) and $200,000 (all other taxpayers).
    - The itemized deduction for mortgage interest is limited to $750,000 for acquisition indebtedness incurred after December 14, 2017. The deduction for interest on home equity indebtedness is suspended through December 31, 2025.
    - Taxpayers are limited to an aggregate maximum itemized deduction of $10,000 for state and local income (or sales tax in lieu of income tax) and property taxes paid that are paid other than in connection with carrying on a trade or business. An individual may not claim an itemized deduction in 2017 for any prepayment of state or local income tax imposed for a taxable year after December 31, 2017.

(Prepayments of property tax are not subject to this rule and may still be taken as an itemized deduction in the year paid. In addition, 2017 estimated tax payments can be taken as an itemized deduction in 2017 only if paid prior to January 1, 2018.)

  - Miscellaneous itemized deductions subject to the 2% of AGI floor is suspended through December 31, 2025.
  - The threshold for deducting medical expenses is reduced to 7.5% for taxable years beginning after December 31, 2016 and ending before January 1, 2019.
  - The deduction for moving expenses and the exclusion from gross income for reimbursements of qualified moving expenses are suspended through December 31, 2025. An exception is provided for members of the Armed Forces on active duty.
  - The exemption amount for the individual alternative minimum tax is increased to $109,400 (for married filing jointly), $54,700 (married filing separately), and $70,300 (all other taxpayers). Phase out threshold levels are increased to $1,000,000 (married filing jointly) and $500,000 (all other taxpayers).
- Payments of alimony and separate maintenance on divorce or separate maintenance instruments executed after December 31, 2018 are not deductible by the payer or taxable to the recipient.
- The estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017 is doubled to $10 million.
- The amount of the individual shared responsibility payment under the Affordable Care Act is reduced to zero for health coverage status for months beginning after December 31, 2018.

B. Business income of individuals, trusts, and estates

For taxable years beginning after December 31, 2017 and before January 1, 2026, new IRC §199A permits an individual taxpayer who has qualified business income from a partnership, S corporation, or sole proprietorship to deduct the sum of the following amounts:

1. The lesser of: (a) the combined qualified business income amount for the taxable year, or (b) 20 percent of the excess, if any, of the taxpayer’s taxable income over the sum of any net capital gain and qualified cooperative dividends, and
2. The lesser of: (a) 20 percent of qualified cooperative dividends or (b) taxable income (reduced by net capital gain).

In no case may the sum exceed the taxpayer’s taxable income for the taxable year (reduced by net capital gain).

The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income.

The deductible amount is equal to 20% of qualified business income determined separately for each qualified trade or business. 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 to the extent such items are effectively connected with a trade or business within the U.S. Qualified business income does not include: (a) certain investment items, (b) any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer, (c) any guaranteed payment to a partner for services rendered with respect to the trade or business, or (d) any amount paid or incurred by a partnership to a partner acting other than in his or her capacity as a partner.

The deduction is fully available to taxpayers with taxable income not exceeding $315,000 for married individuals filing jointly, or $157,500 for other individuals. Above these levels (subject to a phase-in provision), the deduction cannot exceed a limit based on either wages paid or wages paid plus a capital element. The limit is the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. The limit is fully phased in for taxpayers with taxable income in excess of the threshold amount plus $50,000 ($100,000 for a joint return).

Qualified property is depreciable tangible property held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which the depreciable period has not ended before the close of the taxable year. The depreciable period means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under IRC §168.

The deduction does not apply to any trade or business providing services in the fields of health, law, accounting, consulting, financial services, etc. (but does apply architecture or engineering services) where the principal asset of such trade or business is the reputation or skill of one or more of its employees. This exception does not apply to taxpayers whose taxable income does not exceed $315,000 (married filing jointly) or $157,500 (all others). The exception is fully phased out for taxpayers with taxable income in excess of the threshold amount plus $50,000 ($100,000 for a joint return).

A net loss from qualified business income from all qualified trades or businesses is carried forward as a loss from a qualified trade or business to the next taxable year. Any deduction allowed in a subsequent year is reduced (but not below zero) by 20 percent of any carryover qualified business loss.

C. Reduced tax rate for corporations

Corporations are subject to a permanent flat tax rate of 21% for taxable years beginning after December 31, 2017. The maximum corporate tax rate on net capital gain is repealed. The 70 percent dividends received deduction is reduced to 50 percent and the 80 percent dividends received deduction is reduced to 65 percent.

D. Cost recovery provisions

1. Section 179 expensing

The section 179 expense amount is increased to $1,000,000 and the phase-out threshold is increased to $2,500,000. Both amounts are indexed for inflation beginning after 2018. Section 179 property is expanded to include (1) certain depreciable tangible personal property used to furnish lodging or in connection with furnishing lodging; and (2) certain improvements to nonresidential real property placed in service after the date such property was first placed in service, such as roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

2. Temporary cost recovery of qualified business assets (bonus depreciation)

Taxpayers can expense 100% of the cost of qualifying property acquired and placed in service after September 27, 2017 and before January 1, 2027. This applies to all property first used by the taxpayer, even if the property was acquired by another person. The percentage of qualifying property is phased out from 100% in 2022 to 0% in 2027. For the first tax year ending after September 27, 2017, taxpayers can elect to claim the 50% bonus depreciation in lieu of 100% expensing.

3. Modifications to depreciation limits on luxury automobiles and personal use property

Depreciation limits applying to listed property are increased. The maximum allowable deduction for passenger automobiles placed in service after December 31, 2017 and for which bonus depreciation is not claimed is $10,000 for the first year, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years. Computers and peripheral equipment are removed from the definition of listed property.

4. *Qualified improvement property*

A general 15-year recovery period for qualified improvement property is provided in lieu of qualified leasehold, qualified restaurant, and qualified retail improvement property. Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Thus, qualified improvement property placed in service after December 31, 2017 is depreciable over 15 years without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Qualified improvement property does not include any improvement attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

E. Small business accounting methods

1. *Cash method of accounting*

Corporations and partnerships with a corporate partner with average gross receipts of $25 million or less for the three prior taxable-year period would be able to use the cash method of accounting and would not be required to account for inventories. Qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to the $25 million gross receipts test.

2. *Inventory and UNICAP rules*

Businesses with average gross receipts of $25 million or less are fully exempt from the UNICAP rules. This exemption applies to both producers and resellers.

3. *Income recognition*

Accrual-basis taxpayers are required to recognize income no later than the tax 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. Taxpayers without an applicable financial statement or other financial statement would be excepted. Taxpayers would also be able to defer the inclusion of income associated with advance payments for goods and services to the end of the tax year following the tax year of receipt if such income is also deferred for financial statement purposes.

4. *S corporation conversion to C corporation*

S corporations converting to C corporations and required to change to the accrual method of accounting may spread the adjustment resulting from the change in accounting ratably over a six-year period beginning with the year of change.

F. Business-related exclusions and deductions

1. Business interest expense

The deduction for net business interest expense is limited to 30% of the adjusted taxable income of the taxpayer. For taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to depreciation, amortization, or depletion (EBITDA). The amount of any interest not allowed as a deduction may be carried forward five years. The limitation generally applies at the taxpayer level. In the case of any partnership or S corporation, the limitation is applied at the partnership or S corporation level. The limitation does not apply to any taxpayer with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that does not exceed $25 million.

2. Net operating losses

The NOL deduction would be limited to 80 percent of taxable income for losses arising in taxable years beginning after December 31, 2017. The two-year carryback would be permitted only for certain losses incurred in the trade or business of farming. NOLs may be carried forward indefinitely.

3. Like-kind exchanges

Deferral of gain on like-kind exchanges would be permitted only for exchanges of real property that is not held primarily for sale.

4. Section 199 deduction

The deduction for domestic production activities under section 199 is repealed.

5. Certain fringe benefits

No deduction would be permitted for entertainment, amusement, or recreation directly related to the active conduct of the taxpayer's trade or business or for expenses associated with providing transportation fringe benefits. The 50 percent limitation is also extended to expenses of the employer associated with providing food and beverages to employees through an eating facility. For tax years beginning after December 31, 2025, the employer's deduction for such expenses would be totally disallowed.

6. Local lobbying expenses

Deductions for lobbying expenses with respect to legislation before local governmental bodies are disallowed for amounts paid or incurred after the date of enactment.

7. Partnership rules

The technical termination rule for partnerships is repealed. Partnerships would be treated as continuing even if more than 50 percent of the total capital and profits interest of the partnership are sold or exchanged. New elections would not be required or permitted.

G. Business credits

The provision grants a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. The credit is increased for wages in excess of 50%, but not more than 25%. The credit does not apply to wages paid after December 31, 2019.

H. Compensation

The exceptions to the $1 million deduction limitation for commissions and performance-based compensation are repealed. A “covered employee” would include the CEO, the chief financial officer, and the three other highest paid employees. Once an employee qualifies as a covered person, the deduction limitation would apply for Federal tax purposes to that person so long as the corporation pays remuneration to such person (or to any beneficiaries).

Appendix 1

Single	
Current Law (2017)	HR 1 (2018 on)
$0 – 9,325 – 10%	$0 to $9,525 – 10%
Up to $37,950 – 15%	Up to $38,700 – 12%
Up to $91,900 – 25%	Up to $82,500 – 22%
Up to $191,650 – 28%	Up to $157,500 – 24%
Up to $416,700 – 33%	Up to $200,000 – 32%
Up to $418,400 – 35%	Up to $500,000 – 35%
Over $418,400 – 39.6%	Over $500,000 – 37%
Head of Household	
Current Law (2017)	HR 1 (2018 on)
$0 - $13,350 – 10%	$0 - $13,600 – 10%
Up to $50,800 – 15%	Up to $51,800 – 12%
Up to $131,200 – 25%	Up to $82,500 – 22%
Up to $212,500 – 28%	Up to $157,500 – 24%
Up to $416,700 – 33%	Up to $200,000 – 32%
Up to $444,550 – 35%	Up to $500,000 – 35%
Over $444,550 – 39.6%	Over $500,000 – 37%
Married Filing Jointly and Surviving Spouse	
Current Law (2017)	HR 1 (2018 on)
$0 - $18,650 – 10%	$0 - $19,050 – 10%
Up to $75,900 – 15%	Up to $77,400 – 12%
Up to $153,100 – 25%	Up to $165,000 – 22%
Up to $233,350 – 28%	Up to $315,000 – 24%
Up to $416,700 – 33%	Up to $400,000 – 32%
Up to $470,700 – 35%	Up to $600,000 – 35%
Over $470,700 – 39.6%	Over $600,000 – 37%
Married Filing Separately	
Current Law (2017)	HR 1 (2018 on)
$0 – $9,325 – 10%	$0 – $9,525 – 10%
Up to $37,950 – 15%	Up to $38,700 – 12%
Up to $76,550 – 25%	Up to $82,500 – 22%
Up to $116,675 – 28%	Up to $157,500 – 24%
Up to $208,350 – 33%	Up to $200,000 – 32%
Up to $235,350 – 35%	Up to $300,000 – 35%
Over $235,350 – 39.6%	Over $300,000 – 37%
Estates and Trusts	
Current Law (2017)	HR 1 (2018 on)
$0 - $2,550 – 15%	$0 - $2,550 – 10%
Up to $6,000 – 25%	Up to $9,150 – 24%
Up to $9,150 – 28%	Up to $12,500 – 35%
Up to $12,500 – 33%	Over $12,500 – 37%
Over $12,500 – 39.6%	