

18 Things to Know about the New Tax Act for 2018

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On December 22, 2017, President Donald Trump signed into law H.R. 1 (Public Law No. 115-97), the bill formerly known as the Tax Cuts and Jobs Act (the “Act”).¹ The Act was the first major overhaul of the Internal Revenue Code in more than 30 years. Even if you are not a tax attorney, you should be familiar with the basic components of the Act as they impact you personally, your business and your clients. This is a basic, high-level summary of a several hundred pages bill; you should consult with a tax professional to learn more about the Act and how it may impact you or your clients’ unique situation. This article primarily focuses on the changes in rates, deductions and credits as they pertain to individuals and businesses. While a significant number of the changes are only in place through the end of 2025, a number of changes that relate to corporations, including the lowered corporate tax rate, are permanent.

Individuals

1. Lower Individual Income Tax Rates. While maintaining the existing seven tax brackets, the Act adjusts the income ranges for the seven brackets and lowered the rates for each bracket. The top rate was decreased from 39.6 to 37 percent, and the other six brackets now range from 10 to 35 percent. A taxpayer’s tax rate will depend upon whether she/he files as an individual, head of household, married filing separately or married filing jointly. Individuals’ marginal tax rate (the highest rate applied to your last dollar of income) and her/his effective tax rate (average rate at which a taxpayer’s earned income is taxed) should be reduced by these changes. In late January, the IRS released new withholding tables. Employees’ paychecks should have already been adjusted - presumably with more money – in accordance with those new withholding tables.

2. Increased Standard Deduction and 3. Suspended Personal Exemption. The Act increases the standard deduction to \$12,000 for individuals, \$18,000 for heads of household and \$24,000 for married couples, and suspended the personal exemption, which, in 2017 was \$4,050 for every person, including children. As a result, more people are expected to take the standard deduction, rather than itemizing. According to the Tax Policy Center, in 2014, approximately 70 percent of Americans took the standard deduction, as opposed to itemizing; this percent will certainly increase, starting with the 2018 tax year.

4. Child Tax Credit. The Act has good news for taxpayers with children; it increases the child tax credit to \$2,000. Additionally, phaseout of eligibility for the credit does not begin until the filer has an adjusted gross income of \$200,000, for individual taxpayers, or \$400,000 for married couples. The child’s social security number must be provided to claim the credit.

5. Changes to Itemized Deductions. The Act provides further support for the tax adage that deductions are a product of legislative grace. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (“[w]hether and to what extent deductions shall be allowed depends upon legislative grace....”). Because Congress has the authority to implement and revoke deductions,

¹ The Senate Parliamentarian ruled that the former title violated Senate procedures, and the Act is now officially known as “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.”

any challenges to these changes by states whose citizens are disproportionately impacted face a steep uphill battle. Examples of deductions the Act trimmed or suspended until after 2025 include deductions for medical expenses, tax preparation fees, unreimbursed business expenses, some gambling losses, and moving expenses. Additionally, net operating losses cannot be carried back. Three notable deductions – state and local taxes (SALT), mortgage interest and charitable contributions are discussed separately.

6. Capped SALT Deduction. The Act caps SALT deductions at \$10,000, including state and local income and property taxes. This cap will have the greatest impact in states with higher tax rates, such as New York and California, but will still impact Kansas and Missouri residents whose combined state, local and property tax liabilities exceed \$10,000. New York, New Jersey and Connecticut have formed a multistate coalition to explore filing challenge to this change on constitutional grounds. Toward the end of 2017, there was a flurry of taxpayers trying to prepay their SALT taxes, including property taxes that were due in 2018, so they could be deducted in 2017. While the IRS guidance limited prepayments to taxes that were assessed, uncertainty remains regarding what prepayments will be allowed. Furthermore, some states may undertake efforts to reclassify some of their citizens' tax payments as charitable deductions, such as to pay for educational expenses, as a creative means to circumvent the \$10,000 limit.

7. Charitable Deductions. The Act does not suspend, or even reduce, charitable deductions. Instead, it increases the cap on charitable deductions from 50% to 60% of adjusted gross income. However, the Act eliminates charitable deductions for individuals donating funds to university athletic departments in exchange for seating rights. With the increase in the standard deduction and the projected reduction in itemized deductions by individual taxpayers, a drop in the top marginal tax rate for individuals and corporation, and an increase in the estate tax deduction, nonprofits are concerned that their donations will drop significantly. Charities should be prepared for a drop in giving and should develop and target their fundraising goals accordingly.

8. Mortgage Interest Deduction and 9. HELOC Deduction. The Act caps deductions for homes purchased after December 14, 2017 to the first \$750,000 in mortgage indebtedness. While this may only impact a select number of taxpayers in the Kansas City metro area, where Zillow.com estimates the median home price at \$166,100, this will have a larger impact in states such as New York, New Jersey and California, where the median home price is much higher. Furthermore, the interest on a home equity line of credit (HELOC) is no longer deductible if the HELOC was used for anything other than acquisition indebtedness. Tax practitioners are awaiting further guidance from the IRS, but there is a general assumption that deductions related to the use of a HELOC for improvement of the property may still be allowed. In suspending this deduction, the Act does not grandfather loans previously taken out for items that are unrelated to the property's acquisition or substantial improvements.

10. Estate Tax. The Act does not eliminate the estate tax, but temporarily doubles the exemption to \$10 million. Indexed for inflation this exemption is \$11.2 million. Combined, a couple could exclude \$22.4 million in 2018. If you or a client has an estate that exceeds \$5 million (the base in 2017 that will once again be the base in 2025 should Congress not extend the expiring provisions), then proper planning should occur in order to take advantage of this expanded exemption.

Corporations and Pass-Through Entities

11. Corporate Tax Rate. The Act permanently lowers corporate tax rates from a top rate of 35 percent to a flat rate of 21 percent and eliminated the corporate alternative minimum tax. With the lowered tax rates, corporations should pay significantly less in taxes, which may provide an incentive for some individuals to form a corporation rather than a pass-through entity, such as an LLC, LLP, S Corp. or sole proprietorship. The reduction in the corporate tax rate has been cited as a reason for some companies' decision to provide tax cut bonuses to their employees and increase wages.

12. Taxation of International Income. In an effort to provide an incentive to bring money back overseas, the Act changes the United States' system of taxation as it pertains to corporations. The United States taxes all United States persons on their worldwide income, but allows corporations to defer paying taxes until that money is repatriated into the United States. For corporations, they will now receive an exemption for certain foreign income that is received as foreign source dividends. Furthermore, corporations holding earnings offshore can repatriate the money and pay a special tax of 15.5 percent for profits and 8 percent for reinvested foreign earnings. As covered in the media, proponents of the Act assume that corporations that have sheltered money offshore now have an incentive to bring that money back and potentially reinvest it in their businesses, provide higher wages to their workers or return some of that money to their shareholders through higher or special dividends.

13. Expense Deductions. The Act allows businesses to immediately expense capital investments and expands the first-year bonus depreciation rules through December 31, 2022 (and longer for some other property), increases the deduction to \$1 million, and expands the definition of eligible property. The Act also provides good news for lawyers (and others) looking to purchase new or used luxury automobiles. The Act provides an increased depreciation deduction, as long as the car is used over 50 percent for business. The increased depreciation may encourage business owners to purchase more expensive automobiles. Immediate deductions mean corporations will not have to deduct these expenses over a certain period of time and will be encouraged to invest in their businesses.

14. Pass-Through Deduction. To provide certain owners of pass through entities – such as partnerships, limited liability corporations, and other similar entities – an effective lower tax rate, the Act provides a 20 percent deduction on pass through income. A pass-through entity is one that does not pay income tax at the corporate level, but, instead, the owners pay tax on the profits at ordinary income tax rates. The Act carved out exceptions for professional groups such as engineers and architects, but did not include lawyers or accountants. However, lawyers and accountants whose income is below \$157,500 for single filers and \$315,000 for joint filers could still be eligible. Lawyers and other professionals will need to consult with their tax professionals to determine whether it makes sense to explore ways to carveout certain aspects of their business in order to take advantage of this deduction. Furthermore, business owners should consult with their tax practitioners in determining how this deduction will work, especially after the IRS issues much needed guidance regarding the deduction, and should be wary of requests from employees to be treated as independent contractors in order to take advantage of the new deduction.

15. Business Entity Formations. Lawyers advising on the formation of entities should be prepared to discuss the advantages and disadvantages of forming a corporation versus a pass-through entity, given the narrowing of the tax rates. While a corporation is still subject to double taxation in that the profits are taxed at the corporate and individual level, subject to certain limitations, the profits can be distributed as dividends and taxed at a lower rate.

16. Business Deductions. Without detailing the changes to business deductions, readers should be aware that changes, including change to deductions including those for business interest, stricter rules for deducting net operating losses, and reduced or eliminated deductions for business entertainment and other fringe benefits, including transportation (parking, mass transit, etc.), were part of the Act.

Other provisions

17. 529 Plans. For readers who send or are looking to send their kids to private schools, the Act allows taxpayers to use up to \$10,000 per child from a 529 plan to pay for private school expenses.

18. IRS Resource Limitations. In implementing the Act, the IRS will need to provide guidance and regulations, despite its well-known budget and personnel issues. Regardless of what you have read in the media, you should assume that the IRS will move forward with this responsibility and taxpayers and tax practitioners should not rely upon any resource or personnel limitations in making any decisions. The next IRS Commissioner – likely Charles “Chuck” Rettig, an experienced tax attorney nominated by President Trump to serve for the next five years – will help determine how the Service implements the Act and what regulations it issues.

While this article identifies 18 aspects of the new Act, you should not assume that this article discusses the many facets of the tax bill. Readers should consult with a tax professional to learn more, and continue to monitor guidance, regulations and other developments concerning the Act, including any pronouncements regarding IRS enforcement priorities. When in doubt, consult with your tax practitioner to receive guidance regarding your unique tax situation.



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