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The Tax Cuts and Jobs Act

On December 22, 2017, President Trump achieved his first significant legislative victory, and signed into law what is informally known as The Tax Cuts and Jobs Act (Pub. L. 115-97). The Act ushers in sweeping changes that will affect most taxpayers, including individuals, small and large businesses, multi-national corporations, tax-exempt organizations, and so on. It is being called the largest tax overhaul since the Tax Reform Act of 1986.

Projected to cost $1 trillion using "dynamic" scoring (this takes account of potential economic growth) or nearly $1.5 trillion using a "static" model (this takes less account of presumed behavioral changes and was the maximum permitted "size" of the tax reform bill), the Act moved quickly over the course of about six weeks: the House of Representatives introduced its version of the bill in early November, and passed it on November 16th; that same day, the Senate Finance Committee passed its version of the bill, which the full Senate passed (with amendments) on December 2nd. A Conference Committee then hammered out the differences between the two bills, producing a single, "reconciled" bill, which the House passed on December 19th, and the Senate passed on December 20th, with three small amendments to satisfy points of order and the so-called "Byrd rule" – including changing the bill's informal title noted above; the House "re-passed" the amended bill that same day, since the identical bill must pass both Houses of Congress to become law.

The Act is now officially called "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," and generally takes effect on January 1, 2018. To satisfy Senate budget rules – see the "Byrd rule" above – and make the bill "fit" within that allowable $1.5 trillion, most of the provisions affecting individuals are temporary and run from 2018 through 2025; most of the provisions affecting businesses, however, are permanent. (Republican drafters of the Act hope and anticipate that a future Congress will either extend the individual changes or make them permanent.)

Although “tax simplification” was a stated goal of the law’s drafters, the tax law is now more complicated for many, particularly those who receive “pass-through” business income from an entity such as a partnership or limited liability company and may be eligible for a 20% deduction on this income. Understanding that much remains to be learned about this new legislation, here is a selected “first look” at this law, particularly as it applies to individuals.

Individuals

Rates. The Act keeps seven income tax rates but reduces them, so that the new top rate is 37% (the current rates are: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%). Here is the rate schedule that will apply to taxable income in 2018:

Rate	Single	Married Joint	Heads of Households	Married Separate
10%	0 - $9,525	0 - $19,050	0 - $13,600	0 - $9,525
12%	>$9,525-$38,700	>$19,050-$77,400	>$13,600-$51,800	>$9,525-$38,700
22%	>$38,700-$82,500	>$77,400-$165,000	>$51,800-$82,500	>$38,700-$82,500
24%	>$82,500-$157,500	>$165,000-$315,000	>$82,500-$157,500	>$82,500-$157,500
32%	>$157,500-$200,000	>$315,000-$400,000	>$157,500-$200,000	>$157,500-$200,000
35%	>$200,000-$500,000	>$400,000-$600,000	>$200,000-$500,000	>$200,000-$300,000
37%	>$500,000	>$600,000	>$500,000	>$300,000

Standard deductions, personal exemptions and itemized deductions. Deductions, like exclusions and exemptions, reduce taxable income, and therefore, a taxpayer’s income tax. The Act, from 2018 through 2025, eliminates personal exemptions, and generally eliminates or modifies most itemized deductions. Most taxpayers therefore will now simply take the larger standard deduction. Here is a brief rundown on this:

Standard deduction. Taxpayers who do not itemize deductions to reflect payments for items such as state and local taxes, mortgage interest and charitable contributions take the “standard” deduction; like many other deductions and tax benefits that reduce a taxpayer’s “regular” tax, the standard deduction is not deductible in computing the alternative minimum tax (AMT – see below). The Act basically doubles this deduction, so that in 2018 it will be: $24,000 (married, filing jointly), $18,000 (heads of households) and $12,000 (single taxpayers). (The 2017 standard deductions are: $12,700 (married, filing jointly), $9,350 (heads of households) and $6,350 (single taxpayers and married, filing separately)). The additional deduction remains for taxpayers who are at least age 65 or blind ($600 for each category).

Personal exemptions. As noted above, the Act eliminates personal exemptions, or the current $4,050 exemption that eligible taxpayers can claim for each of themselves and their dependents (usually, their children); taxpayers with “too much” income, however, can entirely lose this exemption, which also is not deductible in computing the AMT.

> **Comment.** For those with large families, the loss of this exemption may (or may not) be offset by the larger standard deduction and an enhanced child tax credit (see below).

Itemized deductions. Itemized deductions are reported on Schedule A of the Form 1040 (individual income tax return), and include deductions for medical and dental expenses, state and local taxes (known

as “**SALT**”), mortgage interest, investment interest, charitable contributions, casualty and theft losses and various miscellaneous deductions. Because of the “Pease limitation,” which applies to all itemized deductions (other than those for medical expenses, investment interest, and casualty, theft and wagering losses), taxpayers with “too much” income typically lose about 3% of these deductions. The Act eliminates “Pease,” and modifies or eliminates most itemized deductions. Here are some specifics:

— **Medical and dental expenses.** Under current law, medical and dental expenses must exceed 10% of a taxpayer’s “adjusted gross income” (AGI) to be deductible. The Act maintains the 7.5% threshold for taxpayers who are at least 65 (this provision expired at the end of 2016), and from 2017 through 2018, applies the 7.5% threshold to all taxpayers. As of 2019, the 10% threshold will again apply to all taxpayers.

— **SALT.** SALT allows taxpayers to deduct payments for state and local income taxes (or sales tax, if elected instead), real property taxes and various other local taxes – *provided that* that the taxpayer is not subject to the AMT, which disallows the deduction. The Act caps the SALT deduction for all state and local taxes at $10,000 for married couples filing jointly and single taxpayers, and at $5,000 for a married individual filing separately (these amounts are frozen and will not be indexed for inflation); the Act also disallows a deduction for foreign real property taxes.

Comment. This change is likely to increase taxes for very high-income taxpayers in high-tax states, such as New York, New Jersey and California, assuming they paid “enough” regular tax and were outside the AMT. That is, such taxpayers could take the SALT deduction, which could run into the tens of thousands of dollars, and thereby save significant federal income tax; although the new lower income tax rates may lessen the probable tax increase for these taxpayers, the new $10,000 cap on SALT could still prove costly for them. “Merely” high-income taxpayers in high-tax states who *were* subject to the AMT could not take the SALT deduction anyway, and therefore may not feel this cap directly. Nonetheless, this change, coupled with the mortgage interest reduction (see below), may adversely affect home prices in these high-tax states and make home ownership less attractive. Note that the Act precludes a 2017 deduction for a 2017 prepayment of 2018 state and local *income* taxes, although such a prepayment may work with 2018 real property taxes.

— **Home mortgage interest.** The Act changes the rules regarding home mortgage interest. Mortgage interest paid on acquiring, building or substantially improving a principal residence and one other residence (e.g., a vacation home) is still deductible, although the total debt can only be up to $750,000 (rather than $1 million). Mortgages incurred on or before December 15, 2017 are grandfathered, but if such a mortgage is refinanced after that date, the grandfathering will be affected if the proceeds from the refinancing exceed the actual refinanced amount, or the refinancing extends the length of the original mortgage. Also, as of 2018, a deduction is no longer allowed for interest on home equity indebtedness (the debt could be up to $100,000); existing home equity loans are not grandfathered.

Comment. Homeowners who refinance their mortgage to take advantage of lower rates often take out additional amounts to cover their closing costs; they also often alter the length of the original mortgage, frequently extending it. Such changes may “ungrandfather” some of the refinanced amount, thereby affecting the deductibility of the resulting interest payments.

— **Charitable contributions.** The rules for charitable contributions are complicated, and the amount of the potential deduction depends on the nature of the gift (e.g., cash? marketable securities?) and the type of charity to which the gift is given (e.g., public charity? (think: college or museum), private foundation?). Cash gifts to a public charity garner the largest potential deduction. The Act increases

the deduction for such gifts from 50% to 60% of the taxpayer's "contribution base" (generally, AGI). (There is a five-year carryforward if the taxpayer can't fully use the deduction in the year the gift was made).

Comment. With fewer people likely to itemize because of the SALT deduction limitation and larger standard deduction, charities are worried that fewer people will donate, since non-itemizers will not see a "direct" tax benefit for their charitable gift (the deduction will be subsumed in the larger standard deduction). This increased contribution level for cash gifts is presumably designed to help address this concern.

— **Personal casualty and theft losses.** A personal casualty loss typically arises from "fire, storm, shipwreck, or other casualty, or from theft." To be deductible, the total casualty and theft losses must exceed 10% of a taxpayer's AGI. The Act suspends such losses (from 2018 through 2025) unless they are attributable to a "Federally declared disaster."

— **Miscellaneous itemized deductions.** Current law allows miscellaneous itemized deductions to the extent they exceed 2% of AGI (they are disallowed under the AMT); these deductions include tax preparation fees and fees associated with the collection of income. The Act disallows miscellaneous itemized deductions.

Above-the-line deductions. Above-the-line deductions are valuable, and are subtracted from a taxpayer's total income in arriving at AGI, the last line on page one of the Form 1040. The House version of the Act eliminated many of these deductions, including 1) the $250 deduction for school teachers who pay for classroom supplies themselves, 2) student loan interest, 3) the tuition deduction, and 4) moving expenses. The Act retains the first three deductions (the tuition deduction expired at the end of 2016), but eliminates the deduction for moving expenses, except for those in the Armed Forces. It also makes the following permanent change to alimony payments:

— **Alimony payments.** Effective for divorce separation agreements entered into after December 31, 2018, the payor spouse will no longer be able to deduct maintenance payments to his or her ex-spouse, who will also no longer be taxable on this payment (child support payments continue to be non-deductible and not includible in the recipient's income). Existing agreements are unaffected by this change unless they are modified and expressly provide that this change applies.

Comment. The original House bill would have made this provision effective for agreements entered into after December 31, 2017 (the Senate bill did not address this issue). With the effective date postponed for a year, divorcing spouses who would benefit from current law presumably will seek to wrap things up before 2019, while those who would benefit from the new law will probably be in no rush. Also, the rationale for this provision has been modified: the House Ways & Means Committee Majority Tax Staff explained in its summary of the House bill that this provision would eliminate what is effectively a "divorce subsidy" under current law; the Conference Committee Report on the final bill explains that the provision is intended to follow the principle set forth in *Gould v. Gould*, a 1917 Supreme Court decision holding that maintenance payments are not taxable income to the recipient. (*Gould* dealt with monthly payments that were made in 1913 and 1914, or before and shortly after the enactment of the income tax, which occurred on October 3, 1913.)

Income exclusions. Current law excludes certain items from a taxpayer's income, such as part of the gain from the sale of the taxpayer's principal residence or various employer-provided benefits. Here is how the Act deals with some of these exclusions.

— **Sale of principal residence.** Current law allows a single taxpayer to exclude up to $250,000 of gain ($500,000 if married, filing jointly) on the sale of the taxpayer's residence, provided that for two of the five preceding years, the property was the taxpayer's principal residence. The benefit is only available for one sale (or exchange) every two years. Although both the House and Senate versions of the Act would have required that the property be a principal residence for five of the prior eight years, that provision did not make it into the final Act. Thus, this gain exclusion remains unchanged.

— **Employer-provided benefits.** The House bill made more of these benefits taxable than did the Senate bill, including taxing graduate students on their tuition waivers or taxing private school employees whose children attended the school at reduced (or free) tuition (the waiver or reduction of tuition would be "phantom" income). This provision did not make it into the Act, nor did the elimination of dependent care and adoption assistance programs. Qualified bicycle commuting reimbursements are suspended from 2018 through 2025. Note that because companies will no longer be able to deduct costs relating to certain employee "fringe benefits," such as commuter passes and employee parking, companies may decide to curtail or discontinue these items.

Tax credits. A "credit" is a dollar-for-dollar offset against the taxpayer's tax. A "refundable" credit means that even if the taxpayer owes no income tax (perhaps through a combination of low income and offsetting deductions), the taxpayer will still receive that credit by way of a direct payment from the government; a non-refundable credit can only offset an income tax liability that would otherwise be paid. The Act makes changes in certain credits, including the child tax credit:

— **Child tax credit.** Current law allows taxpayers a $1,000 credit for each "qualifying child" under age 17, and has a refundable portion. The credit has different requirements, and starts to phase out if the taxpayer has "too much" income (modified AGI over $75,000 for single taxpayers, and $110,000 for married couples filing jointly). The Act increases the credit (from 2018 through 2025) to $2,000 per qualifying child, and increases the level at which the credit starts to phase out ($400,000 for married couples filing jointly, and $200,000 for any other taxpayers). It increases the refundable portion to up to $1,400 per child, and permits an additional credit of $500 for dependents other than a qualifying child.

Alternative minimum tax (AMT). The AMT has been mentioned above. It is a parallel tax system that requires taxpayers to figure their taxes twice – the "regular" way and the AMT way: whichever amount is higher is the amount of tax owed. Originally targeted at a handful of wealthy taxpayers, the AMT now reaches deep into the middle class and makes many items nondeductible that are otherwise deductible for regular tax purposes, such as state and local taxes. Although AMT repeal was a stated goal of tax reformers, they were only partially successful: the corporate AMT was eliminated, but the individual AMT remains; it will affect fewer taxpayers, however. The Act increases the AMT exemption to $109,400 for married taxpayers filing jointly (from $84,500) and to $70,300 for single taxpayers (from $54,300) for single taxpayers; it also increases the threshold at which the AMT exemption begins to phase out to $1 million for married joint filers (from $160,900) and to $500,000 for single filers (from $120,700).

Treatment of certain "pass-through" income. Many businesses are structured as "pass-through" entities, such as S corporations, partnerships and limited liability companies. This means that income the business throws off is not taxable to the entity itself, but "passes through" to the entity owners, and is taxable on their individual income tax returns, where it can be subject to the owner's top rate (potentially 39.6% in 2017). To benefit such pass-through owners, the Act generally allows a 20% deduction for the "qualified business income" from a "qualified trade or business," which generally means any trade or business other than a "specified service trade or business" or the trade or business of "performing services as an employee," unless the income from those excluded businesses is under a certain amount.

Comment. These quoted terms perhaps give an idea of just how complex this new provision is. The bottom line is that this section will require careful study to understand the extent to which pass-through businesses may be eligible for this 20% deduction, and how taxpayers might be able to structure their "businesses" to qualify for this deduction. This provision is designed to help pass-through business owners, so that they too benefit from the Act's pro-business provisions, since the top rate for C corporations (which pay tax at the entity level, unlike pass-throughs) drops from 35% to 21% in 2018.

529 accounts. These are tax-preferred accounts that allow parents, for example, to save for their children's higher education. Although the House bill would have allowed a 529 account to be created for a child *in utero* (an earlier Senate version did too), that provision did not make it into the Act. Nevertheless, as of 2018, the Act now permits distributions up to $10,000 per year for a beneficiary's tuition at "an elementary or secondary public, private, or religious school." Additional language in the Senate bill would have permitted this $10,000 to also be used for home schooling expenses, but was the second of three provisions stricken to satisfy the "Byrd rule" challenges mentioned at the beginning of this discussion.

Gift and estate tax exclusion. Under current law, an individual can protect $5.49 million worth of property from gift and estate tax, or $10.98 million per married couple; the 2018 inflation-indexed amounts were scheduled to rise to $5.6 million per individual or $11.2 million per married couple (these numbers derive from the $5 million "basic exclusion amount," for which inflation indexing began in 2012). Both the House and the Senate bills doubled the exclusion to $10 million as of 2018 (with inflation indexing); the House also repealed the estate tax and the generation-skipping transfer tax (GST) in 2025 (the GST is an additional tax that applies to transfers, either outright or in trust, to people such as grandchildren). Although the Act does not repeal the estate tax and the GST, it doubles the $5 million exclusion to $10 million, indexed for inflation, from 2018 through 2025. The 2018 inflation adjustment for this $10 million exclusion, however, is now subject to the less generous "chained CPI" calculation (see below), which will likely produce a lower number than $11.2 million per individual or $22.4 million per married couple. (Yes, the IRS needs to issue new 2018 inflation-adjusted numbers.) The Act retains the current basis adjustment rules, which effectively "mark to market" the basis of a decedent's appreciated (and depreciated) assets, effectively eliminating built-in capital gains (a "step-up" in basis) as well as built-in losses (a "step-down" in basis).

Comment. Wealthy taxpayers have another incentive to make significant lifetime gifts, as a future Democratic Congress or Administration may reduce these expanded exclusion amounts. Note that annual exclusion gifts, which currently allow a donor to give $14,000 per donee ($28,000 if the donor's spouse joins in the gift), are also subject to the new chained CPI. Thus, it is unclear whether this new measure will still result in a 2018 increase to $15,000 per donee for annual exclusion gifts.

Individual provisions generally sunset in 2026. To ensure that the Act "fits" within the allowable $1.5 trillion price tag mentioned above (thereby complying with Senate budget rules), most of the Act's individual provisions will sunset in 2026 – meaning that unless a future Congress extends these changes, the tax law will revert to where it is now for individuals. Other provisions, some of which are briefly touched on below, generally would be permanent.

No more Roth IRA "recharacterizations." Under current law, a taxpayer who converts a traditional IRA into a Roth IRA is subject to income tax on the portion of that traditional IRA that was funded with pre-tax dollars (i.e., dollars on which income tax has not yet been paid). If, relatively soon after that conversion, the converted assets decline, the taxpayer owes income tax on value that is no longer there; in that circumstance, the law has allowed the taxpayer to "undo" the conversion and recharacterize the Roth IRA as a traditional IRA, provided this happens before the deadline for filing the tax return reporting the conversion

(generally, October 15th of the year following the year of conversion). Congress appears to have concluded that taxpayers were taking unfair advantage of this provision, since the Act prohibits recharacterizations as of 2018. Thus, although it will no longer be possible to unwind a Roth conversion, it will still be possible to undo, for example, a Roth contribution so that it will instead be treated as a contribution to a traditional IRA.

Affordable Care Act individual mandate. To help reduce its cost, the Act eliminates the "shared responsibility payment," or the penalty that applies if individuals do not maintain "minimum essential coverage" under the Affordable Care Act (a/k/a "Obamacare"). This provision is scored at raising $300+ billion over 10 years, on the theory that many people who would otherwise be eligible for subsidies to help buy insurance would decide to go without it, thereby saving the government money. Because Republican Senator Susan Collins of Maine was concerned about the effect of this provision on the stability of Obamacare marketplaces, Senate Majority Leader Mitch Connell of Kentucky promised her a vote on legislation that would shore up these marketplaces. Some House Republicans have expressed opposition to such a measure, and its fate remains unclear.

Inflation adjustments – chained consumer price index (CPI). Many items in the tax law are annually indexed for inflation, including income tax brackets and the gift and estate tax exclusion. The Act adopts the chained CPI that was in both the House and Senate bills – meaning that inflation-adjusted numbers will rise less quickly, thereby indirectly increasing taxes, and correspondingly reducing the Act's cost. This permanent change applies to taxable years beginning after December 31, 2017 (i.e., generally, as of 2018), and means that the IRS will need to revisit the 2018 inflation-adjusted numbers that it published in Revenue Procedure 2017-58, issued on October 19, 2017.

Business provisions

Selected corporate changes. There are numerous changes to corporate taxation, including dropping the top tax rate from 35% to 21% as of 2018, repealing the corporate AMT, limiting the deductibility of interest expenses and allowing 100% "expensing" (up-front deductions to recoup costs) for "qualified property." There are also significant changes in the taxation of multi-national corporations, including moving to a more "territorial" system of taxation, whereby "foreign-source" income is generally exempt from taxation. (As part of that transition, there is a mandatory deemed repatriation, for the last tax year starting before January 1, 2018, of accumulated post-1986 deferred foreign income, with a 15.5% tax on cash or cash equivalents, and an 8% tax on all other earnings.)

Tax-exempt organizations

Excise tax on net investment income of private colleges and universities. Both the House and Senate bills proposed a 1.4% excise tax on the net investment income of private colleges and universities. The Act maintains this provision, which applies to institutions with at least 500 full-time students (or full-time equivalents) and with assets of at least $500,000 per student. (The third and final Byrd-rule challenge in the Senate eliminated language that referred to at least 500 "tuition-paying" students, as this was designed to specifically protect a Kentucky school that does not charge tuition but does have a significant endowment.)

To sum up

There is much to digest in this 500+ page bill, and we have only begun to scratch the surface. To summarize, the Act is clearly designed to benefit businesses, both large and small, in the belief that a more favorable tax environment will boost the economy and therefore benefit everyone. Most individuals will see

lower taxes as well, although those reductions are temporary. The new 20% deduction for most pass-through business income is a marvel of complexity and will keep tax advisors and accountants occupied for months figuring it out. And then there are the folks at the IRS, who must translate this new law into forms, guidance and regulations. It's going to be busy.

January 7520 rate

The January 2018 7520 remains at 2.6%, where it was in December 2017. The January mid-term applicable federal rates (AFRs) are up slightly: 2.18% (annual), 2.17% (semiannual), and 2.16% (quarterly and monthly). The December mid-term AFRs were: 2.11% (annual), 2.10% (semiannual), and 2.09% (quarterly and monthly).

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