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CLIENT ALERT – TAX LAW OVERHAUL

HOW WILL THE *TAX CUTS AND JOBS ACT* AFFECT YOU AND YOUR BUSINESS?

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As we are sure you are aware, President Trump signed into law the *Tax Cuts and Jobs Act* (the "Act"). This is the most comprehensive tax reform bill in decades and will change the way you, your family, and your business calculate and pay certain taxes. This Alert highlights some of the most significant changes.

C Corporations

Reduced Corporate Tax Rate. The main feature of the Act was the replacement of the graduated tax rates for C corporations (the highest of which was 35%) with a flat rate of 21%. Additionally, the Act repealed the corporate Alternative Minimum Tax.

Changes to DRD Rules. Prior to the Act, a corporation was entitled to a 100% dividends received deduction ("DRD") for dividends received from a corporation in its affiliated group, an 80% DRD where the recipient-corporation owned 20% or more of the stock (by vote and value) of the dividend-paying corporation, and a 70% DRD where the recipient owned less than 20% of the stock of the dividend-paying corporation. The Act retained the 100% DRD for dividends received from a corporation in its affiliated group, but lowered the DRD for dividends received from a 20% or more owned corporation to 65% and lowered the DRD for dividends received from a less than 20% owned corporation to 50%.

Note: Most of the changes in the Act for C Corporations are permanent, while most of the changes applicable to individuals (including owners of pass-through businesses) expire after December 31, 2025.

Pass-Through Businesses

The QBI Deduction.[1] Prior to the Act, income from partnerships, S corporations, or sole proprietorships was simply passed through and allocated among owners of such business entity (hence the term "pass-through business") and taxed at each owner's individual rate. In light of the significant reduction in the tax rate for C corporations, the Act provides a tax break for pass-through businesses as well.

Through the 2025 tax year, a non-corporate taxpayer (i.e., an individual, estate, or trust) may deduct from taxable income an amount equal to 20% of qualified business income ("QBI")[2] derived by the taxpayer from pass-through businesses. This QBI deduction is subject to a number of *very* complex limitations and qualifications; we have summarized the most commonly applicable limitations below.

W-2 wage limitation: Generally, the QBI deduction for each pass-through business[3] cannot exceed the greater of the taxpayer's allocable share of (i) 50% of W-2 wages paid to employees by such pass-through business, or (ii) the sum of 25% of W-2

[1] A number of short-hand names are used for the new deduction available to (some) pass-through businesses under the ACT, including the QBI deduction, the 199A deduction, the pass-through income deduction. The term used in this Client Alert is the QBI deduction.

[2] QBI is defined as the net amount of domestic qualified items of income, gain, deduction, and loss with respect to a taxpayer's qualified businesses.

[3] Notice that, if a taxpayer has QBI from multiple pass-through businesses, the QBI deduction is calculated for each such business.

wages plus 2.5% of the unadjusted cost basis of such business' qualified property. "Qualified property" generally means property that is both subject to depreciation and used in the production of QBI.

The W-2 wage limitation does not apply, however, if the individual owner's taxable income is less than the "threshold amount" of $175,000 (or $315,000 for married individuals filing a joint return). Above this threshold amount, the W-2 limitation is phased in over a $50,000 range (or a $100,000 range for married joint-filers).

Service business limitation: Where a pass-through entity engages in a specified service business, the benefit of the QBI deduction is unavailable with respect to income derived from such a business, unless the taxpayer's taxable income is less than the threshold amount described above. The phase-in rules for the W-2 wage limitation are applicable here as well.

The term "specified service business" includes the work carried on by many professionals, such as doctors, lawyers, accountants, athletes, stock brokers, and investment advisors, and also includes any other trade or business in which the principal asset is the reputation or skill of one or more of its employees or owners.

Other Important Business Provisions

Deduction for NOLs Modified. Net operating losses ("NOLs") existing as of the end of 2017 may continue to offset 100% of taxable income, whether carried back for two years or carried forward for up to 20 years. Under the Act, the deduction for NOLs arising in tax years after 2017, however, is now limited to 80% of the taxpayer's taxable income for the year to which the NOLs are carried. Additionally, post-2017 NOLs generally cannot be carried back, but may be carried forward indefinitely.

More Generous Capital Expenditure Rules. Previously, Section 179 of the Internal Revenue Code allowed a business to deduct the full purchase price of qualifying property[4] in the tax year such property was purchased or leased, subject to two limits: (i) a deduction limit, set at $500,000 in 2015; and (ii) a spending cap of $2 million. Under the Act, Congress doubled the Section 179 deduction limit to $1 million and increased the spending cap to $2.5 million to further incentivize small and medium-sized businesses to invest in themselves.[5] The deduction limit and spending cap will be indexed for inflation starting in 2019.

Additionally, as an incentive for larger businesses spending more than the Section 179 spending cap, the Act modifies the so-called Bonus Depreciation provision. Prior to the Act, a business was permitted to take a 50% first-year bonus depreciation deduction for qualifying property placed into service in a given tax year, so long as such property was brand new. Now, for qualifying property purchased and placed into service between September 28, 2017, and December 31, 2022, the Act permits businesses to take a 100% first-year bonus depreciation deduction for such property, whether new *or* used, so long as the asset is "new" to the business. The deduction is phased out over the period from 2023 through 2026.

Provisions Affecting Employees. The Act repeals several deductions and exclusions that had previously benefitted employers and employees, some of which are summarized below:

Moving Expenses. For taxable years 2018 through 2025, the Act suspends the deduction for an employee's unreimbursed moving expenses. Moreover, during the same period, employees may not exclude moving expense reimbursements from gross income.

Business Entertainment. The Act repeals the provision permitting a taxpayer to

[4] The deduction is only available for qualifying property that is used primarily – that is, more than 50% of the time – for business purposes rather than for personal purposes.

[5] The availability of the Section 179 deduction phases out for businesses purchasing more than $2.5 million of qualifying property.

deduct 50% of entertainment, amusement, or recreation expenses that are directly related to the active conduct of the taxpayer's trade or business. Starting in 2018, no deduction is allowed for these expenses.

Travel Expenses. The Act generally disallows an employer deduction for expenses associated with providing qualified transportation fringe benefits to its employees, including parking, transit passes, vanpool benefits, and reimbursements for qualified bicycle commuters.

Individuals

Please note: Unless stated otherwise, changes applicable to individuals are temporary, starting January 1, 2018, and expiring after December 31, 2025.

Reduced Tax Rates. The Act reduces tax rates for many taxpayers. These temporary tax rates after 2017 are 10, 12, 22, 24, 32, 35, and 37 percent. Under prior law, the rates were 10, 15, 25, 28, 33, 35, and 39.6 percent.

Standard Deduction vs. Itemized Deduction. The Act encourages taxpayers to take the standard deduction rather than itemize their deductions by nearly doubling the standard deduction ($24,000 for married individuals, filing jointly) and eliminating or restricting itemized deductions. Specifically, the Act repeals all miscellaneous itemized deductions that had previously been subject to the two-percent floor, limits mortgage interest deductions for qualified residence indebtedness incurred after December 15, 2017,[6] and limits state and local tax deductions.[7] The deduction for charitable contributions was expanded so that taxpayers may deduct up to 60% (rather than 50%) of their adjusted gross income in charitable contributions.

Estate, Gift, and GST Taxes. The Act doubled the lifetime gift and estate tax exemption. As a result, the 40% tax only applies to assets in excess of $11.2 million per person or $22.4 million for married couples (indexed for inflation). The Act maintains the provision for annual exclusion gifts ($15,000 in 2018), and the Act continues to permit a beneficiary to receive a step-up in basis to the fair market value of property received from a decedent.

Conclusion

The Act made extensive (and very complicated) changes to federal tax law. This Client Alert provides a general overview of a few of the most important provisions of the Act. It is not intended to, and does not, constitute tax advice. Please contact any of Bell Nunnally's tax professionals to discuss your tax situation and the impact the Act may have on your unique tax situations.

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[6] The Act limits the mortgage interest deduction to interest on a maximum of $750,000 of acquisition indebtedness for tax years after December 31, 2017, and before January 1, 2026. Existing mortgages as of December 15, 2017, are grandfathered, and those homeowners will continue to receive a deduction for interest on a maximum of $1 million of acquisition indebtedness.

[7] Individuals are limited to a deduction of $10,000 ($5,000 for a married individual filing separately) for the aggregate of (i) state and local income tax (or, alternatively, sales tax), and (ii) state and local property taxes; provided, however, the limitation does not apply to state and local property/sales taxes that are incurred in carrying on a trade or business or for the production of income.