Federal Relations Advisory

The Tax Cuts and Jobs Act and other recent tax changes: What does it all mean?

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OVERVIEW

Congress finished up 2017 with a bang by passing the Tax Cuts and Jobs Act. The bill was signed into law by President Trump on Dec. 22, 2017. The TCJA lives up to its name in many ways, including by slashing the corporate income tax rate, reducing the tax rate for business income of "pass-through businesses," such as partnerships, S corporations, and independent contractors, and reducing individual income tax rates. However, in order to help pay for reduced rates and other tax-relief provisions, the TCJA also eliminates or cuts back on many individual and business tax deductions and credits. As the saying goes, the devil is in the details, and the ultimate impact on a particular business or individual will vary based on the specific circumstances. Most of the provisions of the TCJA became effective Jan. 1, 2018, meaning that the new law is in effect even though some of its provisions are not yet fully understood and very little guidance has been issued by the IRS.

Delays of a number of tax provisions related to health care, including a two-year delay of the Cadillac tax, were included in a separate legislation addressing funding for the federal government signed into law Jan. 22, 2018.

This advisory provides a high-level overview of certain aspects of these recent tax law changes. This advisory is of interest to employers of all sizes.

HEALTH TAX CHANGES

The individual mandate, which imposes a tax penalty on individuals who do not have minimum essential coverage, is repealed effective Jan. 1, 2019. The mandate remains in effect for years before 2019, including 2018. The Cadillac tax is delayed for an additional two years and (unless further delayed or repealed) will take effect in 2022. The tax on health insurance companies (often called the "health insurance tax," or HIT) for major medical coverage is suspended for 2019. Although insurance companies are legally liable for this tax, it is generally passed on to employers and other policyholders as part of the premium. The suspension of the medical device tax is continued for 2018 and 2019.

Other taxes and fees related to health care remain in effect, including the employer penalty provisions that apply to applicable large employers (that is, employers with at least 50 full-time equivalent employees for the prior year) if affordable minimum-value coverage is not provided. There is also no change in the Affordable Care Act employer health coverage reporting requirements.

TAX CHANGES FOR BUSINESSES

The Tax Cuts and Jobs Act cuts business tax rates and makes other business-friendly changes to the tax laws. Key provisions include the following:

» Reduction of the corporate tax rate to 21 percent.

» Repeal of the corporate Alternative Minimum Tax.

» Enhanced cost-recovery deductions through increased Section 179 expensing and extension and modification of the bonus depreciation rules.

For pass-through businesses, the TCJA provides tax relief through a new, and complicated, deduction for 20 percent of certain qualified business income. Pass-through businesses include partnerships, limited liability companies (LLCs), S corporations and sole proprietorships (e.g., an individual performing services as an independent contractor). Whereas the income of C corporations is taxed twice, once at the corporate level and again when dividends are distributed to shareholders, the income of pass-through businesses is taxed only at the individual level (i.e., all the income is "passed through" to the individual owners of the business). Tax relief for pass-through businesses could have been provided through further reductions in individual income tax rates. However, a variety of concerns and issues led to the adoption of another method designed to separate "business income" from "personal service income."

In addition to being complicated, the new deduction is also subject to a variety of limitations. Here's a high-level outline:

» In general, pass-through businesses can deduct 20 percent of their qualified business income as defined in the new law. With a maximum individual income tax rate of 37 percent, this effectively means a top rate of 29.6 percent for qualified business income of a pass-through entity. The deduction is not allowed in determining adjusted gross income; rather, it applies to reduce taxable income.

» However, the deduction is limited in the case of "specified service businesses." Specified businesses include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, investment management, trading or dealing in securities, commodities, etc., or where the principal asset of the trade or business is the "reputation or skill of one or more of its employees."

    - In the case of specified service businesses, the 20 percent deduction is fully available only for married individuals filing joint returns with taxable income of less than $315,000 (half of that, or $157,500, for single individuals). The 20 percent deduction is phased out ratably for married taxpayers filing joint returns of more than $315,000 to $415,000 of taxable income and more than $157,500 to $207,500 of taxable income for single filers.

» Further, a separate limitation on the deduction based on W-2 wages or a combination of W-2 wages and capital investment phases in over the same income ranges described above (regardless of the type of business).

» These limitations mean that for specified service businesses, the 20 percent deduction will be unavailable to joint filers if their taxable income is above $415,000 and unavailable to single filers with taxable income above $207,500 (and will be limited within the phase-out range). For pass-through businesses that are not specified service businesses, the deduction will remain available above these income ranges but will be limited based on W-2 wages or a combination of W-2 wages and capital investment based on a formula in the law.

These limitations represent a compromise of differing goals. On the one hand, Congress wanted to provide tax relief for all types of businesses, not just corporations. On the other hand, Congress also wanted to prevent potential avoidance of individual tax rates through the recharacterization of personal service income as "business income."

The TCJA also cuts back on or repeals a number of current business deductions and credits to pay for tax rate cuts, including the following:

» New limitations on the deduction for net operating losses of C corporations.

» New limitations on net business losses of pass-through businesses.

» Restrictions on the deductibility of net interest expense.

» New limitations on the deductibility of expenses for entertainment and fringe benefits.

» Repeal of the Section 199 manufacturing deduction.

TAX CHANGES FOR INDIVIDUALS

Individual Income Tax Rates and Rate Brackets

The TCJA generally lowers individual income tax rates. However, because the way in which taxable income is calculated is also changed (e.g., through modifications to deductions), not all individuals will necessarily see their taxes reduced.

Individual Income Tax Rates and Rate Brackets for 2018:

Tax Rate	Married Filing Jointly		Single	
	If taxable income is	The tax is	If taxable income is	The tax is
10%	$0 to $19,050	10% of taxable income	$0 to $9,525	10% of taxable income
12%	$19,051 to $77,400	$1,905, plus 12% of the excess over $19,050	$9,526 to $38,700	$952.50, plus 12% of the excess over $9,525
22%	$77,401 to $165,000	$8,907, plus 22% of the excess over $77,400	$38,701 to $82,500	$4,453.50, plus 22% of the excess over $38,700
24%	$165,001 to $315,000	$28,179, plus 24% of the excess over $165,000	$82,501 to $157,500	$14,089.50, plus 24% of the excess over $82,500

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Tax Rate	Married Filing Jointly		Single	
	If taxable income is	The tax is	If taxable income is	The tax is
32%	$315,001 to $400,000	$64,179, plus 32% of the excess over $315,000	$157,501 to $200,000	$32,089.50, plus 32% of the excess over $157,500
35%	$400,001 to $600,000	$91,379, plus 35% of the excess over $400,000	$200,001 to $500,000	$45,689.50, plus 35% of the excess over $200,000
37%	$600,001 or more	$161,379, plus 37% of the excess over $600,000	$500,001 or more	$150,689.50, plus 37% of the excess over $500,000

Different rate brackets apply to other situations not listed above, such as individuals filing as heads of household and married taxpayers filing separately.

The tax rates on capital gains and qualified dividends are not changed. Thus, the maximum rate of tax on such income is generally 20 percent or 15 percent, with higher rates for certain assets. The 3.8 percent net investment tax, enacted as part of health care reform, remains in effect. This tax applies to married taxpayers filing joint returns with modified adjusted gross income in excess of $250,000 ($125,000 for single taxpayers).

Increased Standard Deduction

The TCJA combines individual personal exemptions and the standard deduction into a new, higher standard deduction. For 2018, the standard deduction is $12,000 for single filers and $24,000 for married taxpayers filing joint returns.

By way of comparison, under prior law, in 2018, a married couple with two children would have been eligible for a standard deduction of $13,000 and personal exemptions of $16,600, for a combined deduction of $29,600 (compared to the lower new standard deduction of $24,000 under the TCJA). Thus, the loss of personal exemptions may result in a lower deduction under the TCJA compared to prior law. However, there are other provisions in the TCJA that may alleviate this impact, and the overall result may still be a lowering of taxes, depending on the particular circumstances. For example, the repeal of the personal exemption phase-out (PEP), enhancements to the child tax credit (including a doubling of the credit from $1,000 per child to $2,000 per child) and changes to various itemized deductions could impact taxes under the TCJA compared to prior law.

Itemized Deductions

As a result of the increased standard deduction and new limitations on itemized deductions, fewer people are expected to itemize deductions starting in 2018. The following chart provides a high-level overview of how the TCJA has changed some popular itemized deductions.

Summary of Changes to Certain Itemized Deductions:

Deduction	TCJA
State and local taxes (SALT)	Limits the deduction for state and local income, property and sales taxes to a combined total of $10,000 annually.
Home mortgage interest	The deduction is retained, but the amount of qualifying debt is reduced from $1 million to $750,000. Applies to new debt (i.e., debt incurred on or after Dec. 15, 2017) with a limited transition rule for certain home purchases made pursuant to a written binding contract in effect before Dec. 15, 2017. Debt incurred before the effective date and that is refinanced later continues to be "grandfathered" and subject to the prior-law rules to the extent the refinancing does not increase the amount of prior outstanding debt.
Deduction for interest on home equity loans	Repealed, effective starting in 2018, including for existing debt.
Charitable contributions	The deduction is retained, and the maximum deduction for cash contributions is increased from 50% of adjusted gross income to 60% of adjusted gross income, starting in 2018.
Medical expense deduction	The floor on the itemized deduction medical expenses is reduced to 7.5% of adjusted gross income for 2017 and 2018. Starting in 2019, the deduction is limited to medical expenses in excess of 10% of adjusted gross income.
Personal casualty and theft losses	Limited to losses incurred in a federally-declared disaster area, starting in 2018.

Individual Alternative Minimum Tax

The TCJA increases the AMT exemption amounts and the thresholds at which the exemption amounts begin to phase out. In 2018, for married taxpayers filing joint returns, the exemption amount is increased to $109,400 and the phase-out threshold is increased to $1 million. For single taxpayers, the exemption amount is increased to $70,300 and the phase-out threshold is increased to $500,000. These dollar amounts are indexed for inflation.

Sunset of Individual Tax Changes

The changes to the individual income tax provisions generally are temporary, and will revert back to prior law after 2025 (unless Congress acts before then to extend or modify the law).

ESTATE AND GIFT TAX

An early version of what became the TCJA had proposed eventual repeal of the estate tax. The final version keeps the tax in place, but reduces the impact by doubling the exemption amount from $5 million to $10 million. The $10 million will be indexed for inflation. The provision is effective for estates of persons dying and gifts made after Dec. 31, 2017. The new provision sunsets so that the estate tax provisions revert back to prior law after 2025 (unless extended or modified before then).

CONCLUSION

The TCJA promises significant tax relief and will deliver on that promise for many businesses and individuals. However, the 185-page law contains many details that will have a different effect on each situation, which can't be addressed in a short overview. Businesses and individuals should consult their tax advisors to determine exactly how they will be impacted by the new law.

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