What the Tax Cuts & Jobs Act (TCJA) means, Part II

As a follow up to our newsletter distributed last week, we wanted to provide more information based on further research and analysis since enactment of these tax law changes on December 22. Please note that we will continue to provide more analysis as our understanding of the new legislation advances and as more guidance is issued by the IRS on these matters. Our prior newsletters may be found by clicking on the "newsletter archive" on the bottom of our website.

Please note that the analysis provided below is a snapshot of what we believe to be the most critical changes of the TCJA. This is new legislation that is over 500 pages long and the analysis which follows includes items which we believe to be the most pertinent to our clients and taxpaying community.

Issues related to individuals

Individual Rates	Overall rate decrease; 7 brackets retained
Standard Deduction	$24,000 (MFJ)
Personal Exemptions	Repealed
Child/Family Credit	Increased
AMT	Exemption increased; Exemption phaseout threshold substantially increased
SALT Deduction	Limited to $10,000 in property and state/local income taxes (except for taxes incurred in a trade or business)
Mortgage Interest Deduction	Limited to interest on up to $750,000 of acquisition indebtedness; Repeals deduction for home equity indebtedness
Itemized Deduction Limitation	Repealed

A comparison of Federal Married Filing Joint tax rates using previously scheduled 2018 tax rates versus the new TCJA rates:

IncomeRange	TCJA (New Law)	Scheduled 2018 rate (Old Law)
$1 to $19,050	10%	10%
$19,051 to $77,400	12%	15%
$77,401 to $156,150	22%	25%
$156,150 to $165,000	22%	28%
$165,001 to $237,950	24%	28%
$237,951 to $315,000	24%	33%
$315,001 to $400,000	32%	33%
$400,001 to $424,950	35%	33%
$424,950 to $480,050	35%	35%
$480,051 to $600,000	35%	39.6%
Over $600,000	37%	39.6%

Key individual provisions:

- The child tax credit has been increased from $1,000 in 2017 to $2,000 in 2018. Additionally, this credit “phases-out” with income above $110,000 in 2017 and income above $400,000 in 2018.

- Qualified distributions from a 529 Plan have been expanded to include “qualified expenses” for elementary school and high school. This is potentially beneficial for those paying private school tuition with a material amount of tax free growth on 529 plan contributions.

- State and local (i.e. personal residence property taxes) now limited to a total itemized deduction of $10,000. For those of you concerned about the deductibility of property taxes on investment properties and rentals, this limitation is not applicable to those assets.

- The interest deduction on mortgages originated after December 15, 2017, with certain exception, is now limited to interest expense on $750,000 of indebtedness. For those with loans obtained prior to December 15, the interest expense deduction is limited to $1,000,000 of indebtedness. This limitation is pertinent to personal homes and is not applicable to investment and rental properties. Mortgage interest on a home equity line of credit for a personal residence is no longer deductible.

- Deductions for charitable contributions essentially remain unchanged. There may be planning opportunities for those taxpayers who may be close to claiming the now higher standard deduction instead of itemizing. One such strategy may be to lump contributions every other year in order to claim these contributions as itemized deductions.

- Previously, certain deductions could be claimed if they exceeded 2% of adjusted gross income. These deductions included certain legal fees, asset management fees and unreimbursed employee expenses. Theses deductions have been repealed by the TCJA.

- Prior to the TCJA, alimony payments were deductible by the payer of those payments and included in income by the recipient. This is now repealed for any divorce or separation instrument signed after December 31, 2018. For those who are going through a divorce or negotiating potential changes to existing agreements, it is critical that this change be contemplated as part of the divorce proceedings. Previously entered into agreements not subject to change will not be impacted by the TCJA.

<u>Issues related to business</u>

A lot has changed, but plenty of things remain the same. Some key changes:

- One of the many significant changes is the reduction in the corporate tax rate to a flat rate of 21%. Regardless of this rate decrease, several illustrations that follow will show that the effective rate on corporate earnings, including the taxes paid by shareholders on dividends received, generally result in a higher combined tax rate than the rate paid by owners of flow through entities such an LLCs and S-Corps and sole proprietors.

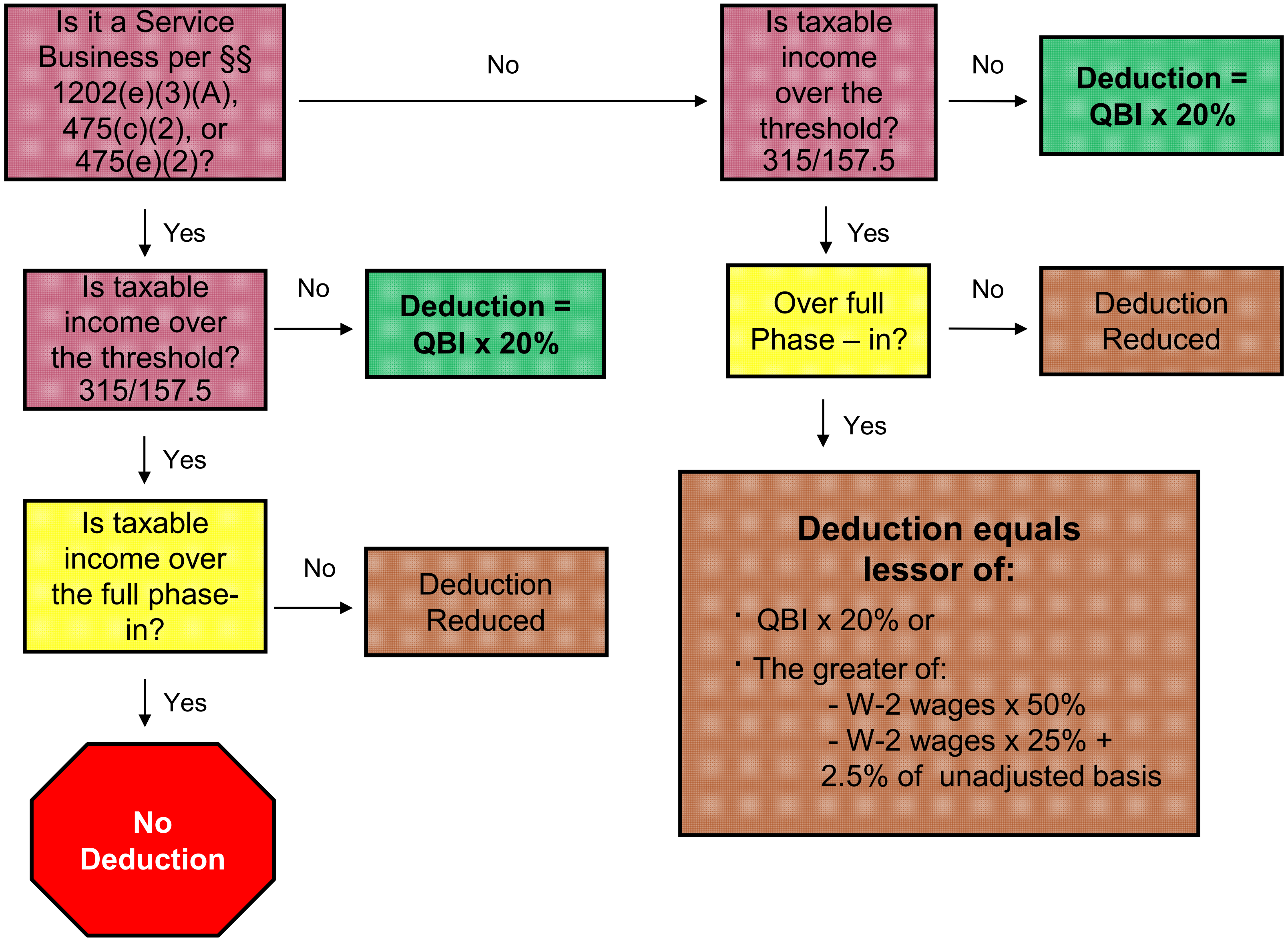
- Owners of S-Corp shares or LLC memberships may now qualify for a deduction equal to 20% of "qualified business income (QBI)" from pass-through entities. This new deduction is perhaps one that will have the most impact on business owners and based on our analysis and correspondence with other tax professionals including CPAs and tax attorneys, this is an area not widely understood at this time. Here are some of the basics related to the business pass through rate:

    - For those with taxable income in excess of $415,000 (MFJ) the deductionis limited to the greater of:
        - 50% of W-2 Wages
        - 25% of W-2 Wages plus 2.5% of unadjusted basis (cost of assets)

    - Unavailable to Specified Service Business owner's taxable income (income from all sources) in excess of $415,000 (MFJ). Specified service income is "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal assets of such trade or business is the reputation or skill of one or more employees." Specifically excluded from this category of service business are architects and engineers. We anticipate a lot of confusion and potential litigation / case law based on this impactful designation of "specified service business"

    - Limitations phased-in from $315,000 - $415,000 (MFJ) of taxable income

Please refer to the flowchart and examples on the following pages for helpful illustrations.


Is it a Service Business per §§ 1202(e)(3)(A), 475(c)(2), or 475(e)(2)?
No
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Over full Phase – in?
No
Deduction Reduced
Yes
Deduction equals lessor of:
QBI x 20% or
The greater of:
- W-2 wages x 50%
- W-2 wages x 25% + 2.5% of unadjusted basis
Yes
Is taxable income over the threshold? 315/157.5
No
Deduction = QBI x 20%
Yes
Is taxable income over the full phase-in?
No
Deduction Reduced
Yes
No Deduction

Business Entity (Re)Classification

Marginal Rate Example –
Taxable Income of $315,000 (MFJ)

Pass-through

Business Income		$ 100.00
Special Business Deduction	20%	(20.00)
Taxable Income		$ 80.00
Income Tax	24%	$ 19.20
Business Income		$ 100.00
Less: Income Tax		(19.20)
Net to Business Owner		$ 80.80
Tax Rate		**19.2%**

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	18.8%	(14.85)
Net to Shareholder		**$ 64.15**
Tax Rate		**35.85%**

Business Entity (Re)Classification

Marginal Rate Example –
Taxable Income of $600,000 (MFJ) or Greater

Pass-through

Business Income		$ 100.00
Special Business Deduction	20%	(20.00)
Taxable Income		$ 80.00
Income Tax	37%	(29.60)
Business Income		$ 100.00
Less: Income Tax		(29.60)
Net to Business Owner		$ 70.40
Tax Rate		**29.6%**

**Assumes the W-2 Wage Limitation doesn't apply*

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	23.8%	(18.80)
Net to Shareholder		**$ 60.20**
Tax Rate		**39.8%**

Business Entity (Re)Classification

Marginal Rate Example –
Taxable Income of $600,000 (MFJ) or Greater

Example of the 50% W-2 Wage Limitation

Qualified Business Income		$	700,000
General Deduction	20%	$	(140,000)
W-2 Wages		$	200,000
50% W-2 Wage Limit	50%	$	(100,000)

Qualified Business Income		$	700,000
199A Deduction			(100,000)
Taxable Income from the Business		$	600,000
Income Tax	37.0%	$	222,000

Effective Tax Rate **31.71%**

Business Entity (Re)Classification

Marginal Rate Example –
Taxable Income of $600,000 (MFJ) or Greater

Example of the Asset Limitation–
Investment Real Estate

Qualified Business Income		$	70,000
General Deduction	20%	$	(14,000)
W-2 Wages		$	-
25% of Wages	25%	$	-
Unadjusted Basis of Assets		$	2,300,000
2.5% of Assets	2.5%	$	57,500

Qualified Business Income		$	70,000
199A Deduction			(14,000)
Taxable Income from the Business		$	56,000
Income Tax	37%	$	20,720

Effective Tax Rate **29.60%**

Note, deleveraging would increase QBI & the 199A Deduction

Service Business (Re)Classification

Marginal Rate Example –
Taxable Income of $315,000 (MFJ)

Pass-through

Business Income		$ 100.00
Special Business Deduction	20%	(20.00)
Taxable Income		$ 80.00
Income Tax	24%	$ (19.20)
Business Income		$ 100.00
Less: Income Tax		(19.20)
Net to Business Owner		$ 80.80
Tax Rate		**19.2%**

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	18.8%	(14.85)
Net to Shareholder		**$ 64.15**
Tax Rate		**35.85%**

Service Business (Re)Classification

Marginal Rate Example –
Taxable Income of $415,000 - $479,000 (MFJ)

Pass-through

Income		$ 100.00
Normal Pass-Through Tax	35%	(35.00)
Net to Business Owner		$ 65.00
Tax Rate		**35.0%**

No Deduction

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	18.8%	(14.85)
Net to Shareholder		**$ 64.15**
Tax Rate		**35.85%**

Service Business (Re)Classification

Marginal Rate Example –
Taxable Income of $479,000 – $600,000 (MFJ)

Pass-through

Income		$ 100.00
Normal Pass-Through Tax	35%	(35.00)
Net to Business Owner		$ 65.00
Tax Rate		**35.0%**

No Deduction

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	23.8%	(18.80)
Net to Shareholder		**$ 60.20**
Tax Rate		**39.80%**

Service Business (Re)Classification

Marginal Rate Example –
Taxable Income Over $600,000(MFJ)

Pass-through

Income		$ 100
Normal Pass-Through Tax	37%	(37)
Net to Business Owner		$ 63
Tax Rate		**37.0%**

No Deduction

C-Corp

Corporate Income		$ 100.00
Corporate Income Tax	21%	(21.00)
Net to Corporation		$ 79.00
Dividend		$ 79.00
Shareholder Income Tax	23.8%	(18.80)
Net to Shareholder		**$ 60.20**
Tax Rate		**39.80%**

Qualified Business Income (QBI) Deduction

Example #1
Sole Proprietor of Operating Business
(Income Below Phase-Out Range)

Taylor, married and a sole proprietor, has $100,000 net business income from her bagel shop in 2018. Taylor and her husband have $34,000 of other income and will take the standard deduction ($24,000) in 2018.

Based on these facts, below is a summary of Taylor's QBI deduction in 2018:

Net business income (a)	$100,000
Other income	34,000
Adjusted gross income	$134,000
Less: Standard deduction	- 24,000
Taxable income (b)	$110,000
QBI deduction*	**$20,000**

** QBI deduction = Lesser of: (a) 20% of net business income ($100,000 x 20% = $20,000) or (b) 20% of taxable income ($110,000 x 20% = $22,000)*

Qualified Business Income (QBI) Deduction

Example #2
Sole Proprietor of Operating Business
(Income Above Phase-Out Range)

Jack, married and a sole proprietor, has $1,000,000 net business income from his custom motorcycle shop in 2018. Jack and his wife have $50,000 of other income and will have $60,000 of itemized deductions ($10,000 real estate and state income taxes + $50,000 charitable donations) in 2018. Additionally, Jack's motorcycle business has $250,000 of W-2 wages and $100,000 of assets (unadjusted cost basis).

Based on these facts, below is a summary of Jack's QBI deduction in 2018:

Net business income (a)	$1,000,000
Other income	50,000
Adjusted gross income	$1,050,000
Less: Itemized deductions	- 60,000
Taxable income (b)	$990,000
QBI deduction*	**$125,000**

** QBI Deduction = Lesser of: (a) 20% of net business income ($1,000,000 x 20% = $200,000), (b) 20% of taxable income ($990,000 x 20% = $198,000) or (c) greater of: (i) 50% of W-2 wages ($250,000 x 50% = $125,000) or (ii) 25% of W-2 wages plus 2.5% of unadjusted cost basis of assets ([$250,000 x 25%] + [$100,000 x 2.5%] = $65,000)*

Qualified Business Income (QBI) Deduction

Example #3
S-Corporation Shareholder in a Service Business
(Income Below Phase-Out Range)

Carl, married and a 50% owner in Numbers, Inc. (a bookkeeping firm), has $100,000 of pass-through net business income in 2018. Carl and his wife have $90,000 of other income and expect to take the standard deduction ($24,000) in 2018.

Based on these facts, below is a summary of Carl's QBI deduction in 2018:

Net business income (a)	$100,000
Other income	90,000
Adjusted gross income	$190,000
Less: Standard deduction	- 24,000
Taxable income (b)	$166,000
QBI deduction*	**$20,000**

** QBI deduction = Lesser of: (a) 20% of net business income ($100,000 x 20% = $20,000) or (b) 20% of taxable income ($166,000 x 20% = $33,200)*

Qualified Business Income (QBI) Deduction

Example #4
S-Corporation Shareholder in a Service Business
(Income Above Phase-Out Range)

Amy, married and a 33.33% owner in Smiles, Inc. (a dental clinic), has $550,000 of pass-through net business income in 2018. Amy and her husband have $50,000 of other income and expect to take the standard deduction ($24,000) in 2018.

Based on these facts, below is a summary of Amy's QBI deduction in 2018:

Net business income (a)	$550,000
Other income	250,000
Adjusted gross income	$800,000
Less: Standard deduction	- 24,000
Taxable income (b)	$776,000
QBI deduction*	**$0**

** QBI deduction is completely phased out because Amy is in a service business and her income is above the phase-out range for married taxpayers*

Qualified Business Income (QBI) Deduction

Example #5
Partner in a Partnership Involved in Rental Real Estate
(Income Below Phase-Out Range)

Sara, married and a 25% partner in Blackacre, LLP (a rental real estate partnership), has $250,000 of pass-through net business income in 2018. Sara and her husband have $30,000 of other income and expect to take the standard deduction ($24,000) in 2018.

Based on these facts, below is a summary of Sara's QBI deduction in 2018:

Net business income (a)	$250,000
Other income	30,000
Adjusted gross income	$280,000
Less: Standard deduction	- 24,000
Taxable income (b)	$256,000
QBI deduction*	**$50,000**

** QBI deduction = Lesser of: (a) 20% of net business income ($250,000 x 20% = $50,000) or (b) 20% of taxable income ($256,000 x 20% = $51,200)*

Qualified Business Income (QBI) Deduction

Partner in a Partnership Involved in Rental Real Estate (Income Above Phase-Out Range)

Paul, married and a 50% partner in Greenacre, LP (a rental real estate partnership), has $750,000 of pass-through net business income in 2018. Paul and his wife have $100,000 of other income and will have $50,000 of itemized deductions ($10,000 real estate and state income taxes + $40,000 charitable donations) in 2018. Additionally, Greenacres, LP has $120,000 of W-2 wages and $4,000,000 of assets (unadjusted cost basis).

Based on these facts, below is a summary of Paul's QBI deduction in 2018:

Net business income (a)	$750,000
Other income	100,000
Adjusted gross income	$850,000
Less: Itemized deductions	- 50,000
Taxable income (b)	$800,000
QBI deduction*	**$ 65,000**

** QBI Deduction = Lesser of: (a) 20% of net business income ($750,000 x 20% = $150,000), (b) 20% of taxable income ($800,000 x 20% = $160,000) or (c) greater of: (i) 50% of W-2 wages ($120,000 x 50% x 50% = $30,000) or (ii) 25% of W-2 wages plus 2.5% of unadjusted cost basis of assets ([$120,000 x 50% x 25%] + [$4,000,000 x 50% x 2.5%] = $\boxed{\$65,000}$)*

Some other key business changes include expansion of Section 179 allowing for immediate expensing of certain fixed assets and bonus depreciation. Specific key changes include:

- Bonus depreciation has been increased to 100% versus 50% for assets purchase after September 27, 2017. The assets which now qualify include used assets which were previously excluded.

- Section 179 has been increased to an annual expensing limit of $1,000,000, up from $500,000.

- Improvements that now qualify for section 179 includes certain improvements to nonresidential real property including roofs, HVAC, fire protection and alarms.

One additional key change affects the carried interest rules. The new legislation now indicates that the holding period of a profits interest must now be three years to qualify for long term capital gains, any holding period shorter than this will be treated as short term capital gains. Limited partners will still obtain long term gains with a hold period in excess of one year. It is unclear to us at this point if this change is applicable to all carried interest including private equity and real estate sponsors or specific to only certain financial professionals. We will be doing more analysis on this subject.

As stated at our opening, the points covered here are those we thought most applicable to our clients. There are a lot of new concepts introduced in the TCJA and we will continue to inform ourselves so we can best serve our clients in complying with these new laws and exploit any benefits which may now be available in managing our tax liabilities. Best wishes to a healthy, happy and successful 2018.

Thank you,

Simantob & Associates, Inc.

Simantob & Associates, Inc.
Certified Public Accountants