Jackson Walker

Tax Reform and its Impact on Individuals and Businesses

	Prior Law	Tax Cuts and Jobs Act	Impact
Tax Brackets	**Seven Rates** Ranges from 10% to 39.6% 39.6% top rate applied to income in excess of $470,000 for married couples filing jointly	**Seven Rates** 10% - up to $19,050 12% - up to $77,400 22% - up to $165,000 24% - up to $315,000 32% - up to $400,000 35% - up to $600,000 37% - $600,000 and beyond * all expiring 12/31/2025	The new rate brackets apply new, lower rates that will benefit most taxpayers In previous iterations of the legislation, the rate bracket hurdles for higher income tax payers were greater. Those hurdles were lowered (to still beneficial levels), and an expiration was put into place to help offset the cost of the legislation. Inflation adjustments to the taxable income were also modified to use a method that grows at a slower pace (chained CPI)
Standard Deduction and Itemized Deductions	Standard deduction: $6,350 for single filers and $12,700 for married couples filing jointly Itemized deductions are phased out starting at $313,800 for married couples filing jointly Personal exemption of $4,150 per person in a family	No itemized deduction phase outs, but the standard deduction is raised for single filers to $12,000 and $24,000 for married couples filing jointly Personal exemptions are eliminated and child tax credit is increased to $2000 (phased out beginning at $400,000) Deductions allowed for state & local tax, property tax or sales tax, but $10,000 cap The home mortgage interest deduction is allowed only up to $750,000 for newly purchased homes (from $1 million) Eliminates the 2% AGI miscellaneous deduction (e.g., miscellaneous pass through deductions, casualty/theft losses, investment expenses, etc…) * all expiring 12/31/2025	The standard deduction is not really doubled - personal exemptions (currently $4050 per person) are being eliminated to fund the increase Taxpayers who itemize cannot: • use personal exemptions • deduct state income taxes over $10,000 The net effect of the change may be to push more people into using the standard deduction, thereby accomplishing simplification

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Capital Gains	Current upper limit is 20%	The capital gains rate is unchanged	Previous proposals would have treated capital gains, dividends and interest as ordinary income, but at half the effective rate
401(k)	For 2018, individuals are able to contribute up to $18,500 annually with respect to 401(k) plans	No change	Discussions prior to the release of the legislation had included a drop in 401(k) contributions to $2,400 annually
S Corporation/ Partnership/ Sole Proprietorship	Income items flow through a pass-through entity and are taxed based on the tax rate applicable to the ultimate taxpaying owners of the entity	A taxpayer can deduct 20 percent of his allocable share of "qualified business income" of LLCs, partnerships, S corporations and sole proprietorships <u>But</u>, if taxpayer's taxable income exceeds the "threshold amount" ($315,000 for joint filers or $157,500 for single filers) such deduction cannot exceed the greater of: (i) 50% of taxpayer's allocable share of W-2 wages; or (ii) the sum of (a) 25% of W-2 wages and (b) 2.5% of the purchase price of qualified property used in the trade or business The deduction applies to "specified service businesses" (e.g., law, medicine, accounting, investment, etc…) as well, but only where the taxpayer's taxable income does not exceed the threshold amount (subject to phase out above such amount)	The deduction originated in the Senate bill, and varied between 17.4% and 23% before landing at 20% Taken alone, this deduction would reduce the effective pass through rate to a maximum rate of 29.6%, but the specified service business limitation and the threshold amount limitation will significantly impact the ability to take such deductions High wage-paying businesses may fit the 50% of W-2 wages and thus qualify for the 20% deduction. Real estate companies may fit the 2.5% of assets and also qualify for the 20% deduction. But for many other businesses with modest wages and limited tangible assets, this 20% deduction may be illusory once income thresholds are reached Notably, the specified service business limitation does not apply to engineering and architecture

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Corporate Tax	Maximum rate: 35% 48% Combined rate w/ dividends Combined rate, with dividends and the Net Investment Income Tax of 3.8% (the "NII"): 50.5%	Maximum rate is reduced to 21% (industrialized world average rate: 22.5%) Combined rate, with dividends: 36.8% Combined rate, with the NII: 39.8%	The corporate tax rate reduction should lead to renewed interest in C corporations: • Combined may be equivalent to a partnership investment where income exceeds threshold amounts (based on specific facts regarding W-2 income and qualified property) • Eliminates partnership complexity Section 1202 small business corporations may become one of the best bets in entity formation - An investment in qualifying small business stock can be sold tax-free (a 0% capital gains rate) if held for at least five years, effectively dropping the income tax rate to 21%
Business Tax Changes for Corporations, Partnerships and Other Entities		100% accelerated depreciation for capital expenses – applies 2018 through 2022, and then phases out at 20% per year, beginning in 2023 Section 179 expensing is increased to $1 million for "qualified property" (i.e., tangible personal property used in a trade or business), with a phase-out beginning at $2.5 million For non-corporate taxpayers, the excess of aggregate deductions attributable to trades and businesses, over the sum of (i) aggregate gross trade or business income or gain of the taxpayer plus a (ii) threshold amount ($500,000 for married filing jointly, $250,000 for others) must be carried forward as NOLs	The immediate deduction and expensing opportunities would enable entities to recover their expense on a much quicker basis for the next five years. Further, the deduction would even apply to previously used property, a departure from prior law where the taxpayer could only take accelerated deductions with respect to items the original use begins with the taxpayer. The excess business loss limitation will reduce the ability for partners in a partnership (and shareholders in an S corporation) to deduct losses against ordinary income from other sources

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Business Tax Changes Continued…		Business (whether C corp, partnership or other) deduction for interest expense (if not offset by interest income) is limited to 30% of adjusted taxable income. For pass through entities, this is determined at the entity level. Exemptions exist if: (i) If average annual gross receipts for the three prior tax years do not exceed $25 million; or (ii) The entity is a real property development, construction, acquisition, rental, operation, management or leasing trade or business that makes an election The deduction for net operating losses are is limited to 80% of taxable income, and although NOLs can be carried forward indefinitely, they cannot be carried back Dividends received deduction is reduced to reflect the lowered corporate rate (80%/70% DRDs are now 65%/50%) Deductions for executive compensation of greater than $1 million for public/registered corporations have become more difficult - commissions and performance-based compensation now subject to the limit The domestic production activities deduction has been eliminated along with most other business credits Certain meals and entertainment expenses are no longer be deductible Eliminates the corporate AMT	The limitation on the deduction of interest expenses could create a chilling effect on corporate bond programs Unrelated businesses should be operated within separate entities in situations where the individual businesses may be exempt from the interest limitation under the $25 million average annual gross receipts test

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International		Creation of a territorial tax system - Multinational corporations will generally not be taxed on their foreign active profits other than high profit foreign subsidiaries Repatriation – 15.5% for cash and 8% for illiquid assets, payable over 8 years	Repatriation of foreign assets has become the avenue to offset other tax breaks to hit the $1.5 trillion limit on tax reform, and therefore the rate crept up from the House Bill to the Senate Bill to the final version of the legislation.
Carried Interest		Three-year holding period requirement for treatment as long term capital gain with respect to certain partnership interests received in connection with the performance of services where the partnership business activity includes investing in or developing securities, commodities and real estate	Gains would be short-term capital gains, unless the underlying investment is held for more than three years Applies with respect to both the sale of the partnership interest as well as the underlying assets Although seemingly aimed at hedge funds and private equity, hedge funds often generate short-term capital gains already, and private equity funds typically hold for more than three years
Executive Compensation		Employees who receive stock in their employer as compensation upon the exercise of options or settlement of restricted stock units may elect to defer recognition of income for up to 5 years following exercise, subject to meeting tests for 80% employee participation (and excluding top earners)	There are many limitations with respect to the 83(i) election, which significantly curtails its usefulness to employees. Further, the deferral election only applies with respect to federal income taxes. Therefore the employer would generally need to collect and pay over employment related taxes, so withholding would still be applicable
Affordable Care Act Taxes	3.8% on "net investment income" and an additional 0.9% Medicare employment tax	Repeal of the individual mandate to buy insurance, but no change to the net investment income or Medicare tax	Future legislation may be used to repeal and replace the Affordable Care Act.

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Estate Tax		Estate and gift tax exemption doubled (to just under $11.2 million per taxpayer) * expires 12/31/2025	Although permanent repeal was debated, the end result was to expand the exemption, taking many people outside the reach of estate and gift taxes The step up in basis for assets owned by a decedent was untouched, leaving a very significant benefit to those receiving property from a decedent
Alternative Minimum Tax		Retained for individuals, but with a higher exemption amount	The AMT was retained for individuals due to the cost of the legislation
Other Surprising Changes		1031 is now only applicable with respect to real property No deduction allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if payments are subject to a nondisclosure agreement No long-term capital gain treatment for sales of self-created patents and IP A sale of 50% or more of a partnership interest is no longer a termination 529 accounts can be used to fund elementary and secondary school expenses at up to $10,000 per year Employer contributions to medical savings accounts are still not taxable income Alimony payments are not deductible by payor spouse or included in the income of the payee spouse	

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