Tax Reform? – An Analysis of the Individual Provisions of the 2017 Tax Act

January 30, 2018

On December 22, 2017, the United States Congress enacted legislation that is informally known as the Tax Cuts and Jobs Act (the “Act”). The Act is generally effective starting in calendar year 2018 (or fiscal years that begin after December 31, 2017). Most of the tax provisions will expire on December 31, 2025. Unless the effective date is otherwise mentioned, the discussion below applies to 2018 through 2025 taxable years.

This client alert only discusses the provisions of the Act that affect individuals. The business provisions of the Act (including the international provisions) are discussed in a separate client alert).

Several provisions that were included in the House or Senate versions of the tax bill (or both) were dropped at the Conference Committee level. Our understanding is that some of these provisions may be included in a potential 2018 tax bill.

Individual Taxation

Below is a summary of the provisions of the Act that relate to the income tax liability of individuals.

	2018 – Pre-existing Tax Law	2018 – Revised Tax Law
Ordinary Income Rate	Seven rate brackets ranging from 10-39.6%	Seven rate brackets ranging from 10-37%
Long-term Capital Gain and Dividend Rate	Three rate brackets ranging from zero to 20%	Change in thresholds, but no change in rates
Rate on Business Income	Taxed at ordinary rates	Deduction of 20% to reduce rate
Alternative Minimum Tax (AMT)	Rate of 26-28%; Exemption of \$86,200 (\$55,400 for single taxpayers)	Exemption increased to \$109,400 (\$70,300 for single taxpayers)
Net Investment Income Tax	Rate of 3.8%	No change
Personal Exemption	\$4,150 per dependent, but a phase-out for high income individuals	Repealed
Basic Standard Deduction	\$6,500 – single \$13,000 - joint	\$12,000 – single \$24,000 – joint
Child Tax Credit	\$1,000 per child, but a phase-out for middle-income taxpayers	\$2,000 per child, but a phase-out for high-income taxpayers
Dependent Credit	None	\$500 per US citizen dependent, but a phase-out for high-income taxpayers
Kiddie Tax	Taxed at the parent’s rate	Taxed at trust rates (without the 10% bracket)
Itemized Deduction Limitation	No limit, but a phase-out for high-income individuals	No limit; phase-out repealed
Medical and Dental Expenses	Deduction over 10% of adjusted gross income (7.5% for those over 65 years old)	Deduction over 7.5% (regardless of age) of adjusted gross income (2017 and 2018 only)
State and Local Taxes	Deduction allowed	Deduction allowed (but limited to \$10,000)
Foreign Taxes	Deduction for real property and income taxes allowed	Only income tax deduction allowed

Mortgage Interest	Deduction on first $1.1 million of principal (on up to two residences)	Deduction for home equity interest repealed; Deduction allowed on first $750 thousand of principal ($1 million, in the case of debt incurred before December 15, 2017).
Investment interest	Deduction (but limited to investment income)	No change
Charitable contributions	Deduction (but limited to 50% of adjusted gross income)	Limitation increased to 60%
Teacher expenses	Up to $250	No change
Miscellaneous itemized deductions	Deduction over 2% of adjusted gross income	No deduction
Penalty under Individual Healthcare Insurance Mandate	$695 or less	Reduced to zero after 2018
Effect of Death on Basis	Step-up to fair market value	No change
Estate Tax	Rate of 18-40%	No change
Gift Tax	Rate of 18-40%	No change
Estate and Gift Tax Lifetime Exclusion Amount	$5.49 million	$10.98 million

Rate Brackets. The Act does not change the number of brackets. However, the rates and bracket thresholds would change significantly. The rates under the Act and current law are as follows:

Married Couples Filing a Joint Return – Ordinary Income Rates

Taxable Income	2018 – Pre-existing Tax Law	2018 – Revised Tax Law
$19,050 or less	10%	10%
$19,050 to $77,400	15%	12%
$77,400 to $165,000	25-28%	22%
$165,000 to $315,000	28-33%	24%
$315,000 to $400,000	33%	32%
$400,000 to $600,000	33-39.6%	35%
More than $600,000	39.6%	37%

Married Couples Filing a Joint Return – Long-term Capital Gains and Dividends – Rate Thresholds

Rate	2018 – Pre-existing Tax Law	2018 – Revised Tax Law
Zero	$77,400 or less	$77,200 or less
15%	$77,400 to $480,050	$77,200 to $479,000
20%	More than $480,050	More than $479,000

Single Individuals – Ordinary Income Rates

Taxable Income	2018 – Pre-existing Tax Law	2018 – Revised Tax Law
$9,525 or less	10%	10%
$9.525 to $38,700	15%	12%
$38,700 to $82,500	25%	22%
$82,500 to $157,500	25-28%	24%
$157,500 to $200,000	28-33%	32%
$200,000 to $500,000	33-39.6%	35%
More than $500,000	39.6%	37%

Single Individuals – Long-term Capital Gains and Dividends – Rate Thresholds

Rate	2018 – Pre-existing Tax Law	2018 – Revised Tax Law
Zero	$38,700 or less	$38,600 or less
15%	$38,700 to $426,700	$38,600 to $239,500
20%	More than $426,700	More than $239,500

Under the Act, the largest decrease in tax would potentially go to high-income married taxpayers. The high rate drops from 39.6% to 37%, providing a significant benefit. Under prior law, the 39.6% rate applied to taxable income over $480,050. The increase to $600,000 for the highest rate bracket would provide an additional significant benefit to this group. The benefit to high-income single taxpayers is not as great, as the highest rate bracket threshold only moved from $426,700 to $500,000.

The rate brackets after 2018 will be adjusted for inflation. However, the methodology will change from the current use of the Consumer Price Index for All Urban Consumers ("CPI-U") to the Chained Consumer Price Index for All Urban Consumers ("C-CPI-U"). This is expected to reduce the benefits of the changes in rate brackets (and other tax attributes) over time.

The Act does not require the Internal Revenue Service (IRS) to issue new wage withholding tables until January 2019. However, new wage withholding tables have already been released. The new tables are required to be used by February 15, 2018. However, early adoption is encouraged.

State Taxes. The Act generally limits the personal deduction of state and local taxes to $10,000 per taxable year. Property and income taxes can be deducted up to the limit. Taxpayers can deduct sales tax, in lieu of income taxes.

Practitioners had thought, based on early versions of the legislation, that it might be possible to prepay 2018 income taxes in 2017. The Act provides that income taxes that are prepaid will be treated as paid on the last day of the taxable year to which it relates. As a result, it would not be possible to deduct 2018 (and later) income taxes in 2017 to avoid the $10,000 limitation. Whether a prepayment of property taxes is allowed is an open question and depends, in part, on whether the tax was assessed before December 31, 2017.

State and local (and foreign) taxes that relate to a trade or business are still deductible, as well as taxes that relate to the production of income. That is, taxes that in past have been properly deducted on Schedules C, E, and F are still deductible.

AMT. The AMT is retained for individuals. However, the exemption amount is increased to $109,400 ($70,300 for single taxpayers). In addition, the phase-out threshold is increased to $1 million ($500,000, in the case of a single taxpayer).

Under prior law, most individuals were liable for AMT due to adjustments for state and local tax deductions. With the new limitation of the deduction to $10,000, it is doubtful that many individuals will be liable for AMT in the future.

Business Income. For 2017, individual rates on business income could go as high as 39.6%. The Act significantly reduces the taxes owed by business owners. Individuals, estates, and trusts will be permitted to deduct an amount equal to 20% of taxable domestic net profits from a partnership, S corporation, or sole proprietorship. This provision reduces the rates on business income to a range of approximately 8 to 29.6%.

Employees will not benefit from the 20% deduction with respect to their wages. In addition, the trade or business of performing services as an employee is not treated as trade or business that qualifies for the deduction. Similarly, wages and guaranteed payments received by an equity-holder in a business will not be taken into account in determining the amount of the deduction.

Service income received by high-income taxpayers will not generally qualify for the 20% deduction. A service trade or business will not generally be treated as a qualifying trade or business if the principal asset of the business is the reputation or skill of one or more employees or owners. More specifically, the deduction is generally unavailable with respect to services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. (The deduction is available with respect to engineering and architecture services.) In addition, the deduction is generally not available with respect to a service trade or business which consists of investing and investment management, trading, or dealing in securities (and other financial assets).

Service trades or businesses described in the prior paragraph will qualify for the 20% deduction if the taxpayer has taxable income of $315,000 ($157,500 for single taxpayers) or less. The benefit of the deduction is phased-out for taxpayers over the taxable income threshold. The benefit is fully phased out if the taxpayer has taxable income of $415,000 ($207,500 for single taxpayers) or more. It should be noted that taxable income, for this purpose, takes into account all of the income and deductions of the taxpayer (other than the 20% deduction).

The deductible amount with respect to each trade or business is computed separately and equals 20% of the net income of the trade or business. The deductible amount is reduced by 20% of the net loss for each trade or business (including net losses that were carried forward from prior taxable years). The total deduction is limited to 20% of the ordinary taxable income of the taxpayer (i.e., taxable income reduced by net capital gains and dividend income that qualifies for preferred rates).

If the taxpayer has a net aggregate loss for all of the qualifying trades or businesses in a taxable year, no deduction is available in that taxable year. The net aggregate loss is than carried forward indefinitely and reduces the 20% deduction in subsequent taxable years.

The deductible amount with respect to each trade or business is generally limited to 50% of the W-2 wages (including elective deferrals and deferred compensation) paid during the calendar year that ends during the taxable year. Only wages that are allocable to qualifying business income are taken into account. In addition, wages that are not reported on Form W-2 on a timely basis (or within 60 days of the extended due date) will not be treated as W-2 wages for this purpose.

Capital-intensive businesses (such as real estate) can use a different formula to determine the W-2 wage limitation (if greater). In such case, the formula is 25% of W-2 wages, plus 2.5% of the basis of tangible depreciable property (without adjustment for depreciation, amortization, or depletion). The basis of tangible property will not be taken into account after the end of the depreciable useful life of the property (or ten years, if later). For example, if an individual acquires a rental property for $100 million, the limitation on the deduction would be at least $2.5 million each year (even if the business has no employees).

The W-2 wage limit will not apply to a taxpayer with taxable income of $315,000 or less ($157,500 in the case of a single individual). The limit is phased-in for taxpayers over the taxable income threshold. The benefit is fully phased-in if the taxpayer has taxable income of $415,000 ($207,500 for single taxpayers) or more. It should be noted that taxable income, for this purpose, takes into account all of the income and deductions of the taxpayer (other than the 20% deduction).

In determining the net income or loss of a qualified trade or business, all items of income, gain, deduction, or loss ("taxable income items") attributable to the qualified trade or business are generally taken into account to the extent included or allowed in determining taxable income for the taxable year. Taxable income items with respect to a qualified trade or business are only taken into account if they are effectively connected with a US trade or business. In addition, investment items (e.g., capital gain or loss, dividends, interest) and related expenses are not taken into account in determining net income or loss.

In addition to the above, certain other items are eligible for the 20% deduction. These items are:

- dividends received from a real estate investment trust (REIT) that does not qualify for the preferred tax rate for capital gains and dividends,
- patronage dividends received from a cooperative, and
- the net amount of domestic taxable income items allocable from a publicly-traded partnership (that is not treated as a corporation) that is attributable to a qualified trade or business (including gain from the sale of the partnership).

The 20% deduction is not taken into account in determining the amount (or usage) of a net operating loss (NOL) and is generally treated as an itemized deduction. However, individuals that do not itemize are also entitled to the 20% deduction. In addition, the 20% deduction is not available for purposes of the self-employment tax or the net investment income tax.

> Example. Assume H and W file a joint return and have taxable income of $420,000 (before the 20% deduction). H engages in a trade or business that has net income of $300,000 (and W-2 wages of $100,000 and no tangible property). W also engages in a trade or business that has a net loss of $40,000 (and no W-2 wages). In addition, H and W have a net aggregate loss carryforward from the prior taxable year of $50,000.
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> The maximum deduction available with respect to H's business is $60,000 ($300,000 times 20%). However, the W-2 wage limit is $50,000 ($100,000 times 50%). As a result, the deductible amount with respect to H's business is limited to $50,000.
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> The deduction is reduced by 20% of the net losses from W's businesses and the carryforward loss from the prior taxable year. Thus, the deduction is reduced by $18,000 ($90,000 times 20%).
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> The deduction before limitation is $32,000 ($50,000 less $18,000). The taxable income limitation equals $84,000 ($420,000 times 20%). As a result, the deduction equals $32,000.

Excess Business Losses. At present, individuals can generally deduct active business losses. However, net losses from passive activities are carried forward indefinitely.

The Act would impose a limitation on all net business losses of an individual, estate, or trust. Net losses from trades or businesses (including from a partnership or S corporation) in excess of $500,000 ($250,000 in the case of a single taxpayer) would be disallowed. The disallowed loss could be carried forward indefinitely. However, the limit on NOL deductions of 80% of taxable income would also apply to the carryforward of excess business losses. The existing limit on passive losses would continue to apply (and applies first).

Carried Interests. Investment managers frequently get a share of profits in investment vehicles that relate to the capital contributed by investors. The economics of such a carried interest bears resemblance to compensation for services. However, under prior law, income from a carried interest was typically taxed at capital gains rates (up to 20%) if an underlying investment was held for at least one year.

The Act changed the holding period for long-term capital gain treatment attributable to carried interests (i.e., a profits interest in a fund partnership that is received for services) from one year (the general requirement) to three years. This provision applies to gain on the sale or exchange of an interest in the fund partnership, as well as to gain recognized by a partnership from the sale or exchange of an asset held by the partnership for portfolio investment on behalf of third-party investors (e.g., securities, commodities, real estate, and options or derivatives with respect to the foregoing).

Gain that does not meet the three-year holding period requirement would be treated as short-term capital gain (even if the gain would otherwise be treated as ordinary compensation income pursuant to section 83).

This change may have limited effect on the tax treatment of employees and partners of private equity and real estate funds, since such funds frequently hold investments for more than three years. It may affect the employees and partners of hedge funds with respect to gain from the windup of the fund (but not gain from the underlying investments, which are typically held for less than one year).

The provision on carried interests does not apply to a partnership interest that is held by a corporation. It is possible that the provision provides an unintended exemption from the rule for carried interests that are held by S corporations.

A special rule applies if a carried interest is transferred to a member of the taxpayer's family or a colleague. In such case, the gain that is attributable to assets that are held by the partnership for less than three years is included in gross income by the transferor as short-term capital gain.

Like many of the provisions in the Act, the changes to the taxation of carried interests apply to taxable years beginning after 2017. As a result, existing carried interests would be subject to the new rules.

Other Personal Deductions. The Act would also repeal the following personal tax benefits:

- deduction for personal casualty losses (other than with respect to a federally designated disaster),
- deduction for alimony payments (as well as inclusion in gross income by recipient) for divorces and separations executed (or modified) after December 31, 2018,
- charitable deduction of college athletic event seating rights,
- deduction and exclusion for moving expenses (other than for members of the armed forces), and
- exclusion for bicycle commuting reimbursements.

Other Provisions. The Act changes the tax treatment of certain self-created intangible assets. As a result, the creator of a patent, invention, model or design (whether or not patented), or secret formula (or process) will not be able to treat these assets as a capital asset. Gain or loss from the sale or exchange of such property will be treated as ordinary income or loss. This change is effective for dispositions after December 31, 2017.

WTS Observation

The Act presents a major overhaul of many longstanding aspects of US taxation. One surprising aspect of the Act is that there are so many taxpayers whose taxes will increase as a result (either in 2018 or several years later). The individuals whose taxes will increase are in all income brackets. That being said, businesses (and people who invest in businesses) seem to generally do the best under the changes.

The Act is estimated to cut taxes by approximately $1.5 trillion over ten years. The proponents of the Act believe that the increased economic growth caused by the tax reductions will provide extra tax revenue for the government and will pay for some or all of the projected increase in the deficit. Time will tell if they are correct.

The Act will possibly be the first of several pieces of tax legislation that will be signed into law in 2018. Other significant tax bills that are expected to receive serious consideration, include:

- repeal of Obamacare taxes that have not yet become effective (e.g., the medical device and “Cadillac” healthcare plan excise taxes),
- technical corrections to the new partnership audit rules (and other recently-enacted tax laws), as well as the Act itself,
- extension of tax provisions that recently expired (or are due to expire in the near future), and
- enactment of tax reform provisions that were dropped from the Act.

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