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Tax Law

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Income Tax Provisions of the Tax and Jobs Act

On December 22 President Donald J. Trump signed into Law H.R. 1, "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," the most comprehensive tax reform measure since 1986. We've limited our summary to the income tax provisions of the Act we believe are most relevant to our readers. We are also publishing separate alerts on the estate, gift and generation-skipping transfer tax provisions, as well as the provisions that affect tax-exempt organizations. This alert does not cover the international provisions of the Act, but we will circulate a separate alert later if there is sufficient interest. If you are interested in provisions of the Act not covered here, please contact us.

Effective Dates

In order to pass this legislation with a majority vote in the Senate, instead of the normally required 60 votes, the legislation was enacted as a budget reconciliation measure. The Senate's "Byrd" rule prohibits legislation enacted under budget reconciliation from adding to the deficit outside of the 10-year budget window. The legislation also needed to constrain any increase in the deficit during the 10-year budget window to the $1.5 trillion permitted by the budget resolution that had been previously adopted. The original name of the bill, the "Tax Cut and Jobs Act," was also held to violate the Byrd rule, so it was removed from the bill, although it will likely continue to be referred to by that name.

In order for the significant changes enacted for corporations, including the new 21 percent income tax rate, to be permanent, it was necessary that virtually all of the provisions in the legislation affecting individuals – including those that lower tax rates, increase exemptions and repeal deductions – sunset, or expire, after 2025. Without further legislation, in 2026 the tax code will look very much like it does today for individual taxpayers. Of course, if the balance of power in Washington shifts, there could be new tax legislation even before 2026.

Basis Increase at Death

The Act retains Internal Revenue Code Section 1014, which provides for a fair market value income tax basis for all property received from a decedent. This provision has been a part of the law and is not changed by the Act, so it does not sunset after 2025.

Maximum Tax Rate

The Act lowers the maximum income tax rate applicable to individuals to 37 percent beginning in 2018. The maximum rate will become applicable when taxable income exceeds $600,000 on a joint return, $500,000 on the return of a single individual and $300,000 on the return of a married person filing separately. The maximum tax rate on long-term capital gain income and qualified dividend income will remain at 20 percent, and the 3.8 percent Medicare tax is also retained. After 2025, the maximum rate will revert to 39.6 percent.

Itemized Deductions

Charitable contributions. The Act increases the limitation on the deduction of cash contributions to publicly supported charities and private operating foundations from 50 percent of the taxpayer's adjusted gross income to 60 percent, beginning in 2018.

State and local taxes. Beginning in 2018, the Act will repeal all deductions for state and local taxes in excess of $10,000. A taxpayer may deduct up to $10,000 of state property or income taxes (or sales taxes in lieu of income taxes). For many people, it will be beneficial to pay the remaining balance due on any 2017 state income or property taxes in December, provided you are not already subject to the Alternative Minimum Tax and the payment does not cause you to become subject to AMT. Your accountant can help you with this analysis.

The Act prohibits any deduction in 2017 for 2018 state or local taxes that are paid during 2017, so there is no benefit to making prepayments of taxes you expect to owe for 2018.

Home mortgage interest. The Act reduces the maximum amount of a home mortgage loan on which interest can be deducted from $1 million to $750,000 after December 31, 2017. Existing loans incurred before December 15, 2017 are grandfathered at the prior $1 million amount. The deduction of interest on home equity loans of up to a $100,000 loan amount is repealed beginning in 2018.

Medical expenses. The Act also leaves intact the deduction for medical expenses, which the House bill would have repealed. For 2017 and 2018, the adjusted gross income threshold above which medical expenses may be deducted is lowered from 10 percent to 7.5 percent, both for purposes of the regular income tax and the alternative minimum tax.

Alimony payments. The Act repeals the deduction for alimony payments for divorce or separation agreements entered into after December 31, 2018 (so in this case the repeal was delayed for one year). The spouse receiving alimony will also not be taxed on such amounts after 2018.

Casualty losses. The Act limits the deduction for casualty losses to losses sustained from events declared by the president to be disasters, beginning in 2018.

Miscellaneous itemized deductions. The Act repeals all of the miscellaneous itemized deductions that were subject to the floor of 2 percent of adjusted gross income, beginning in 2018. This encompasses a variety of deductions including fees for tax return preparation, unreimbursed employee business expenses, investment fees and expenses, and union and professional dues.

Although not specifically addressed, it appears that trusts and estates will continue to be able to deduct those expenses that would not have been incurred if the particular property had not been held in an estate or trust. Tax regulations provide that expenses of this nature are not treated as miscellaneous itemized deductions, so they should not be affected by the legislation.

Student loan interest. The Act leaves intact the deduction for interest expense incurred on a student loan. This deduction would have been repealed by the House bill.

Overall limitation on itemized deductions. The phase-out of itemized deductions is repealed for tax years after 2017.

Alternative Minimum Tax

The alternative minimum tax will remain a part of our tax system for individuals with an increase of the exemption amount to $109,400 for married taxpayers filing a joint return and $70,300 for single individuals. The income level where the exemption phases out was increased to $1 million for married taxpayers filing a joint return and $500,000 for single individuals. Many people who were subject to AMT in the past will find it does not apply to them beginning in 2018. For many people, the principal item that caused them to become subject to AMT was the deduction of state and local income and property taxes. Beginning in 2018, this deduction will be limited to $10,000 per year, which will result in fewer people being subject to AMT. The deduction of miscellaneous itemized deductions also contributed to individuals becoming subject to AMT, and these deductions are also repealed beginning in 2018.

The Act did repeal the corporate alternative minimum tax, which the Senate bill would have retained. Considerable concern had been raised that retaining the corporate alternative minimum tax would have taken away much of the value of certain tax credits, including the research and development credit.

Business Income Received by Individuals and From Pass-Through Entities

The Act generally followed the approach adopted by the Senate regarding income received by individuals from pass-through entities and proprietorship businesses. New IRC Section 199A provides a deduction in the amount of 20 percent of the taxpayer's net qualified business income that, when coupled with the 37 percent maximum income tax rate, results in a maximum effective income tax rate on qualified business income of 29.6 percent. The deduction is limited to an amount equal to the greater of: i) 50 percent of the W-2 wages paid by the business; or ii) the sum of 25 percent of the W-2 wages paid by the business and 2.5 percent of the unadjusted tax basis of the depreciable assets used in the business where the depreciation life has not expired. For this purpose, an asset is given a minimum depreciation life of 10 years. The use of "unadjusted basis" will generally mean that depreciable assets will be considered at their original purchase cost when computing the 2.5 percent number. This limitation establishes a significant advantage for businesses that employ significant numbers of people or significant amounts of capital.

There is an exception to this limitation for individuals with taxable income less than $157,500 or married couples filing jointly with taxable income less than $315,000 of taxable income, in both cases before considering the pass-through deduction.

The provision is not applicable to service-based businesses except for those earning below the above threshold amount. Engineering and architectural firms were excluded from the prohibition generally applied to service-based businesses.

The original Senate version of this provision did not allow the deduction for estates and trusts that pay income tax on their income that is not distributed to their beneficiaries. The Conference Committee changed this so that estates and trusts will also be eligible for the deduction if they own a qualified business directly or through a pass-through entity. It appears that the W-2 wages and asset basis allocated by the business to the trust or estate is further allocated between the trust or estate and its beneficiaries based on the amount of the income that is distributed or retained by the trust or estate.

Qualified business income does not include income earned outside of the United States (except for Puerto Rico), investment income such as interest (other than interest generated by the business), dividends or dividend-equivalent amounts, commodities gains, foreign currency gains, income received from notional principal contracts (derivatives) and income from annuities not related to the business. All short- and long-term capital gains are excluded as well.

Dividends from Real Estate Investment Trusts (REITs) – excluding capital gain dividends – dividends from cooperatives and income from a qualified publicly traded partnership also qualify for the 20 percent pass-through deduction.

Carried Interests

A carried interest is generally an interest that a service provider receives with respect to the future profits to be earned by a partnership or limited liability company.

The interest is generally granted for the performance of services rather than the provision of capital to the business. Critics of the existing carried interest rule have suggested that it is not good tax policy to permit an employee to ultimately recognize capital gain income as compensation for services. The Act preserves current law treatment of carried interests; however, the interest must be held for a minimum of three years in order to result in capital gain treatment for the service provider.

Treatment of Sales of Patents

Beginning in 2018, income resulting from the sale of a patent will be treated as ordinary income rather than a capital gain if the patent is sold by the inventor of the patent or by a taxpayer who holds the patent with a tax basis derived from the inventor. IRC Section 1235 is retained to provide capital gain treatment on patent sales by taxpayers other than the inventor or others with tax basis derived from the inventor.

Sales of Music Copyrights

The Act retains the current capital gain treatment for the sale of music copyrights by the songwriter. An early version of the House bill would have repealed this provision, but the change was later dropped.

Limitation on the Deduction of Business Losses

For taxpayers other than corporations, business losses in excess of $250,000 for an unmarried taxpayer and $500,000 for a married couple filing jointly cannot be deducted against other nonbusiness income after 2017. Any disallowed amounts will be carried forward as a net operating loss, which can be deducted against business income in future years.

Like-Kind Exchanges

IRC Section 1031 is amended to limit tax-deferred like-kind exchanges to those involving real property. Exchanges of like-kind personal property will be subject to taxation after 2017. The most significant impact of this change for many high-net-worth families is that it will no longer be possible to do like-kind exchanges of aircraft and works of art.

Sale of Stock

The Senate bill contained a provision that would have eliminated a taxpayer's ability to "specifically identify" the particular shares of stock that had been sold by the taxpayer. This rule allows a taxpayer to choose its shares having the highest tax basis. Under the House bill, taxpayers would have been required to use the "first-in, first-out" identification method, which would have resulted in higher taxes where the taxpayer's earliest purchased shares were purchased at the lowest price. The final version of the Act did not include this provision, so taxpayers will still be permitted to specifically identify the shares that they sell.

Section 529 Plans

The Act expands the levels of education for which expenses can be paid with funds held in Section 529 plans. Currently, these funds can only be used for expenses related to post-secondary education. Beginning in 2018, up to $10,000 per student per year can be used to pay expenses in connection with public, private or religious elementary or secondary education. A provision that would have allowed the payment of these expenses for home schooling was removed after the Senate Parliamentarian ruled that the provision violated the Byrd rule because the provision was extraneous to the budget.

Sale of Life Insurance Policies

Taxpayers who no longer have a need for life insurance policies they hold often sell those policies in a secondary market funded by a variety of investors. For purposes of determining the seller's gain on such a sale, the IRS issued a ruling that provides the income tax basis of the policy is the total amount of premiums paid, reduced by the mortality cost of the insurance provided by the policy. The Act reverses the IRS position that the tax basis must be reduced by the mortality charge and allows sellers to claim as their tax basis the total amount of premiums paid on the policy prior to its sale.

Business Tax Reform

Corporate tax rate. The Act permanently lowers the income tax rate for C corporations to 21 percent beginning in 2018.

Cost recovery. The Act provides for an immediate deduction for 100 percent of the cost of qualified property placed in service after September 27, 2017, and before January 1, 2023. From 2023 through 2026, the percentage that can be deducted declines 20 percentage points each year so that in 2027, no expensing is permitted under the provision. For longer-production property and certain aircraft, the deductible amount begins declining by 20 percentage points each year from 2024 through 2027. The provision will apply to used property as well as new property. In general, qualified property is personal property with a depreciable life of 20 years or less, but also includes motion picture and television productions for which a deduction would have been allowed under Section 181, without regard to the dollar limitations imposed by that section. Property used in a real estate trade or business does not qualify.

Cost recovery with respect to real property. The Conference Agreement dropped a provision in the Senate bill that would have reduced the recovery period for the cost of both residential and nonresidential real property from 39 years and 27.5 years, respectively, to 25 years for both types of property. The 39-year and 27.5-year periods will remain in effect. The Conference Agreement did follow the Senate bill in consolidating qualified improvement property, qualified leasehold improvement property and qualified restaurant property into a new single definition called "qualified improvement property." This property includes any improvement made to a nonresidential building after the building has been placed in service but does not include expenditures for enlarging the building, for escalators or elevators, or for the internal structural framework of the building. Expenditures constituting qualified improvement property can be depreciated over 15 years.

Increase in amount that can be expensed under IRC Section 179. The Act increased the amount that can be expensed under IRC Section 179 beginning in 2018 to $1 million, and increases the amount where the phase-out of the deduction begins to $2.5 million.

Business interest expense. Beginning in 2018, the deduction of interest by a business would be limited to 30 percent of its adjusted taxable income plus the amount of business interest income. For tax years beginning before January 1, 2022, taxable income is increased by the amount of deductions taken for depreciation, depletion and amortization, thereby yielding a higher deduction limit. An exception to the limitation is provided for businesses having average gross receipts of $25 million or less for the three prior taxable years. Real property businesses can elect to be exempted from the limitation by agreeing to use the alternative depreciation system, which results in somewhat longer depreciation periods for buildings.

Limitation on deduction of net operating losses. The Act repeals the two-year carryback period for net operating losses incurred after 2017 but allows an indefinite carryover period. Only 80 percent of taxable income may be eliminated by a net operating loss deduction after 2017.

Compensation Provisions

Provision taxing deferred compensation on vesting is dropped. A provision of the Senate bill that would include deferred compensation in income when it is no longer subject to a "substantial risk of forfeiture" — effectively on vesting — even if not payable until a future year, was dropped by the Conference Committee.

Limitations on executive compensation. Section 162(m) currently imposes an annual limit of $1 million on the deductibility of compensation paid by a public company to each of its covered employees. The Act amends Section 162(m) to repeal prior exceptions for performance-based compensation, including stock options and commissions, and clarifies that the list of covered employees includes the CEO, the CFO and the three other most highly compensated officers.

Once an employee is covered, they will continue to be included for as long as they receive compensation from the company (including after termination of employment). The amendment applies to taxable years beginning after December 31, 2017, with a grandfather provision for contracts that were binding on November 2, 2017.

Excise tax on executive compensation paid by tax-exempt organizations. The Act imposes a 21 percent excise tax on tax-exempt employers for payment of compensation in excess of $1million to the five highest-paid employees of the organization.

Deferral of qualified broad-based equity awards. The Act allows employees who are granted stock options or restricted stock units through a broad-based employee plan covering at least 80 percent of employees to elect to defer recognition of any gain on their exercise of the options or vesting of the units for up to five years, if such election is made within 30 days after such rights vest or become transferable. However, such plan and election is not available to 1 percent owners or the four highest-compensated officers.

Please do not hesitate to contact us if you have any questions about how the Act will apply to your particular circumstances.