January 3, 2018

**Explanation of the Tax Cuts and Jobs Act**

Dear Client,

On December 22, 2017 President Trump signed into law the Tax Cuts and Jobs Act (TCJA). The Act is a sweeping tax package containing many changes to the Internal Revenue Code. Here's a look at some of the more important elements of the new law that have an impact on both individuals and businesses. Unless otherwise noted, the changes are effective for tax years beginning in 2018 through 2025.

**Individuals**

**Tax rates.** The new law imposes a new tax rate structure with seven tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The top rate was reduced from 39.6% to 37% and applies to taxable income above $500,000 for single taxpayers, and $600,000 for married couples filing jointly. The rates applicable to net capital gains and qualified dividends were not changed. The “kiddie tax” rules were simplified. The net unearned income of a child subject to the rules will be taxed at the capital gain and ordinary income rates that apply to trusts and estates. Thus, the child's tax is unaffected by the parent's tax situation or the unearned income of any siblings.

**Standard deduction.** The new law increases the standard deduction to $24,000 for joint filers, $18,000 for heads of household, and $12,000 for singles and married taxpayers filing separately. Given these increases, many taxpayers will no longer be itemizing deductions. These figures will be indexed for inflation after 2018.

**Exemptions.** The new law suspends the deduction for personal exemptions. Thus, starting in 2018, taxpayers can no longer claim personal or dependency exemptions. The rules for withholding income tax on wages will be adjusted to reflect this change, but IRS was given the discretion to leave the withholding unchanged for 2018.

**New deduction for “qualified business income.”** Starting in 2018, taxpayers are allowed a deduction equal to 20 percent of “qualified business income,” otherwise known as “pass-through” income, i.e., income from partnerships, S corporations, LLCs, and sole proprietorships. The income must be from a trade or business within the U.S. Investment income does not qualify, nor do amounts received from an S corporation as reasonable compensation or from a partnership as a guaranteed payment for services provided to the trade or business. The deduction is not used in computing adjusted gross income, just taxable income. For taxpayers with taxable income above $157,500 ($315,000 for joint filers), (1) a limitation based on W-2 wages paid by the business and depreciable tangible property used in the business is phased in, and (2) income from the following trades or businesses is phased out of qualified business income: health, law, consulting, athletics, financial or brokerage services, or where the principal asset is the reputation or skill of one or more employees or owners.

**Child and family tax credit.** The new law increases the credit for qualifying children (i.e., children under 17) to $2,000 from $1,000, and increases to $1,400 the refundable portion of the credit. It also introduces a new (nonrefundable) $500 credit for a taxpayer's dependents who are not qualifying children. The adjusted gross income level at which the credits begin to be phased out has been increased to $200,000 ($400,000 for joint filers).

**State and local taxes.** The itemized deduction for state and local income and property taxes is limited to a total of $10,000 starting in 2018.

**Mortgage interest.** Under the new law, mortgage interest on loans used to acquire a principal residence and a second home is only deductible on debt up to $750,000 (down from $1 million), starting with loans taken out in 2018. And there is no longer any deduction for interest on home equity loans, regardless of when the debt was incurred.

**Miscellaneous itemized deductions.** There is no longer a deduction for miscellaneous itemized deductions which were formerly deductible to the extent they exceeded 2 percent of adjusted gross income. This category included items such as tax preparation costs, investment expenses, union dues, and unreimbursed employee expenses.

**Medical expenses.** Under the new law, for 2017 and 2018, medical expenses are deductible to the extent they exceed 7.5 percent of adjusted gross income for all taxpayers. Previously, the AGI “floor” was 10% for most taxpayers.

**Casualty and theft losses.** The itemized deduction for casualty and theft losses has been suspended except for losses incurred in a federally declared disaster.

**Overall limitation on itemized deductions.** The new law suspends the overall limitation on itemized deductions that formerly applied to taxpayers whose adjusted gross income exceeded specified thresholds. The itemized deductions of such taxpayers were reduced by 3% of the amount by which AGI exceeded the applicable threshold, but the reduction could not exceed 80% of the total itemized deductions, and certain items were exempt from the limitation.

**Moving expenses.** The deduction for job-related moving expenses has been eliminated, except for certain military personnel. The exclusion for moving expense reimbursements has also been suspended.

**Alimony.** For post-2018 divorce and separation agreements, alimony will not be deductible by the paying spouse and will not be taxable to the receiving spouse.

**Health care “individual mandate.”** Starting in 2019, there is no longer a penalty for individuals who fail to obtain minimum essential health coverage.

**Estate and gift tax exemption.** Effective for Decedents dying, and gifts made, in 2018, the estate and gift tax exemption has been increased to roughly $11.2 million ($22.4 million for married couples).

**Alternative minimum tax (AMT) exemption.** The AMT has been retained for individuals by the new law but the exemption has been increased to $109,400 for joint filers ($54,700 for married taxpayers filing separately), and $70,300 for unmarried taxpayers. The exemption is phased out for taxpayers with alternative minimum taxable income over $1 million for joint filers, and over $500,000 for all others.

As you can see from this overview, the new law affects many areas of taxation. If you wish to discuss the impact of the law on your particular situation, please give me a call.

**Businesses**

**Corporate Tax Rates Reduced.** For tax years beginning after December 31, 2017, the corporate tax rate for C-corporations is a flat 21% rate.

**Corporate Dividends-Received Deduction Percentages Reduced.** For tax years beginning after December 31, 2017, the 80% dividends received deduction is reduced to 65%, and the 70% dividends received deduction is reduced to 50%.

**Alternative Minimum Tax Repealed.** For tax years beginning after December 31, 2017, the corporate AMT is repealed.

For a corporation, the AMT credit is allowed to offset the regular tax liability for any tax year. For tax years beginning after 2017 and before 2022, the AMT credit is refundable in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the tax year over the amount of the credit allowable for the year against regular tax liability. Accordingly, the full amount of the minimum tax credit will be allowed in tax years beginning before 2022.

**Code 179 Expensing.** A taxpayer may, subject to limitations, elect under Code Section 179 to deduct (or “expense”) the cost of qualifying property, rather than to recover such costs through depreciation deductions. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business, and includes off-the-shelf computer software and qualified real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).

Passenger automobiles subject to the Code Section 280F limitation are eligible for Code Section 179 expensing only to the extent of the Code Section 280F dollar limitations. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the Code Section 280F limitation, the maximum cost that may be expensed for any tax year under Code Section 179 is $25,000.

For property placed in service in tax years beginning after December 31, 2017, the maximum amount a taxpayer may expense under Code Section 179 is increased to $1 million, and the phase-out threshold amount is increased to $2.5 million. For tax years beginning after 2018, these amounts (as well as the $25,000 sport utility vehicle limitation) are indexed for inflation. Property is not treated as acquired after the date on which a written binding contract is entered into for such acquisition.

In addition, under the new law, the definition of “qualified real property” under Code Section 179 is expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging as well as the following improvements to nonresidential real property after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

**Temporary 100% Bonus Depreciation of Qualifying Business Assets.** A 100% first-year deduction for the adjusted basis is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (after September 27, 2017, and before January 1, 2024, for certain property with longer production periods). Thus, the phase-down of the 50% allowance for property placed in service after December 31, 2017, and for specified plants planted or grafted after that date, is repealed. The additional first-year depreciation deduction is allowed for new and used property. (The pre-Act law phase-down of bonus depreciation applies to property acquired before September 28, 2017, and placed in service after September 27, 2017.)

In later years, the first-year bonus depreciation deduction phases down, as follows: 80% for property placed in service after December 31, 2022 and before January 1, 2024; 60% for property placed in service after December 31, 2023 and before January 1, 2025; 40% for property placed in service after December 31, 2024 and before January 1, 2026; and 20% for property placed in service after December 31, 2025 and before January 1, 2027.

For certain property with longer production periods, the beginning and end dates in the list above are increased by one year. For example, bonus first-year depreciation is 80% for long-production-period property placed in service after December 31, 2023 and before January 1, 2025.

**Luxury Automobile Depreciation Limits Increased.** For passenger automobiles placed in service after December 31, 2017, in tax years ending after that date, for which the additional first-year depreciation deduction under Code Section. 168(k) is not claimed, the maximum amount of allowable depreciation is increased to: $10,000 for the year in which the vehicle is placed in service, $16,000 for the Second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period. For passenger automobiles placed in service after 2018, these dollar limits are indexed for inflation. For passengers autos eligible for bonus first-year depreciation, the maximum first-year depreciation allowance remains at $8,000.

For passenger automobiles acquired before September 28, 2017, and placed in service after September 27, 2017, the pre-Act phase-down of the Code Section. 280F increase amount in the limitation on the depreciation deductions applies.

**Other Listed Property.** Computer or peripheral equipment is removed from the definition of listed property, and so isn't subject to the heightened substantiation requirements that apply to listed property.

**Recovery Period for Certain “Qualified” Real Property Shortened.** For property placed in service after December 31, 2017, the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property are eliminated, a general 15-year recovery period and straight-line depreciation are provided for “qualified improvement property”, and a 20-year ADS recovery period is provided for such property. Qualified improvement property is defined as any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Thus, qualified improvement property placed in service after December 31, 2017, is generally depreciable over 15 years using the straight-line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property, is depreciable as nonresidential real property, using the straight-line method and the mid-month convention.

**Limits on Deduction of Business Interest.** For tax years beginning after December 31, 2017, every business, regardless of its form, is generally subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. The net interest expense disallowance is determined at the tax filer level. However, a special rule applies to pass-through entitles, which requires the determination to be made at the entity level, for example, at the partnership level instead of the partner level.

For tax years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion and without the former domestic production activities deduction (which is repealed effective December 31, 2017).

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships (see below).

An exemption from these rules applies for taxpayers (other than tax shelters) with average annual gross receipts for the three-tax year period ending with the prior tax year that do not exceed $25 million.

**Net Operating Loss Deduction.** For net operating losses (NOL) arising in tax years ending after December 31, 2017, the two-year carryback and the special carryback provisions are repealed, but a two-year carryback applies in the case of certain losses incurred in the trade or business of farming. However, under the new law, NOLs can be carried forward indefinitely.

For losses arising in tax years beginning after December 31, 2017, the NOL deduction is limited to 80% of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation.

**Domestic Production Activities Deduction Repealed.** For tax years beginning after December 31, 2017, the Domestic Production Activities Deduction is repealed.

**Like-Kind Exchange Treatment Limited.** Generally effective for transfers after December 31, 2017, the rule allowing the deferral of gain on like-kind exchanges is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. However, under a transition rule, the pre-Act like-kind exchange rules apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

**Five-Year Write-off of Specified R&E (Research & Experimentation) Expenses.** For amounts paid or incurred in tax years beginning after December 31, 2021, “specified R&E expenses” must be capitalized and amortized ratably over a 5-year period (15 years if conducted outside of the U.S.), beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred.Specified R&E expenses subject to capitalization include expenses for software development, but not expenses for land or for depreciable or depletable property used in connection with the research or experimentation (but do include the depreciation and depletion allowances of such property). Also excluded are exploration expenses incurred for ore or other minerals (including oil and gas). In the case of retired, abandoned, or disposed property with respect to which specified R&E expenses are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

**Employer's Deduction for Fringe Benefit Expenses Limited.** For amounts incurred or paid after December 31, 2017, deductions for entertainment expenses are disallowed, eliminating the subjective determination of whether such expenses are sufficiently business related; the current 50% limit on the deductibility of business meals is expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer; and deductions for employee transportation fringe benefits (e.g., parking and mass transit) are denied, but the exclusion from income for such benefits received by an employee is retained. In addition, no deduction is allowed for transportation expenses that are the equivalent of commuting for employees (e.g., between the employee's home and the workplace), except as provided for the safety of the employee.For tax years beginning after December 31, 2025, the Act will disallow an employer's deduction for expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

**No Deduction for Amounts Paid For Sexual Harassment Subject to Nondisclosure Agreement.** Under the Act, effective for amounts paid or incurred after the enactment date, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

**Deduction for Local Lobbying Expenses Eliminated.** For amounts paid or incurred on or after the date of enactment, the Code Section 162(e) deduction for lobbying expenses with respect to legislation before local government bodies (including Indian tribal governments) is eliminated.

**Rehabilitation Credit Limited.** For amounts paid or incurred after December 31, 2017, the 10% credit for qualified rehabilitation expenditures with respect to a pre-'36 building is repealed and a 20% credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure which can be claimed ratably over a 5-year period beginning in the tax year in which a qualified rehabilitated structure is placed in service.A transition rule provides that for qualified rehabilitation expenditures (for either a certified historic structure or a pre-'36 building), for any building owned or leased (as provided under pre-Act law) by the taxpayer at all times on and after January. 1, 2018, the 24-month period selected by the taxpayer (under Code Section 47(c)(1)(C)(i)), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation (Code Section 47(c)(1)(C)(ii)), is to begin no later than the end of the 180-day period beginning on the date of the enactment, and apply to such expenditures paid or incurred after the end of the tax year in which such 24- or 60-month period ends.

**New Credit for Employer-Paid Family and Medical Leave.** For wages paid in tax years beginning after December 31, 2017, but not beginning after December 31, 2019, the Act allows businesses to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave (FMLA) if the rate of payment is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. All qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave (all less-than-full-time qualifying employees have to be given a commensurate amount of leave on a pro rata basis).

**ACCOUNTING METHOD CHANGES**

**Taxable Year of Inclusion.** In general, for a cash basis taxpayer, an amount is included in income when actually or constructively received. For an accrual basis taxpayer, an amount is included in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (i.e., when the “all events test” is met), unless an exception permits deferral or exclusion. A number of exceptions that exist to permit deferral of income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (e.g., income is recognized as the goods are provided or the services are performed).

Under the new law, generally for tax years beginning after December 31, 2017, a taxpayer is required to recognize income no later than the tax year in which such income is taken into account as income on an applicable financial statement (AFS) or another financial statement under rules specified by IRS (subject to an exception for long-term contract income under Code Section. 460).

The Act also codifies the current deferral method of accounting for advance payments for goods and services provided by Revenue Procedure 2004-34 to allow taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes. In addition, it directs taxpayers to apply the revenue recognition rules under Code Section. 452 before applying the original issue discount (OID) rules under Code Section. 1272. (Code Section. 451)

In the case of any taxpayer required by this provision to change its accounting method for its first tax year beginning after December 31, 2017, such change will be treated as initiated by the taxpayer and made with IRS's consent.

Under a special effective date provision, the AFS conformity rule applies for OID for tax years beginning after December 31, 2018, and the adjustment period is six years.

**Cash Method of Accounting.** For tax years beginning after December 31, the threshold for the gross receipts test (i.e., the average annual gross receipts for the entity for the three preceding tax years) which allows corporations and partnerships with a corporate partner to use the cash method (i.e., other than tax shelters) has been increased from $5 million to $25 million regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. Thus, taxpayers with annual average gross receipts that do not exceed $25 million (indexed for inflation for tax years beginning after December 31, 2018) for the three prior tax years are allowed to use the cash method.

In addition, the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations are retained. Accordingly, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of the method clearly reflects income.

**Accounting for Inventories.** For tax years beginning after December 31, 2017, taxpayers which carry inventories that meet the $25 million gross receipts test are not required to account for inventories under Code Section. 471, but rather may use an accounting method for inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer's financial accounting treatment of inventories. In addition, such taxpayers can use the cash method of accounting instead of the accrual method.

**Capitalization and Inclusion of Certain Expenses in Inventory Costs.** For tax years beginning after December 31, 2017, the gross receipts test threshold for applying the uniform capitalization (UNICAP) rules, which generally require the capitalization of certain direct and indirect costs associated with the manufacture or re-sale of real or personal property, has been increased to $25 million. Thus, any producer or re-seller that meets the $25 million gross receipts test is exempted from the application of the UNICAP rules of Code Section 263A. Previously, the gross receipts test threshold for retailers and wholesalers was $10 million, while all manufacturers, regardless of the amount of gross receipts were subject to the UNICAP rules. The exemptions from the UNICAP rules that are not based on a taxpayer's gross receipts are retained.

**Accounting for Long-Term Contracts** For contracts entered into after December 31, 2017, in tax years ending after that date, the exception for small construction contracts from the requirement to use the percentage-of-completion method is expanded to apply to contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $25 million gross receipts test.

Use of this PCM exception for small construction contracts is applied on a cutoff basis for all similarly classified contracts (so there is no accounting method change adjustment under Code Section. 481(a) for contracts entered into before January 1, 2018).

We hope you find the above overview of the more important changes to the tax code helpful, and, if you have any questions, please do not hesitate to contact us.

Very truly yours,

Richard Scrivanich, Partner

For Harvey & Parmelee LLP