UNDERSTANDING THE TAX CUTS AND JOBS ACT

The following is a basic 7-page summary of the tax changes contained in the 1,097-page Tax Cuts and Jobs Act (The Act) passed earlier this year. This summary is concerned primarily with changes that impact individuals, small businesses and pass-through entities.

We are not going to cover Estates and Trusts, Corporations or retirement plan changes at this time. Individuals interested in the full impact can find detailed discussion at https://taxfoundation.org and https://en.wikipedia.org. Commerce Clearing House also has a 108 page summary which discusses current rules and the changes for all entities.

The Act is meant to last 8 years during which Congress plans to continue to evaluate and update the tax laws for subsequent periods. There are a few provisions which are designated as permanent changes to the tax code and they are annotated as such below.

How Taxable Income and Tax and Calculated:

None of the changes will make any sense if you do not understand how your taxes are determined. The below is a very abbreviated discussion of that calculation.

Gross income: This is everything earned from work, investments, income from flow-through entities and net self-employment income. Some things are net of their applicable expenses like self-employment or rental income, while others are just the actual amount earned such as wages and interest income.

Adjustments: These are referred to as "above the line deductions" because they reduce the "*Adjusted Gross Income"* or "AGI". These include (but are not limited to) health savings account and self-employed retirement contributions, student loan interest and tuition and fees. The more adjustments you have, the lower your AGI and the more other deductions you can claim.

Adjusted Gross Income (AGI): This is the number on the last line of Page 1 of the Form 1040 and the first number on Page 2. It is determined by subtracting the adjustments from the gross income. AGI is used to limit certain deductions, credits and exemptions in the higher income brackets. So it is a very important number.

Deductions: These are allowances deducted from Gross Income or AGI. A deduction reduces your taxable income. Some are limited to amounts that exceed a certain percentage of AGI. Some are limited in higher AGI brackets to the point where they are not allowed at all.

Exemptions: These are amounts deducted for each person in the household. Again, these can be limited or completely eliminated at higher income brackets and they change nearly every year.

Taxable Income: This is the AGI minus deductions and exemptions.

Tax: There are three main types of tax reported on the Form 1040 but they are not the only ones:

Income Tax – Federal Income Tax (FIT) is tax on the taxable income that is computed based on a progressive chart whose applicable percentages are determined by the amount of the taxable income. The higher the taxable income, the higher the tax percentage and the more the income tax.

Self-Employment Tax - Self Employment (SE) tax is 15.3% of the net earnings from self-employment. It is, essentially, the self-employed person's contribution to Social Security. A wage-earner pays ½ and their employer pays ½. In the case of a self-employed person, they are employer and employee so they pay 100% of the social security tax.

Alternative Minimum Tax - Also known as AMT, is an additional tax that is applied to higher incomes to reduce or eliminate the preference items that could prevent them from paying their fair share. The calculation removes most of the allowable adjustments, deductions and, sometimes, even the personal exemptions. The difference between the AMT income tax and the regular income tax is the AMT which is added to the regular tax so that the taxpayer pays whichever is the higher amount of tax. "*Yes, wealthy people really do pay more tax*".

Tax Credits: There are certain credits allowed against income tax which reduce the amount owed. These include: taxes paid to other countries, child and dependent care, education, child tax credit, retirement savings and residential energy. These are deducted from income tax before adding the other taxes to arrive at Total Tax.

Total Tax: The total tax due is the sum of FIT (net of tax credits) + SE + AMT

Payments: These are deductions against tax for amounts paid or credits applied and include: FIT withheld from wages, amounts paid directly during the year, Earned Income Credit (a partial refund of Social Security Tax for low-income families), any overpayment applied from prior years and some refundable credits.

Tax Due or Refund: After you subtract the payments from the total tax you are left with either an amount due or a refund. I'm not going to go in to why I firmly believe owing tax is better than getting a refund, but, if you're interested, call the office and ask. I'll be happy to explain it.

NOTE: Remember that a 'deduction' reduces your taxable income, but a 'credit' reduces the actual tax. So, for a person in the 10% tax bracket, a deduction will reduce their tax by $1 for every $10 spent on the deduction. A Credit reduces the tax by $1 for every $1 of credit.

Changes Included in The Act:

OK. Now that we have a basic understanding of how everything is calculated, let's get down to cases. The following is a brief summary of each change impacting individual taxpayers (as opposed to other tax-paying entities). For the purposes of this discussion, the term 'Couples' means married individuals and surviving spouses. 'Unmarried/Single' refers to unmarried taxpayers. Married individuals filing separate returns are afforded ½ of the amounts allowed to couples. Heads of Household have special rules which are detailed where pertinent.

Changes to Gross Income:

Business Income: Reportable business income is the net surplus or deficit after the deduction of business expenses. Currently, this is business income from proprietorships, partnerships and small corporations (S-Corps) which are considered "pass-through" entities whose income is taxed at the taxpayer's tax rate and the business is not taxed as a separate entity.

20% deduction: The Tax Cuts and Jobs Act allows a new deduction on pass-through entity income calculated as follows:

- The lesser of
  - The combined qualified business income* amount of the taxpayer OR
  - 20% of the excess of the taxable income in excess of net capital gains and aggregate qualified dividends
- Plus the lesser of
  - 20% of the aggregate qualified dividends OR
  - The taxable income of the taxpayer reduced by net capital gains

**Combined qualified business income is 20% of the combined net amount of all businesses gains and losses* plus *20% of any real estate investment trust dividends* plus *20% of publicly traded partnership income*

The deduction is limited to

- 50% of any wages from the qualified business OR
- 25% of the W-2 wages plus 2.5% of the unadjusted basis of qualified depreciable property at the close of the tax year.
- For partners or shareholders not receiving Forms W-2, they are treated as having W-2 wages in an amount equal to his or her allocable share of the wages of the entity for the year.

The deduction is phased out for taxpayers at higher incomes based on a complicated calculation that is not necessary to detail in this venue.

Entertainment, Meals & Transportation: The new law eliminates the deduction previously allowed for entertainment, meals and transportation with the following exceptions:

- Food and beverage expenses that are directly related to the production of income are still 50% deductible but the 50% exclusion is now applicable to food and beverages provided to employees on work travel or on the employer's premises for the convenience of the employer.
- Any and all expenses in the other entertainment and travel categories that are directly related to the active conduct of the taxpayer's trade or business are 100% deductible.

Excess Business Losses: In the case of pass-through entities, excess losses, defined as the amount by which business expenses exceed business income plus the threshold amount of $400 for couples and $250,00 for unmarried individuals. These excess loss amounts will not be allowed as deductions for the tax year, but can be carried forward to subsequent years. However, The Act eliminates the carryback options and limits the carryforwards to 80% of the taxable income for the carryforward year.

Capital Investments: Full and immediate expensing of short-lived capital investments (purchases of depreciable business equipment) and increases the Section 179 expense cap from $500,000 to $1,000,000

Interest Expense: This deduction is being limited to 30% of the earnings before interest, taxes, depreciation and amortization (EBITDA) for the first 4 years and then 30% of earnings before interest and taxes (EBIT) thereafter.

Child Unearned Income or "Kiddie Tax": Prior to The Act, all unearned income (passive income that the child gets without working for it) of a child under 19 or a student up to age 24 had to be taxed at the higher of either the child's or the parents' tax bracket. Further, since all children were included, the unearned income of siblings could, literally, push the parents into higher brackets and everyone was paying more.

Under the new rules, the unearned income will be taxed according to the brackets applicable to trusts and estates. Therefore, the child's tax is totally unaffected by the tax situation of the child's parent or sibling earnings.

Capital Gains: The major change here is that the 'breakpoints' between the 0%, 15% and 20% rates are being indexed using new inflation adjustment factors. This will allow for greater gains and lower taxes on those gains as shown below. Allowable amounts for Married Filing Separate is ½ of the allowance for Joint filers in all brackets.

0% applies to net capital gains up to $38,600 for single filers, $51,700 for Heads of Household, and $77,200 for couples
15% applies to net gains from $38,600 to $425,800 for single filers, $51,700 to $452,400 for Heads of Household, and $77,200 to $479,000 for couples
20% applies to all net gains above the 15% maximums

Additional changes include:

- A provision that gains from sale of exchange of capital assets held less than 12 months, such as stock may receive long-term capital gain treatment if certain conditions are met. The change centers primarily on the substance of the transaction rather than the form of the agreement.
- Expansion of the definition of Capital Asset (which excludes inventory, depreciable property, copyrights and musical compositions) to exclude these additional self-created properties: patents, inventions, models, designs, secret formulas or processes.

Higher Education Distributions: Currently, any qualified distribution from a 529 savings plan is tax exempt from inclusion in gross income. However that exemptions applies only if the funds are used for '*qualified expenses at a higher education institution that participates in the federal student loan program*'. 'Qualified expenses' include tuition, fees, books, supplies and equipment (including computers and software, if compulsory for classes) required for enrollment and attendance as such an institution as well as room and board, for students carrying at least a ½ time class load. The exemption is limited to the educational institutions published costs for all expenses.

The New Law adds apprenticeship programs to the definition of "higher education" provided they are held at accredited institutions eligible to participate in the Department of Education student aid programs. It also allows for a distribution of up to $10,000 to cover tuition for enrollment or attendance at a public, private or religious elementary or secondary school. The limitation is a per-student, rather than per-account basis (for beneficiaries of multiple savings accounts).

Debt Discharge or Cancellation: Any discharge or cancellation of debt is considered reportable income to the debtor. That means that, if you don't pay a debt and it is written off, that amount must be included in your calculation of gross income for the tax year in question.

Under current law there is an exemption to this if the loan is forgiven for working in a designated profession or an occupation or area with unmet needs.

Under the new rules, all Student Loans which are discharged or forgiven are excludable from gross income. Further that exemption is extended to discharges due to death or disability of the student.

Contributions, Distributions & Rollovers to ABLE Accounts: An ABLE Account is a special tax exempt account set up on behalf of a disabled individual which is designed to supplement benefits from private insurance, Medicaid, SSI and other sources. There are limits on contributions and distributions that are annual and cumulative and the monies must be used for qualified disability expenses, but the distributions and rollovers to similar accounts (such as combining 2 or more ABLE accounts in to one) are tax exempt if used by the beneficiary.

Under the new law, amounts from Education Savings 529 plans may be rolled over, tax free, into ABLE accounts for the same beneficiaries or for a member of the beneficiaries' family including: spouses, children, parents, grandparents, step-members, uncles & aunts, nieces & nephews, spouses of any of the above and first cousins. (Also see Savings Credit below)

Exclusions from Gross Income: Certain income amounts may be excluded from Gross Income, but The Act is changing which ones and how much on several.

Employee Achievement Awards: cash and cash equivalents like gift cards and certificates (except certificates that give the right to select tangible personal property from a limited list of options), vacations, meals, lodging, tickets to anything, stocks, bonds or other securities and other intangible personal property will no longer qualify as an excludable Employee Achievement award and must be included in gross income.

Alimony Exclusion: The Act provides that, in the case of separation and/or divorce agreements, alimony and separate maintenance payments are now excludable from the income of the payee-spouse.

Moving Reimbursements: Any employer reimbursements for non-deductible moving expenses is now includable the in gross income of the employee.

Bicycle Commuting Reimbursement: Current law allows the exclusion from Gross income of $20 per month of reimbursed bicycle commuting expenses. The new law suspends this exclusion through the end of the Act's active period.

Other Commuting Reimbursements: The exclusions for reimbursement of parking, mass transit and van pool costs are not suspended and continue to be excludable.

Changes to Adjustments to Income:

Alimony:_The Act provides that, in the case of separation and/or divorce agreements, alimony is no longer a deductible adjustment by the payor-spouse

Moving Expenses: which were previously allowed in a work-related move that was more than 50-miles from the previous tax home are suspended except for members of the Armed Forces (including spouses and dependents) on active duty who move pursuant to a military order and incident to a permanent change of station.

Changes to Deductions and Exemptions:

Standard Deduction:

Under current law, the AGI is allowed to be reduced by a certain allowable amount depending of the filing status of the taxpayers. The most recent deductions amounts are as follows:

Married filing joint & Surviving Spouses	$12,700
Head of Household	$ 9,350
Single and Married Filing Separate	$ 6,350 ($0 if the spouse itemizes deductions)

Additional amounts allowed for the elderly and disabled is $1,250 to $1,550 depending on filing status
Individual who are claimed as dependents are limited to $1,050 or $350 over their earned income.

Under The Act the standard deduction is increased as follows:

Married filing joint & Surviving Spouses	$24,000
Head of Household	$18,000
Single and Married Filing Separate	$12,000

Additional amounts are still allowed for the elderly and disabled; and there will still be limitations on Individuals who are claimed as dependents. All amounts will be adjusted for inflation after 2018.

Itemized Deductions:

For taxpayers whose expense amounts for the following costs:

Medical care and treatment (in excess of 10% of income)
Mortgage interest (any interest paid on debt secured by a primary residence),
Property, state, local and sales taxes
Theft and casualty losses
Charitable donation and
Unreimbursed employee and miscellaneous expenses (in excess of 2% of income)

exceed the Standard deduction, they can itemize on Schedule A and claim the lion's share of those amounts (limitations on medical and unreimbursed apply). This benefit is phased out at higher income levels $313,800 for couples, $287,650 for heads of household and $261,500 for unmarried taxpayers.

The new law suspends the phase-out limitations for the duration of the Act and includes these additional provisions:

- Mortgage Interest on Residence: Interest on the purchase (acquisition) is still deductible up to a debt limit of $750,000 but other use (equity) interest deductions are suspended.
- Unlimited deductions for state, local, property and foreign property taxes are limited to taxes paid for the production of income
- The personal state, local, property and other taxes will only be deductible up to a maximum of $10,000 per couple for the aggregate of all these 'other' taxes with the exclusion of foreign property tax and prepayments of taxes which are no longer deductible. The exception to this is State and Local property taxes which are deductible if prepaid in 2017, but not subsequently.
- Casualty and theft losses are only deductible if the loss is attributable to a federally-declared disaster.

- All gambling/wagering expenses are now limited to amount of the winnings whether the individual is a professional gambler or not.
- The 50% of earned income limit on Charitable contributions is increased to 60% but it eliminates the deduction for college athletic seating rights.
- The medical expense threshold amount is reduced from 10% (7.5% for 65 and older) to 7.5% across the board.
- The allowable deduction for entertainment, meals and transportation are no longer allowed unless the activity is directly associated with the operation of a trade or business.
- Miscellaneous itemized deductions are no longer deductible, including unreimbursed employee expenses.

Personal Exemptions:
Currently, there is allowed a personal exemption for each person in the household of $4,050. That reduction to taxable income gets phased out at higher income levels. The phase out range starts at $156,900 for Married couples filing separate returns and ends at $436,300 for Couples.

Under The Act, the exemption amount is reduced to zero for everyone. This, of course, is offset by the increase in the standard deduction and the reduced tax rates.

Changes to Tax Credits:

Child Tax Credit (CTC):
Currently, taxpayers with children under the age of 17 who are dependents on the tax return may receive a non-refundable credit against tax (a credit that can take tax to zero but not put the taxpayer in a refund position) of $1,000 per child. This credit is phased out at higher income levels starting at $55,000 for married filing separate, $75,000 for unmarried taxpayers and $110,000 for couples.

The New Law increases the amount to $2,000 per child with phaseout starting at $400,000 for couples and $200,000 for all other taxpayers. It adds a $500 non-refundable credit for certain non-child dependents.

Additional Child Tax Credit:
This is a refundable portion of the Child Tax Credit that kicks in when the total CTC meets certain criteria:

- The amount the total CTC exceeds the combined Regular and AMT tax, or
- The greater of:
  - 15% of the taxpayer's earned income in excess of $3,000 or
  - The amount of social security tax in excess of the earned income credit (this second part is applied only to taxpayers with 3 or more children)

Under the New Law the refundable amount is reduced to $1,400 per child but the threshold is also decreased to $2,500.

Saver's Credit: A non-refundable credit against tax for amounts contributed to retirement savings plans such as 401K, IRA or SEP plans. The credit is limited to a maximum of $2,000 and is calculated based on a percentage rate (determined by income level) applied to the actual contributions made. This credit is phased out when AGI exceeds $62,000 for joint filers, $46,500 for heads of household and $31,000 for singled and filing separate taxpayers.
Under the New Law, ABLE accounts (see above) qualify the beneficiary for the saver's credit on any contributions made to his/her ABLE account.

Changes to Alternative Minimum Tax (AMT):

Currently, for taxpayers with higher incomes, significant passive income, preferential deductions and other "loopholes" that can significantly reduce their taxable income, the Code creates an 'additional tax' to close up the benefits of many if not most of these. The following is a partial list of deductions, exclusions and exemptions that are added back either entirely or in part to the taxpayer's taxable income before figuring the Alternative Minimum Tax Amount that must be paid:

- Tax exempt Interest
- Accelerated depreciation, amortization and depletion
- Small business stock exclusion
- Itemized and Standard deductions
- Research and experimental expenses
- Incentive stock options
- Passive activity losses (a passive activity is one where the taxpayer is not actively earning the income like interest and rents)
- Net operating losses
- Losses from publicly traded partnerships

There is a flat exemption amount $84,500 for couples and $54,300 for unmarried taxpayers that is reduced by 25% of the taxpayer's income in excess of $160,900 for couples and $120,700 for unmarried taxpayers.

The New Law increases the exemption amounts to $109,400 for couples and $70,300 for unmarried persons. These amounts are also reduced by 25% of the income in excess of increased phase-out thresholds of $1 million for couples and $500,000 for unmarried taxpayers. However, these exemptions are completely eliminated at income levels of $1,437,600 for couples and $781,200 for unmarried individuals.

Changes to Tax Rates:

The New law changes the rates and the income levels at which those rates kick in.

Single Filer

Current Law		Tax Cuts and Jobs Act	
10%	$0-$9,525	10%	$0-$9,525
15%	$9,525-$38,700	12%	$9,525-$38,700
25%	$38,700-$93,700	22%	$38,700-$82,500
28%	$93,700-$195,450	24%	$82,500-$157,500
33%	$195,450-$424,950	32%	$157,500-$200,000
35%	$424,950-$426,700	35%	$200,000-$500,000
39.6%	$426,700+	37%	$500,000+

Married Filing Jointly

Current Law		Tax Cuts and Jobs Act	
Note: The Head of Household filing status is retained, with a separate bracket schedule.			
10%	$0-$19,050	10%	$0-$19,050
15%	$19,050-$77,400	12%	$19,050-$77,400
25%	$77,400-$156,150	22%	$77,400-$165,000
28%	$156,150-$237,950	24%	$165,000-$315,000
33%	$237,950-$424,950	32%	$315,000-$400,000
35%	$424,950-$480,050	35%	$400,000-$600,000
39.60%	$480,050+	37%	$600,000+

Other Changes:

Inflation Adjustment: Many of the amounts in the Internal Revenue Code are adjusted to reflect inflation based on market indexing figures published by the Department of Labor. The current adjustment is based on the *Consumer Price Index* which is based on prices paid by typical urban consumers on a set mix of marketplace products and services.

Under the new law, the indexing will be permanently based on the *Chained Consumer Price Index* which is a measure of the average change in prices over time. This indexing method takes into account the ability of people to change their purchasing habits based on price changes. It does this by allowing for consumer substitution between item categories for the goods and services that make up the index. This should allow for more accurate inflation indexing in the tax code.

Combat Zone Benefits: Of particular interest in our area is the special rules related to active members of the Armed Forces serving in Combat Zones. These include:

- Exclusion from taxation of any pay received while serving in a combat zone
- Exemption from taxes (forgiveness of income taxes) upon death while serving or from wounds, disease or injury while serving in a combat zone
- Special estate tax rules reducing such taxes when death occurs in a combat zone
- Surviving spouse benefits for death or missing status from combat zone, such as permitting joint returns
- Suspension of time provisions for filing returns
- Exclusion from telephone excise taxes for calls originating in a combat zone

The New Law extends these same benefits to active duty members serving in "Hazardous duty areas". This means that the Sinai Peninsula of Egypt is now a benefits area.

Obamacare: The Obamacare mandate tax penalty is permanently repealed as of January 1, 2019. You are still required to be covered until December 31, 2018, but afterwards, you do not have to carry insurance to avoid the penalty tax imposed by the Affordable Care Act.

Projected Impact of the Changes (from The Tax Foundation* report):

** The Tax Foundation is an independent, non-profit foundation founded in 1937 that studies, and analyses our country's tax laws and the resulting impact on our economy and the welfare of our citizens and reports their findings to our lawmakers, the media and us, the taxpayers. You can find them at https://taxfoundation.org .*

According to the Tax Foundation's key findings, the Tax Cuts and Jobs Act will reform individual and corporate income taxes significantly lowering marginal tax rates and the cost of capital resulting in:

- A 1.7% increase in Gross Domestic Production (GDP)
- Increased wages of 1.5%
- 339,000 additional full-time equivalent jobs
- An additional $1 trillion in federal revenues from economic growth with about $600 billion from the permanent provisions and $400 billion from the temporary provisions
- GDP increase of an average of .29% per year (2.13% compared to current 1.84%) over the next decade
- Aggregate 1.1% increase in after-tax incomes of all taxpayers

These impacts are the result of all the changes including the reduced corporate income tax to 21% and the elimination of the corporate AMT. They also take into account the temporary nature of The Act which ends in 2027. However, it the plan were enacted permanently, the results would be:

- GDP increase of 4.7%
- Increase in wages of 3.3%
- Increase in full-time equivalent jobs of 1,614,000
- After tax income would increase 1.9% on average
- After considering economic growth, after tax incomes would increase 6.5% on average

However, the cost of the bill at that point might exceed its benefits which is why they have made it temporary so that changes can be made to improve any provisions that are not performing as anticipated.

That said, the Tax Foundation agrees with me that this dramatic overhaul of the United States Tax Code will be very pro-growth which should have a substantial impact not only on the economy as a whole, but should be felt by each and every taxpaying citizen who should start to notice their budgets easing up a little by 2019.

Conclusion:

What do I think? I think this is a GREAT first step. Its one of the finest and most comprehensive overhauls I have seen in my 40 years in the taxation industry. It also accomplishes a lot of what was promised during the election campaign:

- It eliminates the Obamacare penalty for NOT having medical insurance
- It decreases taxes for the average taxpayer
- It closes up a lot of loopholes formerly used by the wealthy to avoid paying taxes
- It reduces taxes on businesses so they can free up money for raises and new jobs

Over the next decade, given all of the above, I also believe that the improved economy will help reduce the National Deficit by more than the projected $1 trillion because I have faith that the American Entrepreneur can do better than projections because we are better at making our money do more and go farther than any governmental entity can fathom.

I hope this small explanation helps you to understand the new law better. If you have any questions about how particular items in your personal taxes will be impacted, please don't hesitate to call and set up an appointment to discuss the matter. 2018 is the phase-in year so we need to really be on top of your finances to make the most of the new laws.

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