SHOOK HARDY & BACON

UPDATE OF THE LAW 2018

John W. ("Jay") Simpson
Shook, Hardy & Bacon L.L.P.
2555 Grand Boulevard
Kansas City, Missouri 64108
816-474-6550
jsimpson@shb.com

2018 Tax Update

1. Reduction in Corporate Income Tax Rate; Repeal of Corporate AMT

The Tax Cuts and Jobs Act (the "***Act***") reduces the corporate income tax rate to 21% and eliminates all brackets and graduated rates applicable to corporate income. This is a 14 point reduction from the prior maximum rate of 35%. This change is generally effective for taxable years beginning after December 31, 2017.

The Act also repeals the corporate alternative minimum tax ("***AMT***").

2. Modification of Individual Income Tax Rates

For taxable years from 2018 through 2025, the Act retains seven individual income tax brackets, but the rates are lower and the brackets have been adjusted. A top marginal rate of 37% applies to married individuals filing jointly with taxable income over $600,000 and to single taxpayers with taxable income over $500,000. Previously, the highest marginal rate was 39.6%. These rate reductions expire after 2025.

The Act also changes the method by which the tax rate brackets are indexed for inflation. The new method, referred to as "chained CPI," results in a slower increase in the maximum amounts that are subject to tax under each bracket. Over time, this means that more income will be taxed at the higher marginal rates (i.e., compared to the amounts that would have been taxed under the old "CPI" indexing method.

The following is a table showing the new individual income tax rates:

Rate	Joint Return	Individual Return
10%	$0 -- $19,050	$0 -- $9,525
12%	$19,050 -- $77,400	$9,525 -- $38,700
22%	$77,400 -- $165,000	$38,700 -- $82,500
24%	$165,000 -- $315,000	$82,500 -- $157,500
32%	$315,000 -- $400,000	$157,500 -- $200,000
35%	$400,000 -- $600,000	$200,000 -- $500,000
37%	Over $600,000	Over $500,000

3. Increase in Standard Deduction for Individuals; Elimination of Personal Exemptions

The Act increases the standard deduction amounts to $24,000 for married taxpayers filing jointly and $12,000 for single taxpayers. Again, this change expires after 2025. The increase in the standard deduction, coupled with the elimination and/or reduction of certain itemized deductions for individuals (discussed below), should cause a substantial reduction in the number of taxpayers who elect to itemize deductions.

The Act repeals the deduction for personal exemptions.

4. Limitation on Deduction for State and Local Taxes; Elimination of Miscellaneous Itemized Deductions

Under the Act, the itemized deduction for state and local real and personal property taxes, and state and local income taxes, is limited to $10,000 for married taxpayers filing jointly and single taxpayers, and $5,000 for married taxpayers filing separately. The Act also eliminates all miscellaneous itemized deductions.

5. Limitation on Mortgage Interest Deduction

The Act reduces the amount of the deduction for mortgage interest. Prior to the Act, interest paid on "acquisition indebtedness" (indebtedness incurred in acquiring, constructing, or improving a principal residence, and one second home) was allowed as an itemized deduction. The maximum amount of such indebtedness with respect to which an interest deduction was permitted was $1 million for taxpayers filing jointly ($500,000 for single taxpayers). A deduction was also permitted for interest paid on home-equity indebtedness secured by a principal residence (and one second home) up to $100,000 for married taxpayers filing jointly (and $50,000 for single taxpayers).

For loans incurred after December 15, 2017, the Act reduces the amount of acquisition indebtedness eligible for the itemized deduction from $1 million to $750,000 for married taxpayers filing jointly (and from $500,000 to $375,000 for single taxpayers). These lower caps apply for the years 2018 through 2025. Indebtedness incurred prior to, or after, these years would be unaffected. Also, after 2025, the higher $1 million (or $500,000) limitations apply again, even for indebtedness incurred between 2018 and 2025.

Finally, for the years 2018 through 2025, the Act eliminates the deduction for interest on home-equity indebtedness, unless the home equity indebtedness qualifies as "acquisition indebtedness" (i.e., indebtedness incurred in acquiring, constructing, or improving a principal residence, and one second home). If this test is met, the normal rules for "acquisition indebtedness" (described above) will apply during the years 2018 through 2025.

6. Alternative Minimum Tax for Individuals

The Act retains the alternative minimum tax (AMT) system for individuals, with some modifications. The AMT generally requires individuals to calculate their tax liability twice—under the regular tax system and then under the AMT system. The individual must then pay the higher of the two amounts. Generally, a taxpayer's AMT income is calculated by (a) adding to regular taxable income certain tax-preference items and deductions that were available under the regular tax system, but that are not available under the AMT system, and then (b) subtracting the taxpayer's applicable AMT exemption amount. The applicable AMT exemption amount is based on the taxpayer's filing status and income, as the exemption amount is phased out as a taxpayer's income increases. The tax rate imposed on the resulting AMT income is generally 28 percent.

For taxable years from 2018 through 2025, the AMT exemption amount has been increased from $84,500 to $109,400 for married taxpayers filing jointly (from $54,300 to $70,300 for single taxpayers). Most importantly, the threshold at which the AMT exemption begins to phase out has also been increased. For married taxpayers filing jointly, the Act increases this amount from $160,900 to $1 million, while for single taxpayers, the phase-out threshold has been raised from $120,700 to $500,000.

7. <u>Deduction for Qualified Business Income</u>

The Act generally allows a noncorporate taxpayer who has "qualified business income" ("***QBI***") from a partnership, S corporation or sole proprietorship to deduct 20% of this QBI amount.

QBI is defined, generally, as all domestic (U.S.-source, including Puerto Rico) business income other than investment income. QBI does not include any amount that is treated as reasonable compensation of the taxpayer for services rendered to the business (W-2 salary for an S corporation) or any amount paid by a partnership that is a guaranteed payment for services performed.

<u>Limitations</u>. The QBI deduction cannot exceed the greater of (a) 50% of the taxpayer's share of the W-2 wages paid by the business generating the QBI; or (b) the sum of 25% of the taxpayer's share of the W-2 wages paid by the business generating the QBI, plus 2.5% of the initial, unadjusted basis of all qualified property held by such business. Qualified property is generally defined as tangible, depreciable property that is held by the business at the close of the tax year.

There are phase-ins for the W-2 limitations for taxpayers with taxable income between $157,500 ($315,000 in the case of a joint return) (the threshold amounts) and $227,500 ($415,000 for a joint return) (the fully phased-in amounts). Specifically, the limitations described in the preceding paragraph do not apply at all unless the taxpayer's taxable income is at least equal to the threshold amounts and, if the threshold is met, the limitations are phased-in as the taxpayer's taxable income scales from the threshold amount to the fully phased-in amount.

<u>Thresholds and exclusions</u>. The QBI deduction does not apply to "specified service businesses," which means any trade or business that involves the performance of services (a) in health, law, accounting, consulting, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more employees or owners or (b) consisting of investing, investment management, trading, or dealing in securities, partnership interests or commodities. The Act, however, specifically excludes engineering and architecture services from the definition of specified service business.

The "specified service business" exclusion does not apply for a taxpayer whose taxable income does not exceed $315,000 for married individuals filing jointly ($157,500 for other individuals). Over these threshold amounts, the QBI deduction is phased out over the next $100,000 of taxable income for joint filers ($50,000 for other individuals).

8. <u>Expanded Expensing</u>

The Act allows 100% bonus depreciation for the cost of certain business assets placed in service after September 27, 2017. This 100% expensing applies only to "qualified property," which includes, generally, tangible personal property with a recovery period of 20 years or less. Under the Act, however, the term "qualified property" does not include qualified improvement property (e.g., certain improvements to nonresidential buildings). Instead, this property generally becomes subject to a 15-year recovery period. Finally, the Act includes in the definition of "qualified property" <u>used</u> property acquired and placed in service by the taxpayer. Under prior law, <u>used</u> property did not qualify for bonus depreciation.

The increased bonus depreciation is temporary under the Act. Although the bonus depreciation percentage is 100% through 2022, the percentage declines by 20 percent each year after 2022 and reaches zero by 2027.

The Act also increases the expensing deduction available under Code Section 179. Under prior law, a taxpayer could expense immediately up to $500,000 in qualifying property placed in service in a particular tax year. This benefit was phased out if the taxpayer placed qualifying property of more than $2 million in service in a single year. Under the Act, a taxpayer may immediately expense up to $1 million of qualifying property, and the phase out of this deduction starts at $2.5 million of property placed in service.

9. New NOL Limitations

Under the Act, a taxpayer's deduction for NOLs in a particular taxable year is limited to 80% of the taxpayer's taxable income for that year. Also, NOLs may now be carried forward indefinitely, but generally cannot be carried back to prior taxable years.

10. Deduction Limitations for Meals, Entertainment and Fringe Benefits

The Act reduces and/or eliminates certain deductions related to meals, entertainment and recreation activities. These new rules apply for any expenses incurred after January 1, 2018.

Meals. Under existing law, meals related to business travel or client events are subject to a 50% deduction limitation. Certain meals, however, have been fully deductible. These categories of fully-deductible meals included: (a) meals excluded from employee income as de minimis fringe benefits; (b) meals provided at a qualified employer-operated dining facility on or near the employer's business premises; and (c) meals provided for the convenience of the employer

Under the Act, the meals that were previously fully deductible are now subject to a 50% limitation. In addition, after 2025, meals provided at an employer-operated dining facility or for the convenience of the employer will no longer be deductible. Also, after 2025, expenses related to the operation of an employer-operated dining facility will no longer be deductible.

Entertainment, amusement, or recreation. Historically, a business has not been entitled to claim deduction for expenses related to the provision of entertainment, amusement, or recreation activities, unless there was a valid business purpose associated with the activity. If the valid business purpose existed, then, in general, the business was entitled to claim deduction equal to 50% of the expenses. There were strict guidelines, however, for determining what qualified as business-related entertainment, amusement, or recreation.

The Act eliminates all deductions for expenses related to entertainment, amusement, or recreation activities, even if the activities (such as sporting and concert tickets, golf outings, and other forms of client entertainment) have a valid business purpose. The Act also eliminates the "charitable sporting tournament" sponsorship deduction, although it is possible that some portion of the sponsorship payment may still be deductible as a charitable donation.

Even under the Act, it appears that one exception remains intact. Expenses associated with events such as nondiscriminatory employee holiday parties and employee group recreation activities are apparently still deductible.

11. Elimination of Deduction for Sexual Harassment/Abuse Settlement Payments Made Under an Agreement that Contains a Non-Disclosure Agreement

Under the Act, if (a) a business makes a payment to settle a sexual harassment or sexual abuse claim, **and** (b) the settlement is subject to a nondisclosure agreement, the settlement payment is no longer deductible. Also, under the new provision in the Act, no taxpayer is entitled to claim a deduction for attorney fees related to this type of settlement.

12. Deduction Prohibited for Certain Government Settlements

Under existing Section 162(f) of the Internal Revenue Code, if a business pays a fine or penalty to a governmental authority, the payment is not deductible. If, however, the payment to the governmental authority represents a payment of restitution (including remediation of property), the payment is deductible. Now, under the Act (new Section 162(f)), and subject to a key exception described below, a taxpayer will not be able to deduct any amount paid to, or at the direction of, any governmental authority pursuant to a settlement or court order.

The Act provides an exception to this new deduction limitation for payments made in restitution (including remediation of property), or payments made in order to come into compliance with law. The exception applies, however, only if the applicable settlement agreement or court states expressly that the payment meets the requirements for the exemption. Also, even if this exemption test is met, the taxpayer must demonstrate that the payment met the deductibility requirements under old Section 162(f), as in effect prior to the Act (i.e., the payment is not a fine or penalty).

The Act also requires all governmental authorities to report to the IRS any payment that is identified—in the applicable settlement agreement or court order--as having met the requirements for deductibility under the Act. This is, in essence, an invitation for the IRS to sign off on the deductibility of any settlement (or court-ordered) payment to a governmental authority.

13. Elimination of Most Section 1031 Exchanges

The Act eliminates like-kind exchange treatment under Section 1031 for all types of property other than real property. This means that exchanges of equipment and collectibles will no longer qualify for tax-free treatment under Section 1031.

14. South Dakota v. Wayfair

South Dakota v. Wayfair, a case recently argued before the United States Supreme Court, will likely determine whether the states can require online retailers (such as Amazon and Wayfair) to collect and remit use taxes on sales to their online customers. South Dakota has asked the Court to overturn its 1992 decision in *Quill v. North Dakota,* which prohibits states from doing so. During oral arguments, the Court seemed to be divided on the issue.

This is a critical issue for the states. It has been estimated that a decision in favor of the states in this case would increase state revenues by over $12 billion per year.