US Tax Reform – what does it all mean?

Without question, the most fundamental overhaul of the US tax system since Reagan's Tax Reform Act of 1986 is the Tax Cuts and Jobs Act 2017, brought in to law by the Trump administration on 22 December 2017.

The Bill is undeniably positive for corporations and business owners, and arguably the majority of American taxpayers are likely to experience a reduction in their tax liabilities (at least temporarily – many of the new individual measures expire in 2025) as a result of the new provisions introduced.

However, there is a potential sting in the tail for homeowners and those who usually reside in the US with higher state and local taxes.

The act is complex and wide-ranging, but we hope to cut through the jargon by providing an overview of the key aspects affecting businesses and individuals.

A flat 21% corporate tax rate

The headline act of the new Bill is the flat rate of 21% for corporate tax – replacing the previously graduated rates of 15-35%. The big winners here are personal services corporations, whose profits were previously taxed at a flat rate of 35%. The 21% rate helps to bring the US in line with other G20 nations, and goes some way to ease the burden of corporate double-taxation that has blighted owners of C corporations until now.

Taxation of foreign operations & dividend income for businesses

The act contains provisions that make the repatriation of foreign profits more tax efficient, such as a one-off 15.5% tax on cash and 8% tax on equipment. The aim again being an attempt to stimulate investment in the US.

Deductibility of dividends received by C corporations from business investments have been restricted. Previously where a corporation held over 20% of the common stock of a business, it could deduct 80% of any dividend income – the new Act restricts this deduction to 65%.

A brand new deduction for pass-through businesses

Owners of S Corps, LLCs, Partnerships and Sole Proprietors ('pass through entities') will now be able to deduct 20% of their Qualified Business Income (QBI) on their own tax returns. The mechanics behind the new deduction are complex, but it is designed to act as an additional itemized deduction on the individual's return. The deduction is however not available for most service businesses and is phased out above certain income levels - $157,500 for single filers and $315,000 for joint filers.

Restrictions on use of business losses

Effective from 1 January 2018, business losses (NOLs) can no longer be carried back to previous tax years to generate refunds against taxes previously paid. Additionally, these NOLs are restricted to 80% of taxable income – previously a business could offset up to 100% of taxable income using accumulated losses.

Restrictions on deductible expenses for meals and entertainment

Previously a business could deduct 50% of meal and entertainment spend against income. The new law eliminates this deduction entirely. Additionally, where previously meals provided to employees for the convenience of the employer were 100% deductible (such as in-office or at a staff cafeteria), this is now reduced to 50%.

Individual income tax rates are reduced

On the surface this was always going to be a crowd-pleaser. Five of the seven income tax rates have been reduced, (albeit temporarily – effective currently between 2018-2025). Moreover, the brackets for each tax rate have also been increased – and will continue to do so in line with inflation.

Income $		Tax rate (%)	
Individuals	**Joint**	**2017**	**2018 -**
Up to 9,525	Up to 19,050	10	10
9,526 - 38,700	19,051 - 77,400	15	12
38,701 - 82,500	77,401 - 165,000	25	22
82,501 - 157,500	165,001 - 315,000	28	24
157,501 - 200,000	315,001 - 400,000	33	32
200,001 - 500,000	400,001 - 600,000	35	35
500,001 -	600,001 -	39.6	37

Standard deductions are doubled; personal exemptions suspended

From 1 January 2018 taxpayers are no longer able to claim personal exemptions ($4,050 for each taxpayer, spouse and dependent in 2017). To compensate for this loss, the available standard deduction is almost doubled to $12,000 for single filers, $18,000 for head of households and $24,000 for those filing joint returns.

Those who itemize their deductions (and thus cannot make use of the increased standard deduction) are likely to lose out. Similarly, taxpayers with large numbers of dependents may also suffer (although child tax credits have been doubled to $2,000 for children under 17).

Restrictions on state and local taxes

One of the more controversial aspects of the new Act is the restriction on the deductibility of state and local taxes paid. From 2018, taxpayers who itemize their deductions can deduct a maximum of $10,000 of state and local taxes paid. This could penalize tax payers residing in high tax states, as well as homeowners.

Restrictions on mortgage interest deductions

A further controversial aspect of the Act, and one that will again hit the pockets of homeowners, is the new restriction on the amount of mortgage interest that is deductible. From 2018 – 2025, interest is deductible on mortgage debt only up to $750,000. Moreover, interest incurred on home equity debt is now wholly-disallowable.

One concession granted is that the $750,000 ceiling only applies to mortgage debt incurred after 15 December 2017. Mortgage debt charged prior to this date is still subject to the previous $1 million limit. Home equity interest is wholly-disallowed irrespective of the date the debt was taken on.

Estate & inheritance tax exemptions are doubled

The new bill doubles the current exemptions for gift and estate taxes to $10 million. Adjusted for inflation, in 2018 the limit is expected to be $11.2 million, up from $5 million in 2017. This presents significant tax planning opportunities for high net worth individuals and families, as these extensions are only in place until 2025.

Other changes to itemized deductions

The Act introduces a raft of measures that restrict the scope of various itemized deductions that were previously allowed. In theory, these restrictions, viewed alongside the doubling of the standard deduction, meaning many taxpayers will be better off simply claiming the standard deduction and not itemizing – thus simplifying the annual tax filing process.

However, those that itemize may well end up suffering more tax as a result:

- **Moving expenses:** the deduction is suspended until 2025, except for members of the armed forces.
- **Alimony payments:** these are no longer deductible for divorces finalized from 1 January 2019. Likewise, alimony receipts will be excluded from the recipients' taxable income.
- **Misc. itemized deductions:** There will no longer be a general deduction available, subject to the 2% of AGI floor.
- **Use of home as office:** Employees working from home will no longer be able to claim use of home as office expenses deductions.

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The new tax Bill represents a step-change in US taxation, and as such, no action should be taken prior to seeking professional advice. This article is not written with the intent that it be used to avoid penalties under the Internal Revenue Code, or to promote, market, or recommend to another person any tax related matter.

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