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The Tax Cuts and Jobs Act of 2017 – Considerations for Law Firms

The Tax Cuts and Jobs Act (the "Act") made significant changes to the Internal Revenue Code of 1986, affecting individuals, U.S. businesses and international taxpayers.

Key Provisions of the Act:

- Reduction in individual and corporate income tax rates
- $10,000 annual limit on deduction of state and local income taxes (SALT). This includes deduction for real estate taxes
- No deduction for miscellaneous itemized deductions
- Increased standard deductions
- Introduction of new Code Section 199A, which provides for a tax deduction of 20% of qualified business income, subject to limitations and exclusions

How Does the Act Impact Law Firms, Partners and Associates?

Choice of Entity

Incorporated firms:

The Act eliminates the unfavorable tax rates of personal service corporations (taxed at the highest individual rate prior to the Act). Firms operating as C-Corporations will enjoy a significant tax savings on income left in the corporation. Under the Act the rate is a flat 21%.

There is no change to the double taxation that results when C-Corporations distribute their earnings in the form of dividends.

No doubt there is discussion among partnerships and S-Corporations about whether to convert to C-Corporation status. In addition to the double tax on distribution consideration must be given to:

- Double tax upon asset sales
- Possible application of personal holding company tax rules
- Extent of debt service payments
- State income tax deductions
- Non-deductible expenses such as entertainment, life-insurance and business meals

Pass-through entity:

Firms organized as limited liability partnerships (LLPs), Limited liability Companies (LLCs) and S-Corporations do not pay tax at the entity level. Rather the net income or loss is passed-through to the firm's partners or shareholders. Partners pay the tax on their personal tax returns.

The Act provides for a new personal income tax deduction equal to 20% of qualified business income. Owners of pass-through entities are entitled to this deduction with limitations and exclusions.

First, partners and shareholders with **individual taxable** income no greater than $157,500 filing single and $315,000 married filing joint, are allowed the deduction without limitation. For single filers with taxable income in excess of $157,500, but less than $207,500, and married filing jointly of $315,000 to $415,000, the deduction phases out with no deduction once taxable income reaches the maximum amount.

Guaranteed payments to partners do not qualify for the deduction

There is a specific exclusion for owners of "specified service businesses." If taxable income is above the phase-out threshold mentioned above there is no deduction allowed for such businesses. The practice of law is a specified service business.

For businesses that are not specified service businesses and the income threshold is exceeded, the deduction is subject to limitations as follows:

- 20% deduction is limited to the greater of 50% of W-2 wages or 25% of W-2 wages plus 2.5% of the original cost basis of depreciable property acquired within the previous 10 years.

The QBI deduction will also apply to self-employed individuals as long as their taxable income does not exceed the phase-out maximum.

Tax planning to reduce taxable income to take advantage of the 199A deduction may include:

- Profit sharing and other deductible retirement plan funding
- Bunching of charitable contributions to lower taxable income
- Income deferral planning

Entertainment and fringe benefit expenses

Entertainment expenses are no longer deductible. Business meals continue to be deductible at 50% however, meals provided on premises, previously 100% deductible, are now limited to 50% deduction.

Employer deductions for employee transportation fringe benefit such as parking and mass transit are no longer deductible. The exclusion from the employee's income is retained.

Section 179 and bonus accelerated depreciation

The Act has increased the amount of immediate expense deduction allowed under Code Sec. 179 for property placed in service after December 31, 2017. The maximum amount a taxpayer can deduct is $1,000,000 (increased from $500,000). The Act also expands the definition to certain non-residential real property. It is important to note that the states have not all expanded their expense limitation under Sec. 179. New Jersey, for example, allows only $25,000 as an annual deduction.

The Act also allows 100% bonus deduction for qualified property placed in service after September 27, 2017 and before January 1, 2023. A 50% deduction was allowed under prior law but only for new property. The Act now allows the full expense for new and used property.

Limits on deduction of business interest

The limitation applies to taxpayers with average annual gross receipts of $25 million. For these businesses interest expense deduction is limited to 30% of the business's adjusted taxable income. For years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to depreciation, amortization, or depletion. After December 31, 2021, these deductions are included in the computation, effectively lowering the interest deduction limitation.

New limitations on excess business loss

The Act disallows a non-corporate taxpayer's business loss as a current deduction against other income. Under this new rule, excess business losses are carried forward and treated as part of the taxpayer's net operating loss carryforward.

An excess business loss for the year is the excess of the aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses, over the aggregate gross income or gain of the taxpayer, plus a threshold amount. The threshold, adjusted for inflation, is $500,000 for married filing jointly and $250,000 for other individuals.

Individual W-2 wage earners and guaranteed payments, non-qualified specified service income

For individuals receiving compensation in the form of wages, guaranteed payments and excess specified service income, no Sec. 199A deduction is available. Key components of the Act applicable to these individuals are as follows.

- Top individual tax rate lowered to 37% from 39.6%. This rate applies to taxable income over $500,000 for single individuals and $600,000 for married joint filers. Prior to the Act the top rate was applied at income of $418,400 for single filers and $470,700 for married filing jointly
- $10,000 limitation for deduction of state and local income taxes. With the limitation of this deduction and increased standard deduction of $12,000 single and $24,000 married filing joint, many taxpayers may no longer itemize their deductions as the standard deduction may be higher
- With the $10,000 SALT deduction limitation state tax on pass-through business income is no longer deductible beyond the limitation
- "Bunching" of charitable donations to receive a benefit for the deduction. Taxpayers may opt to bunch a few years donations into one year to cause their itemized deductions to be greater than the standard deduction in any given year
- No deduction for unreimbursed employee business expenses

Take advantage of tax planning opportunities

The 2017 Tax Cuts and Jobs Act creates planning opportunities for businesses and individuals to benefit from the tax savings measures under the Act. Because each business and individual's taxable income and deductions are unique, each individual set of facts and circumstances must be reviewed.

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