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New Tax Law Changes Impact Attorneys

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Introduction

On December 22, 2017, the Tax Cut and Jobs Act, Pub. L. No. 115-97 (the Act) was signed into law bringing forth sweeping changes to the Internal Revenue Code (IRC). The changes to the IRC are thought by many to be the largest in over three decades. Most of the changes were effective beginning January 1, 2018 and have wide-ranging effects on individuals and businesses. This article will discuss how the changes may impact the practice areas of family law, estate and gift, as well attorneys who are owners of a practice.

Family Law

The IRS Publication 504 defines alimony as "a payment to or for a spouse or former spouse under a divorce or separation agreement." Previously, alimony was generally deductible by the payer and includable in income by the recipient. Under the Act, starting on January 1, 2019, alimony payments/receipts will no longer be deductible or includable in income for divorce agreements that are finalized after that date. Divorces entered into before December 31, 2018 will continue to treat alimony as deductible/includable.

The structuring of personal exemptions was often an important consideration when negotiating a divorce settlement agreement. The Act has suspended personal exemptions for tax years beginning January 1, 2018 through December 31, 2025. However, the child tax credits have increased, which could increase their significance as a negotiating point. There are also significant changes to tax rates and deductions, which may cause previous divorce agreements to be revisited for potential modification.

Although legal fees, professional fees and court costs commonly incurred in divorces are generally nondeductible, there were some exceptions to this general statement. Legal and accounting fees were deductible if they were incurred for tax advice or paid to determine or collect income such as alimony but they were subject to a 2 percent floor of adjusted gross income. The Act has suspended miscellaneous itemized deductions previously subject to the 2 percent floor.

Estate and Gift

The basic exclusion amount (i.e. the amount with which a decedent is entitled to reduce their estate when figuring estate taxes) was set at $5 million in 2011, and has been adjusted for inflation for each subsequent year. The amount of the exclusion for 2017 was $5.49 million for an individual, or $10.98 million for a couple electing portability. The Act doubled the basic exclusion amount to $10 million for estates of decedents dying during the years 2018 to 2025 while maintaining inflation adjustments. The amount for 2018 will be adjusted for inflation to approximately $11.2 million per person or $22.4 million per couple electing portability.

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The generation skipping tax (GST) exemption amount has followed the basic exclusion amount. After 2025, the exclusion will reset to the amounts prior to 2018, which provides a window of opportunity for attorneys to assist in a tax minimization strategy. Although proposed, there were no changes enacted to estate, generation skipping or gift tax rates.

There are provisions in the Act that change the way inflation is calculated. Under previous tax law, inflation was measured by the consumer price index for all urban consumers (CPI-U), which tracks the cost of goods and services that affect the typical household. The new law uses a measure called the Chained CPI, which assumes consumers will seek a cheaper alternative when a particular good or service becomes too expensive. The result is that the Chained CPI grows slower than the CPI-U; therefore, certain IRS inflation sensitive numbers will rise at a slower rate than under the old law. Changes in the inflation calculation will affect many areas including income limitations discussed later in this article.

Owners of Pass-Through Entities

Changes brought about by the Act affect many attorneys who own law practices through pass-through entities. For tax years beginning after December 31, 2017 and before January 1, 2026, the Act adds a new deduction (pass-through deduction) for individual taxpayers for 20 percent of their "qualified business income" (QBI). This deduction applies to owners of pass-through entities, which includes sole proprietorships, partnerships and S-corporations, and will be taken as a deduction at the individual return level. It is available to taxpayers who itemize their deductions and to those who take the standard deduction.

QBI is defined as the net amount of income, gain, deduction and loss with respect to a trade or business. Certain types of investment-related items are excluded from QBI, for example, capital gains or losses, dividends and interest income (unless the interest income is properly allocable to the business). Compensation paid to the taxpayer by the business (including guaranteed payments to partners) is excluded from the definition of an individual's QBI.

QBI specifically excludes income from a "specified service trade or business." A specified service trade or business is a business whose principal asset is the reputation or skill of one or more of its employees, and includes businesses in the fields of law, accounting, health care professionals, and consulting, among others. Specifically excluded from the definition of a specified service trade or business, however, are architects and engineers. While professionals in a specified service trade or business are generally not eligible for a deduction related to QBI, there are certain situations in which they will be entitled to the QBI deduction.

Taxpayers in a specified service business are entitled to a deduction for 20 percent of their QBI, provided their income does not exceed certain amounts. A married taxpayer filing jointly would be entitled to a QBI deduction provided their taxable

income was less than $315,000 ($157,500 for individuals filing under any other status). Once taxable income is over the $315,000/$157,500 limits, the deduction begins to phase out until taxable income reaches $415,000/$207,500. After taxable income exceeds the upper limits of the phase out, the deduction for 20 percent of QBI is disallowed to taxpayers with income from a specified service business. The taxable income thresholds and phase out amounts will be adjusted for inflation beginning in 2019.

Other Provisions Affecting Businesses

Depreciation

New and used property purchased after September 27, 2017 and before January 1, 2023 for use in a business is eligible for 100 percent bonus depreciation. Prior law allowed only 50 percent bonus depreciation and only property whose original use began with the taxpayer was eligible for the bonus depreciation. In addition, the limit for expensing under IRC Section 179 for property purchased for business use increased to $1 million for property placed in service during the year. The limit under the prior law was $500,000.

Meals and Entertainment

The Act repeals deductions for entertainment, even when directly related to the conduct of a taxpayer's trade or business. However, meals that are directly related to the taxpayer's trade or business, and can be adequately supported as to how they are related to the conduct of the taxpayer's trade or business are deductible at 50 percent. The 50 percent limitation is expanded to include meals provided to employees for the convenience of the employer, which was previously allowed at 100 percent.

Other Deductions Disappearing

Beginning in 2018, employer subsidized parking and transportation are no longer allowed as a deduction for businesses. In general, it does not change the non-taxability of these fringe benefits to employees.

Previously an attorney working in a law firm with unreimbursed employee expenses was allowed a miscellaneous itemized deduction, subject to a limitation of 2 percent of adjusted gross income on his or her individual return. As mentioned previously, under the Act, miscellaneous itemized deductions subject to the 2 percent floor are no longer allowed as deductions for individual taxpayers.

Conclusion

As you can see, the new tax changes have a wide impact across the legal community. It is important to mention it is still very early in the process of understanding the changes to the tax law. This article is meant as a high-level overview and an identification of potential issues as opposed to specific advice. Additional clarification and guidance is expected once the IRS issues the regulations related to the Act. With any significant change in tax law, there is always new information to learn and apply, which creates both challenges and opportunities for individuals and businesses.

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