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Tax Alert:
2017 TAX CUTS & JOBS ACT
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INTRODUCTION

The 2017 Tax Cuts & Jobs Act was passed by Congress on December 20, 2017 (the "New Act"), and was signed by President Trump on December 22, 2017. We issue this initial summary of the legislation to give our clients and friends an opportunity to better consider any actions that might be beneficial before year-end. Over the next few months, we will plan to communicate further about specific issues and opportunities under the New Act.

As has been widely noted, most corporate taxpayers will see substantial reductions in their federal income tax liabilities. Similarly, many individual taxpayers will see significant income tax savings, particularly among the wealthiest individuals. However, there are certain individual fact patterns that could yield increased income tax liabilities under the current law – notably those who live in cities and/or states with higher income tax rates.

There's very little in the way of simplification or reform. The cuts in rates are certainly substantial, but the process of tax reporting will remain largely the same for many people – both in the manner of calculation and in the manner of reporting. Those who may benefit from simplification would be those who no longer need to itemize (due to an increased standard deduction), and those who will no longer be subject to the individual alternative minimum tax. Corporate taxpayers (mostly larger companies) will no longer be faced with the corporate alternative minimum tax, creating some simplification.

However, for most small business owners, the tax savings will come with increased complexity and analysis. As is discussed further below, the introduction of the new "qualified business income" deduction for pass-through entities raises many questions and ambiguities; and that in turn leads to many opportunities for such businesses to restructure to take advantage of this deduction.

Most of the changes will be effective January 1, 2018. While the changes for corporate taxpayers are permanent, many of the changes relating to individuals will expire in 2025. The effective dates give taxpayers some time to plan, though there are some things to consider in the limited number of days remaining during 2017. Though every fact pattern will have its own nuances, to the extent feasible, taxpayers should generally consider:

- Deferring income into 2018 in order to benefit from lower rates, including but not limited to postponing:
  - (i) conversions of traditional IRAs to Roth IRAs,
  - (ii) cancellation of indebtedness income,
  - (iii) invoicing or billing of customers, and
  - (iv) exercising stock options (assuming it would not result in forfeiture).

- Accelerating personal and business deductions into 2017 to get both the benefit of higher rates and to take advantage of deductions that are disappearing. Though there are practical limits on the ability to accelerate state and local tax deductions, taxpayers will likely get some benefit by beefing up their 2017 4th quarter state/local estimated income taxes. For taxpayers who have been considering making charitable contributions in 2017 to get more tax benefit, but are unsure to whom to give, they might consider quickly establishing a donor-advised fund to allow deductible contributions to be made in 2017.
- Re-characterizing Roth conversions done in 2017 in order to re-do the Roth conversion in 2018 at lower rates – assuming that there hasn't been significant appreciation in the Roth account following the 2017 conversion; and note that the New Act gets rid of the ability to re-characterize after 2017, so that needs to be considered.

What follows is an overview of some of the provisions of the New Act, broken down by type of tax. The overview is not intended as an exhaustive review of all of the New Act's provisions; rather, we highlight here the provisions that we believe are the most relevant for our clients.

INDIVIDUAL INCOME TAXES

The following is a summary of some of the more important components of an individual's income tax return, and how each of those components was (or was not) changed under the New Act – but excluding pass-through business income which is reviewed further below.

	Current Law	*New Act*
Individual Tax Rates	10, 15, 25, 28, 33, 35, 39.6%	10, 12, 22, 24, 32, 35, 37%
Top Long-Term Capital Gains and Qualified Dividends Tax Rate	20% (plus 3.8% NIIT)	20% (plus 3.8% NIIT), and retains thresholds of current law when determining the preferential tax rates on such income.
Alternative Minimum Tax (AMT)	28% of alternate income calculation.	Raises the AMT exemption, as well as the threshold for phasing out the AMT exemption, which will reduce application of the AMT.
Personal Exemptions	$4,050	Eliminated.

	Current Law	*New Act*
Standard Deduction (Married/Single)	$12,700 / $6,350	$24,000 / $12,000
Itemized Deductions – State & Local Taxes	The deduction for state and local income and property tax (“SALT”) deductions are generally unlimited, though they can be reduced by reason of (i) the AMT, or (ii) the “Pease” limitations which phase-out the benefit of itemized deductions.	The SALT deduction is capped at $10,000.
Itemized Deductions – Mortgage Interest	Limits deductibility to mortgages of up to $1,000,000, and includes first mortgages and home equity loans and lines of credit. Mortgage indebtedness on both primary home and vacation home is eligible.	Deductibility of interest limited to $750,000 of “acquisition indebtedness,” and excludes home equity loans or lines of credit. But mortgage indebtedness on vacation homes remains eligible.
Itemized Deductions - Charitable Contributions	Contributions to public charities limited to 50% of AGI, with 5-year carryforward of unused deduction.	Contributions to public charities limited to 60% of AGI, with 5-year carryforward of unused deduction.
Itemized Deductions – Medical Expenses	Qualified medical and dental expenses deductible to the extent they exceed 10% of AGI.	Qualified medical and dental expenses deductible to the extent they exceed 7.5% of AGI; but only for 2018.
Itemized Deductions – Miscellaneous Deductions Subject to 2% Floor	Certain expenses (e.g., tax preparation fees, investment fees, and unreimbursed employee business expenses) are deductible to the extent they collectively exceed 2% of AGI.	Miscellaneous itemized deductions are not deductible during 2018 through 2025.

	Current Law	*New Act*
Kiddie Tax	Unearned income taxed at parent's rates (if higher); requires integration with parents' income tax return.	Unearned income taxed at trust/estate rates; no need to integrate calculations with parents' income tax returns.
Net Investment Income Tax (NIIT)	3.8%	3.8%
Carried Interest	Capital gain treatment, such that preferential long-term capital gains rates apply if the interest is held for more than one year.	Capital gain treatment, but must hold interest for 3 years in order to get preferential long-term capital gains rates.
Child Tax Credit	$1,000, with a phase-out of the credit beginning when AGI reaches $110,000 (for married filing joint).	$2,000 ($1,400 of which is refundable), and phase-out does not begin until AGI reaches $400,000.
Casualty Losses	Deductible generally, regardless of whether part of a declared national disaster, with limitations based on taxable income.	Only deductible if loss is related to a declared national disaster, with existing limitations based on taxable income.

Those who should see healthy tax reductions include most middle class families with children, certain wage earners in states with no or low taxes, and small business owners who operate their businesses in the form of pass-through entities (i.e., partnership, S corporations, disregarded entities, and proprietorships). For families with children, the increased standard deduction is not likely to make up for the loss of personal exemptions. However, the expanded child tax credit (which is both larger and phased out more gradually), along with the rate reductions, should cause most families with children to see a net tax benefit.

The following are some additional notable items and anticipated effects:

- *Individual Mandate* – The Patient Protection and Affordable Care Act set forth an individual responsibility payment for individual taxpayers who do not purchase health insurance that satisfied certain minimum levels. Beginning on January 1, 2019, the individual responsibility payment is repealed, and does not sunset in 2025 like many of the other individual tax provisions.

- *Alternative Minimum Tax* – While retained under the New Act, very few people should expect to be impacted by the AMT. The increase of the AMT exemption under the New Act, the increase

threshold for phasing out the AMT exemption, and the reduction of the SALT deduction, should cause a very significant reduction in the number of taxpayers who will pay the AMT.

- *Marriage Penalty* – The so-called "marriage penalty," which refers to the increased taxes paid when two earners become married, is lessened under the New Act.

- *529 Accounts* – These plans can now be used to pay for private elementary and secondary school expenses, whether the schooling is public, private (not including homeschooling), or religious. However, the tax-free treatment of such 529 withdrawals will be limited to $10,000 per student, per year.

- *Carried Interest* – Much attention has been paid to the ability of those running private equity and hedge funds to receive long-term capital gain treatment for personal services. Notwithstanding a pledge by the President, and others on Capitol Hill, to end the carried interest loophole, it survived. While it now comes with a 3-year required holding period, that is not much of an obstacle for the typical private equity or hedge fund.

- *Retention of "Stretch IRA" Rules* – There has been discussion for many years now of removing the ability of a non-spouse beneficiary to defer distribution of an inherited IRA (or certain employer-sponsored retirement accounts) over the beneficiary's life expectancy. The legislation did not address this particular provision of the law.

- *Re-characterization of Roth IRA Contributions* – The New Act provides that a conversion contribution to a Roth IRA can no longer be unwound (e.g., where the value of the converted funds goes down).

- *Sec. 1031 Like-Kind Exchanges* – The New Act would limit the applicability of the like-kind exchange rules to real property only (but excluding real property held primarily for sale – such as lots held by developers). Prior to the New Act, certain types of tangible personal property could be exchanged without recognizing gain.

ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

	Current Law	***New Act***
Estate & Gift Tax	40% rate, $5,490,000 exemption per individual (indexed for inflation).	Commencing 2018, exemption for estate and gift tax doubled from $5.6 million to $11,200,000 per person (indexed for inflation); rate remains at 40%.

	Current Law	*New Act*
GST Tax	40% rate, $5,490,000 exemption (indexed for inflation).	Commencing 2018, exemption for GST tax doubled from $5.6 million to $11.2 million (indexed for inflation); rate remains at 40%.
Tax Basis	Step-up in tax basis for certain property passing at death.	Step-up in tax basis for certain property passing at death.

While there were proposals for repeal of the estate, gift, and GST taxes in the House Bill, ultimately the new Act retains these taxes, and makes no meaningful changes to the "structure" of this transfer tax regime, but substantially increases the Exemptions. The significant expansion of the Exemptions continues a trend that began with the 2001 Tax Act, prior to which the Exemption had long been set at $600,000 per person, without any increases for inflation.

Under the new Act, an even smaller proportion of the population will now be exposed to such taxes. With the portability of the Exemptions remaining in the law, married couples now have a combined Exemption of $22,400,000 beginning on January 1, 2018.

It is notable that many loopholes/gaps that have long eroded the estate, gift and GST tax base were not addressed in the new Act. There remains the ability to create defective grantor trusts – where a grantor can make a completed gift of assets to a trust, but continue to pay income tax on the trust's income without such payments being considered a further gift. Grantor Retained Annuity Trusts (or "GRATs") also went unchanged, so that many of the creative uses of such trusts remain available. Similarly, there was nothing in the legislation that addresses discounting of valuations relating to closely-held businesses, which is consistent with the Trump administration's withdrawal of the previously proposed regulations in 2016. These are just some of the many opportunities that continue to be available to wealthy families, which had previously been threatened for repeal or modification.

Many wealthier taxpayers have been postponing certain lifetime estate planning initiatives due to the legislative uncertainty, and the New Act now provides some relative clarity. The increased Exemptions, along with the continued step-up in basis of assets on death, will cause many to reconsider gifts that were driven by federal estate tax planning. Indeed, planning to take advantage of the step-up in tax basis will become an even greater focus for many taxpayers.

However, as mentioned previously, many of the individual tax provisions expire, including the increased Exemptions which will expire at the end of 2025. This brings back memories of the "fiscal cliff" situation at the end of 2012, where the Exemptions were scheduled to revert back to a lower figure – causing many taxpayers to pull the trigger on making large gifts to use their Exemption. The prospect of this sunset will unfortunately cause there to be some continued level of uncertainty as it relates to gifting for federal estate tax planning purposes.

CORPORATE TAXPAYERS (“C” Corporations)

	Current Law	*New Act*
Top Tax Rate	35%	21%
Corporate AMT	Parallel tax calculation with top rate of 20%.	Eliminated.
Depreciation / Sec. 179	Immediate write-off of certain capital purchases under Sec. 179, but limited to $500,000; with remaining purchases depreciated under varying rules, including 50% first year “bonus” depreciation for eligible property.	Immediate write-off of all capital under Sec. 179, but limited to $1,000,000; through 2022, 100% first year “bonus” depreciation for eligible property, with the bonus depreciation decreasing ratably for the 5 years following 2022.
Research & Development Expenditures	Immediate deduction.	Beginning in 2022, must be capitalized.
Interest Expense	No limitation	Limited to business interest income, plus 30% of a business’s adjusted taxable income; with special rules for certain types of indebtedness.
Net Operating Losses	Can fully deduct against income in other taxable years, including carrying back and carrying forward.	Can only deduct a post-2017 NOL against 80% of taxable income, and post-2017 NOLs could not be carried back except in limited circumstances.

The changes for corporate taxpayers are the most significant within the New Act. Not only are the size of tax reductions the most significant, the changes are not nearly as complex as those for businesses operated through pass-through entities. There will be some areas of complexity for corporate taxpayers relating to repatriation of foreign income, but those changes are nonetheless favorable (and discussed further below).

PASS-THROUGH BUSINESSES ("S" Corporations, Partnerships, Disregarded Entities)

	Current Law	*New Act*
Tax Rates – Non-Service Businesses and Engineers and Architects	Subject to tax at individual rates up to 39.6%	Subject to tax at individual rates up to 37%, but an individual taxpayer generally may deduct 20% of domestic "qualified business income" (QBI) from a pass-through business, effectively reducing the individual income tax rate on such income by 20%. The amount of the deduction is limited to 50 percent of the W-2 wages paid to the entity's employees (or 25 percent if sufficient capital such as real estate); but the wage limit only applies if an individual's income is over $315,000 for married filing joint (and $157,500 for other individuals). The deduction is not available to trusts and estates.
Tax Rates – Service Businesses (other than Engineers and Architects)	Subject to tax at individual rates up to 39.6%	Subject to tax at individual rates up to 37%; 20% deduction does not apply to specified service businesses (e.g., law, accounting, financial services, artistic performers, consulting), except in the case of a taxpayer whose taxable income does not exceed $315,000 (for married individuals filing jointly; $157,500 for other individuals); the benefit of the deduction for service providers is phased out for taxable income between $315,000 and $415,000 for married individuals filing jointly (and between $157,500 and $207,500 for other individuals). Service businesses would have the same wage limitation on the deduction, subject to taxable income thresholds.

	Current Law	*New Act*
Depreciation / Sec. 179	See topic under Corporate Taxpayers, above	See topic under Corporate Taxpayers, above
Research & Development Expenditures	See topic under Corporate Taxpayers, above	See topic under Corporate Taxpayers, above

The deduction for QBI (housed in new IRC Sec. 199A) effectively creates a disparity between wage earners and self-employed persons. Never before has the law applied an income tax rate to the employees who work for a pass-through company which is guaranteed to be higher than the business owner's tax rate (assuming the same level of income).

Further, the mechanics of the deduction provide proportionally greater benefits for wealthier business owners, as the deduction percentage remains static as income moves up through the tax brackets. For example, a business owner in the 22% bracket would see a tax rate reduction on QBI equal to 4.4% (20% deduction multiplied by 22% bracket). However, a business owner in the 37% rate bracket would see a tax rate reduction on QBI equal to 7.4% (20% deduction multiplied by 37% bracket).

This new deduction for QBI will undoubtedly cause a flurry of planning activity among closely-held business owners, looking to find ways to maximize the income that can be considered QBI. The following are some preliminary examples of strategies that might be pursued:

- *Characterizing Income as Non-Services Income* – We can expect that pass-through businesses will look to structure their delivery of products and services in a manner that will look and feel more like product sales (or services that are within QBI), and less like services that do not qualify as QBI. For businesses that provide both QBI products/services and non-QBI products/services, there would seem to also be the temptation to allocate overhead and expenses more heavily to the non-QBI, so long as there is a reasonable basis for doing so.

- *Revisiting Amounts Paid to Owners as Wages and Guaranteed Payments* – QBI does not include amounts received by a shareholder as wages, or by a partner as a "guaranteed payment" (meaning that it is not determined with regard to partnership income and therefore doesn't impact a partner's capital account).

  In the context of S corporations, there has long been an incentive to try to keep owner wages low, and dividend distributions high; the QBI rules will enhance that incentive in most cases, putting even greater focus on what is "reasonable compensation" for an owner. For entities classified as partnerships, there is no pre-existing reasonable compensation limitation (as there was not really a need for one). As a result, entities taxed as partnerships may have significant flexibility in maximizing the amount of income that qualifies as QBI. For those partnerships that have historically used guaranteed payments as a material part of a partner's income, such partnership will likely be looking at ways to restructure to turn such payments into distributive shares of partnership profit.

- *Restructurings to Meet the Wage Limitation* – Many businesses may find that their QBI deduction will be constrained by the wage limitation. One way to come within the wage

limitation would of course be to increase hiring and/or increase wages. But that comes at a cost, and many businesses are perhaps more likely to look at converting independent contractors to employees.

- *Converting from Employee to Owner* – If the wage limitation is not an issue for a particular business, then that business may look to find ways to bring key people into ownership, as a means of helping to bring a lower tax bite for such key persons.

- *Converting to a C Corporation* – For more successful service firms, the owners will not benefit from the deduction due to the phase-outs; and as a result would pay up to 37% on QBI. Such businesses might consider converting to a C corporation as a means of taxing earnings they intend to retain at a lower 21% rate. But the 21% rate is still high enough (in conjunction with state corporate income taxes where applicable) that, when combined with the tax rate on qualified dividends (and the QBI treatment available to pass-through entities), a business owner would likely pay a higher tax rate on distributed earning from a C corporation than if the same income were earned and distributed in a pass-through entity.

INTERNATIONAL TAX PROVISIONS

	Current Law	***New Act***
Foreign Earnings Repatriation – Dividends Received Deduction	Repatriation of foreign source earnings to domestic corporation (i.e., dividends from foreign companies) is subject to U.S. taxation at regular corporate income tax rates, up to 35%	100% of foreign-source portion of dividends paid by certain foreign corporations (excluding PFICs) to U.S. corporate shareholder (that owns at least 10%) would be exempt from U.S. taxation. Available only to C corporations that are not REITs or regulated investment companies.
Mandatory/Deemed Repatriation	Not applicable under current law. Foreign income not taxed until distributed/repatriated to the U.S. via dividend.	U.S. shareholders owning at least 10% of a foreign corporation would be taxed on post-1986 net foreign earnings and profits (15.5% on earnings and profits comprising cash or cash equivalents; 8% on remaining earnings and profits). This tax may be paid over a period of up to 8 years.

	Current Law	*New Act*
Base Erosion Prevention	Payments from domestic corporations to foreign corporations are deductible but subject to U.S. withholding taxes; however, tax treaties often limit the withholding taxes.	A new "base erosion tax" is enacted to apply to a "base erosion amount".

The changes proposed in the international tax arena move the U.S. away from the worldwide tax system that's been in place, and closer toward a territorial tax regime. The mandatory repatriation/inclusion is designed as a transition rule for purposes of implementing the "participation exemption system" (i.e., a territorial system). As can be surmised, the intent of these changes is for U.S. multinational corporations to bring cash/assets back into the U.S. for reinvestment within the U.S.

CONCLUSION

It's hard to consider the New Act a "reform" because it continues to build on the platform of the Internal Revenue Code of 1986. While there are new concepts added into the law (e.g., the QBI deduction for owners of pass-through entities), and tweaks to certain provisions, the general framework of the Internal Revenue Code remains largely the same. If any part of the New Act could be considered to be a reform, it would be the international tax provisions, as those do structurally change the manner in which the U.S. taxes (or doesn't tax) foreign income.

Nonetheless, the changes are the most dramatic since the 1986 Tax Reform Act, and will provide significant tax relief to many. As can be seen in the summary above, business owners (and their advisors) will need to grapple with a complex set of new rules, but the cost should be well outweighed by the tax savings.

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