Advanced Planning Group

EYE ON CONGRESS

January 2018

Tax Cuts and Jobs Act (H.R. 1)

The "Tax Cuts and Jobs Act" (TCJA) has been passed by Congress and signed by President Trump. TCJA contains major tax revisions to the federal Internal Revenue Code (IRC). This enactment followed Joint Conference Committee modifications to bills passed by each chamber in mid-December 2017.

The Senate acted under budgetary limitations according to procedural rules it passed earlier in 2017 when considering an extension of the 2017-2018 Budget. The effect of the Senate limitation was to enable a simple majority of that chamber to pass a "reconciliation" bill whereby tax revenue reductions over the next ten years could be no greater than $1.5 trillion considering any tax increases.

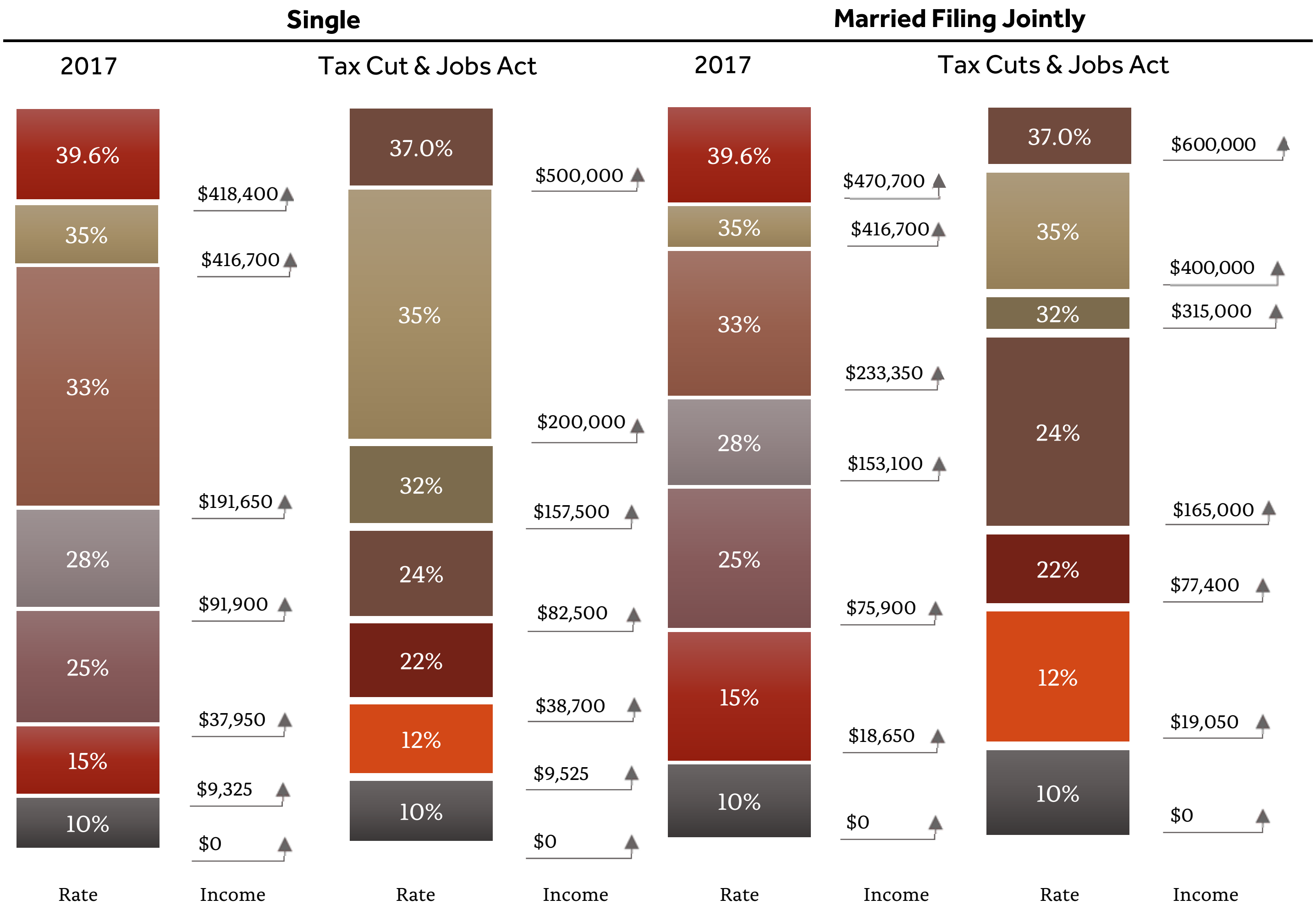
The law incorporates broad scale reform and a simplification of the individual and corporate tax codes in many areas, as well as changes to federal gift and estate tax laws. Changes of this magnitude have not occurred since an overall revision of the U.S. Tax Code in 1986.

Individual Income Taxes

Changes to the individual income tax code adhere to the stated goal of certain Congressional leaders to eliminate many popular tax benefits and deductions in exchange for broadly lowered tax rates. Tax changes for individuals are scheduled to expire after 2025 in order to comply with the Senate limits for revenue reduction, except as noted in the following paragraphs.

The enacted bill retained the existing seven-bracket structure but at different marginal rates. The calculation for cost of living changes has been modified from the current Department of Labor (DOL) issued annual increases for tax brackets, qualified plan contribution limits and many other areas. The use of the Consumer Price Index for All Urban Consumers (CPI-U) has been replaced with a method known as "Chained CPI-U." This is anticipated to result in reduced inflation adjustments in relation to the standard CPI-U. There is a reduced weighting of certain living expenses for the Chained CPI-U and a recognition that consumers will substitute cheaper goods (e.g., store brand vs. national brand) during inflationary periods.

The following chart depicts the changed tax rates and income levels of the final bill in relation to the current tax rates and income levels, for single and married filing jointly taxpayers.



Marginal taxable income rates for estates and trusts are 10% up to $2,550, 24% up to $9,150, 35% up to $12,500 and 37% for amounts over $12,500. In addition to a lower effective rate at many income brackets, the standard deduction has been increased significantly—from the current $6,350 single/$12,700 married to $12,000 single/$24,000 married. The percentage of taxpayers who itemize deductions is expected to be sharply reduced with some estimates of only 15% who will itemize deductions in future years. The increased standard deduction comes with an important alert:

- All **personal exemptions** are repealed, eliminating the ability for individuals (and particularly those with many dependents) to obtain additional tax deductions. The increased standard deduction (and family/child tax credits discussed below) is expected to offset this loss for many taxpayers. Those over age 65 in 2018 will retain an additional $1600 deduction if single or $1300 each if married.

Those who continue to itemize can expect to see many itemized options eliminated or reduced, including:

- **Mortgage interest deduction** under the TCJA is reduced to $750,000 of acquisition debt (reduced from $1 million); additionally, the home equity interest deduction is eliminated.
- The deduction for **state and local income taxes (SALT)** and the state sales tax are capped at $10,000 annually. Many individuals in high income tax jurisdictions may see their effective income taxes increase significantly as a result of the reduced deduction.
- The deduction for **property taxes** is preserved, though limited to $10,000 annually. The SALT, sales, and property taxes are **combined** for an overall limited deduction of $10,000.

The charitable and tax-exempt organization areas have been modified in multiple ways:

- The deduction for **charitable contributions** is preserved in its current form, however, the Adjusted Gross Income (AGI) limit for cash contributions increased from 50% to 60%. Keep in mind that the larger standard deduction is expected to lower the number of those who choose to itemize.
- A charitable deduction is no longer available for **college athletic event seating rights**. Previously there had been an 80% deductible amount for game and event tickets.
- Tax exempt organization compensation is now subject to a **21% excise** tax on amounts paid to each of the five highest paid executives that exceeds $1 million. There is an exception to this rule for licensed medical professionals in the performance of medical services.
- **Unrelated Business Income Tax** (UBIT) is now required to be calculated separately for each trade or business and offsetting of income between businesses is prohibited for tax-exempt entities.
- The law imposes a **1.4% excise tax on endowments** of private colleges and universities that have at least 500 tuition paying students and assets valued at $500,000 per full-time student.
- The law allows **payments up to $10,000** annually per student from **Section 529 plans** to elementary and secondary schools, including public, private, or religious schools.

Other deductions and tax rules impacting individuals include:

- All **miscellaneous itemized deductions** subject to the 2% floor are repealed through 2025. Taxpayers can no longer deduct tax preparation fees and fees for investment management.
- **Individual Alternative Minimum Tax (AMT)** was retained with higher thresholds ($70,300 single/$109,400 married). The phase out of the AMT exemption was increased to $500,000 for single filers and $1 million for married filing jointly.
- Deduction for **medical care expenses** was retained with a lower 7.5% threshold for 2017 and 2018 only. The medical expense deduction reverts to a 10% threshold beginning in 2019.
- Deduction for **alimony** was repealed while accordingly the recipient of alimony will not recognize income on payments. This is effective after December 31, 2018, to allow time for negotiations of settlements that are now in process or contemplated for 2018.

- Elimination in many respects of **personal casualty loss** deductions, unless in a declared federal "disaster zone" under the Stafford Disaster Relief and Emergency Assistance Act. Theft losses will no longer be deductible.
- **Moving expenses** for individuals are no longer deductible after 2017. Qualified moving expense **reimbursement exclusion** has been repealed, except in the instance of military personnel. These changes sunset after 2025.
- **Pease** limitation on itemized deductions is generally repealed.
- **IRC Section 1031** "like-kind exchange" rules are now limited to **real property only** that is not held primarily for sale. Section 1031 is no longer available for other property types including livestock or personal property.
- A three year holding period is required for a **carried interest** (applicable partnership interests) to qualify as a long-term capital asset. This will impact hedge fund owners and various investors.

The TCJA provides enhanced **child tax credits** to offset the loss of the personal exemption. The law provides a child tax credit of $2,000 per dependent child under 17. This is intended to offset the loss of the personal exemption per child. Furthermore, the income exclusion limits for eligibility have been increased to $110,000 single/$220,000 married. The credit begins to be phased out at income of $400,000 for married taxpayers and $200,000 for other taxpayers. The maximum **refundable credit** would be **$1,400**. There is a **$500 nonrefundable credit for dependents** who are not children of the taxpayer.

Note that current rates on capital gains and dividends, as well as the applicable income thresholds, are not generally impacted by the tax bills, nor is the imposition of the 3.8% Medicare surtax on net investment income. As a result, the 20% rate on capital gains and dividends will remain tied to the highest marginal tax bracket threshold under IRC Section 1(h) with thresholds identified in the bill as $425,800 single/$479,000 married. The Medicare net investment tax likewise applies at levels above $200,000 single/$250,000 married.

Changes in the qualified plans and Individual Retirement Accounts (IRAs) areas were relatively minor for most taxpayers.

- Persons who have a **401(k) loan** outstanding and terminate from their employer will now be able to repay the loan by the time of filing their income tax return.
- **Roth conversions** will no longer be eligible for recharacterization or converting back to a traditional IRA. Once the conversion is made, there is no "do over" if the market value of the investments drops in value by the next filing date with extensions. Roth IRA contributions can still be recharacterized as a traditional IRA contribution within permitted filing limitations.

Business Tax Provisions

Corporate **Alternative Minimum Tax** (AMT) has been repealed permanently. This is in contrast to AMT for individual taxpayers who merely saw an increase in the exemption amount which expires after 2025. The AMT credit carryover is available for future tax years to those corporations with existing carryovers.

The TCJA provides for a unique tax relief method for certain pass-through income of S corporations, partnerships, LLCs, and sole proprietorships. This is a major tax law change.

Pass Through Business Tax Relief

The bill includes relief for owners of businesses not taxed as C corporations too, coming in the form of a new income tax deduction. The deduction is itself contained in the new IRC Section 199A, allowing many non-corporate taxpayers[1] to deduct up to 20% of their pass-through income derived from S corporations and partnerships. However, the precise amount, and even the availability of this deduction for some taxpayers, are matters of some complication.

Section 199A(c) defines a new class of income, Qualified Business Income (QBI). Basically, QBI is business income received by a business that is connected with the U.S., which would otherwise be included in the taxable income of the taxpayer claiming the deduction. Some income is excluded from the deduction, such as income from certain real estate investment trusts (REITs), cooperatives, and publicly traded partnerships.

20% of a taxpayer's QBI may generally be deducted under Section 199A. However, there are several potential limitations, including the following:

- The amount of the deduction may be limited to 50% of W-2 wages for certain high income taxpayers (that is, single taxpayers earning more than $207,500, or joint filers earning more than $415,000 annually).
- The deduction is reduced for owners of "specified service businesses" who have taxable income in excess of $157,500 (individual filers) or $315,000 (married filing jointly).
- The deduction may not be available at all for owners of "specified service businesses" who have taxable income in excess of $207,500 (individual filers) or $415,000 (married filing jointly).
- "Specified service businesses" are those in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset is the reputation or skill of one or more of its employees. Engineering and architecture firms have been specifically excepted from this exception (i.e., the deduction is available to engineers and architects).

Pass-Through Taxation vs. C Corporation Taxation

- The lowering of the C corporation bracket to 21% is virtually certain to prompt discussion among owners of many S corporations and partnerships as to whether converting to C corporation taxation may result in tax savings.
- Indeed, converting to, or forming as, a C corporation may make sense for many businesses, including those capital-intensive ones with temporarily reduced profits.

[1] The deduction is also generally available to trusts and estates

- For many businesses, however, the need to distribute earnings and profits as taxable dividends – that is, two levels of tax – will continue to militate against converting to or forming as a C corporation.
- This issue will likely provoke considerable discussion between business owners and their tax advisors. While there appears to be no general rule applicable to all businesses, an awareness of the issues involved, which are complex, may help to differentiate some advisors.

Corporate Tax Changes

A major emphasis within the Trump administration and the broader Republican caucus has been corporate tax reform, focused largely on reducing the corporate income tax rate (applicable to C corporations) in an effort to make the U.S. tax system more competitive on an international scale. Congress lowered the corporate tax rate to a flat 21%, compared to the current 35% maximum rate with graded levels.

In exchange for the corporate rate reduction, certain common deductions will now be disallowed, including deductions for most forms of entertainment, recreation, and other items.

Notable business provisions include:

- Increase in the IRC Section 179 expense limit and applicable threshold to as much as $1 million; the phaseout of the expense limit begins at $2.5 million, which is an increase from the prior $2 million.
- Modification of the threshold for accrual basis accounting for corporations from $5 million in gross receipts to $25 million and the prior 70% dividends received deduction is reduced to 50%.
- Certain business assets will be eligible for 100% expensing on a temporary basis that scales down incrementally; bonus depreciation under IRC Section 168(k) is modified to allow full expensing prior to 2023 under certain circumstances. The final bill provides for enhanced depreciation deductions for certain non-residential real property and residential rental property.
- Repeal of the domestic production activities deduction (DPAD). IRC Section 199 had allowed for a 9% deduction previously.
- Elimination of Net Operating Loss (NOL) carrybacks for most businesses, and a limit on the deduction to 80% of taxable income going forward.
- A limitation on net business interest expense deductions to 30% of adjusted taxable income (though businesses with revenues under certain thresholds will be exempt).

Estate and GST Tax Repeal

Political promises to eliminate the “death tax” have been modified under the law in the interests of complying with the Senate rules limiting the time period for tax cuts. The final version doubles the federal gift, generation skipping transfer (GST) tax, and estate tax exemptions under current law with reversion to a $5 million exemption (as indexed) to the federal estate and GST tax starting in 2026. The exemption reversion is scheduled to be indexed from the base year of 2016 using the Chained CPI-U. This creates a situation similar to the estate tax repeal under EGTRRA 2001 (with its sunset in 2010). The estate tax survived that modification, and may yet survive this change in future Congressional sessions.

A benefit of the higher exemptions may be the tax-free step-up in basis heirs would achieve, eliminating taxation (estate or capital gains) on estates up to approximately $22.4 million for married couples beginning in 2018 with the exemption indexed for inflation. This may alter the estate planning landscape to a large extent, favoring arrangements that the senior generation will retain select assets rather than transfer the assets to a trust. The extensive use of trusts has been a common planning arrangement.

It should be noted that the gift tax was to remain in place under proposals, even if the estate tax had been repealed. Retention of the gift tax was an effort to restrict income shifting to family members in lower brackets. TCJA retains the federal estate, gift and GST taxes. Higher gift exemptions, however, may provide opportunities to shift assets for income tax planning purposes nonetheless. . Note that the annual gift tax exclusion is unchanged under the law and will be $15,000 per donee in 2018.

Large lifetime exemptions may provide a strong incentive for the wealthy to undertake wealth shifts during life to guard against future changes in the transfer tax laws which could be far less favorable than the current environment. The large GST tax exemptions may also provide a large incentive for the wealthy to establish dynastic trust arrangements to similarly insulate against future changes in transfer tax laws.

Expiration Alerts for Individual and Estate Tax Changes

The vast majority of the tax law changes applicable to individual income taxes as well as estate, gift and GST taxes, "sunset" starting in 2026 (at which point current law comes back into effect). Senate rules limited the tax reduction period (via increased exemption), so the law "sunsets" many changes to avoid creating budget deficits beyond the 10-year window. The TCJA provides "permanence" for many of the corporate tax changes.

In an effort to fit within the budgetary framework, the Senate version adopted effectively repeals the "individual mandate" (the requirement to have health insurance). TCJA modified the mandate under the Affordable Care Act (ACA) by replacing the penalty tax stated amount of $695 in current law with "$0." While the failure to collect a tax would not normally provide a revenue boost for Congressional Budget Office (CBO) purposes, the savings on subsidies provided under the federal health insurance exchanges (due to fewer sign-ups) are estimated to be substantial. This controversial provision sunsets the effective repeal of the individual mandate in 2026.

International Tax Changes

Provisions of the TCJA provide a 100% exemption that is only available for C corporations (S corporations and individuals are not eligible under IRC Section 245A). The potential exemption applies to the foreign source portion of dividends received from certain foreign corporations. This is similar to "participation exemptions" available under the laws of many countries. Changes are intended to make the U.S. more competitive globally along with moving overseas cash onshore.

The new exemption for C corporations is not intended to reward those companies attempting to repatriate profits and cash accumulated over time by foreign subsidiaries, so the law requires inclusion in taxable income of the taxpayer's share of prior accumulated foreign earnings of the foreign corporation. The effective tax rate is 8% or perhaps 15.5% depending on the nature of the corporation's assets. The effective rate is arrived at by way of deductions against the taxpayer's higher nominal statutory tax rate.

Rules to minimize the loss of the U.S. income tax base have been enacted as part of the law. These efforts by Congress are reflected in the "Base Erosion and Anti-Abuse Tax" (BEAT) which applies to businesses which make significant payments to foreign affiliates. The intent is to limit companies that substantially reduce their U.S. income tax by making cross-border payments to affiliates. BEAT applies if 10% of the cross-border payments exceed the regular U.S. tax liability. There is an anti-inversion rule that denies the participation exemption and imposes a 35% tax in respect of "expatriated entities" during the 10 years following enactment of the TCJA.

There are many details contained in these changes for taxation of international entities that are beyond the intended scope of this limited analysis. It is strongly recommended that advice of qualified counsel in this area be retained to provide guidance where a particular taxpayer may be impacted.

Conclusion

For most taxpayers, the tax changes represent a reduction in their tax liabilities, at least through 2025 when many individual provisions are scheduled to expire. The TCJA was ushered in without bipartisan support. There are expiration dates that assure a Congressional revisit of controversial changes when (not if) there is a change in the administration and members of Congress. Change is the new "Permanent."

Simplicity was the stated objective for tax reform, for a significant portion of U.S. taxpayers this is not the likely outcome. A currently complex tax system has been simplified in many areas and the TCJA represents the largest tax law change since 1986. The IRC will remain a puzzle to all but a limited few given these changes. A professional planning team will remain essential for many taxpayers to navigate the new rules and identify tax-efficient opportunities in the future.