Eye on Washington

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Tax Cuts and Jobs Act of 2017

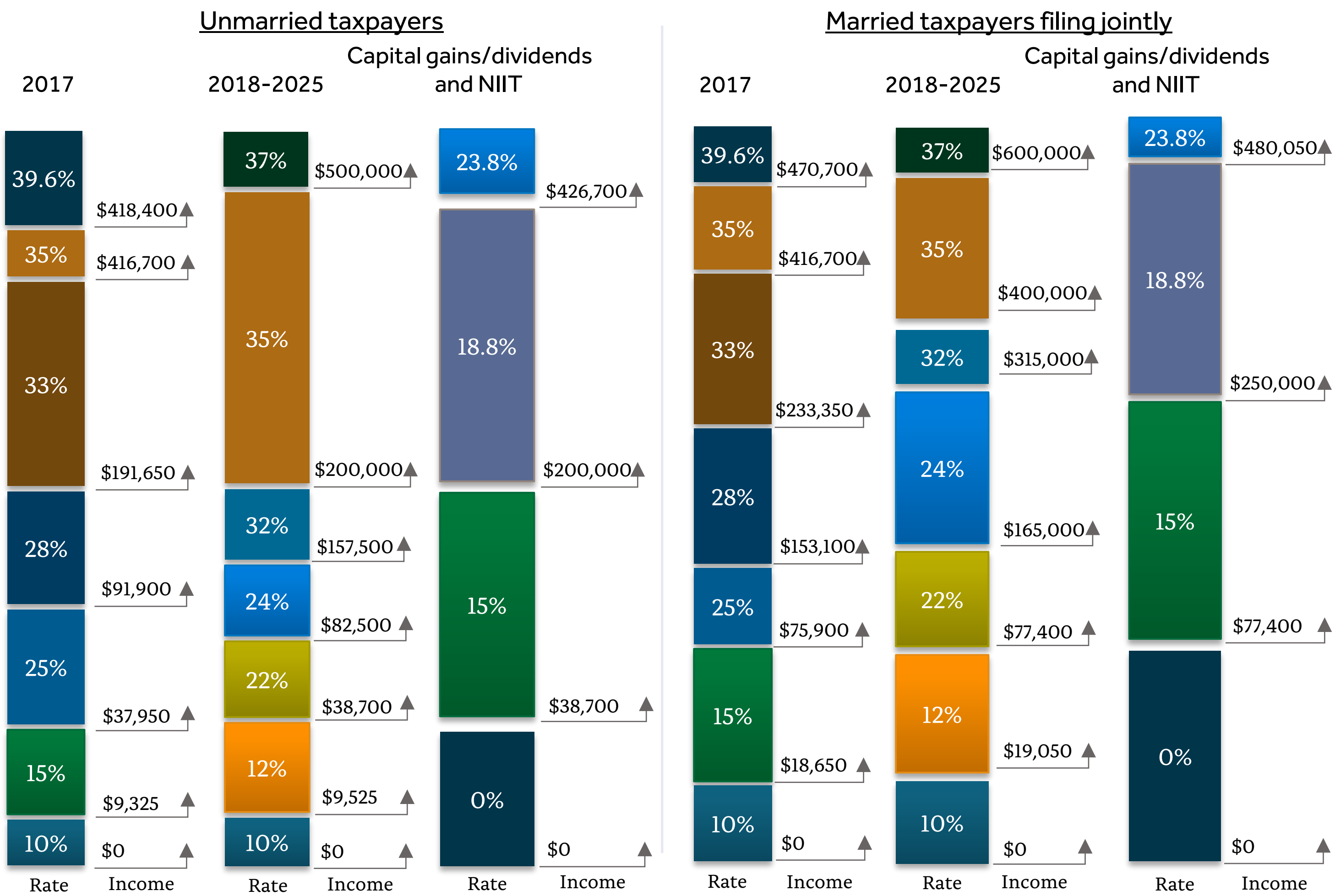
On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017, securing a hard-fought victory on the legislative front for a Republican Congress stymied on other efforts during a tumultuous year. While the bill makes good on several key reform initiatives for the GOP, the price of passing legislation without any Democratic support whatsoever is a built in “kill switch” that sunsets major elements of the bill after eight (8) years. As a result, the ultimate fate of this latest round of tax reform appears tied to the economic benefits such reform has promised. Absent meaningful broad based cuts and improved growth in the private sector, it is likely that the GOP will not be in a position to secure a greater durability for the changes. While “permanence” of tax law is never assured, the automatic sunset introduces an additional wild card that makes effective tax planning a continuous challenge.

In the aggregate, the new law enacts broad scale reform and simplification (to an extent) of the individual and corporate tax codes, as well as changes to gift and estate tax laws.

Individual Income Taxes

Changes to the individual income tax code generally adhere to a philosophy of eliminating many popular tax benefits and deductions in exchange for broadly lowered rates. Note that current rates on capital gains and dividends, as well as the applicable income thresholds, are not impacted by the legislation, 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 current law (e.g., $425,800 single/$479,000 married). The Medicare net investment tax likewise applies at levels above $200,000 single/$250,000 married.

The following chart compares the current and new tax rates and income levels for single and married taxpayers and for capital gains and dividends and net investment income.



In addition to a lower effective rate at many income brackets, the standard deduction has been increased significantly—from current $6,350 single/$12,700 married to $12,000 single/$24,000 married. In an effort to simplify the tax preparation process, the percentage of taxpayers who itemize deductions is expected to go from one-third of all taxpayers under current law to fewer than 10%. The increased standard deduction comes with one important caveat:

- The personal exemption is repealed, eliminating the ability for individuals (and particularly those with many dependents) to obtain additional tax deductions. The increased standard deduction is expected to offset this loss for many taxpayers.
- Additionally, an enhanced child tax credit of $2,000 per child may help offset the loss of the personal exemption for those with dependent children under 17. Along with the credit increase (formerly $1,000 per child), the income exclusion limits for eligibility have been increased as well ($200,000 unmarried/$400,000 married filing jointly).

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

- The **mortgage interest deduction** is capped at $750,000 of acquisition debt (reduced from $1 million); additionally, the home equity interest deduction for up to $100,000 of home equity debt is eliminated. Existing mortgages and refinancings of such mortgages are grandfathered; and purchases under binding contracts entered into prior to December 15, 2017, that close by January 1, 2018, are grandfathered as well.
- The deduction for **state and local income taxes, sales taxes, and/or property taxes** is now capped at $10,000 annually. Note that taxpayers may aggregate between income taxes, property taxes and/or sales taxes (i.e., the deduction is not limited to one or the other). In states with high local tax rates, some individuals may still lose a meaningful tax benefit. Note that 2018 state and/or local income taxes prepaid in 2017 will not be considered paid until 2018; *prepayment of property taxes, however, may be considered paid in 2017—not all jurisdictions permit prepayment of such taxes, and any prepaid taxes must have been assessed in 2017 to qualify for a deduction in 2017.*
- The deduction for **charitable contributions** remains intact, with the Adjusted Gross Income (AGI) limit for cash contributions increasing from 50% to 60%.

Other deductions and tax rules impacting individuals include:

- Individual alternative minimum tax (AMT)—preserved, however the AMT exemption is increased significantly ($70,300 single/$109,400 married), and the income level for phase-out of such exemptions is increased as well ($156,300 single/$208,400 married).
- Pease limitation on itemized deductions is repealed.
- Ability to **recharacterize a Roth IRA conversion** by October 15th of the following tax year (i.e., when a Roth conversion of a traditional IRA proves to be unwise due to downturn in markets) is eliminated.
- Deduction for medical care expenses—preserved, including a lower 7.5% AGI threshold for 2018 only.
- Above the line deduction for alimony is repealed—recipient of alimony does not recognize income on payments (effective for divorce decrees and separation agreements entered into after 2018).
- Elimination in many respects of personal casualty loss deductions.
- Limits the **1031** "like-kind exchange" benefit to real property.
- Expanded 529 savings plans eligibility—starting in 2018, may use up to $10,000 annually per beneficiary towards elementary or secondary school (public, private, or religious).
- Additionally, a 529 plan can be converted to a 529A (ABLE) in certain circumstances as well.
- Starting in 2019, the bill essentially repeals the "individual mandate" (the requirement to have health insurance) as required under the Affordable Care Act by reducing the penalty tax to 0% (note that such repeal does not sunset in 2026).
- *Finally, note that the proposed first-in first-out (FIFO) cost basis rules for securities **was not included** in the final legislation.*

With respect to life settlement transactions, such sales (post December 31, 2017) are now subject to a significant new reporting requirement, both for the acquiring party as well as the issuer of the policy. Furthermore, any policy sale subject to such rules is no longer eligible for any exemption otherwise available under the transfer for value rules.

Pass-Through Business Tax Relief

Owners of businesses taxed on a pass-through basis (S corporations, partnerships, LLCs, and sole proprietorships) will be able to claim a deduction for a portion of business income based on a set of somewhat complex rules.

"Qualified Business Income" will be eligible for a deduction of up to 20% of such income (essentially lowering the top ordinary tax rate to 29.6%). Key rules:

- The deduction is limited to 50% of the taxpayer's allocable share of W-2 wages paid by the business (or the sum of 25% of W-2 wages plus 2.5% of the unadjusted basis [after acquisition of all qualified property]).
- As an example: a business with $1 million of pass-through income to the owners pays $1 million in wages to the employees of the business. Half a million dollars ($500,000) of the pass-through income will therefore be eligible for the 20% deduction, generally allocated by an owner's ownership interest.
- Note that the W-2 limit will not apply to taxpayers with taxable income under $157,500 single/$315,000 married, and will be phased in as income exceeds such levels.
- Note additionally that the preferred rates apply to passive "business activities" as opposed to passive "investment income"—as such, rent, royalties, etc. received by a pass-through will generally not be eligible for the preferential rate; however qualified REIT dividends, cooperative dividends and certain publicly traded partnership income may still be eligible for a deduction.
- Certain professional service firms (physicians, attorneys, accountants, financial service professionals, etc.) will not generally be eligible for the deduction, however businesses in the field of engineering and architecture may be eligible. For professional service firms with taxable income below certain thresholds ($207,500 single/$415,000 married), some level of deduction may still be available.

Overall, the rules governing preferred pass-through treatment are quite complex and subject to numerous caveats and qualifications. Expert and thorough guidance in this area will be paramount for most pass-through business owners.

Lastly, note that the preferred rate for **"carried interest"** (capital gains treatment for partnership profits interests) now requires a three-year holding period rather than the current one year for certain partnerships engaged in capital market transactions. This provision is not subject to the sunset that otherwise impacts the preferred pass-through tax treatment described above.

Estate and GST Tax Exemption Increases

While the so called "death tax" is not repealed under the new law, it is effectively repealed for the overwhelming majority of estates. The federal gift, generation skipping transfer (GST), and estate tax exemptions are doubled from the current $5 million level (indexed for from 2011) starting in 2018. Each individual will therefore have an exemption of $11.2 million to shelter assets from federal gift, estate or GST tax. This amount continues to be indexed for inflation moving forward.

A benefit of the higher exemptions may be the ability of for taxpayers to utilize the tax-free step-up in basis, eliminating taxation (estate or capital gains) on estates up to approximately $22.4 million for heirs of married couples. This may alter the estate planning landscape to a large extent, favoring arrangements that retain assets with the senior generation rather than many common trust planning arrangements to effect lifetime wealth shifts.

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

Note that certain states continue to impose a state estate tax on estates at much lower thresholds. While some states have tied their state exemption levels to the federal level, it is unclear whether such states will modify their state estate taxes to maintain a lower threshold moving forward. For example, New York State is scheduled to introduce a state exemption that matches the federal level beginning in 2019, however such exemption was expected by New York legislators to be much lower when the legislation was passed.

Sunset in 2026

Long term consistency and predictability in tax laws is never assured in a vibrant democracy, and in this respect, Congress has built in the need to revisit the legislation in late 2025 if not sooner. Without a filibuster proof majority in the Senate (60 votes), Republicans were bound by the "Byrd Rule," which requires legislation that is projected to create deficits beyond a ten (10) year window to automatically sunset. To this end, most of the above described changes impacting individuals, pass-through businesses and estates are scheduled to expire starting in 2026, where an automatic reversion to current (2017) law will take place. The trade-off was (legislatively at least) a permanence for the changes applicable to C corporations described below.

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. The final bill has established a **corporate tax rate of 21%**, compared to the former top 35% rate. The 21% is a flat rate, and there is no longer a special rate required for personal service corporations. Additionally, the corporate AMT is repealed (though prior year minimum tax credits from AMT may continue to be carried forward).

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

Other notable provisions include:

- Modification of the threshold for accrual basis accounting for corporations from $5 million in gross receipts to $25 million.
- Certain business assets will be eligible for 100% expensing on a temporary basis that scales down incrementally.
- Repeal of the domestic production activities deduction (DPAD).
- Increase in the Section 179 expense limit to $1 million and increase in applicable threshold to $2.5 million (with amounts indexed for inflation moving forward).

- Elimination of net operating loss (NOL) carrybacks (except for farming NOLs and NOLs of property and casualty insurance companies, which may be carried back two [2] years), and limit on deduction to 80% of taxable income.
- A limitation on business interest expense deductions to 30% of adjusted taxable income (though businesses with average annual gross receipts below $25 million will be exempt).
- Enhanced depreciation deductions for certain non-residential real property and residential rental property.

A new section 83(i) has been included in the Code to provide tax benefits to employees of certain start-up companies as well. Such section provides that taxation may be deferred on the receipt of stock upon the exercise of a nonqualified stock option or in settlement of a restricted stock unit for up to five (5) years where the company provides such benefits to at least 80% of its employees.

Conclusion

While there is widespread skepticism about the individual impact of tax cuts or the benefits that may be conferred on the broader economy, the most significant tax reform since 1986 is certain to be felt far and wide. Notably, an extremely complex tax system does not appear to be in any danger of becoming easier to decipher under the new law. An astute planning team will remain essential for many taxpayers to both navigate new rules and identify tax-saving opportunities moving forward.