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LEGAL UPDATE

COMPREHENSIVE TAX REFORM IN PLACE AS CONGRESS PASSES THE TAX CUTS AND JOBS ACT

On December 20, 2017, Congress passed the most extensive package of reforms to the United States income tax system since the overhaul of the tax code in 1986. Enacting tax reform has been a key priority of the Trump administration and GOP leaders in Congress, and the GOP tax reform bill moved forward at a breakneck pace, with the final tax reform legislation in place less than two months after the first draft of the bill was released by the House Ways and Means Committee, as we wrote about in our recent advisory. The breadth and magnitude of the final version of the tax reform bill, generally referred to as the "Tax Cuts and Jobs Act"[1] ("TCJA"), will impact almost all taxpayers (whether individuals, businesses, trusts or estates). Certain of the most notable changes enacted in TCJA are outlined below.

INDIVIDUALS

Unless otherwise noted, the changes described below are effective for the 2018 tax year. With a few exceptions, the individual income tax changes are temporary and will expire on December 31, 2025 absent future legislative action.

- **Individual tax rates.** TCJA retains the current seven-bracket structure, although most individual income tax rates are lowered. The top marginal rate is reduced to 37% (from 39.6%). The top capital gain tax rate remains at 20% (plus, in many cases, the 3.8% net investment income tax). Individuals as well as trusts and estates who are partners or members of a partnership, LLC, or S corporation may benefit from the new deduction for income from certain pass-through businesses (described below).
- **Standard deduction and personal exemption**. The standard deduction is increased to $12,000 for single filers, $18,000 for heads of household, and $24,000 for joint filers, as indexed for inflation. The personal and dependent exemptions are repealed.
- **Home mortgage interest deduction.** The deduction for home mortgage interest is retained, although the amount is limited to interest paid on the first $750,000 of principal, which is a reduction from the current $1 million cap. This deduction continues to apply to a taxpayer's principal residence and one other residence.
- **Home equity indebtedness interest deduction.** TCJA suspends the interest deduction for home equity indebtedness for the temporary period noted above.
- **State and local income, sales and property taxes.** Deductions for state and local income, sales and property taxes are subject to a combined $10,000 cap. Note that prepayment of 2018 property taxes is allowed, but prepayment of 2018 income taxes is prohibited.
- **Charitable contribution deduction.** The cap on charitable contributions of cash to public charities is increased from 50% of AGI to 60% of AGI.
- **Alimony and separate maintenance payment deduction.** Effective for divorce or separation instruments executed after December 31, 2018, alimony and separate maintenance payments are no longer deductible by the payor spouse (and are not treated as income to the recipient). The treatment of child support is unchanged.
- **Other deductions and exclusions.** Numerous other deductions are limited or eliminated, including the moving expenses deduction, and all miscellaneous itemized deductions that are currently subject to the two-percent floor (e.g., expenses for the production of income such as investment and appraisal fees, tax preparation expenses and unreimbursed expenses attributable to the trade or business of being an employee) are disallowed. At the same time, however, TCJA repeals the so-called "phase-out" for remaining itemized deductions.

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- **Family tax credits.** The personal exemption for dependents and the adoption tax credit are eliminated. The child tax credit is raised to $2,000 (from $1,000) per qualifying child under 17 and an additional credit of $500 is added for other dependents, both subject with a phase-out threshold of $400,000 for married couples. The refundable portion of the credit equals 15% of earnings in excess of $2,500 for each qualifying child (but the maximum refundable portion is capped at $1,400 per qualifying child, as indexed for inflation). Social security numbers must be furnished by taxpayers to claim the credit.
- **Medical expense itemized deduction.** Out-of-pocket medical expenses in excess of 7.5% of adjusted gross income are deductible for the 2017 and 2018 tax years, with the floor reverting to 10% in 2019.
- **Individual alternative minimum tax.** The exemption for the individual alternative minimum tax (which is retained) is raised to $109,400 for joint filers (from $86,200) and $70,300 for single filers (from $55,400), and the phase-out threshold for the exemption is increased to $1 million for joint filers (from $164,100) and $500,000 for single filers (from $123,100).
- **Repeal of Affordable Care Act (ACA) individual mandate penalty.** Effective January 1, 2019, the ACA individual mandate penalty is effectively repealed (the amount of the penalty will be set at $0). This provision is permanent.

BUSINESS TAXES (CORPORATE AND PASS-THROUGH)

- **Corporate tax rate.** Beginning in 2018, corporate income tax rates are lowered from a maximum rate of 35% to a flat 21% rate. This provision is permanent.
- **Corporate alternative minimum tax.** The corporate alternative minimum tax is eliminated. This provision is permanent.
- **New deduction for qualified business income from certain pass-through businesses.** TCJA creates a new 20% deduction for qualified business income from certain pass-through businesses, including partnerships, S corporations, and LLCs. Individual taxpayers also may be able to deduct 20% of qualified dividends paid by REITs, qualified publicly traded partnership income, and qualified cooperative dividends. Income that is paid as compensation to owners is not eligible for the deduction. The deduction is phased out for certain service industries (including health, law, and professional services) where the owner's income exceeds $315,000 for married couples or $157,500 for single individuals, and is limited for owners with such income levels in other service industries to the greater of 50% of wages paid, or 25% of wages paid plus 2.5% of business tangible property. These provisions will expire on December 31, 2025 absent future legislative action.
- **Expensing of capital investment.** Short-lived capital investments acquired and placed in service over the next five years can be fully and immediately expensed. Expensing under Code Section 179 is increased to $1,000,000 (from $500,000).
- **Tax treatment of interest.** Deductions of net interest expense are limited to 30% of earnings before interest, taxes, depreciation, and amortization (EBITDA) for four years, and 30% of earnings before interest and taxes (EBIT) thereafter, with exceptions for businesses with gross receipts of $25 million or less.
- **Net operating loss deduction (NOLs).** NOL carrybacks are eliminated, and NOL carryforwards are limited in any year to 80% of taxable income for that year.
- **Business credits and deductions.** Numerous business credits and deductions are eliminated, including the Code Section 199 domestic production/manufacturing deduction, deductions for entertainment, and like-kind exchanges for personal property (like-kind exchanges for real property are retained).
- **Deductibility of certain executive compensation.** TCJA retains the concept that compensation paid to certain executive officers of publicly traded corporations (CEO and top three highest paid employees) in excess of $1 million is not deductible, but broadens the group to include CFO, and any individual who was previously employed by the company as its CEO, CFO, and top three highest paid employees. It also eliminates exemptions from this limitation for commission and performance-based compensation.
- **Taxation of carried interests.** Carried interests in investment partnerships and LLCs (but not in active trade or business partnerships and LLCs) will be eligible for capital gain treatment only if held for at least three years.

INTERNATIONAL TAXES

- **International income taxation.** TCJA shifts the United States to a modified territorial tax system, with base erosion provisions and anti-abuse rules, in which foreign-source dividends and profits of U.S. companies are not subject to U.S. tax upon repatriation. Certain anti-abuse rules may be particularly burdensome for insurance companies, including an express provision regarding reinsurance premiums that are paid offshore.
- **Deemed repatriation.** TCJA imposes deemed repatriation of currently deferred foreign profits, taxed at a rate of 15.5% on cash (or cash equivalents) and 8% on foreign earnings that have been reinvested offshore. The deemed repatriation provisions may have an immediate impact on shareholders of controlled foreign corporations. While taxpayers can elect to pay the tax on deemed repatriation of profits under an installment method, the election must be made (and the first installment paid) by the due date of the 2017 income tax return.

- **Active trade or business exception under Code Section 367.** The active trade or business exception under Code Section 367 is repealed, which may pose material challenges for U.S. companies that plan to incorporate a foreign branch or transfer assets to a foreign corporation in a tax-deferred transaction.
- **Additional changes and complications**. TCJA includes numerous changes regarding international taxation, including revisions to the constructive ownership rules and to the definition of a United States shareholder (for purposes of the controlled foreign corporation rules). New provisions regarding global intangible low-taxed income may cause complications and potential income inclusions for U.S. shareholders of offshore companies.

WEALTH TRANSFER TAXES

- **Gift taxes.** The federal gift tax is retained, but the exemption is increased to $11.2 million per individual for tax years beginning after December 31, 2017 (with inflation indexing each year). This provision will expire on December 31, 2025, absent future legislative action.
- **Estate and generation-skipping transfer taxes.** The estate and generation-skipping transfer tax exemptions are doubled from $5.6 million to $11.2 million (as increased with inflation). This provision will expire on December 31, 2025 absent future legislative action.
- **Potential "clawback".** The Treasury Secretary is directed to prescribe regulations addressing the potential extra estate tax on the estate of a decedent who makes gifts using the $11.2 million exemption, but dies after December 31, 2025, when the estate tax exemption goes back to one-half of that amount. It is thought that Congress wants to eliminate such a potential extra tax.

CHANGES RELATING TO NONPROFIT ORGANIZATIONS

- **Tax on private university endowments.** A new 1.4% excise tax is imposed on the net investment income of private universities with at least 500 tuition-paying students and investment and other non-exempt purpose assets of more than $500,000 per student.
- **Excise tax on exempt organization excessive compensation.** A new excise tax (imposed at the corporate tax rate, 21%) is imposed on exempt organizations paying compensation in excess of $1 million to "covered employees" (generally the top five highest-paid employees and employees who were formerly one of the top five highest paid employees). The excise tax would also apply to severance payments to highly compensated employees that equal or exceed three times average base compensation.
- **Unrelated business income tax (UBIT) calculation.** An organization with unrelated business taxable income will be required to calculate its UBIT liability separately based upon each unrelated trade or business, which eliminates the ability to net income and losses among unrelated activities. Because UBIT is taxed at corporate income tax rates, the 21% flat rate will apply.

PLANNING FOR 2018 AND BEYOND

The enactment of the Tax Cuts and Jobs Act brings sweeping changes to the U.S. income tax system, and will require taxpayers to focus on both immediate and long-term planning (which is further complicated by the fact that many of the changes automatically expire at the end of 2025). There are significant new provisions, some of which represent major changes to the current U.S. tax system (such as the international tax provisions, the new deduction for pass-through income, and the 21% corporate rate). Although rates generally have decreased, taxpayers may lose the benefits of certain deductions and credits that are being eliminated or materially limited. It is essential that taxpayers – and their advisors – incorporate these reforms into current and future tax planning.

Look for additional client advisories in the near future that will highlight in more detail certain aspects of the TCJA.

[1] The official title of the act (in accordance with Senate procedural rules) is "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018".

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LEARN MORE ABOUT THE TCJA BY CONTACTING A MEMBER OF OUR TAX DEPARTMENT. FOR INFORMATION ABOUT THE WEALTH TRANSFER TAX PROVISIONS IN THE TCJA, PLEASE CONTACT A MEMBER OF NUTTER'S PRIVATE CLIENT DEPARTMENT.

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