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HIGHLIGHTS OF THE NEW TAX REFORM LAW

Tax Alert | January 15, 2018

On Dec. 22, 2017, President Trump signed the Tax Cuts and Jobs Act (the Act) into law. The summary below addresses the major individual, business and international tax provisions contained in the Act.

As a result of tax reform, there may be planning opportunities available or other changes that will be necessary to comply with the new law that fall outside the scope of normal tax return preparation. Below are highlights of some of the most significant changes affecting individual and business taxpayers.

INDIVIDUAL PROVISIONS

Unless otherwise noted, these provisions apply as of Jan. 1, 2018, and expire (sunset) at the end of 2025.

INCOME TAX

- Tax brackets – The law provides for seven individual tax brackets – 10, 12, 22, 24, 32, 35 and 37%. The top individual rate of 37% will apply for individuals earning $500,000 and above and joint filers earning at least $600,000.
- Individual AMT – The individual AMT is retained, albeit with a higher exemption ($70,300 for individuals and $109,400 for married taxpayers filing jointly) and a higher phase-out threshold ($500,000 for individuals and $1 million for married taxpayers filing jointly.)
- Standard deduction and personal exemptions – The standard deduction is doubled to $12,000 for individuals and $24,000 for married couples, and the additional deduction for the elderly and the blind is retained. The deduction for personal exemptions is repealed.
- Home mortgage interest deduction – The deduction for home mortgage interest will be limited to interest on $750,000 of acquisition indebtedness incurred on newly purchased principal and second residences after Dec. 15, 2017, and a deduction for interest on any home equity loans will not be allowed, regardless of when the loan was obtained.
- State tax deduction – A deduction of up to $10,000 for state and local property, income or sales taxes is allowed. However, the Act precludes taxpayers from pre-paying 2018 state and local income taxes in 2017 in order to get the deduction before the $10,000 cap is imposed after 2017.
- Alimony – Alimony paid pursuant to divorce after Dec. 31, 2018, will not be deductible (or includible in the income of the recipient). Modifications to existing agreements will be impacted.
- Medical expenses – Medical expenses exceeding 7.5% of adjusted gross income (AGI) will be deductible for 2017 and 2018, and the AMT preference for medical expense deductions is eliminated for 2017 and 2018.
- AGI limitations – The 3% of AGI limitation on deductions is suspended, and a reduction for miscellaneous deductions that exceed 2% of AGI is eliminated (including investment management fees, tax preparation fees and unreimbursed business expenses).
- Charitable contributions – The deduction for charitable contributions is preserved, with an increase in the AGI limitation for cash contributions to public charities and certain private foundations from 50% to 60%.
- 529 plans – Up to $10,000 of 529 savings plans can be used per student for public, private and religious elementary and secondary schools.
- Individual Retirement Accounts (IRAs) – A conversion of a traditional IRA to a Roth IRA cannot be recharacterized as a contribution to a traditional IRA. This does not prevent conversion of a traditional IRA into a Roth IRA, only the reversal of such a conversion is barred.

ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER (GST) TAX

- The estate, gift and generation-skipping transfer (GST) tax exemptions are doubled to approximately $11 million, effective January 2018.
- The estate, gift and GST rates remain the same as existing law.

KEY PROVISIONS OF CURRENT LAW THAT WERE UNDISTURBED BY THE BILL:

- Income tax
  - The 3.8 percent tax on investment income under section 1411 and the 0.9% Medicare tax on compensation
  - Tax rates on capital gains and qualified dividends
  - Exclusion of gain on sale of a residence
  - Ability to identify the securities that an investor is deemed to sell (i.e., the Senate's proposal for a 'first-in, first out' method isn't included in the Act)
  - Pre-tax contribution limits (including catch-ups) for 401(k) plans
  - Ability for beneficiaries to 'stretch' IRA withdrawals out over their lifetimes
- Estate, gift and GST tax
  - The gift tax and the rate of tax imposed for estate, gift and GST tax
  - Step-up in basis for inherited assets (other than items of income in respect of decedent)
  - Current design flexibility of grantor retained annuity trusts (GRATs) and rules for 'defective' grantor trusts

BUSINESS PROVISIONS

All provisions are effective for tax years beginning after Dec. 31, 2017, unless otherwise noted.

- Corporate tax rate – Rates are reduced from a top rate of 35% to 21%.
- Corporate alternative minimum tax (AMT) – The corporate AMT is repealed.
- Pass-through businesses – Pass-through businesses are allowed a deduction tantamount to excluding 20% of the business income of many pass-through entities and sole proprietors. For owners otherwise subject to the top 37% individual tax rate, the effective tax rate on qualified income will be reduced to 29.6%.
  - Pass-through owners whose taxable income exceeds $315,000 for a joint return (or lower amounts for single filers) are subject to restrictions on the deduction in situations where the business did not have a specified level of wage payments or a specified amount of tangible, depreciable assets used in the business. In addition, restrictions on the deduction apply to certain service businesses and others described in the new law.
  - Trusts and estates are eligible for the 20% deduction.
  - A new restriction limits an owner's ability to deduct active business losses against nonbusiness income.
- Carried interests – The Act creates a new three-year holding period that must be satisfied to enjoy long-term capital gains rates with respect to certain carried interests in certain investment or real estate funds.
- Capital expensing – The legislation provides for immediate expensing (i.e., 100% bonus depreciation) for certain qualified assets acquired and placed in service after Sept. 27, 2017. The 100% bonus depreciation benefit will begin to phase out in 2023. The Act also increased the expensing allowance under section 179 to $1 million, also subject to a phase-out.

- Business interest – The deduction for net business interest of corporations and many pass-through businesses is limited under a formula. Generally speaking, deductions cannot exceed 30% of EBITDA (earnings before interest, taxes, depreciation and amortization) for the next four years. After that period, interest deductions may not exceed 30% of EBIT (earnings before interest and taxes). Disallowed interest deductions can generally be carried forward indefinitely, but may be subject to certain limitations applicable to partnerships. Certain taxpayers are exempted from these rules, including taxpayers with average gross receipts of $25 million or less for the three years immediately preceding the effective date of this provision, as well as taxpayers involved in certain real estate activities.
- Net operating losses (NOLs) – The Act limits the NOL deduction to 80% of taxable income. Carrybacks are generally eliminated, but unused losses can be carried forward indefinitely.
- Domestic manufacturing deduction – The section 199 domestic production deduction is repealed.
- Research credits and expenses – The legislation retains the research and development credit and requires capitalization and amortization of research and experimental expenses over a five-year period. The capitalization provisions apply to amounts paid or incurred in tax years beginning after Dec. 31, 2021.
- Overall methods of accounting – The Act increase the gross receipts threshold above which C corporations and partnerships with C corporation partners must generally use the accrual method of accounting from $5 million to $25 million.
- Like-kind exchanges – Like-kind exchanges under section 1031 are limited to real property that is not held primarily for sale. Personal property no longer qualifies for tax-deferred treatment.

INTERNATIONAL TAX PROVISIONS

All provisions are effective for tax years beginning after Dec. 31, 2017, unless otherwise noted.

- Establishment of territorial tax system – The Act establishes a 'territorial' system of taxation, for the first time in U.S. history, under which U.S. corporations (not individuals) may deduct dividends received from a 'specified' foreign corporation held for one year.
- Mandatory taxation of deferred foreign earnings at reduced rate – U.S. corporations and certain individuals who own at least 10% of the voting shares of a foreign corporation must take into current income, for 2017,their pro rata share of the untaxed earnings of the corporation. This income is subject to tax at either a 15.5 or 8% rate depending on whether such earnings are attributable to cash or tangible assets of the foreign corporation. Dividends paid in 2017 to U.S. shareholders subject to these rules will not be taxed as regular dividends but will be taxed at these rates. Taxpayers may elect to defer payment of the actual additional taxes resulting from this mandatory inclusion over an eight-year period. However, because the first payment will be due on the date when the taxpayer's final tax payment for 2017 is otherwise due, taxpayers should be prepared to pay an additional amount with their 2017 extension.
- Retention of rules requiring inclusion of income upon investment in U.S. property by a controlled foreign corporation (CFC) – In a surprising change, the final bill deletes the proposal to repeal the current law rule that results in the taxation of offshore earnings corresponding to an investment in U.S. property made by a CFC. The conferees likely retained this provision in order to raise revenue.

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- Special tax rates for offshore intangible income – While the Act sets the overall domestic corporate tax rate at 21%, it also provides special tax rates for foreign intangible income earned directly or indirectly through a CFC. In particular, the Act imposes a 13.125% effective tax rate for intangible income earned directly and a 10.5% rate for intangible income earned through a foreign corporation.
- No extension of 'look-through' rules for certain CFCs – The final legislation does not extend an expiring rule that characterizes income received from a controlled foreign corporation by reference to the underlying income of the controlled foreign corporation. With the expiration of that rule, taxpayers will likely have more subpart F income that will be generally subject to the normal domestic corporate tax rate of 21% and will not enjoy any offsetting dividends received deductions or similar benefits. A wide variety of taxpayers currently rely on this rule and such taxpayers may wish to consider restructuring options.
- Base erosion and anti-abuse tax (BEAT) – To prevent the erosion of the U.S. corporate tax base, the Act imposes a tax of 10% (5% for 2018) on U.S. corporations that make excessive tax deductible payments to related foreign persons. This complex tax operates somewhat like an AMT and will require considerable analysis. The rules apply only to corporate taxpayers with average annual gross receipt of at least $500 million, and only if they have a 'base erosion percentage' of 3% or higher. Companies with significant tax-deductible payments to related persons, such as those with global supply chains, should carefully assess the impact of this provision.
- Definition of intangibles – The final bill contains rules that ensure that goodwill, going concern value and workforce in place will be taxed if transferred to a foreign corporation.
- 'Fair market value' method of apportioning interest expense for purposes of determining foreign tax credits – Current law allows taxpayers to elect the fair market value method of apportioning interest expense, which may benefit taxpayers that have significant intangible assets with high value but low tax basis. The Act disallows the use of this method, forcing taxpayers to apportion based on tax basis. This change may limit the ability of certain taxpayers to claim a foreign tax credit.

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