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2018 TAX REFORM IS HERE: WHAT YOU NEED TO KNOW

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In late 2017, Congress passed a sweeping tax reform bill. (*Act*) that changes the planning landscape for corporations, small businesses, and individuals. President Trump then signed the Act into law.

Those who voted for tax reform claim that the Act will usher in a new era of economic growth that will benefit all. Those who voted against it have criticized the Act as disproportionately benefiting the rich and increasing the national deficit. Regardless of political persuasion, the Act is unquestionably the biggest tax reform in over three decades and has consequences for almost all sectors of the American economy. It creates unprecedented planning opportunities for both individual and business clients.

This memo discusses the Act and its implications. It summarizes the significant business tax reforms introduced by the Act, including a new deduction to lower taxes on owners of pass-through businesses and a reduced corporate income tax rate. It also summarizes the most significant changes to taxation of individuals, including the doubled estate, gift, and generation-skipping (GST) tax exemptions, lower individual income tax rates, and repeal of the individual mandate. It concludes with a discussion of the unprecedented planning opportunities and pitfalls to avoid under the new Act.

Temporary Deduction for Pass-through Businesses

One of the Act's most sweeping changes is the reform of the tax regime that applies to pass-through businesses—sole proprietorships, partnerships, S corporations, and limited liability companies taxed as partnerships or S corporations. Owners of pass-through businesses currently pay tax at their individual tax rates, which could reach as high as 39.6 percent under current law. The owners report income from pass-through businesses on their personal income tax returns, regardless of whether the business distributes the income. Both the House Bill and the Senate Bill wanted to lower the tax burden on owners of pass-through businesses, but took very different approaches. The Act, following the methodology initially taken in the Senate Bill, reduces the effective rate of income tax on most pass-through businesses by providing owners with a 20 percent deduction.

Deduction for Qualified Business Income

For tax years beginning in 2018 and ending in 2025, the Act creates a new deduction of 20 percent to apply against income of pass-through businesses. The deduction applies at the owner level and also applies to 20 percent of qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. In a reversal from early versions of the House and Senate bills, the deduction *is* available for trusts and estates that own pass-through businesses.

The deduction applies to qualified business income (QBI), which is defined as the net amount of *qualified items of income, gain, deduction, and loss* with respect to *a qualified trade or business of the taxpayer*. "Qualified items of income, gain, deduction, and loss" includes business income other than investment income. QBI does not include wages, dividends, investment interest income, capital gains (whether short-term or long-term), commodities gains, or foreign currency gains.

“Qualified Trade or Business” Limitation

Only a *qualified trade or business* may qualify for the deduction. While the definition of *qualified trade or business* is broad, it excludes some activities. Notably, it excludes a category of businesses called *specified service businesses*. The definition of *specified service business* includes:

- any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, and brokerage services;
- any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; and
- any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Although the general definition of *specified service business* excludes many small businesses from being *qualified trades or businesses*, the Act provides an important exception: Joint filers with income below $315,000 and other taxpayers with income below $157,500 can claim the deduction fully on income from specified service businesses. This exception is phased out for taxpayers that exceed the threshold. The phaseout occurs over the next $100,000 for joint filers and $50,000 for other taxpayers. No deduction is available to owners of services businesses if their income exceeds $415,000 for joint fliers or $207,500 for other taxpayers. For purposes of this threshold, taxable income is determined without regard to the deduction. The threshold is also inflation-adjusted under the Act.

The definition of *qualified trade or business* also excludes the trade or business of performing services as an employee. Amounts paid to an owner-employee—for example, an S corporation shareholder that is also an employee—as reasonable compensation are not included in QBI. Similarly, if a partnership makes a guaranteed payment under Internal Revenue Code (*Code*) § 707(c) or a payment for services under Code § 707(a), those payments are not included in QBI.

Determining the Amount of the Deduction

The deduction applies to the taxpayer’s combined QBI amount for the taxable year. This would include the sum of all deductible amounts determined by each qualified trade or business that the taxpayer owns. The combined QBI for the year also includes up to 20 percent of the taxpayer’s qualified REIT dividends and qualified publicly traded partnership income. QBI income does not include income that is not effectively connected with the operation of a U.S. trade or business.

The deductibility of the taxpayer’s combined QBI is subject to limitations. The deduction for each qualified trade or business is the lesser of:

- twenty percent of the taxpayer’s QBI for that trade or business; or
- the greater of (a) 50 percent of the W-2 wages with respect to the trade or business or (b) the sum of 25 percent of the W-2 wages with respect to the trade or business and a capital component consisting of 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

The potentially higher limit for businesses with high basis in qualified property benefits capital-intensive businesses—including real estate businesses—with a low payroll but significant capital investments.

For purposes of this limitation, *qualified property* means tangible property of a character subject to depreciation that is held by—and available for use in—the qualified trade or business at the close of the taxable year, and which is used in the production of QBI, and for which the *depreciable period* has not ended before the close of the taxable year. The *depreciable period* with respect to qualified property of a taxpayer begins on the date that the property is placed in service and ends on the later of 10 years or the last day of the applicable recovery period under Code § 168.

The W-2 wage limit has the same threshold that applies to specified service businesses. It does not apply to joint filers with income below $315,000 and other taxpayers with income below $157,500. It is phased in for taxpayers with income over these amounts and applies fully to joint filers with income over $415,000 and other taxpayers with income over $207,500. The income limit is inflation-adjusted, and taxable income is determined without regard to the deduction.

The W-2 wage limit does not apply to income from publicly traded partnerships or income from the disposition of interests in publicly traded partnerships, but the specified service business limit still applies.

The deduction for QBI does not reduce adjusted gross income and is not dependent on whether taxpayers itemize or take the standard deduction. The deduction cannot exceed the taxpayer's taxable income (after reduction for qualified capital gain). It is expected that new worksheets or forms will be promulgated by the IRS to help calculate and report this deduction.

Highest Effective Tax Rate for Pass-through Businesses

The 20 percent deduction for QBI creates an effective top tax rate of 29.6 percent for owners of pass-through businesses. The 29.6 percent rate is calculated based on the top individual income tax rate of 37 percent using the following formula: 37% * (100 percent - 20 percent). This yields a 20 percent rate reduction. Although this rate is less than the reduction in the corporate income tax rate, it exceeds the amount of the reduced rates on individual taxpayers.

Sunset of Deduction for Qualified Business Income

The deduction is effective for tax years beginning after December 31, 2017, and sunsets for tax years beginning after December 31, 2025. This sunset provision was part of political maneuvering to avoid increasing the federal deficit over the long term, but it opens the Act up to criticism. Unlike the reduction to the tax rates that apply to C corporations, discussed below, the preferential tax treatment to small businesses will expire. If allowed to expire on December 31, 2025, the tax rules for pass-through businesses would return on January 1, 2026 to the rules in effect before the Act's passage (i.e. the rules we have for 2017). Critics argue that the long-term benefit to C corporations, coupled with a short-term benefit to the owners of small businesses, further demonstrates that the Act is aimed more at big business interests than the middle class.

Other Significant Pass-Through Business Changes

Although the new deduction for QBI is the most significant tax reform for most owners of pass-through businesses, the Act makes other significant changes.

Three-Year Holding Period for Long-Term Capital Gain Treatment of Certain Interests

A profits interest in a partnership is the right to receive future profits in the partnership. A profits interest does not give the holder an immediate capital interest, meaning that the holder would not have any right to receive money or other property upon the immediate liquidation of the partnership.

Under current law, a taxpayer is not taxed on receipt of a profits interest unless:

- the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;
- within two years of receipt, the partner disposes of the profits interest; or
- the profits interest is a limited partnership interest in a publicly traded partnership.

This treatment applies with respect to substantially unvested profits interests, provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.

The character of partnership items passes through to the partners, as if the items were realized directly by the partners. This means that, under current law, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

Beginning in 2018, the Act creates a three-year holding period requirement for qualification as long-term capital gain with respect to an *applicable partnership interest*, defined as any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The Act treats as short-term capital gain (taxed at ordinary income rates) for the taxable year the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies.

Although losing long-term capital gain treatment under this rule will cause the gain to be classified as short-term capital gain, it will not subject the gain to self-employment tax. A special rule applies to transfers of the interest to a related party.

The three-year holding period requirement applies regardless of whether the recipient of the interest included income upon receipt under Code § 83(a) or otherwise filed a Code § 83(b) election for the interest.

Net Operating Losses

The Act provides that the *excess business losses* of a taxpayer other than a C corporation are not allowed for the taxable year, but are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years. An *excess business loss* is comprised of the taxpayer's aggregate deductions attributable to the taxpayer's trades or businesses minus the sum of the taxpayer's aggregate gross income or gain with respect to such trades or businesses, plus a threshold amount. The threshold amount is $500,000 for joint filers and $250,000 for other taxpayers and will be adjusted for inflation. The limitation is applied after applying the passive activity loss limitations. The limitation expires on December 31, 2025.

Source of Gain or Loss from the Sale or Exchange of Partnership Interests

Under current law, a foreign person engaged in a trade or business in the United States is taxed on income that is "effectively connected" with the conduct of that trade or business, and partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged. Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not considered in determining the rates of U.S. tax applicable to the person's income from the business.

The Act clarifies that gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have realized effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange (excluding real property gain already classified as effectively connected under the Foreign Investment in Real Property Tax Act of 1980).

Substantial Built-in Losses

A partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless:

- the partnership has made a one-time election under Code § 754 to make basis adjustments; or
- the partnership has a substantial built-in loss immediately after the transfer.

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.

Under current law, a *substantial built-in loss* exists if the partnership's adjusted basis in its property exceeds the fair market value of the partnership property by more than $250,000. Effective January 1, 2018, the Act expands the definition of *substantial built-in loss* by providing that a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. If a partnership has a substantial built-in loss, the partnership must adjust the tax basis of partnership property following a transfer of a partnership interest to approximate the result of a direct purchase of the property.

Outside Basis Limitation for Charitable Contributions

Effective January 1, 2018, the Act expands the Code § 704(d) outside basis limitation on partner losses to provide that generally a partner's distributive share of charitable contributions (based on tax basis of the contributed property) and foreign tax expenditures are allowed only to the extent of the partner's outside basis. This proposal follows the original Senate Bill.

Repeal of Partnership Technical Termination Rule for Transfer of Interests

Under current law, a partnership is treated as terminated for tax purposes if, within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. A partnership is also treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership. These are commonly referred to as technical terminations.

Effective January 1, 2018, the Act repeals the partnership technical termination rule. A partnership will be treated as continuing even if more than 50 percent of the total capital and profits interests of the partnership are sold or exchanged within a 12-month period. This change prevents partnerships from having to make new elections for tax purposes.

The Act does not affect the rule that a partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Conversions of S Corporations to C Corporations

The Act also deals with tax issues resulting from a conversion of an S corporation to a C corporation within two years of the enactment. The rule applies to any *eligible terminated S corporation*, defined as a C corporation that was an S corporation on the day before the date of the enactment of the Act and which made a revocation of its S corporation election in the two-year period following such date, as long as the owners of the stock of such corporation on the date of the revocation of the S corporation election are the same owners (and in identical proportions) as on the date of the Act's enactment.

Effective January 1, 2018, in the case of a distribution of money by an eligible terminated S corporation after the post-termination transition period, the corporation's accumulated adjustments account (AAA) is allocated to the distribution. The distribution is chargeable to accumulated earnings and profits in the same ratio as the amount such AAA bears to the amount of such accumulated earnings and profits. The proposal also provides that, in the case of an eligible terminated S corporation, any taxable income adjustment arising from such a conversion under Code § 481 is taken into account ratably over six years.

Nonresident Aliens as Beneficiaries of Electing Small Business Trusts

An electing small business trust (*ESBT*) may be a shareholder of an S corporation. Under current law, a trust will not qualify as an ESBT if a nonresident alien is a potential current beneficiary. Effective January 1, 2018, the Act repeals this prohibition and allows a nonresident alien to be a potential current beneficiary of an ESBT.

Charitable Contribution Deductions for Electing Small Business Trusts

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Deductibility depends on the type of shareholder.

- A trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which are paid for a charitable purpose under the trust instrument. No carryover of excess contributions is allowed.

- An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts (and not the deduction that applies to individuals) has historically applied. Beginning on January 1, 2018, the Act provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. As a result, the percentage limitations and carryforward provisions applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Changes to Taxation of C Corporations

C corporations pay tax on their own income, and their shareholders pay tax again when the income is distributed as dividends. This double-taxation regime has made C corporations an unattractive option when choosing a form of entity. The Act makes several changes that may make C corporations a more viable alternative for some clients.

Reduced Corporate Tax Rate and Repeal of Corporate Alternative Minimum Tax

Taxable income of a C corporation is currently taxed under a four-step graduated rate structure at rates of 15, 25, 34, and 35 percent. Effective January 1, 2018, the Act eliminates this graduated rate structure, taxes all corporate income at 21 percent, and repeals the corporate alternative minimum tax (AMT). Unlike the deduction for QBI of pass-through businesses, there is no sunset provision for the reduced corporate income tax rate or corporate AMT repeal.

Dividend-Received Deduction

Under current law, a corporation receives a deduction on the full amount of dividends received from a corporate subsidiary that is in the same affiliated group, an 80 percent deduction for dividends received from a corporate subsidiary in which it owns at least 20 percent, and a 70 percent deduction for dividends received from a corporation in which it owns less than 20 percent.

The dividend-received deduction prevents cascading application of the double-taxation regime that applies to C corporations. But the percentage limitations assume a corporate income tax of up to 35 percent, not the 21 percent tax rate that applies under the Act. To bring the percentage limitations into alignment, the Act reduces the 80 percent deduction to 65 percent and reduces the 70 percent deduction to 50 percent.

Capital Contributions

Code § 118 provides that a corporation does not include "contributions to capital" in gross income. The Act provides that the term "contributions to capital" does not include:

- any contribution in aid of construction or any other contribution as a customer or potential customer; and

- any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

The provision applies to contributions made after the date of enactment, but not to contributions made after the date of enactment by a governmental entity under a master development plan that was approved by the governmental entity prior to the date of enactment.

Changes to Business Deductions

The Act also makes several changes that limited the deductions and exclusions that apply to businesses of all types.

Interest Paid or Accrued by a Business

Interest paid or accrued by a business generally is deductible in the computation of taxable income, subject to several limitations. Under the Act, net interest that can be deducted by any business with gross receipts of $25 million or more (measured based on the average over a three-year period) is generally limited to 30 percent of the *adjusted taxable income* for the year. For purposes of this provision, the following are disregarded in computing adjusted taxable income:

- any item of income, gain, deduction, or loss not properly allocable to a trade or business;

- any business interest or business interest income;

- the new 20 percent deduction for certain pass-through income; and

- the amount of any net operating loss deduction.

For taxable years beginning before January 1, 2022, adjusted taxable income is not reduced by deductions allowable for depreciation, amortization, or depletion. The interest deduction limitation does not apply to:

- certain regulated public utilities;
- the trade or business of performing services as an employee; or
- at the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.

Any business interest not allowed as a deduction may be carried forward and used as a deduction in a later year.

Net Operating Losses

A net operating loss (*NOL*) generally means the amount by which a taxpayer's business deductions exceed its gross income. An NOL may be carried back two years and carried forward 20 years to offset taxable income in those years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.

The Act limits the NOL deduction to 80 percent of taxable income, effective for taxable years beginning after December 31, 2017. The Act also repeals the two-year carryback and the special carryback provisions, but provides an exception for certain farming losses. For most taxpayers, NOLs can only offset the current year and future year's income.

Depreciation and Expensing

Unless currently deductible, a taxpayer must capitalize the cost of property used in a trade or business or held for the production of income. Recovery of these costs occurs over time through annual deductions for depreciation or amortization. Under current law, an additional first-year depreciation (*bonus depreciation*) deduction is allowed. Bonus depreciation equals 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for longer production period property and certain aircraft). The 50 percent allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018 for longer production period property and certain aircraft).

The Act increases the 50 percent bonus depreciation under current law to 100 percent through 2022 (through 2023 for longer production period property and certain aircraft). It also extends the current 50 percent bonus depreciation through 2026 (2027 for longer production period property and certain aircraft). The Act removes the requirement that the original use of qualified property must commence with the taxpayer, allowing the additional first-year depreciation deduction for both new and used property.

The enhanced bonus depreciation generally applies to property acquired and placed in service after September 27, 2017, and to specified plants planted or grafted after such date. For a taxpayer's first taxable year ending after September 27, 2017, the taxpayer may apply a 50 percent allowance instead of the 100 percent allowance.

Like-Kind Exchanges

Although an exchange of property—like a sale—is generally a taxable event, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a “like kind” which is to be held for productive use in a trade or business or for investment. Under current law, and with some exceptions, most property that is of the same type as the property received in the exchange qualifies for like-kind exchange treatment.

The Act limits like-kind exchanges to exchanges of real property. It includes a transition rule to allow like-kind exchanges for personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property by December 31, 2017.

Employment-Related Fringe Benefits

The Act repeals the current 50 percent deduction for entertainment, amusement, or recreation expenses connected to the active conduct of the taxpayer’s trade or business. No deduction is allowed for these expenses, including membership dues in a club organized for business, pleasure, recreation, or other social purposes.

The Act continues the current 50 percent limit from December 31, 2017, through December 31, 2025, for expenses for food and beverages provided to employees through an eating facility operating for the convenience of the employer and eliminates the deduction after December 31, 2025.

Effective December 31, 2017, the Act disallows the deduction for expenses relating to entertainment tickets and skyboxes to the extent that the expenses are included as compensation to an employee on the employer’s tax return. The deduction for qualified transportation fringe benefits to employees is also eliminated, except as necessary for the safety of an employee in commuting between work and home.

Territorial System for International Taxation

The Act implements what proponents argue is a more competitive territorial tax system that only taxes businesses on income earned domestically. Businesses no longer will be discouraged from reinvesting their profits in the United States. To avoid creating tax incentives for businesses to reinvest their profits or keep their operations abroad, the Act includes anti-base erosion measures that impose tax on certain income of foreign affiliates.

Changes to Individual Taxation

Temporary Changes to Individual Rates

The Act keeps the current seven-bracket structure, but changes the income level and rates. From January 1, 2018, to December 31, 2025, the individual income tax brackets are set at 10, 12, 22, 24, 32, 35, and 37 percent.

Single Filer			
Current Law		Tax Cuts and Jobs Act	
10%	$0-$9,525	10%	$0-$9,525
15%	$9,525-$38,700	12%	$9,525-$38,700
25%	$38,700-$93,700	22%	$38,700-$82,500

28%	$93,700-$195,450	24%	$82,500-$157,500
33%	$195,450-$424,950	32%	$157,500-$200,000
35%	$424,950-$426-700	35%	$200,000-$500,000
39.6%	$426,700+	37%	$500,000+

Married Filing Jointly			
Current Law		Tax Cuts and Jobs Act	
10%	$0-$19,050	10%	$0-$19,050
15%	$19,050-$77,400	12%	$19,050-$77,400
25%	$77,400-156,150	22%	$77,400-$165,000
28%	$156,150-$237,950	24%	$165,000-$315,000
33%	$237,950-$424,950	32%	$315,000-$400,000
35%	$424,950-$480,050	35%	$400,000-$600,000
39.6%	$480,050+	37%	$600,000+

Temporary Increase in Standard Deduction and Elimination of Personal Exemptions

The Act increases the standard deduction from $6,350 to $12,000 for individuals and from $12,700 to $24,000 for married couples. The standard deduction is indexed for inflation. The Act does not change the additional standard deduction for elderly or blind taxpayers under current law. The increase of the basic standard deduction expires after December 31, 2025.

The Act also repeals all personal exemptions through December 31, 2025, with the withholding rules to be changed to reflect the elimination of personal exemptions.

The widening of brackets, rate reductions, and increase in the standard deduction are all intended to offset the repeal of personal exemptions and ultimately lower individual income taxes. Given the loss of personal exemptions, the increased standard deduction will not provide taxpayers with significant net benefit. But the increased standard deduction will change the way that many taxpayers file their taxes. Given the increased amount and the limitations imposed on many itemized deductions, many taxpayers will find that their standard deduction exceeds their itemized deduction. This will lead to fewer taxpayers taking itemized deductions.

Temporary Change to Individual AMT

The Act increases the exemption amount and the exemption amount thresholds for the individual AMT. For taxable years beginning after December 31, 2017, and before January 1, 2026, the individual AMT exemption amount is increased to $70,300 for single filers and $109,400 for joint filers. The phaseout of the AMT exemption is increased to $1 million for married taxpayers filing a joint return, and $500,000 for all other taxpayers.

No Change to Capital Gains and Investment Income

The Act does not affect the current capital gains rate or repeal the net investment income tax. The top long-term capital gains rate remains at 20 percent and the qualified dividend income rate remains at 20 percent. The net investment income tax rate remains at 3.8 percent.

State and Local Tax Deduction

The Act limits the deduction for state and local taxes to $10,000 ($5,000 in the case of a married individual filing a separate return). The limitation applies to all state and local taxes in the aggregate.

With respect to income (not property) taxes, the Act contains a special rule to prevent prepayment of income taxes in 2017 to take advantage of the current deduction. The Act provides that any amount paid in a taxable year beginning before January 1, 2018, for state and local taxes imposed for a taxable year beginning after December 31, 2017, are treated as having been paid on the last day of the taxable year for which the tax is imposed.

Temporary Decrease in Mortgage Interest Deduction Threshold

The Act modifies the home mortgage interest deduction to reduce the limit on acquisition indebtedness from $1 million under current law to $750,000. A transition rule retains the current $1 million limit for taxpayers who signed binding purchase agreements by December 15, 2017, to close on the sale before January 1, 2018, and who actually purchase the residence before April 1, 2018. The $1 million dollar limit is also retained for mortgages already in effect. The reduced limit expires on December 31, 2025, at which time interest on mortgage indebtedness up to $1 million would be deductible, regardless of when incurred.

Child Tax Credit

The Act increases the child tax credit from $1,000 to $2,000 per child under age 17, with a maximum refundable amount of $1,400 per qualifying child. To receive the child tax credit, the taxpayer must include a social security number for each qualifying child for whom the credit is claimed. It also provides for a $500 nonrefundable credit for qualifying dependents other than qualifying children. The credit phases out at $400,000 for joint filers and $200,000 for all other taxpayers. These changes expire on December 31, 2025.

Temporary Doubling of Estate, Gift, and GST Tax Exemption

The Act doubles the estate, gift, and GST tax exemptions from $5 million to $10 million (adjusted for inflation after 2011) for estates of decedents dying, generation-skipping transfers, and gifts made after December 31, 2017 and before January 1, 2026.

There is no provision for ultimate repeal of the estate, gift, or GST taxes. The increased exemptions remain in place until December 31, 2025, at which time they revert to the current $5 million level (indexed for inflation).

Estate, gift, and generation-skipping transfers remain subject to a maximum tax rate of 40 percent. The current basis step-up under Code § 1014 for property inherited from a decedent remains in place. The rules (including the additional time for relief under Revenue Procedure 2017-34) regarding portability of estate and gift tax exemption also remain in place. Note that there is no portability of the GST tax exemption.

Repeal of Roth IRA Conversion Rule

Current law allows an individual to recharacterize a contribution to either a Roth or traditional IRA as a contribution to the other type of IRA by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year. The recharacterization allows the contribution to be treated as having been made to the transferee IRA on the date of the original contribution to the transferor IRA. The Act provides that a recharacterization cannot be used to unwind a Roth conversion, but it may be used with respect to other contributions. This change becomes effective January 1, 2018.

Repeal of Affordable Care Act Individual Mandate

The Affordable Care Act (*ACA*) contains an individual mandate which penalizes individuals who fail to maintain health insurance that meets at least the ACA's minimum standards. The Act effectively repeals the individual mandate by reducing the penalty to zero. Unlike many changes that occur as of January 1, 2018, the elimination of the individual mandate is postponed until January 1, 2019. The bill leaves intact other aspects of the ACA, such as the so-called Medicaid expansion, pre-existing conditions requirements, and removal of lifetime care caps.

Charitable Contribution Deduction

The Act leaves the current charitable contribution deduction in place as an itemized deduction, but temporarily increases the individual percentage-of-income limitation for cash gifts from 50 percent to 60 percent. The increase applies until December 31, 2025.

The Act denies a deduction for contributions linked to rights to purchase tickets to college athletic events and eliminates the option for donee organizations to report charitable contributions to the IRS instead of sending a contemporaneous written acknowledgment to the donor.

Many changes to the charitable deduction provisions are the indirect result of other provisions of the Act, and the overall impact on charitable giving is uncertain. By increasing the standard deduction and eliminating many itemized deductions, reducing income tax rates, and increasing the estate, gift, and GST exclusion amounts, the Act indirectly takes away some of the tax incentives to make charitable contributions during life or at death.

Planning Under the Act

The impact of the Act is far reaching and will affect tax planning in every sector of the United States economy. Although planning techniques will continue to emerge as attorneys and tax advisors design strategies in light of the new law, there are many tax planning techniques that clients can implement immediately.

Revisiting the Choice-of-Entity Decision

The reduction of the corporate income tax rate from a high of 35 percent to a flat 21 percent and the new 20 percent deduction for QBI of pass-through businesses will dramatically affect the decision of what type of business entity is most tax-efficient for the client. This decision involves multiple considerations, including the business's current and expected payroll and equipment purchases, the possibility that the business will be sold, and the effect of state-level income taxes.

Depending on the owner's tax bracket, using a C corporation may result in a lower tax burden on operating income. As long as the owner's effective marginal rate is more than 21 percent, that rate will exceed the amount that the C corporation would pay on current earnings. But this up-front savings comes at a cost: The income of the C corporation will eventually be taxed again when it is distributed to the owner as dividends. When the 21 percent rate paid by the corporation is added to the tax on the dividend to the owner, it is likely that the aggregate tax on the income earned by the C corporation will exceed the maximum 29.65 rate that applies to owners of pass-through businesses. Still, the client's goals must be considered. A client that plans to reinvest all income into the business and offer it in a public offering may be best served by the C corporation structure.

The choice-of-entity decision must also consider the built-in expiration of the 20 percent deduction for QBI of pass-through businesses. Unlike the reduced rate that applies to C corporations, which is permanent, the 20 percent QBI deduction for pass-through businesses expires on December 31, 2025. If, after considering the client's goals, the pass-through entity provides only a slight advantage over a C corporation, the client should be advised that this slight advantage may disappear in 2026. All else being equal, pass-through businesses will likely remain a better choice. If changes must be made in 2026, it is usually more tax-efficient to convert from a pass-through business to a corporation than to convert from a C corporation to a pass-through business.

Bifurcation of Business Income

Unlike other owners of pass-through businesses, owners of specified service businesses—including businesses that perform services in the fields of health, law, consulting, athletics, financial services, and brokerage services—are subject to income limitations. They do not qualify for the 20 percent QBI deduction if their income exceeds $415,000 for joint filers or $207,500 for other taxpayers. If their income is below $315,000 for joint filers and $157,500 for other taxpayers, the full 20 percent deduction is available. Between these income levels, the deduction phases out. Additional details about the phaseout will likely be promulgated by the IRS as it implements this law.

Full 20% QBI Deduction Available	**Phaseout Applies -** **Partial QBI Deduction Available**	**No QBI Deduction Available**
Income less than $315,000 for joint filers and $157,500 for other taxpayers	Between $315,001 and $414,999 for joint filers and $157,501 and $207,499 for other taxpayers	Income over $415,000 for joint filers or $207,500 for other taxpayers

These thresholds make it important to determine what income is derived from specified service businesses and what income is derived from other sources. Business owners that receive income from multiple sources should consider forming separate entities to separate the income. For example, a law firm that leases part of its building to other professionals could form two entities—one to provide legal services and another to own and lease the real estate. This would delineate the sources of income. Even if the personal services income does not qualify for the QBI deduction, the rental income may still be eligible.

Lifetime Gifting

The doubling of the estate, gift, and GST tax exemptions means that, beginning in 2018, taxpayers can transfer up to $11.18 million of assets without transfer tax consequences. This creates significant gifting opportunities between January 1, 2018, and the sunset of the increased exemptions on December 31, 2025. If the increased exemptions are temporary, clients have until December 31, 2025, to remove assets from their estates and exempt future appreciation from taxation.

Whether a client should make taxable gifts depends on many factors, including the effect of state-level estate and gift taxes. If the client is considering gifts for non-tax reasons (such as asset protection), the increased exemption amount may be enough to tip the scales in favor of a lifetime gift. This is especially true if the client has a gross estate significantly above the exclusion amount.

Spousal Lifetime Access Trusts

Some clients who would otherwise make gifts to irrevocable trusts for tax planning purposes may be reluctant to do so because of the loss of control. These clients may be concerned that lifetime gifts will deplete their funds to such an extent that they can no longer support their current and future lifestyle. For married clients, these concerns can be alleviated with a spousal lifetime access trust (*SLAT*).

A SLAT allows one spouse (*donor spouse*) to make a gift to a non-reciprocal, irrevocable trust that names the donor spouse's spouse (*beneficiary spouse*) as a lifetime beneficiary of the trust. The beneficiary spouse or the couple's children may serve as the trustee if his or her discretion is limited by an ascertainable standard. The gift constitutes a completed gift to remove the asset from the donor spouse's estate, but ensures that the donor spouse will still have access to trust assets through the beneficiary spouse as long as the couple remains married to each other. The SLAT may also give the beneficiary spouse a limited (but not a general) power of appointment to distribute assets among the couple's children after the beneficiary spouse's death.

Clients should evaluate whether to establish SLATs (or make transfers to existing SLATs) before the increased exemption amounts expire. As long as the gifts to the trust are below the increased exemption amount, a transfer to a SLAT may offer increased protection against future changes to the tax laws with little downside risk.

Opportunities for multigenerational (GST/Dynastic) Planning

The increased exemption amounts also create opportunities for GST tax planning. For example, grandparents can combine lifetime gifting with GST tax planning and make lifetime gifts directly to their grandchildren (*skip persons*) instead of their children. This would be particularly beneficial in light of the December 31, 2025, sunset of the increased exemption amounts because it will allow an additional $5 million of assets (twice the current exemption amount) to escape estate taxation at the children's death, by which time the exemption amounts will likely have reverted back to the 2017 levels.

Instead of making outright gifts to skip persons, clients can also establish a GST trust and allocate the increased exemption amount to such trust, rendering it fully exempt from GST tax even when the increased exemption sunsets. For clients with existing trusts to which no GST tax exemption was allocated, 2018 (until the sunset) may be the time to make a late allocation. For clients with existing GST tax exempt and non-exempt trusts, the period of increased exemption could be the ideal time to make distributions out of the non-exempt trusts either directly to skip person beneficiaries or to a GST tax exempt trust.

Assuming there is no clawback of any or all of the doubled exemption amount, a proper allocation to a trust of the increased GST exemption amount should render the trust fully exempt from GST tax for the duration of its term, even after the reversion of the exemption amount back to its current level. It is important to remember that there is no portability of the GST exemption, so each person must use his or her exemption either during lifetime or on death. Otherwise it is lost.

Domestic Asset Protection Trusts and Hybrid Domestic Asset Protection Trusts

Now may be the best time in a client's life to contribute to self-settled domestic asset protection trusts (*DAPTs*). This is especially true for unmarried clients that cannot use the SLAT strategy described above. There are various ways that DAPTs can be designed with built-in flexibility, such as by naming a trust protector or non-fiduciary with authority to add the grantor back as a trustee at a later time (*hybrid DAPT*). Establishing and funding a DAPT not only removes assets (including future appreciation) from the estate, but also provides ongoing asset protection for the term of the trust.

Review and Revision of Prior Estate Plans

All clients that have previously engaged in tax planning should revisit their estate plans, including the dispositive provisions of all testamentary and non-testamentary trusts. These plans should be evaluated for tax purposes, but—perhaps just as importantly—for non-tax purposes. For example, many estate plans make bequests equal to the federal estate tax exemption amount. Clients that may have been comfortable with a $5 million bequest may not be comfortable with a $10 million bequest. And with the built-in expiration of the increased exemption already in place, clients should consider the effect of another change in 2026.

There may also be opportunities to remove limitations in existing trusts. For example, mandatory income distribution standards designed to qualify a trust as a qualified terminable interest property (*QTIP*) trust may no longer be needed. The trust could be amended to replace the mandatory distribution standards with discretionary distribution standards to provide more flexibility.

Re-Inclusion of Assets

Clients that have made previous transfers should revisit those transfers in light of the new law to ensure they still meet the client's planning objectives. For example, assume that a client transferred family limited partnership interests to a DAPT to take advantage of valuation discounts. If the client is infirm and will likely die before December 31, 2025, the client should consider techniques to re-include the partnership interests in the client's estate to take advantage of the basis step-up. Depending on the circumstances, re-inclusion could be accomplished by changing the plan to give the client sufficient incidents of ownership to trigger inclusion in his estate. The client should also consider having a trust protector re-situs the trust in a non-DAPT state.

Power of Appointment Planning

Depending on the circumstances, clients should also consider giving older, trusted relatives a general power of appointment for basis step-up purposes. Giving an elderly relative a general power of appointment over a trust can result in a basis step-up for the trust assets on the death of the elderly relative. If clients have considered this strategy but have been reluctant to move forward because of the size of the elderly relative's own estate, those concerns may be alleviated—at least in the short term—by the increased exemption amounts.

Building Flexibility into Plans

Given the scheduled sunset of the increased estate, gift, and GST tax exemptions and the possibility that changes in Congress and the White House will change the tax laws, flexibility is more important than ever for clients with potentially taxable estates. For example, attorneys may include powers of appointment that allow trust assets to be re-vested in the grantor to obtain a basis step-up. Trust protectors, formula powers of appointment, and other strategies designed to future-proof planning strategies must all be considered.

Attorneys should also consider alternate distribution provisions that change depending on the exemption amount. Just as many trusts were designed after the Economic Growth Tax Relief Reconciliation Act of 2001 (*EGTRRA*), trusts could be designed with one disposition if the increased exemption amounts are in place and a different disposition if the exemption amounts revert to 2017 levels.

Incomplete Non-Grantor Trusts

Clients in states with high income taxes, including California and New York, benefit the most from the state and local tax (*SALT*) deduction, which provides a federal income tax savings to offset their state income tax burden. For clients paying more than $10,000 in state and local income taxes, the new $10,000 cap on the SALT deduction could significantly curb this offset and increase the aggregate state and federal income taxes the client owes. To get relief from this increase, clients should consider incomplete non-grantor trusts (*INGs*).

An ING is a trust designed to be an incomplete gift for federal transfer tax purposes while avoiding grantor trust status. INGs are established in states with strong domestic asset protection laws and a tax system that does not tax trust income. Because the transfer to the trust is not a completed gift for transfer tax purposes, there are no estate or gift tax consequences to establishing the trust. But the non-grantor-trust status allows the trust to be treated as a separate taxpayer for federal and state income tax purposes. The trust will pay federal income taxes on its income, but should escape state income taxation in the grantor's state of residency if properly drafted and administered.

INGs provide opportunities for clients with significant state-level income taxes on assets and who already pay federal income taxes at the highest rate. They should also be considered for clients with assets they plan to sell or otherwise dispose of in a taxable transfer.

Transfers of Appreciated Assets to Charitable Remainder Trusts

With the capital gains rate and the net investment income tax remaining the same as under current law, charitably minded clients should consider using charitable remainder trusts (CRTs) to sell appreciated assets. A CRT allows clients to name themselves or someone else to receive payments for life or for a term of 20 years or less. Income can be paid over multiple lives, allowing income to be paid to a married couple for as long as both spouses are alive. At the end of the trust term, the trust assets pass to the named charity.

CRTs can provide significant tax savings for clients that plan to sell appreciated assets. Instead of selling the asset and paying capital gains tax, the client can transfer the asset to a CRT and allow the trust to sell the asset. The client can maintain control of the asset by serving as the trustee and receive a charitable income tax deduction in the year that the CRT is established. The amount of the deduction is based on the present value of the interest that ultimately passes to the charity. The charity is tax-exempt and can sell the appreciated asset with no tax consequences. This technique allows the client to keep control over the property during life and obtain an up-front tax deduction while allowing the charity to receive the full value of the remainder interest, without reduction for tax on the asset's appreciation.

Conclusion

The Act is the most significant tax legislation in more than 30 years. Although it remains to be seen how the Act will affect the economy, one thing is certain: The Act will provide numerous tax planning opportunities in the coming years, many of which may involve new strategies. We will continue to monitor developments under the Act and keep you informed about the latest planning strategies and techniques under the new law.