Tax Reform or Tax Calamity?

A Closer Look into the Tax Cuts and Jobs Act

presented by the GYF Tax Services Group

Grossman Yanak & Ford LLP
Certified Public Accountants and Consultants

Caution

No part of today's program is intended to serve as specific tax advice or a recommendation to adopt any specific tax strategy or planning initiative. The changes in the U.S. tax code resulting from enactment of the Tax Cuts and Jobs Act number in the hundreds and cover a wide breadth of income tax provisions and issues related to income tax planning and compliance for individuals, families and businesses. As such, and with the very real expectation that the Treasury will issue at least 20-25 separate sets of Regulations interpreting key and complex elements of the Tax Cuts and Jobs Act, as well as other revenue procedures for implementation, revenue rulings and administrative announcements and notices, the information set forth herein may be incomplete. At the very least, there are many unanswered questions regarding certain complex issues that will not be addressed until the future release of the afore-noted documents.

In addition, taxpayer facts and circumstances comprise an important element in the development of any tax planning and strategy. Until such facts and circumstances are considered, it is impossible to express an opinion as to the effect the Tax Cuts and Jobs Act may have on any specific situation. As such, these materials are not to be viewed as authoritative but, rather, as informational. Grossman Yanak & Ford LLP expresses no opinion on any provision discussed herein as it might apply to a particular set of client facts and circumstances.

Please contact Bob Grossman or Don Johnston at 412.338.9300 should you have questions, comments or observations, or if you wish to discuss specific provisions of the Tax Cuts and Jobs Act that might apply to you and/or your company.

Credits

These materials, and the information set forth therein, have been developed from a number of sources including the Tax Cuts and Jobs Act (H.R.1), developed by the 115th Congress (2017-2018); the preliminary versions of the House bill and the Senate bill; the Conference Committee bill; committee reports from the House Ways and Means Committee, the Senate Finance Committee and the Conference Committee; as well as a number of technical resources, writings and interpretive analyses.

Note, also, that portions of this presentation were directly excerpted, with permission, from professional reference materials provided by CCH Incorporated, a Wolters Kluwer business.

Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by six partners, the firm employs approximately 60 personnel who serve corporate and nonprofit entities.

Our firm was founded in 1990 on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

Grossman Yanak & Ford LLP combines a diversity of technical skills with extensive "hands-on" experience to address varied and complex issues for clients on a daily basis. We pride ourselves on bringing value-added resolution to these issues in a progressive and innovative manner. Our ability to produce contemporary, creative solutions is rooted in a very basic and ageless business premise – quality service drives quality results. Our focus on the business basics of quality technical service, responsiveness and reasonable pricing has enabled the firm to develop a portfolio of corporate clients, as well as sophisticated individuals and nonprofit enterprises.

Our professionals understand the importance of quality and commitment. Currently, the majority of the professional staff in our Assurance & Advisory Services and Tax Services Groups hold the Certified Public Accountant designation or have passed the examination and need to complete the time requirements for certification. Each of our peer reviews has resulted in the highest-level report possible, attesting to the very high quality of our firm's quality control function. The collective effort of our professionals has resulted in our firm earning an exemplary reputation in the business community.

Grossman Yanak & Ford LLP…Quality You Deserve!

Professional Services Provided

Assurance Services

- Audits
- Reviews
- Compilations
- Agreed-Upon Procedures Reports
- Attestation Engagements

Tax Services

- Individual Tax Compliance and Planning Services
  - *Compensation Planning*
  - *Tax Aspects of Investment Strategies*
  - *Passive Activity Considerations*
  - *Rental Property Tax Analysis*
  - *Optimization of Interest Deductions*
  - *Education Expense Planning*
  - *Retirement Planning*
  - *Alternative Minimum Tax Planning*
  - *Charitable Giving Strategies*
- Family Tax Compliance and Planning Services
  - *Business Continuation Strategies*
  - *Minimization of Family Tax Costs*
- Business Tax Compliance and Planning Services
  - *Business Structure Analysis*
  - *Compensation Planning*
  - *Inventory Methods Analysis*
  - *S Corporation Analysis*
  - *Tax Accounting Methods Analysis*
  - *Information Return Reporting Analysis*
  - *Deferred Compensation and Retirement Planning*
  - *Operational Tax Strategies*
  - *Tax Strategies Related to Asset Acquisitions*
  - *Employer/Employee Tax Strategies*

Valuation Services

- Corporate Management Applications
- Commercial Activity Transaction Structure
- Valuations for M&A Transactions, Bankruptcy, Tax Planning and Accounting-Based Purposes
- Fairness Opinions
- Marital Dissolution and Equitable Distribution Support for Attorneys
- Matters of Civil Controversy
- Expert Witness Testimony
- Recapitalization for Business Growth and Owner Diversification
- Value Enhancement Services

Consulting Services

- Technology Consulting
- ERP Solutions
- Due Diligence Procedures Related to Mergers, Acquisitions & Divestitures
- Business Planning
- Forecasts and Projections
- Restructuring and Bankruptcy Consultation
- Cost Segregation Studies
- Special Projects
  - *Cost Accounting Systems*
  - *Cash Flow Analysis*
  - *Analysis of Insurance Programs*
  - *Lease vs. Buy Analyses*
  - *Business Valuations*
  - *Fixed Asset Accounting and Related Technology Implementations*

Robert J. Grossman, Partner

Bob heads our firm's Tax and Business Valuation Groups. He has nearly 40 years of experience in tax and valuation matters that affect businesses, both public and private, as well as the stakeholders and owners of these businesses. The breadth of his involvement encompasses the development and implementation of innovative business and financial strategies designed to minimize taxation and maximize owner wealth. As his career has progressed, Bob has risen to a level of national prominence in the business valuation arena.

His expertise in business valuation is well known, and Bob is a frequent speaker, regionally and nationally, on tax and valuation matters. He is a course developer and national instructor for both the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuators and Analysts (NACVA) and served as an adjunct professor for Duquesne University's MBA program. Bob has also written many articles for several area business publications and professional trade journals.

After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is Accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board. Bob received the 2013 NACVA "Thomas R. Porter Lifetime Achievement Award," for his leadership and career achievements to NACVA and the profession, over an extended period of time.

Bob is also a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices and directorships in various nonprofit organizations. Bob received the 2003 Distinguished Public Service Award from the PICPA and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Donald S. Johnston, Partner

Don has spent the majority of his 28-year career serving the tax and consulting needs of privately held organizations and their owners. He has significant experience handling tax planning and compliance-related issues for all types of entities, including corporations, LLCs and partnerships, and a wide base of clientele, ranging from small start-up organizations in the early stages of development to large, billion-dollar entities in need of technical expertise. Don's broad range of expertise encompasses numerous industries.

Don also has extensive experience working with distribution entities and has devised tax-savings strategies for income, franchise and other business-related taxes for numerous middle-market clients. His skills have been utilized for special projects in various areas of expertise, including acquisition planning and due diligence; Section 338(h)(10) acquisition work; stock vs. asset sale analyses for acquisition and/or disposition scenarios; development of strategies to reduce state tax obligations of multi-state entities; complex valuation-related issues; and other tax concerns for individual clients. His background allows him to assist individuals and businesses to determine advantageous strategies for mergers, acquisitions and divestitures.

After graduating from Slippery Rock University with a B.S./B.A. in accounting and finance in 1989, Don spent four years with a large international CPA firm before joining Grossman Yanak & Ford LLP in 1993. He earned his Masters of Science degree in Taxation from Robert Morris University in 1998. Don is a CPA and a member of the AICPA and PICPA. He is also a member of the Allegheny Tax Society.

A graduate of the Leadership Pittsburgh program, Don is an active participant in community affairs. He is a passionate advocate for organ and tissue donation and supports the work of the Center for Organ Recovery & Education (CORE). He previously served as Treasurer of EveryChild, Inc., a Pittsburgh-based nonprofit that serves the foster care and adoption needs of medically-fragile children.

Richard E. Dynoske, Senior Manager

Rick has practiced in the public accounting arena for more than 20 years. He has significant experience in tax planning and tax compliance matters for both publicly and privately held companies.

He spends a considerable amount of time handling consolidated tax return issues. The breadth of his involvement encompasses the development and implementation of innovative corporate and business tax planning strategies, as well as the application of personal financial planning strategies that minimize the overall effect of income, excise, sales and estate and gift taxes.

Rick graduated from Penn State University in 1991 with a B.S. degree in Accounting. He worked for a financial services firm in Pittsburgh before joining Grossman Yanak & Ford LLP in 1995. He has earned a Certificate of Educational Achievement for Tax Planning and Advising for Closely-Held Businesses from the American Institute of Certified Public Accountants.

A CPA in Pennsylvania, Rick is a member both of the American and Pennsylvania Institutes of Certified Public Accountants.

Shawn M. Firster, Senior Manager

Shawn has over 17 years of experience in public accounting. He focuses on providing tax compliance and planning services for various business entities, including corporations, S corporations and partnerships, as well as to high-net-worth individuals. Shawn also has extensive experience in state income and sales and use tax matters. He provides tax planning and compliance services for a variety of industries, including manufacturing, alternative energy production and professional services.

Additionally, Shawn has performed special project work for clients in a variety of areas, including merger and acquisition analysis, multi-state tax planning, financial forecasting, research and development and cost segregation analysis.

A graduate of Pennsylvania State University, Shawn earned his B.S. degree in accounting in 1997. Before joining Grossman Yanak & Ford LLP in 2000, Shawn worked at a regional public accounting firm. He has enhanced his professional training by participating in the various levels of the AICPA National Tax Education Program and other continuing education programs focusing on tax compliance.

A CPA in Pennsylvania, Shawn is a member of the American and Pennsylvania Institutes of Certified Public Accountants. He also serves on the Board of Directors and was Past President of the Allegheny Tax Society. A recent graduate of Leadership Pittsburgh, Inc. (LPI), Shawn is active in the community and regularly volunteers for various service projects and youth baseball and basketball programs.

Michael E. Weber, Manager

Michael has over seven years of professional experience, including six in public accounting. His responsibilities primarily include the provision of tax compliance, planning and research services for corporations, S corporations, partnerships, limited liability companies and not-for-profit organizations, as well as individuals. Michael has provided services for domestic and international clients, including manufacturers, real estate and service companies. He also assists new entities with their formation, planning and tax compliance.

A graduate of Duquesne University, Michael earned his a B.S./B.A. in Accounting in 2007 and his J.D. from the University's School of Law in 2011. He is a Certified Public Accountant and a member of the PICPA.

Michael is a licensed attorney in the Commonwealth of Pennsylvania. He is a member of Allegheny County Bar Association (ACBA), for which he serves as Vice President in the Tax Section and is part of the Young Lawyers Division. Michael is also a member of Global-Pittsburgh, a nonprofit organization that brings together global-minded people in the Pittsburgh region.

William A. Marino, Senior Associate

Bill has over eight years of practice experience in public accounting, specializing in the provision of tax services. His primary responsibilities include tax compliance, strategic planning and research for a broad range of federal and state taxation areas.

Bill has provided various tax services to a diverse group of domestic and international clients, including privately held businesses, publicly traded corporations and not-for profit organizations. He also has significant expertise working with businesses or exempt organizations sponsoring large pension and welfare benefit plans. Bill has served companies engaged in various industries, including research and development; property development, construction and renovation; manufacturing; technology services; oil and gas production; oil and gas support services; restaurants; and aviation.

In addition to his corporate work, Bill has developed a focus in the area of estate and gift tax compliance and planning. He works with individuals and families to devise tax planning strategies for the preservation of family assets, including the utilization of fiduciary entities, such as trusts.

Bill graduated from West Virginia University in 2003 with a B.S. in Business Administration and earned his J.D. in 2006 from West Virginia University College of Law. After working at a regional firm in West Virginia for two years, Bill joined GYF in 2009.

Alexandra H. Palmer, Senior Associate

Alex has over seven years of professional experience in public accounting, specializing in the area of taxation. Her responsibilities primarily include the provision of tax compliance, research and planning services for corporations, S corporations, partnerships, limited liability companies and individuals.

Alex has served clients in a variety of industries, assisting with both domestic and international tax matters, and focusing particularly on companies with activity in multiple states. She has significant experience working with businesses engaged in real estate rental and development, mergers and acquisitions, manufacturing, construction, retail, and the provision of legal and insurance services.

A graduate of Grove City College, Alex earned her B.S. in Accounting in 2010, and subsequently earned her M.S. in Taxation from Robert Morris University in 2012. She is a CPA in the Commonwealth of Pennsylvania and a member of the PICPA and the AICPA.

Alex works with SMC Business Councils, assisting in their lobbying efforts as they seek to bring issues important to small businesses throughout the Commonwealth to the attention of lawmakers in Harrisburg. She is also actively involved in community organizations in her community, serving on the Board at Plum Aqua Club and the Parish Finance Council at Immaculate Conception Church in Irwin.

GYF Professional Education Seminars

The following courses have been presented by our professionals:

- *The Business Valuation Process*
- *Understanding Standards of Value and Levels of Value*
- *Income Approach to Business Valuation*
- *Market Approach to Business Valuation*
- *Cost/Asset Approach to Business Valuation*
- *Quantification and Application of Valuation Discounts*
- *S Corporations vs. C Corporations: Understanding Valuation Differences*
- *Special Purpose Valuations: ESOPs & Buy/Sell Agreements*
- *Special Purpose Valuations: Estate & Gift Tax Planning*
- *Economic Damages: Lost Profits Determinations*
- *Attorney's Guide to Financial Statements*
- *Marcellus Shale: Income Tax & Valuation Issues Related to Landowners*
- *Family Limited Partnerships: Realities of Estate Planning with FLPs*
- *Business Entity Selection & Structuring Transactions*
- *Fraud & Forensic Accounting*
- *Navigating the New Tax Laws: Recent Changes & 2013 Planning*
- *Intangible Assets: Identification, Valuation and Controversial Issues*
- *Understanding ESOPs and Their Use In Exit Planning*
- *Advising Individual Tax Clients for 2013 and Beyond*
- *Analyzing Financial Statements and Their Impact on Value*
- *Exit Planning: Considerations and Steps for Exiting a Business*
- *Planning in a Changing Tax Environment*
- *Law Firm Economics*
- *Corporate Divorce*
- *The Ins and Outs of Non-Cash Compensation*
- *International Taxation*
- *Thorny Issues with Applying the Income Approach in a Legal Setting*
- *Advising Clients on Buy-Sell Agreements*

Materials from these presentations can be downloaded at https://gyf.com/resources/documents/

Table of Contents

Table of Contents

Table of Contents

Table of Contents

Table of Contents

A Closer Look at the Tax Cuts and Jobs Act

I. Introduction

On December 20, 2017, Congress passed the Tax Cuts and Jobs Act (H.R.1) after a 51-48 vote in the Senate and a 224-201 vote in the House of Representatives. The bill was originally presented in the House after months of work putting policy proposals by House committees and the President into legislative language. After initial passage in the House, the Senate then passed its own version of the law, and a Conference Committee was established to reconcile the two very different pieces of legislation. The Tax Cuts and Jobs Act Conference Committee presented the final bill language on December 15, 2017.

Final passage of the Conference bill by both chambers of Congress included an element of drama. After the initial vote in the House, the Senate Parliamentarian determined that two provisions of the Conference bill, and, incredibly, the name of the bill itself, failed to comply with the strict requirements of the Byrd rule.

Compliance with the Byrd rule was critically important to the process, as failure to comply would have required a super-majority vote for passage, versus simple majority in the Senate using budget reconciliation rules. The two offending provisions were removed, and the official name of the bill was changed to "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*," after which the vote in the Senate was held. A second vote in the House followed, and President Trump signed the bill into law on December 22, 2017.

The legislation, Tax Cuts and Jobs Act (TCJA), represents the most significant overhaul of the Internal Revenue Code in more than 30 years. It provides significant reductions in tax rates for individuals, corporations and small businesses; reforms U.S. taxation of international transactions and businesses; eliminates dozens of individual and business tax deductions; expands and enhances many tax credits and deductions; and includes many other changes. It is likely that every U.S. taxpayer, foreign or domestic, individual or business, high-income or low-income, will be impacted in some way by the provisions of the new law.

Goals of the Legislation

The last major tax reform in the United States occurred in 1986, when then-President Ronald Reagan signed into law the Tax Reform Act of 1986. Many of the overriding principles incorporated into the TCJA were similarly embraced in the course of developing that legislation. These principles were presented anew in the "Unified Framework for Fixing Our Broken Tax Code," a document released by Congressional Republicans and the Administration on September 27, 2017.

A Closer Look at the Tax Cuts and Jobs Act

The Framework served as the foundational structure of the current tax reform package and was intended to "achieve pro-American, fiscally-responsible tax reform." According to the GOP-led Congress, "this Framework will deliver a 21st century tax code that is built for growth, supports middle-class families, defends our workers, protects our jobs, and puts America first. It will deliver fiscally responsible tax reform by broadening the tax base, closing loopholes and growing the economy."

The goals of the Framework included:

- Tax relief for middle-class families.
- The simplicity of "postcard" tax filing for the vast majority of Americans.
- Tax relief for businesses, especially small businesses.
- Ending incentives to ship jobs, capital, and tax revenue overseas.
- Broadening the tax base and providing greater fairness for all Americans by closing special interest tax breaks and loopholes.[1]

Each of these structural goals for tax reform were also part of the draft legislation of "The Tax Reform Act of 2014." The draft was released on February 26, 2014, by then-Chairman of the Ways and Means Committee, Dave Camp (R-MI). That legislation was based on analyses by the independent, non-partisan joint Committee on Taxation and, at that time, was not expected to increase the budget deficit to accomplish its goals.[2]

How These Provisions Will Work to Achieve the Goals

It remains to be seen whether the TCJA, as passed, will attain the goals set forth above that have been threaded through Republican tax proposals for decades. In many ways, it initially appears that the provisions in the final bill go far toward attaining those goals. Certainly, reduced individual marginal income tax rates, expanded standard deductions, an enhanced child tax credit and aid to middle-class families should lessen the weight of taxpayers' federal income tax obligations.

The significant expansion of the standard deduction will substantially reduce the number of taxpayers itemizing their deductions in their federal income tax filings. However, the expansion of the standard deduction comes with a repeal of those provisions allowing a deduction for personal and dependency exemptions. As an equalizer, Congress substantially expanded the Child Tax Credit, which adds a layer of tax complexity to the preparation of an individual income tax return.

1 *Unified Framework for Fixing Our Broken Tax Code*, https://www.treasury.gov/press-center/press-releases/Documents/Tax-Framework.pdf

2 *The Tax Reform Act of 2014*, https://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft_022614.pdf

A Closer Look at the Tax Cuts and Jobs Act

Unfortunately, the simplicity desired by the Republicans did not find its way into the final legislation, which is 495 pages in length. The sheer number of changes, as well as the complexity encompassed in many of those changes, will surely lead to further consternation about the unwieldiness of the Internal Revenue Code. Already, the Treasury has released multiple notices adding clarity to the international tax provisions, and the complexity will surely grow as the Treasury drafts regulations to explain and clarify the new statutes. Finally, it has been rumored that a Technical Corrections Bill will be considered for introduction this summer.

As a result of the many nuances contained within the final legislation, it is unlikely that few, if any, taxpayers will be able to take advantage of a "postcard" filing option. Interestingly, for all the discussion, a similar tax return (Form 1040-EZ), was already integrated into the tax system under prior law.

Tax relief for businesses, especially small businesses, is apparent throughout the legislation. For businesses taxed as "regular" corporations, the tax bill significantly reduces the top marginal tax rate, moving it downward to a level more competitive with other industrialized countries. Repeal of the corporate alternative minimum tax (AMT) and expansion of the amounts of capital asset additions that can be expensed both favor businesses and are likely to spur future economic growth.

Smaller businesses, especially those taxed as "pass-through" business entities (S corporations, partnerships and most limited liability companies), benefit from two major provisions within the legislation. The first is a reduction in the individual marginal income tax rates to which the pass-through income is taxed. The second, more important provision is the allowance of a 20% deduction for combined pass-through income at the individual equity owner level. Together with the expansion of the amounts of capital asset additions that can be expensed (as with regular corporations), the TCJA goes a long way in providing relief for businesses, including small businesses.

The final two goals set forth in the Framework – ending incentives to ship jobs, capital, and tax revenue overseas and broadening the tax base and providing greater fairness for all Americans by closing special interest tax breaks and loopholes – are encompassed in the legislation in a significant revision of the international tax rules. Additionally, a smattering of provisions sprinkled throughout the bill address Congressional concerns regarding seemingly favorable current-law tax provisions aimed at assisting very specific taxpayer groups.

Projected Impact of the Legislation

As with any legislation, it is impossible to accurately discern at the outset the exact impact of the provisions contained therein. One of the most contentious issues in contemporary American politics concerns the relationship between federal tax policy and the U.S. economy. Some policymakers and economists believe that

A Closer Look at the Tax Cuts and Jobs Act

higher tax rates discourage work and investment, and that lowering marginal tax rates on labor and capital lead to economic growth. Others are doubtful that a strong relationship exists between taxes and the size of the U.S. economy, and dispute the notion that tax cuts could lead to increased prosperity.

Often, the debate over the economic effects of tax policy boils down to competing interpretations of U.S. economic history. Over many years, there have been numerous studies that have attempted to measure the actual effects of past tax changes on the U.S. economy. As one would expect, it is a difficult endeavor to attempt to isolate the effects of tax policy, particularly in the context of the business cycle, changes in other areas of federal policy, and broader economic trends.

The Tax Foundation, a Washington, D.C.-based "think tank" that collects data and publishes research studies on U.S. tax policies, regularly uses the *Taxes and Growth Model* to forecast the revenue and economic effects of proposed federal tax changes. They have also used the same model to "backcast" the effects of past changes stretching back to the early 1960s.[3]

As can be seen from the work undertaken by the Tax Foundation, set forth in the table below, the measurements produced by application of the model are mixed.

PREDICTED ECONOMIC AND REVENUE EFFECTS OF SEVEN MAJOR TAX BILLS

Tax Bill	Long-Run Change in GDP	Static Change in Annual Revenue (% of GDP)
Kennedy 1962/1964	6.2%	-2.2%
Reagan 1981	8.0%	-2.6%
Reagan 1986	-0.2%	-0.1%
Clinton 1993	-1.5%	0.6%
Clinton 1997	0.8%	-0.6%
Bush 2001	2.3%	-1.5%
Bush 2003	2.3%	-0.2%

Source: Tax Foundation *Taxes and Growth Model*

Note: The figures for Kennedy and Reagan 1981 are somewhat overstated, as major provisions in both bills were repealed shortly after enactment.

[3] *Modeling the Economic Effects of Past Tax Bills*, Tax Foundation, Scott Greenberg, John Olsen and Stephen J. Entin, September 14, 2016, https://taxfoundation.org/modeling-economic-effects-past-tax-bills/

A Closer Look at the Tax Cuts and Jobs Act

Based on the application of these financial models, some economists point to the Kennedy tax cuts of 1962 and 1964, and the Reagan tax cuts of 1981, as examples of tax changes that spurred economic growth. Others, arguing against a strong relationship between tax rates and the economy, highlight the Tax Reform Act of 1986 and the Clinton tax increases of 1993, neither of which appeared to have had significant macroeconomic effects.[4]

With respect to the TCJA, the early months have been nothing short of spectacular. While it is hard to know how "lasting" the impact will be, a January article in the Wall Street Journal noted that the bill seems to be having a rapid and profound effect on the U.S. economy.[5] The article quotes Joseph LaVorgna, chief economist for the Americas at Natixis, an international financial-services arm of France's Groupe BPCE banking firm. LaVorgna notes, "Already, analysts expect the legislation to provide a 7% to 8% boost in aggregate per-share profits for the companies in the S&P 500 this year."

As President Trump noted in his State of the Union address on January 30, 2018, approximately 3,000,000 Americans have been given bonuses as a result of the tax reform. This statistic was included in a list compiled by Americans for Tax Reform, a nonprofit taxpayer advocacy group that is tracking the positive effects of the TCJA.

Several larger employers were among those recognized for rewarding their employees. For example, Waste Management paid $2,000 bonuses to 34,000 employees, Apple paid $2,500 in stock to tens of thousands of employees, and Home Depot gave a $1,000 bonus to every hourly employee.[6]

The ATR list also noted that smaller employers paid significant bonuses too. One of these companies, 1st Summit Bank in Johnstown, paid a $1,000 bonus to every full-time employee, gave salary raises and increased charitable giving. Iron Horse Energy Services, Inc. paid bonuses to all 93 of its employees and noted that, due to a lower tax burden, the company will continue to pay 100% of the cost of employee healthcare.[7]

The new tax law has also driven numerous large capital project announcements from many well-known companies. AT&T pledged to invest an additional $1 billion in the United States in 2018 and pay a special $1,000 bonus to more than 200,000 AT&T U.S. employees – all union-represented, non-management and front-line managers.[8]

---

4 Ibid.

5 *The Tax Law, Just One Month Old, is Roaring Through U.S. Companies*, Wall Street Journal, January 25, 2018, https://www.wsj.com/articles/the-tax-law-just-one-month-old-is-roaring-through-u-s-companies-1516899466

6 *Americans for Tax Reform*, January 31, 2018, https://www.atr.org/list

7 Ibid.

8 *AT&T News Release to Investors*, December 20, 2017, http://about.att.com/story/att_tax_reform.html

A Closer Look at the Tax Cuts and Jobs Act

Exxon expects to spend $50 billion in U.S. projects over the next five years. More than $35 billion of that amount is for projects not previously announced. The company reports that it is also "actively evaluating" projects currently in planning stages as a result of new tax and regulatory changes.[9]

FedEx recently reported a number of positive changes in response to the tax reform legislation. According to a recent release to investors, the company will commit more than $3.2 billion to pension funding, capital investments and employee compensation. Over $200 million, or about 6.3% of the total commitment, will go toward increased compensation, with about two-thirds of that amount going to hourly employees by moving up 2018 annual pay increases by six months. The package delivery company will also contribute $1.5 billion to the pension plan and will invest $1.5 billion to expand the FedEx Express Indianapolis hub and modernize the Memphis SuperHub.[10]

Finally, Apple announced that it plans to invest a total of $350 billion in the U.S. economy over the next five years, while also creating 20,000 jobs.[11]

The final statistics needed to determine whether the TCJA will add significantly to economic growth in the U.S. economy will not be measurable for some time, but the initial responses noted above are quite favorable. It goes without saying that relieving businesses and individuals of excessive income tax burdens frees up cash for more spending that is "directly-related" to economic advances. On the business front, that spending can lead to capital expenditures and expansion of employment opportunities. For individuals, putting more money into taxpayers' pockets will likely lead to greater levels of consumer spending.

The remaining matter to consider in determining the overall economic effect of the legislation is the amount of time that will be afforded the provisions in the TCJA to accomplish their intended purposes before being further modified by a future Congress. President Trump's record over his first year in office is such that many commentators believe that mid-year elections may bring a swing in power for the second half of his first term, especially in the Senate. If such a shift were to occur, it is questionable as to whether any future GOP-led legislation will be passed. In the past, Congress has elected to modify the tax policy and law so regularly that it is almost impossible to properly evaluate the overall impact of any particular tax bill.

---

[9] *Exxon Perspectives Blog*, January 29, 2018, https://energyfactor.exxonmobil.com/perspectives/economic-boon/

[10] *FedEx News Release*, January 26, 2018, http://investors.fedex.com/news-and-events/investor-news/news-release-details/2018/FedEx-Committing-More-Than-32-Billion-in-Wage-Increases-Bonuses-Pension-Funding-and-Expanded-US-Capital-Investment-Following-the-Passage-of-the-Tax-Cuts-and-Jobs-Act/default.aspx

[11] *Apple Insider*, January 17, 2018, http://appleinsider.com/articles/18/01/17/apple-ceo-tim-cook-cites-gop-tax-reform-as-driver-in-350b-us-investment

A Closer Look at the Tax Cuts and Jobs Act

Overview of Materials

Today's presentation is intended to familiarize you with many of the primary provisions of the tax reform legislation. The scope of this presentation is not meant to make each participant an expert, but to sufficiently increase your knowledge base so as to enable you to ask questions and learn more about those specific provisions of the law that are most likely to affect you in 2018 and forward.

To that end, we have structured the program in chapters to segregate the provisions into what we believe are logical elements for consideration:

- Chapter I – Introduction
- Chapter II – Impact on Families and Individuals
- Chapter III – Impact on Pass-Through Entities
- Chapter IV – Impact on Businesses
- Chapter V – Impact on International Taxation
- Chapter VI – Impact on Qualified Retirement Plans
- Chapter VII – Impact on Exempt Organizations
- Chapter VIII – Concluding Thoughts and Practical Considerations

We have included in these materials detailed information relating to all of the major changes. However, these materials are not intended to be authoritative, and should you have a question or issue not easily addressed by the content of this publication, please contact Bob Grossman, Don Johnston, or your GYF executive at 412-338-9300 for further guidance.

We appreciate your support and confidence shown to our Firm over many years and appreciate that you have taken the time to attend our presentation. We hope that you have found it to be informative and helpful.

Thank you for joining us!

A Closer Look at the Tax Cuts and Jobs Act

II. Impact on Families and Individuals

The Tax Cuts and Jobs Act (TCJA) represents the most significant tax reform in over three decades. The legislation significantly modifies the tax rules applicable to individuals through a wide variety of changes, and at least some of these changes will likely reach every taxpayer filing a U.S. income tax return in 2018 and beyond.

Determining the winners and losers under the new law will not be easy. Given the sheer number of changes that will affect individuals, outcomes will rest on underlying facts and circumstances. As such, all taxpayers will need to evaluate how the law affects their particular situations and develop customized planning strategies to position their financial affairs in the most tax-beneficial way possible. Optimization of income tax strategies and minimization of federal income tax liabilities will require careful and ongoing analysis and assessment.

One of the more interesting aspects of the TCJA is the temporary nature of the changes affecting individual taxpayers. All of the substantive provisions affecting individual taxpayers are currently applicable in tax years 2018 through 2025. Thus, at the end of this seven-year period, all of the provisions expire, and the tax law in 2026 will revert to the law in force in 2017. This outcome presupposes that Congress will not see fit to extend the provisions beyond 2025.

Of course, no one participating in today's program should be so naïve as to think that Congress will not, at least in some way, meddle in the law that was recently passed during the next seven years. The issue that becomes front and center is Congress' inability to leave tax laws in force until a proper evaluation of their usefulness can be determined. Moreover, the past experience of Congress in addressing an "extender package" (a tax law renewing an expiring tax provision for another year) one year at a time is not good. Thus, it remains to be seen whether the TCJA provisions affecting individuals will be extended prior to their sunset dates at the end of 2025, or even if the law continues in its current form at that point. Unfortunately, such an environment makes long-term planning extremely difficult, if not impossible.

Marginal Income Tax Rates

At the heart of the legislation, and as heavily promoted by Republicans in both the House and Senate as well as the President, the individual marginal income tax rates and the brackets to which those rates apply, have been changed for tax years beginning after Dec. 31, 2017, and ending before Jan. 1, 2026. While the President had campaigned for a two-rate system, the House bill moved that number to four and, finally, the Senate bill expanded the number of rate brackets to seven. The final bill coming from the Conference Committee contained seven separate marginal income tax rates: 10%, 12%, 22%, 24%, 32%, 35% and 37%.

A Closer Look at the Tax Cuts and Jobs Act

As one would expect, the marginal income tax rates are applied over several ranges of income, commonly referred to as "income brackets," with the highest rates applied to the highest levels of incomes. As such, the final legislation maintains the historical emphasis on the progressive nature of the U.S. individual tax system. The bracket amounts are adjusted annually for inflation. The tax brackets and rates are listed in the tables below.

SINGLE TAXPAYERS – FOR TAX YEARS BEGINNING IN 2018

Rate	*Taxable Income Bracket*	*Tax Owed*
10.0%	$0 to $9,525	10% of taxable income
12.0%	$9,525 to $38,700	$952.50 + 12% of the amount over $9,525
22.0%	$38,700 to $82,500	$4,453.50 + 22% of the amount over $38,700
24.0%	$82,500 to $157,500	$14,089.50 + 24% of the amount over $82,500
32.0%	$157,500 to $200,000	$32,089.50 + 32% of the amount over $157,500
35.0%	$200,000 to $500,000	$45,689.50 + 35% of the amount over $200,000
37.0%	$500,000+	$150,689.50 + 37% of the amount over $500,000

MARRIED INDIVIDUALS FILING SEPARATELY – FOR TAX YEARS BEGINNING IN 2018

Rate	*Taxable Income Bracket*	*Tax Owed*
10.0%	$0 to $9,525	10% of taxable income
12.0%	$9,525 to $38,700	$952.50 + 12% of the amount over $9,525
22.0%	$38,700 to $82,500	$4,453.50 + 22% of the amount over $38,700
24.0%	$82,500 to $157,500	$14,089.50 + 24% of the amount over $82,500
32.0%	$157,500 to $200,000	$32,089.50 + 32% of the amount over $157,500
35.0%	$200,000 to $300,000	$45,689.50 + 35% of the amount over $200,000
37.0%	$300,000+	$80,689.50 + 37% of the amount over $300,000

A Closer Look at the Tax Cuts and Jobs Act

MARRIED INDIVIDUALS FILING JOINTLY & SURVIVING SPOUSES – FOR TAX YEARS BEGINNING IN 2018

Rate	*Taxable Income Bracket*	*Tax Owed*
10.0%	$0 to $19,050	10% of taxable income
12.0%	$19,050 to $77,400	$1,905 + 12% of the amount over $19,050
22.0%	$77,400 to $165,000	$8,907 + 22% of the amount over $77,400
24.0%	$165,000 to $315,000	$28,179 + 24% of the amount over $165,000
32.0%	$315,000 to $400,000	$64,179 + 32% of the amount over $315,000
35.0%	$400,000 to $600,000	$91,379 + 35% of the amount over $400,000
37.0%	$600,000+	$161,379 + 37% of the amount over $600,000

HEADS OF HOUSEHOLD – FOR TAX YEARS BEGINNING IN 2018

Rate	*Taxable Income Bracket*	*Tax Owed*
10.0%	$0 to $13,600	10% of taxable income
12.0%	$13,600 to $51,800	$1,360 + 12% of the amount over $13,600
22.0%	$51,800 to $82,500	$5,944 + 22% of the amount over $51,800
24.0%	$82,500 to $157,500	$12,698 + 24% of the amount over $82,500
32.0%	$157,500 to $200,000	$30,698 + 32% of the amount over $157,500
35.0%	$200,000 to $500,000	$44,298 + 35% of the amount over $200,000
37.0%	$500,000+	$149,298 + 37% of the amount over $500,000

ESTATES & TRUSTS – FOR TAX YEARS BEGINNING IN 2018

Rate	*Taxable Income Bracket*	*Tax Owed*
10.0%	$0 to $2,550	10% of taxable income
24.0%	$2,550 to $9,150	$255 + 24% of the amount over $2,550
35.0%	$9,150 to $12,500	$1,839 + 35% of the amount over $9,150
37.0%	$12,500+	$3,011.50 + 37% of the amount over $12,500

A Closer Look at the Tax Cuts and Jobs Act

The "Kiddie Tax"

The TCJA contains rules intended to simplify the tax on a child's investment and other unearned income (commonly known as the "Kiddie Tax") for years beginning after December 31, 2017 and before January 1, 2026.

The Kiddie Tax was added to the Internal Revenue Code to ensure that higher-income taxpayers could not defeat the intent of the income tax rules. These taxpayers often used various "income shifting" techniques to move unearned income to their children, who presumably, then, could report it at lower marginal rates.

The general rules for imposition of the Kiddie Tax on a child's unearned income include:

- the child is required to file a tax return;
- the child does not file a joint return for the tax year;
- the child's investment income is more than $2,100 (for 2018);
- either of the child's parents is alive at the end of the year; and
- at the end of the tax year, the child is either: (a) under the age of 18; (b) under the age of 19 and does not provide more than half of his or her own support with earned income; or (c) under the age of 24, a full-time student, and does not provide more than half of his or her own support with earned income.

The prior-law rules provided that the net unearned income of a child (for 2018, over $2,100) would be taxed at the parents' highest marginal income tax rates if the parents' tax rates were higher than the child's. The remainder of a child's taxable income (i.e., earned income plus unearned income up to $2,100, less the child's standard deduction) is taxed at the child's rates, whether or not the Kiddie Tax applies to the child. Prior to the TCJA, a child was generally permitted to use the preferential tax rates for qualified dividends and capital gains.

Under the TCJA, effective for tax years beginning after December 31, 2017 and before January 1, 2026, the Kiddie Tax is simplified by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child. As a result, any taxable income attributable to earned income of a child is taxed according to a single individual's tax bracket and rates. It is only the unearned income that is subjected to the ordinary capital gains rates of estates and trusts. Thus, a child's Kiddie Tax is no longer affected by his or her parents' tax situation, nor that of any brother or sister.

A Closer Look at the Tax Cuts and Jobs Act

Capital Gains Rates and Qualified Dividends

Capital gains tax rates remain largely unchanged, with a maximum rate of 20% on gains resulting from most capital transactions as well as qualified dividend income. Lower capital gains rates of 0% and 15% apply to taxpayers with lower levels of adjusted gross income. These levels of income to which the lower preferential capital gains tax rates apply are generally referenced as "breakpoints." Any adjusted net capital gain that would result in taxable income exceeding the 15% breakpoint (but not exceeding the 20% breakpoint) is taxed at 15%.

Breakpoints vary by filing status. For 2018, the 15% breakpoint is $77,200 for joint returns and surviving spouses (half of this amount for married taxpayers filing separately), $51,700 for heads of household, $2,600 for estates and trusts, and $38,600 for other unmarried individuals. The 20% breakpoint is $479,000 for joint returns and surviving spouses (half of this amount for married taxpayers filing separately), $452,400 for heads of household, $12,700 for estates and trusts, and $425,800 for other unmarried individuals.

By way of example, in the case of a married couple filing jointly with an adjusted net capital gain, if that net adjusted capital gain does not result in taxable income exceeding the 15% breakpoint ($77,200), the capital gains tax rate would be 0%. If the net adjusted capital gain caused the couple's taxable income to be $500,000, the adjusted net capital gain would be taxed at 15%, up to the 20% breakpoint. The remaining adjusted net capital gain is taxed at the highest rate of 20%.

The breakpoints are important, as they control the marginal capital gains rate of taxation on capital gain transactions and qualified dividends. For years beginning after 2018, the breakpoints will be indexed for inflation using the chained consumer price index for all urban consumers (C-CPI-U).

The maximum tax rate on unrecaptured IRC Section 1250 gain remains at 25%. Further, the classification of capital gains taxed at 28% (gains on sales of collectibles and sales of qualified small business stock, colloquially known as "28%-rate gains") remains at a maximum rate of 28%. Any amount of unrecaptured Section 1250 or 28%-rate gain, otherwise taxed at a 10% or 15% rate, is taxed at the otherwise-applicable rate.

Net Investment Income Tax

The law did NOT repeal the taxes imposed by the 2008 Obamacare legislation. Under the Affordable Care Act, a tax is imposed on net investment income in the case of an individual, estate or trust. In the case of an individual, the tax rate is 3.8% of the lesser of: (1) net investment income, which includes income from different sources including interest, dividends, annuities, royalties, rentals and other sources, or (2) the excess of modified adjusted gross income over the threshold amount of $200,000 for single taxpayers ($250,000 for married taxpayers filing jointly and surviving spouses, and $125,000 for a married taxpayer filing separately).

A Closer Look at the Tax Cuts and Jobs Act

Changes to the Standard Deduction

The standard deduction is the amount by which the taxpayer's adjusted gross income (AGI) may be decreased to calculate taxable income if he or she does not itemize allowable deductions. Use of the standard deduction is an alternative to itemizing deductions. Generally, the standard deduction is used only if a taxpayer does not have enough itemized deductions to exceed a particular year's standard deduction amount. In these cases, the standard deduction amount is used to decrease AGI, instead of total allowable itemized deductions, in computing taxable income. By increasing the standard deduction, Congress intends to reduce the number of taxpayers who itemize deductions, thereby, simplifying the filing requirements for those individuals.

The basic standard deduction amount varies according to the taxpayer's filing status and is adjusted annually for inflation. For tax year 2018, under the prior law, the amount of the basic standard deduction was scheduled to be $13,000 for married individuals filing joint returns and surviving spouses, $6,500 for single individuals and married individuals filing separate returns, and $9,550 for heads of households. In the case of a dependent for whom a deduction for a personal exemption was allowed under prior law to another taxpayer, the standard deduction for 2018 was limited to the greater of $1,050 or the sum of $350 plus the individual's earned income, up to the applicable standard deduction amount for single taxpayers (again, $6,500 for 2018).

The modifications made to the standard deduction under the tax reform legislation generated a lot of attention. Highly touted as transformative, the standard deduction is temporarily increased under the new law for tax years 2018 through 2025. In 2018, for married individuals filing jointly (and surviving spouses), the standard deduction is increased to $24,000, nearly doubling the amount allowable under the previous law. Under the new law, the standard deduction for taxpayers filing as heads of household is $18,000 and $12,000 for single individuals and married individuals filing separately.

The standard deduction amount for a dependent, as well as the additional standard deduction amounts for the aged and/or blind, are not affected by the law and are not temporarily increased. These standard deduction amounts will be adjusted annually for inflation for tax years beginning after 2018 and before 2026 using the C-CPI-U in the cost-of-living adjustment.

At first blush, the increases to the standard deduction appear to be astoundingly large. Certainly, on a stand-alone basis, the increases are substantial. However, it is noteworthy that the regular tax computation under the TCJA does not work mechanically in the same way as it had in the past, as the new law eliminates all deductions applicable to personal and dependency exemptions.

Repeal of the personal and dependency exemptions work to take away some of the income tax benefit created by the increase in the standard deduction. This anomaly will be discussed in greater detail later in these materials.

A Closer Look at the Tax Cuts and Jobs Act

It is noteworthy that an individual may claim an additional standard deduction amount for "net disaster loss" in tax years beginning in 2016 and 2017. For this purpose, a *net disaster loss* is the "qualified disaster-related personal casualty loss," over any personal casualty gains. A *qualified disaster-related personal loss* means a personal casualty loss arising in a disaster area on or after January 1, 2016, that is attributable to a federally declared disaster. Further discussion of these deductions is set forth on pages 34 of these materials.

The additional standard deduction is also allowed in computing the alternative minimum tax liability.

Repeal of the Deduction for Personal and Dependency Exemptions

The TCJA temporarily repeals the deduction for personal and dependency exemptions for tax years beginning after December 31, 2017 and before January 1, 2026.

Under prior law, the amount of deduction afforded each personal exemption (for taxpayer and spouse) and of a dependency exemption (for each of the taxpayer's dependents) was adjusted annually for inflation. The exemption was scheduled to be $4,150 for 2018, before the passage of the TCJA and the repeal of these exemptions.

Additionally, not all individuals were able to take advantage of the exemption allowances under prior law. An individual whose AGI exceeded an applicable threshold amount based on filing status was required to reduce the amount of the otherwise-allowable exemption deduction. The 2018 applicable threshold amounts of AGI under these rules were scheduled to be $320,000 for married individuals filing a joint return and surviving spouses, $293,350 for heads of households, $266,700 for single individuals, and $160,000 for married individuals filing a separate return. Thus, the repeal of these exemptions will have little effect on many higher-income taxpayers.

The temporary repeal of the personal and dependency exemption deductions (along with the expansion of the standard deduction) adds a new layer of complexity to ensuring that an employee's federal income tax withholding on wages is appropriate. To that end, the IRS is authorized to administer the withholding rules for tax years beginning before January 1, 2019, without regard to the repeal of the personal exemptions (now referred to as "allowances").

The wage withholding rules were initially thought to remain the same as under prior law for 2018. However, the IRS released new withholding tables on January 11, 2018. Employers were instructed to use the 2018 withholding tables to adjust employees' paychecks no later than February 28, 2018.

The Treasury also advised employers to withhold taxes at a 22% rate from special bonuses distributed following the passage of the TCJA, which is lower than the amount that had been previously withheld. The backup withholding rate was 24%. Generally, under backup withholding rules, employers must withhold 24% of certain taxable payments if the payee fails to furnish his or her correct taxpayer identification number to the employer.

A Closer Look at the Tax Cuts and Jobs Act

The new withholding tables are designed to work with the Forms W-4 that employees already have on file with their employers. As such, taxpayers may not need to do anything else at this point in time. According to the IRS, the new tables should result in the correct amount of tax withholding, though it is possible that certain taxpayers may need to change their Forms W-4.

Tax Filing Thresholds for Individuals

As a result of the temporary repeal of the personal and dependency exemption deductions and the temporary increase in the standard deduction, the rules for determining the threshold for an individual required to file a federal income tax return are modified for tax years beginning after December 31, 2017 and before January 1, 2026.

An individual who is not married (single or head of household) is required to file a tax return if his or her gross income for the tax year exceeds the applicable standard deduction. A married individual reaches the filing threshold if his or her gross income, when combined with his or her spouse's gross income for the tax year, is more than the standard deduction applicable to a joint return, provided that:

- the individual and his or her spouse, at the close of the tax year, had the same household as their home;
- the individual's spouse does not file a separate return; and
- neither the individual nor his or her spouse is a dependent of another taxpayer who has income (other than earned income) in excess of the standard deduction for dependents.

FILING THRESHOLDS COMPARISON

	Old Law (2017)	*New Law*
Single individual	$ 10,400	$ 12,000
Single individual, 65 or older or blind	11,950	13,600
Single individual, 65 or older and blind	13,500	15,200
Married individual, separate return	4,050	12,000
Married couple, joint return	20,800	24,000
Married couple, joint return, one spouse 65 or older or blind	22,050	25,300
Married couple, joint return, one spouse 65 or older and blind	23,300	26,600
Married couple, joint return, both spouses 65 or older or blind	23,300	26,600
Married couple, joint return, both spouses 65 or older and blind	25,800	29,200

Head of household	13,400	18,000
Head of household, 65 or older <u>or</u> blind	14,950	19,600
Head of household, 65 or older <u>and</u> blind	16,500	21,200
Qualifying widow(er), surviving spouse	16,750	24,000
Qualifying widow(er), surviving spouse, 65 or older <u>or</u> blind	18,000	25,300
Qualifying widow(er), surviving spouse, 65 or older <u>and</u> blind	19,250	26,600

Expansion of the Child Tax Credit

As addressed earlier, the repeal of the deductions for personal and dependency exemptions represents a major change in tax policy, especially for taxpayers whose incomes did not rise to the level of the phase-outs under prior law. These taxpayers would have been accorded an income tax deduction of $4,150 per exemption for 2018 under the prior law. Thus, had the TCJA not passed, a married couple with two children would have been entitled to a $16,600 ($4,150 x 4) reduction in their taxable income for their personal and dependent exemptions. Assuming that same couple would have been able to reduce their taxable income further with the previous standard deduction of $13,000, their total reduction would have been $29,600 ($16,600 + $13,000). By comparison, the increased standard deduction under the TCJA is $24,000.

With the repeal of the personal and dependency exemptions, this couple finds themselves with $5,600 higher taxable income. To address this negative outcome, Congress decided to expand and increase the child tax credit to afford taxpayers such as these a more tax-beneficial position as a result of the new law.

Under prior law, the child tax credit was generally a nonrefundable personal credit (except in certain circumstances) and was allowed against both the taxpayer's regular tax liability and his or her alternative minimum tax liability. It is important to note that a credit differs from a tax deduction in that a deduction represents a tax benefit equal to the marginal income tax rate applied against that deduction, while a credit represents a dollar-for-dollar reduction in a taxpayer's income tax liability. Thus, a credit is generally deemed to be more beneficial.

Historically, a taxpayer was permitted to claim a credit of up to $1,000 for each of his or her qualifying children (who he or she supported during the tax year). Note, that the rules for determining who qualified as a "child" to which the credit applied were the same as those required for claiming a dependency exemption. As such, although the personal and dependency exemptions have been temporarily repealed, the associated definition of a dependent should still be used in determining whether or not dependents are qualifying individuals for purposes of the credits discussed above.

A Closer Look at the Tax Cuts and Jobs Act

Under prior law, a threshold level of specially defined income was assigned to each of the different filing statuses at which the child tax credit would begin to be reduced, or phased out. The credit phased out once the taxpayer's modified adjusted gross income (MAGI) exceeded $110,000 if married filing jointly, $75,000 if filing as single, and $55,000 if married filing separately. The credit was then reduced by $50 for each $1,000 (or fraction thereof) of MAGI above the threshold amount. MAGI is defined as AGI determined without regard to the exclusions from gross income for foreign earned income, foreign housing expenses and U.S. possession income.

Under the TCJA, and beginning after 2017, the credit amount for each qualifying child is increased to $2,000, and the related phase-out thresholds are significantly increased as well. The threshold for married taxpayers filing jointly was raised to $400,000, and the threshold for all other taxpayers was increased to $200,000. The credit is reduced by $50 for each $1,000 (or fraction thereof) that a taxpayer's MAGI exceeds the threshold amount. Together, these two expanded provisions will work to significantly increase the number of taxpayers benefitting from the child tax credit.

It is also important to note that under prior law, a portion of the credit was refundable to the extent it exceeded the taxpayer's tax liability. This amount was referred to as the additional child tax credit (ACTC) and was equal to the lesser of the unclaimed portion of the nonrefundable credit amount (i.e., up to $1,000 per child) or 15% of the taxpayer's earned income in excess of $3,000. For a taxpayer with three or more qualifying children, the ACTC was either the unclaimed portion of the nonrefundable credit amount or the excess of the taxpayer's share of Social Security taxes, including one-half of any self-employment taxes, over his or her earned income credit for the tax year. Special rules applied to military families to include otherwise-excludable combat zone pay in their earned income when calculating the ACTC.

Under the TCJA, the refundable portion of the credit (the ACTC) has been limited to $1,400 per qualifying child. While the above-noted phase-out thresholds are NOT indexed for inflation, the $1,400 refund limitation per child will be indexed after 2018.

In addition to these changes, a new credit was made available to taxpayers in connection with other qualifying dependents who are qualifying relatives and were supported by the taxpayer during the year. Beginning with the 2018 tax year, a $500 credit will be available for each dependent who does not meet the "qualifying child" test. These dependents must be U.S. citizens, nationals or residents of the United States. This credit is entirely nonrefundable and is to be disregarded in calculating the ACTC.

Looking at the previous example, and assuming that the children of the taxpayers qualify, the application of the child tax credit would yield the results illustrated on the following page.

A Closer Look at the Tax Cuts and Jobs Act

Assume the following:

- The taxpayers had a combined income of $150,000 in the tax year, and their "new" marginal income tax rate is 22%. As such, the loss of the $5,600 deduction as a result of the TCJA changes would yield a net tax cost for federal income tax purposes of $1,232 ($5,600 x 22%).
- If the child tax credit applies, the taxpayers will receive total credits of $4,000 under the TCJA, whereas, they would have received no child tax credit under the old tax laws.
- Thus, the net overall savings available in the TCJA is the difference, or $2,768 ((5,600 x 22%) - $4,000).
- A portion of this credit difference may be refundable, given specific facts and circumstances of the taxpayers' income tax returns.

IMPACT OF CHANGES TO EXEMPTIONS, STANDARD DEDUCTION AND CHILD TAX CREDIT

	Old Law	New Law	Change
Wages - Taxpayer	$ 150,000	$ 150,000	$ -
Personal Exemptions (4)	(16,600)	-	$ 16,600
Standard Deduction	(13,000)	(24,000)	$ (11,000)
Taxable Income	$ 120,400	$ 126,000	$ 5,600
Tax Liability:			
Income Tax on Income	$ 21,408	$ 19,599	$ (1,809)
Child Tax Credit	-	(4,000)	(4,000)
Total Federal Tax Liability	$ 21,408	$ 15,599	$ (5,809)
Marginal Nominal Tax Rate	*25.0%*	*22.0%*	*-3.0%*
Effective Tax Rate	*17.8%*	*12.4%*	*-5.4%*

Assumptions:
1) Married Filing Joint with 2 children
2) Taxpayers have combined wages of $150,000
3) More beneficial in both years for taxpayers to take Standard Deduction

A Closer Look at the Tax Cuts and Jobs Act

As with all other individual tax law changes that were implemented by the TCJA, the adjustments noted above are temporary and are scheduled to sunset as of December 31, 2025. At that time, if not further addressed by Congress, the law will revert to reinstate the laws in effect prior to the enactment of the TCJA.

Expanded Exclusionary Options Related to Student Loan Indebtedness

The issue of ever-increasing costs and fees charged for a college/university education has received a great deal of attention from both the media and both political parties. The issue of funding student debt and the drag that such debt presents for the economy and the specific debtor/graduate, has received significant focus in past legislation. One of the more beneficial provisions that has been incorporated into the tax law in the past allowed a student, in certain circumstances, to exclude from taxable income, the income resulting from the discharge of any student debt forgiveness.

Typically, when a debt is discharged (or forgiven), whether in full or in part, the amount of the debt that no longer needs to be repaid is included in a taxpayer's taxable income, per the Internal Revenue Code. The theory behind this provision is sound, as the debtor has received an economic benefit (in this case, education comprised of college tuition and fees and, possibly, housing). If the debt is discharged at any point, that economic benefit would have been conveyed for free (or less than fair market value). As such, the Code generally requires the inclusion of this economic gain in taxable income, with two exceptions to the general rule.

The first exception is due to the fact that the discharge of a student loan does not give rise to forgiveness of debt income if the discharge is pursuant to a provision in the loan agreement under which all (or a part) of the loan is forgiven, provided the student works for a certain period of time, in certain professions, for any of a broad class of employers. An example might be a student with a teaching degree who works in an inner-city environment for three years in exchange for forgiveness of all (or a portion) of his or her student loans.

In the second instance, a taxpayer would not include in his or her gross income any loans forgiven that were made by tax-exempt organizations, such as education organizations or private foundations, to the extent that the loaned funds were used for educational expenses (i.e., costs to attend an educational institution or costs to refinance outstanding student loans). One additional requirement that must be met to obtain this benefit is that the student borrower cannot be an employee of the lender organization.

With the passage of the TCJA, a new option has been implemented in specific cases to allow for the avoidance of such taxation related to student loan indebtedness. Under the new law, discharge of student loan debts may also be excluded from gross income in cases where the student has passed away or has become totally and permanently disabled.

A Closer Look at the Tax Cuts and Jobs Act

A number of loans qualify for this new exemption, including those from:

- the United States (or an instrumentality or agency thereof);
- a state (or political subdivision thereof);
- certain tax exempt-benefit corporations that control a state, county or municipal hospital and whose employees have been deemed to be public employees under state law;
- an education organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation; or
- certain private education loans (as defined by the Consumer Protection Act).

An example of the application of this provision might be where a former student/borrower is critically injured in an automobile accident and is deemed permanently disabled. If the qualifying lender forgives the indebtedness as a result of the permanent disability, the new provision works to exclude the amount from taxable income, so long as the discharge of debt occurs before January 1, 2026.

Other Changes to Education Tax Benefits

A number of additional provisions were designed to aid taxpayers in funding escalating education costs. President Trump had campaigned on a partial platform of simplifying and combining these provisions, in some fashion, so as to streamline their application and to allow taxpayers to more easily understand and use them. The House bill originally attempted to combine a number of these provisions. However, the legislation coming out of Conference Committee and the reconciliation process was based principally on the Senate version of the bill and did not include any significant changes to the education provisions contained in the Code under prior law.

Perhaps the most significant change to find a place in the final bill relates to Section 529 Plans. The TCJA provides an expansion of the use and applicability of funds saved within a "qualified tuition plan" (commonly known as a "529 Plan").

Very popular in recent years, 529 Plans allow families to formally set money aside for a child's future educational expenses. Contributions to such qualified plans, while not currently deductible, are essentially "tax-free" with respect to all future earnings on those monies, as long they are eventually used to pay "qualified higher education expenses." *Qualified higher education* expenses are defined to include tuition, required fees, books and supplies, as well as room and board.

A Closer Look at the Tax Cuts and Jobs Act

A beneficiary must be designated for each plan. At such time as the beneficiary begins to incur qualified higher education expenses, he or she must be at least a half-time student. There is no limit to the amount of funding that can be withdrawn from the plan each year to pay for these expenses. There is also no limit as to the amount that can be set aside in these qualified tuition plans.

The TCJA has expanded the opportunities for other uses and tax savings through a relaxation on the prior limitations on 529 Plans. Plan beneficiaries may now withdraw up to $10,000 per year for qualified education expenses that are incurred in connection with attendance or enrollment at public, private or religious elementary and secondary educational institutions. The $10,000 limitation applies on a "per-student" basis. Any distributions that exceed this limitation will be taxable.

As noted, other previously-debated provisions slated for elimination, such as that of the student loan interest deduction and modifications to the American Opportunity Credit, were not carried to the final version of the bill. As such, the student loan interest deduction is still available, as is the ability to exclude income for graduate student tuition waivers. The various education-related tax credits also remain unchanged.

Changes to Alimony and Similar Payments

Interestingly, a change that was advanced in both the House and Senate bills that did not receive much attention before their initial release is the repeal of the deduction for alimony payments. Making its way into the final legislation, the repeal of this important and long-standing deduction for the "payor" spouse in a marital dissolution proceeding is certain to change the manner in which these payments are negotiated in the future. At the same time, the repeal of the deduction presents the "payee" spouse with a windfall, as the payments received will no longer constitute taxable income.

A key element of these rules is the effective date. Significantly, the repeal of the alimony deduction is only in effect for divorce and separation agreements entered into after 2018, or before 2019, if the agreement is subsequently modified to include language that adopts the new rules. Otherwise, tax treatment of maintenance payments will continue under the old rules for agreements executed before 2019, or those modified after 2018, as long as the modifications do not include the adoption of the new rules. The special rules for alimony trusts will also continue after 2018, under the same circumstances.

The final directives for all assets, liabilities and future income matters for any divorce or marital dissolution proceeding are usually documented in a divorce and/or separation agreement. Such agreements, or similar documents, are often used to detail how the assets of the marital estate will be split between the parties and to what benefits each party is entitled beyond financial and economic concerns.

A Closer Look at the Tax Cuts and Jobs Act

These agreements often address alimony and separate maintenance payments that one spouse will make to the other, either by court order or through negotiation. While payments for child support are not directly deductible, properly structured alimony and spousal support payments have been deductible under prior law, so long as certain technical requirements set forth below were met.

To qualify for this tax treatment, the payments in question must have been made subject to a legal agreement (with certain stipulations) between the two parties. Additionally, to qualify, the two spouses must be legally separated, filing separate tax returns and not living in the same household. The payments do not include child support payments.

Historically, such payments were able to be deducted by the payor in determining his or her AGI as an above-the-line deduction on his or her tax return, while the payee would report the amounts received as gross income subject to income tax. The perceived abuse from such an arrangement was the ability to shift income subject to tax from a higher income tax bracket with higher marginal income tax rates (the payor's) to one that is lower, with lower marginal income tax rates (the payee's), as illustrated in the example below and on the next page.

Assume the following for H (the payor) and W (the payee):

- H makes $400,000 annually and is ordered to pay W $60,000 annually in qualifying alimony. Note, that such payments are generally in addition to child support and the allocation of marital assets.
- Under prior law, H would have been in a 33% tax bracket for 2018. Thus, his tax on the subject $60,000, after applying the marginal income tax rate, would have been $19,800, without the permitted deduction.
- W, on the other hand, is a homemaker with no other sources of income. Assuming she is in a 25% marginal income tax rate bracket, her tax on the collected alimony would have been $15,000.
- Thus, the economic benefit to the couple overall is the difference, or $4,800.

Note, that due to the loss of a deduction to the payor spouse (in this case, the Husband) under the new law, the $60,000 of alimony deduction lost moves him to a 35% marginal income tax rate, while reducing the Wife's liability to zero. Thus, the change in the tax law has a profound effect on this tax situation.

Certainly, such differences were regularly identified by legal and financial representatives of both parties, and certain negotiated outcomes were often put in place to share this benefit.

Unfortunately, under the TCJA, these planning opportunities are no longer available after 2018. For divorce and separation agreements that are executed after December 31, 2018, taxpayers making the payments detailed above will no longer be able to deduct them from their AGI and taxable income, and the receiving taxpayers will no longer be required to include the payment amounts received in their gross income.

A Closer Look at the Tax Cuts and Jobs Act

EFFECTS OF CHANGES TO TAX TREATMENT OF ALIMONY PAYMENTS

Husband (Single)	Old Law	New Law
Wages	$ 400,000	$ 400,000
Alimony Paid	(60,000)	-
Adjusted Gross Income (AGI)	$ 340,000	$ 400,000
Marginal Nominal Tax Rate	*33.0%*	*35.0%*
Value of Alimony Deduction	**$ (19,800)**	**$ 21,000**
Wife (Single)	**Old Law**	**New Law**
Wages	$ 25,000	$ 25,000
Alimony Received	60,000	-
Adjusted Gross Income (AGI)	$ 85,000	$ 25,000
Marginal Nominal Tax Rate	*25.0%*	*12.0%*
Tax Paid on Alimony Income	**$ 15,000**	**$ -**
"Net" Savings to Both Parties	**$ (4,800)**	**$ 21,000**

Changes to Itemized Deductions

A long-standing goal of both political parties has been tax simplification. One idea to potentially achieve a meaningful level of simplification is to reduce the number of taxpayers required to attach a Schedule A, *Itemized Deductions* form to their annual income tax returns. Tax simplification through a reduction of individuals taking itemized deductions has been part of the fabric of proposed tax reform for many years, and politicians have been fighting for simplification since the passage of the 1954 Tax Act. With this concept at the forefront of the desire for simplification, tax law writers have convinced members of both chambers of Congress that the annual tax return preparation process could be significantly easier for most Americans.

To be sure, eliminating and repealing certain itemized deductions, along with significantly limiting others through mechanical modification while expanding the standard deduction, is likely to significantly reduce the number of taxpayers itemizing their deductions in the future. These changes should reduce tax complexity for these individuals. However, it is still likely that many mid- to high-income individuals will continue to itemize due to owning higher-value homes with qualifying mortgages on which the interest will be deductible and having an inclination, and the resources, to fund desired charitable giving strategies.

A Closer Look at the Tax Cuts and Jobs Act

There is simply no way to overstate the impact of the loss of many of the traditional economic benefits utilized by itemized deduction filers in the past. Certainly, the loss of the full deduction for state and local taxes, qualifying home equity loan interest, and miscellaneous itemized deductions (including tax return preparation fees and investment advisory fees), as well as modifications and changes to the medical deduction and casualty losses, is sure to provide a "hidden" marginal tax rate hike by increasing taxable income for applicable taxpayers. Even though the top marginal rates have been somewhat relaxed under the TCJA, the stealthy manner in which Congress has eliminated these tax advantages can easily work to offset any meaningful benefit of the lower rates.

Prior-Law Limitations on Itemized Deductions

There are other considerations, as well, for higher income individuals. Under prior law, the use of itemized deductions was subject to two separate, significant restrictions under the Pease limitation (named for Congressman Donald Pease, the House Representative who proposed it).

First, there was a direct limitation on the use of miscellaneous itemized deductions, where the deductions were permitted only to the extent that they exceeded 2% of a taxpayer's AGI. Under this restriction, once the limited amount was calculated, allowed miscellaneous deductions were added to all other itemized deductions to generate a "pre-Pease limitation" itemized deduction total.

Then, this pre-Pease limitation total was reduced a second time, by an amount (based on a formula) that the individual's AGI exceeded a statutory threshold level. This limitation could work to eliminate as much as 80% of a taxpayer's total itemized deductions in any particular tax year.

The Pease Itemized Deduction Limitation

Before the passage of the TCJA, a taxpayer could simplify his or her income tax filing by either claiming a standard deduction, based on filing status, or claiming certain itemized deductions of personal expenses, specifically authorized by the Code for determining taxable income. Itemized deductions, under prior law and as discussed throughout these materials, included deductions for medical and dental expenses, certain taxes, interest, charitable contributions, casualty and theft losses, and certain miscellaneous expenses.

Unde the Pease limitation imposed under prior law, individuals whose AGI exceeded an applicable threshold amount were required to reduce the total amount of otherwise-allowable itemized deductions. Those threshold amounts were adjusted annually for inflation. For tax year 2017 income tax returns, the AGI thresholds were determined to be $313,800 for married individuals filing jointly or surviving spouses, $287,650 for heads of households, $261,500 for unmarried individuals filing as single and $156,900 for married individuals filing separately. Had the TCJA not been enacted, these thresholds would have served as the base for the limitation calculation.

A Closer Look at the Tax Cuts and Jobs Act

If any individual taxpayer's AGI exceeded the applicable threshold amount, the taxpayer was required to reduce the amount of allowable itemized deductions by the lesser of: (1) 3% of the excess of the taxpayer's AGI over the applicable threshold amount, or (2) 80% of allowable itemized deductions, reduced by the deductions for medical expenses, investment interest, casualty and theft losses, and wagering losses. The reduction was applied after all other limitations on itemized deductions are applied, including the limit on charitable contributions, the limit on certain meal and entertainment expenses, and the 2%-of-AGI limitation on miscellaneous itemized deductions.

The TCJA temporarily repeals the phase-out or overall limitation on itemized deductions, applicable to tax years beginning after December 31, 2017 and before January 1, 2026.

The repeal of the Pease limitation on total itemized deductions will have a significant effect on the income tax filings for many higher-income taxpayers. Under prior law, a substantial amount of itemized deductions were generally nondeductible because of the limitation. As it was mechanically based on AGI, the planning revolved around controlling (as much as possible) elements of AGI, so as to minimize that factor in certain years to afford a greater level of itemized deductions.

Interestingly, restoration of the amounts that were previously nondeductible due to the limitation will, in many cases, offset the detrimental tax effect that Congress intended with the specific changes to itemized deductions.

Modifications to the Itemized Deduction for State and Local Taxes

Both the House and the Senate bills proposed significant changes to the itemized deduction allowed for state and local income taxes. The deduction has long been part of the U.S. income tax regime and was thought to be untouchable for many decades. Certainly, the jurisdictional bodies that assess the state and local taxes have historically looked at the deduction at the federal level as a means of justifying increases. By the same token, the "net" cost of these state and local taxes have been somewhat more tenable for taxpayers, as the taxes they were paying to these bodies provided a positive cash flow equal to the federal income tax benefit of the deductions.

On the other hand, for some time, Congress has felt that the allowance of a deduction for state and local income taxes was akin to a federal subsidy to the state taxing jurisdictions. It was also noted throughout Congressional records over many years that such a "deemed" subsidy worked to the advantage of higher-tax-rate states and localities. As it was finally decided that such a tax regime was not beneficial for the federal government, and that subsidizing the taxation of state and local tax authorities was not the business of the U.S. government, interest began to grow in repealing the deduction.

A Closer Look at the Tax Cuts and Jobs Act

In the House bill, the deduction for state and local income taxes would have been completely repealed after 2017. Further, taxpayers would no longer have been able to elect to deduct state and local sales taxes in lieu of state and local income taxes. However, even before it was proposed, a modification was made to address those House members representing taxpayers in "high-tax-rate" states who felt the repeal was too onerous and potentially hurtful to their citizenry and constituencies. As a trade-off, in a concession to the real estate industry lobbies and members of Congress representing areas with high real estate tax costs, the House bill did allow for a deduction of property taxes of up to $10,000.

The original Senate plan was more harsh than the House bill. It proposed a complete elimination of the state and local tax deduction and did not provide an exception for real estate and property taxes, as the House bill did. Thus, all state and local taxes would have no longer been deductible under the proposed Senate plan. Through the Senate Finance Committee process and debate on the Senate floor, concessions were made to Senators from high-tax-rate states to allow some benefit for real estate taxes, up to a maximum of $10,000 per year.

The reconciliation process undertaken by the Conference Committee resulted in further changes to the deduction. Ultimately, the final legislation retained the individual taxpayer deduction for amounts paid (up to $10,000) in any combination of state and local and/or property taxes. Further, the final bill allows for taxpayers to use sales taxes to compute the $10,000 maximum deduction in states where there is no income tax.

Under the TCJA, the itemized deduction by individuals for state, local and property taxes, as well as state and local income taxes, and general sales taxes paid during the tax year is limited for tax years 2018 through 2025. An individual can no longer deduct foreign real property taxes, but may still claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for state and local property taxes, income taxes and general sales taxes paid or accrued in the tax year.

Separately, an individual may still claim a deduction for state and local real or personal property taxes paid or accrued in carrying on a trade or business or income-producing activity. Thus, taxpayers carrying on a trade or business, such as an operating company held in a single-member limited liability company or through rental activities, are entitled to deduct those state and local real property or personal property taxes as part of determining their taxable income or loss from those activities.

A self-employed taxpayer who reports his or her trade or business on Schedule C, *Profit or Loss from Business,* and who uses a portion of his or her residence as a qualified home office, will continue to be allowed to deduct the share of real estate taxes related to the home office. Additionally, this deduction will remain separate from the limitation imposed on Schedule A. However, the home office deduction is subject to limitation, based on the income earned by the taxpayer in the related activity.

A Closer Look at the Tax Cuts and Jobs Act

The TCJA also eliminates any further deduction for employees deducting property taxes on a residence that contains a home office. Any taxpayer who received a home office deduction as part of employee business expenses that used to be deductible as a "miscellaneous itemized deduction" on Schedule A will no longer be permitted to deduct the home office or any other employee business expenses, beginning in 2018.

Notable Concerns for Specific Types of Taxpayers

- ***Married Taxpayers*** – Pursuant to the statute, as currently written, the state and local tax deduction is limited to $10,000 ($5,000 for married individuals electing to file separately). Interestingly, the $10,000 limitation is the same for married taxpayers filing jointly and single unmarried taxpayers. As such, the provision essentially represents yet another "marriage penalty," as two single individuals could get a deduction for $20,000, while the married, joint filers would only be permitted to deduct $10,000.
- ***Taxpayers Subject to AMT*** – Historically, the primary "disallowed" deduction for AMT, has been the total state and local tax deduction taken on Schedule A. In some cases, the new limitation on the deduction will work in the taxpayer's favor if it results in the taxpayer no longer being subjected to the AMT.
- ***Taxpayers with Significant Pass-Through Income*** – The TCJA's limitation on the deductibility of state and local taxes is especially harmful for taxpayers with significant pass-through income from S corporations, partnerships or limited liability companies. By limiting this deduction to $10,000, the law effectively disallows all state and local income tax liabilities generated on the pass-through income from those businesses.

  In almost every case, the monies to pay these taxes come from trade or business cash flows, and while paid at the individual level, represent a tax liability associated with that trade or business income. This change is harmful for those businesses, as it inherently requires higher cash distributions to fund equity owner tax liabilities on the trade or business income that was passed through to the owners. No similar provision exists for regular corporations who pay state and local income taxes on income at the corporation level. As such, the statute provides a competitive cash flow advantage to regular corporations.

Potential Responses to the Limitation

There was probably no other provision in the TCJA that was as contentious and challenged on all fronts as this one. Particularly vocal were members of Congress representing high-tax-rate states and states and localities where the costs of housing and the attendant real property taxes are very high.

In these jurisdictions, proposals have been made to implement laws allowing for the creation of a charitable organization or fund, where taxpayers can contribute monies to the fund (instead of paying taxes) and receive a tax credit for the amounts donated. In this way, the amounts paid would be deductible as unlimited charitable

A Closer Look at the Tax Cuts and Jobs Act

deductions versus limited state and local income taxes. On the state income tax returns, contributions to these charitable organizations would be allowed as "credits" against the state income tax liability.

Additionally, the law, as currently enacted, may result in some taxpayers setting up trusts with different beneficiaries to own houses. Each trust would be entitled to its own $10,000 limitation for property tax purposes.

Modifications to the Itemized Deduction for Mortgage Interest

A second "sacred cow" skewered by the TCJA is the mortgage interest deduction. This deduction has historically been heavily defended by lobbyists within the real estate industry and, over many decades, has held up under a number of attempts to repeal or limit the benefit. There is no question that this particular deduction does much to subsidize home acquisitions and, just as the state and local deduction aids taxpayers living in high-tax jurisdictions, helps home acquirers in areas where housing costs are high.

The modifications to the allowance of a deduction for interest date back to the Tax Reform Act of 1986. Prior to that legislation, all interest was deductible, including credit card and personal loan interest accrued and paid on debt incurred for personal consumer expenditures. The 1986 Act repealed the deduction of interest for personal expenditures. The remaining interest that was deductible for income tax purposes (before the TCJA) included interest incurred in connection with the conduct of a trade or business, investment interest (that interest incurred in connection with activities conducted for the production of income, i.e., investment activities), home acquisition indebtedness and home equity indebtedness.

The changes enacted under the TCJA relate specifically to home acquisition indebtedness and home equity indebtedness. Generally, individuals can claim (subject to limitation) interest paid on a home mortgage (i.e., qualified residence interest) as an itemized deduction on Form 1040. "Qualified residence interest" is interest that is paid or accrued during the tax year on either "acquisition indebtedness" or "home equity indebtedness" and is secured by the taxpayer's qualified residence by a mortgage, deed of trust or land contract.

- A *qualified residence*, for this purpose, includes the taxpayer's principal residence and one other residence, such as a vacation home, that is not rented out at any time during the tax year or that is used by the taxpayer for a minimum number of days. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer or boat.
- *Acquisition indebtedness* is debt incurred in acquiring, constructing or substantially improving a qualified residence of the taxpayer, and which secures the residence. Refinanced debt remains acquisition indebtedness to the extent that it does not exceed the principal amount of acquisition indebtedness immediately before refinancing. The maximum amount treated as acquisition indebtedness prior to the changes mandated by the TCJA was $1 million ($500,000 if married filing separately).

A Closer Look at the Tax Cuts and Jobs Act

- *Home equity indebtedness* is any debt, other than acquisition indebtedness, that is secured by a qualified residence. Interest on such debt is deductible, even if the proceeds are used for personal expenditures. Such loans are used by many taxpayers as a basis for financing substantial personal expenses such as automobiles, education and vacations. Under the prior law, the aggregate amount of home equity indebtedness could not exceed $100,000 ($50,000 if married filing separately). In addition, home equity indebtedness was not permitted to exceed the fair market value of the qualified residence reduced by the acquisition indebtedness.

The TCJA makes two substantial changes to the prior-law rules. First, it modifies the amount of home acquisition indebtedness on which an interest deduction will be permitted. Secondly, it generally repeals the deduction for interest on home equity loans. Note, again, that both changes are temporary under the bill and apply specifically to tax years 2018 through 2025. Thus, without further action by Congress prior to the sunset of the new provisions, the provision will revert back to the rules under law before the TCJA.

Additionally, the TCJA reduces the maximum amount that may be treated as acquisition debt to $750,000 ($375,000 if married filing separately) for tax years beginning after December 31, 2017 and before January 1, 2026. The reduction generally applies to any acquisition debt incurred after December 15, 2017. The maximum amount that may be treated as acquisition debt remains $1 million ($500,000 if married filing separately) for any acquisition debt incurred with respect to the taxpayer's principal residence on or before December 15, 2017. Note, however, that the acquisition debt incurred on or before December 15, 2017 reduces the $750,000/$375,000 limit to any acquisition debt incurred after December 15, 2017.

The prior-law $1 million ($500,000 if married filing separately) limit will also continue to apply to a taxpayer who entered a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, so long as the residence is purchased before April 1, 2018.

Similarly, the higher limit continues to apply to any debt incurred after December 15, 2017 to refinance existing acquisition debt on the taxpayer's principal residence, to the extent the amount of the debt resulting from the refinancing does not exceed the amount of the refinanced debt. Thus, the maximum dollar amount that may be treated as acquisition debt on the taxpayer's principal residence will not decrease by reason of a refinancing. The exception for refinancing an existing acquisition will not apply after (1) the expiration of the term of the original debt, or (2) the earlier of the expiration of the first refinancing of the debt or 30 years after the date of the first refinancing.

The modified thresholds are most likely to affect higher-income taxpayers who previously were subject to a phase-out of itemized deductions because of the Pease limitations. As the phase-out for itemized deductions is temporarily repealed for tax years beginning after 2017 and before 2026, the absolute impact of the reduc-

A Closer Look at the Tax Cuts and Jobs Act

tion in the home acquisition indebtedness threshold will depend on the specific facts and circumstances of any particular taxpayer. It is likely that mortgage indebtedness will be given more thought, however, as it is one of the few remaining itemized deductions over which the taxpayer has some level of control.

The TCJA repeals the deduction for interest accrued or paid on home equity indebtedness. As such, a taxpayer may no longer claim an itemized deduction for mortgage interest paid or accrued on any home equity debt of any qualified residence of the taxpayer for tax years beginning after 2017 and before 2026, excepting amounts borrowed for capital improvements to an existing or second residence.

Importantly, it should be noted that the final version of the law preserves the mortgage interest deduction for a second home. Despite the new, lower limit on a mortgage loan for a newly-acquired home, interest remains deductible for loans that are used to buy, build or substantially improve a taxpayer's principal residence AND one other residence of the taxpayer, which is selected for the tax year. If a taxpayer owns more than two residences, the taxpayer must continue to select only one second home each year for the purpose of the mortgage interest deduction.

Finally, if a mortgage is secured by the home of the taxpayer, but the proceeds are used to purchase rental property, property used in a trade or business, or investment property, then the interest on such a loan can be separately deducted elsewhere on the taxpayer's income tax return. Such interest is not subject to the new mortgage interest deduction limitation, and such loan balances are not counted against the limit.

It is not difficult to envision further limitations on this particular deduction in future years, now that the process of paring back the benefit has begun. However, for many individuals, this deduction will be the one that most likely will determine whether itemizing deductions is beneficial to them in future years.

Repeal of the Miscellaneous Itemized Deductions

Historically, miscellaneous deductions constituted a way for taxpayers to take deductions for expenses associated with their activities conducted as an employee and those incurred in connection with the production of income. Additionally, the cost of income tax compliance, a financial necessity, was allowed as tax return preparer fees were deductible in this category. However, because of a statutory limitation under prior law, much of the income tax savings that might have been available from the sum of these miscellaneous deductions was lost.

In what has become known colloquially as the "2% floor rule," certain deductions qualifying as miscellaneous deductions were deductible only to the extent that the total exceeded 2% of the taxpayer's AGI. For obvious reasons, this threshold was most often referred to as the "2% floor."

A Closer Look at the Tax Cuts and Jobs Act

Under prior law, miscellaneous deductions fell into one of four categories:

1. Unreimbursed employee expenses, which generally included expenses of travel, lodging, meals, entertainment, continuing education, subscriptions to professional journals, union or professional dues, professional uniforms, job hunting and business use of an employee's home;
2. Expenses paid or incurred in the production or collection of income, which generally included investment advisory and management fees, subscriptions to investment advisory publications and safety deposit box rental fees;
3. Certain "hobby" expenses for which a deduction was allowed; and
4. Tax return preparation fees.

By way of example, assume taxpayer A has $400,000 of AGI for 2017, and that her total miscellaneous deductions were $10,000. Prior to the enactment of the TCJA, the 2% floor would have been set at $8,000 ($400,000 x 2%). The amount by which the total miscellaneous deductions exceed the threshold is $2,000. Thus, the provision limited A's miscellaneous deductions to just $2,000.

It is not difficult to envision a material reduction in total miscellaneous deductions for many taxpayers under prior law. As such, the changes made by the TCJA may not have as much of an impact as one might first think.

Under the TCJA, all miscellaneous itemized deductions that were subject to the 2% floor are temporarily repealed for tax years beginning after December 31, 2017 and before January 1, 2026. Thus, no miscellaneous itemized deduction subject to the 2%-of-AGI limit may be claimed by an individual on Schedule A for tax years 2018 through 2025. Additionally, an individual cannot claim such deductions in calculating his or her AMT liability, regardless of tax year.

Keep in mind, as with certain other changes to specific itemized deductions, the same items limited under the miscellaneous deduction provision of the TCJA may be deductible if incurred in connection with the conduct of a trade or business activity, including rental activities.

Perhaps the most difficult aspect of this rule to grasp is that legitimate business expenses incurred in connection with employment are no longer deductible. In cases where this provision will be substantial, it is recommended that the employee and employer work together to develop an accountable expense plan to maximize tax advantages related to these expenses.

A Closer Look at the Tax Cuts and Jobs Act

Reduction of the Limitation on the Medical Expense Deduction

Many taxpayers are plagued by steep medical bills each year, having to pay out-of-pocket for those procedures and expenditures that are not covered by their insurance plans. Particularly, elderly taxpayers, especially those living in medically-assisted homes and care facilities, spend substantial sums on medical expenses that are deductible. In an attempt to aid those incurring substantial medical expenses, the federal government provides a medical expense deduction as part of the itemized deductions calculation, subject to a limiting threshold. Most recently, the limitation on this deduction has been increased to 10% of the taxpayer's AGI.

With the passage of the TCJA, this threshold will be reduced to 7.5% across the board. This threshold reduction allows for the potential to deduct a larger portion of those qualifying medical expenses incurred each year.

Expenses tied to medical care that are deemed to be "medically necessary," which are paid during the tax year for the taxpayer, his or her spouse and their dependents, qualify for inclusion in the deduction calculation. These expenses are often those incurred for medical care that addresses diagnosis, cure, mitigation, treatment or disease prevention. Such medical services must have the primary intention of alleviating or preventing a physical or mental health defect or illness and do not include procedures or steps taken in the interest of general health. Such exclusions would include the purchase of vitamins or gym memberships.

Qualifying medical expenses must be for services provided legally by physicians, surgeons, dentists and other certified medical professionals. Other types of expenses, such as those incurred for medical devices, equipment, supplies and diagnostic devices, may also qualify if they are deemed to fall under the category of "medically necessary." This is also the case for the cost of medicines and drugs paid for by the taxpayer. With the exception of insulin, only those medications that require a prescription are deductible.

Qualifying medical expenses also include the cost of medical premiums paid for medical insurance, including plans that cover the expenses of medical care and treatment, transportation to medical facilities and long-term care. Only premium expenses that are not excluded from taxable income through the employer exclusion qualify.

Many senior citizens reside in assisted living facilities, and a portion of that cost can be attributed as a qualifying medical expense. These expenses continue to be deductible and are generally set out on a statement provided each year end by the management of those facilities.

As with many of the other changes made to individual taxation through the TCJA, this reduction in the AGI threshold is only temporary. However, it is important to note that this change will expire after the 2018 tax year. Therefore, it is only in effect for the 2017 and 2018 tax years.

A Closer Look at the Tax Cuts and Jobs Act

Changes to Deductions for Charitable Contributions

One of the most frequently utilized itemized deduction opportunities has been discretionary contributions made by taxpayers to public charities, governments and other qualified organizations (per the Internal Revenue Code). If a taxpayer itemizes deductions, he or she is permitted to deduct (up to a certain amount) those monies and the fair market value of the items they have donated during the tax year to certain approved organizations.

This opportunity remains following the passage of the TCJA, but a few changes have been made to the requirements that must be met in order for donations to qualify as charitable contributions going forward.

The amount that an individual is permitted to deduct (the charitable contribution threshold or limitation) has historically been tied to his or her adjusted gross income (AGI) for the related tax year. Generally, in the case of donations of cash or non-appreciated property to public charities, operating private foundations, certain government entities and other organizations that meet the requirements set out in the Code, the deduction claimed could not exceed 50% of the taxpayer's AGI for any tax year.

The new law temporarily increases this limitation and allows for deduction up to 60% of a taxpayer's AGI. The intention of the provision is to encourage greater levels of charitable giving, as well as to offset any possible negative effect on charitable giving that the other provisions of the TCJA might cause.

This change is effective for tax years beginning after December 31, 2017, and will continue through December 31, 2025. Again, the change is temporary and sunsets on December 31, 2025.

Donors who make contributions in excess of these thresholds have historically been permitted to carry forward their excess contributions for up to five years. This rule remains in effect under the TCJA.

Two additional changes were made to the standard requirements and limitations required when taking a deduction in connection with charitable donations.

First, many donors had previously made contributions to colleges or universities in exchange for the right to purchase tickets to athletic events, expecting to be able to take a deduction of 80% of the contribution when filing their tax returns. The TCJA eliminated this deduction opportunity, with the justification that "taxpayers should only be permitted a charitable deduction commensurate with the value of assets given to charity."

Secondly, additional documentation is needed to support charitable contributions. It is necessary to emphasize the importance of a taxpayer maintaining reliable records of his or her donations. Previously, no deduction was permitted for any contributions made amounting to $250 or more unless they were supported by a contemporaneously issued receipt or supporting statements from the donee organization.

A Closer Look at the Tax Cuts and Jobs Act

The only exception to this rule, exempting the taxpayer from obtaining such substantiation, occurred when the donee organization independently reported the contribution from the donor to the Internal Revenue Service. The TCJA repeals this exception. As such, ALL gifts made of $250 or more are required under the law to be supported by contemporaneously issued documentation before a deduction is permitted.

Limitation on the Personal Casualty and Theft Loss Deduction

Personal casualty and theft loss deductions, while less frequently taken due to the nature of the events driving the economic losses, offer an additional deduction opportunity for those taxpayers who itemize. In the past, taxpayers were able to deduct losses that they sustained during a given tax year and for which they were not compensated by the insurance companies.

Losses derived from a variety of situations were deductible, including fire, storm, shipwreck and/or theft, among others. The floor implemented for calculating what portion of the loss could be deductible was a flat $100. As such, any casualty or theft situation generating a loss in excess of $100 could qualify for a deduction.

Unfortunately, an additional limitation, based on a taxpayer's AGI, was imposed under prior law. Pursuant to this second limitation, personal casualty or theft losses were only deductible to the extent that they exceeded personal casualty gains, and only to the extent that the excess of personal casualty gains plus the amount by which that excess amount (of losses over gains) exceeded 10% of the taxpayer's AGI.

With the enactment of the TCJA, the wide-ranging applicability of the casualty and theft loss deduction has been significantly pared. For tax years 2018 through 2025, this particular itemized deduction is now only applicable for losses incurred in connection with situations that have been deemed "federally declared disasters."

A taxpayer is still permitted to offset personal casualty gains with personal casualty losses that have occurred outside of a federally declared disaster scenario; however, any personal casualty gains that are offset against personal casualty losses derived from federally declared disasters are not factored into the 10% AGI limitation calculation. For tax years 2016 and 2017, the $100 limitation is raised to $500, and the 10% AGI limitation is waived.

Alternative Minimum Tax (AMT)

Though the House version of the bill promoted total repeal of the AMT, the Senate bill took a less aggressive posture. What ultimately came out of the Conference Committee was a modified AMT regime with expanded exemption amounts and phase-out thresholds.

A Closer Look at the Tax Cuts and Jobs Act

The AMT is imposed on individuals, estates and/or trusts. A taxpayer's AMT for a tax year is the excess of the taxpayer's "tentative minimum tax" over the regular tax liability. For an individual, estate or trust, the *tentative minimum tax* is equal to 26% of the taxpayer's alternative minimum taxable income (AMTI), up to a certain threshold amount adjusted annually for inflation, plus 28% of any AMTI in excess of the threshold amount. For 2017, the threshold amount is $187,800 ($93,900 for married filing separately).

AMTI is the taxpayer's regular taxable income increased by AMT "tax preference items" and modified by "AMT adjustments." A *tax preference item* is a deduction or exclusion not allowed in computing AMTI, including the exclusion of gain from qualified small business stock, depletion deductions, and tax-exempt interest earned on private activity bonds. *AMT adjustments* are items of income or deductions that are computed differently in determining AMTI, including certain itemized deductions, personal exemptions, the standard deduction, incentive stock options, certain depreciation and net operating losses (NOLs).

For tax years beginning after December 31, 2017 and before January 1, 2026, the AMT exemption amounts are:

- $109,400 for married individuals filing jointly or surviving spouses;
- $70,300 for single or head of household filers; and
- $54,700 for married individuals filing separately (50% of the amount for married individuals filing jointly)

The threshold amounts for phase-out or reduction of the AMT exemption amount are also temporarily increased after 2017. The phase-out threshold is $1 million for married individuals filing jointly or surviving spouses, and 50% of this amount for all other individuals. Thus, the phase-out threshold is $500,000 for an individual filing as single, head of household or married filing separately.

Historically, excepting very specific situations, the most common deductions allowed for regular income tax purposes, but not for purpose of calculating AMTI, were the state and local income tax deduction and the real property tax deduction, along with personal exemptions. These categories have generally comprised a substantial amount of our clients' total deductions, thus reducing the taxpayer's regular income tax. In effect, the disallowance for AMT purposes works to substantially increase the taxpayer's AMTI, often driving those individuals into the higher AMT tax regime.

A Closer Look at the Tax Cuts and Jobs Act

EFFECTS OF CHANGES ON CALCULATION OF THE ALTERNATIVE MINIMUM TAX

	Old Law	New Law	Change
Wages - Taxpayer	$ 400,000	$ 400,000	$ -
Wages - Spouse	-	-	-
Interest Income	1,000	1,000	-
Dividend Income	5,000	5,000	-
Capital Gain Income	9,000	9,000	-
Pass-through Income	-	-	-
Total Income	$ 415,000	$ 415,000	$ -
Adjustments	-	-	-
Adjusted Gross Income (AGI)	$ 415,000	$ 415,000	$ -
Personal Exemptions (4) - Subject to Phase-out	$ (3,984)	$ -	$ 3,984
Itemized Deductions:			
Taxes (Real Estate)	$ (12,000)	$ -	$ 12,000
Taxes (Income)	(16,890)	(10,000)	6,890
Mortgage Interest	(20,000)	(20,000)	-
Contributions	(15,000)	(15,000)	-
Miscellaneous (2% Floor)	(3,700)	-	3,700
Subtotal	$ (67,590)	$ (45,000)	$ 22,590
3% AGI Floor (Phase-out – Pease Limitation)	2,850	-	(2,850)
Total Itemized Deductions	$ (64,740)	$ (45,000)	$ 19,740
Standard Deduction	$ (13,000)	$ (24,000)	$ (11,000)
Greater of Itemized or Standard Deductions	$ (64,740)	$ (45,000)	$ 19,740
Taxable Income	$ 346,276	$ 370,000	$ 23,724
Tax Liability:			
Income Tax on Ordinary Income	$ 86,477	$ 79,399	$ (7,078)
Child Tax Credit	-	(3,250)	(3,250)
Alternative Minimum Tax (AMT)	8,142	-	(8,142)
Medicare Tax on Investment Income	547	556	9
Add'l Medicare Tax on Earned Income	1,350	1,350	-
Total Federal Tax Liability	$ 96,516	$ 78,055	$ (18,461)
Marginal Nominal Tax Rate	*33.0%*	*32.0%*	*-1.0%*
Effective Tax Rate	*27.9%*	*21.1%*	*-6.8%*

Assumptions:
1) Married filing jointly with 2 children
2) Taxpayer has wages of $400,000 & spouse not employed
3) Interest Income = $1,000, Dividend Income = $5,000, Capital Gains = $9,000
4) R/E Taxes = $12,000, Income Taxes = $16,000, Mortgage Interest = $20,000, Contributions = $15,000
5) Total mortgage principal is less than $750,000
6) Total Miscellanous Itemized Expenses = $12,000

A Closer Look at the Tax Cuts and Jobs Act

The significant modification of the allowable itemized deduction for state and local income tax (in combination with the real property tax), along with the elimination of personal exemptions and increased threshold amounts, means that fewer taxpayers will find themselves dealing with the AMT. The example on the previous page illustrates the effects of the changes.

Changes in the Estate, Gift and Generation-Skipping Transfer Tax Exclusions

The House bill proposed a total repeal of the estate tax, which has been long-hated by the Republican Party. However, a total repeal was not included in the Senate bill, which addressed the estate tax by doubling the dollar amount of property that can be transferred in one's lifetime from $5 million to $10 million. This provision survived the reconciliation process and is now part of the final TCJA.

As the $5 million has been inflation-adjusted yearly since its passage, the actual exclusion under the new law is $11.2 million. Thus, a married couple, using gift-splitting, is now able to move more than $22 million of value from their senior-generation estate to junior-generation family members without the imposition of an estate tax. The Generation-Skipping Transfer Tax exemption increases by the same amount.

The most recent Internal Revenue Statistics of Income Tables compiling data from 2016 filings illustrates that only 5,219 estate tax returns were filed in that year. Of this total, just 300 estate tax returns were filed with gross estates in excess of $50 million, and another 3,695 estate tax returns were filed with gross estates between the $5 million to $20 million threshold. Thus, the increase in the estate tax exemption to $10 million, before adjustment for inflation, is certain to considerably reduce the number of future estate tax filings.[12]

The exclusion increase will also allow taxpayers, who had fully utilized their lifetime exclusions, to gift additional assets to junior-generation family members to significantly add to transfers that were previously made.

The new law does not change the "step-up" of basis rules in any way. These rules allow that property received from a decedent as a result of his or her death will obtain a "stepped-up" basis for tax purposes to that property's fair market value of the decedent's date of death. As such, any gain on the subsequent sale of the inherited property will be limited to its purchase price consideration, less its basis at the date of death of the decedent.

[12] *SOI Tax Stats - Estate Tax Statistics Filing Year Table 1(2016)*, https://www.irs.gov/pub/irs-soi/16es01fy.xls

A Closer Look at the Tax Cuts and Jobs Act

Elimination of the Individual Mandate

Implemented in 2014 as a result of the passage of the Affordable Care Act (ACA), individuals were required to carry "minimum essential health insurance" for themselves and all dependents (in most situations). If this requirement was not met, the taxpayer would be subject to a "shared responsibility payment," essentially a penalty for not complying with the mandate. Beginning in 2019, taxpayers will no longer be subject to this "individual mandate." In essence, the new tax legislation repeals this aspect of the ACA. It is important to note that no other elements of the ACA were altered with the passage of the TCJA.

Taxpayers will likely continue to receive proof of their insurance coverage via Forms 1095A-C, but such forms are no longer needed or required for purposes of calculating any potentially applicable penalty as the shared responsibility payment is no longer in effect.

Changes to Gambling Losses Provisions

Under the TCJA, losses from gambling or wagering transactions for purposes of deducting winnings is clarified to include any deduction otherwise allowed to the taxpayer for federal income tax purposes in carrying on any wagering transaction, and not just the actual costs of wagers. This provision not only confirms what most practitioners have thought in the past, but also adds certainty to deducting those "non-wagering expenses involved in the conduct of a wager transaction(s)."

Again, the change is temporary and is effective for tax years beginning after December 31, 2017 and before January 1, 2026.

The change is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but also to other expenses incurred by the individual in connection with the conduct of that individual's gambling activities. Thus, for example, expenses incurred in traveling to and from a casino fall within the scope of the gambling loss limitation, and these expenses may only be deducted to the extent of gambling winnings.

The new rules permit a deduction only as it relates to the actual wager. To avoid confusion, taxpayers should keep some basic principles in mind. First, the deduction is generally available only to taxpayers who itemize deductions. Second, internet-based gambling activities do not qualify for this deduction, even if the source originates overseas.

A Closer Look at the Tax Cuts and Jobs Act

It is important to understand that gambling losses are only deductible to the extent of claimed gambling winnings. Thus, if the taxpayer is in a net gambling loss position, the deduction will be of no benefit.

Keep in mind that, like the use of other deductions in computing taxable income, eligibility for deducting these expenses is still predicated upon meeting statutory guidance and on maintenance of the required record-keeping. This is especially important for travel expenses. Meals eaten while staying at a casino (as well as any ancillary entertainment) are no longer deductible for any business activity under the TCJA, including wagering.

Changes to the Moving Expense Deduction

The TCJA temporarily repeals the deduction for moving expenses for tax years beginning after December 31, 2017 and before January 1, 2026. As a result of this repeal, an employee or self-employed individual may no longer claim an above-the-line deduction in calculating AGI for moving expenses in 2018 through 2025.

Under prior law, an employee or self-employed individuals could claim a deduction for reasonable expenses of moving himself or herself (as well as family members) if the move was related to starting work in a new location. To take a valid deduction, the taxpayer had to meet certain conditions related to geographical distance from the previous residence and minimum period of employment in the new location in order to deduct moving expenses. Deductible moving expenses were limited to the cost of transportation of household goods and personal effects, and travel to the new residence, including lodging but not meals.

Special rules apply to moves made by active duty military personnel. These provisions exclude from income amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouse or dependents) when that move is made pursuant to a military order and incident to a permanent change of station.

A Closer Look at the Tax Cuts and Jobs Act

III. Impact on Pass-Through Entities

An individual taxpayer who receives business income from a pass-through business entity (an S corporation, a partnership, a limited liability company and/or a sole proprietorship) is taxed on that income at the regular individual income tax rates. The individual owners in an S corporation or partnership take into account, on their personal Forms 1040, *U.S. Individual Income Tax Return*, their respective shares of the entity's items of income, gain, loss, deduction and credits that are reported to them on their respective Schedules K-1. Each of these items is required to be included on the owner's separate income tax returns, regardless of whether the income is actually distributed to the owner group in the tax year. In contrast, a sole proprietorship and rental property activities that are not incorporated are not treated as separate from the owner for federal income tax purposes; as such, the owner is taxed directly on the income from that business.

Each year, an individual S corporation shareholder or partner must report his or her share of S corporation or partnership income or loss on his or her form Form 1040, Schedule E, *Supplemental Income and Loss (page 2)*. An individual who owns and operates a business as a sole proprietor must calculate his or her business income or loss on Form 1040, Schedule C, *Profit or Loss from Business*. An individual who owns rental properties must calculate his or her rental income or loss on Form 1040, Schedule E, *Supplemental Income and Loss (page 1)*.

Individual taxpayers compute their regular federal income tax liability for any tax year by multiplying their calculated taxable income (inclusive of all pass-through items) by the appropriate marginal income tax rate, subtracting allowable credits and adding other taxes, if applicable. As discussed earlier, the tax law is progressive and rates are graduated, so income is taxed at higher marginal rates as the individual taxpayer earns more income. For the 2017 tax year, the highest marginal income tax rate for individuals was 39.6%. For tax years beginning after December 31, 2017 through December 31, 2025, the maximum marginal tax rate is 37%. When factoring in additional federal taxes, such as self-employment tax, pass-through income net investment income tax (if applicable), and state and local taxes paid on the income of pass-through business entities, the income can often be subjected to combined tax rates of nearly 50% under prior law, as well as the with the provisions of the TCJA.

Because the individual equity owners are taxed on their shares of the pass-through business income on their personal returns and are responsible for the associated tax liabilities on this income, it is common practice for these businesses to make cash distributions to owners at a level sufficient to meet the portion of their income tax obligation associated with the pass-through income. In fact, many (if not most) shareholder, partnership and operating agreements for pass-through entities include a provision requiring that the company make such distributions each year. Accordingly, pass-through businesses are often required to distribute cash to their

A Closer Look at the Tax Cuts and Jobs Act

owners (at an equivalent level of 40-50% of the business's taxable income), to allow the owners to meet their personal income tax obligations arising out of the inclusion of the company's taxable income. Such distributions pose a significant, and real, economic burden on the operating company and significantly reduce the financial resources remaining in the business for operations and to invest in personnel and capital.

In the discussions leading up to enactment of the TCJA, significant attention had been focused on fact that the United States had the highest corporate tax rate in the industrialized world. The conversations centered on the drag on economic development, as well as the motivation to move operations and business activities offshore to lower tax rate countries, created by such a high tax rate. As such, Congress and the President ultimately saw fit to permanently reduce the top marginal corporate rate from 35% to a flat rate of 21%, effective for tax years beginning after December 31, 2017. This rate reduction will be discussed further in Chapter IV of these materials.

In an attempt to aid those businesses conducted as pass-through entities, both the House and the Senate considered competing proposals intended to address the high individual marginal income tax rate generally applied to that income received at an individual level from pass-through business entities. The House proposal included a reduced tax rate on pass-through business income, while the Senate proposal excluded a percentage of pass-through business income from tax altogether. In the end, the TCJA provides a pass-through deduction that more closely follows the proposed plan from the Senate, though it was modified somewhat by the Conference Committee in the reconciliation process.

Clearly, help for these businesses merits Congressional attention…and action. Recent studies show that approximately 95% of for-profit businesses in the United States are now organized as pass-through business entities. This large complement of businesses and their owners have found themselves subject to very high marginal tax rates, often exceeding the highest income tax rates assessed against regular corporations. In the past, there has been too little attention and focus on these businesses and this problem.

Qualified Business Income Deduction (Pass-Through Deduction)

Under the TCJA, for tax years beginning after December 31, 2017, an individual taxpayer may deduct up to 20% of certain domestic "qualified business income" (QBI) from an S corporation, a partnership, a limited liability company (taxed as a partnership), a rental property activity or sole proprietorship for a tax year. Note, that this pass-through deduction is not taken at the entity level. Instead, it is available only at the individual shareholder, partner, member or sole proprietor level. Thus, it is an ***individual taxpayer deduction***, and not a ***business deduction***, per se.

A Closer Look at the Tax Cuts and Jobs Act

The pass-through deduction for qualified business income (particularly pass-through entities that are not specified service businesses) represents a structural change in U.S. tax law and policy and is anticipated to provide significant tax savings to such businesses. The QBI deduction, and the complex nature of the calculation, is one of the most significant tax reform changes to come from the TCJA.

The new rule comes with certain mechanical limitations to target the benefit at those companies intended by Congress. The deduction may be limited depending on the amount of Form W-2, *Wage and Tax Statement* wages and/or "qualified property" that the business has invested in for its operations.

These limitations may be phased-in or eliminated, depending on whether a taxpayer's taxable income meets certain threshold levels. As would be expected, the QBI deduction is generally not allowed for certain service trades or businesses, but this disallowance is also phased-in for taxpayers whose taxable income meets certain threshold requirements.

Interestingly, Congress saw fit to mechanically incorporate the deduction into taxpayers' returns in an unusual manner. For individual taxpayers, the QBI deduction is NOT allowed in determining adjusted gross income (AGI). Further, while it is also not allowed as an itemized deduction, the pass-through deduction is available to individuals who choose to itemize their deductions and to those who claim the expanded standard deduction.

Note, that trusts and estates also qualify for the QBI deduction, as will a specified agricultural or horticultural cooperative.

Like all of the provisions of the TCJA affecting individuals, it is important to note that the pass-through deduction applies to tax years beginning after December 31, 2017, and before January 1, 2026. Thus, the QBI deduction is yet another temporary provision that will sunset as of December 31, 2025, without further Congressional action prior to that date.

Mechanics of the Pass-Through (QBI) Deduction

As noted, the pass-through deduction is not a business entity level deduction. It is taken at the equity owner tax return level. As such, the deduction is taken on the individual taxpayer's income tax return for any applicable year.

Unfortunately, as will soon be illustrated, the concept of simplicity was not incorporated into the mechanics of the deduction. The provision, as passed, introduces a number of new mechanical concepts and terms, as well as technical requirements, that must be met to take full advantage of the deduction.

A Closer Look at the Tax Cuts and Jobs Act

To determine the deductible amount (i.e., the QBI deduction), a non-corporate (individual) taxpayer can claim a deduction for a tax year for the sum of the following:

1. the *lesser* of:
   (a) the taxpayer's "combined *qualified business income amount*;" or
   (b) 20% of the excess of the taxpayer's taxable income over the sum of (i) the taxpayer's net capital gain and (ii) the taxpayer's aggregate qualified cooperative dividends; plus
2. the *lesser* of:
   (a) 20% of the taxpayer's aggregate qualified cooperative dividends; or
   (b) the taxpayer's taxable income minus the taxpayer's net capital gain.

The pass-through deduction cannot be more than the taxpayer's taxable income (reduced by net capital gain) for any tax year. Further, in determining the deduction amount, the taxpayer's taxable income is computed without regard to the QBI deduction.

The following example illustrates the basic mechanics of determining the QBI deduction.

- Christopher and Carrie, a married couple, have combined wages of $100,000 and capital gain income of $15,000.
- Carrie is also an owner in her family's S Corporation, which is a qualified business, and receives a Schedule K-1 reflecting $250,000 of pass-through income.
- Therefore, Christopher and Carrie's AGI is $365,000 ($100,000 + $15,000 + $250,000).
- They also have itemized deductions in the amount of $50,000, which reduce their taxable income to $315,000, prior to incorporating their pass-through deduction.
- The maximum pass-through deduction from Carrie's family's business is $50,000 ($250,000 x 20%).
- Because Christopher and Carrie's taxable income (excluding the QBI deduction) does not exceed the phase-in threshold of $315,000, there is no limitation on their pass-through deduction.
- Therefore, they can deduct the $50,000, for a final taxable income calculation amount of $265,00

A Closer Look at the Tax Cuts and Jobs Act

DETERMINATION OF THE QBI DEDUCTION

Step 1: Determine QBI and QBI Deduction		
Qualified Business Income (Schedule K-1 Income)	$	250,000
Applicable Statutory Deduction Percentage		20%
Tentative QBI Deduction (subject to limitation)	$	50,000
Step 2: Determine Taxable Income (Excluding QBI Deduction)		
Wages	$	100,000
Ordinary Income from Qualified Business		250,000
Capital Gain		15,000
Adjusted Gross Income		365,000
Deductions		(50,000)
Taxable Income (before QBI Deduction)	$	315,000
Step 3: Determine If Limitation Applies		
A. Taxable Income in excess of $315,000 Floor	$	-
B. Limitation Phase-in Range: $315,001 - $415,000	$	100,000
Limitation in Phase-in Range	$	-
Step 4: Determine Taxable Income		
Taxable Income (before QBI Deduction)	$	315,000
QBI Deduction – Final		(50,000)
Taxable Income (after QBI Deduction)	$	265,000

A Closer Look at the Tax Cuts and Jobs Act

Factoring in the W-2 Wages/Qualified Property Limit

A taxpayer's combined "qualified business income amount" for a tax year equals:

1. the sum of the "deductible amounts" determined for each qualified trade or business carried on by the taxpayer; plus
2. 20% of the taxpayer's aggregate qualified REIT dividends and qualified publicly traded partnership income.

A qualified trade or business's "deductible amount" is generally the lesser of:

1. 20% of the taxpayer's qualified business income from the trade or business; or
2. An amount which is the greater of:
   (a) 50% of the W-2 wages of the trade or business; or
   (b) the sum of 25% of the W-2 wages of the trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property of the trade or business.

Please note, that the alternative limitations set out in subparagraphs 2(a) and 2(b) above will hereafter collectively be referred to as the "W-2 wages/qualified property limit."

The rationale behind this limitation seems to be a desire to restrict the benefit of the deduction to those pass-through businesses that invest in people and/or equipment. It appears that Congress wanted to help those companies that conduct true operating businesses.

The following example illustrates the mechanics of the W-2 wages/qualified property limit:

- Michelle operates a sole proprietorship that produces and sells sports memorabilia. The business buys a machine for $200,000 that can efficiently produce the memorabilia, and places the machine in service in tax year 2018. In 2018, the business has two part-time employees with total wages of $40,000.
- The W-2 wages/qualified property limit on the business's deductible amount for 2018 is $20,000, which is the greater of:
  1. 50% of W-2 wages ($40,000 × 50% = $20,000), or
  2. the sum of 25% of W-2 wages ($10,000) plus 2.5% of the unadjusted basis of the machine immediately after its acquisition ($200,000 × 0.025 = $5,000), for a total of $15,000.
- As such, any final determination of the QBI deduction for Michelle could not exceed $20,000, the greater of the two alternative W-2 wages/qualified property limits.

A Closer Look at the Tax Cuts and Jobs Act

APPLICATION OF THE W-2 WAGES/QUALIFIED PROPERTY LIMIT

Step 1: Calculate Form W-2 Wage Limit:

Form W-2 Wages x 50%	$ 40,000	x	50.0%	=	$ 20,000

Step 2: Calculate Combined Wage/Qualified Property Limit:

Sum of:					
Form W-2 Wages x 25%	$ 40,000	x	25.0%	=	$ 10,000
Qualified Property x 2.5%	$ 200,000	x	2.5%	=	$ 5,000
Combined					$ 15,000

Step 3: Determine W-2 Wages/Qualified Property Limit:

	Step 1		Step 2
Greater of Step 1 and Step 2	$ 20,000	>	$ 15,000

Phase-In of W-2 Wages/Qualified Property Limit

To ease the impact of these complex limitation calculations, the rules provide an exception for individual taxpayers with lower taxable incomes. The W-2 wages/qualified property limit noted above does not apply or require consideration if the taxpayer's taxable income for the tax year is equal to or less than $315,000 for taxpayers filing a joint return and $157,500 for single taxpayers.

For other taxpayers, the W-2 wages/qualified property limit may be phased in as income grows beyond the threshold levels. If the taxpayer's taxable income for the tax year is more than the thresholds noted above, but not more than $415,000 for a joint return and $207,500 for a single taxpayer (and if the W-2 wages/qualified property limit amount for the qualified trade or business is less than 20% of the taxpayer's qualified business income for that trade or business), then:

1. the W-2 wages/qualified property limit does not apply for the qualified trade or business; and
2. the amount that is 20% of the taxpayer's qualified business income from the qualified trade or business is reduced by a reduction amount.

   The reduction amount is calculated by:

   (a) subtracting the qualified trade or business's W-2 wages/qualified property limit amount from the amount that is 20% of the taxpayer's qualified business income from the trade or business; and then

A Closer Look at the Tax Cuts and Jobs Act

(b) multiplying the difference determined in (a) above, by a fraction; the numerator of which is the amount by which the taxpayer's taxable income for the tax year exceeds the $315,000 threshold amount for a joint return ($157,500 for a single taxpayer), and the denominator is $100,000 for a joint return ($50,000 for a single taxpayer).

A simple example illustrates the mechanics of the phase-in rules related to the W-2 wages/qualified property limit.

- Jack and Jill are a married couple. Jill has a qualified business that is not a specified service business.
- For tax year 2018, Jack and Jill file a joint return reporting taxable income of $365,000, which is the exact midpoint or 50% of the limitation phase-in range of $315,000 - $415,000 for married taxpayers filing jointly.
- In that tax year, qualified business income from Jill's business is $250,000, which results in a preliminary 20% combined QBI deduction (before limitation) of $50,000.
- Jill's share of wages paid by the business in the tax year is $40,000, so 50% of the W-2 wages (the first limitation) from the business is $20,000. *(Note that for purposes of this example, we have not incorporated any qualified property factors into the calculation.)*
- The gross QBI limitation amount, before evaluating the limitation phase-in, is $30,000 ($50,000 - $20,000).
- The gross QBI limitation is then reduced by 50% ($30,000 - $15,000), which is the applicable percentage of excess taxable income in the phase-in range.
- This 50% adjustment is determined simply by taking the couple's taxable income of $365,000 and subtracting the lower end of the phase-in range of $315,000, then dividing it by the total amount of the applicable limitation range of $100,000 ($415,000 - $315,000).
- Therefore, the $50,000 deduction amount is therefore reduced by $15,000, which is the net [adjusted] limitation. Again, the limitation is reduced because the taxpayers' taxable income did not exceed the top end of the phase-in range.
- As a result, Jack and Jill would receive a pass-through deduction of $35,000 ($50,000 - $15,000).

A Closer Look at the Tax Cuts and Jobs Act

DETERMINATION OF QBI DEDUCTION WITH LIMITATION

Step 1: Determine QBI and QBI Deduction								
Qualified Business Income x 20%	$	250,000	x		20.0%	=	$ 50,000
Step 2: Calculate Combined Wage/Qualified Property Limit*							
Form W-2 Wages x 50%	$	40,000	x		50.0%	=	$ 20,000
Step 3: Determine [preliminary] Limitation Amount							
		Step 1			Step 2		
Step 1 – Step 2	$	50,000	–	$	20,000	=	$ 30,000
Step 4: Determine Phase-in Percentage							
Taxable Income in Excess of $315,000 Floor =	$	50,000	/	$	100,000	=	50%
	[Phase-in Range ($315,000 - $415,000)]						
Step 5: Determine Phase-in of Limitation							
		Step 3			Step 4		
Step 3 x Step 4	$	30,000	x		50%	=	$ 15,000
Step 6: Determine Pass-through Deduction							
		Step 3			Step 5		
Step 1 – Step 5	$	50,000	–	$	15,000	=	$ 35,000

** This example excludes any consideration of the wages/qualified property limitation.*

"W-2 wages" are all wages that the taxpayer's qualified trade or business paid to its employees during the calendar year that ends in the business's tax year. *W-2 wages*, for these purposes, also include annual deferrals under IRC Section 401(k) plans, simplified employee pensions, IRC Section 403(b) annuities, amounts deferred under deferred compensation plans, and designated Roth contributions.

For pass-through deduction purposes, W-2 wages must be properly allocable to qualified business income. They also must be properly included in a return (e.g., Form W-2, *Wage and Tax Statement*) filed with the Social Security Administration on or before the 60th day after the filing due date.

"Qualified property," for limitation testing purposes, is depreciable tangible property, which is held by and available for use in the qualified trade or business at the close of the tax year, and is used during the tax year to produce qualified business income. To be qualified, the property's depreciable period cannot end before the close of the tax year. Property that is sold and no longer available for use in the trade or business is not taken into account in determining the qualified property limitation.

A Closer Look at the Tax Cuts and Jobs Act

Excluding Specified Service Trades or Businesses

The Senate Finance Committee had concerns that non-operating businesses that are primarily professional in nature could take advantage of the QBI deduction by applying it against personal service income generated in their professional capacities. To combat this outcome, the final bill carves out a substantial portion of the pass-through business sector providing professional services. Under the TCJA, a non-corporate (individual) taxpayer can claim the pass-through deduction for income from many types of trades or businesses carried on by the taxpayer, but not for certain "specified service trades or businesses" (with exceptions).

A *specified service trade or business* is any trade or business:

- that involves the performance of services in the fields of accounting, actuarial science, athletics, brokerage services, consulting, financial services, health, law, or the performing arts; or
- that involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; or
- whose principal asset is the reputation or skill of one or more of its employees or owners.

Note, that the TCJA excludes architecture and engineering from the definition of a specified service trade or business. Thus, these businesses can be qualified trades or businesses for purposes of the QBI deduction, if they meet the remaining statutory requirements. Additionally, note that performing services as an employee is not a qualified trade or business.

As with operating businesses, the TCJA provides an income threshold to exclude smaller specified service businesses and allow them to take advantage of the deduction. For individuals with lower taxable incomes, it is possible to carry on a specified service trade or business and also claim a modified QBI deduction. The taxable income threshold amounts for the exception are $415,000 for taxpayers filing a joint return ($315,000 threshold amount + $100,000); or $207,500 for all other taxpayers ($157,500 threshold amount + $50,000).

If a taxpayer's taxable income for the tax year is less than the amounts listed above, then the taxpayer may take into account a percentage of his or her qualified items of income, gain, deduction or loss, and W-2 wages and/or unadjusted basis of qualified property that are allocable to the specified service in computing qualified business income, W-2 wages and unadjusted basis of qualified property for the tax year.

The following example shows the applicability of the deduction limit phase-in for specified service businesses.

- Tom, a single taxpayer, has taxable income of $177,500, of which all is attributable to his legal practice that is a sole proprietorship (i.e., a specified service business) after paying wages of $80,000 to his employees.

A Closer Look at the Tax Cuts and Jobs Act

- Because his taxable income is less than the $207,500 threshold for specified service businesses, Tom can claim a QBI deduction, but only for an applicable percentage of his qualified items of income, gain, deduction or loss, and the W-2 wages from the service business. *(No qualified property factors included.)*
- Tom's taxable income exceeds the phase-in range for single filers by $20,000 ($177,500 – $157,500). Since the phase-in range for single filers is $50,000, Tom must divide the amount by which his income exceeds the lower end of the phase-in range over the entire range.
- Tom determines that his limitation amount is 40% ($20,000 / $50,000). Accordingly, he can utilize the remaining 60% of his qualified items of income, gain, deduction or loss, and the W-2 wages from the specified service business.
- In determining includible qualified business income, Tom takes into account 60% of his taxable income of $177,500 ($106,500). In determining the includible W-2 wages, Tom takes into account 60% of the paid wages of $80,000 ($48,000).
- Tom then calculates the final QBI deduction by taking the lesser of: 20% of $106,500 ($21,300), or 50% of $48,000 ($24,000). Thus, Tom is able to take a pass-through deduction for $21,300.

DETERMINATION OF QBI DEDUCTION WITH LIMITATION FOR A SPECIFIED SERVICE BUSINESS

Step 1: Determine Preliminary QBI and QBI Deduction						
Qualified Business Income x 20%	$ 177,500	x		20.0%	=	$ 35,500
Step 2: Calculate Combined Wage/Qualified Property Limit*						
Form W-2 Wages x 50%	$ 80,000	x		50.0%	=	$ 40,000
Step 3: Determine Phase-in Percentage						
Taxable Income in Excess of $157,500 Floor =	$ 20,000	/	$	50,000	=	40%
	[Phase-in Range ($157,500 – $207,500)]					
Step 4: Determine Includible Combined QBI Deduction						
	100% – Step 3			Step 1		
(100% – Step 3 Percentage) x Step 1	60%	x	$	35,500	=	$ 21,300
Step 5: Determine Includible Wage/Qualified Property Limit						
	100% – Step 3			Step 2		
(100% – Step 3 Percentage) x Step 2	60%	x	$	40,000	=	$ 24,000
Step 6: Determine Pass-through Deduction						
	Step 4			Step 5		
Lesser of Step 4 or Step 5	$ 21,300	<	$	24,000		

** This example excludes any consideration of the wages/qualified property limitation.*

A Closer Look at the Tax Cuts and Jobs Act

Calculating the QBI Deduction for Multiple Businesses

Importantly, the qualified business income of a qualified trade or business carried on by a taxpayer for a tax year is the net amount of ALL of the individual taxpayer's business's qualified items of income, gain, deduction and loss. Items of income, gain, deduction and loss are qualified to the extent they are effectively connected with the conduct of a trade or business within the United States, and are included or allowed in determining taxable income for the tax year. Accordingly, taxpayers that have owners in multiple businesses must net their qualified business income items together to determine their pass-through deductions.

If the net amount of qualified income, gain, deduction and loss is less than zero, the loss is carried over to the next tax year. Any deduction allowed in the next tax year is reduced (not below zero) by 20% of any carryover qualified business loss. The example below shows the calculation for multiple qualified businesses with net loss.

- Tim owns two qualified businesses. In 2018, he has qualified business income of $200,000 from Business A and a qualified business loss of $250,000 from Business B. Tim cannot claim the QBI deduction for 2018, (due to a combined net loss) but will carryover the qualified business loss of $50,000 to 2019.
- In 2019, Tim has qualified business income of $100,000 from Business A and $50,000 from Business B. To determine his QBI deduction for 2019, Tim reduces the 20% deductible amount determined for the $150,000 qualified business income (from both businesses combined) by 20% of the $50,000 carryover qualified business loss.
- Thus, qualified business income for 2019 would be $100,000, producing a QBI deduction of $20,000.

DETERMINATION OF QBI AND QBI DEDUCTION FROM MULTIPLE BUSINESSES

Step 1: Determine 2018 Qualified Business Income (Loss)						
- 2018 Qualified Business Income (Business A)	$	200,000				
- 2018 Qualified Business Income (Business B)	$	(250,000)				
Qualified Business Loss	$	(50,000)				
Step 2: Determine 2019 QBI Deduction – Prior to Loss Carryover						
- 2019 Qualified Business Income (Business A)	$	100,000				
- 2019 Qualified Business Income (Business B)	$	50,000				
	$	150,000	x	20.0%	=	$ 30,000
Step 3: Determine 2019 QBI Deduction in Consideration of Carryover						
Qualified Business Income for 2019	$	150,000	x	20.0%	=	$ 30,000
Less:						
Carryover of Qualified Business Loss from 2018	$	(50,000)	x	20.0%	=	$ (10,000)
Final Qualified Business Deduction for 2019						$ 20,000

A Closer Look at the Tax Cuts and Jobs Act

An additional example illustrates the calculation for multiple qualified businesses with loss carryover:

- James and Susan are married. They file a joint return for the tax year, on which they report taxable income of $300,000 (determined without regard to the QBI deduction).
- James has a sole proprietorship, a qualified trade or business, and Susan is a partner in the ABC Partnership, a qualified trade or business. Neither qualified business is a specified service business. They have a carryover qualified business loss of $30,000 from 2018. *(No qualified property factors are included.)*
- In 2019, James has $150,000 of qualified business income from his business, so 20% of the qualified business income is $30,000. Because the couple's taxable income is below the $315,000 threshold amount for a joint return, the wage limit does not apply to James's business. As such, his deductible amount is $30,000.
- Susan's allocable share of qualified business loss from the ABC Partnership is $50,000 in 2019, so 20% of the qualified business loss is $10,000. Because the couple's taxable income is below the $315,000 threshold amount for a joint return, the wage limit does not apply to Susan's partnership. Thus, her deductible amount for the ABC Partnership is a $10,000 reduction to the deduction amount.
- The couple's combined QBI deduction amount is $14,000, which is comprised of the $30,000 deductible amount for James's business, the $10,000 reduction for the ABC Partnership, and a $6,000 reduction (20% × $30,000) attributable to the carryover qualified business loss.

DETERMINATION OF QBI AND QBI DEDUCTION FROM MULTIPLE BUSINESSES (WITH LOSS CARRYOVER)

Step 1: Determine 2019 QBI Deduction – Prior to Loss Carryover

Qualified Business Income x 20%					
- 2019 Qualified Business Income (James)	$ 150,000	x	20.0%	=	$ 30,000
- 2019 Qualified Business Income (Susan)*	$ (50,000)	x	20.0%	=	(10,000)
	$ 100,000			=	$ 20,000

** The loss works to produce a reduction to the combined deduction.*

Step 2: Determine 2019 QBI Deduction – with Loss Carryover

Qualified Business Income for 2019	$ 100,000	x	20.0%	=	$ 20,000
Less:					
Carryover of Qualified Business Loss from 2018	$ (30,000)	x	20.0%	=	$ (6,000)
					14,000

A Closer Look at the Tax Cuts and Jobs Act

Definitions Related to the QBI Deduction

Qualified items of income, gain, deduction or loss do not include:

- items of short-term capital gain or loss, or long-term capital gain or loss;
- dividends, income equivalent to a dividend, or payments in lieu of dividends;
- interest income that is not properly allocable to a trade or business;
- the excess of gain over loss from commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business;
- the excess of foreign currency gains over foreign currency losses from specific transactions, other than transactions directly related to the business needs of the business activity;
- net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets);
- amounts from an annuity not received in connection with the trade or business; or
- items of deduction or loss properly allocable to the preceding items.

Qualified business income does not include:

- reasonable compensation paid to the taxpayer by the business for services rendered;
- guaranteed payments to a partner for services rendered;
- other payments to a partner for services rendered;
- qualified REIT dividends;
- qualified cooperative dividends; or
- qualified publicly traded partnership income.

In determining the individual's alternative minimum taxable income, qualified business income is determined without regard to the minimum tax preferences and adjustments.

A Closer Look at the Tax Cuts and Jobs Act

Individual-Level Deduction

As noted previously, for S corporations, partnerships and limited liability companies taxed as partnerships, the pass-through deduction is applied at the shareholder or partner level. Each shareholder or partner must take into account his or her pro rata share of each qualified item of income, gain, deduction and loss, and each partner must take into account his or her allocable share.

Further, each shareholder or partner is treated as having W-2 wages and unadjusted basis immediately after acquisition of qualified property for the tax year, in an amount equal to his or her pro rata share of the S corporation's or his or her allocable share of the partnership's W-2 wages and unadjusted basis for the tax year as determined in the regulations. The share of W-2 wages is determined in the same manner as the shareholder's or partner's share of wage expenses. The share of the unadjusted basis of qualified property is determined in the same manner as the shareholder's pro rata share or partner's allocable share.

While the QBI deduction is applied at the shareholder or partner level, the complexity of partnership and S corporation tax filings will undoubtedly increase, with more separately-stated items required to be reported by pass-through entities to their owners. Schedule K-1 reporting will now need to include information for each qualified trade or business conducted by a pass-through entity (with identification of whether that business is or is not a specified service activity), the W-2 wages of the entity and the unadjusted basis of depreciable assets. All of these items will be necessary for tax years beginning after December 31, 2017 and forward for computation of any particular owner's pass-through deduction.

To allow enforcement of proper calculations of the new pass-through deduction, the rules note that a taxpayer who claims the QBI deduction may be subject to the 20% accuracy-related penalty for a substantial understatement of income tax if the understatement is more than the greater of 5% (not 10%) of the tax required to be shown on the return for the tax year, or $5,000.

One final example demonstrates how significant an impact this provision of the TCJA may have on owners of pass-through entities. Assume that Charles and Ann, a married couple, are owners of a qualified business that they started 20 years ago. They remain active in the business, which has grown to be very profitable.

- In 2017, the company produced pass-through business income of $1,000,000 that was reported on their Schedule K-1. In addition, they earned combined salaries of $300,000 from the business. After factoring in their itemized deductions and exemptions, the couple's taxable income is $1,200,000.
- Based on the tax tables applicable for tax year 2017 (before the TCJA), Charles and Ann would incur a federal income tax liability of approximately $420,000, with an effective income tax rate of approxi-

A Closer Look at the Tax Cuts and Jobs Act

mately 35%. Of their $1,200,000 of taxable income, approximately $730,000 is subject to tax at the highest individual marginal income tax rate of 39.6%.

- Assuming a similar taxable income position for tax year 2018 (after the TCJA), Charles and Ann will incur a federal income tax liability of approximately $309,000, with an effective income tax rate of 25.8%. The TCJA will result in a tax savings of approximately $111,000 for Charles and Ann.

ECONOMIC IMPACT OF THE QBI DEDUCTION

Step 1: Determine QBI and QBI Deduction

Qualified Business Income x 20%	$ 1,000,000	x 20.0%	= $ 200,000

Step 2: Determine Taxable Income (Excluding QBI Deduction)

	2017	2018	Difference
Wages	$ 300,000	$ 300,000	$ -
Ordinary Income from Qualified Business	1,000,000	1,000,000	-
Adjusted Gross Income	1,300,000	1,300,000	-
Deductions	(100,000)	(100,000)	-
Taxable Income (before QBI Deduction)	$ 1,200,000	$ 1,200,000	$ -

Step 3: Determine Taxable Income

	2017	2018	Difference
Taxable Income (before QBI Deduction)	$ 1,200,000	$ 1,200,000	$ -
QBI Deduction	n/a	(200,000)	(200,000)
Taxable Income (after QBI Deduction)	$ 1,200,000	$ 1,000,000	$ (200,000)

Step 4: Determine Federal Tax Liability

	2017	2018	Difference
Federal Income Tax Obligation	$ 420,431	$ 309,379	$ (111,052)

While some tax savings are achieved through the tax rate reductions and changes in income tax brackets, the most significant tax savings for this couple is a direct result of the QBI deduction, which excludes $200,000 ($1,000,000 x 20%) from taxation at the highest individual tax rate of 37%. The QBI deduction alone provides Charles and Ann with tax savings of approximately $74,000 ($200,000 x 37%).

The couple's tax savings of $111,000 will reduce the need for their business to distribute funds to meet their federal income tax obligations on the pass-through income. As such, more funds will be available to reinvest and grow the business with additional employees and capital.

A Closer Look at the Tax Cuts and Jobs Act

Reconciling the Business Marginal Tax Rates

It is important to understand what has been accomplished with the enactment of the pass-through deduction and how it corresponds with the rate reduction afforded regular corporations in the TCJA. Note, first, that the highest marginal ***individual*** income tax rate under the TCJA is 37%. Thus, taxpayers with significant pass-through income will likely see that income subjected to this marginal rate. In contrast, the highest ***corporate*** income tax rate is now 21%. The gap is substantial, and without the QBI deduction, the rate differential would most certainly afford a tax and competitive cash flow advantage to companies structured as regular corporations.

However, the QBI deduction goes a great distance to harmonize these two rates. Assume, as an example, a pass-through business entity that has $1 million of qualified business income, and that equates to taxable income. Without the deduction, the tax would be simply $1 million x 37% ($370,000). However, if that taxpayer is able to take advantage of the QBI deduction, the amount of the $1 million qualified business income that is subject to tax is reduced to 80%, or $800,000. Assuming that the taxpayer remains subject to the same marginal rate, the income tax is $296,000 ($800,000 x 37%).

It is important to understand that the effect of the deduction is to reduce the effective income tax rate on the $1 million of qualified business income to 29.6% ($296,000 / $1,000,000). As such, the deduction (without limitation) serves to reduce the marginal rate to which the QBI is subject by 7.4% (37% - 29.6%), which is 20% of the original, highest marginal rate of 37%.

Next, the issue of the dividends tax (on a C corporation shareholder) must be considered. The undistributed earnings of a pass-through entity can generally be distributed tax-free. However, a company structured as a "regular" Subchapter C corporation cannot make tax-free distributions. Amounts distributed from a C corporation are generally characterized as dividends, subject to tax at a minimum tax rate of 15% (0% for married taxpayers with up to $77,200 of income) and a maximum tax rate of 20%. Additionally, it is probable that there is an additional net investment income tax of 3.8% on the individual income.

Assume a C corporation with $1 million in taxable income. The tax at the corporate level is $210,000 ($1,000,000 x 21%). Payment of the tax leaves retained earnings in the corporation of $790,000 ($1,000,000 - $210,000). If the $790,000 is distributed to the shareholders as a dividend, a second layer of tax at a minimum of 15% (for most taxpayers) will be assessed. Thus, the tax on the dividend distribution at the shareholder level will be $118,500 ($790,000 x 15%). The sum of the tax paid at both the corporate level and the shareholder level is $328,500. This total tax equates to a rounded combined marginal tax rate of 32.9% on the regular corporation.

As compared to the C corporation rate, the effective tax rate changes enacted under the TCJA for pass-through business entities appears to align relatively closely to the 21% flat tax rate allowed for regular corporations.

A Closer Look at the Tax Cuts and Jobs Act

Reorganization As a Question

Questions continue as to the viability and propriety of considering a change from a pass-through structure to a regular corporation and vice-versa, given the impact of the TCJA. On the one hand, the federal income tax rate on regular corporations (at the corporate level) is still 8.6% (29.6% - 21%) lower than the effective pass-through rate. On the other hand, the pass-through entity structure allows for an overall combined effective rate that is lower than the regular C corporation effective rate incurred to get the earnings out to the shareholders.

However, such decisions as reorganization cannot be undertaken in such a shallow vacuum, however, as state taxes are also a major consideration. In Pennsylvania, the pass-through income is subjected to an individual income tax rate of 3.07% while regular corporations are subject to a 9.99% corporate income tax rate. Note, that the corporate rate differs somewhat from the effective rate because there is a 21% federal income tax benefit associated with the deduction for state income tax. The net effective rate, then, is approximately 7.89%. In any case, it is easy to see that the combined effective federal and state income tax rate for Pennsylvania corporations is 28.89%, versus the pass-through effective rate of 32.67% (29.6% + 3.07% at the individual level). The gap in the annual income tax liability, then, is the difference, or 3.78% (32.76% - 28.89%). This analysis, of course, does not include consideration of dividend tax at the regular corporation shareholder level.

The second, and more major, consideration is the timing of owner exit from the business considering re-organization. If the business is intended to be a very long-term hold, there may be some merit in focusing on the year-to-year tax savings accorded a regular corporation entity structure. This is especially true if there is a capability to avoid the shareholder-level dividends tax by virtue of paying out earnings as compensation, rent, or consulting and management fees (Note that this planning is complex and beyond the scope of today's program).

However, shareholder-level income taxes can rarely be avoided on a sale of assets. It is likely that any short- to mid-term sale of assets would result in the two layers of tax discussed above and would work to make such a transaction substantially more expensive than if the pass-through entity status been maintained.

As is always the case, there are many more technical and subjective considerations that merit attention when thinking of a business reorganization. Suffice to say, that the propriety of such a determination is not possible without careful analysis of all facts and circumstances specific to a particular company or ownership group.

Issues Affecting Partnerships

Required Holding Period for Long-Term Capital Gain Passed for Partners with Carried Interests

A great deal of attention has been focused on New York hedge fund managers using prior-law carried interest rules to convert what appears to be personal service income, which is subject to ordinary income tax

A Closer Look at the Tax Cuts and Jobs Act

rates, into capital gains income that is subject to the preferential capital gains rates. The TCJA adds new rules to limit this planning strategy and answer the protests against this type of planning.

A "carried interest" in a partnership is an interest consisting of the right to receive future partnership profits that is given to a partner in exchange for performing services for the partnership. Carried interests are often used by partnerships in the investment management business. Such a partnership interest is not taxed when a fund manager partner receives it. The Internal Revenue Service generally treats the receipt of a partnership profits interest for services as a nontaxable event. This treatment applies only to substantially nonvested profits interests.

As noted, in recent years, the tax treatment of income from a carried interest given in exchange for asset management services, such as services for private equity funds, venture capital funds and hedge funds, has received a lot of attention. Investment funds are usually partnerships, with the fund manager as the general partner and the investors as limited partners. The fund manager itself is generally a partnership whose members have investment management expertise. The fund manager receives management fees and a carried interest. Income from the carried interest passes through from the fund manager partnership to its member partners whose professional skills generate capital income for the fund's investors. The income may be short-term or long-term capital gain realized by the underlying investment fund as it sells off investment assets. The point of contention has been that long-term capital gain allocated to the individual partners may represent compensation for services as fund managers. Some who view this income as compensation for services have called for it to be taxed at ordinary income rates.

The holding period for a capital asset is the length of time that the taxpayer owns the property before disposing of it. The tax treatment of recognized gain or loss depends (in part) on whether the taxpayer's holding period is short-term or long-term. Long-term gain or loss arises from assets held for more than one year; anything else is considered to be short-term gain or loss.

"Net capital gain" is the excess of net long-term capital gain for the tax year over net short-term capital loss for the tax year. For an individual taxpayer, an estate or a trust, any adjusted net capital gain that otherwise would be taxed at the ordinary 10% or 15% rate is not taxed. Any adjusted net capital gain that otherwise would be taxed at the ordinary rates (over 15% and below 39.6%) is taxed at a 15% rate. Any adjusted net capital gain that otherwise would be taxed at the ordinary 39.6% rate is taxed at a 20% rate.

As a result of the TCJA, a three-year holding period now applies to certain net long-term capital gains with respect to any applicable partnership interest held by the taxpayer. If a taxpayer holds an applicable partnership interest at any time during the tax year, this rule treats as short-term capital gain (taxed at ordinary income rates), the amount of the taxpayer's net long-term capital gain from the applicable interest that exceeds the amount of such gain calculated as if a three-year holding period applies instead of a one-year period. In making this calculation, long-term capital losses also are taken into account as if a three-year holding period applies.

An "applicable partnership interest" is any interest in a partnership that is transferred to or held by the taxpayer in connection with the performance of services by the taxpayer or a related person in any applicable trade of business, even if the taxpayer made contributions to the partnership. An *applicable partnership interest* does not include (1) any interest in a partnership held by a corporation, or (2) any capital interest in the partnership that provides the taxpayer with a right to share in partnership capital based on the amount of capital contributed or on the value of the interest subject to tax when the interest is received or vested.

An "applicable trade or business" is one whose regular business activity consists of (1) raising or returning capital, and (2) either investing in or disposing of specified assets, or developing specified assets. "Specified assets" are securities, commodities, real estate held for rental or investment, cash or cash equivalents, or options or derivative contracts with respect to these assets. An interest in a partnership, to the extent of the partnership's proportionate interest in these assets, is also a specified asset.

If a taxpayer transfers an applicable partnership interest to a related person, the taxpayer must include in gross income, as short-term capital gain, as much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest.

Basis Limitation on Partner Losses, Applicability of Charitable Contributions and Foreign Taxes

A partner's distributive share of partnership loss is not allowed to the extent that it exceeds the adjusted basis of the partner's partnership interest. Disallowed loss is allowed as a deduction at the end of the next partnership tax year to the extent that the partner's adjusted basis at that point exceeds zero.

A partner's basis in its partnership interest is increased by its distributive share of income and decreased by distributions by the partnership. A partner's basis is also decreased by its distributive share of partnership losses and expenditures not deductible in computing partnership taxable income and not properly chargeable to capital account.

When a partnership makes a charitable contribution of appreciated property, a partner generally can claim as a deduction his or her distributive share of the property's fair market value. In turn, the partner's basis is reduced, but only by the partner's distributive share of the adjusted basis of the contributed property (and not its fair market value).

A Closer Look at the Tax Cuts and Jobs Act

A partnership is not allowed to claim deductions for charitable contributions or foreign taxes at the partnership level. With respect to foreign taxes, as with charitable contributions made by the partnership, the partners take into account their distributive shares of the foreign taxes paid by the partnership.

Under current regulations, the basis limitation on partner losses does not take into account the partner's share of partnership charitable contributions or foreign taxes.

The basis limitation on partner losses is modified under the TCJA to take into account a partner's distributive share of (1) partnership charitable contributions, and (2) taxes paid or accrued to foreign countries and U.S. possessions. For a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. A special rule provides that if the partnership makes a charitable contribution of property whose fair market value is greater than its adjusted basis, the basis limitation on partner losses does not account for the partner's distributive share of the excess.

Treatment of Sale or Exchange of Partnership Interests by Foreign Persons

A foreign person that is engaged in a trade or business in the United States is taxed on income or gain that is "effectively connected" with the conduct of that trade or business. The effectively connected test considers (1) the extent to which income or gain is derived from assets used in the conduct of the U.S. trade or business (the "asset use" test), and (2) whether the activities of the trade or business were a material factor in realizing the income or gain (the "business activities" test).

A foreign partner in a partnership is treated as engaged in the conduct of a trade or business within the United States if the partnership is engaged. Even though the source of gain or loss from the sale or exchange of personal property is generally determined based on where the seller resides, a foreign partner may have effectively connected income due to the asset use or business activities of the partnership in which he or she is an investor.

Special rules treat gain or loss on the sale of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business. If consideration received by a nonresident alien or foreign corporation for its interest in a partnership is attributable to a U.S. real property interest, that consideration is treated as received from the sale or exchange in the United States of the real property.

Gain from sales of U.S. real property interests may be subject to a 15% withholding tax on the amount realized on the transfer.

A Closer Look at the Tax Cuts and Jobs Act

With the TCJA, gain or loss from any sale, exchange or other disposition of a partnership interest is effectively connected with a U.S. trade or business, to the extent that the transferor would have had 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. Any gain or loss from the hypothetical asset sale must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

Gain or loss treated as effectively connected income is reduced by the amount treated as effectively connected income, which relates to gain or loss of a nonresident alien or foreign corporation from the disposition of a U.S. real property interest.

In addition, the transferee of a partnership interest must withhold 10% of the amount realized on the sale or exchange, unless the transferor certifies that it is not a nonresident alien or foreign corporation. The amount withheld may be reduced (at the transferor's or transferee's request), if the Internal Revenue Service determines that the reduced amount will not jeopardize income tax collection on the gain realized.

If the transferee fails to withhold the correct amount, the partnership must deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

Technical Termination of Partnerships

For federal income tax purposes, a partnership is considered "terminated" if (1) no part of any business, financial operation or venture of the partnership continues to be carried on by any of its partners, or (2) within a 12-month period, there is a sale or exchange of 50% of more of the total interest in partnership capital and profits. The second type of termination – sale or exchange of 50% of total partnership interest – is termed a "technical termination."

A *technical termination* causes two deemed transfers:

1. The terminated partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and
2. Immediately afterwards, in a liquidating distribution, the terminated partnership is deemed to distribute its interests in the new partnership to the purchasing partner and the remaining partners.

Generally, neither the remaining partners, nor the partnership, recognize gain or loss on the deemed contribution to the new partnership and the subsequent deemed liquidating distribution.

A Closer Look at the Tax Cuts and Jobs Act

A technical termination causes the following tax consequences:

- The terminated partnership's tax year closes on the date of the sale or exchange that triggers the termination. The resulting short tax year may cause a bunching of the partnership income for the remaining partners.
- The new partnership must file new tax elections regarding accounting methods, depreciation methods, installment sales and amortization and depletion.
- Generally, partnership depreciation recovery periods restart.
- The new partnership must file new optional basis adjustment elections.

Thus, a technical termination does not necessarily end the partnership's existence, but only terminates some of the "old" partnership's tax attributes.

As a result of the TCJA , the rule providing for technical termination of partnerships is repealed for partnership tax years beginning after December 31, 2017.

An advantage of not having a technical termination may be the continued use of the prior depreciation method and remaining lives for the historic asset basis. The disadvantage is that the new owners will be required to live with the existing partnership elections and accounting methods. A closing-of-the-books method may be used to allocate income and loss between the "old partners" and the "new partners" to produce the same effect as a technical termination on the determination of pre-closing income and loss at the closing of the tax year.

Issues Relating to Electing Small Business Trusts (ESBT)

Qualified Beneficiary of an ESBT

All shareholders of an S corporation must be individuals, estates, certain specified trusts or certain tax-exempt organizations. An electing small business trust (ESBT) may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates and certain charitable organizations that are eligible to hold S corporation stock directly.

Each potential current beneficiary of an ESBT is treated as a shareholder, except that for any period in which there is no potential current beneficiary of the trust, the trust itself is treated as the shareholder. A "potential current beneficiary" is a person who is entitled to a distribution from the trust or who may receive a distribution at the discretion of any person. Any person who may benefit from a power of appointment is not

A Closer Look at the Tax Cuts and Jobs Act

a potential current beneficiary if the power has not been exercised. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT without causing disqualification of the S corporation election. If the potential current beneficiaries of an ESBT would disqualify an entity from S corporation status, the ESBT has a grace period of one year to dispose of its stock in the S corporation, thereby avoiding disqualification.

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and, generally, is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income is not taxed to the beneficiaries of the ESBT, regardless of whether or not the income is distributed by the ESBT.

Under the TCJA, a nonresident alien individual may be a potential current beneficiary of an ESBT without causing the loss of the S corporation status. Thus, an ESBT's nonresident alien potential current beneficiaries would not be considered to be disqualifying shareholders. Accordingly, the ESBT's share of S corporation income is taxed to the ESBT (whether or not distributed), not to its nonresident alien potential current beneficiaries.

Charitable Contribution Deduction for an ESBT

Under prior law, the deduction for charitable contributions by an ESBT is determined by the rules applicable to trusts, rather than the rules applicable to individuals. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income (without limitation), which are paid for a charitable purpose, pursuant to the terms of the governing instrument. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction (limited to certain percentages of AGI), generally with a five-year carryforward, of amounts in excess of this limitation.

Under the TCJA, the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts. Instead, the deduction is determined by rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Specifically for purposes of the contribution base for percentage limitations, AGI is computed in the same manner as in the case of an individual. However, the deductions for costs that are paid or incurred in connection with the administration of the trust and, which would not have been incurred if the property were not held in such trust, are to be treated as allowable in arriving at AGI. This a taxpayer-favorable change.

A Closer Look at the Tax Cuts and Jobs Act

S Corporation Conversions to C Corporations

Generally, once S corporation status ends, C corporation rules apply. There are, however, special rules for distributions during the post-termination transition period. Distributions made by a former S corporation during its post-termination transition period are treated in the same manner as if the distributions were made by an S corporation. The post-termination transition period is:

1. the period beginning on the day after termination of S corporation status and ending on the later of (i) the day that is one year after the termination, or (ii) the due date for filing the return for the last year as an S corporation (including extensions);
2. the 120-day period beginning on the date of any determination pursuant to an audit following the termination of the corporation's S election and which adjusts a Subchapter S item of income, loss or deduction of the corporation arising during the S period; and
3. the 120-day period beginning on the date of a determination that the corporation's election to be classified as an S Corporation had terminated for a previous tax year.

An S corporation's accumulated adjustment account determines the tax effect of distributions when the corporation has accumulated earnings and profits. Additionally, if the corporation's S election is terminated, the accumulated adjustment account balance will be necessary to determine the amount of money that can be distributed tax-free during the post-termination period. Distributions from a terminated S corporation are treated as paid from its accumulated adjustment account if made during the post-termination transition period.

When the taxable income of a taxpayer is computed under a different accounting method than the prior year (e.g., when changing from the cash method to the accrual method), adjustments need to be made. In computing taxable income for the year of change, the taxpayer must take into account those adjustments which are necessary to prevent items of income or expense from being duplicated or omitted. The year of change is the tax year for which the taxable income of the taxpayer is computed under a different method than the prior year. Generally, net adjustments that decrease taxable income are taken into account entirely in the year of change, and net adjustments that increase taxable income are taken into account ratably during the four-tax-year period beginning with the year of change.

Under the TCJA, any adjustment resulting from an accounting method change that is attributable to an eligible S corporation's revocation of its S corporation election during the two-year period beginning on December 22, 2017, will be taken into account ratably over a six-year period beginning with the year of change.

A Closer Look at the Tax Cuts and Jobs Act

An eligible terminated S corporation is any C corporation:

- which was an S corporation on the day before December 22, 2017;
- which, during the two-year period beginning on December 22, 2017, makes a revocation of its election to be classified as an S Corporation; and
- the owners of the stock of which, determined on the date of revocation, are the same owners (and in identical proportions) as on December 22, 2017.

If an eligible terminated S corporation distributes money after the post-termination transition period, the accumulated adjustments account will be allocated to such distribution. Further, the distribution will be chargeable to accumulated earnings and profits in the same ratio as the amount of such accumulated adjustments account bears to the amount of such earnings and profits.

A Closer Look at the Tax Cuts and Jobs Act

IV. Impact on Businesses

A long-time goal and initiative of tax reform and the Republican agenda, which came to fruition with the enactment of the TCJA, has been serious corporate tax change. The Congressional and Presidential motivation to make America's operating environment more comparable with the rest of the industrialized world is intended to enhance the competitive viability of operating in the United States. The new tax reform legislation goes a long way in meeting these goals.

Unlike the individual provisions previously discussed, the TCJA provides permanent changes that benefit corporate taxpayers. Again, the intention of these provisions is to stimulate the U.S. economy, level the playing field for U.S. corporations competing in international commerce, and to encourage U.S. businesses to keep more of their operations within the borders of the United States.

These taxpayer-friendly provisions include a significant reduction to the corporate tax rate, favorable changes to corporate deductions and tax credits, and a switch to a territorial tax system for companies that earn income outside of the United States. Note, the latter is discussed in these materials in Chapter V.

Effective for tax years beginning after December 31, 2017, the TCJA replaces the prior-law graduated corporate structure with a new rate regime that rests solely on a single flat rate of 21% on all taxable income.

The TCJA also makes numerous other important changes to corporate taxation. The new law fully and permanently repeals the corporate alternative minimum tax (AMT). It also permits items that are depreciated under current law to be fully expensed in the year placed in service through 2022, with a phase-out of that benefit thereafter.

To create some level of revenue to offset the tax cuts, the TCJA imposes new limits on the deduction for net business interest, repeals the IRC Section 199 domestic manufacturing deduction, and disallows like-kind exchanges for assets other than real property.

Corporate Income Tax Rate Reduction

While President Trump campaigned on a top marginal income tax rate of 15% for America's corporations, and the bills introduced by the both the House and the Senate proposed a 20% top marginal income tax rate, the Conference Committee compromise yielded a flat marginal income tax rate of 21%. The enacted rate still represents a significant reduction from the prior-law graduated rate system.

A Closer Look at the Tax Cuts and Jobs Act

As noted, for tax years beginning after December 31, 2017, the TCJA permanently eliminates the previous graduated corporate tax rate structure, and corporate taxable income is taxed at a flat 21% rate.

Prior to the TCJA, C corporations were subject to a graduated rate system that included four tax rates ranging from 15% to 35%. The specific graduated tax brackets were set fairly low (incomes under $75,000), with taxable income of $335,000 and above being taxed generally at a flat rate of 34%. However, the prior law also resulted in a 35% corporate rate for taxable income in excess of $10 million. The top marginal income tax rate under the prior law was the highest in the industrialized world and, according to most observers, placed the United States at a significant competitive disadvantage as compared to alternative business locales.

From a planning perspective, many questions have been asked as to whether existing entity structures require modification because of the provisions of the TCJA. As was discussed in Chapter III, such decisions should not be made solely on federal income tax ramifications. State income taxes also play an important role in such decisions (for example, in Pennsylvania, a 9.99% state corporate income tax rate versus a 3.07% individual income tax rate) and must be considered. Further, the double layer of taxation applicable to regular C corporations under U.S. law must be integrated into reorganization planning, and the expected holding period of the equity interests must be estimated or determined.

In addition to the tax ramifications associated with a potential reorganization, business equity owners must be attentive to any number of other "non-tax" business exigencies that are part of the decision-making process.

As a result of the corporate tax rate change, a number of other rate-related changes were required, including:

- Under prior law, personal service corporations (PSCs) did not have the advantage of using the lower graduated tax rates and were subjected to a flat tax at the highest marginal rate of 35%. No special tax rate is provided for PSCs under the TCJA; therefore, they are also taxed at a flat 21% rate. Note, that this provision works to end certain planning initiatives for these corporations related to strategies intended to exclude a corporation from the PSC classification, thereby, allowing the lower graduated rate structure.

- The rules for withholding of tax on dispositions of U.S. real property were modified. Under prior law, a 35% tax was required to be withheld on certain dispositions by domestic partnerships, estates and trusts and distributions by foreign corporations, REITs and RICs. The TCJA replaces that tax with the highest rate of tax in effect for the tax year. As such, these dispositions are now subject to a flat income tax withholding rate of 21%.

- The provision disallowing the graduated corporate tax rates or the accumulated earnings credit to transferee corporations upon certain transfers has been repealed.

A Closer Look at the Tax Cuts and Jobs Act

Section 15 – Effect of Changes

The Internal Revenue Code includes a provision under Section 15 entitled, "Effect of Changes." This is an important provision of the Code as it provides guidance on how to calculate an income tax liability for any taxpayer whose tax year spans the effective date of any tax rate change under *Subtitle A, Chapter 1, Subchapter A.* This tax includes income taxes. Specifically, Section 15 works as a proration device for calculating a liability, (in this case, income tax) for a taxpayer with a fiscal year that bridges the effective date of a rate change.

By way of example, assume that ABC Corporation is a regular C corporation and has an August 31st fiscal year end. The rate change mandated by the TCJA is 21%, effective for all tax years beginning after December 31, 2017. Thus, ABC corporation's fiscal year 2017 would begin on September 1, 2017 and end on August 31, 2018. This fiscal year includes January 1, 2018, the first day that the new 21% rate is in effect.

The question then arises as to how these circumstances should be treated. Section 15 provides that guidance:

(a) General Rule – If any rate of tax imposed by this chapter changes, and if the taxable year includes the effective date of the change (unless that date is the first day of the taxable year), then:

(1) tentative taxes shall be computed by applying the rate for the period before the effective date of the change, and the rate for the period on and after such date, to the taxable income for the entire taxable year; and

(2) the tax for such taxable year shall be the sum of that proportion of each tentative tax, which the number of days in each period bears, to the number of days in the entire taxable year.

In effect, the provision works to prorate the tax liability calculation for any taxpayer. The tax is computed twice under these rules – first, under the "pre-change" rules and, second under the "post-change" rules. The calculations are then weighted by the number of days in which the taxpayer operated under each set of rules.

In the above example, ABC Corporation would have approximately 4/12 of its taxable income liability calculated under the pre-change rates, and approximately 8/12 of its taxable income liability calculated under the TCJA 21% rate. In this way, ABC corporation is able to immediately benefit from the reduced income tax rate included in the TCJA.

The issue initially encountered in utilizing the proration rules is whether they even apply to the TCJA. There is nothing in the statutory language of the TCJA or the final Conference Committee report that indicates that Section 15 applies to the corporate tax rate change. If the provision does not apply, the reduced rate would not benefit a fiscal year taxpayer until day one of its first fiscal year beginning after December 31, 2017.

A Closer Look at the Tax Cuts and Jobs Act

In the example above, ABC Corporation would not enjoy the reduced rate of 21% until its new fiscal year begins on September 1, 2018, should Section 15 be found to not apply. Many commentators initially advocated the position that Section 15 does apply to the corporate tax rate, as the committee reports were silent on the issue

On April 16, 2018, the Internal Revenue Service issued Notice IR-2018-99, confirming that, "Due to a provision in the recently enacted Tax Cuts and Jobs Act (TCJA), a corporation with a fiscal year that includes Jan. 1, 2018 will pay federal income tax using a blended tax rate and not the flat 21 percent tax rate under the TCJA that would generally apply to taxable years beginning after Dec. 31, 2017." The Notice adds, "The blended rate applies to all fiscal year corporations whose fiscal year includes Jan. 1, 2018."

This Notice clarifies and confirms that the guidance in Section 15 applies, and that all fiscal-year corporations will enjoy a blended tax rate.

Dividends-Received Deduction

Prior to the TCJA, a corporation was allowed a deduction for dividends received from other taxable domestic corporations. The amount of the deduction was dependent upon the amount of stock that was held in the distributing corporation. The deduction was equal to 70% of the dividend received if the ownership in the entity was less than 20% of the total outstanding stock. For a dividend received from a 20% (or more) owned corporation, the amount of the deduction was equal to 80% of the dividend received. If the entity owned 100% of the corporation, the dividend received was totally exempt from federal income tax.

Under the new tax law, for tax years beginning after December 31, 2017, the 70% dividends-received deduction is reduced to 50%, and the 80% dividends-received deduction is reduced to 65%. The 100% deduction remains the same.

Alternative Minimum Tax for Corporations

The TCJA permanently repeals the alternative minimum tax (AMT) for corporations, for tax years beginning after December 31, 2017. The AMT is only applicable to individuals, estates, and trusts after 2017.

No tax has faced a more beleaguered history than the AMT. Essentially a parallel income tax system, the AMT was intended to provide a second tax calculation methodology that disallowed certain tax incentives and allowances permitted under the regular tax system. The overall intent of the AMT has been to ensure that all corporations with real economic income pay some level of income tax each year.

A Closer Look at the Tax Cuts and Jobs Act

Prior to the TCJA, the corporate AMT rate was 20%, with an exemption amount of up to $40,000 available to offset a corporation's Alternative Minimum Taxable Income (AMTI). Corporations with average gross receipts of less than $7.5 million for the preceding three tax years were exempt from the AMT under pre-TCJA tax law.

The repeal of the corporate AMT is a welcome change for many corporations. Beyond the generation of federal income tax revenue, the second parallel tax system added significant complexity to an already-complex "regular" tax system. The elimination of the AMT is one of the few areas of the new tax law that actually reduces complexity in the Internal Revenue Code.

The permanent repeal of the corporate AMT for years beginning after December 31, 2017 does not mean a total dismissal of AMT issues. As a result of certain prior-law AMT carryover rules, the corporate AMT will continue to be a part of certain taxpayers' tax calculations as they work to utilize certain AMT-related carryforwards in future years.

For tax years beginning after December 31, 2017, any unused minimum tax credit of a corporation from years beginning before January 1, 2018, may still be used to offset regular tax liability for any future tax year. Note, that there is no set number of years to which the minimum tax credit can be carried forward. As such, the carryforward period is indefinite.

Also, a portion of any unused minimum tax credit remains refundable for tax years 2018 through 2021. The refundable portion is 50% (100% in 2021) of any excess minimum tax for the year, over any credit allowable against regular tax for that year.

Business Interest Limitation

The TCJA, as enacted, adds a significant change to the traditional deduction for business interest. Prior to the new law, interest paid or accrued by a business was generally deductible in the computation of taxable income, subject to various limitations. For a taxpayer "other than a corporation," the deduction for interest on indebtedness that was allocable to property held for investment (investment interest) was limited to the taxpayer's net investment income for the tax year.

For tax years beginning after 2017, the deduction for business interest is limited to the sum of:

- the taxpayer's business interest income;
- the taxpayer's floor plan financing interest; and
- 30% of the taxpayer's adjusted taxable income for the year.

A Closer Look at the Tax Cuts and Jobs Act

As with many tax provisions, careful attention must be paid to definitions to fully comprehend the limitation:

- ***Business interest*** – any interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest.

  It is obvious from the definition that Congress intended the "interest expense" addressed in this provision to be that interest incurred in connection with the conduct of business operations of any particular trade or business.

- ***Business interest income*** – the amount of interest includible in the taxpayer's gross income for the tax year that is properly allocable to a trade or business. It does not include investment income.

  Hereto, the interest income is that generated from operating assets. It is assumed that certain interest might be generated from invested working capital, but beyond such a circumstance, it is unlikely that most businesses will have substantial business interest income, as the definition delineates it from investment income.

- ***Business interest floor plan financing interes****t* – interest paid or accrued on indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired.

Importantly, while the limitation would apply to most taxpayers, the TCJA provides an exception for small businesses. The business interest limitation does not apply to small businesses with average gross receipts of $25 million or less (adjusted for inflation).

A taxpayer meets the small business test for the tax year if its average annual gross receipts for the three tax years ending with the prior tax year do not exceed $25 million (adjusted for inflation after 2018). In the case of a taxpayer that is not a corporation or partnership, the gross receipts test is applied in the same manner as if the taxpayer were a corporation or partnership. The small business exception is not available to tax shelters.

Any business interest paid or properly accrued for any trade or business that is limited under this provision may be carried forward indefinitely. This carryforward is discussed in greater depth below.

Note, also, that the business interest limitation applies to both partnerships and S corporations. The deduction limitation is computed and applied at the pass-through business entity level, and the disallowed interest of the business entity is then allocated to each partner or shareholder as "excess business interest."

The obvious effect of the new rule is to limit the deduction of net interest expenses to 30% of the affected taxpayer's adjusted taxable income. In the first step of the computation, the deduction for business interest and floor plan financing interest is permitted to the full extent of business interest income and floor plan financing interest. The second step comes into play if the taxpayer has any interest expenses that exceed these amounts. In these cases, the deduction is limited to 30% of adjusted taxable income.

A Closer Look at the Tax Cuts and Jobs Act

For purposes of applying the business interest limitation, the taxpayer's adjusted taxable income is calculated by starting with taxable income determined for regular tax purposes and excluding the following items:

- any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- any business interest or business interest income;
- the amount of any net operating loss deduction;
- the 20% deduction for qualified business income of a pass-through; and
- for tax years beginning before January 1, 2022, any allowable deduction for depreciation, amortization or depletion.

The Internal Revenue Service is authorized to provide other adjustments to the computation of adjusted taxable income as it deems necessary to facilitate the intent of the provision.

Under the TCJA, for purposes of calculating the business interest deduction limitation, a trade or business does not include the performance of services as an employee. Therefore, wages of an employee are not included as part of the taxpayer's adjusted taxable income.

For taxpayers involved in a real property trade or business, there is an election available under the TCJA to be excluded from the limitation. An electing real property trade or business is any real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

The result of such an election is that interest expenses paid or accrued in an electing real property trade or business is not business interest subject to the limitation. The election is made at a time and manner as provided by the Internal Revenue Service. Once made, the election is irrevocable.

The amount of business interest not allowed as a deduction for the tax year under the new rules can be carried forward and treated as business interest paid or accrued in the succeeding tax year. The interest may be carried forward indefinitely, subject to certain restrictions for partnerships and S corporations.

As noted above, for partnerships or S corporations, the limitation on the deduction of business interest is applied at the entity level. Any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership or S corporation. While any business interest not deductible generally may be carried forward indefinitely to succeeding tax years, restrictions apply for these pass-through business entities.

A Closer Look at the Tax Cuts and Jobs Act

The adjusted taxable income of each partner or shareholder is determined without regard to the partner's or shareholder's distributive share of any item of income, gain, deduction or loss of the partnership or S corporation. This prevents double-counting of the same dollars used in the adjusted taxable income of the entity generating additional interest deductions passed through to those partners or shareholders.

In a case where the partnership or S corporation has excess taxable income for purposes of the deduction limit, then the excess is passed through to the partners or shareholders. The adjusted taxable income of each partner or shareholder is increased by the partner's or shareholder's distributive share of the entity's excess taxable income. A partner's or shareholder's distributive share of partnership excess taxable income is determined in the same manner as his or her distributive share of non-separately stated taxable income or loss of the entity.

The excess taxable income of a partnership or S corporation is a percentage of the entity's adjusted taxable income for the year, and is calculated as follows:

- 30% of the entity's adjusted taxable income, over its net excess business interest (the excess of business interest of the entity, reduced by floor plan financing interest, over business interest income); over
- 30% of the entity's adjusted taxable income.

The above-noted addition to a partner's or shareholder's adjusted taxable income is intended to allow the partners or shareholders to deduct more interest than they may have paid or incurred during the year, to the extent the entity, itself, could have deducted more business interest.

The disallowed interest of a partnership or S corporation is NOT carried forward to the succeeding tax year. Rather, the disallowed interest of the entity is treated as excess business interest that is allocated to each partner or shareholder in the same manner as any non-separately stated item of taxable income or loss.

Allocated excess business interest for the current tax year is treated by the partner or shareholder as business interest paid or accrued by the partner or shareholder in the next succeeding year. The allocated excess business interest is carried forward to the next succeeding tax year by the partner or shareholder, but only to the extent that he or she is allocated excess taxable income from the entity in the succeeding year. Excess taxable income allocated to a partner or shareholder for any tax year must be used against excess business interest from the entity from all tax years before it may be used against any other business interest.

Should a partner or shareholder find that he or she does not have enough excess taxable income from the entity to offset the carried forward excess business interest, the interest must continue to be carried forward to succeeding tax years. In all subsequent tax years, the excess business interest carried forward by the partner or shareholder is treated as paid or accrued in the next subsequent tax year and may only be used against excess taxable income allocated by the entity to the partner or shareholder for that tax year.

A Closer Look at the Tax Cuts and Jobs Act

The following example illustrates the mechanics behind the calculations for the business interest limitation in a partnership or other pass-through entity. Assume that P (a partnership) is owned equally by X Co. (a "regular" C corporation) and an individual. Further, assume that P generates $160,000 of net income during the tax year, which includes a $40,000 expense for interest paid or accrued on trade or business debt.

Initially, the overall limit must be calculated to determine if the interest expense exceeds 30% of the partnership's adjusted taxable income (before consideration of the interest expense deduction). As calculated under this limitation, P's "deductible" interest expense is $60,000 for the year [($160,000 + $40,000) x 30%]. Thus, P reports non-separately stated income for the tax year of $160,000 (taking the full amount of the interest expense).

The "excess" limitation amount for P is $20,000 ($60,000 – $40,000). P's "excess taxable income" is $66,667, which is computed by applying a fraction – the numerator of which is the excess limitation amount, and the denominator is the general limitation amount multiplied by P's adjusted taxable income [$20,000 / ($60,000 × $200,000)]. As X Co. is a 50% partner, its distributive share of P's excess taxable income is $33,333.

Note, that these calculations are performed at the business entity (partnership) level.

Turning to the partner level, X Co. has no taxable income from its other operations for the tax year, and it has paid or accrued $25 of business interest expense. Under the TCJA, X Co.'s "partner-level" adjusted taxable income for the year is computed without regard to the distributive share of the non-separately stated income of P.

X Co.'s deduction for its business interest expense of $25,000 (the non-P interest expense incurred in its trade or business operations) is limited to 30% of the sum of its adjusted taxable income (without inclusion of the pass-through income from P), plus its distributive share of the "excess" taxable income from the P partnership.

Thus, the amount of the $25,000 interest expense that is deductible is $10,000 [30% × ($0 + $33,333)]. As a result of the TCJA, X Co. may deduct $10,000 of its business interest and has an interest deduction disallowance of $15,000. The disallowed amount of $15,000 represents the amount of excess business interest at the partner level and is treated as an amount paid or accrued by X Co. in the following tax year.

Unfortunately, computations such as this one do nothing for simplifying the Internal Revenue Code. One must appreciate that the goal of generating some level of revenue from a tax bill designed to provide substantial tax cuts is a necessary part of the budget process. However, the stealthy manner in which provisions such as this find their way into the final bill is dismaying, as the added complexity (and associated cost) of taxpayer compliance can be stifling.

The Internal Revenue Service issued Notice 2018-28 on April 2, 2018, providing further explanation of the business interest limitation rules.

A Closer Look at the Tax Cuts and Jobs Act

Simplified Accounting Rules for Small Businesses

Under the TCJA, the cash method of accounting and other, simpler (and often, taxpayer-beneficial) accounting methods have been made available to more taxpayers. As a result, most taxpayers who meet a $25 million average annual gross receipts test (i.e., total gross receipts of $25 million or less) will be able to use the cash method of accounting. They will also not be required to apply the inventory or uniform capitalization (UNICAP) rules, nor will they be required to use the percentage of completion method for small construction contracts.

These changes are important, as they can be very beneficial for many businesses beginning in 2018. In many cases, the broadening allowance for use of the cash method of accounting will add an element of simplicity to businesses' recordkeeping and tax compliance. As always, careful planning and consideration is required to determine if any tax savings and/or other economic benefits might result from a change to the cash basis accounting method.

The combined effect of the changes made under the TCJA will be to replace a number of different gross receipts tests (for determining who qualifies as a small taxpayer) with a single gross receipts test that utilizes the new $25 million threshold. In nearly all cases under the new law, the $25 million threshold is a significant increase from the prior thresholds, which ranged from $1 million to $25 million. The changes not only increase the number of businesses that will qualify as a small businesses, but also greatly simplify the gross receipts determinations, which will expand the qualifications for businesses to use the cash basis of accounting.

Cash Method of Accounting

The ability to use the cash method of accounting for small businesses is expanded for tax years beginning after December 31, 2017. Under the new definition, a "small business" is a business that meets the gross receipts test (i.e., average gross receipts of $25 million or less). The average annual gross receipts amount of $25 million is adjusted for inflation for tax years beginning after December 31, 2018.

A Closer Look at the Tax Cuts and Jobs Act

The steps for calculating the gross receipts are:

- determine gross receipts for each year in the three-tax-year period;
- compute the average annual gross receipts for the three-tax-year period; and, finally,
- determine if the average annual gross receipts for the three-tax-year period are $25 million or less (to be adjusted for inflation for tax years beginning after 2018).

By way of example, ABC Corporation wants to determine if it can use the cash method of accounting under the expanded gross receipts test for the 2018 tax year. For the three tax years ending with the 2017 tax year, the corporation had gross receipts of $15 million, $30 million and $24 million (tax years 2015, 2016 and 2017, respectively). Its average annual gross receipts for the three-tax-year period are $23 million. As such, ABC Corporation meets the gross receipts test for 2018, and can use the cash method of accounting.

In order to properly make a change in accounting method under these new rules, the taxpayer will prepare and file Form 3115, *Application for Change in Accounting Method*. The taxpayer should always follow the Internal Revenue Service instructions (and procedures) when applying for a change in accounting method.

Accounting for Inventories

Prior to the TCJA, businesses were required to account for inventories using an allowable inventory method, and were required to use the accrual method of accounting. However, the cash method was permitted for certain small businesses that met the gross receipts test and had average gross receipts of not more than $1 million ($10 million for businesses operating in certain defined industries). Under prior law, these businesses accounted for inventory as non-incidental materials and supplies. This method allowed the business to deduct the costs of incidental materials and supplies in any taxable year in which those items were first used in the business's operations or were consumed in the business's operations.

Under the TCJA, for tax years beginning after December 31, 2017, a business is not required to use inventories if it meets the $25 million gross receipts test.

A business that meets this test can use a method of accounting for inventory that:

- treats inventory as non-incidental materials and supplies; or
- conforms to the business's financial accounting treatment of inventories.

A Closer Look at the Tax Cuts and Jobs Act

A business's financial accounting treatment of inventories is the method of accounting reflected in an applicable financial statement or, if the business does not have an applicable financial statement, in the business's books and records as prepared in accordance with its accounting procedures.

A taxpayer making a change in accounting method under the exception to the required use of inventories for small businesses should treat the change as initiated by the taxpayer and made with the Internal Revenue Service's consent for purposes of any adjustment on the filing of Form 3115, *Application for Change in Accounting Method*.

Capitalization and Inclusion of Certain Expenses in Inventory Costs

Under prior law, many business entities that held inventory were required to comply with the Uniform Capitalization (UNICAP) rules, which have been part of the income tax law since the passage of the Tax Reform Act of 1986. These rules generally required certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in inventory or capitalized into the basis of such property.

Often referenced as the "super-capitalization" rules, the thrust of the UNICAP rules was to defer the deduction of certain statutorily defined period expenses by adding them to the cost of a taxpayer's inventory or tangible assets when incurred. In that way, the deduction of those capitalized costs was deferred until the inventory was sold, or the asset's cost was recovered through tax depreciation deductions.

These rules are very complex, and absolute compliance is difficult. In many situations, taxpayers and the Internal Revenue Service are unable to agree as to the proper interpretation of the law and its underlying Treasury regulations, and many larger cases (upon audit) have resulted in going Appeals or Court for relief.

The TCJA includes relief from these rules for certain smaller taxpayers. For these taxpayers, the UNICAP rules have been eliminated for tax years beginning after December 31, 2017. Under the new law, a taxpayer is not required to apply the UNICAP rules for any tax year if it meets the $25 million gross receipts test. In addition, the expanded exception to these rules applies to any producer or reseller, other than a tax shelter.

This provision is a welcome and, potentially, very beneficial change for small businesses that qualify for this exception. It may also produce a sizable tax deduction for small businesses in tax year 2018, to the extent that prior year amounts included in inventory or other assets are recovered as deductible expenses.

A taxpayer that qualifies for this exception will need to apply for a change in accounting method using the normal procedures applicable to such changes. It is expected that new regulations will be issued to provide details to qualifying taxpayers who will be making this change.

A Closer Look at the Tax Cuts and Jobs Act

Changes to Bonus Depreciation Rules

Temporary 100% Cost Recovery of Qualifying Business Assets

Special accelerated tax depreciation and cost recovery allowances have long been part of the Internal Revenue Code, with the intended motivation being to encourage capital investment in new machinery and equipment, which is perceived by Congress to create new jobs.

Before passage of the TCJA, an additional first-year bonus depreciation deduction was allowed for 50% of the adjusted basis of qualified property, the original use of which had to begin with the taxpayer (meaning the property had to be "new"), as long as the property was placed in service before January 1, 2020 (January 1, 2021, for certain property with a longer production period). The 50% allowance was originally scheduled to be phased down for property placed in service after December 31, 2017 (after December 31, 2018, for certain property with a longer production period).

Effective with the enactment of the TCJA, the bonus depreciation rate is increased to 100% for property acquired and placed in service after September 27, 2017, and before January 1, 2023. The rate of bonus depreciation will phase down thereafter.

Interestingly, the TCJA eliminates the previous requirement that only new property is eligible for bonus depreciation. The implications of this change are very broad. For example, by statute, it appears as though the entire cost of eligible depreciable property acquired in a business acquisition through a purchase of assets or through an acquisition of the units of an LLC or partnership interests of an entity taxed as a partnership, would be permitted to be expensed in a single year.

This change could cause a very different determination of investment return for an investor who is acquiring an operating entity. The end result is the ability to immediately expense that portion of the purchase price that is allocated to short-term assets (i.e., the manufacturing equipment). This could be a material factor in determining the ultimate purchase price. This change is significant and should be carefully considered for all transactions and tax years beginning after December 31, 2017.

It is important to understand that not all property will be eligible for bonus depreciation, and there are some special rules related to certain industries. Care should be taken to ensure that one understands the special rules and special assets that are either excluded from the statute or specifically allowed under the law. If you do have specific questions, please contact your GYF executive.

A Closer Look at the Tax Cuts and Jobs Act

In general, the bonus depreciation percentage rates under the TCJA (by tax year) are as follows:

- 100% for property placed in service after September 27, 2017, and before January 1, 2023;
- 80% for property placed in service after December 31, 2022, and before January 1, 2024;
- 60% for property placed in service after December 31, 2023, and before January 1, 2025;
- 40% for property placed in service after December 31, 2024, and before January 1, 2026;
- 20% for property placed in service after December 31, 2025, and before January 1, 2027;
- 0% (bonus expires) for property placed in service after December 31, 2026.

For tax years beginning after December 31, 2017, taxpayers may elect to apply the 50% rate (instead of the 100% rate) for qualified property placed in service during the taxpayer's first tax year ending after September 27, 2017. The TCJA dictates that the time and manner of making the election will be provided by the Internal Revenue Service.

It is also important to understand that a taxpayer is permitted to make an election to bypass the use of bonus depreciation. In some situations, this may be beneficial, depending upon the specific situation and the facts and circumstances of the taxpayer. While not commonly used, this election can be an important tax planning strategy in the right circumstance and should always be considered.

Recovery Period for Real Property Shortened

In an important change, effective for property placed in service after December 31, 2017, "qualified improvement property" is removed as a specifically named category of property eligible for bonus depreciation.

Under prior law, such eligibility as qualified improvement property as a separate category of property eligible for bonus depreciation was necessary because some types of improvements that met the definition of qualified improvement property had a recovery period of 39 years. Thus, this 39-year qualified improvement property would not have been eligible for bonus depreciation without the separate category (bonus depreciation generally only applied to property with an MACRS recovery period of 20 years or less).

The TCJA, however, provides a standard 15-year recovery period for all qualified improvement property placed in service after December 31, 2017. This means that qualified improvement property will be eligible for bonus depreciation because it has a recovery period of 20 years or less. This is a significant and important change for taxpayers.

A Closer Look at the Tax Cuts and Jobs Act

Special Bonus Depreciation Rules for Businesses that Have Floor Plan Financing

The TCJA has placed limitations on the use of bonus depreciation for any trade or business that has floor plan financing, and such interest on the floor plan indebtedness is excluded from the limitations on interest expense under the new law. As noted earlier, businesses with floor plan interest are permitted a full tax deduction for the interest incurred on the indebtedness. As a trade-off, these businesses are not permitted to use bonus depreciation, and must depreciate their capital expenditures under the normal ("non-bonus") rules.

Used Property Acquired for Use in a Trade or Business

Property acquired and placed in service after September 27, 2017, which was previously used by an unrelated person, can now qualify for bonus depreciation if the property meets certain "acquisition requirements."

These acquisition requirements are met if:

- the taxpayer did not use the property at any time before acquiring it; and
- the taxpayer acquired the property by "purchase."

Any acquisition is considered a purchase unless the property:

- is acquired from a person whose relationship to the taxpayer would bar recognition of a loss in any transaction between them (with the taxpayer's family limited to spouse, ancestors and lineal descendants);
- is acquired by one member of a controlled group of corporations from another member (substituting 50% for the 80% that would otherwise apply with respect to stock ownership requirements);
- has a basis in the hands of the acquiring taxpayer determined, in whole or in part, by reference to the adjusted basis of the person from whom the property was acquired (e.g., a gift); or,
- has a basis determined relating to inherited or bequested property.

As noted earlier, this change can be significant, especially in situations where an entire business is acquired.

Effective Date of Bonus Depreciation Provisions

Note, that the effective date of the bonus depreciation provision is for property placed in service after September 27, 2017. This is one of the very few provisions that have any specific applicability to tax years ended on December 31, 2017, or later. Taxpayers should keep in mind that the TCJA can prove beneficial if they purchased new or used assets during the period September 28th through December 31st. In these cases, and if the assets were placed in service, the total cost can be expensed in 2017.

A Closer Look at the Tax Cuts and Jobs Act

Expensing of Depreciable Assets (IRC Section 179)

A taxpayer may (subject to limitations) elect under Code Section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions. Prior to the TCJA, the maximum amount a taxpayer could expense was $500,000 of the cost of qualifying property placed in service for any tax year. The $500,000 amount was reduced on a dollar-for-dollar basis (but not below zero) by the amount by which the cost of qualifying property placed in service during the tax year exceeded $2 million. These amounts were indexed for inflation.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. It includes off-the-shelf computer software as well as qualified real property (i.e., qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property).

Under the TCJA, the Section 179 dollar limitation is increased to $1 million, and the investment limitation is increased to $2.5 million for tax years beginning after December 31, 2017. These increases are permanent and will be inflation-adjusted for tax years beginning after 2018.

Additionally, the definition of "qualified real property" eligible for expensing is expanded to include improvements to the interior of any nonresidential real property (qualified improvement property), as well as roof components, heating, ventilation and air-conditioning property, fire protection and alarm systems, and security systems installed on such property.

The exclusion from expensing for tangible personal property used in connection with lodging facilities (such as residential rental property) is eliminated. The $25,000 Section 179 expensing limit on certain heavy vehicles is scheduled to be inflation-adjusted after 2018.

As under prior law, a taxpayer must elect to treat qualified real property as Section 179 property. If the election is made, and the total cost of all Section 179 property (including qualified real property exceeds the investment limitation, the dollar limitation is subject to reduction on a dollar-for-dollar basis.

By definition, "qualified improvement property" is an improvement to an "interior portion" of a building that is nonresidential real property, provided the improvement is placed in service after the date that the building was first placed in service. However, improvements related to the enlargement of the building, an elevator or escalator, or the internal structural framework of the building are not qualified improvements.

In April 2018, the Internal Revenue Service issued FS-2018-9, explaining the bonus depreciation and Section 179 expensing rules.

A Closer Look at the Tax Cuts and Jobs Act

Net Operating Losses (NOLs)

Historically, a net operating loss (NOL) was permitted to be carried back two years and carried forward 20 years to offset taxable income in such years. Different carryback periods were applied with respect to NOLs arising in varying circumstances. For example, extended carryback periods were allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses.

Two important changes to the NOL rules will be far-reaching. With the enactment of the TCJA, NOLs arising in a tax year ending after December 31, 2017 are no longer allowed to be carried back (with very limited exceptions for NOLs attributable to farm losses and certain insurance companies) and are permitted only to be carried forward. The 20-year limitation on carryforwards is repealed, and NOLs may now be carried forward indefinitely.

The other substantive change relates to how much income in any future year may be offset by a NOL. Under the new law, a NOL arising in a tax year beginning after December 31, 2017, may only reduce 80% of taxable income in any remaining carryback or carryforward tax year (versus 100% under prior law).

The effective date provides that the provision limiting a NOL deduction to 80% of taxable income is effective for NOLs arising in tax years ***beginning*** after 2017. The effective date eliminating the two-year carryback period is for NOLs arising in tax years ***ending*** after 2017.

This difference is important to 2017/2018 fiscal-year taxpayers. A NOL arising in the 2017/2018 fiscal year may not be carried back two years, since it arose in a tax year ending after 2017. However, the same NOL is not subject to the 80%-of-taxable-income limitation, since the NOL did not arise in a tax year beginning after 2017.

Effective for NOLs that arise in tax years beginning after December 31, 2017, the NOL deduction for a future tax year is limited to the lesser of:

- the aggregate of NOL carryovers (i.e., carryforwards) to the tax year, plus NOL carrybacks to the tax year; or
- 80% of taxable income computed for the tax year, without regard to the NOL deduction allowed for the tax year.

Importantly, since the 80%-of-taxable-income limit applies to losses arising in tax years beginning after December 31, 2017, NOL carrybacks and carryforwards attributable to losses that arise in tax years beginning before January 1, 2018, are not subject to the 80% limitation.

A Closer Look at the Tax Cuts and Jobs Act

In determining the portion of a NOL that arose in a tax year beginning after 2017, and which remains available for carryback or carryforward, the new 80%-of-taxable-income limitation applies. Consequently, the portion of such a NOL that remains available for carryback or carryforward to another tax year is the excess (if any) of the amount of the loss, over the sum of 80% of the taxable income for each of the tax years to which the loss was previously applied.

It is important for taxpayers to consider their options with respect to tax year 2017. Any loss that is incurred in 2017 will not be limited under the 80% rule if any portion of that remaining loss is carried forward. As a result, it may make sense for a taxpayer to increase the amount of the 2017 NOL (as permitted under the law) to take into account the fact that the loss (as carried forward) will not be limited to the 80%-of-taxable-income rule in the future. In the right circumstance, proper planning for the situation could result in favorable short-term tax benefits.

Domestic Production Activities Deduction (Code Section 199)

The domestic production activities deduction (DPAD) under Internal Revenue Code Section 199 is repealed for tax years beginning after 2017.

Under prior law, the DPAD, which was allowed for certain qualifying U.S.-based activities, was equal to 9% of the lesser of the taxpayer's qualified production activities income (QPAI) or the taxpayer's taxable income (determined without regard to the DPAD) for the tax year. A taxpayer's QPAI is its domestic production gross receipts (DPGR), reduced by allocable cost of goods sold and other deductions, expenses and losses.

This 9% tax deduction was introduced into tax law to provide additional tax benefits to U.S. manufacturers, and to reduce the perceived disadvantages such businesses had in competing around the world. This deduction was directly tied to the fact that the U.S. federal income tax rate of 35% was near the highest in the industrialized world. Since the federal income tax rate was reduced to 21% under the TCJA, this provision is no longer needed.

Employer's Deduction for Entertainment, Commuting Benefits and Meals

Prior to the TCJA, a taxpayer was permitted to deduct up to 50% of expenses relating to meals and entertainment costs. Housing and meals provided for the convenience of the employer on the business premises of the employer were excluded from the employee's gross income, and various other fringe benefits provided by employers (such as qualified transportation fringe benefits and other benefits) were not included in an employee's gross income.

Under the new TCJA rules, most entertainment costs incurred and commuting benefits provided after 2017, as well as certain employer-provided meal costs, are no longer deductible.

A Closer Look at the Tax Cuts and Jobs Act

As a result, most entertainment expenses (including expenses for a facility used in connection with entertainment) that are paid or incurred after 2017, generally are not tax deductible. In addition, most employers cannot deduct expenses paid or incurred after December 31, 2017, for any qualified transportation fringe benefit (van pools, transit passes, qualified parking, and bicycle commuting).

There is always some confusion about which meals are deductible, and to what extent are they deductible. First, it is important to note, that the effective date of the changes applicable to the repeal is effective for amounts paid or incurred after December 31, 2025. Additionally, there are only two circumstances where the rules repealing a deduction for meals are applicable.

The first situation relates to meals that are excludable from an employee's income because they are provided to employees (and their spouses and dependents) for the employer's convenience, and on the employer's business premises (i.e., "the convenience of employer rule"). The second instance relates to food, beverage and facility expenses for meals that are de minimis fringe benefits (and are, therefore, excludible from the employee's compensation and taxable income).

Thus, an employer may still continue to deduct 50% of its expenses for food, beverages and related facilities that are furnished on its business premises. Moreover, those meals provided in conjunction with entertaining clients will remain 50% deductible, as will employee travel meals. Business and holiday parties also remain 100% deductible. However, client entertainment expenses, including costs incurred for sporting events, are no longer deductible.

Employers cannot deduct expenses paid or incurred after 2017 for providing any transportation, payment or reimbursement to an employee in connection with travel between the employee's residence and place of employment, except as necessary to ensure the employee's safety.

The TCJA's elimination of meals and entertainment deductions can have material tax consequences for certain businesses. Taxpayers should take great care to ensure that they understand the rules in this area so they know what is, and what is not, limited under the new rules.

Research and Experimentation Expenses

A highly regarded activity related to future economic growth and job creation centers on the creation of new and ever-improving technology. Recognized by Congress as integral to the well-being of the economy, incentives for research and experimentation expenditures have long been part of the Internal Revenue Code.

A Closer Look at the Tax Cuts and Jobs Act

While the TCJA maintains a deduction for expenditures incurred in these activities, the expensing alternatives are not as lucrative as under prior law. Before passage of the TCJA, a taxpayer was permitted to use one of three alternative methods to account for research and experimental expenditures:

1. currently deduct the expenditures in the year in which they are paid or incurred;
2. elect to treat the expenditures as deferred expenses, amortizable over a period of at least 60 months, beginning in the month that benefits are first realized from the expenditures; or
3. elect to amortize the expenditures over 10 years, beginning in the tax year in which they are paid or incurred.

If none of these options were used by the taxpayer, they were generally required to capitalize the expenditures.

The TCJA effectively eliminates the "current" deduction alternative for research and experimentation expenses incurred after 2021. In addition, the rule allowing taxpayers to elect an amortization period of 60 months or more, beginning when benefits are first realized, is eliminated after 2021. As such, only the rule allowing a taxpayer to elect 10-year amortization of research and experimental expenditures, beginning in the year the expenditures are paid or incurred, remains available after 2021.

Amounts paid or incurred for specified research or experimental expenditures after December 31, 2021, attributable to foreign research, must be amortized ratably over 15 years. Note, however, that there is no restriction on the deduction of research or experimental expenditures attributable to foreign research if paid or accrued before 2022.

Research and experimental expenditures are well addressed within the statutes, regulations and case law, and must be given careful consideration in their classification and treatment for federal income tax purposes.

Employee Achievement Awards

Generally, employers may take a tax deduction for the cost of achievement awards given to employees for length of service or safety achievement (subject to certain limitations). Under prior law, a maximum $400 deduction limit applied on the amount an employer was permitted to deduct with respect to all "non-qualified" employee achievement plan awards provided to the same employe. In the case of one or more "qualified" plan awards made to a single employee, the employer's deduction limitation could not exceed $1,600.

Work-related prizes and awards are generally excluded from a recipient employee's income if they qualify as an employee achievement award. To qualify as a tax deduction under prior law, the award had to be an item of tangible property and could not be a cash or cash-equivalent award, such as a gift card.

A Closer Look at the Tax Cuts and Jobs Act

The TCJA clarifies the prior-law rules by prohibiting all non-tangible property in an employee award and amends the definition of "tangible personal property," for purposes of what is deductible as an employee achievement award, to exclude the following: cash, cash equivalents, gift cards, gift coupons and gift certificates (except an arrangement giving an employee the limited right to select and receive tangible personal property from a limited number of pre-selected or pre-approved items). The term *tangible personal property* also excludes vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities and other similar items.

Business Credits

Employer Credit for Paid Family and Medical Leave

Prior to the TCJA, no credit was available to employers in consideration of compensation paid to employees while on family or medical leave. The TCJA adds a provision allowing eligible employers to claim a credit for paid family and medical leave.

The new credit is equal to 12.5% of wages paid to qualifying employees during any period in which such employees are on leave under the Family and Medical Leave Act of 1993 (FMLA), provided that the rate of payment is at least 50% of the wages normally paid to the employee.

The FMLA credit is part of the general business credit available to companies and is only available for wages paid in tax years beginning after December 31, 2017 and before January 1, 2020. The credit is also permitted as a credit against the AMT, if applicable.

The FMLA requires an employer with 50 or more employees (within a 75 mile radius) to give eligible employees 12 weeks of "unpaid" leave for births, adoptions and family illnesses. An employer is required to provide coverage for: (a) the birth of a child; (b) the placement of a child with the employee for adoption or foster care; (c) the need to care for a seriously ill child, spouse or parent; and (d) an employee's own serious illness.

An employer may require that a request for leave be supported by certification issued by the health care provider for the applicable party. Spouses who are employed by the same employer may be limited to an aggregate of 12 weeks if leave is sought for a birth, adoption or to care for an ill parent.

In order to be eligible, an employee must have worked at least one year for the employer providing coverage. During that period, the employee must have worked at least 1,250 hours. Generally, an employer is entitled to a 30-day advance notice of an employee's intent to take leave if the leave is "foreseeable," such as for the birth or adoption of a child. However, the 30-day requirement is relaxed for unforeseen circumstances (e.g., a premature birth or a sudden change in medical condition).

A Closer Look at the Tax Cuts and Jobs Act

Under the TCJA, the FMLA credit is only available with respect to wages paid in tax years beginning in 2018. Wages incurred, but not paid, in a tax year beginning in 2018 do not qualify for the credit. In addition, the credit terminates after 2019 and, therefore, may not be claimed on wages paid in tax years beginning after 2019.

The FMLA credit allowed with respect to any employee, for any tax year, is not to exceed an amount equal to the product of:

- the normal hourly wage rate of the employee for each hour (or fraction thereof) of actual services performed for the employer; and
- the number of hours (or fraction thereof) for which the leave under FMLA is taken.

If an employee is not paid an hourly wage rate, the wages of such an employee should be prorated to an hourly wage rate in accordance with regulations established by the Internal Revenue Service. The maximum amount of leave subject to the credit for any employee, for any tax year, may not exceed 12 weeks.

An employer may elect not to claim the FMLA credit. The election can be made at any time before the expiration of the three-year period beginning on the last day for filing the tax return for the year of the election (without regard to extensions). The election is made in the manner prescribed by regulations issued by the Treasury.

Rehabilitation Credit

The Rehabilitation Credit available under prior law was a 20% credit provided for qualified rehabilitation expenditures (QREs) with respect to a certified historic structure (i.e., any building that is listed in the National Register) or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10% credit was provided for QREs with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. A building was treated as having met the substantial rehabilitation requirement under the 10% credit, only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the tax year, exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

Straight-line depreciation or the alternative depreciation system (ADS) method was required to be used in order for rehabilitation expenditures to be treated as qualified for the credit.

A Closer Look at the Tax Cuts and Jobs Act

Under the TCJA, the 20% credit for QREs, with respect to certified historic structures, is now claimed ratably over a five-year period. In addition, the 10% credit for QREs, with respect to non-historic structures first placed in service before 1936, is repealed.

The Rehabilitation Credit is limited to 20% of QREs of the taxpayer for qualified rehabilitated buildings, and is claimed ratably over a five-year period beginning in the tax year in which the rehabilitated building is placed in service. The definition of a "qualified rehabilitated building" remains a building and its structural components for which depreciation is allowable and that has been substantially rehabilitated and placed in service before the beginning of the rehabilitation. However, the building must be a certified historic structure, but any expenditure attributable to rehabilitation of the structure is not a QRE unless it is a certified rehabilitation.

Like-Kind Exchange Treatment Limited

Under prior law, the Like-Kind Exchange rules provided that no gain or loss would be recognized to the extent that property (which included a wide range of property, from real estate to tangible personal property) held for productive use in the taxpayer's trade or business, or property held for investment purposes, is exchanged for property of a like-kind (a "Section 1231 exchange") that was also held for productive use in a trade or business or for investment.

Effective for transfers after December 31, 2017, the TCJA modifies the rule allowing the deferral of gain on like-kind exchanges to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. However, under a transition rule, the pre-TCJA like-kind exchange rules apply to exchanges of personal property, if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

A Closer Look at the Tax Cuts and Jobs Act

V. Impact on International Taxation

Significant focus has been given to the antiquated U.S. tax code as it applies to companies conducting business outside the borders of the country. While certain domestic business tax provisions, including the much-anticipated marginal rate reduction to 21%, go far in addressing the competitive disadvantages of the United States in the international tax arena, additional emphasis was needed in this area. A number of new, international-specific provisions added by the TCJA work to move the country forward in creating a positive business environment from which to conduct worldwide operations.

Changing from a Worldwide Tax Regime to a Territorial Tax Regime

The United States is one of the very few industrialized countries with a worldwide system of taxation and, historically, has had the highest statutory corporate tax rates among countries that are members of the Organization for Economic Cooperation and Development (OECD). The worldwide system of taxation, combined with the high tax rates, has not only discouraged business activities within our borders, but also has actually encouraged companies to keep foreign earnings offshore because, under the prior law, such earnings were not taxed until repatriated to the United States.

100% Foreign Dividend Participation Exemption

In order to encourage a U.S. Corporation to begin shifting profits back to the United States, the TCJA includes a 100% foreign dividend participation exemption, which is available to offset the inclusion of foreign earnings on a U.S. tax return. The idea behind the provision is simply to incentivize multi-national corporations to either keep their worldwide operations within the borders of the United States or, alternatively, not subject their foreign-subsidiary earnings to U.S. taxation. For income previously earned in a foreign jurisdiction, the U.S. government is requiring an automatic inclusion (with a reduced rate of tax) into a corporation's domestic gross income.

A 100% deduction is now allowed for the "foreign-source portion" of dividends received from a "specified 10%-owned foreign corporation" by a domestic corporation that is a U.S. shareholder of the foreign corporation.

Under this new rule, a *specified 10%-owned foreign corporation* is any foreign corporation with respect to which any domestic corporation is a U.S. shareholder. The *foreign-source portion* of any dividend from a specified 10%-owned foreign corporation is the amount that bears the same ratio to the dividend as (1) the undistributed foreign earnings of the specified 10%-owned foreign corporation bears to (2) the total "undistributed earnings"

A Closer Look at the Tax Cuts and Jobs Act

of that corporation. *Undistributed earnings* are the earnings and profits of a specified 10%-owned foreign corporation, as of the close of the tax year of the specified 10%-owned foreign corporation in which the dividend is distributed, that are not reduced by dividends distributed during that tax year.

Additionally, no foreign tax credit or deduction is allowed for any taxes paid or accrued (or treated as paid or accrued) with respect to a dividend that qualifies for the 100% participation exemption deduction. For purposes of computing the foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10%-owned foreign corporation must compute its foreign-source taxable income (and entire taxable income) by disregarding (1) the foreign-source portion of any dividend received from that foreign corporation for which a participation deduction is allowed, and (2) any deductions properly allocable or apportioned to that foreign-source portion or the stock with respect to which it is paid.

Furthermore, a domestic corporation is not permitted a participation deduction for any dividend on any share of stock that is held by the domestic corporation for 365 days or fewer during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.

Transition Tax

A transition tax is now imposed on accumulated foreign earnings, without requiring an actual distribution, upon the transition to the new participation exemption system. Under the transition rule, for the last tax year beginning before January 1, 2018, any U.S. shareholder of any controlled foreign corporation (or other foreign corporation that is at least 10%-owned by a domestic corporation) must include in income its pro rata share of the accumulated post-1986 foreign earnings of the corporation as of November 2, 2017 or December 31, 2017, whichever amount is greater.

A portion of the mandatory income inclusion is deductible. The deduction amount depends upon whether the deferred earnings are held in cash or other assets. The deduction results in a reduced rate of tax of 15.5% for the included deferred foreign income held in liquid form and 8% for the remaining deferred foreign income. A corresponding portion of the foreign tax credit is disallowed. To ease the cash flow burden that this tax invokes, the transition tax can be paid in installments over an eight-year period.

With respect to any U.S. shareholder, the aggregate foreign cash position is the greater of:

1. the aggregate of the U.S. shareholder's pro rata share of the cash position of each specified foreign corporation of the U.S. shareholder, determined as of the close of the last tax year of the specified foreign corporation that begins before January 1, 2018; or

2. one half of the sum of:
   (a) the aggregate described in item (1), above, determined as of the close of the last tax year of each specified foreign corporation that ends before November 2, 2017, plus
   (b) the aggregate described in item (1), above, determined as of the close of the tax year of each specified foreign corporation that precedes the tax year referred to in item (a)

The cash position of any specified foreign corporation is the sum of:

1. cash held by the foreign corporation, plus
2. the net accounts receivable of the foreign corporation (the excess, if any) of the corporation's accounts receivable over its accounts payable, determined under Code Sec. 461, plus
3. the fair market value of the following assets held by the corporation:
   (a) actively traded personal property for which there is an established financial market
   (b) commercial paper, certificates of deposit, the securities of the Federal government and of any State or foreign government
   (c) any foreign currency
   (d) any obligation with a term of less than one year
   (e) any asset that the Secretary identifies as being economically equivalent to the assets described above

No foreign tax credit or deduction is allowed for a portion of any foreign income taxes paid or accrued with respect to any mandatory inclusion amount for which a deduction is allowed under the above rules. The disallowed portion of the foreign tax credit is 55.7% of foreign taxes paid attributable to the portion of the inclusion amount attributable to the U.S. shareholder's aggregate foreign cash position, plus 77.1% of foreign taxes paid attributable to the remaining portion of the mandatory inclusion amount.

Electing to Pay Net Tax Liability from Deferred Foreign Income in Installments

A U.S. shareholder of a deferred foreign income corporation may elect to pay the net tax liability resulting from the mandatory inclusion of deferred foreign income in eight installments. If installment payment is elected, the payments for each of the first five years equal 8% of the net tax liability. The amount of the sixth installment is 15% of the net tax liability, increasing to 20% for the seventh installment and 25% for the eighth installment.

A Closer Look at the Tax Cuts and Jobs Act

The first installment must be paid on the due date (determined without regard to extensions) of the tax return for the last tax year that begins before January 1, 2018 (the tax year of the mandatory inclusion). Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding tax year.

An election to pay the net tax liability from the mandatory inclusion in installments must be made by the due date of the tax return for the last tax year that begins before January 1, 2018 (the tax year in which the pre-effective-date undistributed earnings are included in income under the transition rule). The Treasury Secretary has authority to prescribe the manner of making the election.

The net tax liability that may be paid in installments is the excess of (i) the U.S. shareholder's net income tax for the tax year in which an amount is included in income under the mandatory inclusion rules, over (ii) the taxpayer's net income tax for that year determined without regard to the mandatory inclusion and any income or deduction properly attributable to a dividend received by the U.S. shareholder from any deferred foreign income corporation. The net income tax is the regular tax liability reduced by the general business credit.

Acceleration of Payment of Installments Due

If any of the following circumstances arise, the unpaid portion of all remaining installments is due on the date of the event (or, in a bankruptcy proceeding or similar case, the day before the petition is filed):

- there is an addition to tax for failure to pay timely any required installment of the transition tax,
- there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case),
- the U.S. shareholder ceases business, or
- another similar circumstance arises.

This acceleration rule does not apply to the sale of substantially all the assets of the U.S. shareholder to a buyer if the buyer enters into an agreement with the Secretary under which the buyer is liable for the remaining installments due in the same manner as if the buyer were the U.S. shareholder.

Deficiency Found in Installment Payments

If an election is made to pay the net tax liability from the mandatory inclusion in installments, and a deficiency is later determined with respect to that net tax liability, the additional tax due is prorated among the installment payments. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment. However, these rules do not apply if the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax.

Base Erosion

Foreign corporations are subject to tax in the United States on their U.S.-source income. There are two systems in place to tax this income. Regular tax rates apply to income that is *effectively connected* with a U.S. trade or business ("effectively connected income" or "ECI"), and a 30% tax rate applies to non-effectively connected income ("fixed or determinable annual or periodical gains, profits and income" or "FDAP income"). FDAP income is subject to withholding at the source, and the 30% tax rate may be reduced by an applicable income tax treaty. ECI is subject to rules similar to those that apply to the business income of U.S. persons. Deductions are available to reduce the amount of ECI that is subject to tax in the United States. As a result, foreign-owned U.S. subsidiaries are able to reduce their U.S. tax liabilities through deductible payments of interest, royalties, management fees and reinsurance to related foreign parties. These payments are thought to erode the U.S. tax base if they are subject to reduced or zero rates of tax withholding in the United States.

Reporting Requirements

There are also enhanced reporting requirements for domestic corporations with foreign ownership to track the U.S.-sourced income amongst related-parties. A domestic corporation that is 25% foreign-owned must provide certain required information to the IRS on Form 5472, *Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Busines*s. A corporation required to file Form 5472 must also maintain records necessary to determine the correct treatment of transactions with related parties.

A corporation is "25% foreign-owned" if 25% or more of the total voting power or value of its stock is owned by at least one foreign person at any time during the tax year. A related party is: (1) any 25% foreign shareholder of the domestic reporting corporation, (2) any person related to the reporting corporation or to a 25% foreign shareholder of the reporting corporation, or (3) any other person related to the reporting corporation.

New reporting requirements will require the collection of information regarding a taxpayer's base erosion payments, and the applicable penalty for failure to report is increased.

Calculation of Base Erosion Tax Payments

Applicable taxpayers, which include corporations other than a regulated investment company (RIC), a real estate investment trust (REIT) or an S corporation, that have average annual gross receipts of at least $500

A Closer Look at the Tax Cuts and Jobs Act

million over the past three tax years and a base erosion percentage of 3% or higher for the tax year (2% for taxpayers that are members of an affiliated group that includes a bank or registered securities dealer), are required to pay tax equal to the "base erosion minimum tax amount" for the tax year.

The *base erosion minimum tax amount* is generally derived by comparing 10% (5% for tax years beginning in calendar year 2018) of the taxpayer's modified taxable income to the taxpayer's regular tax liability. For tax years beginning after December 31, 2025, the 10% rate is increased to 12.5%, and the taxpayer's regular tax liability is reduced by the aggregate amount of allowable credits. An 11% rate and 2% base erosion percentage apply to taxpayers that are members of an affiliated group that includes a bank or registered securities dealer.

A "base erosion payment" is any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and, with respect to which a deduction is allowable. These payments include any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation. A base erosion payment also includes any premium or other consideration paid or accrued by the taxpayer to a foreign person that is a related party of the taxpayer for any reinsurance payments. A base erosion payment does not include any amount paid or accrued by a taxpayer for services, if such services meet the requirements for eligibility for use of the services cost method determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure, and if the payments for services have no markup component.

A base erosion tax benefit includes:

1. any deduction allowed under IRC Chapter 1 for the tax year with respect to any base erosion payment;
2. for base erosion payments made to purchase property subject to depreciation (or amortization in lieu of depreciation), any deduction allowed in IRC Chapter 1 for depreciation (or amortization in lieu of depreciation) for the tax year with respect to the property acquired with the payment;
3. in the case of reinsurance payments, any reduction in the gross amounts of premiums or other consideration on insurance, annuity contracts or indemnity insurance, and any deduction under Code Section 832(b)(4)(A) from the amount of gross premiums written on insurance contracts during the tax year for the premiums paid for reinsurance; and
4. in the case of a payment with respect to a surrogate foreign corporation or a foreign member of that corporation's expanded affiliated group, any reduction in gross receipts with respect to that payment in computing the taxpayer's gross income for the tax year.

The base erosion tax benefit attributable to any base erosion payment on which tax is imposed and with respect to which tax has been deducted and withheld under Code Sections 1441 and 1442, is not taken into account in computing modified taxable income or the base erosion percentage. However, the amount not taken into account in computing modified taxable income is reduced under rules similar to the rules under Code Section 163(j)(5)(B), as in effect before December 22, 2017.

For purposes of determining an applicable taxpayer's modified taxable income (in the case of a taxpayer to which Code Section 163(j) applies for the tax year), the reduction in the amount of interest for which a deduction is allowed by reason of that provision is treated as allocable, first, to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to related parties.

The base erosion percentage is the percentage, for any tax year, that is determined by dividing:

1. the aggregate amount of base erosion tax benefits of the taxpayer for the tax year, by
2. the aggregate amount of the deductions allowable to the taxpayer for the tax year, taking into account the base erosion tax benefits and disregarding: (i) any deduction allowed under Code Sections 172, 245A or 250 for the tax year, (ii) any deduction for amounts paid or accrued for services to which the exception for the services cost method applies, and (iii) any deduction for qualified derivative payments that are not treated as a base erosion payment.

Interest Limitation

The foreign tax credit limitation must be calculated separately for certain categories, or "baskets," of income. There are generally two separate foreign limitation categories – a "passive category income" basket and a "general category income" basket. Foreign-source taxable income for each category is gross income for the category, less expenses, losses and other deductions. The allocation and apportionment of deductions for purposes of determining the foreign tax credit limitation generally requires that the expense is first allocated to a specific class of income, and then apportioned between the statutory groupings and the residual grouping. The foreign tax credit limitation can be increased by maximizing the portion of worldwide taxable income that is foreign-source taxable income. Minimizing the amount of interest expense that is allocated and apportioned to foreign-source income is one way to increase foreign-source taxable income.

Allocation and apportionment of interest expense must be made on the basis of the assets, and not gross income. Under the asset method, taxpayers apportion interest expense to the various statutory groupings based on the average total value of the assets within the grouping for the tax year, according to the asset valuation rules and asset characterization rules of the regulations. Taxpayers may no longer use the fair market value method to allocate and apportion interest expense. All allocations and apportionments of interest expense must be determined using the adjusted basis of the assets. The use of gross income to allocate and apportion interest expense continues to be disallowed.

A Closer Look at the Tax Cuts and Jobs Act

VI. Impact on Qualified Retirement Plans

Individual Retirement Arrangements (IRAs)

There are two basic types of individual retirement arrangements (IRAs): traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, to which only nondeductible contributions may be made. The principal difference between these two types of IRAs is the timing of income tax inclusion.

Contributions to both traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts or contracts, and with separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Recharacterization/Conversion of IRA Contributions

A recharacterization election effectively reverses the contribution from one type of IRA to another (e.g., Roth to traditional or traditional to Roth). The contribution being recharacterized is treated as having been originally contributed to the second IRA on the same date, and for the same tax year, as that in which the contribution was made to the first IRA.

If, on or before the due date for any tax year, a taxpayer transfers (in a trustee-to-trustee transfer) any contribution to an IRA made during the tax year from that IRA to any other IRA, the contribution is treated as having been made to the transferee plan, and not to the transferor plan. This rule is not available unless the amount transferred in a recharacterization is accompanied by any net income allocable to the contribution. Further, it applies only to the extent that no deduction was allowed with respect to the contribution to the transferor plan.

Both the election to recharacterize and the transfer of the assets must both take place on or before the due date (including extensions) of the tax return for the year for which the contribution was made for the first IRA. Once a recharacterization election has been made, it cannot be revoked. However, in some situations, the amount may be reconverted at a later date.

Changes to Recharacterization under the TCJA

The TCJA made changes to the IRA recharacterization provisions. Under the new legislation, for tax years beginning after December 31, 2017, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA no longer applies to a conversion contribution to a Roth IRA. As such, after the TCJA, recharacterization cannot be used to unwind a Roth IRA conversion.

A Closer Look at the Tax Cuts and Jobs Act

Earlier versions of the tax reform legislation enacted by both the House and Senate eliminated recharacterization entirely. The provision was narrowed considerably in the reconciled version to target only conversions to Roth IRAs. Thus, an individual may still make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA. In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, however, the individual is precluded from later unwinding the conversion through a recharacterization.

The abuse that the new provision is intended to prevent is tied to changes in the trading process of those assets contained in the IRA throughout any particular year. If a conversion is undertaken, the taxpayer/IRA owner will pay income tax calculated on the fair market value of the of the arrangement's assets at the date of the conversion. Thus, a conversion transaction locks in the value and the incumbent tax liability.

If the value of the assets increases after the conversion transaction, the planning strategy is validated as waiting would have driven a higher tax cost for the taxpayer at that point in time. On the other hand, a severe drop in value after the conversion results in the taxpayer having paid a significantly higher tax bill than necessary if he or she had waited for the value adjustment. The recharacterization option allowed taxpayers great flexibility in planning and developing strategy.

Internal Revenue Code Section 401(k) Plans

As the House prepared to release the first drafts of its tax reform bill, significant discussion took place about reductions in amounts being contributed to Section 401(k) plans, as well as other possible modifications to those plans. These debates caused a great deal of consternation among taxpayers, media and politicians alike.

As a result of a very hard push-back, House Ways and Means Committee Members excluded the discussed changes from the bill prior to its release. Likewise, The Senate Finance Committee did not include any modifications to the Section 401(k) rules.

Non-Cash Compensation

Common compensation strategies often include the granting of equity interests in the employer company. In these instances, there is almost always an income and deduction event. The recipient/employee recognizes income to the extent of the fair market value of the equity interest on the date of grant (less any amount that the recipient/employee paid for the equity interest) in the first tax year in which the property (equity interest) becomes "substantially vested."

A Closer Look at the Tax Cuts and Jobs Act

Property is *substantially vested* if the rights of the person having the beneficial interest in the property are not subject to a "substantial risk of forfeiture," or are freely "transferable." Generally, an employee's right to stock or other property is subject to a *substantial risk of forfeiture* if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services. An employee's right to stock or other property is *transferable* if the employee can transfer an interest in the property to any person other than the transferor of the property.

Governance of such grants of equity for federal income tax purposes is generally set forth in Section 83 of the Internal Revenue Code. These rules work to control the timing and the amount of the compensation that is recognized by the employee and deducted by the employer. Property includes real and personal property, other than money or an unfunded and unsecured promise to pay money in the future.

Note, that an important exception within the statute allows a voluntary election, known as an "IRC Section 83(b) election." Such an election provides that a person who receives property (including employer stock) in connection with the performance of services can elect to have the excess of the fair market value of the restricted property over his or her cost included in gross income and taxed in the year the property is received, even though the property remains substantially nonvested. The election must be made no later than 30 days after the property is transferred.

If a proper and timely IRC Section 83(b) election is made, the amount of compensatory income is capped at the fair market value of the property as of the transfer date (less any amount paid for the property). Once made, the restricted property election cannot be revoked without IRS consent.

Changes to Non-Cash Compensation Rules under the TCJA

The TCJA changes these rules by adding another deferral opportunity. Under the new law, a qualified employee of a privately held company may elect to defer the inclusion in his or her gross income the amount of income attributable to qualified stock transferred to the employee by the employer. This election is an alternative to being taxed in the year in which the property vests or in the year it is received under IRC Section 83(b). The election to defer income inclusion for qualified stock must be made no later than 30 days after the first date the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

A Closer Look at the Tax Cuts and Jobs Act

If a qualified employee elects to defer the inclusion of income, the employee must include the income in his or her gross income for the tax year that includes the earliest of:

- the first date the qualified stock becomes transferable, including transferable to the employer;
- the date the employee first becomes an excluded employee;
- the first date on which any stock of the employer becomes readily tradable on an established securities market;
- the date five years after the earlier of the first date the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture; or
- the date on which the employee revokes his or her inclusion deferral election.

The relevant factors here are definitional. "Qualified stock" is any stock in a corporation that is the employer of the qualified employee if: (1) the stock is received in connection with the exercise of an option or in settlement of a restricted stock unit (RSU), and (2) the option or RSU was granted by the corporation in connection with the performance of services as an employee and during a calendar year in which such corporation was an eligible corporation. Qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to (or otherwise receive cash in lieu of stock from) the corporation. Numerous complexities exist within the definitions and must be analyzed before taking advantage of this new deferral opportunity.

Essentially, the TCJA allows a qualifying private company to offer its rank-and-file employees the opportunity to defer income tax inclusion on compensatory stock options or RSUs for up to five years. Note, that the Conference Report language clarifies the regulations further. In order to satisfy the requirement that 80% of all applicable employees be granted stock options or RSUs with the same rights and privileges, the company must grant *either* stock options *or* RSUs for the year and cannot grant a combination of stock options *and* RSUs. The requirement applies to both new hires and existing employees.

Nonqualified Deferred Compensation

The House bill contained changes to the nonqualified deferred compensation rules that would have proven detrimental (if not fatal) to the use of such plans as mechanisms for customized compensation for key employees. However, the House's proposed changes in this area did not make it to the Senate bill and are not part of the final TCJA legislation. As such, the nonqualified deferred compensation rules continue as under prior law.

A Closer Look at the Tax Cuts and Jobs Act

VII. Impact on Exempt Organizations

Tax-exempt organizations are often referred to as "nonprofit corporations" or "not-for-profit entities" because the organizations are established with an alternative motive other than business profit, such as charitable giving or education. Such organizations that annually comply with specific requirements of the Internal Revenue Code are generally exempt from taxation by the federal government. However, exempt organizations are not totally free of the responsibility of paying all taxes. Exempt organizations may still be responsible for employment taxes, income tax on business activities that are unrelated to the exempt purpose of the organization, and other forms of taxes, such as excise taxes.

Although the TCJA was principally focused on the areas of individual and business taxation, Congress did enact a number of important changes to the Internal Revenue Code that were aimed at exempt organizations. These changes, which will be detailed in the following sections, most notably impacted:

- taxation on an exempt organization's income from business activities unrelated to the exempt purpose of the organization;
- taxation of net investment income of private colleges and universities; and
- excise tax on excessive compensation of exempt organization executives.

Taxation of an Exempt Organization's Unrelated Business Income

The income of an exempt organization is generally not subject to income taxation under the Internal Revenue Code. However, income tax may be imposed on exempt organizations engaging in certain business activities, if those activities constitute a trade or business that is regularly carried on by the organization, and the trade or business is not substantially related (aside from the need of the organization for funds or the use it makes of the profits) to the organization's performance of the purposes or functions on which its exemption is based. The net income sourced to these activities is commonly referred to as "Unrelated Business Taxable Income" (UBTI).

UBTI is the gross income derived from any unrelated trade or business (reduced by the regular deductions allowed for income tax purposes), which is directly connected with the carrying on of such trade or business. Exempt organizations are required to report UBTI on federal Form 990-T, and activities generating positive UBTI are subject to income taxation based upon federal corporate income tax rates. The new maximum federal corporate tax rate is 21% for tax periods beginning after December 31, 2017 .

A Closer Look at the Tax Cuts and Jobs Act

Exempt organizations may conduct more than one unrelated business activity in a particular tax period. Prior to the enactment of the TCJA, exempt organizations computed UBTI for each activity during its applicable tax period. If one activity produced net business operating losses (NOLs) during the tax period, that NOL could be utilized to offset the net business income produced by another activity. After all business activities were combined together, any excess NOLs could be carried back a maximum of two tax periods, or carried forward to future tax periods for a maximum of 20 years, as a dollar-for-dollar reduction of taxable income.

In the TCJA, Congress sought to prevent net losses sustained by one unrelated trade or business from offsetting net income from another separate, unrelated business in the same tax year. This change is intended to serve as a revenue-raising measure to offset potential lost tax revenues from the significantly reduced corporate tax rate structure included in the legislation.

Additionally, Congress placed new limitations on exempt organizations' utilization of NOLs generated in a tax year beginning after December 31, 2017, which mimic the limitations for corporations. Moving forward, the full balance of any NOL sustained within one unrelated business activity may be carried forward to the next tax period, but the NOLs carried forward may only offset a maximum of 80% of the exempt organization's net income within the same activity. No NOLs may be carried back for years beginning after December 31, 2017.

Under the new rules set forth in the TCJA, net income or loss is computed separately for each unrelated business activity. If one of the unrelated business activities produces a NOL (deductions exceed gross income) in the current tax period, that NOL is limited to $0. The excess deductions that produced the NOL are carried forward to the next tax period, and may offset up to 80% of net income reported in the following tax period for only that particular unrelated business activity, but no other unrelated business activity.

All unrelated business activities that produce net income in a tax period are combined, then a special $1,000 deduction is allowed against the combined net income from the exempt organization's unrelated business activities. The new mechanics for calculating UBTI for 2018 and after are illustrated in the following example.

- A charitable organization engages in three separate unrelated business activities during its tax period that began January 1, 2018, and ended December 31, 2018. The organization reports the following operating detail for the tax year:

	Activity 1	Activity 2	Activity 3
Income	$ 5,000	$ 5,000	$ 5,000
Deductions	(7,000)	(3,000)	(2,000)
Net Income/(Loss)	($2,000)	$2,000	$3,000

A Closer Look at the Tax Cuts and Jobs Act

- Activity 1 produced a net loss of $2,000 for 2018. The NOL is not permitted to offset any income generated by the other two business activities. As a result, the excess deductions that produced the 2018 tax loss are carried forward to 2019. If Activity 1 produces income in 2019, the excess deductions will be available to offset up to 80% of 2019 net taxable income.
- Activities 2 and 3 produced net income for 2018. The income from both activities is combined and results in total net income of $5,000. A special deduction of $1,000 is allowed as a reduction against the combined income and, therefore, the net income from the charitable organization's combined unrelated business activities is $4,000 for 2018.

The new rules under the TCJA regarding the limitation on the utilization of NOLs apply only to NOLs from unrelated business activities that are sustained for tax years beginning January 1, 2018, and moving forward. Therefore, if an exempt organization sustained a NOL from unrelated business activities prior to January 1, 2018, and the NOLs were carried forward to future tax periods, those NOLs may continue to offset combined net income from unrelated business activities on a dollar-for-dollar basis.

Those NOLs generated in years ending before the enactment of the TCJA are applied to net business income first. Then, if any income remains, the special $1,000 deduction is applied to that remaining net business income. Using the same facts as the previous example, the example below provides an illustration regarding the transition rule for NOLs sustained in tax years prior to tax reform.

- A charitable organization engages in three separate unrelated business activities during its tax period that began January 1, 2018, and ended December 31, 2018. The organization reports the following operating detail for the tax year:

	Activity 1	Activity 2	Activity 3
Income	$ 5,000	$ 5,000	$ 5,000
Deductions	(7,000)	(3,000)	(2,000)
Net Income/(Loss)	($2,000)	$2,000	$3,000

- In this example, assume that the charitable organization had elected to carry forward a NOL of $2,000 from the 2017 tax period to the current tax period (2018).
- Activity 1 produced a net loss of $2,000 for 2018. The NOL is not permitted to offset any income generated by the other two business activities. As a result, the excess deductions that produced the

2018 tax loss are carried forward to 2019. If Activity 1 produces income in 2019, the excess deductions will be available to offset up to 80% of 2019 net taxable income.

- Activities 2 and 3 produced net income for 2018. The income from both activities is combined and results in total net income of $5,000. After combining Activity 2 and 3 income, the NOL of $2,000 is utilized against the combined net income of Activities 2 and 3, reducing the amount to $3,000. A special deduction of $1,000 is also allowed as a reduction against the combined income. Therefore, the net income from the charitable organization's combined unrelated business activities is $2,000 for 2018.
- Note, that if Activities 2 and 3 had produced combined income of just $2,000, the entire amount of income would have been offset by the 2017 NOL carryover, and the benefit of the special deduction of $1,000 would have been lost for 2018.

Taxation of Net Investment Income of Private Colleges and Universities

The TCJA added a new Internal Revenue Code section that imposes a 1.4% tax on the net investment income of certain private colleges and universities in each tax year beginning after December 31, 2017.

The tax is imposed on educational institutions that:

- have at least 500 students during the preceding tax year, of which more than 50% are located in the United States;
- are private educational institutions and not a state college or university that is under the direction, or owned and operated, by a state government or political subdivision; AND
- have assets with an aggregate fair market value of at least $500,000 per student (not including assets used directly in carrying out the institution's exempt purpose), as measured at the end of the preceding tax year.

For purposes of the new investment income tax, the number of students of an institution is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

Investment income for which the tax applies includes the gross amount of interest, dividends, rents, royalties and net capital gains from the sale or disposition of securities. Total investment income is reduced by amounts paid for the production, management, conservation or management of assets producing investment income, such as investment management fees charged by an investment management firm.

A Closer Look at the Tax Cuts and Jobs Act

The new net investment income tax is imposed, not only on net investment income generated from investment assets held by the private educational institution, but also from investment assets held by organizations related to the private educational institution. Related organizations include any organization that:

- controls, or is controlled by, an applicable education institution;
- is controlled by one or more persons who also control that educational institution; or
- receives support or is operated for the benefit of the applicable educational institution.

This provision has been quite controversial, and the final bill reflects an increase in the assets-per-student threshold from $250,000 (as proposed in the original House bill) to $500,000 as included in the final bill.

Excise Tax on Excessive Compensation of Exempt Organization Executives

In conjunction with new business limitations on compensation paid to certain employees, the TCJA established a new excise tax, payable by exempt organizations, on compensation to employees that exceeds a certain threshold amount. Because of the substantial dollar thresholds on which the excise tax is based, the new excise tax will most likely impact only the largest of exempt organizations, which are paying significant levels of compensation to key top-level employees.

An exempt organization will be liable, within a tax year, for the 21% excise tax (which is equal to the new maximum corporate tax rate on income) on the ***sum*** of:

- wage compensation paid to a "covered employee" in excess of $1 million (not including any excess parachute payments); and
- any excess parachute payments paid to a covered employee by that tax-exempt organization.

A *covered employee* includes any current or former employee of the exempt organization who is one of the five highest-compensated employees for the current tax year, or a covered employee of the organization (or any predecessor organization) for any preceding tax year that began after December 31, 2016.

For purposes of this new excise tax, there is a new definition for "parachute payments" that is limited to the payment of compensation to a covered employee when such payment is contingent on:

- the employee's separation from employment with the tax-exempt employer, ***and***
- the combined present value of the compensation payments being equal to, or in excess of, an amount equal to ***three times*** the "base amount."

A Closer Look at the Tax Cuts and Jobs Act

The *base amount* equals the average annual compensation payable by the organization and includible in the covered employee's gross income, computed over the covered employee's five most recent tax years ending before the date the separation occurs (the "base period"). If the covered employee has been employed by the organization for fewer than five years, the portion of this five-year period during which the covered employee performed services for the company is the base period. If the base period includes a short tax year, then compensation paid during the short year is annualized.

A Closer Look at the Tax Cuts and Jobs Act

VIII. Concluding Thoughts and Practical Considerations

Time does not permit a more detailed analysis of the many remaining provisions included in the Tax Cuts and Jobs Act (TCJA). In reality, a significant number of unknowns remain, which will require clarification by Treasury or Congress. In the coming months (and years) taxpayers can expect a steady stream of interpretive rulings, notices and revenue procedures from the Internal Revenue Service to provide clarification and further guidance on complying with the mandates of the new law.

As noted, early estimates suggest that numerous sets of interpretive Treasury regulations will be required to "flush out" the many nuances and unknowns contained in the new statutes. These regulations will be drafted by the Internal Revenue Service. However, the process by which these regulations are generated and vetted is a slow and methodical endeavor. As such, it should not come as a surprise that certain regulations may take an extended amount of time to produce – perhaps several years.

Lastly, the general protocol for legislation this sizable is the later introduction of an additional law intended to clean up errors and omissions in the initial law. Generally referred to as a "Technical Corrections Bill," such bills have historically been passed six months to a year after the initial law is enacted. The time gap is a necessary part of the process, as time is required to identify the shortcomings in the original law that may necessitate modification and clarification.

So, where do taxpayers find themselves in the wake of all of this activity? Clearly, sitting on the sidelines and waiting is not a viable option. As has been discussed throughout today's presentation, many of the most beneficial provisions are already in effect. To defer action is to forgo the benefits (or at least a portion of them) afforded by the tax law.

Grossman Yanak & Ford LLP intends to incorporate preliminary assessment of the effects of the TCJA for both our business and individual clients as we move through the 2018 income tax filing season. However, such assessments will not answer the bell for many of our clients (and other taxpayers) who have very specific tax facts and circumstances and who require a significant "re-posturing" as they move through calendar 2018 and into the future. For more detailed assessments and more comprehensive tax strategy development, it would likely benefit all taxpayers to undertake a more all-inclusive and wide-ranging analysis.

From a planning standpoint, the following brief summary should work to trigger some of the more significant tax benefits afforded by the TCJA that we believe merit our clients' consideration.

A Closer Look at the Tax Cuts and Jobs Act

Individuals

Individuals, generally, should be thinking of how they are affected by the expansion of the standard deduction, the loss of their personal and dependency exemptions, the modified income tax rates and the "pro-taxpayer" modifications to the alternative minimum tax.

Further, care should be taken to consider the ramifications of losing the state and local income tax deduction in excess of $10,000, as well as changes to the other itemized deductions, including the loss of miscellaneous deductions and the property and casualty loss deduction.

For individuals owning homes, thought should be given to the modification and paring of the property tax deduction, as well as the home mortgage interest deduction changes, including the repeal of the home equity loan interest deduction rules.

We also advocate careful assessment and consideration of charitable giving strategies, such as a "bunching" of these deductions, which may serve to better benefit certain taxpayers that are charitably-inclined.

Thought should also be given to the loss of the home office deduction for taxpayers who previously took this deduction as an itemized deduction in their capacities as employees.

For higher-income taxpayers, the changes relating to the estate, gift and generation-skipping tax, wherein the lifetime exclusion amounts are doubled, merit consideration and integration into current estate and gift tax planning strategies.

Businesses

Businesses, generally, need to consider asset capitalization and expensing opportunities for capital asset purchases after the effective date of the legislative provisions. Section 179 expensing, as well as bonus depreciation, provide businesses with an unparalleled opportunity to write off such expenditures in the year of acquisition. The immediate deduction works to generate current-period tax savings, thereby, lessening the cash-flow burden of making these asset acquisitions.

For the first time, certain limitations on the deductibility of business interest must be considered in tax planning. Affecting companies with average gross receipts in excess of $25 million, this change will require integration into the modeling process for determining rates of return on capital investments and the overall weighted average cost of capital. As such, those assessing capital projects funded with debt will be required to include a new paradigm in that assessment.

A Closer Look at the Tax Cuts and Jobs Act

Determining and utilizing net operating losses will also require greater care in the future to ensure that the tax benefits associated with such losses are optimized in light of the changes in these rules.

For businesses organized as pass-through business entities, significant planning and analysis will be required for the proper determination of the qualified business income deduction.

Also, the reduced corporate tax rate, as well as the modified individual tax rates for pass-through entity income, will require close attention to ensure that cash outflows for these obligations are minimized, particularly in calendar year 2018.

Finally, for businesses organized as foreign entities, or that conduct foreign business operations and other activities, the TCJA includes many changes. These changes are a significant modification of the prior-law rules and will require many applicable organizations to rethink, not only the tax strategy development process, but also the way that the operations of the business are conducted.

In Closing

Numerous other changes integral to the successful implementation of the TCJA are included in the bill and will need to be fully digested to take full advantage of the new rules. Many of the most salient issues were discussed today, but other, more obscure provisions can also play a substantial role in tax planning for both individuals and companies, under specific facts and circumstances.

As such, specific items of interest to you that were not part of today's program or were glossed over quickly, should be discussed with our presenters. You may do this after the presentation, if you have time, or you may contact any of the presenters at your convenience.

Grossman Yanak & Ford LLP is in its 28th year. Over that time period, we have experienced much success. We understand, and we have never forgotten, that all of our success comes from our clients, contacts and friends. The support shown to the founding partners of this firm, as well as to all of our professionals, is a humbling experience, and we thank you for that support.

We appreciate your attendance today and hope that the information offered herein helps each of you to better understand the key elements of the TCJA and how it might affect you as you move forward into 2018. Thank you!

Robert J. Grossman
412-338-9304
grossman@gyf.com

Donald S. Johnston
412-338-9309
djohnston@gyf.com