A Review of the Tax Cuts and Jobs Act – What You Need to Know Now

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With the passage of the Tax Cuts and Jobs Act ("Act"), there is much concern as well as confusion as to the impact the new legislation has on both businesses and individuals alike.

The tax changes contained in the Act are the most sweeping since the Tax Reform Act of 1986. As with any tax change, there will be winners and losers, but all taxpayers should be familiar with how the new legislation could affect their specific situation.

Below is a summary of the tax changes we believe will be relevant to you, your company, or your clients. (Please be aware that changes will likely result as technical corrections are issued and more guidance is released.)

Individual Taxes

Many individual taxpayers are asking, "How will my tax situation change in light of the new law?" As with any tax matter, the answer will vary greatly depending on the person's specific circumstances. We have summarized below the changes that will affect a large number of taxpayers. (Note that the majority of the individual changes discussed here will expire after 2025 if Congress does not act to extend those provisions.)

Individual rates and brackets have been revised, and overall rates are generally lowered, with the top rate dropping from 39.6% to 37%. These tax cuts are scheduled to expire after 2025, and there is no change to the preferential long-term capital gains tax rate.

For eligible taxpayers, **the child tax credit** is increased from $1,000 to $2,000, and a $500 credit is provided for certain **non-child dependents**.

Mortgage interest deductions for new purchases of first or second homes is capped at $750,000 in mortgage debt for mortgages incurred after December 15, 2017. There are no changes for current mortgages put into place under prior rules. However, home equity loan interest is no longer deductible, even for existing debt.

Changes to **pass-through taxation** are significant. We will need to wait to get more specific as more details are released, but at some point, there may be the opportunity to restructure to take advantage of these lower tax rates. (See the **Business Taxes** discussion in this article for changes that can impact flow-through owners.)

With the doubling of the **lifetime gift exemption** to $11.2 million per person, fewer estates are subject to estate tax. Consideration should be given to making those gifts sooner rather than later to lock in the benefit before it is scheduled to revert back to the lower amounts in 2026.

The **standard deduction** is nearly doubling. For example, for married filing jointly, the standard deduction is increasing from $12,700 to $24,000. That means that if your mortgage interest and charitable contributions (the only two remaining itemized deductions of considerable size) are less than that amount, you should consider bundling your charitable contributions into one year. For example, you could switch from annual to an every-other-year contribution schedule – in one year you would contribute twice the amount you'd usually give and then skip the following year. This would allow you to exceed the standard deduction amount every other year in order to maximize the tax benefit of your charitable contributions.

Alimony relating to any divorce or separation agreement executed or potentially modified after December 31, 2018 is not deductible by the payor spouse and is not included in the income of the payee spouse.

Carried interest – A new three-year holding period is required to qualify for long-term capital gain treatment.

The new tax law retains, but modifies to some degree, the **individual alternative minimum tax (AMT)**. An increase in the income level exemption and elimination of state tax deductions will likely reduce the number of taxpayers subject to AMT.

Distributions from **529 Plans** can be used to fund tuition and various expenses at elementary, secondary, and religious schools. Historically, distributions have been limited to postsecondary education.

Business Taxes

Pass-through businesses such as S corporations, LLCs, partnerships, and sole proprietors receive a new 20% deduction from their income. That benefit is phased out for professional service businesses owned by individuals with taxable income of more than $157,500 (single filers) or $315,000 (joint filers). The deduction is equal to 20% of qualified business income. However, there are several limitations, including a limitation based on W-2 wages and assets relative to the qualified business.

Taxpayers other than corporations may not deduct **excess business losses**. Excess business losses are equal to aggregate deductions for a trade or business minus the sum of business income plus $250,000 (or $500,000 for joint filers). The $250,000 and $500,000 amounts will be indexed for inflation. This rule is applied at the partner (or S-corporation shareholder) level. Essentially, an individual taxpayer with a business loss from a flow-through entity can only use up to $500,000 (if married filing jointly) or $250,000 (if single) of losses from such entity to offset income from other sources (wages, interest, dividends, capital gains, etc.).

The **corporate AMT** is repealed.

There is a **new corporate tax rate** of 21%, replacing the 35% maximum tax rate.

The **dividends received deduction percentages** are reduced. There is an increase in the **Section 179** limit, increasing the maximum deduction from $500,000 to $1 million and increasing the phase-out of such deduction for assets placed in service during the year from $2 million to $2.5 million. Qualified property now also includes Qualified Improvement Property (QIP) and improvements to non-residential rental property placed in service after the property was first placed in service, such as roofs, HVAC, fire protection, and alarm systems. The updated rules are effective for the 2018 tax year.

Small taxpayer provisions – The limitations in **Section 448** (relating to the use of the cash method of accounting) have been modified so that taxpayers with annual average gross receipts under $25 million (historically under $5 million – “Small Taxpayers”) are permitted to use the cash method of accounting. Small Taxpayers with inventory are no longer required to apply **uniform capitalization rules (UNICAP)**. Also, Small Taxpayers subject to **Section 460**, utilizing long-term contact accounting methods, would no longer be required to use the percentage of completion method of accounting.

When reviewing **full expensing**, subject to certain limitations, 100% bonus depreciation applies to qualified property acquired and placed in service on or after September 28, 2017. For the 2017 tax year, taxpayers can choose to simplify their bonus depreciation calculation by electing to apply 50% bonus depreciation to all assets placed in service that year in lieu of applying 50% bonus to assets placed in service before September 28, 2017 and 100% bonus to assets placed in service on or after September 28, 2017. Qualified property is expanded to include used property.

Beginning in 2022, **research and development costs** must be capitalized and amortized over five years.

Revenue recognition – Revenue cannot be deferred for tax purposes beyond the time the revenue is recognized for financial statement purposes. The new tax law also codifies a rule similar to the rule set forth in Rev. Proc. 2004-34 for deferred revenue.

Interest expense limitation – Interest expense is limited to business interest income plus 30% of “adjusted taxable income.” The Act contains numerous exceptions to this rule, as well as special rules relating to flow-through entities.

Limitation on net operating loss (NOL) usage – NOL usage is limited to 80% of taxable income. Additionally, the new tax law repeals the ability to carry back NOLs (historically a two-year carryback was allowed) and increases the NOL carryforward from 20 years to until the NOL is used.

Like-kind exchange – Section 1031 exchanges are limited to real property only.

Limitation on fringe benefits – Most entertainment expenses are no longer deductible. Business meals are still deductible subject to the existing rules (50% limitation).

Repeal of 199 deduction – The Section 199 (domestic production activities) deduction is repealed.

Carried interest – A new three-year holding period is required to qualify for long-term capital gain treatment. ▶

Technical terminations – Technical terminations are repealed for tax years beginning after December 31, 2017.

Substantial built-in loss in the case of transfer of partnership interest – A reduction in the tax basis of partnership property following a transfer of a partnership interest is now required if the transferee partner would be allocated a loss of $250,000 or more under a hypothetical liquidation immediately after the transfer.

International Tax

Mandatory deemed repatriation – The new tax law requires all U.S. shareholders – U.S. citizens, residents, partnerships, trusts, and corporations – that own 10% or more of the voting shares of a controlled foreign corporation (CFC) to include their pro rata share of all CFC accumulated net earnings and profits (E&P) in their 2017 income. Cash earnings are subject to a 15.5% tax rate, while non-cash earnings are subject to an 8% tax rate. The rates are achieved via a dividends-received deduction, which brings the effective tax rate to these levels.

In addition, corporate shareholders of CFCs can take advantage of a modified foreign tax credit that can reduce the U.S. tax due on the deemed repatriation amount. The Act also retains the special rule for S corporations that are shareholders of CFCs, whereby the S corporation shareholders will not take the deemed repatriation amount into income until certain triggering events occur. It is clear that U.S. shareholders of a CFC must, at a minimum, ensure they have correctly calculated the E&P of their CFC to determine the impact of the deemed repatriation. Likewise, C corporation shareholders must calculate the foreign tax pools available to be credited under the modified foreign tax credit provisions.

Territorial tax system – The Act moves the U.S. to a modified "territorial tax" system, through which U.S. C corporations will not pay U.S. tax on certain profits earned outside the U.S. This change is accomplished by allowing domestic corporations a deduction (similar to the dividends-received deduction) whereby a U.S. C corporation that owns 10% or more of a foreign corporation will not pay any U.S. tax on the foreign source portion of dividends paid by the foreign corporation. The deduction is available for dividends from any foreign corporation other than passive foreign investment companies (PFICs).

Changes to Subpart F – The Act retains existing Subpart F anti-deferral rules and the Section 956 deemed repatriation rules, but makes several changes. Importantly, a new category of Subpart F income will require U.S. shareholders to include the global intangible low taxed income (GILTI) of CFCs in current U.S. taxable income. The mechanics of the GILTI provision are complex, but their effect is to establish a minimum tax regime that applies to U.S. shareholders of certain CFCs with income over a so-called routine return on tangible depreciable business assets.

In addition to navigating the complexity of these calculations, U.S. shareholders must determine the U.S. tax basis of assets held by CFCs, which can be a daunting task. In addition to creation of the GILTI rules, the Subpart F rules are modified so that a larger class of U.S. shareholders of foreign corporations are subject to the Subpart F deemed inclusion rules. This expansion is triggered by expanding the definition of "U.S. shareholder," subject to the Subpart F provisions, to include any U.S. person who owns at least 10% of the vote or value of the CFC, rather than only including those with 10% or more of the voting power. The attribution rules, which can require the application of the Subpart F rules on U.S. persons without a direct interest in a CFC, have also been expanded. U.S. taxpayers may need to reevaluate their exposure to the Subpart F provisions under these expanded definitions.

Base Erosion Anti-Abuse Tax (BEAT) – The BEAT provisions apply to U.S. corporations with an average of $500 million of gross receipts over the past three years that make certain deductible payments to related foreign persons exceeding a threshold defined under these provisions. The goal of these provisions is to restrict U.S. corporations from eroding the U.S. tax base by making deductible payments to offshore affiliates. Any such corporation will pay tax under the BEAT provisions on the excess of 10% of its taxable income (modified for this purpose) over its regular tax liability for the year, reduced by certain credits. Regulated investment companies (RICs), real estate investment trusts (REITs), and S corporations are not subject to the BEAT provisions. The effort to monitor and track the application of BEAT rules is significant. In addition, the new tax law authorizes an expanded Form 5472 to capture additional information on base erosion payments as well as increased penalties ($25,000 per form versus the prior $10,000 per form) for late filed or incomplete Forms 5472.

Compensation and Benefits

Executive Compensation

Elimination of exceptions to public company $1 million compensation deduction limit – With an exception for compensation pursuant to a binding contract in effect on or before November 2, 2017 (and which is not subsequently materially modified), public companies are not able to deduct compensation in excess of $1 million for their principal executive officer, principal financial officer, and three other most highly compensated officers, due to the elimination of the performance-based compensation and commissions compensation exceptions. Public companies that have been relying on these exceptions may face paying significant amounts of non-deductible compensation to such employees in the future.

Qualified entity stock option and restricted stock unit (RSU) grants – Certain employees of private companies (excluding employees who are 1% and greater owners, the CEO, the CFO, or among the four highest compensated officers) are able to make limited (maximum of five years) compensation deferral elections for income tax purposes in connection with the income taxability of stock options and/or stock-settled RSUs, which are exercised/settled in 2018 or after, if they are granted under an equity compensation plan that provides for grants to at least 80% of the employer's employees.

Widespread use of this deferral election opportunity is not likely due to the 80% coverage requirement, as companies have almost universally limited the grant of stock options and RSUs to members of senior management. Further, the illiquidity of the private company stock that would be received in connection with these grants, combined with the fact that the deferral would be limited to income tax such that, upon exercise or settlement, even where the deferral election is made, the employee may need the funds to meet his or her FICA tax liability, will likely limit the impact of this provision. Perhaps certain smaller and earlier-stage companies that cannot afford to pay significant cash compensation and instead use stock options and/or stock-settled RSUs to attract and compensate their employees may have a greater interest in establishing the plans needed to provide the deferral election opportunity.

IRAs and Tax-Qualified Retirement Plans

ROTH IRA recharacterizations – When an individual converts a traditional IRA (pre-tax) into a ROTH IRA (after-tax), the individual must pay the income taxes generated by the conversion from pre-tax to after-tax. However, individuals have also been able to reverse that decision, undo such a conversion, and consequently not incur the resulting tax liability, provided that the reversal is implemented by the individual's tax return due date, including extensions (by the following October 15). As of 2018, the ability to reverse the conversion of a traditional IRA to a ROTH IRA is eliminated. Consequently, if an individual wishes to reverse the 2017 conversion of a traditional IRA to a ROTH IRA, the reversal must have occurred by the end of 2017 (rather than by October 15, 2018).

Extension of the **60-day rollover period for tax-qualified retirement plan loan offset distribution amounts** permits the amount treated as an otherwise taxable distribution from a tax-qualified retirement plan, Section 403(b) plan, or governmental Section 457(b) plan as the result of an unpaid plan loan to be rolled over after the previous law's 60-day period. This is provided the deemed distribution occurs after 2017 and the rollover occurs on or prior to the due date (including extensions) for filing the income tax return for the plan participant's tax year in which the amount is treated as distributed.

Tax-qualified retirement plans 2016 disaster relief permits individuals having their principal residence at any time during 2016 located in a "2016 disaster area" (i.e., declared as such by the president) to receive not more than $100,000 of otherwise impermissible in-service distributions from tax-qualified retirement plans, Section 403(b) plans, and governmental Section 457(b) plans, and, if they are younger than age 59 1/2, without imposition of the otherwise applicable 10% early withdrawal tax on those amounts. Individuals receiving such distributions are able to recontribute the amounts back to the plan (or other eligible plan, such as an IRA or the plan of a new employer) within a three-year period without tax. Alternatively, they can pay tax on the unrecontributed amounts as if the distributions were paid ratably over a three-year period. Plan amendments may be required, and affected employers may wish to consult with their attorneys about any necessary plan amendments that should be adopted for this purpose.

Fringe Benefits and Family and Medical Leave Payments

The **employee moving expense deduction** is suspended, with an exception for certain moves by members of the armed forces, for 2018 through 2025.

The **employer deduction** is eliminated for certain expenses, including:

- Entertainment, amusement, or recreation expenses, including facility expenses, even if they are business-related (as of 2018).
- Membership dues to any club organized for business, pleasure, recreation, or other special purposes (as of 2018).
- Providing qualified transportation fringes (certain parking, transit passes, van pools, and bicycle commuting expenses) to employees (as of 2018).
- Except as necessary for ensuring the safety of an employee, the employee's commuting expenses (as of 2018).
- Providing food and beverages to employees through an eating facility that meets the requirements for *de minimis* fringes and for the employer's convenience (after 2025).

Employer reimbursements of moving expenses are fully taxable with an exception for certain moves by members of the armed forces.

Employer credit for compensation paid to employees on paid family and medical leave – For 2018 and 2019 only, an employer with a written policy in effect under which full-time employees can receive not less than two weeks ▶

(as well as a proportionate amount for part-time employees) of annual family and medical leave (under the Family and Medical Leave Act of 1993) is entitled to a general business credit equal to 12.5% of the compensation it pays to certain employees (employed for at least one year and having a rate of compensation not in excess of $72,000 [for 2018]) while they are on such a leave. The 12.5% credit amount is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

Trusts and Estates

The Act, effective January 1, 2018, **doubles the amount that can be exempted** from **federal estate tax** to around $11 million per taxpayer (depending upon how inflation adjustments are calculated). This provides taxpayers with an excellent opportunity to accomplish significant asset protection and business succession planning until the provision sunsets at the end of 2025.

Opportunities for planning abound – Because the Act prevents the deduction of state and local income, real estate, and sales tax, some taxpayers may wish to consider setting up incomplete non-grantor trusts in order to shift income out of the reach of state tax authorities. The income would be subject to the highest tax rate at the federal level for all income over $12,500, but it could avoid state income taxes entirely.

Taxpayers may want to consider making gifts to parents (or, better yet, to trusts for their parents). With the doubled exemption, this strategy offers a viable opportunity to accomplish an increase in basis for income tax planning purposes. Life insurance planning will continue to be important for taxpayers not only to provide liquidity to their survivors, but also as a source for tax-free retirement income.

Tax Exempt Organizations

Unrelated business taxable income (UBTI) treatment of entities exempt from tax under Internal Revenue Code Sections 501(a) and 511 – The Act does not include any provision to clarify treatment if an entity has dual tax exempt status, for example, under 501a, 401(a), and 115 of the Code, pertaining to its exposure to Section 511 (UBIT).

Exclusion of research income from UBTI – There were proposed modifications to this exclusion. The final law, however, contains no change to existing provisions.

UBTI separately computed for each trade or business activity – Previously, an organization could determine its unrelated taxable income on an aggregate income and subtract aggregate deductions, thereby allowing offset of multiple trades and businesses. Effective for tax years after December 31, 2017, unrelated business income must first be computed separately with respect to each trade or business, the aggregate of which cannot be less than zero. An NOL is only allowed with respect to a trade or business from which the loss arose. There is a special transition rule for NOLs carried into years beginning after January 1, 2018.

21% excise tax on excessive compensation paid by tax-exempt organizations (Section 4960) – As of the 2018 tax years, tax-exempt employers are liable for an excise tax equal to 21% of the sum of remuneration paid to their "covered employees": (a) in excess of $1 million, plus (b) any amount that would constitute an excess parachute payment under the Golden Parachutes rules (but with respect to the employee's separation from service rather than a change of control of the employer).

The Act does **not** modify:

- Existing provisions of **excise tax of private foundation investment income** or of the **private operating foundation requirement relating to the operation of an art museum**.
- Current provisions regarding the **exception to private foundation excess business holding rules**.
- Current provisions connected to **Section 501(c)(3) on organizations being prohibited from making statements relating to political campaigns**.
- Current provisions regarding **additional reporting requirements for donor-advised funds sponsoring an organization**.

The Act includes **no provision**:

- To repeal **tuition remission or related benefits under Section 117(d)** or to repeal the **exclusion for educational assistance programs under Section 127 from taxable income (up to $5,250)**.
- On the **limitation on exclusion for employer-provided housing under Section 119**.
- On **interest on private activity bonds** issued after December 31, 2017 as gross income of the taxpayer.

The Act:

- Includes a provision repealing the exclusion from gross income for interest on a **bond issued to advance refund another bond**.
- Follows the Senate amendment with modification regarding **excise tax based on investment income of private colleges and universities**. The provision impacts only a small number of colleges and universities, effective after December 31, 2017.

Renewable Energy

While Congress left the **wind production tax credit (PTC)** and the **solar energy investment tax credit (ITC)** intact and unaltered, the tax equity financing sector will likely be impacted by the new tax legislation. Specifically, the **reduction of the overall corporate income tax rate to 21%**, the new **bonus depreciation regime**, the **imposition of the new Border Erosion Anti-Abuse Tax (BEAT)**, the **elimination of the Section 708(b) technical termination rules**, and a host of other **new tax rules for limiting and suspending some business interest deductions** will all impact tax equity renewable energy financing transactions previously negotiated, as well as affect renewable energy project financings currently being negotiated.

In addition, the **elimination of the corporate AMT**, the **modification of the NOL rules**, and the **imposition of less taxpayer-favorable revenue recognition rules** (which may impact the use of pre-paid power purchase agreements [PPAs]) will also impact the renewable industry.

Because most renewable tax equity financings are typically done through legal entities taxed as partnerships for federal income tax purposes, the new law's treatment and special handling of pass-through entities, including the taxation of the partners in those entities, is expected to give rise to complex tax issues for both existing deals and new projects.

On new deals, these changes are expected to impact both the pricing of tax equity and the amount of such equity that renewable energy project sponsors may raise. However, the level of impact to tax equity remains to be seen, especially given the year-by-year, case-by-case nature of the BEAT, as experienced by that segment of the renewable energy tax equity capital markets that generate a BEAT liability against which the PTC and ITC can now only partially offset.

There may also be some opportunities created by the Act; for example, in the area of repowering existing wind energy facilities.

What's Next?

We are certainly living in interesting times! Clearly, the Act has sweeping changes impacting most taxpayers. As they say, "the devil is in the details." As with any legislation of this size, we expect that there will be technical corrections required at some point in time.

Similarly, we expect the Internal Revenue Service to issue regulations and other guidance to provide additional insight on these changes. However, it will be some time before the bulk of such guidance is available.

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