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Tax Alert

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Highlights of Tax Law Changes Under The Tax Cuts and Jobs Act

Individual Tax

For individuals, the Act retains the alternative minimum tax and the seven-bracket progressive structure with certain modifications and with the new top marginal tax rate of 37% (formerly 39.6%). The standard deduction is essentially doubled, but several popular deductions have been eliminated, which will impact households differently. Among the deductions repealed are the deductions for personal exemptions and the miscellaneous itemized deductions, including investment management fees and tax advisory fees. In addition, the deduction for state and local taxes (including income, sales, and property taxes) are now subject to an aggregate $10,000 limitation, and the mortgage interest deduction is limited to acquisition indebtedness of $750,000 in principal value. For loans incurred before December 15, 2017, current homeowners may keep the current limitation of $1 million, but the interest expense deduction from home equity lines are no longer deductible.

On the other hand, the child tax credit has been enhanced, the threshold for claiming medical expense deduction has been reduced to 7.5% of adjusted gross income (which allows for higher medical expense deduction), and an increased 60% adjusted gross income limitation applies for cash contributions made to public charities to allow for a higher contribution deduction. The Act also modifies Section 529 accounts to expand its use for qualifying primary and secondary education.

The Act does not change the current tax treatment of qualified dividends and capital gains. However, for taxpayers who are service providers to investment funds and who seek long-term capital gains treatment on the sale or disposition of a "profits interest" or "carried interest," the holding period requirement is extended from more than one year to three years. Certain profits interests issued by an LLC or partnership entity are exempt from this carried interest rule, so individual taxpayers should pay attention to the application of the new rules. As noted, there are many changes that should be considered in your individual tax planning. Please consult your personal tax advisor for specific recommendations.

The new law contains many other changes that will affect individuals, including some that will not take effect immediately. For example, for couples that are divorced or separated beginning in 2019, alimony payments will no longer be deductible to the payor, and such payments will not be treated as taxable income to the recipient.

Estate and Gift Tax

The Act temporarily doubles the unified credit basic exclusion amount for tax periods 2018 through 2025. For 2018, the exclusion for estate, gift, and generation skipping tax ("GST") is increased to $11.2 million per person adjusted for inflation. After 2025, that increased amount will sunset and return the exclusion amount to an amount calculated under former law ($5.49 million per person for 2017). The step-up in income tax basis for assets held by a decedent remains a substantial tax benefit for heirs. However, the increased federal gift and generation-skipping transfer tax exemptions, along with the increased annual gift exclusion of $15,000, may significantly impact many present estate plans. Those estate plans should be reviewed in light

of these changes. This is particularly important for taxpayers whose estate plan includes one or more trusts intended to reduce or defer estate taxes – the effect of trusts with so-called "formula clause" can be quite unexpected because of the significant increase in the estate and gift tax exemption amounts. Further, in many cases the income tax benefits of not gifting during lifetime can outweigh potential savings in future estate taxes.

As the final form of the Bill was only released on December 21, 2017, many questions remain. Moreover, many provisions delegate authority to the Internal Revenue Service to interpret details of the Act and thus new guidance in the form of regulations, rulings, and notices will be issued for us to work through. However, to best prepare for the upcoming changes of 2018 and beyond, we recommend that you contact us to assist in effective decision making.

Business Tax

Most of the tax provisions are effective beginning January 1, 2018, and sunset after 2025. However, the new corporate tax rate for traditional "C" corporations is intended to be permanent and does not expire, at least until further laws are passed. The change in the corporate tax rate from the highest marginal rate of 35% to a flat 21% rate can warrant some businesses to consider a reorganization or conversion into a "C" corporation (or electing tax treatment as a "C" corporation), rather than remaining a pass-through structure for tax purposes. At the highest marginal tax rates, the combined 21% corporate rate with a 23.8% qualified dividend rate results in an effective combined rate of 39.8% on income paid to an individual shareholder, compared to the top federal income tax rate of individuals at the new 37% highest marginal rate plus the 3.8% Medicare surtax. But the difference is not dramatic, and the business must also factor in state and local tax effects and whether earnings will be distributed or reinvested.

Another major change in the business tax regime is the so-called 20% deduction on qualified business income ("QBI") of owners and partners of S corporations, Limited Liability Companies ("LLCs"), partnerships, and sole proprietorships. QBI is defined generally as ordinary income less ordinary deductions that the taxpayer earns from a sole proprietorship, S corporation, or partnership. QBI does not, however, include any wages earned as an employee of the business. The QBI deduction is subject to several complicated limitation rules, and is available only for income from a trade or business that is conducted in the United States. For example, one of these limitations is the limitation that the QBI deduction not exceed the greater of either (i) 50% of the taxpayer's allocable share of the W-2 wages paid by the business, or (ii) the sum of 25% of the taxpayer's allocable share of the W-2 wages paid by the business plus 2.5% of the taxpayer's allocable share of the unadjusted basis of all qualified property. Certain exceptions to the W-2 wage limitations are available if taxable income does not exceed a "threshold" amount for the tax year. For 2018, the threshold amounts are $315,000 for married taxpayers filing jointly and $157,500 for all other taxpayers. These amounts are indexed for inflation beginning in 2019. It is important to note that certain service industries, such as health, law, accounting, and consulting (not including individuals with income below an applicable threshold amount), are not eligible for the deduction.

The pass-through deduction effectively reduces the highest marginal tax rate of the pass-through owners to 29.6% plus the 3.8% Medicare surtax. Since this effective rate is considerably lower than the effective combined corporate and individual rate (noted above at 39.8%) applicable to income received as dividends from C corporations, the pass-through structure may be preferable where the deduction is available. In addition, certain businesses with separate entities for payroll

and management or asset leasing may need to be reviewed and reorganized for optimal results. Given these changes, among others, businesses should evaluate their entity structure and options going forward. A company currently structured as a pass-through entity should consider whether they can benefit and take advantage of the 20% deduction.

International Tax

Perhaps the most dramatic changes in the new tax law are related to the taxation of certain foreign income earned by U.S. "C" corporations. Prior to the new law, U.S. corporations (as well as individuals and partnerships) were generally taxed on worldwide income earned directly by that corporation. A common business model was to operate abroad through a foreign subsidiary corporation, which allowed for tax deferral in many cases. Beginning in 2018, the U.S. tax system of foreign activities shifts to a territorial system. Under this new system, a U.S. corporation that owns at least 10% of a foreign corporation will generally not be subject to income tax on dividends received from that subsidiary's foreign activities if the U.S. corporate shareholder satisfies the requisite holding period of the foreign stock. (The foreign subsidiary may remain subject, however, to income taxes imposed by the foreign jurisdiction.) This new U.S. income exclusion is not available to other types of U.S. shareholders, including individuals, partnership, and S corporations, and also does not aid U.S. "C" corporations that directly operate abroad (rather than through a subsidiary). Thus, non-corporate U.S. shareholders will continue to be subject to tax on dividends received from foreign corporations. Accordingly, in many cases there is an incentive under the new law to own foreign incorporated businesses through a U.S. "C" corporation in order to benefit from the new rules.

Moreover, while the new territorial system for foreign activities is effective after December 31, 2017, there are new repatriation tax rules that are effective for tax years before 2018. A repatriation tax is imposed on accumulated and previously untaxed (post-1986) income accrued through the 2017 tax year (affecting tax returns to be filed as soon as March 15, 2018) earned by certain foreign corporations (generally including those corporations in which U.S. taxpayers own more than 10%). The tax applies whether or not the cash is actually repatriated to the U.S., and it applies to all controlled foreign corporations ("CFCs") as well as non-CFCs that have earnings not previously subject to U.S. income tax. In most cases, the new tax is effectively 15.5% for foreign earnings held in cash or cash equivalents and 8% tax on all other foreign earnings held in illiquid assets as of certain measurement points during the final calendar quarter of 2017. An election is available to pay the tax on the deemed repatriation in installments over 8 years. However, timely and careful planning will be required to gather this information to compute the repatriation tax, and foreign financial statements may need to be translated into U.S. terms. Although the new rules concerning the income exclusion for dividends of a foreign corporate subsidiary benefit only U.S. parent "C" corporations, the repatriation tax affects all U.S. shareholders of foreign corporations.

There are other provisions that may apply to earnings derived from foreign assets. Despite the territorial tax system, a new U.S. minimum tax applies on global intangible low-taxed income of foreign subsidiaries if the amount of income of a foreign subsidiary exceeds an implied 10% rate of return on certain foreign company assets. On the other hand, to keep intangible assets from moving offshore, a deduction is available for U.S. corporations with foreign-derived intangible income ("FDII"), essentially reducing the effective corporate tax rate for U.S. corporations serving foreign markets. Between 2018 and 2025, 37.5% of a domestic corporation's FDII will be

deductible, thereby bringing the effective U.S. tax rate on FDII to 13.125%. This effective tax rate is increased to 16.406% in 2026. To prepare for these various tax law changes, taxpayers should consult with their tax advisors as appropriate.

To the extent that foreign owners hold an interest in a U.S. limited liability company or U.S. partnership, it is important to note that the new law reverses a recent Tax Court ruling and codifies a position taken by the Internal Revenue Service to treat gain or loss recognized by a foreign partner on a sale of interest in a U.S. partnership as taxable in the U.S. Therefore, foreign owners of U.S. business interests should also evaluate the tax structure of business interests held in the U.S. Given this reversal, the reduction of the U.S. corporate tax rate and estate planning objectives, foreign owners may want to consider owning U.S. business interests through a corporation rather than through a pass-through entity. Whether a U.S. or foreign corporation is used for this purpose will depend on other considerations.

Prudent careful estate planning is particularly important for foreign individuals because the estate tax exemptions accorded to U.S. citizens and permanent residents are not available to non-resident aliens. U.S. estate tax on U.S. assets can often be legitimately avoided by such persons through ownership of stock in a foreign corporation. Unlike stock in a U.S. corporation, ownership of a foreign corporation is not considered a U.S. asset for estate tax purposes even if the corporation owns U.S. assets directly or indirectly, and thus can serve as an effective estate tax blocker for U.S assets owned by foreign individuals. (Some of these rules are modified by international tax treaties.) Care must also be taken to consider the U.S. and foreign income tax consequences if income-producing assets are owned through a corporation for estate tax purposes. Other alternatives should also be considered, such as a trust, which might be a more suitable option and result in less adverse income tax consequences than a corporation. An added benefit of both a foreign corporation or a trust is that they can often avoid the cumbersome administrative and reporting requirements involved in transferring assets upon the death of the foreign owner.

This alert is intended only as a summary of some of the principal changes made by the new law. There are many other changes and new provisions that will materially impact many of our clients. Although the economic effects may not be felt until early 2019, when tax returns are prepared for 2018, it is advisable and beneficial to review how the changes might affect you early in 2018, when there might be planning opportunities either to take advantage of new provisions in the law or to mitigate the potentially adverse effects of some of the changes. In many instances, no general rules or recommendations can be made without taking into account your individual circumstances. So, please consider consulting with your tax professionals, and let us know if any of our tax attorneys can be of assistance.

This *Tax Alert* was written by the Norris McLaughlin & Marcus tax department. If you have any questions regarding the information in this alert or any other tax related matters, please email tax@nmmlaw.com

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