TAX REFORM

Key considerations for individuals and business owners

February 2, 2018
Our speakers

Randy Abeles
Partner
Randy has 40 years of experience and works with high-net-worth individuals and families, service organizations and closely held companies, providing guidance through tax regulations.

Matt Talcoff
Partner
Matt has over 25 years of advising business owners, financial executives and other high net worth individuals with their business and tax needs.

Thomas M. Wright
Partner
Tommy's primary expertise is in tax planning for family wealth preservation, wealth transfers, charitable transfers, closely held business enterprises, family offices and taxation of multigenerational families.

Jamie Klosterman Sanders
Partner
Jamie works with high-net-worth families, trustees, business owners, and charitable organizations to structure and coordinate transactions around family wealth preservation, wealth transfers, charitable transfers and asset protection.
Agenda

• Introduction
• Individual income provisions
• Business provisions
• Estate and wealth provisions
OVERVIEW OF INDIVIDUAL INCOME PROVISIONS
## Individual impacts – income

<table>
<thead>
<tr>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Brackets and rates</strong></td>
<td>Seven tax brackets—10, 12, 22, 24, 32, 35, and 37 percent. The top individual rate of 37 percent will apply at incomes of $500,000/$600,000.</td>
<td>Many other rates remain the same including capital gains (15 percent / 20 percent), unrecaptured 1250 (25 percent), collectibles (28 percent), net investment income (NII) (3.8 percent), and AMT (26 percent/28 percent); Note the large marriage penalty</td>
</tr>
<tr>
<td><strong>Brackets and rates for estates and trusts</strong></td>
<td>Condenses the number of tax brackets from seven to four, including 10, 24, 35 and 37 percent brackets</td>
<td>Highest marginal rate is for income in excess of $12,500; AMT exemption for trusts remains unchanged</td>
</tr>
<tr>
<td><strong>Alternative minimum tax (AMT)</strong></td>
<td>Retained with higher exemptions ($70,300 / $109,400); phase-out of exemption increased to $500,000 / $1 million</td>
<td>Elimination of largest preference items and increased exemption means less taxpayers will be hit with AMT</td>
</tr>
</tbody>
</table>
### Individual impacts – income (cont.)

<table>
<thead>
<tr>
<th></th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal exemptions</td>
<td>Repeals</td>
<td>Increased child credit ($2,000) will make up for this; Those in AMT didn’t benefit from this in the past</td>
<td>For lower income families, consider income minimization strategies to optimize the refundable portion of the credit</td>
</tr>
<tr>
<td>Standard deduction</td>
<td>Doubles to $12,000 / $24,000; retains additional deduction for blind and elderly</td>
<td>More taxpayers will now claim the standard deduction; Potential impact on home ownership due to less benefit from mortgage interest and property tax deductions</td>
<td>Maximize charitable contribution benefit across family; Consider ‘bunching’ of deductions; Analyze after tax benefit of mortgage interest deduction versus less expensive non-deductible alternatives such as margin loans</td>
</tr>
<tr>
<td>Mortgage interest</td>
<td>Limited to interest on $750,000 of indebtedness on newly purchased principal and second residences incurred after Dec. 15, 2017; not allowed for home equity loans.</td>
<td>The $750,000 limit is not indexed for inflation; Can refinance pre-Dec. 15, 2017 loans and still qualify for a deduction up to $1 million</td>
<td>Interest on a home equity line of credit used to refinance acquisition debt qualifies for a deduction; Potential deduction for interest attributed to home office or investments in excess of $750,000; Conversion to rental property prior to sale or 1031 exchange should be explored</td>
</tr>
<tr>
<td>State and local tax deductions</td>
<td>Deduction of up to $10,000 for state and local property, income or sales taxes allowed</td>
<td>This limitation does not apply to business deductions; some states are looking to circumvent this limitation, many others are modifying their conformity with federal law which will likely result in increased state tax liabilities</td>
<td>Business owners should give increased scrutiny to whether taxes paid are personal or business; individuals may want to reconsider their state of residency</td>
</tr>
<tr>
<td>Charitable contributions</td>
<td>Deduction preserved, with increase in adjusted gross income (AGI) limitation from 50 percent to 60 percent on cash contributions</td>
<td>The contribution limit on appreciated property remains at 30 percent; deductions for rights to athletic seats is now eliminated; charitable contributions is one of the remaining itemized deductions; fewer people will benefit from charitable contributions with the higher standard deduction</td>
<td>If typical annual contributions will result in taking the standard deduction, consider ‘bunching’ several years of gifts together and donate to a donor advised fund; consideration should be given to timing of contributions to maximize the offset against ordinary income rather than capital gains/dividends; Consider use of charitable remainder trusts or charitable lead trusts</td>
</tr>
<tr>
<td>529 plans</td>
<td>Up to $10,000 of 529 plans can be used per student for public, private and religious elementary and secondary schools</td>
<td>It currently appears that existing balances may be used for these expanded purposes; the $10,000 limit is per beneficiary regardless of the number of accounts</td>
<td>With the expansion of the eligible schools, individuals should revisit gifting more to 529 plans, while there may not be a federal tax deduction, many states offer a deduction or credit; Consider use for college room and board (doesn’t qualify for 2503(e) exclusion); Take advantage of five year election</td>
</tr>
<tr>
<td>Tax Act</td>
<td>Observation</td>
<td>Planning</td>
<td></td>
</tr>
<tr>
<td>------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
<td></td>
</tr>
<tr>
<td><strong>Other deductions</strong></td>
<td>Deductions for casualty and theft losses limited to those incurred in a disaster area</td>
<td>Maintain careful records of all home improvements to maximize the deduction</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Alimony paid for divorce after Dec. 31, 2018 not deductible/includible after 2018</td>
<td>Careful analysis of divorce agreements from a tax standpoint must be reviewed; Agreements in place but not yet finalized must be reviewed to consider the impact of this change on both spouses</td>
<td></td>
</tr>
<tr>
<td><strong>Miscellaneous deductions</strong></td>
<td>Eliminates miscellaneous deductions over 2 percent of AGI</td>
<td>Consider approaching the investment advisor about alternative structures to their investment management fees such as a carried interest arrangement; For ultra high net worth individuals, consider comprehensive family entity restructuring to achieve trade/business deductibility based on Lender Management versus U.S. Tax Court case; increase investments in mutual funds; awareness of allocating tax preparation fees to business or rental activities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The loss of 2 percent deductions will negatively effect many individual taxpayers</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Individual impacts – income (cont.)

<table>
<thead>
<tr>
<th>Medical expenses</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical expenses exceeding 7.5 percent of AGI deductible for 2017 and 2018; eliminates AMT preference for medical expense deductions for 2017 and 2018.</td>
<td>Most taxpayers don’t qualify for this deduction due to the high AGI threshold; The change in the law will help taxpayers under age 65 by reducing the threshold from 10 percent to 7.5 percent</td>
<td>Consider ‘bunching’ of medical expenses to exceed the AGI threshold; Maximize other medical deductions such as health savings accounts</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Overall limitation on deductions (Pease Limitation)</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Suspends 3 percent of AGI limit on deductions</td>
<td>A small bright spot in itemized deductions</td>
<td>Increasing charitable deduction will result in more beneficial result due to lack of additional limitation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual retirement accounts (IRAs)</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conversion of traditional IRA to a Roth IRA cannot be recharacterized; can still convert traditional IRA into a Roth IRA.</td>
<td>This change disallows a prior planning opportunity; the ‘backdoor Roth’ is still available</td>
<td>Continue to contribute to a traditional IRA and convert to a Roth each year as a ‘backdoor’ contribution</td>
</tr>
</tbody>
</table>
Individual net operating losses

• For net operating losses (NOLs) arising in tax years ending after Dec. 31, 2017
  – NOL deduction to 80 percent of taxable income (determined without regard to such NOL)
  – Example: A has $90 NOL in 2018 that is carried forward to 2019. In 2019, A has $100 of taxable income. The NOL carryforward can only offset $80 of 2019 taxable income, and the remaining $10 NOL is carried forward indefinitely.
Individual net operating losses (cont.)

• For most taxpayers, carryback is repealed, but NOLs can be carried forward indefinitely
  – Terminate on death, but under section 1.642(h)-1, trust losses may flow to beneficiary

Exception

• Two year carryback for farming trade or business (defined in section 263A(e)(4))
Key provisions of prior law left undisturbed

• Income tax
  - The 3.8 percent tax on investment income under section 1411 and the .9 percent Medicare tax on compensation
  - Tax rates on capital gains and qualified dividends
  - Exclusion of gain on sale of a residence
  - Ability to identify the securities that an investor is deemed to sell, i.e., the Senate’s proposal for a ‘first-in, first out’ method not included
  - Pre-tax contribution limits (including catch-ups) for 401(k) plans
  - Ability for beneficiaries to ‘stretch’ IRA withdrawals out over their lifetimes
  - Student loan interest deductions, adoption assistance programs, dependent care accounts, tuition waivers, employer paid tuition, teacher supplies deduction and Archer medical savings accounts
1. Corporate tax rates reduced from a top rate of 35 percent to 21 percent
2. Individual tax rate of owners reduced from a top rate of 39.6 percent to 37 percent
3. Pass-through entity deduction up to 20 percent of the qualified business income
4. Enhanced depreciation deductions for capital expenditures (bonus and section 179)
5. Alternative minimum tax repealed for corporations and higher exemption for individual owners
6. Potential limit on Interest deduction based on 30 percent of modified taxable income
7. NOL rule changes generally reduce value of NOL carryforwards
8. Active business loss limitations apply at the individual level
9. Small business exemptions exist for limits on interest deduction and accounting methods
10. Many tax credits preserved (TIPs, Work Opportunity Tax Credit (WOTC), research and development (R&D))
11. Charitable contribution deductions preserved
12. Deduction for domestic production activities (section 199) was repealed
13. Elimination of Tax Deductions for Entertainment
14. Transition to territorial system—mandatory tax up to 15.5 percent on accumulated foreign earnings (slightly higher rate for individuals)
15. Decoupled and diverse state income tax systems
16. Carried interest provisions added with 3 year holding period
17. Transaction related changes including limits on interest deductions and enhance write-offs
18. Estate and gift tax exemptions nearly doubled to approximately $11 million
Business tax planning opportunities

• Accelerate deduction/defer income in 2017
  – Cost segregation studies – new construction, existing buildings purchased or renovations in current year or prior years
  – Maximize depreciation deductions/tangible asset regulations
  – Review accounting methods
    • Deduction of prepaid expenses
    • Maximize deductions of accrued expenses
    • Deferral of advanced payments
    • Deferral of trade discounts

• Evaluate entity selection options
CORPORATE TAX RATE CUTS

The choice of entity question
Details of the reduced corporate tax rate

• Tax rate reduction from 35 percent to 21 percent
  – Compare to top individual tax rate of 37 percent
  – Effective in 2018 (audited financial statements (AFS) for deferred taxes in 2017 statements)
  – Repeals AMT for corporations not individuals
  – No special 35 percent rate for personal service corporations

• Dividends received deductions (DRD)
  – Corporation-to-corporation dividends adjusted accordingly
  – Reduces 80 percent DRD to 65 percent and 70 percent DRD to 50 percent to preserve current effective rates
Reducing 35 percent to 21 percent – individual owner investing in C corporation

- **Current (2017) income tax rules**
  - $100 of corporate income
    - Less $35 tax at 35 percent rate
  - $65 of cash on balance sheet
    - Less $13 tax at 20 percent rate
  - $52 of after tax cash
    - 48 percent combined income tax rate
    - 3.8 percent tax on $65 or $2.47
    - **All-in 50.47 percent tax rate**

- **Future income tax rules**
  - $100 of corporate income
    - Less $21 tax at **21 percent rate**
  - $79 of cash on balance sheet
    - Less $15.8 tax at 20 percent rate
  - $63.2 of after tax cash
    - 36.8 percent combined income tax rate
    - 3.8 percent tax on $79 or $3
    - **All-in 39.8 percent tax rate**
  - Note: Max individual rate of 37 percent
    - 20 percent reduction is **29.6 percent on certain business income**
Planning around the new rates (C corporation/entity choice)

• New income tax rules (C corporations)
  - $100 of corporate income
    • Less $21 tax at 21 percent rate
  - $79 of cash on balance sheet
    • Less $15.8 tax at 20 percent rate
  - $63.2 of after tax cash
    • 36.8 percent combined income tax rate
    • 3.8 percent tax on $79 or $3
  - All-in 39.8 percent tax rate

• Planning opportunities
  - Defer the 20 percent dividend and 3.8 percent NII tax
    • Reinvesting cash in the business
  - Avoid the 20 percent dividend and 3.8 percent NII tax
    • At death or
    • Stock gifts to charity that would otherwise be made in cash
  - Reduce the 20 percent dividend and 3.8 percent NII tax
    • if shares held by lower-rate taxpayers
    • including from gifts, trusts, etc.
With corporate rates far below individual rates – a blast from the past?

• Accumulated earnings tax
  – Section 531
  – Applies to accumulated earnings ‘beyond the reasonable needs of the business.’

• Personal holding company tax
  – Section 541
  – Applies to ‘incorporated talents’ or pocketbooks

• Section 482
  – Reallocate items among commonly controlled businesses
PASS-THROUGH ENTITIES
20 percent pass-through deduction in a nutshell (section 199A)

- Deduction limited to 20 percent of qualified business income
- Applies to operating income of active businesses
  - If at 37 percent tax rate then the 20 percent deduction results in an approx. **29.6 percent federal tax**
  - Compared to
    - 21 percent top corporate tax rate
    - 37 percent top individual tax rate
    - 39.8 percent top corporate/dividend tax rate
    - **29.6 percent** potential pass-through tax rate
- Does not apply, generally, to professions or financial businesses
- Additional limitations based on greater of
  - 50 percent of W-2 wages (i.e., business must pay W-2 wages of 40 percent of income for full 20 percent deduction) or
  - 25 percent of W-2 wages plus 2.5 percent of original cost of depreciable, tangible property
- Business type and wage/asset limits do not apply below **income limits** ($315,000 MFJ)
- Only applies to income taxes (not self employment or NII tax calculations)
No benefits (above the income threshold) for owners of ‘specified service businesses’ defined as –

• Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or

• Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees [OR OWNERS],

• What does this mean?
  – For example, could a restaurant operation be a service business under this provision?
Problems and issues

• **Employee** versus **independent contractor**?
  - Conversions under $315,000?

• Are all ‘service businesses’ without large physical plants disqualified because their ‘principal asset’ is the **skill and reputation of their employees or owners**?

• Are dermatology clinics forbidden, but tanning salons allowed (property)?
  - Is there a better way?

• Can an **owner without wages or assets pay himself** a wage and get a 14 percent deduction, in effect?
  - Can partners be employees?

• Will ‘reasonable compensation’ rules apply to **S corporations**?
  - Will they apply to partnerships or proprietorships?
Revisiting the rate reductions for individuals investing in C corporations

• Current income tax rules
  – $100 of corporate income
    • Less $35 tax at 35 percent rate
  – $65 of cash on balance sheet
    • Less $13 tax at 20 percent rate
  – $52 of after tax cash
    • 48 percent combined tax rate
    • 3.8 percent tax on $65 or $2.47
    • All-in 50.47 percent tax rate

• Proposed income tax rules
  – $100 of corporate income
    • Less $21 tax at 21 percent rate
  – $79 of cash on balance sheet
    • Less $15.8 tax at 20 percent rate
  – $63.2 of after tax cash
    • 36.8 percent combined income tax rate
    • 3.8 percent tax on $79 or $3
    • All-in 39.8 percent tax rate
Example 1 – high income taxpayers – no wages or tangible property

• Investor with $1 million of salary income buys an empty lot for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to use as a parking lot that generates gross parking fees of $200,000

• With $200,000 of gross income, but paying $40,000 to an independent contractor to manage the lot, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income

• The 20 percent deduction does not apply – not enough ‘wages’ and not enough ‘depreciable property’
Example 2 – high income taxpayers - wages

- Investor with $1 million of salary income buys an empty lot for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to use as a parking lot that generates gross parking fees of $200,000

- With $200,000 of gross income, but paying $40,000 to an employee to manage the lot, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income

- The 20 percent deduction of $20,000 applies – because at least $40,000 of wages were paid
Example 3 – high income taxpayers – tangible property

• Investor with $1 million of salary income buys parking structure for $1 million, paying $200,000 of cash and borrowing $800,000 at 5 percent interest, to generate gross parking fees of $200,000. With $200,000 of gross income, but paying $40,000 to a contractor to manage the facility, and $20,000 for insurance and $40,000 of interest, there is $100,000 of net income. Assume no depreciation deductions for simplicity.

• Even without wages the $20,000 deduction would be allowed.
  – The alternative annual limitation is 2.5 percent of the taxpayer’s original $1 million investment in depreciable tangible property or $25,000 – plus 25 percent of wages paid if any.
  – $1 million base is not ‘depreciated’ down – it is unadjusted – for 10 years or full life if longer – as long as property is used in business.
  – Effectively assumes ‘normal’ return is 12.5 percent
Example 4 – high income taxpayers - lease to a service business

• Meets ‘wage’ test and ‘asset’ test
• But leases the garage to a hospital for their patients and visitors
• **Maybe all benefits are disallowed** because this is a forbidden business providing services in the field of ‘health’
• Certainly that limit would apply to an investment in a radiology center, or urgent care facility, even if the investor were passive, not a physician providing services
Joint filers incomes below $315,000 – a special rule

No wage or asset requirements, and no service business limitations

• Phased-out quickly as income rises from $315,000 to $415,000
  – Close to 100 percent marginal tax rate?

• Many lawyers, accountants, physicians and dentists probably earn < $315,000 of household income

• For two married accountants, lawyers, physicians, or dentists each earning $150,000, the total deduction is $60,000 for a tax cut in the range of $15,000
## Tax rate analysis – flow-through entities

<table>
<thead>
<tr>
<th>TCJA - flow-through</th>
<th>Active owners</th>
<th>Passive owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top individual rate</td>
<td>37.00%</td>
<td>37.00%</td>
</tr>
<tr>
<td>Less: flow-through income deduction (20%)</td>
<td>-7.40%</td>
<td>-7.40%</td>
</tr>
<tr>
<td>Net investment income tax</td>
<td>0.00%</td>
<td>3.80%</td>
</tr>
<tr>
<td>State (example) taxes</td>
<td>5.23%</td>
<td>5.23%</td>
</tr>
<tr>
<td>Less: federal benefit of state taxes</td>
<td>0.00%</td>
<td>0.00%</td>
</tr>
<tr>
<td>Maximum marginal rate</td>
<td>34.83%</td>
<td>38.63%</td>
</tr>
<tr>
<td>TCJA - C corporation</td>
<td>Active owners</td>
<td>Passive owners</td>
</tr>
<tr>
<td>--------------------------------------------</td>
<td>---------------</td>
<td>----------------</td>
</tr>
<tr>
<td>Federal tax rate</td>
<td>21.00%</td>
<td>21.00%</td>
</tr>
<tr>
<td>State (example) taxes</td>
<td>5.88%</td>
<td>5.88%</td>
</tr>
<tr>
<td>Less: Federal benefit of state taxes</td>
<td>-1.23%</td>
<td>-1.23%</td>
</tr>
<tr>
<td>Maximum marginal rate</td>
<td>25.64%</td>
<td>25.64%</td>
</tr>
<tr>
<td>Net tax rate ‘savings’</td>
<td>9.19%</td>
<td>12.99%</td>
</tr>
</tbody>
</table>
Tax rate breakeven – C corporation dividends

<table>
<thead>
<tr>
<th>C corporation - flow-through break-even</th>
<th>Active owners</th>
<th>Passive owners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal tax rate</td>
<td>21.00%</td>
<td>21.00%</td>
</tr>
<tr>
<td>State (example) taxes</td>
<td>5.88%</td>
<td>5.88%</td>
</tr>
<tr>
<td>Less: federal benefit of state taxes</td>
<td>-1.23%</td>
<td>-1.23%</td>
</tr>
<tr>
<td>Dividend % of corporate profits</td>
<td>31.7%</td>
<td>44.7%</td>
</tr>
<tr>
<td>Federal tax on dividends</td>
<td>7.54%</td>
<td>10.64%</td>
</tr>
<tr>
<td>State tax on dividends</td>
<td>1.66%</td>
<td>2.34%</td>
</tr>
<tr>
<td>Maximum marginal rate</td>
<td>34.84%</td>
<td>38.62%</td>
</tr>
</tbody>
</table>
C corporation versus flow-through – other considerations

- Future dividend/distribution expectations
- Future ownership considerations
- Accumulated earnings tax considerations
- Partnership conversion considerations
- Waiting period for S corporation ‘re-election’
- Exit strategy impacts
- Business valuation on sale
- Impact to any existing or planned estate/gift planning
- Future political/legislative changes
CAPITAL EXPENSES
Depreciation, expensing, bonus depreciation
Depreciation - complex analysis but generally…

- Basic, pre-bonus depreciation rules, viewed as non-economic by some, remain in baseline (MACRS)
- 100 percent bonus depreciation through 2022, then phased out through 2026
- Applies to new and used property acquired
- Changes to real property depreciation complex, and may depend on applying business interest limitations
- Applied for property acquired after Sept. 27, 2017
- Qualified improvement property (QIP) remains (Qualified LHI, restaurant and retail improvement eliminated) – But no life provided and needs to be 20 years or less to be 100 percent bonus eligible
- Section 179 - $1 million permanent expensing, s/t limitations and phase-outs beginning at $2.5 million (individuals not trusts)
  - QIP interior of non-residential rental property and will include roofs, HVAC, fire protection, Security Systems
  - Careful planning needed
- State conformity is a question and an opportunity
BUSINESS INTEREST DEDUCTIONS CUTBACK
Important changes to interest limitations

• Caps net interest deduction at 30 percent of an amount based on earnings (EBITDA) for four years, then limits the deduction to 30 percent of earnings before interest and taxes (EBIT)

• Taxpayers with average gross receipts of $25 million or less and car dealers using floor plan financing loans to fund their inventory are excluded from the interest limitation

• Allows ‘limited’ deductions to carry forward forever

• Various exceptions for real estate, utilities, farming and certain small businesses

• Special rules for partners and partnerships
Interest limitation using EBITDA

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $500,000

30 percent of base = $150,000
No limitation applies

Carryforward allowed indefinitely
Interest limitation using EBIT

Company worth $3 million
Debt of $2 million @ 5 percent
Equity of $1 million

Earnings before interest and depreciation = $500,000
Depreciation = $200,000
Interest = $100,000
Taxable income before limitation = $200,000

Base for limitation = $300,000

30 percent of base = $90,000
$10,000 interest is ‘limited’

Carryforward allowed indefinitely
OTHER IMPORTANT BUSINESS DEDUCTION LIMITATIONS, LIBERALIZATIONS, OR DEFERRALS
Good news

- Financial statement deferred tax liability may be reduced
- Corporate AMT repealed after 2017 (but Individual AMT remains)
- Expanded use of cash method of accounting for small C corporations and partnerships with C corporation partners with < $25 million gross receipts
- Expands the uniform capitalization (UNICAP) small business exception
- Generally exempts certain small business taxpayers from requirement to keep inventory
- Expands percentage of completion method exception for certain construction contracts
- Retains R&D credit (but amortization after Dec. 31, 2022)
- Retains other credits including TIPs and WOTC (for hires on or before Dec. 31, 2019)
- Favorable depreciation rules (but QIP?)
- Repeals technical termination of partnerships
Not good news

- No more manufacturer’s deduction (section 199)
- No more NOL carrybacks – some limitations and modifications to the carryforward rules
- Modifies the exclusion from income of certain contributions to capital (e.g., state/city grants)
- Limits like-kind-exchanges to certain real property
- Increased limitations on deductibility of certain expenses of entertainment
- Limits on business interest expense
- Limit on state income tax deductions for flow-throughs
- Deemed repatriation (good news, bad news)
- Changes public company executive compensation deductibility (section 162(m)) rules
New loss limitation rule applies to taxpayers other than corporations

• Prohibits deducting ‘excess losses’ against wage and/or investment income

• Excess business loss
  – The excess of deductions from all trades or businesses of the taxpayer in excess of
  – Gross income from such businesses plus $250,000 (single or MFS) or $500,000 (joint)

• Limitation is applied at the individual or trust level, not at the entity level

• Losses limited by rule carry over as NOL

• Excess loss limit applied after passive activity loss limits are applied
Important changes to NOL deductions

• Carryback and carryforward
  – Repeals the carryback period (two-year)
  – Provides for an indefinite carryforward period
  – Applicable to losses arising in taxable years ending after Dec. 31, 2017

• Limits NOL deduction to 80 percent of taxable income for losses arising in taxable years beginning after Dec. 31, 2017
CLOSE-UP ON REAL ESTATE
Multiple moving pieces in commercial real estate

• Reduced pass-through tax (via 20 percent deduction) likely to apply in many cases
• Real estate investment trusts (REITs) automatically get that benefit, possibly including mortgage REITs
• Potentially serious limits on ‘active losses’
• Business interest disallowance will not apply
  – But at the cost of some depreciation benefits
• Like-kind-exchanges preserved
• Carried interest defined, but essentially preserved, longer holding period
CLOSE-UP ON PROFITS INTERESTS AND CARRIED INTERESTS
Treatment of carried interest

- Expressly recognizes the concept of different treatment for profits interests in an ‘applicable trade or business’ defined as
  - A regular, continuous and substantial activity of
  - Raising or returning capital, and either
    - Investing in or disposing of specified assets, or
    - Developing specified assets
  - Specified assets include securities, commodities, real estate, cash, options, derivatives and partnership interests
- But, for now, only applies a three-year holding period
CLOSE-UP ON PRIVATE EQUITY
Issues for private equity

• Generally good news for treatment of carried interest if held for three years
• Business interest limitations may limit leverage
• NOL rules and other rules may require restructuring
• Reconsider choice of entity (partnership versus corporation) for portfolio companies
• Founders or other individuals may have rate issues, self-employment issues and net investment income tax issues
• Write off of used assets in M&A transaction
OVERVIEW OF THE STATE TAX CONSIDERATIONS
State taxation – Decoupled and diverse state income tax systems

• Will states legislatures decouple?
  – 2018 sessions have begun, 47 states and the District of Columbia scheduled to be in session, most sessions end by June

• A question of conformity
  – Rolling, fixed, selective

• Some provisions broaden the federal income tax base (e.g., interest expense limitations)
  – Potential windfall for states

• Some provisions allow deductions from the federal income tax base (e.g., bonus depreciation)
  – Expect decoupling for state purposes

• Other state responses
  – State income tax systems and rates could change
  – Deduction and exemption eliminations, base expansions and new taxes, e.g., gross receipts taxes
  – Continued aggressive nexus expansion

• Many planning opportunities exist
  – Location selection, nexus
  – Choice of entity and state specific elections
  – Capital expenditures, section 179
  – Credits and incentives
OVERVIEW OF THE INTERNATIONAL BUSINESS PROVISIONS
What about offshore earnings and profits?

- **New tax holiday for offshore earnings:**
  - Deferred offshore earnings taxed in 2017 for calendar year ‘deferred income corporations’
    - ‘Clears the earnings and profits (E&P) decks’
  - Two tier rates (15.5 percent/8 percent): cash versus non-cash assets
  - Applies to a U.S. shareholder (individuals will get slightly higher rates)
  - Must take into account share of ‘aggregate’ earnings in all foreign countries
  - But can offset positive earnings in some foreign countries with deficits of others
  - Election to defer payment of tax over eight years
  - Special election for S corporation shareholders – can defer until triggering event
    - (e.g., sale or liquidation)
- **Other Items**
  - Global intangible low tax income (GILTI)
  - Base erosion anti-abuse tax (BEAT)
  - Planning
GILTI and FDII

- Section 250 imposes a tax on
  - GILTI (10.5 percent)
  - Foreign derived intangible income (FDII) (13.125 percent) and

- GILTI is a tax computed on income earned by foreign subsidiaries (limited foreign tax credit)

- FDII is a tax computed on income earned by U.S. entity on foreign income

- Calculations measure income against an appropriate return (10 percent) on the tangible assets of the applicable corporation

- Special lower tax rates do not apply to individuals
OVERVIEW OF TRANSFER TAX PROVISIONS & RELATED PLANNING
### Individual impacts – estate, gift and trust

<table>
<thead>
<tr>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estate, gift and generation-skipping transfer tax (GST)</td>
<td>Exemptions are doubled to approximately $11.2 million, effective Jan. 1, 2018. The estate, gift and GST tax rates remain the same as existing law. Estate and GST tax not repealed. Provisions sunset after 2025.</td>
<td>Increased exemptions revert to 2017 law Jan. 1, 2026. Indexed for inflation post 2011. Annual exclusion increased to $15,000 per donee. Basis step-up is retained for property subject to estate tax.</td>
</tr>
<tr>
<td>Impacts – estate and trust income taxation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Tax Act</strong></td>
<td><strong>Observation</strong></td>
<td><strong>Planning</strong></td>
</tr>
<tr>
<td>-----------------</td>
<td>-----------------</td>
<td>--------------</td>
</tr>
<tr>
<td>Estate &amp; trust income taxation</td>
<td>Section 1 - new tax rate schedule and brackets for income taxation</td>
<td>Seven brackets; top rate of 37 percent applies to income in excess of $12,500</td>
</tr>
<tr>
<td></td>
<td>Section 199A 20 percent pass-through deduction for “qualified business income”</td>
<td>Applies to estates &amp; trusts invested in “qualified businesses” held in flow through entity (possible ESBT exception – see below)</td>
</tr>
<tr>
<td></td>
<td>Section 461 limitation for “excess business losses” of non-corporate taxpayers</td>
<td>Applies to estates &amp; trusts (applies to non-corporate taxpayers)</td>
</tr>
<tr>
<td></td>
<td>Section 67(g) repeals miscellaneous 2 percent type deductions</td>
<td>Applies to estates &amp; trusts; controversy over whether Trustee &amp; Executor fees &amp; other administration expenses remain deductible under section 67(e)</td>
</tr>
<tr>
<td></td>
<td>Section 164(b)(6) $10,000 limit on deduction for state and local taxes</td>
<td>Applies to estates &amp; trusts; no deduction for foreign real property taxes</td>
</tr>
</tbody>
</table>
### Impacts – estate and trust income taxation

<table>
<thead>
<tr>
<th><strong>Tax Act</strong></th>
<th><strong>Observation</strong></th>
<th><strong>Planning</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Electing small business trusts (ESBTs)</td>
<td>Applies individual charitable deduction limits and carry over provisions under section 170 to ESBTs</td>
<td>Charitable deductions for ESBTs subject to same limits as individuals. Prior to Act, the charitable deduction for trusts was computed based on its gross income assuming language was present in document – section 642(c)</td>
</tr>
<tr>
<td>Section 199A deduction</td>
<td>The section 199A deduction may not be available to ESBTs without technical corrections due to section 641(c)(2)(C) language</td>
<td>Needs clarity; hopefully will be answered in technical corrections bill later this year</td>
</tr>
<tr>
<td>Section 1361 permits non-resident aliens as beneficiaries of ESBTs effective Jan. 1, 2018</td>
<td>Prior to the Act, non-resident aliens could not be ESBT beneficiaries</td>
<td>Makes ESBTs inherently more flexible for families as the world becomes more global</td>
</tr>
<tr>
<td>Section 461 limitation for “excess business losses” of non-corporate taxpayers</td>
<td>There is some thought that the 461 limit may apply separately to the ESBT portion of the trust and again to the non-ESBT portion of a trust</td>
<td>If there is independent application of the limitation then this may increase the ability to claim business losses (ESBT portion and non-ESBT portion)</td>
</tr>
</tbody>
</table>
Observations on impact of reform on estate planning

• Doubling of the exemptions (and indexing thereafter) would effectively repeal the estate tax for many individuals
  – But sunsetting makes the planning more problematic

• The doubling of the estate tax exemption is reason enough to review the estate plan, e.g., the funding of a so-called ‘credit shelter’ trust (‘bypass trust’)

• Key inquiries will be
  – Whether the current or projected estate will be taxable in the first place, and
  – Whether there is a need (or, just as important, a desire) to reduce the taxable estate
    • Perhaps just use the increased exemption to fix problems with existing planning

• Plans for estate tax liquidity should be revisited
  – For increased exemptions, sunsetting, etc.
Impact of tax reform on transfer tax planning

• Increase in the estate, gift and GST exemptions to approximately $11.2 million (indexing thereafter) will effectively repeal the estate tax for many individuals
  – Jan. 1, 2026 these increased exemptions revert to 2017 amounts (indexed for inflation)
  – Potential for legislative changes after 2020 presidential and congressional elections that could reduce exemptions sooner than scheduled

• Basis step-up retained for assets subject to estate tax inclusion

• No change in transfer tax rates – top rate remains 40 percent

• Treasury has not addressed how the scheduled reduction in exemption amounts will be handled computationally; will there be ‘clawback?’

• Existing formula clauses in estate planning documents need careful review and can create unintended consequences in their current form
  – Formula clauses can result in ‘dis-inheritance’ or diminished assets passing to surviving spouse or to a martial trust
  – Existing testamentary charitable trust clauses in estate planning documents need careful review to determine if they remain appropriate or necessary
Impact of tax reform on transfer tax planning

• Due to the complexity of the transfer tax system, sophisticated estate planning lawyers must be engaged. These law changes necessitate a review of all estate and gift plans and related documents in order to insure flexibility in reacting to the scheduled and unscheduled changes in the law and to avoid unintended consequences with existing documents.

• Concepts to review and planning opportunities include:
  – Income tax basis step-up planning
  – Trust planning
  – Designated beneficiary review
  – Account designations
  – Retirement, financial and insurance planning
  – GST planning
  – Marital planning
  – Charitable planning
  – Educational funding
Income tax basis step-up planning

- With fewer individuals subject to transfer tax, income tax basis in inherited or gifted assets becomes more important in overall tax planning
- Basis step-up retained for assets subject to the estate tax inclusion
- Utilization of the power of substitution language in grantor trust agreements to permit exchanges of assets with grantor to achieve high basis assets for the trust (including cash) and low basis assets for grantor
- Electing portability of unused estate exemptions (DSUE) at first death
- Utilization of powers of appointment to trigger estate tax inclusion in estates where values are under the applicable exemption amounts
- Review formula clauses in wills and revocable trusts for funding bypass trusts (no additional step-up at second death) versus marital deduction trusts (step-up at second death) to insure tax efficient result with asset basis
Trust planning for new and existing trusts

• Planning considerations include trust situs (including locations of assets, beneficiaries, administrators and trustees), state income taxation, trust duration, fiduciary and advisor appointments, trust governance, powers of appointment, grantor trust provisions, release of grantor trust status, S corporation provisions, needs of beneficiaries, distribution policies, trust accounting policies, generation skipping provisions, and maximization of asset basis

• Employ above considerations in wills and revocable trusts, new trust agreements or for decanting of existing trusts
Review of beneficiary designations and property characterization

- Review of beneficiary designations in light of increased transfer tax exemptions for IRAs, retirement plans, life insurance and annuities and coordination with current estate plan

- Review of financial account designations to coordinate with current estate plan.
  - Examples: Joint tenants with rights of survivorship, joint tenants, transfer on death or paid on death accounts

- Estate equalization considerations and options when estate consists of substantial separate property due to asset concentrations in one spouse
Retirement, financial and insurance planning

- Review of life and disability insurance coverage and needs
- Estate liquidity planning
- Review of casualty and liability insurance coverage and needs
- Conversions of (or contributions to) Roth IRAs
- Section 529 plan funding for educational needs
- Gifting to life insurance trusts to remedy underfunded or leveraged policies to maintain adequate death benefit, or to repay loans
- Gifting to irrevocable trusts to allow trust repayment of existing loans
- Review of retirement plan beneficiaries – consider charitable beneficiaries only in appropriate circumstances
- IRA distribution income tax planning
Retirement, financial and insurance planning

• Prohibition on re-characterizations of Roth IRA to a traditional IRA – section 408A(d)(6)(B)(iii)

• Transfer for value rule for life insurance policy transactions – ‘reportable policy sales’ do not qualify for the exclusion from income for death benefits paid – section 101(a)(3)

• New reporting requirement for ‘reportable policy sales’ – section 6050Y

• ‘Reportable policy sales’ – acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured apart from the acquirer’s interest in such life insurance contract

Generation-skipping tax planning

- Additional funding of existing GST trusts or creation of new dynastic trusts for generational planning
- Outright gifts to grandchildren and other ‘skip’ persons
- Review existing non-exempt or partially exempt trusts to determine if late allocations of GST exemption are appropriate
- Review estate plans to determine the optimal utilization of the increased GST exemption in their wills or revocable trusts
- Consider gifts to GST trusts to allow trust repayment of existing loans
- Create new GST exempt trusts to purchase assets from existing non-GST trusts
- GST exemption cannot be ported to surviving spouse
Marital planning

- Review estate plans to maximize basis step up at death through minimization of bypass trust funding and/or use of portability elections.

- Use portability credit of surviving spouse to fund a new intentionally defective grantor trust (IDGT) with stepped up assets after first death.

- Explore disclaimer planning for estates with sophisticated executors and cooperative surviving spouses.
  - The will may leave everything into a qualified terminable interest property trust (QTIP or marital trust). The executor and surviving spouse then execute a qualified disclaimer (within 9 months of date of death) up to the exact amount that is preferable to pass to a bypass/credit shelter trust or by identifying specific high basis assets to pass to the bypass/credit shelter trust.
Charitable planning

- Charitable giving done during lifetime versus at death more beneficial due to lifetime income tax savings
- Use of low basis assets for funding charitable gifting
- Cash gifts to public charities – 60 percent of AGI limit
- Donor advised funds – IRS issued Notice 2017-73 regarding future proposed regulations for payment of personal pledges and purchase of tickets
- Donor advised funds must now report to IRS average grant amounts made
- Electing small business trusts – now subject to same charitable deduction limits applicable to individuals
- Deduction no longer available for charitable portion of collegiate athletic ticket purchases (no donative intent)
Education related planning

- Continued ability to fund $75,000 into section 529 plans with five year ‘spread’ election on Form 709
- Up to $10,000 per year per student may be used to fund qualified expenses for K-12 education – section 529(c)(7)
- Continued unlimited gift exclusion for direct payment of tuition to educational institutions
- Section 529 plan assets – rollovers allowed to Achieving a Better Life Experience (ABLE) Plans for disabled – section 529(c)(3)(C)(i)(III)
- Section 529A ABLE plan changes – increased funding by beneficiary – section 529A
Thank you

Randy Abeles
Partner
randy.abeles@rsmus.com
+1 312 634 3326

Matt Talcoff
Partner
mathew.talcoff@rsmus.com
+1 617 241 1216

Thomas M. Wright
Partner
tommy.wright@rsmus.com
+1 713 625 3520

Jamie Klosterman Sanders
Partner
jamie.sanders@rsmus.com
+1 713 350 6135
Visit our tax reform resource center for more information on how legislation can affect your business and tax planning.
Upcoming tax reform webcasts

What does the Tax Cuts and Jobs Act mean for pass-through entities? February 14, 2018

How does the Tax Cuts and Jobs Act affect your choice of entity? February 28 2018
THANK YOU FOR YOUR TIME AND ATTENTION
### Business impacts

<table>
<thead>
<tr>
<th>Business provisions – pass-through entities</th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>20 percent deduction for qualified business income from pass-through entities</td>
<td>Applies to REITS, publicly traded partnerships, trusts/estates, trade or business and certain service companies</td>
<td>Restrictions exist based on entity level wages and tangible/depreciable assets and individual taxpayer income levels &lt;phased out: $315,000 to $415,000 (MFJ)&gt;</td>
<td>Analysis of businesses and activities to see if there are nonqualified activities that should be separated out or combined (grouping opportunities?)</td>
</tr>
<tr>
<td></td>
<td>Compensation to business owners does not factor into the deduction calculation</td>
<td></td>
<td>Analysis to see if activity rises to definition of trade or business</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Analysis of employee versus independent contractor</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Planning for capital expenditures</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Analysis and planning for owner compensation to ensure trade or business definition is met, while optimizing the 20 percent deduction</td>
</tr>
</tbody>
</table>
## Business impacts (cont.)

<table>
<thead>
<tr>
<th>Business provisions – pass-through entities</th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NOL restrictions</td>
<td>Excess business losses are carried over as net operating losses</td>
<td>Net operating losses should be evaluated to determine future benefit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>NOLs generated during tax years beginning after Dec. 31, 2017 through 2025 are limited to 80 percent of taxable income</td>
<td>Managing taxable income may become significant</td>
</tr>
<tr>
<td></td>
<td></td>
<td>NOL carryback provisions are eliminated</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Unused losses can be carried forward indefinitely</td>
<td></td>
</tr>
</tbody>
</table>
### Business impacts (cont.)

<table>
<thead>
<tr>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business provision - general</strong>&lt;br&gt;Temporary 100 percent expensing for certain business assets for qualified property</td>
<td>Expansion of definition of qualified property&lt;br&gt;Effective Sep. 27, 2017&lt;br&gt;Phase out begins in 2023&lt;br&gt;Section 179 expensing limit increased to $1 million – also subject to phase out</td>
<td>Planning for current and long term capital expenditure needs</td>
</tr>
<tr>
<td><strong>Depreciation limits on luxury autos and personal use property increased</strong></td>
<td>Effective for property placed in service after Dec. 31, 2017&lt;br&gt;Amounts to be indexed for inflation&lt;br&gt;Removes computer and peripheral equipment from definition of listed property</td>
<td>Revisit leasing versus purchasing policies</td>
</tr>
</tbody>
</table>
## Business impacts (cont.)

<table>
<thead>
<tr>
<th></th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business provision - general</td>
<td>Business interest expense limitations</td>
<td>Interest expense cannot exceed 30 percent of EBITDA – in effect for four years</td>
<td>Debt obligations and financing needs should be evaluated for limitations and potential restructuring opportunities</td>
</tr>
<tr>
<td></td>
<td></td>
<td>After four years – limit is 30 percent of EBIT</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Excess interest may be carried forward, with certain limitations</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Small business exemption (preceding three year average gross receipts &lt;$25 million)</td>
<td></td>
</tr>
<tr>
<td>Business provision - general</td>
<td>Carried interest – a three year holding period is required for long-term capital gain rates</td>
<td>This will impact those in the private equity and real estate space</td>
<td>Questions remain regarding the asset subject to the three year holding period; Questions also surround the applicability to 1231 gains</td>
</tr>
</tbody>
</table>
### Business impacts (cont.)

<table>
<thead>
<tr>
<th>Business provisions - general</th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business provisions - general</td>
<td>Domestic manufacturing activities deduction (DPAD) eliminated</td>
<td>DPAD deduction of 9 percent of income from qualified activities has been repealed</td>
<td>Maximize the deduction in 2017</td>
</tr>
<tr>
<td>R&amp;D expenditures</td>
<td>R&amp;D expenditures</td>
<td>R&amp;D credit remains intact</td>
<td>Consider timing of R&amp;D and ability to claim credits</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Capitalization of R&amp;D is required, including software development</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Costs are amortized ratably over five years (15 years for non-US R&amp;D)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Effective for years beginning after Dec. 31, 2021</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Law change is considered an accounting method change – non automatic</td>
<td></td>
</tr>
</tbody>
</table>
### Business impacts (cont.)

<table>
<thead>
<tr>
<th>Business provision - general</th>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall method of accounting</td>
<td>Use of cash method for C corporations and partnerships with C corporation partners is expanded</td>
<td>Applies to businesses with gross receipts up to $25 million (increased from $5 million)</td>
<td>Small business clients should be analyzed to determine if an accounting method change is favorable</td>
</tr>
<tr>
<td>Like kind exchanges (LKE)</td>
<td>No longer applicable to personal property/limited to real property only</td>
<td>Consider whether a LKE makes sense for real property sales</td>
<td></td>
</tr>
</tbody>
</table>
### Business Impacts (cont.)

<table>
<thead>
<tr>
<th>Tax Act</th>
<th>Observation</th>
<th>Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Disallowance of entertainment expenses</td>
<td>No deduction is allowed for any activity considered to be entertainment, amusement of recreation, or payment of membership dues to any club. Further restrictions apply to expenses associated with employer provided eating facilities under the de minimis fringe exception, effective after Dec. 31, 2017.</td>
<td>Clients should review company policies with respect to entertainment expense and club membership policies. Detail should be given to general ledger accounts used to properly isolate expenses still qualifying for the 50 percent deduction (food and beverages associated with the trade or business).</td>
</tr>
<tr>
<td>Disallowance of qualified transportation fringe</td>
<td>Expenses associated with providing qualified transportation fringe to employees (except for safety reasons) and expenses incurred for employer provided transportation (for commuting between residence and place of employment) are disallowed</td>
<td>Clients should review company policies with respect to transportation benefits.</td>
</tr>
</tbody>
</table>