TAX BULLETIN 2017-9

TAX REFORM SIGNED INTO LAW

NATIONAL WEALTH PLANNING STRATEGIES GROUP, U.S. TRUST

DECEMBER 22, 2017

OVERVIEW

Without much fanfare but with typical political controversy, the House and Senate successfully reconciled their respective tax bills. House and Senate conference committee members leaned in favor of many provisions contained in the Senate proposal. A significant move in that direction was retaining the elimination of the Affordable Care Act's individual mandate (the penalty for failing to maintain minimum essential health care coverage) and using the Senate's methodologies for taxing income from pass-through businesses (but some elements of the House bill entered into the computation). In other circumstances, a true compromise was reached, such as meeting in the middle on modifications to mortgage interest deductibility. Following the political maneuvering, the new tax legislation (the "Act"), has now been approved by Congress and signed into law by President Trump on December 22.

In order to abide by Senate budget reconciliation rules and ensure the Act does not result in budget deficits outside the 10-year budget window, the Act makes almost all individual income tax provisions temporary — nearly all expire at the end of 2025. No doubt, this will create tax complexity and political difficulties. On the other hand, most corporate provisions are permanent. This Tax Bulletin 2017-9 summarizes certain provisions of the Act and adds observations on income, estate and pass-through taxation.[1] Taxpayers may want to consider the implications of typical year-end decisions, such as selling capital assets and charitable giving, in light of the changes noted below, and discuss their particular circumstances with their tax advisors before taking action.

INDIVIDUAL TAXES

	Current Law[2]	Final Legislation[3]
Individual Tax Rates	10, 15, 25, 28, 33, 35, 39.6%	10, 12, 22, 24, 32, 35, 37% Top rate would apply to income over $600,000 for married filing jointly; $500,000 for single[4]
Standard Deduction	$12,700 ($6,350 if single)	$24,000 ($12,000 if single), enhanced for elderly and blind[4]
Kiddie Tax	Unearned income of a child taxed at parents' tax rate if higher than child's rate	Simplifies kiddie tax by applying trust rates to unearned income of a child[4]
Personal Exemption	$4,050, subject to phase-out	Eliminates; merged with higher standard deduction[4]

INDIVIDUAL TAXES (continued)

	Current Law	Final Legislation[3]
Child / Dependent Tax Credits	$1,000, per qualifying child subject to phase-out beginning at $110,000 (married) and $75,000 (single taxpayers)	$2,000 per qualifying child $500 per non-child dependent; subject to phase-out beginning at $400,000 (married) and $200,000 others[4]
Top Capital Gains/Dividend Tax Rate	20% (plus 3.8% surtax)	Current maximum rate is retained; same breakpoints as current law
Itemized Deductions	Under the "Pease" limitation, up to 80% of most itemized deductions are lost when adjusted gross income exceeds $313,800 ($261,500 for single taxpayers)	Repeals the Pease limitation on itemized deductions Mortgage interest deduction: $750,000 limit on acquisition indebtedness retained (principal or secondary residence); deduction for home equity loan repealed Deduction for state and local income, sales tax and real property taxes limited to $10,000 in aggregate ($5,000 for married filing separately); deduction allowed for state and local taxes on trade or business or if related to production of income. Payment of income taxes in 2017 for a subsequent year would not be deductible in 2017. No comparable rule for real estate taxes. [4] Deduction for medical expenses retained and liberalized for 2017 and 2018 [4]
Retirement Savings	Contributions can be placed into deferred account, up to contribution cap	Unchanged
AMT	Parallel tax calculation with top rate of 28% and $84,500 exemption for married taxpayers ($54,300 others); phase out of exemption begins at $160,900 for married taxpayers ($120,700 others)	Retains and modifies AMT; exemptions raised to $109,400 (married) and $70,300 (others); phase-out of exemption begins at $1 million for married taxpayers ($500,000 others) [4]
Carried Interest	Retains character as capital gain and eligible for preferential tax rates	Requires three-year holding period to attain long-term capital gains rate
Investment Surtax	3.8% tax on "net investment income"	Unchanged – continues to apply

OBSERVATIONS – INDIVIDUAL TAXES

Under the Act, there will be winners and losers on the personal income tax side. Generally, wage earners from no-tax states[5] could see tax savings under the Act. For instance, a Florida taxpayer earning $1 million with moderate itemized deductions may see a tax savings of about $30,000 under the Act. A similar taxpayer in New York State may see a savings of about $3,500 according to our preliminary analysis.[6]

Conversely, very high-wage earners from high-tax states could see a higher tax bill. A taxpayer earning $3 million in New York City may see a significant tax increase: $44,000 under the Act, due in part to the loss of significant deductions. A similar taxpayer in Florida would see a tax savings of about $91,000 under the Act (primarily due to the lower top rate, elongated 35% tax bracket and regaining itemized deductions that are no longer phased-out), according to our preliminary analysis.

Married couples could fare worse than two single taxpayers with a similar amount of income. The so-called marriage penalty hits particularly hard under the new tax brackets. The penalty is also exacerbated by permitting married couples only a $10,000 state income/real estate tax deduction, but allowing single filers a deduction in the same amount ($20,000 combined). Under the changes, a single taxpayer with $500,000 of wages living in a state that imposes a state income tax (and $10,000 of charitable deductions) would pay a federal tax of about $143,690. Two single taxpayers would pay a total of $287,380. However, if these taxpayers were married, their joint tax liability would jump to $298,280, an increase of $10,900.

It appears that state of residence, type of income (wages versus new "qualified business income"), and mortgage interest will be among the most important factors for determining whether one is better or worse off under the Act.

WEALTH TRANSFER TAXES

	Current Law	Final Legislation[3]
Estate / Gift / GST Tax	40% rate, $5,490,000 exemption (indexed for inflation)	Commencing 2018, exemption for estate, gift and GST tax doubled from $5.6 million to $11.2 million (indexed for inflation) Enhanced exemption expires end of 2025
Tax Basis Upon Death	Step-up for estate property	Same as current; step-up for estate property

OBSERVATIONS – WEALTH TRANSFER

The transfer tax proposals in the Act extend the already limited reach of the federal estate, gift and GST taxes to even a smaller subset of only the wealthiest of taxpayers. There would be a temporary doubling of the exemptions until the end of 2025, reverting to current law in 2026. The step-up in basis at death would continue the entire time. Given the high exemption amounts ($11.2 million for individuals and $22.4 million for a married couple in 2018), that would effectively repeal the tax for most people. This change would have a significant effect on both testamentary and lifetime estate planning.

<u>Testamentary planning</u>. It is common for wills and other testamentary documents (such as revocable trusts) to contain dispositions which reference the estate (and GST) exemptions which are in effect at death. These so-called "formula" provisions would automatically adjust for changes in the exemption amounts. While this may achieve a beneficial tax result, the temporary doubling of the exemptions may also cause unintended consequences to the dispositive plan. For example, a common plan is to leave the estate exemption to a bypass trust, and the balance for the surviving spouse, either outright or in a marital trust. For a hypothetical $10 million estate, if death occurs in 2017 that would result in roughly half to the bypass trust and half to the spouse. However, if death occurs in 2018 to 2025, that would result in the entire estate being left to the bypass trust. Complications could further arise for individuals living in certain states which impose their own estate tax. Wills and other testamentary documents should be reviewed to make certain they accurately reflect the testator's wishes. As always, documents should be drafted with flexible provisions that can be adjusted for future changes.

<u>Lifetime planning</u>. Lifetime gifts are often made in order to reduce the estate tax that would otherwise be incurred at death. While the doubling of the exemptions may avoid the need for lifetime gifting for certain individuals, that may only be the case if death occurs before 2026. Accordingly, the tax consequences of making a current gift may

have to be compared with alternative estate tax scenarios. The temporary nature of the increase in transfer tax exemptions also raises the issue of whether it is advisable to lock-in the higher exemption by making a lifetime gift. (Similar issues arose in 2012, when there was uncertainty whether the $5 million estate exemption would continue in 2013.) This raises the question of whether the gift could be structured in a manner that could be "undone" if the higher exemption is made permanent. It also raises the question of whether there would be recapture (so-called "clawback") if a lower exemption is in effect at death. In that regard, it appears that the new legislation would eliminate the concern about recapture. In sum, the uncertainty of the estate exemption amount at death will make lifetime planning more challenging.

CORPORATE TAXES

	Current Law	Final Legislation[3]
Top C-Corporate Rate	35%	21% and effective 2018
AMT	Parallel tax calculation with top rate of 20%	Eliminates AMT
Business Investments	Limited immediate expensing; balance subject to depreciation	Immediate expensing for new and used qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (Jan. 1, 2024 for certain property) and partial expensing for other property acquired after 2022 and before 2027.
Interest Expense	No limitation	Limited to business interest *income*, plus 30% of a business's adjusted taxable income (EBITDA for 2017-2021 and EBIT thereafter); with special rules for "floor plan financing indebtedness"; full deduction for small businesses with gross receipts of $25 million or less

PASS-THROUGH ENTITY TAXES

	Current Law	Final Legislation[3]
Top Rate: Pass-Through Entities (S-corporations, LLCs, LLPs and Partnerships) /Sole Proprietorships	Subject to tax at individual rates up to 39.6%	An individual taxpayer generally may deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship[4] In the case of a taxpayer who has qualified business income from a partnership, S corporation or sole proprietorship, the amount of the deduction is limited to the greater of (i) 50% of the W-2 wages paid by business or (ii) sum of 25% of W-2 wages paid by business and 2.5% of business capital. This wage limitation (i) does not apply if taxpayer's taxable income is less than $157,500 ($315,000 for joint return); (ii) applies fully if taxable income exceeds $207,500 ($415,000 for joint return); and (iii) applies proportionately if taxable income is between those two limits Trusts and estates that own business interests qualify for this deduction Deduction is a post-AGI item, even for taxpayers not itemizing deductions

PASS-THROUGH ENTITY TAXES (continued)

	Current Law	Final Legislation[3]
Pass-Through Entities – Service Businesses	Subject to tax at individual rates up to 39.6%	For "specified service business," (i) 20% deduction applies fully if taxpayer's taxable income is less than \$157,500 (\$315,000 for joint return); (ii) no deduction if taxable income exceeds \$207,500 (\$415,000 for joint return); and (ii) a partial deduction if taxable income is between those two limits.[4] Service business includes accounting, law, consulting, investing, etc., but excludes engineering and architecture services

OBSERVATIONS – PASS-THROUGH ENTITIES

As originally proposed, the House and Senate took fundamentally different approaches to the taxation of pass-through entities (sole proprietorships, partnerships, LLCs, LLPs and S-corporations). While both differed from each other, they both shared the goal of creating preferential treatment for certain pass-through income. The Act largely took the Senate's approach but adopted a few elements of the House's approach. The Act approaches small business relief by permitting a non-itemized deduction of 20% of qualified business income; the reduced amount would then be subject to normal marginal tax rates. Therefore, the top tax rate for business income would be 29.6% ((100% - 20% = 80%) x 37% = 29.6%). The provision is riddled with a host of complex limitations. For taxpayers not in the top income tax bracket, the value of the deduction will depend on the marginal bracket that would otherwise be imposed on the income.

Owners of service businesses (e.g., law, accounting and consulting, etc., but not engineering or architectural services) generally would be eligible for the 20% deduction unless taxable income exceeds \$315,000 for married filing jointly (\$157,500 for others). The benefit begins being phased out and fully eliminated out over the next \$100,000 for married filing jointly (\$50,000 for others). The following is a simple example for a pass-through entity.

EXAMPLE

H and W file a joint return on which they report taxable income of \$200,000 (determined without regard to this provision). H has a sole proprietorship that is a qualified business and is a "specified service business." W is an employee and receives only W-2 wages from her job.

H's qualified business income is \$150,000. 20 percent of the qualified business income is \$30,000. Because H and W's taxable income is below the \$315,000 threshold amount for a joint return, (i) the wage limit does not apply to H's qualified business, and (ii) the limitation applicable to specified service businesses does not apply. H's deductible amount for qualified business income is \$30,000.

On their joint return, H & W would qualify for a \$30,000 deduction, reducing their taxable income from \$200,000 to \$170,000. That taxable income would then be subject to ordinary income rates.

While upper-income wage earners in high-tax states generally do not fare well under the Act, taxpayers with substantial income from pass-through businesses should see a tax benefit compared with current law, since the weighted average rate of business income would be approximately 30%. Capital gains, dividends, and other preferential income from a business would not be considered "business income" and would continue to be taxed at preferential tax rates.

Under the initial Senate version, the pass-through deduction was not available to trusts or estates. Under the Act, however, trusts and estates can benefit from the pass-through deduction.

CORPORATE INTERNATIONAL TAXES

	Current Law	Final Legislation[3]
International Corporate Tax – Scope	Worldwide with deferral available	100% of foreign-source portion of dividends paid by foreign corporation to U.S. corporate shareholder (that owns at least 10%) would be exempt from U.S. taxation
One-Time Deemed Repatriation of Foreign Earnings	No	U.S. shareholders owning at least 10% of a foreign corporation would be taxed on post-1986 net foreign earnings and profits (15.5% on earnings and profits comprising cash or cash equivalents; 8% on remaining earnings and profits); may elect to pay tax over a period of up to 8 years, in annual installments that allow more to be paid at the back end

OTHER PROVISIONS

There are other provisions of note that are not included in the charts above.

- **Roth recharacterization no longer allowed.** Under current law, if you convert a traditional IRA to a Roth IRA, you can "recharacterize" that conversion within certain time limits, in effect undoing it. For tax years beginning after 2017, the Act repeals this rule, meaning you can no longer recharacterize a Roth conversion. From the current language of the effective date, it is unclear whether this would prevent a 2017 Roth conversion that has already occurred from being recharacterized in 2018.
- **Taxation of Alimony.** Under current law, alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse. Child support payments are not treated as alimony. The House bill proposed to reverse this treatment, making alimony and separate maintenance payments non-deductible to the payor spouse and non-taxable to the receiving spouse. The Senate bill had no similar provision. The Act generally follows the House bill but delays the effective date by one year, generally being effective for any divorce or separation instrument executed after December 31, 2018.
- **Sale of principal residence exclusion.** Under current law, up to $250,000 of gain ($500,000 if filing jointly) on the sale of a principal residence may not be taxed. Among the requirements is that the principal residence be owned and used as your principal residence for two out of the last five years. You can use this rule only once every two years. This exemption is available regardless of income. Both the House and Senate Bills proposed that (i) the principal residence must be owned and used as your principal residence for five out of the last eight years and (ii) you can use this rule only once every five years. In a surprise, this modification was not included in the Act. Moreover, the proposal to limit the exclusion if income exceeds specified amounts was also not included in the Act. As a result, no changes are made to the principal residence exclusion rules.

- **Identification of Securities Sold, Exchanged and Gifted.** Under current law, gain or loss generally is recognized for Federal income tax purposes on the sale of property. A taxpayer's gain or loss on a disposition of property is the difference between the amount realized on the sale and the taxpayer's cost basis in the property disposed of. If a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares sold are deemed to be drawn from the earliest acquired shares (the "first-in-first-out rule"; FIFO). However, if a taxpayer specifically identifies the shares of stock to be sold, the shares of stock treated as sold are the shares that have been identified. The same rules apply to charitable gifts and gifts to trusts or family members. Although the Senate bill had proposed mandating that the FIFO rule be used, the Act makes no changes; the current rules will remain in place.
- **Like-kind exchanges**. Currently real estate and personal property can qualify for a tax-deferred like-kind exchange. The property must be held either for investment or for use in a trade or business. Under the Act, like-kind exchanges will be available only for real estate, not personal property. This will end, for example, like-kind exchanges of art. This new rule is effective for transfers after 2017. However, there is a transition rule to allow like-kind exchanges of personal property to be completed if you have either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.
- **529 Savings Plans.** Currently, funds in 529 Saving Plans can be withdrawn tax-free if used for higher education expenses. The Act allows up to $10,000 per year used for elementary and high school tuition and specifically allowing funds to be used for private and religious schools. A provision that would have also allowed funds to be used for home schooling was dropped at the last minute and is not in the final legislation.
- **Charitable Gifts.** A charitable contribution deduction is currently limited to a certain percentage of the individual's adjusted gross income (AGI), and this limitation varies depending on the type of property contributed and the type of exempt organization receiving the property. Currently, cash contributed to public charities, private operating foundations, and certain non-operating private foundations generally may be deducted up to 50% of the donor's AGI. Under the Act, this 50% limitation would be increased to 60%. The provision would retain the 5-year carryover period to the extent that the contribution amount exceeds 60% of the donor's AGI.
- **Investment Expenses and Investment Interest.** Under current law, investment expenses are deductible as a "miscellaneous itemized deduction" if, and to the extent, they exceed 2% of AGI. The Act repeals the deduction for "miscellaneous itemized deductions" that are subject to the 2% AGI limitation, such as investment management expenses. The deduction for investment interest remains untouched and, as under current law, would be limited to investment income.

YEAR-END INDIVIDUAL TAX PLANNING

Year-end tax planning is shaping up to be more complicated this year. Investors should work with their tax advisors to understand the impact of tax reform relevant for them. US Trust does not provide tax advice.

- **Timing of Payment of 2018 Real Estate Taxes** - Since up to $10,000 of state income tax, real estate taxes or sales tax would be deductible under the Act, it may make sense to accelerate the payment of taxes. For example, a taxpayer could pay all but $10,000 of their 2018 real estate taxes in 2017. If taxes are paid to a bank (escrow account), the taxpayer gets the deduction in the year when the bank pays the property taxes (not when the taxpayer pays the bank). For taxpayers subject to AMT in 2017, there is no benefit from accelerating the payment of real estate taxes; real estate taxes are not deductible when computing 2017 AMT.
- **Accelerating or Deferring Capital Gains**. Due to the differences in state tax rates and nuances in individual tax situations, it is difficult to generalize the impact of accelerating or deferring capital gains and losses. Although income tax rates and tax brackets will significantly change in 2018, the long term capital gains rate will remain the same. The income limits for imposing the 15% and 20% capital gain rates will also remain the same; the 20% rate will apply when taxable income exceeds $479,000. However, the Act's combination of lower rates and fewer deductions could mean that a taxpayer's "taxable income" could rise in 2018, meaning the taxpayer would expose more capital gain to the 20% bracket. In addition to the capital gains tax, a 3.8% investment surtax is imposed on capital gains exceeding certain thresholds. The surtax is not modified under the Act and would be in addition to usual income taxes. While it may be wise for some taxpayers to accelerate capital losses before year end (or, depending on where the taxpayer lives, recognize gain before year end), given the limited time between passage of the new tax law and its effective date, there may simply not be enough time to make these decisions with appropriate calculations.
  - **States with an Income Tax** - There are 16 states plus Washington, D.C. that impose a top tax rate of about 7% or greater, including California, Connecticut, New Jersey and New York. For a taxpayer with an income above $470,000, the current marginal combined capital gain rate (assuming a 7% state rate), taking certain phase-outs into account, is about 25.4%. Under the new tax law, the marginal combined capital gain rate would increase to about 27%. Therefore, from a preliminary analysis, taxpayers in those states could be better off accelerating capital gains into 2017. Conversely, those taxpayers may be better deferring capital losses into 2018. Before any action is taken, taxpayers should also determine if they are subject to AMT, and, of course, consult with a tax professional to tailor the analysis to their particular facts. Slight differences in marginal rates in 2017 for taxpayers subject to the AMT could change the analysis. The time value of money should also be considered. The surtax, would add an additional 3.8% in both instances.
  - **States with no Income Tax** – There are nine states that do not impose a state income tax on capital gains (including Florida, Texas and New Hampshire). For a taxpayer with income above $470,000, the marginal capital gain rate, taking certain phase-outs into account, is about 21.2%. Under the Act, the marginal capital gain rate would drop to 20%. Therefore, from a preliminary analysis, taxpayers in those states could be better off accelerating capital losses

into 2017 and deferring capital gains into 2018. The surtax, would add an additional 3.8% in both instances.

- **Charitable gifts could be worth more if deducted in 2017 instead of 2018**. The top marginal tax rate for 2018 would be 37% (down from 39.6%) - some taxpayers who are in the current 39.6% bracket will drop to 35% since that bracket is elongated to cover income up to $600,000 for married taxpayers. Therefore, a charitable deduction could be worth more if made in 2017 rather than 2018. There is a host of complexities, such as phaseouts and caps that can affect any particular taxpayer's decision. There is no substitute for individualized advice from your tax professional. It is also noted that with the elimination of state and local tax deductions (and even with a $10,000 allowable deduction), some taxpayers may actually use the standard deduction if they have no charitable deductions. As a result, some portion of their charitable deductions in 2018 could be "wasted."
- **Timing of Payment of Final Estimated State Income Taxes (Due January 2018)**. State and local income taxes are deductible provided that the tax payment is authorized by the state and is based on a reasonable estimate of the taxpayer's actual state income tax liability for the current year, even though the taxpayer receives a refund after the close of the year for which the payments were made. The Act restricts taxpayers from attempting to prepay next year's state income tax in 2017 and claiming a deduction for such payment. Specifically, an amount paid in 2017, with respect to a State or local income tax imposed for 2018 or later, will be treated as paid at the end of 2018 or such other year as the tax is imposed.
- **Miscellaneous Itemized Deductions**. Tax preparation fees will be non-deductible under the Act.[4] Individuals may want to pay for tax services rendered in 2017 this year.
- **3.8% Surtax.** The Act does not directly change the 3.8% surtax imposed on "net investment income." However, it indirectly changes it. Under current law, when calculating a taxpayer's net investment income, a taxpayer can deduct investment expenses (after application of the 2% floor) and deductible state income taxes, to the extent those are properly allocable to net investment income. The deductibility of those expenses changes in 2018 -- investment expenses will be nondeductible, and state income taxes (with other state taxes) are limited to $10,000. As a result, those expenses might not reduce net investment income in 2018. If those expenses would indeed reduce net investment income in 2017, taxpayers should consider accelerating those payments into 2017.
- **Roth Recharacterization.** Under current law, if you convert a traditional IRA to a Roth IRA, you can "recharacterize" that conversion within certain time limits, in effect undoing it. For tax years beginning after 2017, the Act repeals this rule, meaning you can no longer recharacterize a Roth conversion. From the current language of the effective date, it is unclear whether this would prevent a 2017 Roth conversion that has already occurred from being recharacterized in 2018. If you converted a traditional IRA to a Roth in 2017 and are considering recharacterizing that conversion, it might make sense to do that in 2017 and avoid the less-than-clear effective date provision.
- **Gifts**. Taxpayers should consider the timing of making gifts that result in gift or GST taxes. Exemptions for both will double next year under the Act and a delay in gifting could reduce or eliminate such taxes

CONCLUSION

Given the significant tax changes for next year, year-end planning will be especially difficult. It is important to understand the implications that the Act can have on your particular tax situation. Taxpayers should focus on year-end tax planning in earnest.

[1] Tax Bulletin 2017-5 summarized the key tax provisions in HR1, known as the Tax Cuts and Jobs Act (the "House Bill"), which was passed (227-205) by the House on November 16, 2017. Tax Bulletin 2017-6 summarized the key tax provisions in the initial Senate bill HR1, also known as the Tax Cuts and Jobs Act, which was subsequently amended and passed (51-49) by the full Senate on December 2, 2017. The final Senate version was similarly summarized in Tax Bulletin 2017-7, and Tax Bulletin 2017-8 summarized the reconciled bill agreed to by both chambers.

[2] Inflation-adjusted amounts for 2017.

[3] The name "Tax Cut and Jobs Act" had to be removed; this legislation was signed into law by President Trump on December 22, 2017.

[4] This proposed change would be effective starting in 2018 and would not apply to taxable years beginning after December 31, 2025 (e.g. sunsets at the beginning of 2026).

[5] There are nine states that impose no state income tax: AK, FL, NH, NV, SD, TN, TX, WA and WY (NH and TN impose a tax only on dividends and interest).

[6] This illustration assumes the following itemized expenses: charitable gifts $10,000, real estate tax $30,000 (limited to $10,000 under the proposal), mortgage interest of $15,000, and appropriate state income taxes, where applicable.