BEERMANN
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HOW THE TAX CUTS AND JOBS ACT AFFECTS YOU

I. New Opportunities for Estate Planning and Gifting

The doubling of the estate, gift, and GST tax exemptions to $11.18 million per person ($22.36 million per couple) opens a significant, once-in-a-lifetime opportunity for you to protect more assets than ever. Combined with the IRS's withdrawal of the anti-discounting section 2704 regulations earlier in 2017, tax reform opens the door for dynasty trusts, family partnerships, discounted gifts, and other strategies that could shield entire fortunes for your beneficiaries.

Although the estate tax and GST tax exemption doubled on January 1, 2018, to $11.18 million per person, this increased exemption expires on December 31, 2025. You may be tempted to wait, given that eight years may feel like forever. But remember that this tax legislation is likely to be heavily modified if the political pendulum swings in the other direction. (The clock is already ticking steadily towards the 2018 midterms and 2020 Presidential election.) Of course, we have tools that can build flexibility into your plan, including trust protectors, decanting powers, and other strategies to deal with future changes. But those future strategies only work to preserve options if we implement plans while the exemption is available.

If you have any concerns about how the death tax will impact your family, give us a call today so we can maximize the opportunities afforded by the new bill. And, if in doubt, call now and let's strategize while there's still time.

II. Changes to Individual Income Taxes

A. Temporary Changes to Individual Rates

The Act keeps the previous seven-bracket structure, but changes the income level and rates. From January 1, 2018, to December 31, 2025, the individual income tax brackets are set at 10%, 12%, 22%, 24%, 32%, 35%, and 37% as follows:

Single Filer			
Old Law		Tax Cuts and Jobs Act	
10%	$0-$9,525	10%	$0-$9,525
15%	$9,525-$38,700	12%	$9,525-$38,700
25%	$38,700-$93,700	22%	$38,700-$82,500
28%	$93,700-$195,450	24%	$82,500-$157,500
33%	$195,450-$424,950	32%	$157,500-$200,000
35%	$424,950-$426,700	35%	$200,000-$500,000
39.6%	$426,700+	37%	$500,000+
Married Filing Jointly			
Old Law		Tax Cuts and Jobs Act	
10%	$0-$19,050	10%	$0-$19,050
15%	$19,050-$77,400	12%	$19,050-$77,400
25%	$77,400-156,150	22%	$77,400-$165,000
28%	$156,150-$237,950	24%	$165,000-$315,000
33%	$237,950-$424,950	32%	$315,000-$400,000
35%	$424,950-$480,050	35%	$400,000-$600,000
39.6%	$480,050+	37%	$600,000+

B. Temporary Increase in Standard Deduction and Elimination of Personal Exemptions

The Act increases the standard deduction from $6,350 to $12,000 for individuals and from $12,700 to $24,000 for married couples. The standard deduction is indexed for inflation. The Act does not change the additional standard deduction for elderly or blind taxpayers under old law. The increase of the basic standard deduction expires after December 31, 2025.

The Act also repeals all personal exemptions through December 31, 2025, with the withholding rules to be changed to reflect the elimination of personal exemptions.

C. Temporary Change to Individual Alternative Minimum Tax (“AMT”)

The Act increases the exemption amount and the exemption amount thresholds for the individual AMT. For taxable years beginning after December 31, 2017, and before January 1, 2026, the individual AMT exemption amount is increased to $70,300 for single filers and $109,400 for joint filers. The phase-out of the AMT exemption is increased to $1 million for married taxpayers filing a joint return, and $500,000 for all other taxpayers.

D. State and Local Tax Deduction

The Act limits the deduction for state and local taxes to $10,000 ($5,000 in the case of a married individual filing a separate return). The limitation applies to all state and local taxes, including property taxes, in the aggregate.

With respect to income (not property) taxes, the Act contains a special rule to prevent prepayment of income taxes in 2017 to take advantage of the old deduction. The Act provides that any amount paid in a taxable year beginning before January 1, 2018, for state and local taxes imposed for a taxable year beginning after December 31, 2017, are treated as having been paid on the last day of the taxable year for which the tax is imposed.

E. Temporary Decrease in Mortgage Interest Deduction Threshold

The Act modifies the home mortgage interest deduction to reduce the limit on acquisition indebtedness from $1 million under old law to $750,000. A transition rule retains the old $1 million limit for taxpayers who signed binding purchase agreements by December 15, 2017, to close on the sale before January 1, 2018, and who actually purchase the residence before April 1, 2018. The $1 million dollar limit is also retained for mortgages already in effect. The reduced limit expires on December 31, 2025, at which time interest on mortgage indebtedness up to $1 million would be deductible, regardless of when incurred.

F. Child Tax Credit

The Act increases the child tax credit from $1,000 to $2,000 per child under age 17, with a maximum refundable amount of $1,400 per qualifying child. To receive the child tax credit, the taxpayer must include a social security number for each qualifying child for whom the credit is claimed. It also provides for a $500 nonrefundable credit for qualifying dependents other than qualifying children. The credit phases out at $400,000 for joint filers and $200,000 for all other taxpayers. These changes expire on December 31, 2025.

G. Repeal of Roth IRA Conversion Rule

The old law allowed an individual to re-characterize a contribution to either a Roth or traditional IRA as a contribution to the other type of IRA. Now, the Act provides that a re-characterization cannot be used to unwind a Roth conversion, but it may be used with respect to other contributions. This change becomes effective January 1, 2018.

H. Repeal of Affordable Care Act Individual Mandate

The Affordable Care Act (ACA) contains an individual mandate which penalizes individuals who fail to maintain health insurance. The Act effectively repeals the individual mandate by reducing the penalty to zero. Unlike many changes that occur as of January 1, 2018, the elimination of the individual mandate is postponed until January 1, 2019. The Act leaves intact other aspects of the ACA, such as the so-called Medicaid expansion, pre-existing conditions requirements, and removal of lifetime care caps.

I. Charitable Contribution Deduction

The Act leaves the old charitable contribution deduction in place as an itemized deduction, but temporarily increases the individual percentage-of-income limitation for cash gifts from 50% to 60%. The increase applies until December 31, 2025.

The Act denies a deduction for contributions linked to rights to purchase tickets to college athletic events and eliminates the option for donee organizations to report charitable contributions to the IRS instead of sending a contemporaneous written acknowledgment to the donor.

J. Medical Expense Deduction

The Act preserves the deduction for medical expenses, and changes the floor from 10% to 7.5% for tax years 2017 and 2018. So, taxpayers can now deduct qualified medical expenses that are over 7.5% of their adjusted gross income for the year – including the 2017 tax return due April 17, 2018. For tax years after 2018, the floor will return to 10%.

III. Changes to Businesses

A. C Corporations and Changes under the Act

Corporations are subject to two levels of taxation. A C Corporation pays tax on its own income, and its shareholders pay tax again when the income is distributed as dividends.

This double-taxation regime has made C corporations an unattractive option for business owners in most circumstances. The Act makes several changes to taxation that may make C corporations a more viable alternative entity structure.

(1) Reduced Tax Rate and Repeal of Corporate Alternative Minimum Tax

Taxable income of a C corporation was previously taxed under a four-step graduated rate structure of 15%, 25%, 34%, and 35%. Effective January 1, 2018, the Act eliminates this graduated rate structure, taxes all corporate income at 21%, and repeals the corporate alternative minimum tax (AMT). This reduction of corporate income tax rate and corporate AMT repeal is permanent.

(2) Capital Contributions

Code § 118 provides that a corporation does not include "contributions to capital" in gross income. The Act provides that the term "contributions to capital" does not include:

- any contribution in aid of construction or any other contribution as a customer or potential customer and
- any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

B. Changes to Pass-through Businesses

Significant changes are made in the reform of the tax regime that applies to pass-through businesses—sole proprietorships, partnerships, S corporations, and limited liability companies taxed as partnerships or S corporations. Owners of pass-through businesses pay tax at their individual tax rates, which reached as high as 39.6% under the old laws. Now owners may qualify for a deduction for these types of businesses. Below is a summary of the notable changes for pass-through businesses.

(1) Temporary deduction for Qualified Business Income

For tax years beginning in 2018 and ending in 2025, the Act creates a new deduction of 20% to apply against income of pass-through businesses. The deduction applies at the owner level and also applies the 20% deduction to qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Significantly, the deduction is also available for trusts and estates that own pass-through businesses.

The deduction applies to qualified business income (QBI), which is specifically defined as the net amount of *qualified items of income, gain, deduction, and loss* with respect to *a qualified trade or business of the taxpayer*. "Qualified items of income, gain, deduction, and loss" includes business income other than investment income. QBI does not include wages, dividends, investment interest income, capital gains (whether short-term or long-term), commodities gains, or foreign currency gains.

While the definition of *qualified trade or business* is broad, it excludes some activities. Notably, it excludes a category of businesses called *specified service businesses*. The definition of *specified service business* includes:

- any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, and brokerage services;
- any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners; and
- any trade or business which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

Although the general definition of *specified service business* excludes many small businesses from being *qualified trades or businesses*, the Act provides an important exception: Joint filers with income below $315,000 and other taxpayers with income below $157,500 can claim the deduction fully on income from specified service businesses. This exception is phased out for taxpayers that exceed the threshold. No deduction is available to owners of services businesses if their income exceeds $415,000 for joint filers or $207,500 for other taxpayers. For purposes of this threshold, taxable income is determined without regard to the deduction. The threshold is also inflation-adjusted under the Act.

The definition of *qualified trade or business* also excludes the trade or business of performing services as an employee.

Further, the deductibility of the taxpayer's combined QBI is subject to limitations. The deduction for each qualified trade or business is the lesser of:

- 20% of the taxpayer's QBI for that trade or business; or
- the greater of (a) 50% of the W-2 wages with respect to the trade or business or (b) the sum of 25% of the W-2 wages with respect to the trade or business and a capital component consisting of 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property.

The W-2 wage limit has the same threshold that applies to specified service businesses. Additionally, the W-2 wage limit does not apply to income from publicly traded partnerships or income from the disposition of interests in publicly traded partnerships, but the specified service business limit still applies.

The deduction for QBI does not reduce adjusted gross income and is not dependent on whether taxpayers itemize or take the standard deduction.

(2) Three-Year Holding Period for Long-team Capital Gain Treatment for Certain Interests

Beginning in 2018, the Act creates a three-year holding period requirement for qualification as long-term capital gain with respect to an applicable partnership interest. This is defined as any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business.

(3) Net Operating Losses

The Act provides that the *excess business losses* of a taxpayer are not allowed for the taxable year, but are carried forward and treated as part of the taxpayer's net operating loss carryforward in subsequent taxable years. An *excess business loss* is comprised of the taxpayer's aggregate deductions attributable to the taxpayer's trades or businesses minus the sum of the taxpayer's aggregate gross income or gain with respect to such trades or businesses, plus a threshold amount. The threshold amount is $500,000 for joint filers and $250,000 for other taxpayers and will be adjusted for inflation. The limitation is applied after applying the passive activity loss limitations. The limitation expires on December 31, 2025.

Effective January 1, 2018, the Act repeals the partnership technical termination rule. A partnership will be treated as continuing even if more than 50% of the total capital and profits interests of the partnership are sold or exchanged within a 12-month period. This change prevents partnerships from having to make new elections for tax purposes. The Act does not affect the rule that a partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

(4) Conversions of S Corporations to C Corporations

The Act also deals with tax issues resulting from a conversion of an S corporation to a C corporation within two years of the enactment. The rule applies to any *eligible terminated S corporation*, defined as a C corporation that was an S corporation on the day before the date of the enactment of the Act and which made a revocation of its S corporation election in the two-year period following such date, as long as the owners of the stock of such corporation on the date of the revocation of the S corporation election are the same owners (and in identical proportions) as on the date of the Act's enactment.

Effective January 1, 2018, in the case of a distribution of money by an eligible terminated S corporation after the post-termination transition period, the corporation's accumulated adjustments account (AAA) is allocated to the distribution. The distribution is chargeable to accumulated earnings and profits in the same ratio as the amount such AAA bears to the amount of such accumulated earnings and profits. The proposal also provides that, in the case of an eligible terminated S corporation, any taxable income adjustment arising from such a conversion under Code § 481 is taken into account ratably over six years.

(5) Electing Small Business Trusts

An electing small business trust (ESBT) may be a shareholder of an S corporation. Under old law, a trust would not qualify as an ESBT if a nonresident alien is a potential current beneficiary. Effective January 1, 2018, the Act repeals this prohibition and allows a nonresident alien to be a potential current beneficiary of an ESBT.

Another change about ESBT is the treatment of a charitable contribution passed through by an S corporation which depends on type of the shareholder.

- A trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which are paid for a charitable purpose under the trust instrument. No carryover of excess contributions is allowed.
- An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts (and not the deduction that applies to individuals) has historically applied. Beginning on January 1, 2018, the Act provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. As a result, the percentage limitations and carryforward provisions applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

C. Other Changes to All Businesses

(1) Interest Paid or Accrued by a Business

Interest paid or accrued by a business generally is deductible in the computation of taxable income, subject to several limitations. Under the Act, net interest that can be deducted by any business with gross receipts of $25 million or more (measured based on the average over a three-year period) is generally limited to 30% of the *adjusted taxable income* for the year. For purposes of this provision, the following are disregarded in computing adjusted taxable income:

- any item of income, gain, deduction, or loss not properly allocable to a trade or business;
- any business interest or business interest income;
- the new 20% deduction for certain pass-through income; and
- the amount of any net operating loss deduction.

For taxable years beginning before January 1, 2022, adjusted taxable income is not reduced by deductions allowable for depreciation, amortization, or depletion. The interest deduction limitation does not apply to:

- certain regulated public utilities;
- the trade or business of performing services as an employee; or
- at the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.

Any business interest not allowed as a deduction may be carried forward and used as a deduction in a later year.

(2) Net Operating Losses

Under old law, net operating losses (NOLs) might be carried back two years and carried forward 20 years to offset taxable income in those years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.

The Act limits the NOL deduction to 80% of taxable income, effective for taxable years beginning after December 31, 2017. The Act also repeals the two-year carryback and the special carryback provisions, but provides an exception for certain farming losses. For most taxpayers, NOLs can only offset the current year and future year's income.

(3) Depreciation and Expensing

Unless currently deductible, a taxpayer must capitalize the cost of property used in a trade or business or held for the production of income. Recovery of these costs occurs over time through annual deductions for depreciation or amortization. Under old law, an additional first-year depreciation *(bonus depreciation)* deduction was allowed. Bonus depreciation equals 50% of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for longer production period property and certain aircraft). The 50% allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018 for longer production period property and certain aircraft).

The Act increases the 50% bonus depreciation under old law to 100% through 2022 (through 2023 for longer production period property and certain aircraft). It also extends the old 50% bonus depreciation through 2026 (2027 for longer production period property and certain aircraft). The Act removes the requirement that the original use of qualified property must commence with the taxpayer, allowing the additional first-year depreciation deduction for both new and used property.

The enhanced bonus depreciation generally applies to property acquired and placed in service after September 27, 2017, and to specified plants planted or grafted after such date. For a taxpayer's first taxable year ending after September 27, 2017, the taxpayer may apply a 50% allowance instead of the 100% allowance.

(4) Like-Kind Exchanges

Although an exchange of property—like a sale—is generally a taxable event, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" which is to be held for productive use in a trade or business or for investment.

The Act now limits like-kind exchanges to exchanges of real property. It includes a transition rule to allow like-kind exchanges for personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property by December 31, 2017.

(5) Employment-Related Fringe Benefits

The Act repeals the old 50% deduction for entertainment, amusement, or recreation expenses connected to the active conduct of the taxpayer's trade or business. No deduction is allowed for these expenses, including membership dues in a club organized for business, pleasure, recreation, or other social purposes.

The Act continues the old 50% limit from December 31, 2017, through December 31, 2025, for expenses for food and beverages provided to employees through an eating facility operating for the convenience of the employer and eliminates the deduction after December 31, 2025.

Effective December 31, 2017, the Act disallows the deduction for expenses relating to entertainment tickets and skyboxes to the extent that the expenses are included as compensation to an employee on the employer's tax return. The deduction for qualified transportation fringe benefits to employees is also eliminated, except as necessary for the safety of an employee in commuting between work and home.

D. Final Thoughts

If you own a business, relying on old rules of thumb or ignoring this monumental change in business taxation could mean paying enormous amounts of unnecessary taxes. Many of the new, business-oriented deductions have specific rules to qualify. Although this Act has been the subject of intense media discussion, don't rely on television programs, blog posts, or press releases. Instead, contact us so we can analyze how to maximize your benefits under the Act.

IV. New Opportunities for Real Estate Investment

With the changes to the mortgage interest deduction and State and Local Tax deduction, real estate investors can now benefit from lower taxes by creating a pass-through entity. As discussed in the business section, those who have qualified pass-through income can claim up to 20% in tax deductions.

Further, as discussed in the business section, the Act limits the deductibility of business interest expense for most taxpayers to the sum of business interest income in addition to 30% of adjustable tax income. However, a real property trade or business can elect out of the new business interest disallowance regime, at the cost of longer depreciation recovery periods. If opting out, depreciation periods will become 30 years (instead of 27.5 years) for residential real estate property and 40 years (instead of 39 years) for nonresidential real estate property.

The Act also disallows personal property to be claimed under the 1031 exchange as a tax deductible. Real estate investors who used the 1031 exchange to save money on things like furniture and equipment used for real estate investing will no longer be allowed to do so under the Act.

The Act affects real estate investors and the real estate market both positively and negatively. Contact us now before you get into real estate investing, start a real estate business, or take on new real estate investments in 2018.

Final Considerations and Next Steps

Planning to minimize income taxes is a balancing act. We are available now to answer your questions about tax reform and work with you to take full advantage of the opportunities.

Second, now is a great time to review your estate plan.