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A Review of the Tax Cuts and Jobs Act — What You Need to Know, Now.

As the nation awaits President Trump's highly anticipated signing of the Tax Cuts and Jobs Act ("Act"), which is scheduled to occur within the next 10 legislative days, there is much concern, as well as confusion, as to the impact the new legislation will have on both individuals and businesses alike.

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

Below is a compilation of the shorter and longer term considerations relating to the tax changes that we think will be relevant to you. We will continue to monitor future changes as we move forward. Please be aware that, at this point, the actual legislative language is not currently available, but is expected to be released shortly. Accordingly, some of the information provided below may change.

Note that any changes to what you would normally do relating to year-end tax planning should be discussed with your tax advisor prior to implementation.

INDIVIDUAL TAXES

Many individual taxpayers are, based on the proposed tax reform language, asking us – what should we do? Well – as with any tax matter, the specific answer will vary based on the taxpayer's specific facts. However, given what we know of the tax reform language impacting individuals, a few common themes are evident. For example, for many individual taxpayers, it may be beneficial to defer income and/or accelerate deductions, but any changes to what you would normally do for year-end tax planning should be discussed with your tax advisor. There also may be gift, estate, and trust implications to consider, which are discussed later in this document. There are clearly other matters to consider and, immediately below, we have summarized the shorter and longer term changes that we think will be relevant to you. Note that the majority of individual changes discussed below will expire after 2025 if Congress does not act to extend those provisions.

Considerations Before Year-End

Should you pre-pay your state taxes? The new legislation limits this deduction to $10,000 between state and property taxes in 2018, so it is important to maximize its effect this year. That said, if you are subject to Alternative Minimum Tax (AMT), you may not benefit from the deduction. There had been some discussion about prepaying your 2018 state and local income taxes this year, but the final version of the bill prohibits taking that deduction on this year's return. If you are holding a bill for real estate taxes due in 2018, then you may be able to pay, and deduct, that amount, depending on your specific situation. If you have a Q4 2017 state tax payment that was otherwise due in January, you should consider paying it in December. Even if you are in AMT, prepaying the Q4 state tax payment can reduce your Net Investment Income Tax (NIIT) liability.

Consider whether any charitable contributions should be paid by year end. Since the top income tax bracket is going down, there could be a greater benefit to you by paying and deducting contributions in 2017, as opposed to a later tax year. On the other hand, your effective tax rate could actually be higher next year with the loss of the state tax deduction and the increase in the standard deduction, so it might be beneficial to put off the deduction until next year.

The standard deduction is increasing to $24,000 from $12,700, so if your mortgage interest and charitable contributions (the only two remaining itemized deductions of considerable size) are less than that amount, you should consider bundling your charitable contributions into one year. One thought is that every other year you would pay twice the amount paid in one year, so that you exceed the standard deduction amount in order to maximize the benefit of your charitable contributions.

As noted above, prior to making any payments, discuss with your tax advisor to make sure that they are beneficial to your specific situation.

Longer Term Considerations

Changes to pass-through taxation are significant in the new bill. We will need to wait as more details are released, but at some point, there may be the opportunity to restructure to take advantage of these lower tax rates.

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

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

Other Relevant Items Within the Tax Bill

- **Individual rates and brackets have been revised, and overall rates are generally lowered, with the top rate dropping from 39.6% to 37%.** These tax cuts are scheduled to expire after 2025, and there is no change to the preferential long-term capital gains tax rate.
- **Taxation of carried interest**, for those who are members of firms such as private equity and hedge fund businesses, a new three-year holding period is required to qualify for capital gain treatment.
- **Mortgage interest deductions** for new purchases of first or second homes will be capped at $750,000 in mortgage debt for mortgages incurred after December 15, 2017. There are no changes for current mortgages put into place under prior rules. However, home equity loan interest will no longer deductible, even for existing debt.
- **The bill retains, but modifies to some degree, the individual AMT.** An increase in the income level exemption and elimination of state tax deductions likely reduces the number of taxpayers subject to AMT.
- For eligible taxpayers, **the child tax credit is increased**, from $1,000 to $2,000, and a $500 credit is provided for certain non-child dependents.
- **Distributions from 529 Plans** can be used to fund tuition and various expenses at elementary, secondary and religious schools. Historically, distributions were limited to postsecondary education.

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BUSINESS TAXES

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

The corporate AMT is repealed.

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

The dividends received deduction percentages will be reduced.

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

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

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

Moving forward, **research and development costs** must be capitalized and amortized over five years.

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

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

Limitation on NOL usage – NOL usage will be limited to 80% of taxable income. Additionally, the bill repeals the ability to carry-back NOLs (historically a 2 year carryback was allowed) and increases the NOL carryforward from 20 years to until the NOL is used.

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

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

Repeal of 199 deduction – The section 199 (Domestic Production Activities) deduction will be repealed.

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

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

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

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INTERNATIONAL TAX

Mandatory deemed repatriation – The Conference bill requires all U.S. shareholders – U.S. citizens, residents, partnerships, trusts, and corporations – that own 10% or more of the voting shares of Controlled Foreign Corporation (CFC) to include their pro rata share of all CFC accumulated net earnings and profits (E&P) in their 2017 income. The effective tax rate that applies to this deemed repatriation has increased slightly from the prior House and Senate versions – cash earnings will be subject to a 15.5% tax rate, while non-cash earnings will be subject to an 8% tax rate. The rates are achieved via dividends received deduction, which brings the effective tax rate to these levels.

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

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

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

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

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

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COMPENSATION AND BENEFITS

Executive Compensation

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

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

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

IRAs and Tax-Qualified Retirement Plans

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

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

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

Fringe Benefits and Family and Medical Leave Payments

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

Employer deduction eliminated for certain expenses, including:

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

Employer reimbursements of moving expenses are fully taxable with an exception for certain moves by members of the armed forces. Employers anticipating the payment of employee moving expenses in the near future may wish to consider making those payments prior to 2018.

Employer credit for compensation paid to employees on paid family and medical leave – For 2018 and 2019 only, an employer with a written policy in effect under which full-time employees can receive not less than two weeks (as well as a proportionate amount for part-time employees) of annual family and medical leave (under the Family and Medical Leave Act of 1993) will be entitled to a general business credit equal to 12.5% of the compensation it pays to certain employees (employed for at least one year and having a rate of compensation not in excess of $72,000 (for 2018) while they are on such a leave. The 12.5% credit amount will be increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%.

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TRUSTS AND ESTATES

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

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

Taxpayers may want to consider making gifts to parents (or, better yet, to trusts for their parents). With the doubled exemption, this continue to be important for taxpayers not only to provide liquidity to their survivors but also as a source for tax free retirement income.

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TAX EXEMPT ORGANIZATIONS

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

Exclusion of research income from unrelated business taxable income – The thought process was to modify the exclusion, however, there is no change to existing provisions.

Unrelated business taxable income separately computed for each trade or business activity – An organization determines its unrelated taxable income on an aggregate income and subtracts aggregate deductions, thereby allowing offset of multiple trades and businesses.

Senate amendment accepted – Effective for tax years after December 31, 2017, unrelated business income must first be computed separately with respect to each trade or business, the aggregate of which can not be less than zero. A net operating loss is only allowed with respect to a trade or business from which the loss arose. There will be a special transition rule for NOLs carried into years beginning after January 1, 2018.

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

The Conference agreement does not modify:

- Existing provisions of **excise tax of private foundation investment income**, or of the private operating foundation requirement **relating to the operation of an art museum**
- Current provision regarding the **exception to private foundation excess business holding rules**
- Current provisions connected to **section 501(c)(3) on organizations permitted to make statements relating to political campaign in the ordinary course of activities in carry out exempt purpose**
- Current provisions regarding **additional reporting requirements for donor advised funds sponsoring an organization**

The agreement includes no provision:

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

The agreement:

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

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RENEWABLE ENERGY

While Congress left the wind production tax credit (PTC) and the solar energy investment tax credit (ITC) intact and unaltered, the tax equity financing sector will likely be impacted by the new tax legislation. Specifically, the reduction of the overall corporate income tax rate to 21%, the new bonus depreciation regime, the imposition of the new Border Erosion Anti-Abuse Tax (BEAT), the elimination of the section 708(b) technical termination rules, and a host of other new tax rules for limiting and suspending some business interest deductions will all impact tax equity renewable energy financing transactions previously negotiated, as well as affect renewable energy project financings currently being negotiated. In addition, the elimination of the corporate AMT, the modification of the NOL rules, and the new imposition of less taxpayer favorable revenue recognition rules, which may impact the use of pre-paid power purchase agreements (PPAs), will also impact the renewable industry.

Because most renewable tax equity financings are typically done through legal entities taxed as partnerships for U.S. federal income tax purposes, the new law's treatment and special handling of pass-through entities, including the taxation of the partners in those entities, are expected to give rise to complex tax issues for both existing deals and new projects. On new deals, these changes are expected to impact both the pricing of tax equity and the amount of such equity that renewable energy project sponsors may raise. However, the level of impact to tax equity remains to be seen, especially given the year-by-year, case-by-case nature of the BEAT, as experienced by that segment of the renewable energy tax equity capital markets that generate a BEAT liability against which the PTC and ITC can now only partially offset. As with any change, there may be some opportunities also created by the new law; for example, in the area of repowering existing wind energy facilities.

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What Does CohnReznick Think?

We are certainly living in interesting times! The past few months have been tumultuous for everyone, especially for those who have been following the various tax proposals. Clearly, the Act, if signed by the President – which is expected early in the near term – will have sweeping changes impacting most taxpayers. As they say, "the devil is in the details"! Once the final text of the legislation is released, we will provide additional insight addressing what you need to know, now.

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