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JAH TAX REFORM SUMMARY

As you likely are aware, the Federal government recently passed a sweeping tax reform package. This legislation is far-reaching, providing opportunities and challenges for all taxpayers seeking to be as tax efficient as possible. We at Johnston, Allison and Hord felt it important to make sure that you had a broad overview of the Tax Cuts and Jobs Act (the "Act") so that you may better consider those topics that may impact you.

Individual Tax Reform

Individual tax rates are cut, but there are significant changes to available credits and deductions. Many are referenced here for your review, but there may be additional changes or specific qualifications that apply to your situation.

A. **Rates** – The top rate is now 37%, down from 39.6%. There remain seven tax brackets. Rates for each bracket have been reduced. In addition, "Kiddie" tax rates have been simplified by taxing children at individual rates and their unearned income at trust and estate rates.

1. The standard deduction is doubled to $24,000 for joint filers, while personal exemptions have been eliminated. These changes will impact taxpayers differently depending on family size and whether the taxpayers itemize deductions.
2. The Act generally retains existing rates and breakpoints on net capital gains and qualified dividends (i.e. 0%, 15%, and 20%).
3. The rate thresholds, standard deductions, and various other thresholds throughout the Act adjust according to inflation as measured under the Chained Consumer Price Index for All Urban Consumers (C-CPI-U).

B. **Family and Individual Tax Credits**

1. Child Tax Credit – Increased to $2,000 per child with an additional $500 for non-child dependents. The credit begins to phase out at $400,000 for joint filers, and is refundable up to $1,400.
2. Limitation on losses for noncorporate taxpayers – Excess business losses are treated as part of the NOL carryover for future years.
3. 529 Plan Reforms – 529 Plans are expanded to allow for distributions of up to $10,000 per beneficiary when used for public, private, and religious elementary and secondary schools as well as home school expenses.
4. ABLE Accounts – 529 plans may be rolled over to ABLE accounts (accounts for disabled individuals and their families) without penalty subject to ABLE contribution limits in certain circumstances. Additionally, beneficiaries may contribute an additional amount above the $15,000 contribution limit, up to the lesser of the Federal poverty line or the beneficiary's compensation.
5. Overall limitation on itemized deductions – Total itemized deductions are no longer subject to the Pease limitations. This reduced allowable itemized deductions by 3% of the amount AGI exceeded $313,800 (for joint filers), up to a total of 80%.

C. **Deductions and Exclusions**

1. Home mortgage interest deduction – Mortgage interest is deductible on acquisition indebtedness up to $750,000 on a principal residence and a second home, down from $1 million. The deduction no longer applies to home equity lines (HELOCs). Existing loans other than HELOCs are grandfathered.
2. State and Local taxes – Aggregated state and local taxes (including sales, income, and property taxes) are only deductible up to $10,000. However, such taxes incurred in a trade or business, including investment and rental activities, continue to be deductible.
3. Charitable contribution deduction – The AGI limitation for cash contributions to public charities and private operating foundations is increased from 50% to 60%.
4. Medical expenses – Medical expenses are now deductible to the extent they exceed 7.5% of AGI rather than 10% of AGI.
5. Alimony – Alimony is no longer income to the recipient, but is also no longer deductible by the payor spouse.
6. Miscellaneous Itemized Deductions – A class of previously aggregated items including various fees, expenses, and dues are no longer deductible.

D. **Roth IRA conversions** – Recharacterization of contributions is restricted to prevent the unwinding of Roth IRA conversions.

E. **Estate Tax** – The estate and gift tax exclusion is doubled to $11.2 million for 2018 and continues to increase with inflation. This same increase applies to Generation-Skipping Transfers.

F. **Alternative Minimum Tax** – The AMT exemption is increased to $109,400 for married taxpayers and the phase-out threshold is increased to $1 million.

G. **Obamacare Individual Mandate** – Starting in 2019, there is no penalty for a failure to maintain health insurance. This does not change the employer coverage and reporting obligations.

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Passthrough Income Deductions

There has been much discussion regarding the new deductions for pass-through income. The general rule is that pass-through income (otherwise known as Qualified Business Income or QBI) can receive a deduction up to 20% on domestic income from a partnership, LLC, S corporation, or sole proprietorship.

The 20% deduction generally is limited to the greater of either: (a) 50% of the W-2 wages paid, or (b) the sum of 25% of the W-2 wages plus 2.5% of the unadjusted basis of all qualified property. Due to these limitations, careful planning is imperative as it is possible for a pass-through entity to distribute income and not receive the deduction.

The deduction does not apply to income from specified services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services. Architects and engineers still may take advantage of this deduction. The deduction should be accessible to developers, while some industries, such as insurance, may have different determinations on deductibility depending on the specific services provided.

The W-2 wage limit and the specified services limitations do not apply for taxpayers with taxable income not exceeding $157,500 ($315,000 in the case of a joint return).

Special rules allow for the deduction to be applied to qualified REIT dividends among other entities. Contrary to previous versions, trusts and estates may be eligible for the 20% deduction.

Business Tax Reform

Similar to the individual reforms, business tax reform starts with a dramatic cut to the corporate rate paired against the new pass-through treatment while broadening the base through modifications to available deductions and credits. Additionally, there are numerous changes intended to make compliance and tax accounting simpler for more taxpayers.

A. Rates – The corporate tax rate is reduced to a single flat rate of 21%.

B. Cost Recovery

1. Full expensing is allowed for certain new and used property put in service by the taxpayer starting in 4th quarter 2017.
2. Depreciation limitations are increased for luxury cars and other listed property.
3. Recovery periods for certain real property have been shortened, though some changes may be dependent on future corrective legislation.

C. Small Business Reforms

1. Allowable Section 179 expensing is increased from $500,000 to $1 million, and increases the phase-out threshold to $2.5 million.
2. Various accounting method restrictions are removed from companies with less than $25 million in annual gross receipts.
3. Certain S corporations that revoke their status within 2-years of the tax reform bill may take advantage of Section 481 transition rules.

D. Like-Kind Exchanges – 1031 exchanges now are limited to real property not held primarily for resale.

E. Business Related Exclusions, Deductions, etc.

1. Interest expense deductions are limited to 30% of taxable income for businesses with more than $25 million in annual gross receipts, with exceptions for real estate trades and other businesses.
2. NOL deductions generally are limited to 80% of taxable income. NOL carrybacks generally are disallowed. NOL carryforwards are allowed indefinitely.
3. Local lobbying expenses no longer are deductible.
4. Deductions for domestic production activities are repealed.
5. Technical termination rules no longer apply to partnerships.
6. Carried interest now requires a 3-year holding period for long-term capital gains treatment.
7. Research and experimental expenditures generally are amortized over a 5-year period.
8. Sexual harassment and abuse settlements subject to nondisclosure agreements are nondeductible.

F. Reform of Business Credits

1. Rehabilitation credits now are limited to certified historic structures and taken ratably over 5 years.
2. Employers providing qualified paid family and medical leave receive a tax credit for such payments.

G. Insurance – Among other provisions directed at the insurance industry, death benefits are not excludable from income if paid out on a life insurance contract, or any interest in a life insurance contract, transferred in a "reportable policy sale," a sale in which the acquirer has no insurable interest in the life of the insured.

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Business Tax Reform Continued

H. Compensation

1. Performance based pay for CEO's is no longer an exception to the $1 million limitation on compensation deductibility.
2. A new provision allows for the deferral of income with respect to qualified stock options for up to five years outside of the 409A regime.

I. Other Provisions

1. Section 743(b) adjustments triggered by substantial built-in-losses are now also measured at the partner level under a hypothetical disposition.
2. Charitable contributions and foreign taxes are now taken into account in determining a partner's share of loss under basis limitations.
3. Electing small business trusts may have a nonresident alien as a beneficiary. In addition, ESBTs are governed by the charitable deduction rules applicable to individuals rather than trusts.
4. Multiple changes have been made with respect to beer wine and distilled spirits including lower tax rates, changes to excise taxes, and additional accounting changes.

Exempt Organizations

During the debate on tax reform, many charities expressed concerned about how the increased standard deduction and proposed changes to the charitable deduction would affect charitable funding. That said, the reform bill has provisions specific to exempt organizations in addition to broadly applicable business tax changes.

1. Unrelated business taxable income is computed separately for each trade or business activity rather than aggregating those activities.

2. UBIT is increased by those fringe benefit expenses for which the deduction now is disallowed.

3. A 21% excise tax is imposed on executive compensation in excess of $1 million and certain golden parachute payments subject to limited exceptions.

4. An excise tax is imposed on sufficiently large endowments held by private colleges and universities.

5. Private foundations may qualify for an exception to the tax on excess business holdings that otherwise would be generated by qualifying philanthropic business holdings.

International Tax Provisions

Broadly speaking, the Act moves the U.S. from a worldwide system towards a territorial system where the U.S. taxes domestic income and reduces the taxation of income generated elsewhere in the world. In addition to changing the structure of international taxation, the Act includes special repatriation rates in order to encourage the repatriation of foreign generated income. These changes are coupled with special rates for foreign-derived intangible income and additional Subpart F rules that begin to implement this shift to a territorial system within the existing international tax framework. In order to prevent abuse of these changes, new base erosion and anti-abuse provisions have been added. While the provisions are intended to drive investment to the U.S., taxpayers should review their operations as the new provisions may favor investment abroad in certain circumstances.

These changes to the tax code present a unique opportunity for taxpayers and businesses to maximize their tax efficiency. We have summarized key aspects of the Act; however, there are numerous changes not discussed above that may apply to your situation. Additionally, there may be changes discussed here that appear to apply, but have limited application due to restrictions placed on certain provisions. Finally, any planning in response to these changes must be mindful of the various sunset provisions that, at least for now, limit the duration of certain reforms.

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