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TAX AND WEALTH MANAGEMENT

ALERT

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THE TAX CUTS AND JOBS ACT: IMPACT AND PLANNING

By Michael S. Williams and Nadine Doolittle

On December 20, 2017, Congress passed the Tax Cuts and Jobs Act (the "Act") instituting sweeping changes to the Internal Revenue Code.[1] By now, many taxpayers are familiar with the 'big ticket' changes the Act brings to the tax code. Effective January 1, 2018, the federal estate, gift and generation-skipping transfer tax exemptions double, the standard deduction for individuals nearly doubles, personal exemptions are repealed, the top ordinary income tax rate for individuals and trusts decreases from 39.6% to 37%,[2] and the top corporate tax rate falls from 35% to 21%.

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An exhaustive list of the changes implemented by the Act is beyond the scope of this Alert. This Alert is intended to provide a brief summary of the key provisions of the Act that are most likely to impact wealth preservation and estate planning goals. Where applicable, planning suggestions are provided, however, the changes to the tax code are numerous and will affect each taxpayer differently. We welcome the opportunity to discuss the impact of the Act on your estate planning goals and recommend that you also discuss planning opportunities with your accountants and financial advisors.

Estate and Gift Taxes

The Act retains the gift, estate, and generation-skipping transfer ("GST") taxes, but doubles the exemption amounts that each person may use to pass assets to his or her heirs tax-free. Effective January 1, 2018, the exemption amounts will be $11,200,000 ($22,400,000 for married couples). Other provisions remain unchanged including the gift, estate, and GST tax rate of 40%, the gift tax annual exclusion amount of $15,000 per donee for 2018 ($30,000 for a married couple), and portability of unused gift and estate tax exemption to a surviving spouse.

Under a Donald Trump Presidency and Republican controlled Congress the political climate was ripe for a complete repeal of the estate tax. With the estate tax intact under this new legislation (albeit with greatly increased exemptions) and concerns over the rising national debt, it now seems unlikely that a political climate more favorable to estate tax repeal will exist in the foreseeable future. Therefore, high net worth individuals should continue to plan for the estate tax and everyone should be prepared for the possibility of a future Congress pushing to cutback the expanded exemption amounts. Under the Act, if Congress does not act before then, the increased exemption amounts are scheduled to revert back to current law on January 1, 2026.

Planning Pointer For individuals who were near or slightly above the exemption amounts under prior law, this represents a great opportunity to review your estate planning documents. We may able to simplify your planning documents to reduce administration costs and burdens on the beneficiaries of your estate.

For individuals with assets near or above the newly increased exemption amounts, all of the same transfer tax minimization strategies continue to apply. You may want to consider using your increased exemption amounts to fund lifetime gifts to your heirs. As under current law, lifetime gifts may be more tax efficient than retaining assets in your estate. Appreciation on such gifts accrues outside of your estate, but income tax considerations must also be weighed.

A Note for New York Residents

In 2014, Governor Cuomo signed into law sweeping changes to the New York state estate tax. That legislation aimed to increase the New York estate tax exemption each year until it reached parity with the federal estate tax exemption amount on January 1, 2019 (New York decedents dying between April 1, 2017 and December 31, 2018 have a state exemption of $5,250,000). However, because the New York statute calculates the state estate tax exemption amount separately rather than tying it directly to the federal estate tax exemption amount, the increased federal estate tax exemption will have no effect on the New York estate tax exemption.[3]

Individual Income Taxes

The Act replaces the existing individual income tax rate structure. Effective January 1, 2018, the top individual income tax rate will be 37%. This will apply to incomes over $500,000 for single taxpayers and $600,000 for married taxpayers filing jointly. Notably, the Act makes no changes to capital gains rates or to the net investment income tax. The 3.8% net investment income tax will continue to apply to passive ordinary and capital gain income over certain thresholds.

A Note for New Jersey Residents

Unrelated to the Act, the New Jersey estate tax is repealed effective January 1, 2018. New Jersey also imposes an inheritance tax, but transfers to spouses, parents, descendants, and charities are all exempt.

Under prior law the income tax brackets were adjusted annually based upon the Consumer Price Index for All Urban Consumers (“CPI-U”). The Act replaces this with the Chained Consumer Price Index for All Urban Consumers (“C-CPI-U”). In plain terms, this is a slower, slightly less taxpayer friendly index for inflationary adjustments. Finally, the changes to the individual income tax rate structure are all set to expire after 2025 if a future Congress does not act to extend them.

Standard Deduction and Itemized Deductions

The Act increases the basic standard deduction for single individuals from $6,350 to $12,000 and for married individuals filing jointly from $12,700 to $24,000. This increase along with the limitations discussed below to some of the most-used itemized deductions will result in many taxpayers who currently itemize their deductions using the standard deduction under the new law. The Act also removes the current provision providing a personal exemption deduction of $4,050 for each of the taxpayer, the taxpayer's spouse, and any dependents. Taxpayers with dependent children will benefit from an increased child tax credit. The Act raises the child tax credit from $1,000 to $2,000 per qualifying child and increases the adjusted gross income threshold for phase-out of the credit to $400,000 for married taxpayers filing jointly and $200,000 for all other taxpayers.

The key changes to itemized deductions include:

- **State and Local Tax Deduction**. The Act maintains the tax deduction for state and local property and income taxes (or, if elected, sales taxes), but limits the deduction to $10,000 for both single taxpayers and married taxpayers filing jointly ($5,000 for married taxpayers filing separately).

Planning Pointer The Act contains a provision that negates any benefit of prepaying 2018 state and local income taxes, but this does not apply to property taxes. For many taxpayers, if possible, it will be advantageous to pay any invoices for 2018 property taxes and estimated income taxes for the fourth quarter of 2017 (due January 15, 2018) before December 31, 2017.

- **Home Mortgage Interest Deduction**. Under current law, taxpayers may deduct interest paid on acquisition indebtedness for their principal residence and one additional residence. The acquisition indebtedness upon which interest can be deducted cannot exceed $1,000,000 ($500,000 for married taxpayers filing separately). The Act maintains this limit for current home owners, but lowers the cap to $750,000 ($375,000 for married taxpayers filing separately) for purchases beginning in 2018. The Act repeals a provision allowing home owners to deduct interest on up to $100,000 ($50,000 for married taxpayers filing separately) of home equity indebtedness.

- **Miscellaneous Itemized Deductions Subject to the Two-Percent Floor**. The Act completely repeals the provision under current law that allows taxpayers to itemize deductions for many miscellaneous expenses to the extent they exceed, in the aggregate, 2% of the taxpayer's adjusted gross income ("AGI"). Common miscellaneous itemized deductions include investment fees and expenses, dues to professional societies, licenses and regulatory fees, malpractice insurance premiums, and any other unreimbursed business expenses incurred by an employee.

Planning Pointer If possible, taxpayers that incur miscellaneous itemized deductions in excess of the 2% of AGI floor should accelerate payment of any such expenses so that they are incurred before December 31, 2017.

Income Taxes on Trusts and Estates

The income tax brackets for trusts and estates are highly compressed; therefore, the income of an irrevocable non-grantor trust or estate is subject to the highest rate of taxation on income exceeding a much smaller threshold than individuals. For 2018, the tax rate is 37% for ordinary income of trusts and estates that exceeds $12,500. As with individuals, this does not include the additional 3.8% net investment income tax on passive income.

529 Plans

Under current law, contributions to 529 plans are not deductible for federal income tax purposes, but all income within a 529 plan is exempt from tax so long as distributions are made for qualified higher education expenses. Contributions to 529 plans in excess of the gift tax annual exclusion amount for each donee will reduce the transferor's available estate and gift tax exemptions. The Act expands the distributions allowed under a 529 plan to include up to $10,000 per student to be used for elementary and secondary school tuition.

Planning Pointer For some, the purposes served by a 529 plan can be achieved through other planning mechanisms including direct tuition payments or trusts that authorize education payments. Despite this, 529 plans provide some unique benefits and the opportunity for tax-free growth of funds. The Act expands the utility of 529 plans for parents and grandparents who expect their descendants to attend private or religious elementary or secondary schools.

Corporate Taxes

The signature provision of the Act is the slashing of the top corporate tax rate from 35% to 21%. The Act also repeals the alternative minimum tax ("AMT") on corporations. Under current law, the corporate AMT operates to ensure that corporations, which take advantage of certain deductions and credits, must pay a minimum tax of 20% on corporate income. The reduced rate of 21% combined with the repeal of the corporate AMT provides a huge tax savings for businesses organized as C corporations.

Special Provisions for Passthrough Entities

Under both current law and the Act, generally the income of a passthrough entity including a partnership, S corporation, and sole proprietorship is taxed at the partner or shareholder level rather than the entity level.[4] All shareholders, partners, or owners of passthrough entities will benefit from the reduced individual income tax rates provided by the Act, but some will also benefit from a new 20% deduction on "qualified business income."

Generally speaking, qualified business income is income effectively connected with the conduct of a trade or business within the United States that is not "specified investment-related income." Specified investment-related income includes items such as: (i) any item taken into account in determining long-term capital gain or loss, (ii) dividends and income equivalent to a dividend, and (iii) interest income not allocable to a trade or business.

The Act creates a complex set of rules to determine who will be able to utilize the 20% deduction on qualified business income and to what extent. First, there are disfavored business types known as "specified service trades or businesses" (defined below) and then there are all other trades and businesses. We'll get to the limitation on income from specified service trades or businesses in a moment, but for everyone else:

If a taxpayer's taxable income (that's all taxable income, not just qualified business income) does not exceed $157,500 ($315,000 for married taxpayers filing jointly), the taxpayer can deduct 20% of qualified business income without limitation. For taxpayers with taxable income that exceeds the threshold by up to $50,000 ($100,000 for married taxpayers filing jointly), a limitation is phased-in. Taxpayers with taxable income that exceeds the threshold by more than $50,000 ($100,000 for married taxpayers filing jointly) are fully subject to the limitation.

If a taxpayer is subject to the limitation, the taxpayer may deduct an amount equal to the lesser of 20% of qualified business income or the limitation amount. The limitation amount is the greater of (i) 50% of the W-2 wages paid with respect to the trade or business, or (ii) the sum of 25% of the W-2 wages with respect to the trade or business and 2.5% of the unadjusted basis, immediately after acquisition, of all tangible, depreciable property used in the trade or business.

Planning Pointer The addition of the 2.5% of unadjusted basis of tangible property to the limitation allows certain business owners that otherwise would not have been able to meet the wage test, such as real estate developers, to take advantage of the deduction.

Specified Service Trade or Business

More onerous limitations apply to income from a "specified service trade or business" including any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or, generally, 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.[5]

The Act creates a complex set of rules to determine who will be able to utilize the 20% deduction on qualified business income and to what extent.

For taxpayers with taxable income that does not exceed $157,500 ($315,000 for married taxpayers filing jointly), the taxpayer may utilize the full 20% deduction of qualified business income. For taxpayers with taxable income that exceeds the threshold by up to $50,000 ($100,000 for married taxpayers filing jointly), another complex W-2 wage-based limitation applies to the deduction of qualified business income. Congress created a cliff for taxpayers with taxable income that exceeds the threshold by more than $50,000 ($100,000 for married taxpayers filing jointly). Those taxpayers may not deduct any of their qualified business income from a specified service trade or business.

Additional Notes on the Qualified Business Income Deduction

- The deduction is a "below the line" deduction and therefore, it is not allowed to be used in computing AGI. This means it will not affect any limitations elsewhere in the tax code that are based on AGI. The deduction is available to taxpayers that itemize their deductions and those that use the standard deduction.

- Trusts and estates are eligible for the 20% deduction.

- The threshold amounts are indexed for inflation.

- If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year and will operate to reduce the deduction available in that future year.

Planning Pointer These changes are dramatic and complex. The above is a simple overview of a complex set of rules. Many business owners will benefit from either the new passthrough deduction or the lower corporate tax rate. Some business owners will also want to reevaluate the entity classification of their business to take advantage of the low corporate tax rate. The new corporate tax rate and the restrictions applicable to the passthrough deduction will also create new opportunities to use C corporations in personal wealth planning.

Changes for Charitable Contributions

Under current law, individuals who itemize their deductions may deduct charitable contributions on their personal income tax returns subject to certain limitations on their AGI. For public charities, private operating foundations, and certain private foundations that make enough qualifying distributions, the limitation is currently 50% of AGI for cash contributions and 30% of AGI for contributions of appreciated property. For all other private foundations, the limitation is currently 30% of AGI for cash contributions and 20% of AGI for contributions of appreciated property. The Act increases the AGI limit for cash contributions to public charities, private operating foundations, and certain private foundations with sufficient qualifying distributions to 60% of AGI.

Planning Pointer This provision will benefit taxpayers who make large cash gifts to public charities or qualifying private foundations.

Other Notable Provisions of the Act

- Repeals the overall limitation on itemized deductions (sometimes referred to as the "Pease limitation").

- Changes the "kiddie tax" by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of certain children (those under the age of 19 and college students under the age of 24). Under current law, the unearned income of such children is taxed at the parents' tax rate if the parents' tax rates are higher than those of the child.

- Repeals provision providing for a technical termination of a partnership under I.R.C. § 708(b)(1)(B) upon the sale or exchange of 50% or more of the total interest in partnership capital and profits within a 12-month period.

Concluding Remarks

In less than two weeks, we will toast a new year. Unlike prior years where we understood the landscape of the tax laws, 2018 will be a year for review, reflection, and in many cases, change. We look forward to discussing with you the impact of the tax changes on your individual estate plan. ◆

This summary of legal issues is published for informational purposes only. It does not dispense legal advice or create an attorney-client relationship with those who read it. Readers should obtain professional legal advice before taking any legal action.

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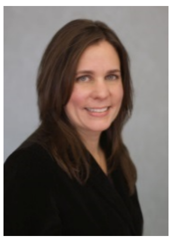

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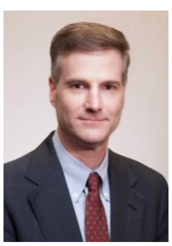

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[1] The full text of the Tax Cuts and Jobs Act is available here.
[2] The Act does not repeal the additional 3.8% net investment income tax on passive income exceeding certain thresholds.
[3] NY Tax Law § 952(c)(2)(B). The statute defines the New York "basic exclusion amount" as $5 million multiplied by a cost-of-living adjustment based upon the percentage by which the consumer price index for the preceding year exceeds the index for the year 2010. This is the same definition as provided in the current iteration of the Internal Revenue Code. *See* I.R.C. § 2010.
[4] Multi-member limited liability companies are generally treated as partnerships for federal tax purposes, but under the "check-the-box" regulations they may elect to be treated as S corporations or C corporations.
[5] Unlike the Senate's version of the bill, the final Act excludes from this definition engineering and architecture services.