SHERMAN WELLS
SYLVESTER & STAMELMAN LLP

# TAX AND TRUSTS & ESTATES UPDATE

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## *The Tax Cuts and Jobs Act – How It May Affect You*

On Friday, December 22, 2017, President Trump signed into law a sweeping tax reform bill: the Tax Cuts and Jobs Act (the "Tax Bill"). The Tax Bill will have significant impact on the taxation of individuals and corporations, and is set to be effective as of January 1, 2018, with most provisions expiring as of December 31, 2025, except as otherwise provided.

The Tax Bill represents a major overhaul to the U.S. tax system. Below is a summary of the Tax Bill's key provisions.

### TAX CHANGES APPLICABLE TO INDIVIDUALS

- **Individual Tax Rates.** Under the Tax Bill, there will be seven tax brackets: 0%, 10%, 12%, 22%, 24%, 32%, 35%, with a top individual rate of 37%. Currently, the maximum individual tax rate is 39.6%. The new tax rates will be applicable for tax years 2018 to 2025, reverting back to a top rate of 39.6% as of 2026.

- **Standard Deduction.** The standard deduction will increase from $6,500 to $12,000 for individuals, and from $13,000 to $24,000 for married couples. Personal exemptions will be repealed at all income levels.

- **SALT/Property Taxes.** The deduction for state and local income taxes, as well as sales and property taxes, will be limited to an aggregate of $10,000 for married and single filers, and to $5,000 for married filers filing separately. In addition, most miscellaneous itemized deductions that were subject to the 2% of Adjusted Gross Income ("AGI") floor will be disallowed (e.g., Section 212 expenses, accounting/legal/unreimbursed business expenses). The floor for deducting medical expenses will be lowered from the current 10% of AGI to 7.5% of AGI, but only for tax years 2017 and 2018, reverting back to 10% for tax years 2019 and thereafter.

- **Child Tax Credit.** The amount of the Child Tax Credit will increase from $1,000 to $2,000 for single filers and married couples. The tax credit is fully refundable up to $1,400 and begins to phase-out for families making over $400,000.

- **Mortgage Interest.** The mortgage interest deduction will remain but with slight changes: (1) for homeowners with existing mortgages that were taken out to buy a home, there will be no change to the current mortgage interest deduction; (2) for homeowners with new mortgages on a first or second home, the home mortgage interest deduction will be available for a mortgage amount up to $750,000.

**In This Issue**




**Office Locations**

**New Jersey**
210 Park Avenue
2nd Floor
Florham Park NJ 07932
973.302.9700

**New York**
54 W. 40th Street
New York NY 10018
212.763.6464

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- **AMT brackets.** The alternative minimum tax (the "AMT") is retained; however, the exemption amount will be increased to $109,400 for married individuals (as opposed to the current amount of $86,200) and $70,300 for single individuals (as opposed to $55,400 currently). In addition, the phase-out exemption amount will begin at $1,000,000 for married individuals (as opposed to the current amount of $164,100) and $500,000 for single individuals (as opposed to $123,100 currently). Again, these exemption amounts will be in effect for taxable years 2018 to 2025, reverting back to current levels in 2026.

- **Capital Gains**. The current 20% maximum rate on long-term capital gains and qualified dividend income remains the same. The capital gain exclusion on the sale of a primary residence also remains unchanged.

TAX CHANGES APPLICABLE TO BUSINESSES

- **Corporate Tax Rate.** The corporate tax rate is permanently decreased to 21% for tax years beginning in 2018.

- **Corporate AMT.** Under the Tax Bill, effective for tax years beginning January 1, 2018, the corporate alternative minimum tax (the "AMT") will be repealed. Currently, the corporate AMT rate is 20%, with an exemption amount of up to $40,000, which phases out starting at $150,000 of alternative minimum taxable income.

- **Dividends Received Deduction.** Under current law, corporations that receive dividends from other corporations are entitled to a deduction for dividends received. If the corporation owns at least 20% of the stock of another corporation, an 80% deduction is allowed. Otherwise, the deduction is limited to 70%. Under the Tax Bill, the 80% dividends received deduction will be reduced to 65%, and the 70% deduction will be reduced to 50%.

- **Business Interest Deductions.** The Tax Bill amends Section 163(J) of the Code to limit the deduction for business interest expense for any taxable year to the sum of: (1) the business interest income of the taxpayer for the taxable year; and (2) 30% of the "adjusted taxable income" of the taxpayer for the taxable year. "Business interest" expense means any interest paid or accrued on indebtedness properly allocable to a trade or business regardless of whether it is related party or unrelated party indebtedness. Any business interest disallowed as a deduction under this provision can be carried forward indefinitely. Taxpayers exempt from this deduction include those whose average annual gross receipts for the 3 prior taxable years ending with the prior taxable year do not exceed $25 million. Notably, for taxable years beginning on or after January 1, 2018, and ending before January 1, 2022, "adjusted taxable income" will be computed without regard to any deduction allowable for depreciation, amortization or depletion, thereby potentially increasing the base to which the 30% is applied and potentially increasing the permitted interest deduction for those years.

- **Modification of NOL Deductions.** Under current law, a net operating loss ("NOL") may generally be carried back 2 years and carried forward 20 years to offset taxable income in prior and future years, as applicable, with different carryback periods applicable depending on the circumstances (for example, longer carryback periods were allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses). Under the Tax Bill, the 2-year carryback and special carryback provisions are repealed, except in the case of certain losses incurred in a farming business. In addition, the NOL deduction will be limited to 80% of taxable income. An exception will apply to the NOLs of property and casualty insurance companies, which will be allowed to carry back their losses 2 years and carry forward their losses 20 years to offset 100% of taxable income in such years. These modifications apply to NOLs arising in tax years ending after December 31, 2017.

- **Research and Experimentation Expenses.** Currently, taxpayers can deduct the amounts of certain reasonable research and experimentation ("R&E") expenses paid or incurred in connection with a trade or business. For R&E expense amounts incurred in tax years beginning on or after January 1, 2021, certain "specified" R&E expenses will need to be capitalized and amortized ratably over a 5-year period (15 years if the research and experimentation is conducted outside the United States), beginning with the midpoint of the tax year in which the specified R&E expenses were paid or incurred. The term "specified R&E expenses" includes software development expenses but excludes land and depreciable property used in connection with the research, as well as exploration expenses incurred for ore or other minerals.

- **Fringe Benefits.** Currently, businesses can deduct up to 50% of expenses relating to meals and entertainment. Under the Tax Bill, deductions for entertainment expenses will be disallowed for amounts incurred or paid after December 31, 2017, and the current 50% limit on the deductibility of business meals will be expanded to meals provided through an in-house cafeteria or otherwise on the premises of the employer. In addition, deductions for employee transportation fringe benefits (e.g., parking and mass transit) will be disallowed, and no deduction will be allowed for transportation expenses that are the equivalent of employee commuting.

- **Code Section 179 Expensing.** In general, under Code Section 179, a taxpayer may, subject to limitations, elect to deduct, or expense, the cost of "qualifying property" (as defined in Code Section 179) rather than to recover such costs through depreciation deductions. Under current law, the maximum that a taxpayer could expense in the year in which the property was placed in service was up to $500,000 of the cost of such property, with that amount reduced (but not below zero) by the amount by which the cost of qualifying property exceeded $2 million. The Tax Bill increases the deduction amount to $1,000,000 with respect to any "qualifying property" placed in service in tax years beginning on or after January 1, 2018, with the phase-out threshold amount increased to $2.5 million. In addition, the definition of "qualified real property" under Code Section 179 is being expanded to include certain depreciable tangible personal property used mainly to furnish lodging or in connection with furnishing lodging, as well as certain improvements to nonresidential real property after the date such property was first placed in service (such as roofs, heating, ventilation and air-conditioning, fire protection and alarm systems, and security systems).

- **Temporary 100% Cost Recovery of Qualifying Business Assets.** Currently, an additional first-year bonus depreciation deduction is allowed for 50% of the adjusted basis of "qualified property," if the property was originally used by the taxpayer and was placed in service by the taxpayer prior to January 1, 2020 (or January 1, 2021, for certain property with longer production periods). The 50% deduction was phased down for property placed in service on or after January 1, 2018 (or January 1, 2019 for certain property with longer production periods). Under the Tax Bill, the first-year deduction for the adjusted basis of "qualified property" is increased to 100% for any property acquired and placed in service after September 27, 2017, and prior to January 1, 2023 (different periods apply for property with longer production periods). This additional first-year depreciation deduction will be allowed for new and used property. The first-year bonus depreciation deduction phases down gradually at 20% per year between the years 2022 and 2026. The first-year bonus depreciation sunsets after 2026.

- **Recovery Period for Real Property.** Currently, the cost recovery periods for real property are generally 39 years for nonresidential property and 27.5 years for residential property. Under current law, there are separate definitions and rules for qualified leasehold improvement property, qualified restaurant property and qualified retail improvement property. If a taxpayer elected the "accelerated depreciation system" ("ADS") method of depreciation, residential rental property had a recovery period of 40 years. Under the Tax Bill, the separate definitions articulated above are eliminated, and a general 15-year recovery period and straight-line depreciation are provided for qualified improvement property, and a 20-year ADS recovery period is provided for such property. The provisions apply to property placed in service on or after January 1, 2018. As a result, qualified improvement property placed in service on or after January 1, 2018 will be generally depreciable over 15 years using a straight-line method. In addition, the ADS recovery period for residential rental property placed in service on or after January 1, 2018 will be 30, not 40, years.

- **Excessive Employee Compensation.** Under current law, publicly traded corporations can claim a deduction of up to $1 million for compensation paid or accrued with respect to a "covered employee." Exceptions to this deduction apply for commissions and performance-based compensation, including stock options, as well as to payments to tax-qualified retirement plans. For tax years beginning on or after January 1, 2018, the exceptions to the $1 million deduction limitation for commissions and performance-based compensation will be repealed. In addition, the definition of a "covered employee" is modified to include the principal executive officer, the principal financial officer, and the three other highest paid officers. In addition, if an individual was or is determined to be a covered employee with respect to a publicly traded corporation for any tax year beginning after Dec. 31, 2016, that individual will remain a covered employee for all future years. The above changes do not apply to any compensation arrangement under a written binding contract which was in effect on November 2, 2017, and which was not materially modified thereafter.

## TAX CHANGES APPLICABLE TO PASS-THROUGH ENTITIES

- **New Deduction for Pass-Through Income.** Currently, the net income of sole proprietorships, partnerships, LLCs and S corporations is not subject to an entity level tax and instead passes through to its owners or shareholders on their individual tax returns.

  Under the Tax Bill, for tax years beginning on January 1, 2018, and ending on December 31, 2025, non-corporate taxpayers, including a trust or estate, that have "qualified business income" ("QBI") from a partnership, S corporation, or sole proprietorship will be allowed to deduct the sum of: (1) the lesser of (a) the "combined qualified business income amount" of the taxpayer, or (b) 20% of the excess, if any, of the taxable income of the taxpayer for the tax year over the sum of net capital gain and the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year; and (2) the lesser of (a) 20% of the aggregate amount of the qualified cooperative dividends of the taxpayer for the tax year, or (b) taxable income of the taxpayer for the tax year. The 20% deduction is not allowed in computing adjusted gross income but instead is allowed as a deduction that reduces taxable income.

  For purposes of the above, QBI generally means the net amount of "qualified items of income, gain, deduction, and loss" relating to any qualified trade or business of the taxpayer but excluding certain investment items, reasonable compensation paid to the taxpayer by any qualified trade or business for services rendered with respect to the trade or business, any guaranteed payments for services made under Code Section 707(c), or payments for services made under Code Section 707(a).

  The availability of the deduction is limited for pass-through entities other than sole proprietorships as follows: the deduction cannot exceed the greater of: (1) 50% of the W-2 wages with respect to the qualified trade or business; or (2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all "qualified property."

  Certain other thresholds and exclusions apply. The provision is codified in new Code Section 199A (Qualified Business Income).

- **Partnership Termination.** Currently, under Code Section 708(b)(1)(B), a partnership is considered terminated for tax purposes if, within any 12-month period, there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. This rule will be repealed for partnership tax years beginning on or after January 1, 2018.

- **Limitation on Excess Business Losses of Non-corporate Taxpayers.** For taxable years 2018 through 2025, any excess business loss of a non-corporate taxpayer will be disallowed and will be treated as a net operating loss carryover to the following taxable year. The "excess business loss" of a taxpayer for a taxable year is defined under the Tax Bill as: (1) the aggregate deductions of the taxpayer for the taxable year that are attributable to trades or businesses over (2) the aggregate gross income or gain of the taxpayer for the taxable year attributable to such trades or businesses plus $250,000 (or twice this amount in the case of a joint return, with both amounts adjusted for inflation). In the case of a partnership or an S corporation, the provision shall apply at the partner or shareholder level. This provision will apply after the application of the passive loss rules under Code Section 469.

- **Carried Interest.** The taxation of carried interests and other partnership interests held in connection with the performance of services will generally be retained going forward. However, gain with respect to these partnership interests will be recharacterized as short-term gain to the extent that the capital asset giving rise to the gain has been held for 3 years or less, regardless of whether an election under Section 83(b) is made. Currently, gain from the sale of a capital asset held for more than 1 year is generally treated as long-term capital gain, and so taxable at a much lower rate. Short-term capital gains are taxed at ordinary income tax rates, although they can generally be offset by net long-term capital losses. Notably, the 3-year holding period will not apply to any capital interest in a partnership which provides a right to share in partnership capital commensurate with the amount of capital contributed to the partnership.

- **Partnership "Substantial Built-In Loss".** Currently, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless the partnership has made an election under Section 754 of the Code to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer, in which case adjustments are made with respect to the transferee partner. Under the current law, a partnership has a substantial built-in loss if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property. For transfers of partnership interests on or after January 1, 2018, the definition of a substantial built-in loss is modified. Under the Tax Bill, a substantial built-in loss will also exist if the transferee would be allocated a net loss in excess of $250,000 on a hypothetical disposition by the partnership of all of its assets in a taxable transaction for cash equal to the fair market value of the assets immediately after the partnership interest is transferred to the transferee.

- **S Corporations Converted to C Corporations.** Currently, if an S corporation coverts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period ("PTTP") to the extent of the amount in the accumulated adjustment account, are tax-free to the shareholders and reduce the shareholders' adjusted basis in their stock. Under the Tax Bill, if an adjustment is made under Code Section 481(a) by an eligible terminated S corporation, which is attributable to the revocation of its S corporation election (for example, a change from the cash method to an accrual method of accounting), any such adjustment will be taken into account ratably over a period of 6 years beginning with the year of change. Under the Tax Bill, an eligible terminated S corporation will be any C corporation which: (1) is an S corporation before the Tax Bill is enacted; (2) revokes its S corporation election during the 2-year period beginning on the date of enactment; and (3) all of the owners on the date the S corporation election is revoked are the same owners as the owners on the date of the enactment. With respect to the distribution of money by an eligible terminated S corporation, the accumulated adjustment account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits in the same ratio as the amount of the accumulated adjustments account bears to the amount of the accumulated earnings and profits.

## OTHER PROVISIONS OF IMPORTANCE

- **Code Section 1031 Tax-Free Exchanges.** Code Section 1031 allows for the exchange of an asset for a replacement asset of similar kind without triggering a current tax liability from the gain on the sale of the first asset. Currently, tax-free like-kind exchanges under Code Section 1031 are available for real property and certain types of personal property. Under the Tax Bill, tax-free like-kind exchanges will be limited solely to real property that is not held primarily for sale. Unlike many other provisions in the Tax Bill, this provision does not expire at the end of 2025.

- **Modification of Gift/Estate/GST:** Under the Tax Bill, the estate, gift and GST tax exemptions will be doubled to $11.2 million per U.S. domiciliary. Currently, the estate, gift and GST tax exemptions are each $5.6 million per U.S. domiciliary. Like most individual provisions, the exemptions expire at the end of 2025 and revert back to the current law, with inflation adjustments.

- **ESBT.** Generally, currently, the eligible beneficiaries of an electing small business trust ("ESBT") include individuals, estates and certain charitable organizations eligible to hold S corporation stock. Effective on January 1, 2018, a nonresident alien individual may be a potential current beneficiary of an ESBT.

- **Exempt Organizations:** Under current law, the net amount of income and loss from an organization's unrelated trade or business activities is calculated on an aggregate basis. The Tax Bill will require that UBTI be calculated separately for each unrelated trade or business of the organization. This change will effectively prevent tax-exempt organizations from using expenses or losses related to one trade or business to offset UBTI generated from another trade or business. This change may impact the decision of some tax-exempt investors regarding whether to invest in certain entities through a "blocker" corporation. It may also add significant complexity to the reporting of UBTI by certain entities, especially investments with multiple sources of UBTI, such as funds of funds.

## SUMMARY

The Tax Bill is one of the most significant tax reforms in decades and represents the largest one-time reduction in the corporate tax rate in U.S. history. The bill will have far reaching consequences not only for corporations, but also for individuals on all income levels, as well as pass-through and foreign entities. The above summary was designed to describe only certain provisions of the Tax Bill and is solely for informational purposes. It is not meant to constitute tax advice. The members of our tax team will be happy to discuss with you the applicability of the various provisions of the Tax Bill to your particular circumstances. Please contact us for additional information.

## *Attorney Contact Information*

**Sandra Brown Sherman**
Partner
973.302.9716
ssherman@shermanwells.com

**Andrew J. Stamelman**
Partner
973.302.9714
astamelman@shermanwells.com

**Tracy McSweeney Child**
Partner
212.763.6465
tchild@shermanwells.com

**Allison S. Clayton**
Counsel
973.302.9506
aclayton@shermanwells.com

**James A. Mohoney**
Counsel
973.302.9702
jmohoney@shermanwells.com

**Bozena M. ("Bonnie") Diaz**
Associate
973.302.9556
bdiaz@shermanwells.com

**Jonathan Schwartz**
Associate
973.302.9673
jschwartz@shermanwells.com

## *Fiduciary Accountant & Paralegal Contact Information*

**Monika Hilliard**
Fiduciary Accountant
973.302.9701
mhilliard@shermanwells.com

**Judith Kaplan Malamed**
Fiduciary Accountant
973.302.9703
jmalamed@shermanwells.com

**Mary Ellen Myers Greene**
Fiduciary Accountant
973.302.9501
mmgreene@shermanwells.com

**Marci Racaniello**
Fiduciary Accountant
973.302.9699
mracaniello@shermanwells.com

**Beth Corroon**
Paralegal
973.302.9509
bcorroon@shermanwells.com

**Katrina Gieniec**
Paralegal
973.302.9668
kgieniec@shermanwells.com

**Betty Kleiman**
Paralegal
973.302.9705
bkleiman@shermanwells.com

**Beatrice Kwok**
Paralegal
973.302.9704
bkwok@shermanwells.com