New Tax Legislation: Top Ten Action Items & Some Observations

With some of the most dramatic changes in US taxation in over 30 years forthcoming, individuals and businesses should take time to reassess their tax planning for 2017 and future years to determine how they will be affected. While most of the changes take effect in 2018, there is a window in late 2017 for taxpayers to consider one-time actions to take advantage of the transition to the new rules. Here are some of the key action items that you or your business might consider before year-end in response to the new legislation:

Individuals

1. Pay state and local income taxes and real estate taxes

The final Bill limits the combined deduction for state/local income and real estate taxes to $10,000. Currently, taxpayers who are not subject to the alternative minimum tax (AMT) can deduct these expenses as itemized deductions. If you expect to owe additional state and local income taxes for 2017, or if you currently owe real estate taxes, you should consider paying these liabilities before year-end, presuming you itemize and are not subject to AMT (Georgia taxpayers can still receive a state tax benefit even if they are in Federal AMT). Note, however, that the Bill contains a provision specifically disallowing any deduction for a prepayment of *2018* state and local income taxes.

2. Maximize charitable contributions

Under the new law, the standard deduction is set to increase – up to $24,000 for married couples, $18,000 for heads-of-household and $12,000 for all other individuals. If the higher standard deduction will prevent you from itemizing deductions in future years, consider accelerating, or bunching your charitable contributions for future years into 2017. One way to pre-fund your charitable giving for future years is through the creation of a donor-advised fund – you receive an immediate deduction for the money you contribute, but can spread the actual charitable gifts over several years.

3. Apply for your state's scholarship tax credit

A scholarship tax credit is a state-sponsored program that allows taxpayers a credit against state income taxes in exchange for making contributions to qualified non-profits that grant private school scholarships. Ten states, including Alabama, Arizona, Georgia, Kansas, Montana, Oklahoma, Pennsylvania, Rhode Island, South Carolina and Virginia now offer such programs to offset state income tax liability. With the $10,000 deduction limit for state and local income taxes beginning next year, these programs provide taxpayers with the opportunity to trade a potentially non-deductible state tax payment for a deductible charitable contribution. Generally, you must obtain pre-approval to make such a contribution by applying in the preceding tax year – for example, Georgia's scholarship tax credit application for 2018 closes in December of 2017.

Georgia taxpayers should also consider the Qualified Rural Hospital Organization Expense Credit for the same reasons. Donors receive a Georgia tax credit of 90% of their charitable contribution to a rural hospital, and are allowed a maximum credit of $10,000 ($5,000 for single filers). Applications can be submitted beginning in January for the 2018 tax year.

4. Pay off your home equity line of credit

While the new law grandfathers the deduction for mortgage interest on up to $1 million of loan principal, the limit on mortgages taken out after December 15, 2017 will be lowered to $750,000. Additionally, the carve-out allowing taxpayers to deduct interest paid on up to $100,000 of home equity debt will be repealed as of the end of the year. If you are now paying interest on a home equity line of credit, consider paying it down because the interest will no longer be deductible in 2018 or future years; any paydown is an investment decision and should consider the alternatives for deployed capital.

5. Traditional planning is appropriate for most. But for some, more income now may be better: consider a Roth IRA conversion?

In general, with future tax rates dropping, traditional tax planning is appropriate for many individuals: accelerate tax deductions and defer income, where possible. A downward shift in tax rates for the next several years could produce permanent tax savings for deductions or lead to harvested losses now, and income to be recognized at a later date.

Beginning in 2018, taxpayers will no longer be allowed to deduct so-called “miscellaneous” itemized deductions – e.g., investment fees, unreimbursed employee business expenses and tax preparation fees. Certain individuals, such as retirees with large portfolios or employees with significant home office expenses, may find that their taxable income increases under the new law due to the disallowance of these deductions. For taxpayers with potential “excess deductions” or allowable losses usable only in 2017, this year may be the ideal time to use a so-called “Roth conversion,” in which a traditional IRA is converted to a Roth IRA and the deferred IRA income is triggered and reported as current taxable income. Remember that a partial Roth conversion is possible, if your deductions/losses cannot shelter the entire value of your IRA account being recognized as income. Other deferred income items, or appreciated assets, could also be recognized to soak up unused itemized deductions or losses.

The Bill prevents taxpayers from “unwinding” Roth IRA conversions for tax years after 2017 by recharacterizing them back to traditional IRAs, but this flexibility is still available for Roth conversions completed in the 2017 tax year.

6. Review your estate plan and utilize annual-exclusion gifts

There has been much discussion about a repeal of the gift and estate tax, but the final Bill keeps current estate & gift taxable rules and the maximum rate remains at 40%. However, the basic exclusion amount will be increased to $10 million per individual – that is, you can bequeath up to $10 million in assets to your heirs and not owe any gift or estate tax—and, up to $20 million for a married couple. This provision only applies to tax years 2018 – 2025, so consult with your legal

counsel and tax advisors to decide if this change might affect your estate plan. The $14,000 annual exclusion per donee for gift tax purposes remains in place and can be utilized before the end of the year, if gifting is part of your overall estate plan.

Businesses

7. Carry back net operating losses

Taxpayers are now allowed to carry back net operating losses from business activity to offset taxable income in the prior two years, or carry such losses forward for up to twenty years. Beginning in 2018, new rules require businesses to only carry forward losses—no more carrybacks—and future use can only offset up to 80% of taxable income. If your business is in a tax loss (or close to break-even) position for 2017, consider accelerating deductions to maximize the 2017 reportable tax loss amount if it makes sense for your business - for example, by buying and placing new business assets in service before the end of the calendar year and by paying by off cash-basis liabilities. The new, stricter provisions only apply to net operating losses incurred after December 31, 2017, so a 2017 loss can still be carried back two years and can offset 100% of future years' taxable income, if carried forward.

8. Don't wait to buy business assets

The new Bill contains many provisions incentivizing businesses to make capital investments. Under the new law, businesses can write off 100% of the cost of certain qualified property through bonus depreciation. This 100% rate applies to most types of personal property, such as equipment, furniture and computers – and it also expands the definition to include either *new or used* property. However, your business does not need to wait until 2018 to take advantage of this expensing provision – it applies to any qualifying asset placed in service after September 27, 2017.

All Taxpayers

9. Harvest tax losses, accelerate deductions and defer earnings

Tax rates are expected to decrease across the board under the new law: individuals will be subject to a 37% maximum rate and corporations subject to a 21% maximum rate, while owners of pass-through entities will also be allowed a 20% deduction on their qualifying business income. Since 2017 will be the last year under the current maximum rate regime of 39.6% for individuals and 35% for corporations, with no deduction for pass-through income, traditional tax planning would call for harvesting losses and accelerating deductions into 2017 while deferring earnings into 2018. A few strategies to accomplish this include selling securities with built-in losses, pre-paying any deductible items and delaying billings to customers. A downward shift in rates can create a permanent tax savings in certain situations where deductions or losses are accelerated and income is deferred. However, consult your tax advisor before pursuing this strategy as your individual situation could call for a different approach.

10. Do the Math

There is no substitute for preparing multi-year calculations and iterations to project 2017 and future years' tax effects: any decision on actions before year-end should consider the effects on income, deductions and credits benefits and possible risks. Some opportunities may provide immediate tax savings but could result in increased tax in the future, so added factors such as the time value of money and alternative uses of capital should be considered. You must crunch the numbers.

Observations & Comments

Many other areas of the Internal Revenue Code will change, and some proposals were removed from the Bill in the final, frenetic hours of negotiation. Some highlights are listed below and may warrant additional planning if they apply to you or your business. Each provision will be effective for tax years beginning after December 31, 2017, unless otherwise noted.

Individuals

- **Capital gain rates:** the tax rates on capital gains and qualified dividends will remain unchanged.
- **Affordable Care Act taxes:** the "Obamacare taxes" of 3.8% net investment income tax and the 0.9% additional Medicare tax on earned income will remain unchanged.
    - The "individual mandate" requiring individuals to maintain health coverage will be repealed effective December 31, 2018.
- **Charitable contributions:** the adjusted gross income limitation for cash donations to public charities will increase from 50% to 60%. However, payments for the right to purchase seating at a collegiate athletic event will no longer be deductible.
- **Medical expenses:** the House proposal to eliminate the deduction for medical expenses did not survive; instead, under the new Bill the threshold for deducting medical expenses will be reduced from 10% of AGI to 7.5% for all taxpayers.
- **Pease limitation:** the so-called "Pease limitation" on itemized deductions will no longer apply.
- **Alternative minimum tax:** the alternative minimum tax for individuals will remain in place, but fewer taxpayers will be affected by it as the exemption and phase-out amounts are scheduled to increase.
- **Section 529 plans:** distributions from 529 plans can be used for elementary and secondary school, in addition to expenses for college, but not for home-schooling.
- **Graduate students:** tuition waivers provided to graduate students will remain non-taxable.
- **Teachers' expenses:** the deduction for out-of-pocket classroom expenses paid by certain educators will remain in place.

- **Moving expenses:** the tax deduction for moving in connection with a new job will no longer be allowed. In addition, employees will not be able to exclude moving expense reimbursements provided by their employer from their gross income.
- **Education credits:** proposals to combine the American Opportunity and Lifetime Learning Credits into one benefit were not adopted, so the current incentives stay in place.
- **Student loan interest expense:** proposals were made but not adopted. No change here.
- **Alimony:** beginning in 2019, alimony will be neither deductible by the payor nor taxable to the recipient. Existing arrangements in place as of December 31, 2018 will be grandfathered in under the old rules.
- **Specific identification:** the Senate proposal to eliminate the ability of investors to specify which lots of stock they choose to sell or otherwise dispose was removed from the Bill, so current law still applies: stock basis planning is still available for sales, gifts, transfers and charitable contributions
- **Non-resident aliens:** the NRAs who are required to file US tax returns must itemize deductions, and thus, they will most likely lose some existing deductions; plus, like everyone, they lose the personal exemption; whether they win or lose will depend on their overall effective tax rate.

Businesses

- **Corporate rate drops:** probably the key provision in the Bill is the drop of corporate income tax rates from 35% to 21%; and, that the new rates apply in 2018, not 2019 as originally proposed.
- **Business cars and trucks:** the so-called depreciation "caps" on automobiles will be increased for business cars and trucks to nearly triple the early years' expense amounts.
- **Section 179 expense:** the section 179 expense limit will be increased from $500,000 to $1 million. Additionally, there is an expanded definition of real property eligible for the election.
- **Alternative minimum tax:** the alternative minimum tax on corporations will be repealed.
- **Domestic production deduction:** the deduction for domestic manufacturing under Section 199 will be repealed.
- **Interest expense:** the deductibility of net business interest expense generally will be limited to 30% of adjusted taxable income.
- **Like-kind exchanges:** the ability of taxpayers to exchange business property tax-free will be limited to exchanges of real property.
- **R&D credit:** R&D credit is preserved. Under current law, taxpayers may elect to expense research and software development costs, or capitalize these costs and amortize them over five years; beginning in 2022 these costs will need to be capitalized and amortized over five years.
- **Pass-throughs:** there will be many changes to the way that pass-through entities (sole proprietorships, partnerships and S corporations) will be taxed. BT will publish more guidance on the 20% deduction, but the general rule is that certain pass-throughs (including qualified REIT income) will be allowed a 20% deduction for US qualifying

income, to be applied at the partner or S Corp shareholder level. Foreign income doesn't count. Certain businesses have phase outs, and the deduction is a function of the qualifying income, but subject to limits calculated with the entity's W-2 wages and tax bases of assets. The qualifying taxable base of income excludes amounts that are treated as reasonable compensation or guaranteed payments—those amounts will continue to be taxed directly as taxable compensation, as under current law.

- **Small business accounting:** more businesses will be eligible to use the cash method and simplified methods of accounting for inventory.
- **Meals and entertainment:** the Bill provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (*e.g.*, meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the Bill expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer.
- **Carried interests:** under the new law, the favorable capital gains treatment applicable to carried interests will only apply to those transactions with a qualifying holding period of three years or longer. If you are a participant in a deal scheduled to close in early 2018 for which you will not meet the three-year holding requirement, consider accelerating the monetization into 2017. Although there is some ambiguity as to the specific requirements and their applicability to certain types of investments, this strategy might be utilized if there is any uncertainty at the holder or entity level regarding the holding period.
- **International tax changes:** significant changes will be made to the taxation of international businesses, including a deemed repatriation of accumulated foreign earnings. Transition taxes for previously deferred and untaxed income will come back into the US in 2017 at rates of 8% for illiquid assets and 15.5% for earnings attributable to liquid assets measured at November 2, 2017 or December 31, 2017, whichever is higher. New sourcing rules also change where activities are considered taxed. The Bill would change the current worldwide taxation system (with some deferrals) to a participation exemption with current taxation of some types of income. There are also certain "minimum" taxes to be applied to entities that pay significant amounts to offshore, related parties and this is one area where new compliance reporting is required; penalties for failure to report are significant.
  In many cases, the changes will conflict with existing international tax treaties between countries and other protocols. Usually, in these cases, the most recent law change or agreement is controlling, but expect international pushback. Some provisions are ambiguous and confounding. The rules are exceptionally complex and will need additional and future guidance in many areas.
- **Financial statement effects:** financial statements will require analyses and adjustment to deferred tax items. If a company has an overall net deferred asset, they will—

generally—require a charge against earnings or equity as the net deferred asset is revalued using a lower future effective corporate tax rate; the future tax benefits will be realized at a lower rate than is recognized on the current balance sheet. The opposite is true for a company with overall net deferred tax liabilities: generally, it will have a pick up in earnings or equity as the future reversing temporary differences are taxed at a lower corporate tax rate; hence, a lower future tax liability when compared with today's balance sheet. In addition, companies with accumulated foreign earnings will have to assess the income tax accounting resulting from those earnings no longer being able to be considered "permanently reinvested" overseas. And, the financial statement adjustment for potentially disallowed or suspended tax effects for interest expense, executive compensation, NOLs and foreign operations will have to be reviewed.

- **Johnson Amendment repeal is removed:** legislation to allow more political advocacy by churches and other non-profits was removed. The current law remains in effect.

The IRS now must work quickly to incorporate these legislative changes that affect the 2017 tax filing season, and it must allocate scarcer resources—fewer employees, smaller budgets, with limited time—for the necessary reprogramming and protocols to absorb these changes.

This has been a rushed process, and the Bill was drafted relatively quickly—compared with major tax legislation in prior years—some parts are clear, some are not; the entire Conference Package with attachments is over 1000 pages. Expect drafting errors, oversights, surprises and unintended consequences. Additional interpretation and guidance will be needed, but in a split political environment, future technical corrections will be difficult to push through Congress, meaning that the IRS and the Administration may be challenged with interpreting how the new Bill should be implemented. Taxpayers should continue to monitor developments throughout 2018 and future years, as significant changes could still occur without the passage of additional legislation.

The new tax legislation brings along with it significant uncertainty, but also provides taxpayers with unique opportunities to generate added tax savings, perhaps permanent tax savings. Generalizations can be a guide, but optimal navigation for you comes down to this: it depends. It depends on your unique set of circumstances and opportunities.

Consider all the ramifications before you act. If you have questions about any of these tax planning strategies or how the new law might apply to your tax situation, please contact your Bennett Thrasher tax advisor by calling 770.396.2200.

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