

2018 FEDERAL TAX UPDATE

Recent Developments in Federal Income, Estate and Gift Taxes Affecting Individuals and Small Businesses

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These materials summarize important developments in the substantive federal income, estate and gift tax laws affecting individual taxpayers and small businesses using the timeframe of August, 2017, through August, 2018. The materials are organized roughly in order of significance. These materials generally do not discuss developments in the areas of deferred compensation or the taxation of business entities (except to a very limited extent).

Most of the content for Part I of these materials (an overview of the so-called Tax Cuts and Jobs Act) is adapted from Samuel A. Donaldson, *Understanding the Tax Cuts and Jobs Act* (January 3, 2018), available at SSRN: <https://ssrn.com/abstract=3096078>.

I. THE “TAX CUTS AND JOBS ACT” OF 2017

A. INTRODUCTION AND THE PATH TO ENACTMENT

Signed by President Trump on December 22, 2017, Public Law 115-97, formally titled “An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018” but commonly known as the “Tax Cuts and Jobs Act,” represents the most dramatic change to the Internal Revenue Code since passage of the Tax Reform Act of 1986.

Whereas the Tax Reform Act of 1986 was the product of years of bipartisan negotiation, the Tax Cuts and Jobs Act was the product of a deeply partisan and largely closed-door process. Early in 2017, Senate leadership indicated it would not seek to produce “permanent” legislation with bipartisan support. To prevent a Democratic filibuster, Senate procedural rules generally required that tax legislation be revenue-neutral over a ten-year timeframe. That led observers to believe any tax reform would “sunset” after ten years, as was the case with the Economic Growth and Tax Relief Reconciliation Act of 2001. But achieving long-standing tax reform goals proved to be a costly endeavor, even with the potential of a sunset. When it became clear that the hoped-for package of tax cuts would generate a considerable deficit over the next ten years, leadership in both houses scrambled to get the votes required to pass budget resolutions

that permit a cumulative ten-year deficit did not exceed \$1.5 trillion. Passage of those resolutions late in October, 2017, soon led to the introduction of legislation.

The House Ways and Means Committee publicly unveiled its bill (H.R. 1, The Tax Cuts and Jobs Act) on November 2, 2017. Prior to that date, there were only three documents offering any suggestion of what the bill would contain. The first was the Republican blueprint for tax reform, published on June 24, 2016, with the title “A Better Way: Our Vision for a Confident America.” Though not quite a “contract with America,” the 35-page blueprint outlined how Republicans would seek to reform the Internal Revenue Code in the names of fairness and simplicity. It proposed three income tax brackets for individuals (12 percent, 25 percent, and 33 percent), complete repeal of the alternative minimum tax, “postcard filing,” elimination of all itemized deductions except for mortgage interest and charitable contributions, and repeal of the estate and generation-skipping transfer taxes.

The second document was a one-page bullet-point memorandum from the White House issued on April 26, 2017. Given its “length” it is not surprising that the memo was short on detail. It generally agreed with the Republican blueprint but also spoke of a “15% business tax rate,” a “one-time tax on trillions of dollars held overseas,” and the need to “eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers.”

The third document was the Unified Framework for Fixing Our Broken Tax Code, a nine-page memorandum issued on September 27, 2017, by a conglomerate of White House and Congressional leaders. It contained details on three fundamental themes of tax reform (tax relief and simplification for families, competitiveness and growth for job creators, and global competitiveness), but little in the way of specifics as to how those details would be implemented. Like the blueprint and the White House memo, the Framework called for substantially larger standard deduction, a reduction in the number of tax brackets (with a top rate of either 35 percent or 39.6 percent), a larger child tax credit, and the elimination of all itemized deductions except for mortgage interest and charitable contributions. But other themes were explained much more cryptically. Consider this language from the Framework under the heading of “Other Provisions Affecting Individuals,” reproduced in its entirety:

Numerous other exemptions, deductions and credits for individuals riddle the tax code. The framework envisions the repeal of many of these provisions to make the system simpler and fairer for all families and individuals, and allow for lower tax rates.

With only this much background to go on, tax professionals were anxious to see how the House bill exactly implemented these ideas. As it turned out, the House bill was consistent with the broad themes of the Republican blueprint, the White House memo, and the Unified Framework, but it also contained a number of surprises, especially regarding itemized deductions and the treatment of certain exclusions. A “chairman’s mark” from the Senate Finance Committee indicated that while Senate leadership was largely on board with the House

bill, it would take a much different approach on key issues. The House bill passed on November 16, 2017, by a vote of 227 - 205, shifting the spotlight to the Senate.

The Senate bill retained the general themes of the House bill with one important exception: it also included repeal of the individual mandate imposed by the Patient Protection and Affordable Care Act. House leadership questioned whether linking tax reform with continued efforts to strip away “Obamacare” would delay a vote or, even worse, jeopardize the entire endeavor. But the Senate passed by its bill on December 2, 2017, with a 51-49 vote, despite vehement objection from Democrats that the final version of the bill was made available only hours before the vote.

As expected, the House and Senate bills were different, so a Conference Committee bill was required. Generally speaking the House bill was more ambitious in its scope, but the very narrow majority margin in the Senate essentially ensured that the resulting Conference Committee bill would hew more closely to the Senate version.

The 503-page Conference Committee bill was accompanied by a 560-page Joint Explanatory Statement of the Committee of Conference, herein cited as the “Conference Report.” The final legislation, passed on December 20, 2017, contained just a few small differences from the Conference Committee bill. Preliminary estimates from the Joint Committee on Taxation indicate that the ten-year cumulative deficit incurred to implement the Act’s changes will be approximately \$1.5 trillion, just within the margin approved by Congress in its budget packages.

B. INDIVIDUAL INCOME TAX REFORM

1. Individual Ordinary Income Tax Brackets

Originally, Republican leadership sought to reduce both the number of individual income tax brackets and the tax rates. Under prior law, seven tax brackets ranging from 10% to 39.6% applied to an individual taxpayer’s ordinary income. The Blueprint for Tax Reform pushed for three brackets of 12%, 25%, and 33%. But by the time of the Unified Framework, that position changed to brackets of 12%, 25%, and 35%, with the possible retention of the 39.6% bracket.

Ultimately, the Act preserved the seven-bracket regime, though it reduced the rates in the top six brackets and widened the sizes of the top four brackets. The Joint Committee on Taxation estimates the ten-year cost of reducing the individual income tax brackets to be \$1.21 trillion. Estimated Budget Effects of the Conference Agreement for H.R. 1, The “Tax Cuts and Jobs Act” (December 17, 2017) (hereafter, “Estimated Budget”) at 1. The Act also cut the number of tax brackets applicable to trusts and estates from five to four, but it retained the super-thin lower brackets. The following chart offers a visual comparison of pre- and post-Act tax brackets for 2018:

Federal Income Tax Brackets for Individuals, Estates, and Trusts – ORDINARY INCOME

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding			Rate	2018 Taxable Income Exceeding			Rate
Single	Married	Trusts and Estates		Single	Married	Trusts and Estates	
\$0	\$0		10%	\$0	\$0	\$0	10%
\$9,525	\$19,050	\$0	15%	\$9,525	\$19,050		12%
\$38,700	\$77,400	\$2,600	25%	\$38,700	\$77,400		22%
\$93,700	\$156,150	\$6,100	28%	\$82,500	\$165,000	\$2,550	24%
\$195,450	\$237,950	\$9,300	33%	\$157,500	\$315,000		32%
\$424,950	\$424,950		35%	\$200,000	\$400,000	\$9,150	35%
\$426,700	\$480,050	\$12,700	39.6%	\$500,000	\$600,000	\$12,500	37%

* From Revenue Procedure 2017-58, issued October 19, 2017.

2. Individual Adjusted Net Capital Gain and Dividend Income Tax Brackets

Neither the House bill nor the Senate bill intended any changes to the federal taxation of adjusted net capital gain or qualified dividend income. Thus, the three brackets for capital gain and dividend income (0%, 15%, and 20%) remain. Curiously, however, the Act makes very slight modifications to the bracket ceilings, as the following chart indicates:

Federal Income Tax Brackets for Individuals, Estates, & Trusts – CAPITAL GAINS & DIVIDENDS

PRE-TAX CUTS AND JOBS ACT*				POST-TAX CUTS AND JOBS ACT (THROUGH 2025)			
2018 Taxable Income Exceeding			Cap Gain Rate	2018 Taxable Income Exceeding			Cap Gain Rate
Single	Married	Trusts and Estates		Single	Married	Trusts and Estates	
\$0	\$0	\$0	0%	\$0	\$0	\$0	0%
\$38,700	\$77,400	\$2,600	15%	\$38,600	\$77,200	\$2,600	15%
AGI > \$200,000	AGI > \$250,000		18.8%	AGI > \$200,000	AGI > \$250,000		18.8%
\$426,700	\$480,050	\$12,700	23.8%	\$425,800	\$479,000	\$12,700	23.8%

* From Revenue Procedure 2017-58, issued October 19, 2017.

The chart also shows that the Act made no changes to §1411, the 3.8-percent surcharge on net investment income applicable to individuals with adjusted gross incomes above a stated (and still fixed) threshold and to estates and trusts in the highest tax bracket.

3. Zero-Bracket Provisions: Standard Deduction, Personal Exemption, and Child Tax Credit

Prior law achieved a so-called “zero-bracket” through the trinity of the standard deduction, the deduction for personal and dependency exemptions, and the child tax credit. In an effort to

simplify this regime, the Act repeals the deduction for personal and dependency exemptions and embiggens both the standard deduction and the child tax credit. All of the modifications set forth here expire at the end of 2025.

Standard Deduction. The Act substantially increases the amount of the standard deduction, as shown in the following table:

2018 Standard Deduction Pre-Tax Cuts and Jobs Act	Filing Status	2018 Standard Deduction Post-Tax Cuts and Jobs Act
\$13,000	Married Filing Jointly	\$24,000
\$9,550	Head of Household	\$18,000
\$6,500	Unmarried	\$12,000
\$6,500	Married Filing Separately	\$12,000

The Act makes no changes to the inflation-adjusted additional standard deduction amount available to blind taxpayers and those age 65 and over. Thus, for 2018, the additional standard deduction amount for “the aged or the blind” is \$1,300, or \$1,600 if the taxpayer is also unmarried and not a surviving spouse. The estimated foregone revenue over a ten-year period attributable to the increased standard deduction is \$720.4 billion. Estimated Budget at 1.

Personal and Dependency Exemptions. Under prior law, a taxpayer could claim a personal exemption deduction of \$2,000, though this amount was adjusted for inflation (the 2018 inflation-adjusted exemption was set to be \$4,150). Married couples filing jointly could claim two exemptions. In addition, a taxpayer could claim an exemption deduction for each of the taxpayer’s dependents, generally defined as either “qualifying children” or “qualifying relatives.” Thus, for example, a married couple with two qualifying children could claim four personal exemptions on their joint return, a total deduction that would have been \$16,600 in 2018. But if the couple’s adjusted gross income exceeded an inflation-adjusted threshold amount (what was to be \$320,000 in 2018), the amount of the deduction would be gradually reduced (reaching zero if the couple’s 2018 adjusted gross income was \$442,000 or more).

The Act effectively repeals the deduction for personal and dependency exemptions for the years 2018 through 2025 by reducing the exemption amount in those years to zero. The Act expressly retains the regular personal exemption for so-called “qualified disability trusts,” and the nominal personal exemptions currently in play for estates (\$600) and trusts (\$100 or \$300, depending on whether the trust is required to distribute its income) also survive. The Joint Committee on Taxation projects that repealing the personal exemptions will generate over \$1.21 trillion in revenue between 2018 and 2026. Estimated Budget at 1.

Child Tax Credit. The Act generally doubles the amount of the child tax credit and even adds a temporary (smaller) credit for dependents that are not qualifying children of the taxpayer. It also makes the credit more available to upper-middle-class taxpayers by increasing the thresholds before the phaseout begins. It also increases the refundable portion of the credit. The following table summarizes these changes:

Child Credit Feature	Pre-Tax Cuts and Jobs Act	Post-Tax Cuts and Jobs Act
Credit Amount	\$1,000 per child	\$2,000 per child \$500 per other dependent
Phaseout Begins When AGI Exceeds... Unmarried & Head of House Joint Filers	\$75,000 \$110,000	\$200,000 \$400,000
Phaseout Complete When AGI Hits... Unmarried & Head of House Joint Filers	\$95,000 \$130,000	\$240,000 \$440,000
Refundable Portion	15% of earned income in excess of \$3,000	15% of earned income in excess of \$2,500, not to exceed \$1,400 per child (as adjusted for inflation)

The estimated revenue loss from modifying the amount of the child tax credit is \$573.4 billion over ten years. Estimated Budget at 1. The Act also provides that in order to claim the credit for a qualifying child, the taxpayer must include the child's social security number on the return. That provision is estimated to generate \$29.8 billion in revenue over ten years. Estimated Budget at 1.

4. Tax Treatment of Education Expenses

a. Section 529 Plan Withdrawals for Elementary and Secondary Schooling: Distributions from "qualified tuition programs" (more popularly, "§529 plans") are not included in gross income if used to pay for "qualified higher education expenses." The Act now defines "qualified higher education expenses" to include tuition expenses at "an elementary or secondary public, private, or religious school." Importantly, the maximum amount that may be distributed tax-free for elementary and secondary school tuition or for homeschooling expenses is \$10,000 per child (not \$10,000 per account); distributions in excess of that amount will be taxable under the normal rules of §529. The projected revenue cost of this measure is \$500 million over ten years. Estimated Budget at 3.

b. Exclusion for Discharge of Student Loan Debt at Death: New §108(f)(5) generally excludes from gross income the cancellation of a student loan on account of the student's death or total disability if such cancellation occurs after 2017 and before 2026. The new provision is expected to cost about \$100 million in foregone revenue over ten years. Estimated Budget at 3.

c. New Rollovers Between §529 Plans and ABLÉ Accounts: The Act permits amounts from qualified tuition plans to be rolled over to an ABLÉ account without penalty, so long as the ABLÉ account is owned either by the qualified tuition plan's designated

beneficiary or his or her spouse, descendant, sibling, ancestor, stepparent, niece, nephew, aunt, uncle, first cousin, or in-law. Any amounts rolled over from a qualified tuition plan count toward the overall limit on amounts that can be contributed annually to an ABLÉ account. Any rolled-over amount in excess of the contribution limit will be treated as ordinary income to the distributee. Such penalty-free rollovers will be in effect through 2025. The estimated revenue loss from this new rule is expected to be less than \$50 million. Estimated Budget at 3. For more on the contribution limit and ABLÉ accounts generally, see the material below under “Other Individual Income Tax Items of Note.”

d. New Excise Tax on Certain Private Colleges and Universities:

Although this particular reform does not directly affect individuals, it affects college education and is thus included here. Starting in 2018, private colleges and universities may pay an excise tax equal to 1.4 percent of the school’s net investment income, but the excise tax only applies to tax-exempt private schools with: (1) at least 500 tuition-paying full-time equivalent students (more than half of whom are located in the United States); and (2) aggregate endowments of at least \$500,000 per student. The expected revenue gain from this new tax is \$1.8 billion over ten years. Estimated Budget at 5. The Act asks the Treasury to issue regulations describing which assets are used directly in carrying out the school’s exempt purpose and thus are exempt from the tax. Regulations are also to explain the computation of net investment income, though the statute says generally that rules relating to the net investment income of a private foundation will apply for this purpose.

5. Other Exclusions and Deductions Applicable to Individuals

a. Overall Limit on Itemized Deductions Suspended: Section 68 generally reduces the amount of otherwise allowable itemized deductions once a taxpayer’s adjusted gross income exceeds a certain inflation-adjusted threshold. (That threshold, for example, was set to be \$320,000 for married couples and \$266,700 for unmarried individuals in 2018.) For taxpayers with very high adjusted gross incomes, up to 80 percent of itemized deductions could be lost under this rule. Through new §68(f), the Act suspends the application of this phaseout for the years 2018 through 2025.

b. Home Mortgage Interest Deduction Modified: Under prior law, a taxpayer could deduct “qualified residence interest,” generally defined as the interest paid on either “acquisition indebtedness” or “home equity indebtedness.” Acquisition indebtedness is debt incurred to buy, build, or improve either the taxpayer’s principal residence or one other residence selected by the taxpayer (a taxpayer thus cannot have acquisition debt on three or more homes), provided the subject home secures the debt. Home equity indebtedness is any other debt secured by the residence, regardless of how the loan proceeds are used by the taxpayer. Prior law limited the amount of acquisition indebtedness to \$1 million (half that amount for a married individual filing separately) and the amount of home equity debt to \$100,000. Thus, for example, if an unmarried taxpayer borrowed \$1.5 million to purchase the taxpayer’s only home and gave the lender a mortgage on the home, the taxpayer could deduct

11/15 of the interest paid to the lender (\$1 million of the \$1.5 million loan is acquisition debt and another \$100,000 of the loan qualified as home equity debt).

For 2018 through 2025, the Act limits the amount of acquisition debt to \$750,000 (\$375,000 for a married individual filing separately) and suspends entirely any deduction for home equity debt. In the above example, then, the taxpayer can only deduct half of the interest paid to the lender (\$750,000 of the \$1.5 million loan is acquisition debt and none of it qualifies as home equity debt).

Importantly, the new limit on acquisition debt only applies to **debt incurred after December 15, 2017**; preexisting acquisition debt is subject to the original \$1 million cap. The Act also applies the \$1 million acquisition debt cap to taxpayers who made a binding contract before December 15, 2017, to close on the purchase of a principal residence before 2018 and who actually purchase such residence by the end of March, 2018. There is no similar exception for home equity debt—the deduction for interest on home equity debt is suspended regardless of when such debt was incurred.

c. Deduction for State and Local Taxes Unrelated to a Business

Modified: Prior law allowed a taxpayer to deduct state and local property tax as well as either state and local income or sales taxes (as well as foreign real property taxes) without limitation. For example, if a taxpayer in 2017 paid local real property tax of \$5,000 in connection with the taxpayer's personal residence, state income tax of \$10,000, and state sales tax of \$13,000 on personal costs, the taxpayer can deduct a total of \$18,000 (the \$5,000 in real property tax and the sales tax of \$13,000, since that amount is larger than the \$10,000 of state income tax).

For 2018 through 2025, the Act limits the total deduction a taxpayer can claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to \$10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity is repealed entirely. In the example above, then, if the same taxes were paid in 2018 the total deduction would be limited to \$10,000. If, on the other hand, the real property taxes were paid in connection with investment property, the total deduction would be \$15,000 (\$10,000 in state income or sales tax plus the \$5,000 in real property taxes since the real property taxes are incurred in connection with a profit-seeking activity).

The \$10,000 limit on personal state and local taxes is reduced to \$5,000 in the case of a married individual filing a separate return. It seems odd that the limit is the same for joint filers and unmarried individuals (whether filing as head of household or not), but the separate figure for married individuals filing separately clearly signals this is the case.

d. Deduction for Charitable Contributions Modified: The Act increases the deduction limit for cash contributions to charitable organizations. Under prior law, a taxpayer could not deduct more than 50 percent of the taxpayer's "contribution base" (in most cases, an amount equal to the taxpayer's adjusted gross income) for cash contributions. Thus, for example, if a taxpayer donated \$100,000 cash to a qualified charitable organization in

a year in which the taxpayer's contribution base was \$150,000, the taxpayer could deduct only \$75,000 of the contribution in the year of donation. The remaining \$25,000 would carry over to the next year as though the cash contribution was made in that year.

Under the Act, §170(b)(1)(G) now provides that for **cash donations** made from January 1, 2018, through December 31, 2025, the applicable limit is **60 percent of the donor's contribution base**. In the prior example, then, the taxpayer could deduct \$90,000 of the \$100,000 cash contribution under the new rule, with only \$10,000 carrying over to the next year. Further, cash contributions are deemed to happen before all other contributions, maximizing the chance of their deduction.

The Act also **repeals the deduction for 80 percent of payments to an institution of higher education in exchange for the right to purchase seats at athletic events**. Accordingly, such payments are deductible only to the extent the amount paid exceeds the value of the consideration received (the season tickets).

Finally, the Act **repeals §170(f)(8)(D)**, which permitted an exception to the requirement that a taxpayer receive a contemporaneous written acknowledgement from the charity in order to claim a charitable contribution deduction in some cases. The exception contemplated that the Service would promulgate a form by which a charity could provide a substitute for the written acknowledgement, but the Service never did so. (Well, it issued proposed regulations in October of 2015 that it promptly withdrew in January of 2016.) In a couple of Tax Court cases from 2017, taxpayers learned that until Treasury produced such a form, the exception was dormant. Apparently, Congress held little hope that a form would ever be forthcoming, so it simply killed the exception.

The Joint Committee on Taxation estimates the cumulative revenue gain from repealing the overall limit on itemized deductions, limiting the home mortgage interest deduction, limiting the deduction of state and local taxes, and reforming the charitable contribution deduction will be over \$668.4 billion between 2018 and 2026. Estimated Budget at 2.

e. Deduction for Medical Expenses Modified: Prior to 2013, individuals could deduct unreimbursed medical expenses to the extent they exceeded 7.5 percent of adjusted gross income. Part of the Patient Protection and Affordable Care Act increased the deduction threshold from 7.5 percent of adjusted gross income to 10 percent of adjusted gross income, but the 7.5-percent threshold still applied to taxpayers age 65 and over through 2016. For alternative minimum tax purposes, however, all taxpayers were subject to the 10 percent threshold as of 2013.

While the House bill originally called for the complete repeal of the deduction for medical expenses, the Senate version both saved the deduction and made it more attractive. Under the Act, the threshold for deducting medical expenses is 7.5 percent of adjusted gross income for all taxpayers, regardless of age. But this new rule (actually, a return to the old rule) applies for **2017 and 2018 only**. Still, the Joint Committee on Taxation expects that Congress will lose \$5.2

billion in revenue over this two-year period. Estimated Budget at 2. The Act also provides that the medical expense deduction threshold for alternative minimum tax purposes during these years is also 7.5 percent.

f. Deduction for (and Inclusion of) Alimony Payments Repealed:

Prior law provided that the recipient of certain “alimony” payments had to include those payments in gross income. Likewise, individuals making those payments could deduct them in determining adjusted gross income. The Act permanently repeals the deduction for alimony payments and likewise repeals the rules related to inclusion of such payments in gross income, effective for any divorce or separation instrument **executed after 2018** or for any divorce or separation instrument **modified after 2018 where the modification expressly provides that the new law is to apply**. In effect, then, we return to the pre-statute common law, which provided that payments between ex-spouses were neither income to the recipient nor deductible by the payor. In most cases, not surprisingly, the payor of alimony is in a higher tax bracket than the payee. Repealing both the deduction and the inclusion requirement is thus not revenue-neutral; the new regime is expected to generate \$6.9 billion in additional revenue over the next ten years. Estimated Budget at 3.

g. Deduction for Personal Casualty and Theft Losses Limited:

Prior law permitted individuals to deduct losses unrelated to a business or investment activity when such losses arose from fire, storm, shipwreck, or other casualty, or from theft, but only to the extent any such loss exceeded \$100 and only to the extent the net personal casualty loss for the year exceeded 10 percent of an individual’s adjusted gross income. Under the Act, such losses are deductible in 2018 through 2025 only if they are attributable to Presidentially-declared disasters under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

h. Deduction for Moving Expenses Suspended:

Subject to certain requirements related to the distance moved and the amount of work time spent at the new location, §217 generally permits a deduction for moving expenses (costs of moving household goods plus traveling expenses except meals) paid or incurred during the taxable year in connection with starting work as an employee or as a self-employed individual at a new principal place of work. New §217(k) suspends the deduction from 2018 through 2025, except in the case of members of the United States Armed Forces on active duty who move pursuant to a military order and incident to a permanent change of station. The measure is expected to add \$7.6 billion in revenue during the suspension period. Estimated Budget at 2.

i. Suspension of Miscellaneous Itemized Deductions:

Prior law allowed an individual to deduct “miscellaneous itemized deductions” to the extent that they, in the aggregate, exceeded 2 percent of the individual’s adjusted gross income. Section 67 defines a “miscellaneous itemized deduction” as any itemized deduction other than one listed in §67(b). Common examples of miscellaneous itemized deductions include safe deposit box rentals for storing investment assets, net hobby expenses, fees paid for appraisals in connection with casualty loss and charitable contribution deductions, fees paid to accountants and attorneys for tax advice and tax return preparation, and the unreimbursed business

expenses of an employee. New §67(g) suspends any deduction for miscellaneous itemized deductions for 2018 through 2025. The Act makes no change to the above-the-line deduction of up to \$250 for unreimbursed expenses paid by an elementary or secondary school educator.

j. Exclusion for Qualified Bicycle Commuting Reimbursements

Suspended: Section 132(f)(1)(D) allows an employee to exclude from gross income any “qualified bicycle commuting reimbursement,” defined generally in §132(f)(5)(F)(i) as a reimbursement paid to an employee to cover reasonable expenses “for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee’s residence and place of employment.” The exclusion is limited to \$20 per “qualified bicycle commuting month,” defined generally as a month in which the employee uses the bike for a substantial portion of the commute to and from work and during which the employee receives no other qualified transportation fringe. The Act, through new §132(f)(8), suspends the exclusion for qualified bicycle commuting reimbursements from 2018 through 2025. To the surprise of none, the measure is not expected to generate more than \$50 million in revenue during the period of the suspension. Estimated Budget at 2.

6. Other Individual Income Tax Items of Note

a. Kiddie Tax Simplification: Section 1(g) imposes the so-called

“kiddie tax” on the net unearned income of certain minors. Generally, the tax applies where a child is age 18 or under on the last day of the taxable year (or age 23 or under and a full-time student on such date), the child has at least one living parent at such time, the child has more than \$2,100 of unearned income for the year (that was the 2017 threshold), and the child does not file a joint return. If the child is 18 or older, however, the tax does not apply unless the child’s earned income is less than one-half of the amount of the child’s support. Unearned income is defined generally as all income other than compensation for services and distributions from qualified disability trusts. Where the tax applies, the child’s net unearned income (unearned income in excess of the \$2,100 threshold for 2017), is taxed at the parents’ marginal rate if such rate is higher than the rate that would be applicable to the child. Earned income is unaffected by the kiddie tax.

The Tax Cuts and Jobs Act simplifies this regime through 2025. Instead of taxing net unearned income at the parent’s marginal rate, net unearned income is taxed using the same brackets and rates as in effect for trusts and estates. As before, *earned* income of a minor child is still taxed using the ordinary rates and brackets for unmarried persons. The thinking behind this change is that the child’s tax is now “unaffected by the tax situation of the child’s parent or the unearned income of any siblings.” (Conference Report, page 9).

b. Paid Preparers Must Investigate Claims of Head of Household

Status: The Tax Cuts and Jobs Act modifies §6695(g) to direct promulgation of regulations imposing due diligence requirements on paid tax return preparers in determining a taxpayer’s eligibility to file as a head of household. Failure to meet these requirements results in a \$500 penalty per failure.

c. Increased Contribution Limits to ABLE Accounts: Late in 2014, Congress created §529A, which authorized states to create so-called “qualified ABLE programs” under which one could make contributions to a tax-exempt account for the benefit of a disabled individual. A disabled person (defined as one who would qualify as blind or disabled under Social Security Administration rules) may have a single account to which total annual contributions may not exceed the federal gift tax annual exclusion amount (\$14,000 at the time, but now \$15,000). Income from the account is exempt from federal income tax, and distributions made to the beneficiary for “qualified disability expenses” are likewise tax-free. Qualified disability expenses are defined broadly to include education, housing, transportation, employment training, assistive technology, health, wellness, financial management, and legal expenses (some of which are not already covered by Medicaid and OASDI benefits). Any other distributions, however, are subject to a 10-percent penalty and count as resources for purposes of the beneficiary’s Medicaid exemption. There is no income tax deduction for contributions to the account, and any such contributions from third parties are treated as completed gifts of present interests to the beneficiary. Assets inside of an ABLE account do not count as “resources” of the beneficiary for purposes of qualifying for federal assistance. If, however, the account balance ever exceeds \$100,000, the beneficiary will be denied eligibility for SSI benefits. Furthermore, any assets inside of the account upon the beneficiary’s death are subject to Medicaid payback rules.

The Act provides that through 2025, once \$15,000 has been contributed to an ABLE account, the account’s designated beneficiary generally may contribute an additional amount up to such beneficiary’s compensation for the year or, if less, the federal poverty line for a one-person household. Moreover, any such additional contribution is eligible for the so-called “saver’s credit” under §25B.

C. BUSINESS TAX REFORM

1. Reduction in C Corporation Tax Rates

Under prior law, §11(b) set forth four federal income tax brackets applicable to a C corporation’s taxable income:

Taxable Income	Marginal Tax Rate
Up to \$50,000	15%
\$50,001 - \$75,000	25%
\$75,001 - \$10,000,000	34%
\$10,000,001 and up	35%

If a corporation’s taxable income exceeds \$100,000, the lower two brackets are phased out such that the corporation ultimately pays a flat tax of 34 percent on its first \$75,000 of taxable income. In addition, so-called “personal service corporations” paid a flat 35-percent tax on taxable income.

The Act provides for a **flat rate of 21 percent** on all corporate taxable income, with no special rate for personal service corporations, effective for taxable years beginning in 2018 and later. This provision therefore does not “sunset;” it is as permanent as possible. The estimated revenue loss from the new 21-percent flat rate is nearly \$1.35 trillion over ten years. Estimated Budget at 3.

The Act also repeals §1201, which provided that if the maximum corporate tax rate exceeds 35 percent, the maximum rate applicable to a corporation’s net capital gain will be 35 percent. A 21-percent flat rate rendered this rule obsolete.

2. Reduction in Dividends-Received Deduction for C Corporations

Prior law allowed corporations to claim a deduction for dividends received from other domestic corporations subject to federal income tax. The Act reduces the size of this deduction to reflect the lower 21-percent flat tax, as the following table shows:

If the receiving corporation...	The Dividends-Received Deduction under PRIOR LAW was...	The Dividends-Received Deduction under the NEW LAW is now...
Owens less than 20% of the stock of the paying corporation (by vote and value)	70% of the dividend received	50% of the dividend received (so such dividends would be taxed at a top rate of 10.5%)
Owens 20% or more of the stock of the paying corporation (by vote and value)	80% of the dividend received	65% of the dividend received (so such dividends would be taxed at a top rate of 7.35%)
Is a member of the same affiliated group as the paying corporation	100% of the dividend received	100% of the dividend received

3. Qualified Business Income Deduction for Partners, S Corporation Shareholders, and Sole Proprietors

Arguably the most significant component of the 2017 Act is the introduction of new §199A, a provision permitting taxpayers to deduct a percentage of their “qualified business incomes” for the taxable year. Having just given C corporations a substantial break through the flat 21-percent tax rate, Congress (particularly the Senate Finance Committee) wanted to offer some benefit to pass-through entities and sole proprietors.

Already in the Code was §199, a provision that allowed a manufacturer to deduct 9 percent of “qualified production activities income” (or 9 percent of taxable income, if less), but the deduction could not exceed 50 percent of the “W-2 wages” paid to employees. Section 199 thus favored domestic manufacturers that employed workers. By repealing §199 and replacing it with new §199A, Congress looked to make the deduction available to more taxpayers.

Importantly, so as to highlight the benefit to middle-class taxpayers, the new deduction contains some limits applicable only to taxpayers in the 32-percent and above tax brackets.

a. Executive Summary of the New §199A Deduction

(1) Who Qualifies – To qualify for the new deduction, you must be a partner in a business entity taxed as a partnership, a shareholder of an S corporation, or a sole proprietor engaged in a trade or business. C corporations and their shareholders do not qualify for this deduction, nor do employees.

(2) Taxable Income Zones – Your eligibility for the deduction as well as the amount of your deduction depends on your taxable income (without regard to this new deduction).

ZONE 1 → Your taxable income does not exceed \$157,500 (\$315,000 if you're married and filing a joint return with your spouse)

ZONE 2 → Your taxable income exceeds \$157,500 (\$315,000 for joint filers) but does not exceed \$207,500 (\$415,000 for joint filers)

ZONE 3 → Your taxable income exceeds \$207,500 (\$415,000 for joint filers)

(3) Specified Service Businesses – If your business: (1) involves the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; (2) has as its principal asset the reputation or skill of one or more of its employees or owners; or (3) involves the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities, then your deduction may be limited, as shown below:

ZONE 1 → No restriction

ZONE 2 → Your deduction is subject to a phase out

ZONE 3 → You get no deduction at all

(4) Must be Engaged in Conduct of United States Trade or Business – Your partnership, S corporation, or sole proprietorship must be engaged in the conduct of a trade or business within the United States. The deduction is not available with respect to investment or personal activities, even if conducted as partnerships or S corporations.

(5) Deduction Amount – The amount of the deduction depends on your taxable income zone:

ZONE 1 → 20% of “qualified business income”

ZONE 2 → 20% of “qualified business income,” reduced if 50% of your “wage-basis limit” is less

ZONE 3 → 20% of “qualified business income,” or, if less, 50% of your “wage-basis limit”

(6) Qualified Business Income – Generally, “qualified business income” is the net amount of your items of income, gain, loss, and deduction from an eligible trade or business, *except that* items of capital gain and loss (whether short-term or long-term) are excluded. The term also does not include certain dividends from REITs, cooperatives, and publicly-traded partnerships, as those items are subject to special rules. If the net amount from all of your eligible businesses produce a net loss, that net loss carries over to the next taxable year as a loss from a separate qualified trade or business. Compensation paid to you from the business (and guaranteed payments paid to you by a your partnership) are not qualified business income.

(7) The “Wage-Basis Limit” – This amount is *greater* of: (a) 50% of the W-2 wages paid by the business to all employees (including you); and (b) 25% of the W-2 wages paid to all employees (including you) *plus* 2.5% of the unadjusted basis immediately after acquisition of all depreciable property used in the business that is still on hand at the end of the year.

(8) Application to Trusts and Estates – Estates and trusts with interests in partnerships and S corporations are eligible for the deduction. The Act instructs Treasury to issue regulations explaining how the deduction is to be apportioned between fiduciaries and beneficiaries.

(9) Sunrise, Sunset – The new deduction applies in taxable years that begin after 2017 and before 2026. In most cases, this means the deduction expires at the end of 2025. The estimated hit to the federal coffers over the lifespan of this deduction is over \$414 billion. Estimated Budget at 1.

(10) Taken in Addition to Standard Deduction – Although the §199A deduction is not “above the line,” a taxpayer may claim the deduction in addition to the standard deduction. The §199A deduction is thus like the former deduction for personal and dependency exemptions in that a taxpayer need not itemize in order to claim the deduction.

(11) Reduction in Penalty Thresholds Where §199A Deduction Claimed – Section 6662 imposes a penalty equal to 20 percent of any underpayment of federal tax attributable to (among other things) a substantial understatement of income tax. Normally an understatement on an income tax return is “substantial” if it exceeds 10 percent of the amount of tax required to be shown on the return (or, if greater, \$5,000). Now, however, if a taxpayer claims the §199A deduction, an understatement is substantial if it exceeds 5 percent of the amount of tax required to be shown on the return (or \$5,000, if greater). The new statute suggests that the reduced threshold applies even where the understatement is not attributable to the §199A deduction; merely claiming the deduction serves to reduce the threshold, without regard to what triggers the understatement.

b. Under the Hood Look at the New §199A Deduction: Generally under §199A(a), a noncorporate taxpayer may claim a deduction from 2018 through 2025 equal to the taxpayer's "combined qualified business income," but the total deduction cannot exceed 20 percent of the taxpayer's ordinary and dividend income. To compute the deduction amount, therefore, one must determine: (1) the taxpayer's "qualified business income" from any particular activity; (2) how to compute the "combined qualified business income" from all such activities; and (3) the taxpayer's ordinary and dividend income.

Qualified Business Income. Section 199A(c)(1) generally defines "qualified business income" as the net amount of "qualified items of income, gain, deduction, and loss" (think ordinary items effectively connected with the conduct of a United States trade or business that are included or allowed in computing taxable income) with respect to any "qualified trade or business" of the taxpayer.

The statute generally defines a "qualified trade or business" as any trade or business *except for*: (1) one involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services; (2) one where the business's principal asset is the reputation or skill of one or more of its employees or owners; (3) one involving the performance of services consisting of investing and investment management, trading, or dealing in securities, partnership interests, or commodities; and (4) the trade or business of performing services as an employee. But if the taxpayer's taxable income in 2018 is less than \$157,500 (\$315,000 for married couples filing jointly), the first three disqualifications do not apply. (Those taxable income thresholds are to be adjusted annually for inflation.) If the taxpayer's 2018 taxable income is more than \$157,500 but less than \$207,500 (or, in the case of married joint filers, more than \$315,000 but less than \$415,000), however, only a percentage of the qualified items of income, gain, deduction, or loss counts as qualified business income.

Combined Qualified Business Income and the Wage- and Capital-Based Limitation. One would expect "combined qualified business income" simply to be the net sum of the qualified business incomes from all of the taxpayer's trade or business activities, but it's not quite that simple. Instead, §199A(b)(1)(A) effectively defines the term to mean the sum of the *deductible amounts* from each trade or business activity. Section 199A(b)(2) generally provides that the deductible amount is 20 percent of the taxpayer's qualified business income from the trade or business. But for taxpayers with taxable incomes above a set threshold, the deductible amount cannot exceed 50 percent of the "W-2 wages" from the business or, if greater, 25 percent of the W-2 wages plus 2.5 percent of the unadjusted basis immediately after acquisition of all "qualified property." This limit phases in once a taxpayer's taxable income for 2018 exceeds \$157,500 (\$315,000 for joint filers), and applies fully once taxable income for 2018 exceeds \$207,500 (\$415,000 for joint filers).

Under §199A(b)(4), a taxpayer's "W-2 wages" from a trade or business generally means the amount of wages and deferred compensation paid by the taxpayer that are attributable to qualified business income. In the case of partnerships and S corporations, §199A(f)(1)(A)

explains that each partner or shareholder is treated as having W-2 wages in an amount equal to such partner or shareholder's allocable share of the W-2 wages paid by the entity. For S corporations that will be an easy determination. Treasury will have to issue guidance on the application of this rule in the case of entities taxed as partnerships.

Under §199A(b)(6), "qualified property" basically means depreciable tangible property on hand at the close of the taxable year and used in the production of qualified business income, provided the property is still within its "depreciable period" (generally defined as the first ten years in which the taxpayer has placed the property in service or the asset's regular recovery period, whichever is longer).

The Conference Report explains the wage- and capital-based limitation with this example: "[A] taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for \$100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or \$0, or (b) the sum of 25 percent of W-2 wages (\$0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $\$100,000 \times .025 = \$2,500$. The amount of the limitation on the taxpayer's deduction is \$2,500." (Conference Report, page 38.)

Limitation Based on Taxable Income. Even after the application of the foregoing rules, the total deduction under §199A generally cannot exceed 20 percent of the excess (if any) of the taxpayer's taxable income over the sum of any net capital gain plus any "qualified cooperative dividends." By carving out net capital gain, the rule effectively means the total §199A deduction cannot exceed the taxpayer's ordinary and dividend income.

Not an Above-the-Line Deduction. The Act clarifies that the §199A deduction is not allowed in computing adjusted gross income. It is, instead, a "below-the-line" deduction that a taxpayer may claim *in addition to* the standard deduction or as part of the taxpayer's itemized deductions, as was the case with the former deduction for personal and dependency exemptions under §151.

Trusts and Estates. Section 199A(a) only excludes corporate taxpayers from the deduction. By negative implication, therefore, trusts and estates may claim the §199A deduction. In fact, §199A(f)(1)(B) provides that in determining the apportionment of W-2 wages and the apportionment of unadjusted basis in qualified property between fiduciaries and beneficiaries, rules similar to those in the old §199 deduction will apply.

Conference Report Examples. Here are two examples cribbed from the Conference Report's explanation of the Senate version of §199A. (Conference Report at 36-37.) The examples have been altered to reflect the provisions of the final Act.

Example 1

H and W file a joint return on which they report taxable income of \$335,000 (determined without regard to this provision). H is a partner in a qualified trade or business that is not a specified service business (“qualified business A”). W has a sole proprietorship qualified trade or business that is a specified service business (“qualified business B”). H and W also received \$10,000 in qualified REIT dividends during the tax year.

H’s allocable share of qualified business income from qualified business A is \$300,000, such that 20 percent of the qualified business income with respect to the business is \$60,000. H’s allocable share of wages paid by qualified business A is \$100,000, such that 50 percent of the W–2 wages with respect to the business is \$50,000. As H and W’s taxable income is above the \$315,000 threshold amount for a joint return but not above \$415,000, the wage limit for qualified business A is phased in. Accordingly, instead of limiting the deduction amount to the \$50,000 share of W-2 wages, the \$60,000 deduction amount is reduced by 20 percent of the difference between \$60,000 and \$50,000, or \$2,000. H’s deductible amount for qualified business A is therefore \$58,000.

W’s qualified business income and W–2 wages from qualified business B, which is a specified service business, are \$325,000 and \$150,000, respectively. H and W’s taxable income is above the \$315,000 threshold amount for a joint return. Thus, the exclusion of qualified business income and W–2 wages from the specified service business are phased in. W has an applicable percentage of 80 percent. (Their taxable income is \$20,000 more than the threshold amount, and \$20,000 is 20 percent of \$100,000, so they must take 20 percent off the otherwise allowable amounts.) In determining includible qualified business income, W takes into account 80 percent of \$325,000, or \$260,000. In determining includible W–2 wages, W takes into account 80 percent of \$150,000, or \$120,000. W calculates the deductible amount for qualified business B by taking the lesser of 20 percent of \$260,000 (\$52,000) or 50 percent of includible W–2 wages of \$120,000 (\$60,000). W’s deductible amount for qualified business B is \$52,000.

H and W’s combined qualified business income amount of \$120,000 is comprised of the deductible amount for qualified business A of \$58,000, the deductible amount for qualified business B of \$52,000, and 20 percent of the \$10,000 qualified REIT dividends (\$2,000). H and W’s deduction is limited to 20 percent of their taxable income for the year (\$335,000), or \$67,000. Accordingly, H and W’s deduction for the taxable year is \$67,000.

Example 2

H and W file a joint return on which they report taxable income of \$200,000 (determined without regard to this provision). H has a sole proprietorship qualified trade or business that is not a specified service business (“qualified business A”). W is a partner in a qualified trade or business that is not a specified service business (“qualified business B”). H and W have a carryover qualified business loss of \$50,000.

H's qualified business income from qualified business A is \$150,000, such that 20 percent of the qualified business income with respect to the business is \$30,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business A. H's deductible amount for qualified business A is \$30,000.

W's allocable share of qualified business loss is \$40,000, such that 20 percent of the qualified business loss with respect to the business is \$8,000. As H and W's taxable income is below the threshold amount for a joint return, the wage limit does not apply to qualified business B. W's deductible amount for qualified business B is a reduction to the deduction of \$8,000.

H and W's combined qualified business income amount of \$12,000 is comprised of the deductible amount for qualified business A of \$30,000, the reduction to the deduction for qualified business B of \$8,000, and the reduction to the deduction of \$10,000 attributable to the carryover qualified business loss (20 percent of the \$50,000 carryover loss—treated as its own qualified business activity under §199A(c)(2)—is \$10,000). H and W's deduction is limited to 20 percent of their taxable income for the year (\$200,000), or \$40,000. Accordingly, H and W's deduction for the taxable year is \$12,000.

4. Cost Recovery

a. **Expansion of §179 Expensing:** Under prior law, a taxpayer (other than an estate or trust) generally could elect to expense the first \$500,000 of so-called “§179 property” placed in service during the taxable year, but that amount was reduced by the amount by which all such property placed in service during the year exceeded \$2 million. Both of those numbers, however, were adjusted for post-2015 inflation, and we were therefore set to have a cap of \$520,000 for 2018 that would not be reduced until a taxpayer placed in service more than \$2,070,000 in §179 property for the year. Revenue Procedure 2017-58. “Section 179” property, generally, is depreciable tangible personal property (or certain computer software) acquired by purchase for use in the active conduct of a trade or business.

The Act **increases the annual cap from \$500,000 to \$1 million and increases the phaseout threshold from \$2 million to \$2.5 million.** Both numbers will adjust for post-2018 inflation. In addition, the Act **expands the scope of §179 property to include “qualified real property,”** generally defined as any of the following improvements made to nonresidential real property made after the property was first placed in service: roofs, HVAC systems, fire alarms, and security systems. The changes made to §179 are not scheduled to expire, and the estimated revenue loss over the next ten years is nearly \$26 billion. Estimated Budget at 3.

b. **Increased Expensing Bonus Under §168(k):** Prior law allowed a bonus depreciation deduction equal to 50 percent of the adjusted basis of “qualified property” (generally, new property with a recovery period of not more than 20 years and certain improvements made to other property) in the year the property was placed in service. For this

purpose, the property’s adjusted basis is determined after the elective application of §179 but before the application of the regular depreciation rules described in §168(a).

The Act generally increases the bonus depreciation deduction for qualified property as shown in the following table:

Year(s)	Applicable Percentage of Adjusted Basis
2018 – 2022	100%
2023	80%
2024	60%
2025	40%
2026	20%
2027 and later	0%

The Act also generally allows a taxpayer to claim the §168(k) bonus with respect to used property, so long as the property is new to the taxpayer. This measure is expected to cost an aggregate \$86.3 billion over the next ten years. Estimated Budget at 3.

c. Depreciation Limits on Luxury Cars and Certain Personal-Use

Property Modified: The Act increases the limits imposed by §280F(a) on the depreciation of certain passenger cars, as the following table shows:

Maximum Depreciation Deduction for Luxury Car (assuming no §168(k) bonus)	2017 Amounts Pre-Tax Cuts and Jobs Act	2018 Amounts Post-Tax Cuts and Jobs Act
First year the vehicle is placed in service	\$3,160	\$10,000
Second year the vehicle is placed in service	\$5,100	\$16,000
Third year the vehicle is placed in service	\$3,050	\$9,600
Fourth year the vehicle is placed in service and later	\$1,875	\$5,760

The new §280F amounts will be adjusted for inflation, and they are not subject to sunset.

In addition, the Act permanently removes “computer or peripheral equipment” from designation as “listed property.” As a result, for example, a computer will no longer be subject to straight-line cost recovery if the business use of the asset is less than half of its total use, the rule denying a deduction where the business use is by an employee will not apply, and the ongoing substantiation requirements related to the computer’s cost and business use likewise will not apply.

d. Applicable Recovery Period for Real Property Improvements

Consolidated: Prior law had separate rules and depreciation limits for “qualified improvement property,” “qualified leasehold improvements,” “qualified restaurant property,” and “qualified retail improvement property.” The Act eliminates the last three categories so those assets generally become “qualified improvement property.” The Act generally provides that qualified improvement property may be depreciated over a 10-year recovery period (15 years where the alternative depreciation system applies) using the straight-line method and half-year convention. As a result, restaurant buildings (which generally do not meet the definition of qualified improvement property but are instead nonresidential real property) will be depreciable over 25 years using the straight-line method and the mid-month convention.

e. Alternative Depreciation System for Electing Farming Businesses:

Farmers who elect out of the new limitation on the deduction for interest (see below) will automatically elect to depreciate any property with a recovery period of 10 years or more using the “alternative depreciation system,” which generally requires use of the straight-line method over the asset’s class life.

5. Other Business Income Tax Items of Note

a. New Limitation on Excess Business Losses of Individuals,

Partnerships, and S Corporations: Under new §461(l), a noncorporate taxpayer’s “excess business loss” for the taxable year is disallowed and treated as a net operating loss carryover to the next taxable year. “Excess business loss” is defined as the amount by which the taxpayer’s aggregate deductions attributable to all trades or businesses exceeds the sum of the taxpayer’s aggregate gross income attributable to all such trades or businesses plus \$250,000 (or \$500,000 in the case of joint filers). Both of these dollar amounts will be adjusted for inflation, but this new limit under §461(l) expires at the end of 2025. Section 461(l)(4) provides that in the case of a partnership or S corporation, the limitation applies at the partner or shareholder level.

b. Carried Interests:

The benevolent overlord of students everywhere, Wikipedia, explains a carried interest as “a share of the profits of an investment paid to the investment manager in excess of the amount that the manager contributes to the partnership, specifically in alternative investments (private equity and hedge funds). It is a performance fee, rewarding the manager for enhancing performance.” As such, of course, it is compensation for services. But because the carried interest is held in the form of a profits interest of an entity taxed as a partnership, the managers receive their fees in the form of a share of the partnership’s long-term capital gains. So while mutual fund managers and other investment advisors receive fee payments taxable as ordinary income, their counterparts in private equity and venture capital firms enjoy a preferential rate on payments allocable to their partnership profits interests.

The Act purports to address this anomaly through new §1061, which generally treats a partner’s share of long-term capital gain from partnership investments held three years or less as short-term capital gain where the partner acquired the partnership interest through the

performance of substantial services. The rule only applies to partnerships engaged in raising or returning capital and investing in, disposing of, or developing securities, commodities, investment or rental real estate, and cash or cash equivalents.

“That’s pretty much a joke,” writes Washington Post columnist Allan Sloan, “given that venture capital and buyout funds — whose managers are the biggest beneficiaries of the ‘carried interest’ loophole — typically hold investments for well over three years before selling them. This legislation has the appearance of reform, but not the substance.” Sloan, *Carried Interest Reform is a Sham*, Washington Post, December 1, 2017.

The Conference Report states that the three-year holding period applies even in the case of a §83(b) election:

[T]he fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer’s net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

Conference Report at 269. The estimated revenue gain from the new rule is \$1.1 billion over ten years. Estimated Budget at 6.

c. Limiting Like-Kind Exchanges to Real Property: Under prior law, the exchange of personal property held for business or investment use for property of like kind qualified for nonrecognition under §1031. The Act now limits the scope of §1031 to exchanges of real property, simply by changing every reference to “property” in §1031 to “real property,” as well as deleting §1031(e) related to livestock and §1031(i) related to certain stock.

The new limit applies to exchanges completed in 2018 or later. Section 1031 still applies to a like-kind exchange of personal property if either (1) the property given up was disposed of by the taxpayer before 2018; or (2) the property received by the taxpayer was acquired before 2018. The estimated revenue gain from narrowing the scope of §1031 is \$31 billion over ten years. Estimated Budget at 3.

d. Modification of Deduction for Entertainment Expenses: Prior law disallowed a deduction for entertainment costs unless the taxpayer established that the entertainment was “directly related to” or “substantially associated with” the taxpayer’s business or profit-seeking activity. Even then, the taxpayer could only deduct 50 percent of the

cost of the entertainment. The Act amends §274 to disallow a deduction for all entertainment expenses period, no matter whether the entertainment relates to or is associated with the taxpayer's business. The change applies to amounts paid or incurred for entertainment in 2018 or later, and is expected to generate \$23.5 billion in revenue over the next ten years. Estimated Budget at 4.

e. Deduction for Certain Fines and Penalties Explained: Section 162(f) used to be sweet and to the point: "No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." The Act now expands the verbiage of §162(f) considerably, with five new paragraphs, all generally effective as of December 22, 2017. The thrust of the new rule is to deny a deduction for amounts paid or incurred to (or at the direction of) a government or certain listed nongovernmental regulatory entities in relation to the violation of a law or the investigation or inquiry into the potential violation of a law.

The Act contains exceptions for payments that are restitution, remediation of property, or amounts paid to come into compliance with any law that violated or involved in the investigation or inquiry. It also adds reporting requirements whereby government agencies have to report settlement agreements and orders entered into where the amount required to be paid is at least \$600.

f. Deduction for Local Lobbying Expenses Repealed: Section 162(e) generally disallows deductions for lobbying expenses and expenses connected with political campaigns, but prior law contained an exception for expenses connected with appearing before or communicating with "any local council or similar governing body." The exception treated tribal governments as local councils for purposes of this exception. The Act repeals this exception effective as of December 22, 2017. The estimated revenue gain from this measure is just \$800 million over the next ten years. Estimated Budget at 6.

g. No Deduction for Settlements Subject to Nondisclosure Agreements in Connection with Sexual Harassment or Sexual Abuse: Introduced in the Senate Bill, new §162(q) provides as follows:

(q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE.—No deduction shall be allowed under this chapter for—

(1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or

(2) attorney's fees related to such a settlement or payment.

While the statute is clear that settlement payments related to sexual harassment or sexual abuse might be deductible if there is no nondisclosure agreement, it is not clear whether attorney fees paid in cases where there is no nondisclosure agreement could be deductible. On the one hand, §162(q)(2) does not contain the "if such settlement or payment is subject to a nondisclosure agreement" clause, suggesting that the denial of a deduction for attorney fees is

not conditioned on the presence of a nondisclosure agreement. But on the other hand, §162(q)(2) refers to “such” a settlement or payment, which is either a reference to “a settlement or payment related to sexual harassment or sexual abuse” or a reference to “a settlement or payment ... subject to a nondisclosure agreement.” In any case, the new provision applies to amount paid or incurred after December 22, 2017. The estimated revenue gain from the new rule is less than \$50 million over the next ten years. Estimated Budget at 6.

h. Exclusion of and Deduction for Employee Achievement Awards

Modified: Section 74(b) allows an employee to exclude from gross income (and §274(j)(1) sometimes allows an employer to deduct) the value of an “employee achievement award.” Section 274(j)(3) defines an employee achievement award as an item of tangible personal property awarded from an employer to an employee in a meaningful ceremony recognizing the employee’s length of service or safety achievement, provided the circumstances and condition of the award do not create a significant likelihood that the award is just disguised compensation. The Act clarifies that “tangible personal property,” for this purpose, does not include cash, cash equivalents, gift cards, gift coupons, most gift certificates, vacations, meals, lodging, event tickets, stock, bonds, securities, or similar items. The new definition applies to awards made in 2018 or later. The Joint Committee estimates a revenue pickup of less than \$50 million over the next ten years from this new rule. Estimated Budget at 4.

i. Accrual Method Modified:

Traditionally, an accrual-method taxpayer has income when all events have occurred that fix the right to payment and the amount can be determined with reasonable accuracy. This is known as the “all-events test” for income. The Act adds a new §451(b), effective starting in 2018, which generally provides that the all events test is met with regard to an item of income no later than when the income is taken into revenue on the taxpayer’s financial statement. This is expected to add over \$8 billion in federal revenues in the next ten years. Estimated Budget at 4.

The Act also adds a new §451(c), also starting in 2018, allowing an accrual method taxpayer to elect to defer the inclusion of certain advance payments to the end of the year following the year of receipt if such income is likewise deferred for financial accounting purposes. The new rule does not apply to advance receipts of rents, insurance premiums, and other specified items. In effect, this rule is the codification of guidance previously published by the Service (Revenue Procedure 2004-34).

j. More Self-Created Property Excluded from Definition of Capital

Asset: Section 1221(a)(3) provides that copyrights, compositions, letters, memoranda and similar property held by the creator or by someone whose basis is determined with reference to the creator’s basis are not capital assets. The Act adds patents, inventions, models, designs (whether or not patented), secret formulae and processes to this list, applicable to dispositions made in 2018 or later. The Joint Committee estimates this may add about \$500 million in revenues over the next ten years. Estimated Budget at 4.

The House bill likewise called for the repeal of §1235, which provides that a transfer of substantially all rights in a patent or undivided portion thereof by the creator (or an unrelated party who acquired the patent by paying consideration in money or money's worth to the creator before the invention was reduced to practice) automatically qualifies for long-term capital gain treatment. Since self-created patents would not be capital assets under the new law, the House bill figured a provision conferring automatic long-term capital gain treatment would be a contradiction. But the Act makes no change to §1235. So we have one provision (§1221(a)(3)) saying a patent is not a capital asset in the hands of the inventor, but another provision (§1235) says the inventor can still qualify for automatic long-term capital gain treatment on the sale of the entire patent or an undivided portion thereof. If that stands, it would seem the only taxpayers affected by §1221(a)(3) are those who receive patents by gift from the inventor—donees cannot claim the benefit of §1235 because they do not give the inventor consideration in money or money's worth. They are thus stuck with ordinary income treatment.

k. Small Business Accounting Method Reform: Prior law generally limited the cash method of accounting to individuals and businesses that use the cash method for financial accounting purposes. Prior law provided that C corporations, partnerships with a C corporation partner, and certain tax-exempt entities could not use the cash method, with exceptions for certain farming businesses, qualified personal service corporations, and entities with average annual gross receipts of no more than \$5 million for all prior years. A taxpayer also could not use the cash method where the purchase, production or sale of merchandise is an income-producing factor.

The Act now expands the availability of the cash method to include all taxpayers (other than tax shelters) with average annual gross receipts of up to \$25 million for the three prior taxable years, even where a taxpayer produces income from the purchase, production, or sale of inventory. The \$25-million figure will be adjusted for post-2018 inflation.

In addition, taxpayers meeting the \$25 million gross receipts test above are no longer required to use the inventory method of accounting for inventories. Instead, taxpayers can account for inventory either by treating inventory for tax purposes either the same way as the taxpayer accounts for it for financial accounting purposes or by treating inventory as non-incidental materials and supplies (deductible when first used or consumed in the taxpayer's business).

But wait, there's more! Taxpayers meeting the \$25 million gross receipts test are also exempted from the uniform capitalization rules of §263A. This expansion of favorable tax accounting rules applies to taxable years beginning in 2018 and later. The estimated revenue hit from all of these measures is \$30.5 billion over ten years. Estimated Budget at 3.

l. S Corporation Conversions to C Corporations: Given the new 21-percent flat tax applicable to C corporations, some S corporation shareholders might consider terminating the S election, thus converting the entity to a C corporation. Shareholders should know that one consequence of making the conversion might be a change in accounting

method. The former S corporation may have used the cash method if it maintained no inventory, but the new C corporation may be forced to use the accrual method. (Note the discussion immediately above, however, in connection with the expanded availability of the cash method under the Act.)

If a change of accounting method is required, §481(a)(2) requires that in the year of change “there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted...” To mitigate the impact of the “§481 adjustment” in this scenario, the Act creates new §481(d) specifically targeted to conversions from S corporation to C corporation status. Under the new rule, the §481 adjustment” is prorated over the first six taxable years starting with the year of conversion, but only in cases where: (1) the entity was an S corporation on December 21, 2017; (2) the entity revoked its S corporation status on or after December 22, 2017, and on or before December 21, 2019; and (3) all of the persons who were shareholders of the corporation on December 22, 2017 are the only persons who were shareholders of the corporation on the date of the revocation of the S election. The estimated revenue loss from this new rule is \$6.1 billion over ten years. Estimated Budget at 3.

m. New Limit on Deduction of Business Interest: Starting in 2018, the deduction for “business interest” in the case of a taxpayer with average annual gross receipts of \$25 million or more over the past three years is limited to an amount equal to the sum of: (1) the taxpayer’s “business interest income;” plus (2) 30 percent of the taxpayer’s “adjusted taxable income;” plus (3) where applicable, the taxpayer’s “floor plan financing interest.” Any business interest not allowed as a deduction under this rule carries over the next taxable year. In the case of partnerships, the limit is applied at the entity level, and each partner will have a share of the entity’s adjusted taxable income. The Joint Committee estimates this restriction will add over \$253 billion to federal revenues over the next ten years.

Business Interest. New §163(j)(5) defines business interest as any interest paid or accrued on debt properly allocable to a trade or business. The term does not include “investment interest,” which has its own cap under §163(d). Section 163(j)(7) excludes certain businesses from the definition of a “trade or business” solely for purposes of the business interest deduction limitation, meaning the limit on interest expense will not apply to these specified groups. They include the business of being an employee, certain utilities, as well as any “electing real property trade or business” (defined as any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business) and any “electing farming business.” In the case of farmers, though, note the consequence of making the election as regards depreciation of equipment used by an electing farmer as discussed above.

Business Interest Income. New §163(j)(6) defines business interest income as the amount of interest includible in the taxpayer’s gross income for the year that is properly allocable to a trade or business of the taxpayer. Here too, investment interest income expressly does not count as business interest income.

Adjusted Taxable Income. New §163(j)(8) defines adjusted taxable income as the taxpayer's taxable income computed without regard to six items: (1) items not properly allocable to a trade or business; (2) business interest; (3) business interest income; (4) any net operating loss deduction; (5) any deduction for qualified business income under new §199A; and (6) for 2018 through 2021 only, deductions for depreciation, amortization, or depletion. The statute authorizes Treasury to announce other adjustments going forward.

Floor Plan Financing Interest. New §163(j)(9) generally defines floor plan financing interest as interest paid on debt used to finance the acquisition of motor vehicles (defined to include both boats and farm equipment) held for sale or lease and which is secured by such vehicles.

n. Modification of Net Operating Loss Deduction: Prior law allowed a taxpayer to deduct the net operating loss carryovers to the taxable year plus any net operating loss carrybacks to such year. The Act **caps this deduction to 80 percent of taxable income** (computed without regard to the net operating loss deduction).

The Act also **repeals the two-year carryback** of net operating losses except in the case of certain losses incurred by farmers. Similarly, the net operating losses of a property and casualty insurance company may be carried back two years and carried forward 20 years.

Finally, the Act allows for **indefinite carryforwards** of net operating losses, as opposed to the 20-year limit that was in place under prior law (with the exception for property and casualty insurance companies described above). Combined, these modifications are expected to drive up federal revenues by more than \$201 billion over ten years. Estimated Budget at 3.

o. Repeal of Deduction for Income Attributable to Domestic Production Activities: The Act repeals §199, effective for taxable years beginning in 2018 or later. Section 199 had authorized a deduction equal to nine percent of either a taxpayer's "qualified production activities income" or, if less, taxable income. Generally, "qualified production activities income" was excess of the taxpayer's "domestic production gross receipts" over the sum of the cost of goods sold allocable to those receipts and other expenses, losses, and deductions allocable to those receipts. The statute generally defined "domestic production gross receipts" as gross receipts derived from the sale, exchange, disposition, lease, rental, or license of tangible personal property, computer software, motion pictures, films, videotapes, and sound recordings that was made, grown or extracted in whole or in significant part within the United States, as well as real property construction performed in the United States by one in the ordinary course of a construction business. The total deduction, however, could not exceed 50 percent of the W-2 wages paid by the taxpayer that were properly allocable to domestic production gross receipts. Repeal of the deduction is expected to add \$98 billion to federal revenues over the next ten years. Estimated Budget at 4.

p. Excessive Employee Remuneration Limitation Modified: Section 162(m) generally limits the deduction for compensation paid to a “covered employee” of a publicly held corporation to no more than \$1 million per year. A “covered employee” is either a CEO on the last day of the taxable year or an employee whose compensation must be reported to shareholders under federal securities laws because the employee is one of the four most highly compensated officers other than the CEO.

The Act makes a few modifications to this rule starting in 2018, three of which are worth mention here. First, the Act includes the company’s CFO as a covered employee no matter whether the CFO is one of the four highest paid officers. Second, the CEO and CFO are covered employees if they held their roles at any point during the taxable year (not just the last day of the taxable year, as under prior law). Finally, the Act eliminates preexisting exceptions for commissions and performance-based compensation from application of the \$1 million limit. Accordingly, commissions and performance-based compensation now count toward the \$1 million limit. Combined, these new limits are expected to raise some \$9.2 billion in revenues over the next ten years. Estimated Budget at 4.

D. WEALTH TRANSFER TAX REFORM

1. Increase in Basic Exclusion Amount

The American Taxpayer Relief Act of 2012 made permanent the \$5,000,000 basic exclusion amount for federal estate, gift, and generation-skipping transfer taxes that was introduced in the Tax Relief and Unemployment Insurance Reauthorization and Job Creation Act of 2010. The basic exclusion amount adjusted for inflation after 2011.

For decedents dying in	The basic exclusion amount is
2011	\$5,000,000
2012	\$5,120,000
2013	\$5,250,000
2014	\$5,340,000
2015	\$5,430,000
2016	\$5,450,000
2017	\$5,490,000

Pursuant to Revenue Procedure 2017-58, the basic exclusion amount for 2018 was set to be \$5,600,000. But the Act doubles the basic exclusion amount under §2010(c)(3) from \$5 million to \$10 million, with adjustments for inflation after 2011 using a new, “chained-CPI” method. Thus, **the basic exclusion amount for 2018 is \$11,180,000** (nearly twice the \$5.6 million figure originally estimated for 2018).

The Act provides that the basic exclusion amount will revert to \$5 million (adjusted for post-2011 inflation) after 2025. The estimated revenue loss from doubling of the basic exclusion amount is \$83 billion over ten years.

The House Bill called for a temporary repeal of the estate and generation-skipping transfer taxes, along with a reduction in the tax rate applicable to taxable gifts. But the Senate Bill focused only on doubling the basic exclusion amount, an approach adopted in the Conference Bill. Thus, the federal wealth transfer taxes survive, but once again suffer a significant reduction in scope.

2. Retention of Stepped-Up Basis

Neither the House Bill nor the Senate Bill proposed any changes to the application of §1014, which provides a fair-market-value-at-date-of-death basis for property acquired from a decedent. Some commentators were of the belief that if the estate tax was repealed, Congress would be forced to repeal or at least substantially curtail the scope of §1014, perhaps treating property acquired from a decedent the same as property acquired through an inter-vivos gift (with, generally, a carryover basis under §1015). But since the Conference Bill took temporary estate tax repeal off the table, no one was surprised at the retention of “stepped-up” basis under §1014.

3. Post-Act Estate Planning Strategies

Estate planning for unmarried individuals likely changes very little. Some previously “wealthy” single persons (those with, say, estate of \$8 million) no longer need to sweat the federal wealth transfer taxes as part of their estate planning, though they will want to consider how to plan for the potential re-introduction of those taxes in 2026 when the basic exclusion amount is set to drop back to \$5 million (adjusted for post-2011 inflation). Because the doubling of the basic exclusion amount is only temporary under the Act, one should be hesitant to tear down an existing estate plan that took wealth transfer taxes into account.

Planning for married couples, however, could change significantly. The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three “buckets,” each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than one basic exclusion amount (no more than \$11.18 million in 2018)	Combined net worth more than one basic exclusion amount but not more than two basic exclusion amounts (more than \$11.18 million but not more than \$22.36 million in 2018)	Combined net worth more than two basic exclusion amounts (more than \$22.36 million in 2018)

This section of the materials offers a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a \$7 million combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only \$2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of \$2 million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word “dynasty” and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

a. Planning for Bucket One Couples. There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

BUCKET ONE TEMPLATE
* Trust or outright gift upon death of first spouse?
* Ensure stepped-up basis for all assets on death of surviving spouse
* Consider protective portability election

Transfer Upon First Spouse’s Death: Trust or Outright Gift? The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include: (1) the desire of the first spouse to die to control the disposition of his or her assets after death; (2) a concern that the surviving spouse may not have the capacity or desire to manage the assets; and (3) a concern that assets in the name of the surviving spouse might be vulnerable to creditors.

Of course there are also good reasons for clients to prefer an outright gift, like the desire to avoid the costs of trust formation and administration or the desire to avoid the complexity of trusts (you can’t get much simpler than an outright gift). Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

Ensure All Assets Get Stepped-Up Basis on Survivor's Death. Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse's death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse's death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a "step-down" in basis as well (as where the property's value at the time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust that causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result for Bucket One couples, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the amount that can pass to the surviving spouse through a portability election, as described below. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP

election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure 2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

Consider the Protective Portability Election. By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the deceased spouse's unused exclusion amount in addition to surviving spouse's own basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

b. Planning for Bucket Two Couples. Planning for these couples is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often the only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

When Credit Shelter Trust is Better. In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

(1) Asset Appreciation Expected. Unlike the basic exclusion amount, the "deceased spousal unused exclusion amount" from a portability election does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a \$11 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25

years later, the basic exclusion amount will be substantially higher, but the DSUE Amount will still be \$11 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

(2) Client Wants to Use the Generation-Skipping Transfer Tax Exemption.

While the portability election applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

When Portability is Better. But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

(1) Some Assets Don't Fit Well in Credit Shelter Trusts. Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.

(2) Some Surviving Spouses Don't Survive Long Enough. If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.

(3) Stepped-Up Basis May be More Important. Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of the typical credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

BUCKET TWO TEMPLATE

- * Trust or outright gift upon death of first spouse?
- * If outright gift preferred, use disclaimer planning
- * If trust is preferred, use *Clayton* QTIP

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the surviving spouse live after the death of the first spouse?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better answers to those five questions (i.e., after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

Transfer Upon First Spouse's Death: Trust or Outright Gift? It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

Outright Gifts – Disclaimer Planning. If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

Trusts – Clayton QTIP. If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton QTIP* trust. A *Clayton QTIP* is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital deduction as "qualified terminable interest property." But the *Clayton QTIP* trust contains an additional provision: to the extent the executor does not elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton QTIP*. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full deceased spousal unused exclusion amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton QTIP* allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

c. Planning for Bucket Three Couples. Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the \$50 million estate. The techniques used prior to both the Act and the American Taxpayer Relief Act remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include: spousal lifetime access trusts (SLATs); irrevocable life insurance trusts (ILITs); grantor retained annuity trusts (GRATs); charitable lead trusts (CLATs and CLUTs);

charitable remainder trusts (CRATs, CRUTs, NIMCRUTs); donor-advised funds, private foundations, and pooled income funds; family limited partnerships (FLPs) and limited liability companies; installment sales to “defective” grantor trusts; and dynasty trusts. Of course, even some Bucket Two couples may find one or more of these strategies useful in their own planning as well. But it’s now primarily Bucket Three couples that are concerned with gross estate minimization.

E. ALTERNATIVE MINIMUM TAX REFORM

1. Corporate AMT Repealed

Prior law imposed an alternative minimum tax (AMT) on some corporations. The key to calculating a corporation's AMT liability was to determine its “alternative minimum taxable income” (AMTI). The starting point, no surprise, was the corporation’s regular taxable income. Certain adjustments to that figure were made under §§56 and 58. For example, a corporation had to recompute certain depreciation deductions by using the straight-line method rather than the usual accelerated cost recovery system allowed for regular tax purposes. §56(a)(1)(A)(i). The taxable income figure was then further adjusted by the so-called “preference items” in §57. For example, a corporation had to increase taxable income by the amount of tax-exempt interest received on private activity bonds. §57(a)(5)(A). (For regular tax purposes, such interest is excluded from gross income under §103.)

The final major adjustment to taxable income was the “adjusted current earnings” (ACE) adjustment provided in §§56(c)(1) and (g). The purpose of this adjustment was to reflect the corporation's true earnings for the taxable year. Once all adjustments have been made, a “tentative minimum tax” was computed by computing 20 percent of the corporation’s AMTI as exceeds the exemption amount (\$40,000). But the \$40,000 exemption amount was reduced by 25 percent of the amount by which AMTI exceeded \$150,000. §55(d)(3). AMT liability thus applied to the extent tentative minimum tax liability exceeded the corporation’s regular tax liability.

The corporate AMT was only a concern to very large corporations. Certain “small” C corporations were wholly exempt from the AMT. A C corporation with average annual gross receipts of \$7.5 million or less for all three-year periods beginning after 1993 and ending before the taxable year was considered a “small” corporation and, as such, was deemed to have a tentative minimum tax liability of zero. IRC §55(e). For the corporation's first three-year period (or portion of a period), the limit was \$5 million instead of \$7.5 million.

The Act repeals the corporate AMT effective for taxable years beginning in 2018 or later. This repeal is permanent; it is not scheduled to sunset. The estimated revenue loss from repeal is \$40.3 billion over ten years. Estimated Budget at 3.

2. Individual AMT Retained with Higher Exemptions

Individuals, estates, and trusts are likewise subject to the AMT. The minimum tax imposed is the amount by which tentative minimum tax exceeds the regular income tax liability for the year. There is a “tentative minimum tax” when AMTI (computed in roughly the same manner for individuals as for corporations) exceeds the exemption amount. Taxpayers with high AMTIs face a phaseout of the exemption amount.

The House Bill called for complete repeal of the individual AMT to accompany repeal of the corporate AMT, but the Senate would not have it. Instead, the final Act temporarily increases both the exemption amount and the exemptions amount phaseout threshold, as illustrated in the following table (effective for 2018 through 2025):

Taxpayer	PRE-TAX CUTS AND JOBS ACT*			POST-TAX CUTS AND JOBS ACT		
	Joint Filers	Unmarried	Estates and Trusts	Joint Filers	Unmarried	Estates and Trusts
AMT Exemption Amount	\$86,200	\$55,400	\$24,600	\$109,400	\$70,300	\$24,600
Phaseout of exemption amount begins when AMTI exceeds	\$164,100	\$123,100	\$82,050	\$208,400	\$156,300	\$82,050

* Figures from Revenue Procedure 2017-58.

The new dollar amounts are set to be adjusted for inflation, but will expire at the end of 2025. These adjustments are expected to cost about \$637 billion in foregone revenue over this period. Estimated Budget at 2.

F. PROPOSED REFORMS THAT DID NOT SURVIVE THE FINAL BILL

Both the House and Senate bills contained provisions that were left on the cutting room floor by the Conference Committee. A number of these last-minute cuts had been discussed in the popular press, so some clients might be under the mistaken impression that the final Act contains some of these provisions. Accordingly, these materials conclude with a brief mention of various reform proposals from the House and Senate bills that were not included in the final Act, as confirmation that these proposals are not in fact part of the new law.

1. Individual Tax Reforms Not Enacted

a. Exclusion of Gain on Sale of Personal Residence: The House bill made three changes to the §121 exclusion applicable to gain from the sale of a personal residence. First, it replaced the requirement that the taxpayer own and occupy the home for two of the five years prior to the sale with the requirement that the taxpayer own and occupy

the home for five of the right years prior to the sale. Second, it would have limited the application of §121 to every five years instead of every two years. Finally, it would have imposed a phaseout of the exclusion once the taxpayer's adjusted gross income exceeded \$250,000 (\$500,000 for joint filers).

The Senate bill was on board with the first two changes, but it did not include an income-based phaseout. It also provided for a sunset of the changes come 2026. But for reasons not apparent, the Conference bill enacted none of the proposed changes to §121.

b. American Opportunity Tax Credit and Lifetime Learning Credit.

Current law provides for both the American Opportunity Tax Credit and the Lifetime Learning Credit. The American Opportunity Tax Credit gives individuals a credit of up to \$2,500 for qualified tuition and related expenses paid first the "first four years" of post-secondary education in a degree or certificate program, though the credit generally is phased out ratably for taxpayers with adjusted gross incomes between \$80,000 and \$90,000 (double those amount for joint filers). Up to 40 percent of the credit is refundable. The Lifetime Learning Credit is nonrefundable credit of 20 percent of qualified tuition and related expenses, but subject to a cap of \$2,000. The credit extends beyond the first four years of undergraduate education, but is phased out ratably for taxpayers with adjusted gross incomes between \$56,000 and \$66,000 (double those amount for joint filers).

The House bill would have repealed the Lifetime Learning Credit and modified the American Opportunity Tax Credit by also allowing a half-credit in the *fifth* year of undergraduate education. The Senate bill did not address the education credits at all, and the Conference bill did not include the House bill provision.

c. Student Loan Interest: The House bill would have repealed the §221 deduction for interest paid on student loans. The Senate bill contained no similar provision, and it was dropped from the Conference bill.

d. Qualified Tuition and Related Expenses: The House bill would have repealed §222 deduction for qualified tuition and related expenses, but the Senate and Conference bills rejected this.

e. Exclusion for Qualified Tuition Reductions: The House bill called for repeal of §117(d), which generally excludes from gross income the value of tuition reductions furnished to employees, their spouses, and their dependents. Colleges and universities vocally opposed the measure, as it would have made most graduate assistant positions taxable. The Senate bill did not contain this provision, and the provision was dropped from the Conference bill.

f. Exclusion of Interest on United States Savings Bonds Used for Higher Education: The House bill repealed §135, the exclusion of interest earned on a Series EE savings bond issued after 1989 to the extent the interest does not exceed the taxpayer's

qualified higher education expenses. The Senate bill ignored the proposed repeal, as did the Conference bill.

g. Exclusion for Educational Assistance Programs: The House bill also called for repeal of §127, which excluded up to \$5,250 of annual educational assistance provided to an employee by an employer relevant to undergraduate and graduate education. But neither the Senate bill nor the Conference bill included this provision.

h. Deduction and Contributions to Archer Medical Savings Accounts: The House bill made contributions to Archer MSAs nondeductible as of 2018, and likewise provided that such payments would be includible in gross income and count as wages if paid by an employer. But the Senate bill did not include this provision and it was likewise dropped from the Conference bill.

i. Exclusion for Employer-Provided Housing: Section 119 allows an employee to exclude from gross income the value of lodging furnished by an employer for the convenience of the employer, provided the employee is required to accept the lodging on the employer's business premises as a condition of employment. The House bill limited this exclusion to a maximum \$50,000 exclusion, subject to a phaseout based on the employee's compensation. It also disallowed the exclusion entirely to employees who own five percent or more of the employer. The Senate bill did not pick up this provision; neither did the Conference bill.

2. Business Tax Reforms Not Enacted

a. Expenses in Contingent Fee Cases: *Boccardo v. Commissioner*, 56 F.3d 1016 (9th Cir. 1995), held that an attorney could deduct litigation costs in contingent fee cases even though the attorney may later recoup those expenses under the contingent fee arrangement. The House bill would have overruled *Boccardo* through a specific rule disallowing a deduction for litigation costs paid under a contingent fee arrangement until the contingency ends. The Senate bill contained no similar provision, and the Conference bill let it die.

b. 25 Percent Rate on Qualified Business Income: Instead of the 20-percent deduction for qualified business income coined in the Senate bill, the House bill would have instead applied a maximum rate of 25 percent to qualified business income. In addition, the House version treated passive activities differently than active businesses: all of the ordinary income from a passive activity would qualify for the rate preference, but only the "capital percentage" of business income (presumptively 30 percent of the ordinary income) would qualify in the case of active businesses.

3. Wealth Transfer Tax Reforms Not Enacted

As explained above, the House bill called for eventual repeal of the federal estate and generation-skipping transfer taxes, accompanied with a reduced tax rate of 35 percent for

purposes of the federal gift tax. But the Senate settled simply for doubling the basic exclusion amount and leaving the tax rate alone.

II. TITLE