The Tax Cuts and Jobs Act: The impact on the municipal bond market

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Overview

During this Session, we will discuss:

- The Tax Cuts and Jobs Act of 2017
  - Brief summary of proposed versions
  - Final enacted provisions directly affecting local government municipal bonds
    - Elimination of advance refundings
    - Elimination of tax credit bonds
  - Potential collateral effects on municipal bonds
- Sequestration and direct pay (BABs) subsidies
- Issues related to the elimination of advance refundings
- Increased value of state tax exemption for taxable municipal debt
- Potential future legislation

Tax Cuts and Jobs Act—Recap of late 2017

November 2— House version of Tax Cuts and Jobs Act is released

- Eliminates advance refundings
- Eliminates private activity bonds (including 501(c)(3) bonds)
- Eliminates tax credit bonds
- Eliminates bonds to finance professional sports stadiums

November 9– Senate version is released

- Eliminates advance refundings and tax credit bonds

December 15—Conference bill is released

- Municipal bond provisions consistent with Senate version

December 21—Continuing resolution is passed, with waiver of PAYGO restrictions for Tax Cuts and Jobs Act

December 22—Tax Cuts and Jobs Act signed by President

Tax Cuts and Jobs Act—Direct Effects on Municipal Bonds

- Eliminated ability to issue tax-exempt advance refunding bonds after December 31, 2017
  - Advance refunding bonds are bonds issued more than 90 days prior to the redemption of the refunded bonds
  - Current refunding bonds issued within 90 days of when the refunded bonds can be redeemed are ok
- Eliminates ability to issue tax credit bonds after December 31, 2017
  - Qualified Zone Academy Bonds
  - New Clean Renewable Energy Bonds
  - Qualified Energy Conservation Bonds
- No transition rules
- No repeal of private activity bonds and no repeal of stadium bonds
- Tax reform proposals in November prompted a flood of late 2017 transactions, particularly private activity bonds and advance refundings

Tax Cuts and Jobs Act–Indirect Effects on Municipal Bonds

<u>BUY SIDE</u>

- Reduction of tax rates
  - May reduce the value of tax-exemption on municipal bonds to potential buyers, including your local banks
  - May trigger interest rate adjustments in outstanding private placements
- Repeal of corporate alternative minimum tax
  - May increase value of AMT private activity bonds (like industrial development bonds) for corporate taxpayers
- Increases tax rate on insurance companies with tax-exempt interest
- Taxes large private university endowments
- Combine this with already rising interest rates but reduced supply
- Results: Beats me.
- However, we are seeing (1) rising rates in local bank bids on BANs (to make up for reduced value of tax-exemption) and (2) increase in interest rates and premium offered in competitively bid notes and bonds

Tax Cuts and Jobs Act–Indirect Effects on Municipal Bonds

LOCAL CONTEXT

- $10,000 limitation on deductions of state and local taxes (SALT)
  - Raises after-tax cost to taxpayers of state and local taxes (sales, income and property taxes)
  - May cause taxpayer pressure on local government debt issuance for capital projects
  - May increase value of NY state or local tax-exemption of interest earned on notes and bonds issued by State or local issuers in NYS and held by New Yorkers

Sequestration and Direct Pay Subsidies

- Since 2013, direct pay subsidies on Build America Bonds (“BABs”) and other direct pay bonds* has been subject to sequestration under the Budget Control Act of 2011 (BCA)
  - Sequestration reductions have ranged from 6.6% to 8.7%
- Tax Cuts and Jobs Act potentially triggered sequestration under the Pay-As-You-Go Act of 2010 (PAYGO)
  - Potential 100% sequestration
- Waiver of PAYGO restrictions was included in continuing resolution passed on December 21, 2017
  - Appears to eliminate threat of 100% sequestration
  - Continued effect of BCA sequestration through 2023

*These direct pay BAB and recovery zone economic development bonds (“RZEDBs”)issued in 2009 and 2010 had a direct interest payment to the issuer by the federal government equal to 35% of (federally taxable) interest costs. Other than BABs and RZEDBs, other such bonds were Qualified Zone Academy Bonds, Qualified School Construction Bonds, New Clean Renewable Energy Bonds, and Qualified Energy Conservation Bonds, all eliminated by the 2017 Act.

Elimination of Tax-Exempt Advance Refundings

- For federal revenue purposes, there is a doubling of federal tax subsidy during escrow period, when two sets of tax-exempt bonds were outstanding
- Potential market changes following elimination of advance refundings
  - Shorter par call dates (or make-whole calls prior to par call)
  - Tax Exempt Forward Delivery Refunding Bonds – not in a rising interest rate environment
  - Synthetic advance refundings, including derivatives or options that provide equivalent cost savings to issuer (would require state legislation)
  - Taxable sandwich structures, where taxable bonds are issued to advance refund and later currently refunded by tax-exempt bonds
    - Both steps would require present value savings under current law
  - “Cinderella” structures, where taxable refunding bonds convert to tax-exempt status/rates when close to redemption date for refunded bonds
    - Difficult and complicated tax issues
    - Would require state legislation

Other Issues Regarding Advance Refundings

- Pre-tax reform, regulations and rulings governed advance refunding of taxable bonds and other taxable debt
  - In most cases, a tax-exempt advance refunding of taxable debt was not counted as an advance refunding for purposes of old rule allowing one advance refunding
  - No general rule saying that a tax-exempt advance refunding was not treated as an advance refunding
- Post-tax reform, questions about how to apply these rules
  - Many bond counsel are currently discussing and analyzing this issue
  - Expect some guidance or clarifying statements from regulators
  - Right answer is that a tax-exempt advance refunding of taxable debt should be allowed, except in abusive circumstances
- Impact on Important Common Context: Everyday bond issues refinancing various bond anticipation notes. Watch out!!

State and Local Tax-Exemption for Municipal Bonds

- Federal income tax exemption for interest on municipal bonds is governed by federal income tax requirements
- State income tax exemptions are different
  - In most states that impose individual income taxes like New York, the interest on bonds issued by governmental entities within that state is categorically exempt from that state's income tax.
  - Under federal law, bonds issued by U.S. territories (Puerto Rico, Guam, Northern Marianas Islands, U.S. Virgin Islands, etc.) are also exempt from state or local income tax
  - Even if bonds are federally taxable, the interest may be exempt from state income tax (e.g., New York GOBs (and BABs) are exempt from New York personal income tax, even though federally taxable)
  - Therefore, there is still an interest rate savings to be had by New York issuers compared to fully taxable debt

Federal Tax Deductions for State and Local Taxes

- Historically, state and local taxpayers could claim a federal tax deduction for the amount of their state and local taxes paid (income tax, property tax, etc.)
- Effect is to reduce cost to taxpayers of paying state and local taxes
  - Pay $1,000 in local taxes
  - Claim $1,000 deduction on federal income tax return
  - At 35% federal tax rate, value of $1,000 deduction is $350
- Tax Cuts and Jobs Act imposes $10,000 limitation on deduction for state and local taxes
  - In high tax states (CA, NY, NJ, etc.), many taxpayers will not be able to deduct full amount of state and local taxes paid
- Individual investors in taxable bonds (e.g., corporate bonds) may have an increased interest in taxable municipal bonds that are exempt from their state or local income taxes. A new investor class could possibly emerge

Increase in Value of State and Local Tax Exemption on Taxable Municipal Bonds

- Comparison below assumes a taxpayer at the top marginal rates for federal and New York income taxes, and with other state and local taxes in excess of $10,000

	Taxable Corporate Debt	Federally Taxable State/Local Debt Exempt from State Income Tax
Federally taxable interest received	$ 1,000	$ 1,000
Top marginal federal tax rate	37%	37%
Federal tax on interest	$ 370	$ 370
Top marginal state income tax (8.82% in NY)	8.82%	0.00%
State income tax on interest	$ 88	$ -
Total tax rate	45.8%	37%
Total tax cost	$ 458	$ 370

- Potential for market to develop for state/local-tax exempt bonds, even if federally taxable

Potential Future Legislation

- Technical Corrections Bill
  - Transition rules?
- Infrastructure Bill
  - Congress is expected to take up an infrastructure bill in 2018
  - May include provisions affecting municipal bonds:
    - New types of tax-exempt or tax-advantaged bonds for infrastructure projects?
    - Expansion of tax-exempt bonds for public-private partnerships for infrastructure projects?
    - Potential repeal of certain types of tax-exempt bonds to ‘pay for’ other infrastructure spending?

What the Future Holds

- Developments to address elimination of advance refundings
  – Potential IRS/Treasury Guidance on refunding of taxable debt
  – Development of new structures
- Development of market for federally taxable state/local tax-exempt bonds
- As municipal bond tax-exempt interest rates rise, they are closing in on the tipping point where the yield on a 10-year bond is better than the yield on many stocks. This may increase the number of potential buyers of your bonds if and as people move money out of the stock market. Especially once the bull market ends
- A reminder of valuable existing tools in New York State to ameliorate the impact of debt issuance on taxpayers
  – Combined periods of probable usefulness
  – Level debt service vs. 50% rule amortization
  – Weighted average term of bond maximum maturity
  – Layered borrowing strategies

Questions?

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NYGFOA ANNUAL CONFERENCE

Tax Reform Update

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COST RECOVERY

Bonus Depreciation and Section 179

- Bonus Depreciation has been increased to 100%, for both new and used assets, for assets placed in service after 9/27/17

Bonus Depreciation and Section 179

- Bonus Depreciation has been increased to 100%, for both new and used assets, for assets placed in service after 9/27/17

- **Sec. 179 Deduction has been increased to $1M, with a phase out threshold of $2.5M, for assets placed in service starting in 2018. Sec. 179 can now be applied to:**
  - **residential property, and**
  - **to replacement of Roof, HVAC, Fire and Security systems in a commercial building**

Miscellaneous other issues

Like Kind Exchanges will now be limited to Real Estate. It will be interesting to see if the IRS changes its definition of Real Estate for 1031 purposes. Under prior law, Real Estate was defined by local State law (usually meaning the building and its fixtures – like carpeting, cabinetry, etc). Even if the IRS redefines Real Estate to mean only the building portion, this should not be an issue for tax purposes.   Why? 100% bonus rule on new and used property will offset any gains recognized on the sale of 5, 7 and 15 year property.

BUSINESS ENTITY UPDATE

Accounting Methods

Small Business Accounting Method Reform and Simplification

- The gross receipts threshold has increased to $25 million for:
  - Being able to use the Cash Method
  - Being required to show inventory
  - Being subject to UNICAP
  - Being required to use the percentage of completion method

- Gross Receipts Test: Effective tax years beginning after December 31, 2017, taxpayers with average gross receipts of less than $25 million for the prior three taxable years
  - Aggregation rules apply
  - The limitation will be adjusted for inflation for taxable years after December 31, 2018, and rounded to the nearest multiple of $1,000,000

Small Business Accounting Method Reform: Accounting for long-term contracts

Pre-reform Law: Under IRC §446 a taxpayer must choose an accounting method that most clearly reflects income

- Several specialized accrual methods are available in the construction industry

- In general, under IRC §460(a) ***long term contracts*** must be reported using the ***percentage of completion method***
  - A long term contract is defined as any contract for the manufacturing, building, installation or construction of property if not completed within the taxable year (IRC §460(f)(1))
  - Percentage of completion method requires:
    - Compare the costs allocated to the project so far by the total contract costs and multiply by the contract price

Small Business Accounting Method Reform: Accounting for long-term contracts

<u>Pre-reform Law</u>: In general, contracts must be accounted for under the Percentage of Completion Method (PCM) for Tax & AMT unless the contract meets an exception:

1. Manufacturing contract is normally not considered a long term contract UNLESS
   - It is a unique item normally not included in inventory OR
   - An item which normally requires more than 12 months to complete (IRC §460(f)(2))

2. A home construction contract is normally not a long term contract
   - Contracts for work on buildings that have four or fewer dwelling units. Eighty percent or more of the estimated total contract costs must be for the construction, improvement, or rehabilitation of these units (IRC §460(e)(6)(a))

3. Any other construction contract entered into by the taxpayer is not a long-term contract if
   - the contract will be completed within a 2-year period beginning on the commencement date of such contract and
   - The taxpayers average annual gross receipts from the prior three taxable years do not exceed $10,000,000 (IRC §460(e)(1))

Small Business Accounting Method Reform: Accounting for long-term contracts

TCJA Law: Effective for years beginning after December 31, 2017, the gross receipts test is met if the average of the past three years gross receipts is under $25 million

- Aggregation rules apply
- The limitation will be adjusted for inflation for taxable years after December 31, 2018, and rounded to the nearest multiple of $1,000,000
- In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership

- MECHANICS
  - Taxpayers that are eligible to change their accounting method from PCM are allowed to do so as an automatic method change
  - Change is done on a ***cut-off method*** (old contracts burn off under PCM and new contracts start using new accounting method) and does not result in an adjustment but still would require a FORM 3115 (PCM is still required on pre-existing contracts)
  - **Caution: PCM IS STILL MANDATED FOR AMT PURPOSES**

Effective Date: Effective for all contracts entered into after December 31, 2017. This is a permanent provision.

Business Entity Update: Interest Expense Limitation

Effective for taxable years beginning after December 31, 2017

- Amount allowed as a “business interest” deduction for any taxable year should not exceed the sum of:
  - The “business interest income” of such taxpayer
  - 30 percent of the “adjusted taxable income” of such taxpayer, plus
  - The floor plan financing interest of such taxpayer (IRC §163(j))

- The carryforward for disallowed business interest is indefinite

- The term business interest expense and income relates to indebtedness that is properly allocable to a trade or business and does not include investment interest expense or income.

- The term trade or business shall not include:
  - The trade or business of performing services as an employee
  - Any electing real trade or business
  - Any electing farming business or
  - The trade or business of the furnishing or sale of electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or transportation of gas or steam by pipeline if the rates for such furnishing or sale have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative (IRC §163(j)(7)(A))

Business Entity Update: Interest Expense Limitation

- Adjusted taxable income of the taxpayer means the taxable income of the taxpayer computed without regard to:
  - any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
  - Any business interest expense or business interest income
  - The amount of any Net Operating Loss (NOL) deduction
  - The amount of any deduction allowed under IRC §199A (New 20% Passthrough Deduction)
  - Any deduction allowable for depreciation, amortization, or depletion (if it is a taxable year beginning before January 1, 2022)
  - Computed with such other adjusted as provided by the Secretary

- Note: While currently the adjusted taxable income allows for the removal of depreciation and amortization before calculating the limitation, it is only for the first five years. For taxable years beginning after January 1, 2022, the limitation will apply after depreciation and amortization are taken, significantly increasing the limitation.

Business Entity Update: Interest Expense Limitation

Exceptions

- Electing Real Property Trade or Business:
  - Any trade or business (as defined as real property trade or business) which makes an **irrevocable** election
  - The term real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business (IRC 469(c)(7)(C))
  - If an election is made non-residential real property, residential rental property, and qualified improvement property must utilize ADS (slower depreciation lives) and bonus depreciation is not allowed
  - Future ADS depreciation is recalculated by “recasting” the remaining net tax basis of ALL of your QIP, 27.5 and 39 year assets in the year of election.
  - Bonus depreciation would be available for all other property (i.e. personal property and land improvements)

- Exemption for certain small businesses:
  - Interest Expense Limitation will not apply to a taxpayer if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000.
  - In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test will be applied in the same manner as if such taxpayer were a corporation or partnership
  - Aggregation rules do apply for purposes of determining whether the $25,000,000 gross receipts test is met

Business Entity Update: Interest Expense Limitation

Application to Partnerships (IRC §163(j)(4))

- Interest expense limitation is applied at the partnership level and any deduction for business interest must be taken into account in determining the nonseparately stated taxable income or loss of the partnership

- If a partner is allocated excess business interest then:
  - Adjusted basis in the partnership interest is reduced (but not below zero) by the amount of the excess business interest
  - If a partner disposes of a partnership interest, the adjusted basis in the partnership interest is increased immediately before the disposition for excess business interest not utilized
    - No deduction will be allowed to the transferor for any excess business interest resulting in a basis increase due to excess business interest
  - The excess business interest will be deemed paid by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income from such partnership
    - This is a matching principal-if Partnership A provided excess business interest in Year 1 then in the future years Partnership A must provide excess taxable income (cannot use the excess taxable income from other partnerships to utilize the disallowed interest expense)

- Rules similar to these will also apply to any S corporation and its shareholders

Pass-through Entity Updates: Pass Through Deduction

New Pass Through Deduction: IRC §199A

A new 20% deduction of qualified business income is allowed for individuals, estates and trusts that own partnerships, S corporations and sole proprietorships.

- It is referred to as a "pass-through" deduction but is available for sole-proprietors
- The tentative deduction is made for each business and totaled. There is not a grouping election for businesses.
- Although the deduction is generally based on business income, it is taken against taxable income.
- The deduction is available to even a service business if the taxable income is low enough.
- The deduction is available for both itemizers and non-itemizers.

Pass-through Entity Updates: Pass Through Deduction

Qualified Business Income means "***qualified items of income, gain, deduction, and loss***" with respect to any "***qualified trade or business***" of the taxpayer.

The term qualified trade or business does not include specified service trades or businesses ("SSTB"):

- any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees or
- Which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities

- If for the taxable year, the taxable income of a taxpayer is less than $415,000 for a MFJ filer or $207,500 for all other filers, then SSTB will be considered a qualified trade or business for purposes of IRC §199A.

Pass-through Entity Updates: Pass Through Deduction

- The term ***qualified items of income, gain, deduction, and loss*** means items of income, gain, deduction and loss to the extent such are :
  - Effectively connected with the conduct of a trade or business within the United States and
  - Included or allowed in determining taxable income

- Items of ***income, gain, deduction, and loss*** do NOT include:
  - Specified investment-related income (i.e. capital gains, dividends, interest income not related to a trade or business)
  - Amounts paid by an S corporation to the shareholder that are treated as reasonable compensation of the taxpayer
  - Guaranteed payments remitted for services
  - Amounts paid to a partner for services outside of being a partner

Pass-through Entity Updates: Pass Through Deduction

Assuming there are no qualified cooperative dividends for the taxpayer, the deduction is equal to the lesser of:

- the Combined Qualified Business Income (“CQBI”) of the taxpayer, or
- 20% of the excess of the taxpayer's taxable income over the sum of any net capital gain for the taxable year

Pass-through Entity Updates: Pass Through Deduction

Where there is no REIT or publicly traded partnership income, CQBI means with respect to any taxable year, an amount equal to:

	Taxable Income of $315,000 or less in case of joint return ($157,500 for all others)	Taxable Income between $315,000 and $415,000 for joint returns (between $157,500 and $207,500 for all others)	Taxable Income above $415,000 for joint returns(or $207,500 for all others)
Qualified Business	20% QBI	Limitation	Deduction of 20% of adjusted taxable income or QBI LIMITED to 50% of the W-2 wages or 25% of W-2 wages + 2.5% unadjusted basis of qualified property
Service Business*	20% QBI	Limitation	No Deduction

This is more like a tentative deduction because the actual deduction is limited to 20% of taxable income over capital gains.

Pass-through Entity Updates: Pass Through Deduction

Married Filing Joint	Example 1
Taxable Income	$200,000
Qualified Business Income	$250,000

As the MFJ filer has taxable income below $315,000 no phase-out or limitations will apply. In addition, a pass through deduction would be allowed even if the business is considered a specified service trades or business (SSTB).

Lesser of:	199A Calculation
CQBI of the taxpayer (which in this scenario is 20% QBI) or	$50,000 ($250,000 x 20%)
20% of the excess of the taxpayer's taxable income over the sum of any net capital gain	**$40,000 ($200,000 x 20%)**

Pass-through Entity Updates: Pass Through Deduction

Where there is no REIT or publicly traded partnership income, CQBI means with respect to any taxable year, an amount equal to:

	Taxable Income of $315,000 or less in case of joint return ($157,500 for all others)	Taxable Income between $315,000 and $415,000 for joint returns (between $157,500 and $207,500 for all others)	Taxable Income above $415,000 for joint returns(or $207,500 for all others)
Qualified Business	20% QBI	Limitation	Deduction of 20% of adjusted taxable income or QBI LIMITED to 50% of the W-2 wages or 25% of W-2 wages + 2.5% unadjusted basis of qualified property
Service Business**	20% QBI	Limitation	No Deduction

This is more like a tentative deduction because the actual deduction is limited to 20% of taxable income over capital gains.

Pass-through Entity Updates: Pass Through Deduction

- **Limitations for MFJ filers with taxable income above $415,000 or $207,500 for all others**
  - If filers taxable income is above the threshold amounts, the CBQI is limited to the lesser of:
    - 20% of the taxpayer's QBI or
    - The greater of:
      - 50% of the W-2 wages with respect to the QBI or
      - The sum of 25% of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property

- The term W-2 Wages generally includes:
  - The sum of wages ***subject to wage withholding***, elective deferrals, and deferred compensation paid by the partnership, S corporation, or sole proprietorship during the tax year
    - Therefore, reasonable compensation to an S Corporation shareholder would be included, but guaranteed payments to a partnership would be excluded
  - Wages do not include payments to an independent contractor or management fees

Pass-through Entity Updates: Pass Through Deduction

Limitations for MFJ filers with taxable income above $415,000 or $207,500 for all others

- Qualified property is defined in as any tangible property subject to depreciation under Section 167:
  - which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
  - which is used at any point in the taxable years to produce QBI, and
  - the "qualified depreciable period" has not ended before the close of the taxable year.

- The "qualified depreciable period" is the greater of 10 years or the "regular " depreciable period.

- Unadjusted basis means not reduced by accumulated depreciation.

- Please note at this income level, specified service trades or business (SSTB) will no longer be available for a deduction.

Pass-through Entity Updates: Pass Through Deduction

Married Filing Joint	Example 2
Taxable Income	$500,000
Qualified Business Income	$600,000
Wages subject to withholding	$100,000
Qualified Property (unadjusted basis)	$400,000

Lesser of:	CQBI Calculation
20% QBI or	$120,000 ($600,000 x 20%)
The greater of:	
50% of the W-2 wages	**$50,000 ($100,000 x 50%)**
25% of the W-2 wages plus 2.5% of the unadjusted basis of qualified property	$35,000 ($100,000 x 25%)+(2.5% * $400,000)

OR

20% of the excess of the taxpayer's taxable income over the sum of any net capital gain	$100,000 ($500,000 x 20%)

Business Entity Update: Domestic Production Activities Deduction

<u>Pre-reform Law</u>: Under current law, a deduction of 9% of qualified profit may be allowed for certain qualified taxpayers (ie construction companies) as a Domestic Production Activities Deduction (DPAD).

<u>TCJA Law:</u> Full removal of DPAD starting in 2018.

<u>Observation:</u> Taken by itself, this may represent a 3.5% tax rate increase to taxpayers that had previously taken DPAD.

Business Entity Update: Limitation for entertainment and certain fringe benefits

Pre-reform Law: Under current law, a deduction is only allowed for expenses relating to entertainment, amusement or recreation activities, or facilities (including membership dues with respect to such activities or facilities), if the taxpayer establishes that the item was directly related to the active conduct of the taxpayer's trade or business, in which case the taxpayer may deduct up to 50 percent of expenses relating to meals and entertainment. An item is considered directly related if it is associated with a substantial and bona fide business discussion.

A deduction is allowed for food and beverages, and facilities used in connection with food and beverages, furnished on the taxpayer's business premises primarily for employees.

TCJA Law: No deduction is allowed for entertainment, amusement, or recreation; membership dues for a club organized for business, pleasure, recreation, or other social purposes, regardless of whether the taxpayer establishes the expenses were incurred in the active conduct of their trade or business.

Food and beverage expenses incurred by a taxpayer for employee meals are 50% deductible, regardless of whether the meals are associated with business travel or are consumed on the business premise.

Effective Date: These rules shall apply to amounts incurred or paid after December 31, 2017 and the provision is permanent.

Business Entity Update: Limitation for entertainment and certain fringe benefits

Pre-reform Law: Qualified transportation fringe benefits are fully deductible by taxpayer and excludible from an employee's wages

Examples: free or subsidized parking, transit passes, transportation to work, and the bicycling subsidy to employees

TCJA Law: No deduction shall be allowed for any expense incurred for providing any transportation, or any payment or reimbursement, to an employee of the taxpayer in connection with travel between the employee's residence and place of employment

- Exception: Qualified bicycle reimbursements that are included in employee's W-2 wages (no longer excluded from income) for any amounts paid or incurred after December 31, 2017 but before January 1, 2026
- Exception: Transportation expenses that are necessary for ensuring the safety of the employee

Effective Date: These rules shall apply to amounts incurred or paid after December 31, 2017 and the provision is permanent (see qualified bicycle reimbursements for exception).

Business Entity Update: Limitation for entertainment and certain fringe benefits

Pre-reform Law: Gross income generally includes fringe benefits. The treasury regulations provide detailed rules regarding the valuation of flights on an employer provided aircraft. The value of a non-commercial flight is generally determined under the base aircraft valuation formula, SIFL. When an employer provides an aircraft to an officer, director, or owner for non-business flights, it was interpreted that the business expense was not limited to the amount of compensation reportable to its employees. (Treas. Reg. §1.61-21 and Sutherland Lumber-Southwest, Inc. v. Commissioner)

TCJA Law: Exceptions for expenses treated as compensation or otherwise includible in income were modified such that the exceptions only apply to the extent of the amount of expenses treated as compensation. As a result, no deduction is allowed with respect to expenses for an airplane used for an officer, director, or owner non-business flight to the extent the expenses exceed the amount treated as compensation for the specified individual.

Effective Date: These rules shall apply to amounts incurred or paid after December 31, 2017 and the provision is permanent.

Business Entity Update: Limitation for entertainment and certain fringe benefits

Observations:

- Employers may change how they incur expenses for meals & entertainment, transportation etc., given these changes to the tax law
  - Employers may want to consider updating company policies & procedures for such expenses

- Expenditures for meals and entertainment included in an employee's W-2 wages are still completely deductible by the taxpayer, to the extent the deduction is not greater than the amount included in the employee’s taxable income
  - Consider notifying employees if and/or when reimbursements will be included in their W-2 wages

- Explore whether it is more advantageous to lease an aircraft, as opposed to owning to avoid deadhead time of corporate jets

- Deduction for on-site athletic facilities for employees appears to have remained intact after the passing of TCJA

Business Entity Update: C Corporations

Reduction in Corporate Tax Rate

TCJA Law :

- Reduces the corporate tax rate to a flat 21% from a graduated tax rate of 35% for tax years beginning after December 31, 2017
- Repeals the deduction for income attributable to Domestic Production Activities (DPAD) to tax years beginning after December 31, 2017

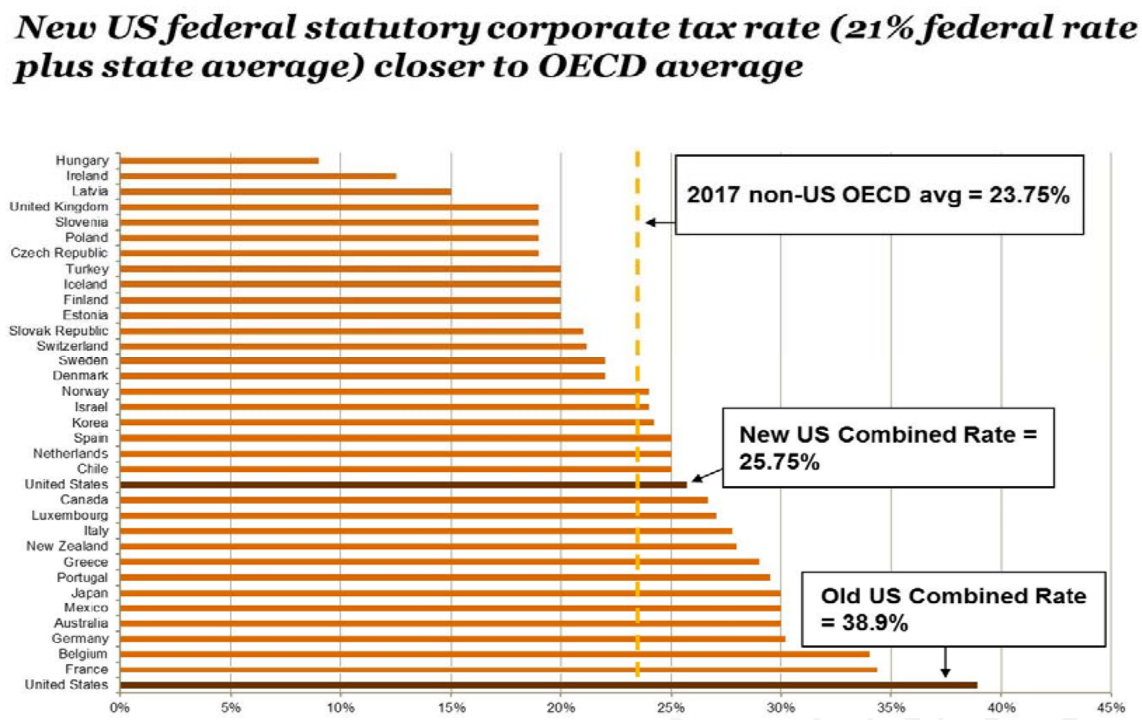
For fiscal year companies, tax is computed under IRC §15

Example: Assume the ABC Company's tax year ends June 30, 2018, and its taxable income is $10,000,000. Because of the rate change provided for in the Conference Agreement, ABC's tax is computed using an average of the rate schedule before and after January 1, 2018 (the effective date of the rate change).

To compute the tax with a "blended rate," ABC first determines the tax on the taxable income of $10,000,000 based on the pre-2018 rates. The tax of $3,500,000 is multiplied by the ratio of 184 days in ABC's 2017 tax year over 365 to arrive at $1,764,384. Next, the tax on the taxable income of $10,000,000 based on the 2018 rates is determined. The tax of $2,100,000 is multiplied by the ratio of 181 days in ABC's 2017 tax year over 365 to arrive at $1,041,370. ABC then adds $1,764,384 and $1,041,370 to determine total tax due of $2,805,754. Dividing the total tax of $2,805,754 by taxable income of $10,000,000 yields a blended statutory rate of 28.06% for a fiscal year ending on June 30, 2018.

Business Entity Update: C Corporations

Reduction in Corporate Tax Rate



Business Entity Update: C Corporations

Dividends Received Deduction

Pre-Reform Law: Corporations which receive dividends from other taxable domestic corporations are generally allowed a deduction equal to 70% of the dividends received. In the case of any dividend received from a 20%-owned corporation, the amount of the deduction is equal to 80% of the dividend received (IRC §243).

- If a dividend is received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100% of the dividend received.
- The aggregate deduction for dividends received is limited to 70% of the corporation's taxable income or 80% of the corporation's taxable income in the case of any dividend received from a 20%-owned corporation (IRC §246).
- For this purpose, certain preferred stock is not taken into account (IRC §246).

TCJA Law: Reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%. Also reduces the corresponding taxable income limitations.

Effective Date: The amendment applies to taxable years beginning after December 31, 2017.

Observation: The amendment provides similar effective tax rates on dividends received under old law (7.35% effective corporate tax rate with 65% DRD and 10.5% effective corporate tax rate with 50% DRD)

Business Entity Update: C Corporations

Repeal of AMT

Pre-Reform Law: Taxpayers must compute their income for purposes of the regular income tax, then recompute their income for purposes of the alternative minimum tax (AMT).

- Corporations with average gross receipts equal to or in excess of $7.5 million over the preceding three tax years are subject to the AMT

TCJA Law: Repeals the corporate AMT for tax years beginning after Dec. 31, 2017 but continues to allow the prior year minimum tax credit to offset the taxpayer's regular tax liability for any tax year and potentially obtain a tax refund to the extent the AMT credit carryovers exceed regular tax liability.

- For tax years after 2017 and before 2022, credit is refundable in an amount equal to 50% of the excess of the credit for the tax year over the amount of the credit allowable for the year against regular tax liability.
- For tax years after 2021, credit is 100% refundable

Observation: Taxpayers other than corporations would continue to be subject to AMT and may need to make adjustments for mine exploration and development costs, mine depletion, and the oil and gas and geothermal intangible drilling and development costs preference.

Business Entity Update: C Corporations

Net Operating Loss

Pre-Reform Law: Net operating losses may not be deducted in the year generated, but may be carried back two years and carried forward 20 years. For net operating losses arising in tax years beginning on or before December 31, 2017, an NOL deduction is allowed up to 100% of taxable income and the two-year carryback and 20 year carryforward apply.

TCJA Law: The Act limits the NOL deduction for NOLs arising in tax years ***beginning*** after Dec. 31, 2017 to 80% of taxable income. The Act also eliminates NOL carrybacks and allows unused NOLs to be carried forward indefinitely, for NOLs arising in tax years ***ending*** after Dec. 31, 2017.

Observation: For fiscal year taxpayers**,** NOLs arising in tax years that begin before December 31, 2017 and end after December 31, 2017 would not be subject to 80% limitation but could not be carried back and could be carried forward indefinitely.

INDIVIDUAL UPDATE

Adjustments to arrive at AGI: Moving Expenses

Pre-reform Law: Expenses paid or incurred during the taxable year related to moving expenses are allowed as an above the line deduction if in connection with the commencement of work by either an employee or self-employed individual at a new principal place of work (IRC §217). In addition, two additional tests must be met:

- **Distance Test:** The new job location must be a least 50 miles farther from the taxpayers old residence that was the old job location
- **Time Test:** The individual must be a full-time employee for a period of 39 weeks during the 12 month period immediately following the arrival in the new area (Separate test for self-employed individuals)

TCJA Law: Generally, the moving expense deduction is suspended for moving expenses incurred after December 31, 2017 and before January 1, 2026.

Note: The deduction would generally still be available for active duty members of the Armed Forces who move pursuant to a military order and incident to a permanent change of station.

Adjustments to arrive at AGI: Alimony Payments

<u>Pre-reform Law</u>: Alimony or separate maintenance payments are generally allowed as an above-the line deductions for the payor (IRC §215), and are included in the income of the payee (IRC §71)

- Alimony payments or separate maintenance payments are generally defined as a payment in cash if:
  - Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument
  - The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income and not allowable as a deduction
  - The payee spouse and the payor spouse are not members of the same household at the time such payment is made AND
  - There is no liability to make any such payment after the death of the payee spouse

<u>TCJA Law</u>: The Act eliminates IRC §215, the current above-the-line deduction for alimony payments and IRC §71, requiring the payee spouse to include alimony payments into income.

<u>Effective Date:</u>

- This provision is effective for any divorce or separation instrument executed after December 31, 2018
- Any divorce or separation instrument executed on or before December 31, 2018 and modified after such date if the modification expressly provides that this section applies.

This is a permanent provision.

INDIVIDUAL UPDATE: Limitations on Losses

Individual Tax Update: Business Loss Limitation

Pre-Reform Law: In order for losses to be deductible, they are first subject to a series of tests that may limit the amount of loss ultimately deductible for the year (Basis, At-Risk, & Passive).

TCJA Law: Disallows an excess business loss of a taxpayer other than a C Corporation

- Excess business loss is the aggregate of deductions against gross income or gain attributable to trades or businesses of the taxpayer beyond $250,000 (single) and $500,000 (married). Note these are amounts for 2018 and will be adjusted for inflation.
- Any excess business loss of the taxpayer for the year is disallowed for that current year and is treated as part of the net operating loss carryover to the following tax year (and subject to new TCJA law).
- Excess business loss is calculated after the application of IRC 469 (Passive Loss Limitations).
- For S-corporations and Partnerships this calculation is done at the shareholder/partner level.
- Certain limitations relating to subsidy receiving farming activities were removed

Effective Date: Effective for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026.

Caution: It appears the provision in the conference agreement could also affect a taxpayer that has previously suspended PAL that are “freed up” as a result of a disposition of the passive activity. In such a case, those losses would be treated as non-passive losses in the year of disposition. To the extent those losses exceed the threshold amount, they would not be available to the taxpayer in the year of disposition but rather would become part of the taxpayer’s NOL and carryforward to subsequent years.

Itemized Deductions: State and local tax deduction

Pre-reform Law: An individual may deduct state and local income taxes or sales tax and state and local property taxes as an itemized deduction, with no specific limitation. (IRC §164)

TCJA Law: An itemized deduction would be allowed for a combination of state and local income taxes, state and local property taxes, and sales tax but be limited to $10,000 in the aggregate ($5,000 for married taxpayers filing a separate return) IRC §164(b)(6)

- Foreign real property taxes are no longer deductible
- The $10,000 limitation is not indexed for inflation
- 2018 state and local **income** taxes paid in 2017 cannot be claimed as an itemized deduction on an individual's 2017 income tax return (Paragraph under IRC §164(b)(6)(B))
- Individuals are generally allowed to deduct state and local property taxes and state and local personal property taxes paid or accrued in carrying on a trade or business without being subject to a limitation

Effective Date: Effective for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026

Itemized Deductions: Home Mortgage Interest and HELOC

Pre-reform Law: Qualified residence interest is deductible as an itemized deduction. Qualified resident interest is defined as acquisition indebtedness (debt incurred in acquiring, constructing, or substantially improving a taxpayer's residence) or home equity indebtedness. The maximum principal balance of acquisition indebtedness is $1,000,000 and only $100,000 of principal is allowed for home equity indebtedness. A taxpayer's primary residence and a second qualifying residence can be combined when analyzing the mortgage interest deduction.

TCJA Law: An itemized deduction will be allowed for acquisition indebtedness for interest related to a principal balance on a taxpayer's primary residence and second qualifying residence not exceeding $750,000. Home equity indebtedness will no longer be available.

Note: Debt incurred before December 15, 2017 would not be affected by the reduction to $750,000 and would be "grandfathered". Any debt incurred before December 15, 2017, but refinanced later, would continue to be covered by the current law to the extent the debt does not exceed the amount refinanced.

Effective Date: Effective for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026.

Itemized Deductions: Medical Expenses

Pre-reform Law: In the 2017 tax year, unreimbursed medical expenses paid with after-tax dollars may be claimed as an itemized deduction, subject to a floor of 10% of taxpayer's AGI, regardless of the taxpayers age (IRC §213)

TCJA Law: Medical expenses may still be claimed as an itemized deduction

- The floor is reduced to 7.5% of AGI for all taxpayers for the 2017 and 2018 tax years
- The floor is increased to 10% of AGI for all taxpayers after the 2018 tax year

- Medical expenses will not be an AMT preference item for 2017 tax year and future tax years
- This is a permanent provision.

Observation: If a taxpayer's home can or should be modified to accommodate its handicapped residents (taxpayer, taxpayer's spouse, or dependents living in the taxpayer's residence), consider making such improvements in 2018 (floor is 7.5% of AGI versus 10%). Refer to Publication 502 for deductible medical expenses.

Itemized Deductions: Charitable Contributions

Pre-reform Law: Cash charitable contributions made to public charities, private operating foundations, and private distributing foundations is limited to 50% of AGI (IRC §170(b)(1)(A))

TCJA Law: The AGI limitation on cash contributions is increased from 50% to 60%

Effective Date: New AGI limitation will apply to contributions made in tax years beginning after December 31, 2017 and before January 1, 2026 (8 years).

Observation: While the AGI limitation increase seems like a great benefit, remember that other tax reform changes like lower tax rates and higher standard deductions might have an indirect impact on charitable giving.

However, high net worth individuals making charitable contributions may receive more benefit as taxpayers previously subject to AMT at 28% who may now pay tax at the 37% ordinary income tax rate.

Individual Tax Reform-Itemized Deductions

Miscellaneous Deductions subject to the 2% floor

Pre-reform Law: Individuals may claim itemized deductions for certain miscellaneous deductions to the extent the expenses exceed 2% of the taxpayer's adjusted gross income. Miscellaneous deductions include investment fees, unreimbursed employee expenses, and tax preparation fees.

TCJA Law: All miscellaneous itemized deductions that are subject to the 2% floor are suspended for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026.

Pease limitation

Pre-reform Law: The total amount of allowable itemized deductions (with the exception of medical expenses, investment interest, and casualty, theft or gambling losses) is reduced by 3% of the amount by which the taxpayer's 2017 adjusted gross income exceeds $313,800 for married filing joint taxpayers, or $261,500 for single filers.

TCJA Law: The overall limitation is suspended for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026.

Observation: As the majority of individuals will move from the itemized deduction to the standard deduction (due to the SALT limitation, miscellaneous deduction removal, and increased standard deduction), the removal of the PEASE limitation benefits high net worth individuals who are still utilizing an itemized deduction.

Individual Tax Reform: Standard Deduction and Personal Exemption

Filing Status	Basic Standard Deduction Amount (2017)
Single & Married Filing Separately	$6,350
Married Filing Jointly & Surviving Spouse	$12,700
Head of Household	$9,350

Filing Status	Basic Standard Deduction Amount (2018)*
Single & Married Filing Separately	$12,000
Married Filing Jointly & Surviving Spouse	$24,000
Head of Household	$18,000

Personal Exemption	$4,050

Personal Exemption	$0

Tax reform would retain the enhanced deduction for the blind and elderly that is available under current law. The basic standard deduction would be adjusted for inflation for tax years beginning after December 31, 2018 and will sunset December 31, 2025.

Thoughts: The significant increase in the basic standard deduction is intended to compensate the loss of personal exemptions. The proposed temporary increase in the standard deduction, in conjunction with the limitation/repeal of itemized deductions, will most likely reduce the number of taxpayers who itemize their deductions going forward.

Individual Tax Reform: Tax Rates

Pre-Reform	TCJA Law
10%	10%
15%	12%
25%	22%
28%	24%
33%	32%
35%	35%
39%	37%

Capital gains tax rates as well as the 3.8% net investment income tax and 0.9% FICA-HI tax were not changed.

Effective Date: Effective for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026

Individual Tax Reform: Tax Rates

Current Law (2018)			New Tax (2018)		
Rate	Taxable income		Rate	Taxable income	
	Single	Married		Single	Married
10%	$0 to $9,525	$1 to $19,050	10%	$0 to $9,525	$0 to $19,050
15%	$9,526 to $38,700	$19,051 to $77,400	12%	$9,526 to $38,700	$19,051 to $77,400
25%	$38,701 to $93,700	$77,401 to $156,150	22%	$38,701 to $82,500	$77,401 to $165,000
28%	$93,701 to $195,450	$156,151 to $237,950	24%	$82,501 to $157,500	$165,001 to $315,000
33%	$195,451 to $424,950	$237,951 to $424,950	32%	$157,501 to $200,000	$315,001 to $400,000
35%	$424,951 to $426,700	$424,951 to $480,050	35%	$200,001 to $500,000	$400,001 to $600,000
39.6%	$426,701 or more	$480,051 or more	37%	Over $500,000	Over $600,000

Individual Tax Reform: Tax Rates

Current Law (2018)			New Tax (2018)		
Rate	Taxable income		Rate	Taxable income	
	HOH	MFS		HOH	MFS
10%	$0 to $13,600	$0 to $9,525	10%	$0 to $13,600	$0 to $9,525
15%	$13,601 to $51,850	$9,526 to $38,700	12%	13,601 to $51,800	$9,526 to $38,700
25%	$51,851 to $133,850	$38,701 to $78,075	22%	$51,801 to $82,500	$38,701 to $82,500
28%	$133,851 to $216,700	$78,076 to $118,975	24%	$82,501 to $157,500	$82,501 to $157,500
33%	$216,701 to $424,950	$118,976 to $212,475	32%	$157,501 to $200,000	$157,501 to $200,000
35%	$424,951 to $453,350	$212,476 to $240,025	35%	$200,001 to $500,000	$200,001 to $300,000
39.6%	$453,351 or more	$240,026 or more	37%	$500,001 or more	$300,000 or more

Individual Tax Reform: Increase in AMT Exemption

- AMT was not repealed for individuals!

AMT Exemption Amount	Pre-Reform Law (2018)	TCJA Law
Married filing joint	$86,200	$109,400
Married filing separate	$43,100	$54,700
Single/Head or Household	$55,400	$70,300

- AMT exemptions are phased out once income exceeds the threshold. The thresholds were increased significantly:

AMT Threshold Amounts	Pre-Reform Law (2018)	TCJA Law
Married filing joint	$164,100	$1,000,000
Married filing separate	$82,050	$500,000
Single/Head or Household	$123,100	$500,000

- Both the increased exemptions and threshold amounts are indexed for inflation

Effective Date: Effective for tax years beginning after December 31, 2017 and scheduled to sunset for tax years ending before January 1, 2026.

Individual Tax Reform: Child Tax Credit

Pre-Reform Law: A qualifying child generally means a qualifying child of the taxpayer (as defined under IRC §152(c)), who has not attained the age of 17.

TCJA Law: Expanded definition to include, non-qualifying children can include dependents over age 17 or parents being cared for in your home.

	Pre-Reform Law	TCJA Law
Credit Amount	$1,000	$2,000*
Phase Out Amount (MFJ)	$110,000	$400,000
Phase Out Amount (any other case)	$75,000	$200,000
Partial Credit for certain other dependents (including non-qualifying child)	$0	$500 Non-refundable

*$1,400 is a refundable amount and for taxable years after 2018 will be adjusted for inflation

- No credit is allowed to a taxpayer with respect to any qualifying children unless the taxpayer includes the social security number of such child on the return.

Effective Date: Effective for all taxable years beginning after December 31, 2017 and before January 1, 2026.

Individual Tax Reform: Other

Disposition of self-created property not treated as a capital asset

- Current law treats a self-created patent, invention, model or design, or secret formula or process as a capital asset.
- The Act treats gain or loss from the disposition of a self-created patent, invention, model or design, or secret formula or process as ordinary in character.
- These amendments apply to dispositions of such property after Dec. 31, 2017 and is permanent.

Elimination of the ACA mandate

- Under current law, the individual shared responsibility provision requires individuals to be covered by a health plan that provides at least minimum essential coverage or be subject to a tax for failure to maintain the coverage.
- Under the new law, the shared responsibility payment for individuals failing to maintain minimum essential coverage has been eliminated.
- Applies to months beginning after 12/31/2018 and is a permanent provision.

ESTATE & GIFT TAX UPDATE:

Individual Tax Reform: Estate & Gift Tax – What has Changed

TCJA Law: Basic exclusion amount has been doubled from $5M to $10M (adjusted for inflation after 2011)

- The 2018 exclusion amount will be approximately $11.2M (will be slightly less due to indexing now using C-CPI)
- The increase in the basic exclusion will substantially reduce the amount of estates otherwise required to pay estate tax. With portability, a couple with a combined estate of $20M will not pay estate tax.

Pre-Reform Law Remains Unchanged for:

- Maximum tax rate is still 40%
- Portability remains. This is not automatic. An estate tax return must be filed for the first spouse to die in order to elect portability.
- Step-up in basis rules are untouched. A decedent's assets obtain a step-up in their tax cost to their fair market value at the date of death (or alternate date).
- Basis carryover for gifts. Gifts made during a donor's lifetime will continue to pass to donee with donor's tax cost.

Effective Date: New basic exclusion amount applies to estates of decedents and gifts made after December 31, 2017 and sunset effective January 1, 2026 with reversion to prior federal law

THANK YOU