STROOCK
SPECIAL BULLETIN

The Largest Tax Reform in 30 Years

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On December 20, 2017, Congress passed the bill informally known as the "Tax Cuts and Jobs Act", and on December 22, 2017, the president signed it into law as Public Law 115-97 (the "Tax Reform Act" or the "Act"). The final version of the law is based mostly on the previous Senate bill, but has many significant modifications. This **Stroock Special Bulletin** discusses certain significant provisions in the Tax Reform Act, and how they may impact individuals and businesses starting in 2018.

Individual Taxation

For individual taxpayers the Act provides numerous changes. The tax rates are generally lowered, the bracket thresholds are increased (see the chart below), and the highest marginal tax rate is lowered to 37%. The "marriage penalty" is greatly reduced by doubling all of the tax brackets (except for the highest tax bracket) for married taxpayers who file joint returns. The standard deduction is expanded to $12,000 for single individuals, and $24,000 for married taxpayers filing joint returns. The child credit is expanded to $2000 per qualifying child and begins to phase out at a higher income rate of $200,000 ($400,000 for married taxpayers filing jointly) for years 2018 through 2025.

Bracket	Single Individuals	Married Filing Jointly
10%	$0 - $9,525	$0 - $19,050
12%	$9,526 - $38,700	$19,050 - $77,400
22%	$38,701 - $82,500	$77,401 - $165,000
24%	$82,501 - $157,500	$165,001 - $315,000
32%	$157,501 - $200,000	$315,001 - $400,000
35%	$200,001 - $500,000	$400,001 - $600,000
37%	Over $500,000	Over $600,000

For individuals, the Tax Reform Act keeps the alternative minimum tax ("AMT") in place, but increases the exemption amount for years 2018 through 2025. The exemption increases to $70,300 for single taxpayers (up from $54,300 in 2017), and to $109,400 for married taxpayers filing jointly (up from $84,500 in 2017). Also, the income thresholds at which this AMT exemption begins to phase out are increased to $500,000 for single taxpayers (up from $120,700 in 2017) and $1 million for married joint filers (up from $160,900 in 2017). The AMT exemptions and phase out thresholds will adjust annually for inflation (using the chained CPI-U index).

Previously, "529 plans" allowed taxpayers to set aside money that would grow, tax-free, for their children's college education. The Tax Reform Act expands the availability of 529 plans to elementary and secondary school education. This expansion will provide a particular benefit to residents of certain states, such as New York, which provide a state income tax deduction for contributions to 529 plans.

The previous House and the Senate versions of the bills would have limited the ability for individuals to exclude gains from the sale of a primary residence. The final version of the Tax Reform Act leaves the law with respect to sales of primary residences unchanged, allowing married taxpayers filing jointly to exclude a full $500,000 (single taxpayers, $250,000) of gain from the sale of a primary residence every two years.

There are, however, some big flies in this tax cut ointment. Personal exemptions ($4050 per person in 2017) are eliminated, and the deduction for state and local income, sales, and property taxes is limited to $10,000 for taxpayers that itemize (married taxpayers that file jointly are probably limited to the same $10,000 as single individuals, although this is not entirely clear). All miscellaneous itemized and many itemized deductions are repealed. The mortgage interest deduction is limited to interest on up to $750,000 of mortgage debt incurred after December 15, 2017 (but the mortgage debt incurred on or before December 15, 2017 remains subject to the higher $1,000,000 limit, and mortgage debt refinanced after December 15, 2017 continues to be deductible to the extent that the replaced debt was deductible). The home equity interest deduction is repealed, even for pre-existing loans. The Act also does not repeal the 3.8% tax on net investment income or the 0.9% additional Medicare tax.

Almost all of the individual tax changes in the Tax Reform Act are scheduled to sunset after 2025. However, the change to inflation adjustments to a "chained CPI-U" is made permanent. Accordingly, if the provisions of the Tax Reform Act are permitted to sunset, not only would tax rates revert to pre-2018 levels, but the bracket thresholds and the exemption amounts would be significantly lower than they would have been in 2026 under the current law, resulting in a potentially very significant tax increase in 2026.

Pass-Through Business Income Taxation

Pass-Through Income Deduction

The Tax Reform Act allows individuals (and trusts and estates) to deduct 20% (a reduction from the 23% in the Senate bill) of "qualified business income" from partnerships, S corporations, and sole proprietorships (the "Pass-through deduction"). The term "qualified business income" means the net amount of items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer, determined in a manner analogous to that used to determine if income is effectively connected with the conduct of a trade or business within the United States. The deduction (which cannot exceed the taxpayer's taxable income) is computed by adding together the income and losses from all of the taxpayer's qualified businesses, and the deduction is available even to taxpayers that take a standard deduction. If there is a net loss with respect to all "qualified business income" for a particular year, such loss is carried over into the next year, to be used to reduce the pass-through income deductions in the next year.

For an individual in the top marginal tax bracket of 37%, this deduction would yield an effective federal tax rate of approximately 29.6% on qualified business income. As described below, however, there are numerous limitations on this deduction that are based on the taxpayer's income, and an individual in the top three tax bracket may not fully benefit from this deduction.

Certain Types of Income Specifically are Excluded

Certain types of income are specifically excluded from being treated as qualified business income. Capital gains or losses, dividends, interest (unless properly allocable to a trade or business), and certain other types of income are all excluded.

Additionally, (A) reasonable compensation payments, (B) any guaranteed payments for services, or (C) any payments for services to partners not acting in their capacity as partners (to the extent described in future regulations) are not included in qualified business income. One can expect that these limitations will create additional incentives to try to reclassify employees as self-employed independent contractors, to reclassify guaranteed payments as profits interests, and to minimize the reasonable compensation payments.

Limitation on Income From Specified Service Businesses

This limitation is imposed on income from certain specified service businesses, which include businesses that perform services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing and investment management, trading, or dealing with securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. Additionally, the trade or business of performing services as an employee is specifically excluded. Many, if not most, pass-through businesses will fall into this category.

The final bill specifically exempts engineering and architecture firms from this limitation, and added to the limitation businesses where the principal asset is the reputation or skill of their owners.

The Pass-through deduction for owners of these personal service businesses is phased out when the owner's taxable income (from all sources and not just from the personal service business) exceeds $157,500 for single taxpayers ($315,000 for married taxpayers who file jointly) and is completely eliminated when the taxable income reaches $207,500 for single taxpayers ($415,000 for married taxpayers who file jointly).

Limitation Based on the W-2 Wages and Capital of a Qualified Trade or Business

The second limitation is based on the W-2 wages and capital of a qualified trade or business. In general, the Pass-through deduction with respect to income from a qualified trade or business cannot exceed 50% of the W-2 wages paid with respect to that trade or business. In contrast to the previous versions of the bill, the Tax Reform Act adds a second test based on a combination of W-2 wages and capital invested, which is designed to benefit capital intensive businesses that do not pay a lot of wages (i.e., real estate investments). Under the Tax Reform Act, the limitation is the greater of (a) 50% of the W-2 wages paid with respect to the qualified trade or business, or (b) 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.

For example, a married taxpayer with income exceeding $600,000 has a 15% interest in a partnership conducting real estate business. The partnership buys a piece of commercial real estate for $10,000,000 and places it in service in 2018. The partnership has no employees in 2018, and earns $500,000 of qualified business income in 2018, with $75,000 of such income allocated to the taxpayer. The W-2 wage limitation on the taxpayer in 2018 is the allocable share (15%) of the greater of (a) 50% of W-2 wages ($0), or (b) the sum of 25% of W-2 wages ($0) plus 2.5% of the unadjusted basis of the real estate immediately after its acquisition ($250,000). The amount of the W-2 wage and capital limitation on the taxpayer's deduction is $37,500 (15% of $250,000). The allocable share of the qualified business income is $75,000, and the amount of the 20% Pass-through deduction is $15,000.

Because the limitation ($37,500) is greater than the deduction ($15,000), the full $15,000 is deductible from the income. As a result, the taxpayer will report only $60,000 of income from this partnership, which will be subject to tax at 37% rate, which results in an effective rate of 29.6%. If this business is also a "specified service business," then the entire deduction would be disallowed because the taxpayer's income exceeds the threshold of $415,000.

The definition of "qualified property" becomes very important for this purpose. Qualified property means tangible property that is subject to allowance for depreciation under Section 167, and (a) which is held by, and available for use in, the qualified trade or business at the close of the taxable year, (b) which is used at any point during the taxable year in the production of qualified business income, and (c) the depreciation period for which has not ended before the close of the taxable year. For this purpose, the depreciation period is measured from the date the taxpayer placed the property into service and is the longer of (x) 10 years, or (y) the depreciation period under Section 168 (without regard to Section 168(g)). There are a lot of unanswered questions in the legislative text, which will need to be resolved by Treasury Regulations, including: (i) application of the limitation for a short taxable year, (ii) application where the taxpayer acquires or disposes of the business during the year, (iii) application to acquisitions of property from related parties, sale-leaseback or other transactions with potential to manipulate the basis of the property, and (iv) application to property acquired in like-kind exchanges or involuntary conversions.

The limitation based on W-2 wages and capital does not apply to owners with taxable income (from all sources and not just from the business) that does not exceed $157,500 for single taxpayers ($315,000 for married taxpayers who file jointly). This limitation in phased in for taxpayers with incomes between $157,500 and $207,500 for single taxpayers (between $315,000 and $415,000 for married taxpayers who file jointly), and the limitation applies fully for taxpayers with incomes exceeding $207,500 for single taxpayers ($415,000 for married taxpayers who file jointly).

One should keep in mind that just because the limitation applies, it does not mean that the deduction will be limited, because the limitation amount may be greater than 20% of the qualified business income.

The following table summarizes the application of these limitations.

Taxpayer's Taxable Income	Specified Service Business Limitation	W-2/Capital Limitation
Income less than $157,000 ($315,000 if married)	Full deduction is allowed, subject to other limitations.	Full deduction is allowed, subject to other limitations.
Income between $157,500 and $207,500 (between $315,000 and $415,000 if married)	Partial deduction is allowed	Deduction is allowed, but is reduced to the extent it exceeds the partial W-2/Capital limitation.
Income in excess of $207,500 ($415,000 if married)	No deduction is allowed	Deduction is allowed, but is reduced to the extent it exceeds the full W-2/Capital limitation.

Preferential Treatment for Income from REITs and PTPs

The Tax Reform Act provides that qualified dividends from real estate investment trusts (REITs) and income from qualified publicly traded partnerships are eligible for the Pass-through deduction and are not subject to many of the limitation described above. This provision benefits energy and real estate ventures formed as master limited partnerships or REITs. For example, dividends from a REIT with no W-2 wages will still be eligible for the Pass-through deduction regardless of the income of the taxpayer. One can expect that this treatment may create an additional incentive to organize investments in the form of a REIT or a publicly traded partnership.

Withholding Tax on Dispositions by Foreign Partners

The Tax Reform Act effectively codifies the holding of the controversial Revenue Ruling 91-32. In that ruling the IRS stated that a foreign partner's gain from the sale or disposition of an interest in a partnership is treated as effectively connected income (usually subject to U.S. taxation) to the extent that the gain is attributable to partnership assets that would have generated effectively connected income if sold by the partnership. The Tax Reform Act adds a new provision in Section 864(c)(8) which effectively restates and codifies the position of the Revenue Ruling 91-32.

The U.S. tax on the foreign partner's disposition of partnership interest is enforced by a new withholding requirement imposed by the new Section 1446(f). The transferee of a partnership interest is now required to withhold 10% of the amount realized on the disposition if the gain on such disposition would be treated as effectively connected under the new Section 864(c). Moreover, if the transferee fails to withhold, the partnership itself is required to withhold the required withholding amount (plus applicable interest) from distributions to the transferee partner.

As a result of these provisions, transferees of partnership interests should request an affidavit of non-foreign status from the transferor. The partnership agreements should include provisions to protect the partnership and the other partners from the risk that some partners may inadvertently fail to comply with their new withholding responsibility.

Partnership Technical Termination

The Tax Reform Act repeals the “technical termination” rule which previously treated partnerships as terminating if within a 12-month period there is a sale or exchange of 50% or more of the total interest in the partnership’s capital and profits.

Treatment of Carried Interests

The Tax Reform Act does not change the general treatment of carried interests under current law, but imposes a longer three-year holding period for capital gain treatment. This provision is expected to have a lesser impact on real estate and private equity funds, than on hedge or short-term hold funds. A separate Stroock bulletin will discuss certain issues relating to carried interests after the Tax Reform Act.

Excess Business Losses

Under the Tax Reform Act, for taxable years starting after December 31, 2017 and before January 1, 2026, excess business losses (i.e., the excess of (i) aggregate deductions, over (ii) gross income and gain from trades or businesses of a taxpayer plus $250,000 for single taxpayers or $500,000 for married taxpayers who file jointly) are not deductible or available to offset non-business income, including passive activity income. Excess business losses may instead be carried forward as an NOL.

Corporate Taxation – 21% in 2018

The Tax Reform Act reduces the top marginal corporate rate from 35% to 21% for tax years beginning after December 31, 2017. The corporate AMT is repealed and the AMT credit will offset regular tax liability for any tax year. For taxable years beginning after 2017 but before 2022, the AMT credit is refundable in an amount equal to 50% of the excess of the minimum tax credit for the taxable year over the amount of credit allowed for the year against regular tax liability. In the case of a taxable year beginning in 2021 the AMT credit is refundable in an amount equal to 100%.

International Taxation

Participation Exemption and Repatriation Tax for Existing E&P

The Tax Reform Act shifts the U.S. corporate tax system closer to a territorial system by providing a participation exemption for foreign-sourced dividends paid by a foreign shareholder to a 10% U.S. shareholder which held the foreign corporation's stock for at least 365 days. This exemption, however, is unavailable for hybrid dividends (dividends that are deductible in the country of the paying company) and requires a stock holding period of at least 365 days during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.

In order to transition to the "participation exemption" system of taxation, the Tax Reform Act provides for a one-time tax on all unrepatriated and previously untaxed earnings and profits of specified foreign corporations at the rate of approximately 15.5% for cash and other liquid assets and approximately 8% for reinvested earnings. For this purpose, the term "specified foreign corporation" includes (i) any controlled foreign corporation ("CFC") that is not also a passive foreign investment company ("PFIC") and (ii) any foreign corporation with respect to which one or more domestic corporations owns, directly, indirectly, or by certain attribution rules, at least 10% of the vote. The tax on unrepatriated income may be paid in installments of 8% of the amount of tax for the first 5 years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% in the eighth year.

Foreign Tax Credits

The Tax Reform Act repeals the indirect foreign tax credit for dividends received from a foreign corporation, retains the indirect foreign tax credit for Subpart F inclusions, and sources income from the sale of inventory based on where production of the inventory occurs.

Modifications of CFC and Subpart F Provisions

Notwithstanding the general territoriality rule, the Tax Reform Act will tax a U.S. shareholder's share of a CFC's "global intangible low-taxed income," or "GILTI," at a 10.5% rate. GILTI is active income in excess of an implied return of 10% of the CFC's adjusted basis in tangible depreciable property used to generate the active income. In addition, a special deduction applies to the intangible income of a U.S. corporation derived in connection with foreign sales or foreign use (effectively a "patent box"), which reduces the effective U.S. federal corporate income tax rate on such income to approximately 13.125%. The Act also exempts a CFC from recognizing gain on the distribution of intangible property to a U.S. shareholder that is a corporation if made by the CFC before the last day of the third tax year of the CFC beginning after December 31, 2017.

The Tax Reform Act also makes a very slight, but very important change to the definition of "U.S. Shareholder" for purposes of the application of Subpart F provisions. Under the new definition, "U.S. Shareholder" is a person who owns at least 10% of the vote or value of the foreign corporation, as opposed to the previous rule that required at least 10% of the vote. Another significant change is that certain stock owned by foreign persons may now be attributed to a U.S. person for purposes of making the U.S. person a "U.S. Shareholder" for CFC purposes. Many existing corporate structures will have to be reexamined and modified in light of these changes.

Base Erosion

A new Base Erosion and Anti-Abuse Tax ("BEAT") tax imposes a "base erosion minimum tax." For purposes of this minimum tax, taxpayers are required to (i) calculate 10% (5% for tax years starting in 2018, and 12.5% for tax years starting after 2025) of their taxable income after adding back deductions for deductible payments to foreign affiliates and a portion of any net operating loss carryforwards and (ii) calculate the taxpayer's tax liability reduced by any tax credits claimed by the taxpayer (other than the R&D credit and certain provisions of the business tax credit, including 80% of the investment tax credit and production tax credit for renewable energy). If (i) is greater than (ii), the taxpayer must pay the difference as a tax. The base erosion minimum tax applies to domestic corporations that have annual gross receipts in excess of $500 million (for the three prior tax years) and that have a "base erosion percentage" of at least 3% or higher (2% for financial group member) for the taxable year.

Insurance Provisions

The Act has special rules relating to the computation of life insurance reserves for tax purposes, the apportionment of the dividends received deduction ("DRD") between life insurance companies and their policyholders, and the amortization of specified policy acquisition expenses (the so-called DAC tax). It generally follows the Senate version of the bill, with very slight numerical adjustments. Under the Act, the life reserves generally would be 92.81% of the statutory reserves (with a special rule for the interest rate used to discount them) and the difference for old contracts between the new reserve and the old reserve would be taken into income (or deducted) ratably over 8 years; the portion of the DRD allocated to life companies would be 70% of the total; and the DAC tax would be increased by lengthening the amortization period from 10 to 15 years and by increasing the amount subject to amortization from 1.75% of annuity premiums to 2.09% and from 7.7% to 9.2% in the case of life contracts (with a different rate for group life contracts). The BEAT provisions also affect reinsurance with foreign affiliates, though a Senate colloquy indicates that at least with "modco" and "funds withheld" arrangements, the minimum tax addback is computed on a net basis.

Taxation of Energy Projects

The Act does not directly change any tax credits or other incentives for the energy industry. However, it makes subtle changes that will indirectly and significantly affect the energy industry. The "base erosion minimum tax" described above may adversely affect the renewable energy industry. For taxpayers such as large multi-national banks, which historically have claimed a significant amount of the renewable energy tax credits, the inability to use tax credits to fully offset the tax liability under the base erosion minimum tax will make the tax credits significantly less valuable for such taxpayers. In effect, this could operate as a partial clawback of the tax savings associated with the investment and production tax credits, including for tax credits for already completed projects. Moreover, the ability to use these tax credits to offset tax liability under the BEAT tax sunsets after 2025.

Under the Tax Reform Act, owners of master limited partnerships ("MLPs") that are publicly traded partnerships (not treated as corporations) will benefit from reduced tax rates with respect to their share of the MLP's income because of the Pass-through deduction described above. The final version of the Act allows this deduction without regard to the W-2 wages limitation, ensuring that the passive investors in MLPs gain the full benefit of the reduced Pass-through deduction.

Tax Exempt Organizations

The final version of The Tax Reform Act does not include the previous proposals to subject state and local entities (including state pensions plans) to the rules governing Unrelated Business Taxable Income ("UBTI"), which would have subjected such entities to a tax on income derived from a trade or business that is not substantially related to such entity's tax exempt purpose.

Previously, private universities were not subject to the tax that private foundations paid on their investment income. The Tax Reform Act imposes a 1.4% excise tax on the "net investment income" of a private institution of higher education if the institution has at least 500 students more than 50% of which are located in the United States and the aggregate fair market value of the institution's assets (other than assets used directly in carrying out its educational purpose) is at least $500,000 per student.

Previously, tax-exempt organizations could net their losses from one UBTI generating trade or business against gains from another unrelated trade or business and pay tax only on the net gains. The Tax Reform Act requires a tax-exempt organization to calculate UBTI separately for each trade or business in which it has an interest and does not allow such netting. However, losses generated before January 1, 2018 will be grandfathered and may reduce gains in subsequent years.

Other Significant Business Taxation Changes

- The deduction for net business interest expense is limited to 30% of the taxable income (subject to certain adjustments).
- Corporate net operating losses carryforwards incurred after 2017 cannot be used to offset more than 80% of the taxable income for the year.
- There are new accelerated depreciation rules for businesses.
- The timing of tax income recognition for certain accrual method taxpayers is accelerated.

Conclusion

Stroock tax attorneys have been closely monitoring the development of the Tax Reform Act, which is the single most significant change to the federal tax laws since 1986. Most individuals, pass-through businesses, and corporations will need to take these changes into account, but the Tax Reform Act creates many unresolved issues that will need to be addressed by subsequent legislation or by administrative regulations. We are available to discuss any questions you may have regarding this Tax Reform Act and its effect on your tax planning.

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