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THE TAX CUTS AND JOBS ACT

A GUIDE THROUGH ITS MANY CHANGES

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INTRODUCTION

Just before Christmas, the President signed into law the biggest changes our federal tax laws have seen in 30 years. The law is indexed as P.L. 115-97 or H.R. 1, and is formally named an act *"To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."* Instead of that mouthful, its more common nickname is the Tax Cuts and Jobs Act, which we will refer to as the "Act."

HOW TO USE THIS GUIDE

The Act's changes are both deep and broad. For that reason, this guide is presented as a mere overview of some of its changes, but is accompanied in this special edition of our newsletter with several articles that go into more detail in a few of these areas, including:

1. A new 20% deduction for flow-through entities
2. Business interest – a new cap on deductibility
3. Mortgage interest, home equity loans, and refinancing
4. Changes impacting compensation and benefits
5. New taxation of multinational businesses

The law itself occupies nearly 1,100 pages of text, which Congress helpfully distilled into a tidy 500+ page summary. Now that you understand what kind of volume we are dealing with, I'll half-heartedly apologize for the length of this article to follow, and its own bloated executive summary. The use of **colored text** throughout the pages below, combined with an index, is designed to help you quickly scan to areas of interest to you, while ignoring the rest of the drivel.

An index to this article is as follows:

1. Commentary
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Observation:
It is interesting that most individual provisions in the Act expire, but most corporate provisions are permanent. The heavy cost of the Act did not allow making the entirety of the tax breaks permanent.

Some, but not all, of the new law has a limited shelf life. Most of the corporate law changes are permanent. However, unless noted otherwise, the reader can assume that the changes impacting individual income tax described below apply only to years 2018 through 2025. At that point, unless salvaged by Congress, the rules revert back to those in place in 2017. This "sunset" feature was part of what enabled the law to follow certain "reconciliation" rules, which in turn allowed it to pass with only a majority vote, rather than a 2/3 vote. (This is the case because under complex procedural rules, the budget cannot be unfavorably impacted by too much, for too long, without falling outside of the reconciliation process.

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COMMENTARY

The law was created in a very partisan way, with Republicans following a unique set of procedural rules that left Democrats powerless to meaningfully impact the results. This unfortunate polarization in Washington (fanned on both sides in the media) has led to dueling descriptions of the law either bringing about the end of the world, or representing the best thing since sliced bread or invention of the wheel. As usual, the real answer is somewhere in the middle, and it is worth distinguishing between what this law truly does vs. what you may have heard from one side or the other.

1. Many complained that the law was assembled far too hastily. Clearly, some significant and curious provisions seemed to materialize overnight, but much of the law has its roots in proposed rules that were shared over a year and a half ago in the House Blueprint and in several other position papers released between then and now.
2. We were told that individuals can begin filing returns on a postcard. This seems unlikely, unless the plan is to shrink the existing form down onto smaller paper by using a font so small it cannot be read with the naked eye. It is very reasonable, though, to speculate that more 1040-EZ or 1040-A forms will be in use instead of the full-blown 1040, or perhaps a new, simplified variant of the 1040 series could be rolled out.
3. We were told the tax Code itself would be overhauled, or at least shortened. That did not happen, as nearly the entirety of the existing Code survived. (A few deductions were removed, but only with language that temporarily suspends them, meaning those sections of the Code survive, but are temporarily dormant.) Many more sections were added, resulting in more pages in the Code than ever before. However, the U.S. taxation of international taxpayers looks very, very different than it did a few weeks ago, and that portion could be described as an overhaul.
4. We were also told that the tax rules would be simplified. That promise has a bit of truth to it, but is otherwise just plain funny. What happened instead was this: Some relatively easy returns became a little easier, but some relatively complex ones became much harder. A number of itemized deductions were removed, and the standard deduction was increased, resulting in far fewer people itemizing anymore. For a run-of-the-mill 1040, itemizing is what caused many filers to need professional help preparing their returns, and many will now be able to file their own. But that represents one end of the spectrum, and for those on the other end, tax preparation just became much harder. (Thus, there is no middle ground – much like the Congress that created this.) Any tax accountant can tell you that the rules for pass-through businesses just became obscenely complex for some upper-income filers, and those of us trying to digest the new international rules are undoubtedly responsible for a nationwide shortage of antacids.

EXECUTIVE SUMMARY

- Most of the changes are applicable as of 1/1/18, although some, like certain depreciation changes, are retroactive to specific dates in 2017.
- Most individual provisions in the Act expire after 2025, while the reduced corporate tax rates and some other provisions are permanent. Other features appear or disappear between now and then.
- The law lands its first blow squarely on the chins of anyone preparing or reviewing 2017 financial statements. Why? Because under Generally Accepted Accounting Principles ("GAAP"), the impact on deferred tax assets or liabilities must be recognized in the year of a law's enactment, and the Act was signed into law in 2017, not 2018.
- Individual tax brackets have changed, providing lower rates for nearly every income level.
- Most individual filers have always had the option to select the standard deduction or itemized deductions – and they still do. However, the standard deduction amount has nearly doubled for all filers, and many commonly-used itemized deductions have been eliminated or significantly capped. The overall phaseout of itemized deductions is removed. Medical expenses and charitable contributions remain as itemized deductions, and are given a bit more potency (assuming the filer itemizes at all). Overall, the changes will result in far fewer filers making use of itemized deductions.
- Personal exemptions have been eliminated.
- The child credit is new and improved for 2018. It doubles in amount, and more filers can use it because the income level at which the benefit is phased out is increased. A smaller credit is available for certain family members who do not qualify for the traditional credit, and a greater portion of the credit is refundable.
- The long-term capital gain rates remain unchanged, as do the net investment income tax and additional Medicare tax.
- Individual AMT still exists, but exemption amounts are increased, which will leave fewer people subject to this tax.
- C-corporations lose the existing tax brackets that top out at 35%, in favor of a flat 21%. The corporate AMT is repealed.
- 20% of pass-through income is now nontaxable. However, significant and complex rules may limit or eliminate this benefit for married filers with taxable income over $315,000, and unmarried filers with taxable income over $157,500.
- Deductions for business interest are capped if net interest exceeds 30% of business income. Entities with average gross receipts of $25 million or less are exempt. Complex definitions and computational rules accompany nearly every word in the preceding two sentences.
- Bonus depreciation and Section 179 deductions have been extended or increased.
- A one-time "toll charge" tax will be assessed on accumulated earnings of Controlled Foreign Corporations. Taxed at either 8% or 15.5%, the first payment of this sneaky new tax is due for most taxpayers by 4/15/18.
- The estate tax remains in place at current rates, but the size of the estate exempt from tax is doubled.

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INDIVIDUAL INCOME TAX

TAXES, RATES, AND CREDITS

Tax rates and brackets for all filing statuses are changed, resulting in new rates of 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Most filers will find the tax rate applicable to any given income level to be more favorable than under prior rules, and the top rate is now 2.6% lower than in the past. Rates applicable to long-term capital gains and qualified dividends remain unchanged. The brackets are indexed for inflation.

The resilient individual alternative minimum tax ("AMT") survives in spite of tough talk threatening to put it out of its misery, but changes were made that will significantly narrow its reach. The AMT exemption amounts are increased to $109,400 for married taxpayer filing joint returns, $70,300 for heads of households and single filers, and $54,700 for married taxpayers filing separately. Phaseout of the exemptions remains, but the income levels at which the phaseouts take place will increase to $1 million for married taxpayers filing jointly and half of that amount for others.

The "kiddie tax" that applies to unearned income of certain children receives new tax brackets and rates that resemble those applicable to trusts and estates. This is a departure from the past, when the child's tax was determined by the parent's brackets and impacted by siblings' incomes. Rates applicable to long-term capital gains and qualified dividends are generally unchanged.

Observation: Kiddie tax returns, other than the kiddie tax component, were often simple, but if the parent had to file an extension, the child did too. The Act's "untethering" of the kid's income from the parents' will allow more children to file returns by April 15.

Lawmakers were proud to point out that the standard deduction is increased significantly to $12,000 for individual filers, $18,000 for single filers with at least one qualifying child, and $24,000 for joint filers. They were not quick to point out, though, that personal exemptions will no longer exist after 2017.

Observation: The exemptions reduced income by more than $4,000 per person, so its loss has a disproportionate impact on large families. Its effect will be tempered, though, by an expanded child credit.

The child credit has been equal to $1,000 per child, applicable only for parents of children under the age of 17, and was phased out at certain income levels. Under the Act, the credit increases to $2,000 per child, with the age 17 limit intact. The income threshold at which the credit begins phasing out has been increased significantly to $400,000 for married taxpayers filing joint returns, and $200,000 for others. Also, an additional credit is created for other "dependents" that allows a credit of $500 for other members of the household under the care of the filer (but excluding the filer). $1,400 of each $2,000 credit may be refundable (paid out even if no tax exists), but not so with the $500 credit.

ITEMIZED DEDUCTIONS

Itemized deductions in general will be used by far fewer filers, because many types of itemized deductions were eliminated, and others were significantly capped. This, combined with the dramatic increase of the optional standard deduction, will render Schedule A as something that is primarily filed by those with very significant charitable contributions or steep medical expenses, relative to overall income.

The phase-out of overall itemized deductions (based on income) will be eliminated beginning after 2017.

Mortgage interest historically has been deductible for interest associated with up to $1,000,000 in acquisition indebtedness on a primary and secondary home, plus $100,000 of home equity indebtedness. The Act eliminates interest deductions for home equity loans, regardless of purchase date; and reduces the $1,000,000 cap to $750,000 for acquisitions made pursuant to contracts entered into on December 15, 2017 or later. Earlier versions of the Act threatened to eliminate interest related to a second home, but the final Act continues to allow it. This topic is addressed in greater detail in another article.

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Observation: Acquisition indebtedness is more commonly known as a mortgage, and describes loans in which the proceeds were used to buy, renovate, or sometimes refinance a home. A home equity loan differs in that the home merely collateralizes the loan, the proceeds of which may have been used for a much wider range of purposes, like buying a motorcycle or financing a vacation. Thus, Congress wished to limit deductions to loans that enable home ownership, rather than those that leverage home ownership for other purposes.

State and local income taxes, as well as local income,

sales, and property taxes, will continue to qualify as itemized deductions, but will be collectively capped at $10,000 for most filers, and $5,000 for married individuals filing separate returns. Certain taxes attributable to carrying on a trade or business or rental property that are deductible on Schedules C or E, respectively, remain unaffected.

Observation: Congressional negotiations over this "feature" were very contentious, because the taxpayers hit the hardest are those in high-tax states like New Jersey, New York, and California. Because their state taxes are high, their itemized deductions were too, and the limitation of this deduction will drive up their federal taxes more than those residing in more tax-friendly states.

Personal casualty losses will no longer qualify as an itemized deduction, other than those originating from federally declared disaster areas.

Charitable contributions will remain part of itemized deductions, subject to a couple changes. The 50%-of-AGI cap for cash contributions to public charities will be increased to 60%. The 5-year carryover of unused contribution deductions will survive. Contributions to colleges that are accompanied by seating rights to athletic events are eliminated.

Observation: Taxpayers whose itemized deductions generally exceed the proposed standard deductions, but not by a wide margin, should consider whether careful "bunching" of expenses would allow them to itemize every other year. A charitable contribution lends itself especially well to this strategy, because it is discretionary. For example, if cash flow allows, consider making charitable contributions that ordinarily are spread over two years instead in one year, and timing other expenditures, to the extent possible, to occur in the same year. This could result in alternating between itemized and standard deductions, with the outcome being lower taxes in each two-year period – all due to timing, without incurring any additional expense.

Medical expenses are retained as an itemized deduction, and their deductibility is expanded in a couple ways. The Act lowers the threshold of deductibility from 10% of AGI to 7.5% for taxpayers of all ages (currently 7.5% applies only to those aged 65 or older, and 10% applies to all others). This change will allow more taxpayers to benefit from the deduction. It also represents one of the few retroactive provisions in the Act, by extending this favorable change to the beginning of 2017.

The entire category of **miscellaneous itemized deductions** has been eliminated. Many taxpayers saw no tax benefit from these expenses in the past because they were deductible only to the extent they collectively exceeded 2% of AGI. Examples **include unreimbursed employee business, expenses to produce income (such as investment management fees), costs of a home office**, and many others. To add insult to injury, fees for **tax preparation services** no longer qualify as itemized deductions. (Costs properly allocable to Schedules C or E remain deductible).

EDUCATION INCENTIVES AND OTHER

Section 529 plans are widely used to help fund education costs. They do so not by providing a deduction, but by allowing the holdings of such plans to accumulate income that is free of tax. The earnings permanently escape taxation if used for qualifying education costs. Until now, those costs have been limited to college expenses. The Act expands its reach to include K-12 education costs, including religious or other private schools and public schools (but not homeschools). This expansion caps the amount spent per year on K-12 costs at $10,000 per student.

Forgiveness of student loan debt is given an expansion of its favorable treatment under the Act. The general rule for any debt forgiveness is that the amount of forgiven debt must be included in income. An exception has existed for some time that excludes student loan forgiveness under certain common circumstances – primarily loans that are forgiven in exchange for the debtor's employment. The Act expands the exclusion to exempt discharges of debt resulting from the student's death or permanent disability.

The **American Opportunity Tax Credit** would have been given one more year of eligibility under an earlier version of the Act, but that proposal did not survive the cutting room floor.

Moving expenses will no longer qualify as deductions, and the ability to exclude an employer's reimbursement of moving expenses from an employee's income is suspended. Both of these changes apply to years 2018 – 2025, but exceptions exist for members of the Armed Forces, who may continue to deduct moving expenses and exclude reimbursements from income.

Alimony payments will now be nondeductible by the payer and nontaxable to the recipient. This applies to divorce agreements executed after 2018. It also can apply to agreements that exist before 2019 if they are modified after 2018 and expressly state that this new treatment should apply. Unlike many individual tax provisions in the Act, this new treatment is not scheduled to expire.

BUSINESSES

Unlike most of the *individual* tax provisions, which expire in a few years, most (but not all) of the business tax changes discussed below are permanent.

C corporation tax rates historically have been taxed based on income brackets, and ranged from 15% to 35%. Under the Act, C-corporations will be taxed at a flat rate of 21% beginning with tax years starting after December 31, 2017.

Observation: It appears, unless guidance is provided to the contrary, that fiscal corporations whose taxable year straddles the date of the change may find that Internal Revenue Code Section 15(a) rules require use of a blended rate to accomplish the change from the old regime to the new.

The corporate alternative minimum tax ("AMT") is repealed.

Personal service corporations have been subject to a flat 35% tax, without benefit of the lower brackets. They now qualify for a flat 21% rate as well.

A new **20% deduction of flow-through income** is among the widest-reaching and most complex provisions in the new law. Effective for taxable years beginning after December 31, 2017 and before January 1, 2026, any individual taxpayer, trust, or estate that owns an equity interest in a flow-through entity ("FTE"), like a partnership, LLC or S-corporation, or is a sole proprietor engaged in a qualified trade or business, may deduct up to 20% of that taxpayer's share of the entity's business income. Rental income appears to qualify, but dividend income, capital gains, and interest income generally do not. Wages or guaranteed payments received from an FTE do not qualify for this deduction.

While some mathematical hurdles remain, filers with taxable incomes that do not exceed $315,000 for married couples, or $157,500 for others, may receive the full amount of the deduction. Those with income over these thresholds face limitations or potential limitations, depending on what type of industry they occupy:

a. Certain **personal service providers** whose taxable income exceeds the threshold face a phaseout of the benefit. The benefit is *partially* phased out when taxable income is between $315,000 and $415,000 for married couples, or $157,500 and $207,500 for others. It is *fully* phased out (no deduction exists at all) if taxable income exceeds those ranges.
b. Taxpayers **other than certain personal service providers**, but whose income exceeds the $315,000 or $157,500 threshold amounts, do not face the phaseout described above that would fully remove the benefit once income exceeds certain levels. These taxpayers instead are subject to potential reductions of the benefit that can be overcome only if (1) wages paid by the entity to its employees are high enough, or (2) the cost of fixed assets held by the entity is high enough.

*Observation: The summary above **greatly** oversimplifies the rules. I would never be so grotesque as to suggest that the cumbersome math behind this new deduction, including staged computations and phaseouts within phaseouts, could leave even a solid tax practitioner feeling like he or she was lobotomized with a melon scoop. But if someone else were to level that accusation at these rules, I wouldn't quibble with their characterization, either.*

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This new 20% deduction of flow through income is addressed in greater detail in a related article.

Business interest expense limitation: For tax years beginning after December 31, 2017, the deduction of interest is limited to 30% of a taxpayer's income. This limit applies regardless of the entity's form of business, and thus applies to C corporations, flow-through entities, and sole proprietorships. However, the limitation does not apply at all for entities with average gross receipts of $25 million or less. Also, "floor plan" interest is given a special exception that allows vehicle dealers to avoid this limitation related to loans collateralized by their vehicle inventories. Certain farms and real estate entities may elect out of this limitation, but only if they agree in exchange to use a less favorable method of tax depreciation than is otherwise available.

The 30% limit applies to *adjusted taxable income* ("ATI"). ATI is generally taxable income generated by the entity other than interest itself, gains unrelated to a trade or business, net operating losses, and the 20% deduction described above related to flow-through income. Interestingly (and significantly), ATI also excludes depreciation, amortization, and depletion deductions, but only until the year 2022.

Observation: While this new 30% limitation is one of the permanent changes in the Act, the ability to add back depreciation, amortization, and depletion ends a few years from now. This will produce a lower ATI, making it more difficult from that point forward for highly-leveraged businesses to avoid a limitation.

An entity has the ability to carry forward, for use in future years, any interest that is limited by these rules. Although the limitation is computed at the entity level, special rules allocate disallowed interest (generated in years the limit applies) or excess income (generated in years the limit does not apply) to flow-through entity owners, for their use in a very complex tracking system that preserves the deduction but will often defer its use.

This limitation, and the excruciatingly convoluted rules that accompany it, are described in greater detail in a related article.

"Bonus depreciation" and the **Section 179 expensing** election, before the Act, allowed immediate full or partial write-off of the cost of qualified property acquisitions. Bonus depreciation allowed 50% of qualifying costs to be deducted immediately, scheduled to be reduced to 40% and 30% in 2018 and 2019, respectively. Section 179 allowed (for 2017) immediate expensing of up to $510,000 in costs, with a phaseout that begins at costs exceeding $2,030,000.

Bonus depreciation, under the Act, is retained through

2026, and provides one of the few retroactive components of the Act by allowing deduction of 100% of qualifying costs for property placed in service after September 27, 2017 (it otherwise would have been 50%, as noted above). The deduction does not remain at 100% through 2026, but is allowed according to the following schedule, based on date placed in service:

9/28/17-12/31/22	100%
1/1/23-12/31/23	80%
1/1/24-12/31/24	60%
1/1/25-12/31/25	40%
1/1/26-12/31/26	20%
1/1/27 and forward	0% (expired)

Significantly, the Act removes the requirement that the taxpayer's use represents the initial use of the property. Both new and used property qualify for the deduction now, as long as the property is "new" to the taxpayer, and was not previously owned by a related party.

The **Section 179 deduction** is greatly expanded by allowing expensing of $1,000,000, with a phaseout that begins at costs exceeding $2,500,000. Interior nonresidential real property improvements now qualify, as do HVAC, security systems, and fire alarm and protection systems. Property used to furnish lodging facilities now qualifies. These increases are permanent, indexed for inflation, and apply beginning with property placed in service in tax years beginning after December 31, 2017.

Net operating losses ("NOLs") historically could be carried back 2 years and forward 20, potentially offsetting all income in those years. The Act eliminates the carryback, but removes the 20-year cap by allowing indefinite carryforward. Also, NOLs can no longer offset all income in the year to which the loss is carried; only 80% of any year's income may be reduced by an NOL. (Certain insurance companies and farms can continue to utilize a carryback.) These changes are permanent, and apply to losses produced in tax years ending after December 31, 2017.

Observation: Corporate AMT is being repealed under the Act, but the new NOL rules inherit a similar percentage-of-income limitation. This move to partial use of NOLs is undoubtedly part of Congress' goal to cause U.S. business taxation to be consistent with that of other countries.

Excess business losses is a new concept that applies only to non-corporate taxpayers, and presents an entirely new limitation. Under prior law, business income of non-corporate taxpayers (such as S corporation or partnership owners) could create a loss that was deductible against other income, potentially fully offsetting items such as wages or investment income. To be deductible, the taxpayer had to have sufficient basis in the investment, and overcome any passive loss limitations.

Under the new rules, the basis and passive loss hurdles remain intact, and new limitations are added for losses that survive those gauntlets. "Excess business losses" are net business losses that exceed $500,000 for married taxpayers filing joint returns, and $250,000 for other filers. The $500,000 or $250,000 amounts, respectively, remain deductible in the year the loss was generated, but the excess business losses are converted to NOLs and carried forward to future years, where (pursuant to other changes in the law discussed earlier) they can offset up to 80% of that future year's income. Business income and losses are aggregated and the limitation is computed at the owner's level for flow-through income.

Example: *Ned, a single filer, owns shares in two S corporations. His share of the first one's net losses is $200,000, and his share of the second one's losses is another $200,000. He has sufficient basis to deduct the losses and no passive loss limitations apply. He also earned income of $500,000 from other sources (wages, interest income, capital gains, etc.) in the same year the two business losses were generated. Under prior rules, he could deduct the $400,000 losses against his $500,000 income, reducing his net income to $100,000. Under the new law, only $250,000 of his $400,000 combined loss is deductible in the year incurred, reducing his net income to $250,000. The remaining $150,000 loss ($400,000 - $250,000) represents his "excess business loss" that must be carried forward to the following year as an NOL, where it can offset up to 80% of that second year's income.*

Observation: This law change, combined with the new inability to carry back net operating losses, presents an entirely new landscape for trade or business owners who struggle through a tough year. Under old rules, three possibilities, in order, could be used to quickly mop up a large loss: It could (1) fully offset current income, (2) be carried back to fully offset prior income, and then (3) be carried forward to fully offset future income. Now, losses must be used more sparingly: (1) current year losses are capped at $250,000 or $500,000, (2) carrybacks have been zapped out of existence (thanks, Congress, for adding insult to injury!), and (3) use of carryforwards is limited, even when sufficient income exists. The losses are not lost, but their use may be deferred.

Like-kind exchanges are now limited to include only real property. Gain can be deferred under IRC Sec. 1031 when property is exchanged if property of a "like kind" is received instead of cash. This rule historically has applied to both real and personal property under the right conditions, but the Act removes the ability to apply this favorable treatment to personal property. The rule change generally applies to exchanges made after December 31, 2017, but an exchange that otherwise qualifies and was partially complete by that date (either the receipt of one property or the disposal of another was accomplished by then) may qualify under the old rules.

Observation: The real estate industry dodged a bullet, as earlier proposals called for complete elimination of like-kind exchange treatment, including for real estate, which makes up the lion's share of Sec. 1031 deals.

Section 199 "DPAD" deduction: There is no sugar-coating this; the Sec. 199 Domestic Production Activities Deduction disappears after 2017.

Observation: The new 20% flow-through income deduction clearly had its roots in this now-defunct deduction. It shares a number of similarities, and can be viewed as sort of a souped-up DPAD deduction, in that the types of industries eligible for the "replacement" deduction are much broader.

Meals & entertainment deductions undergo a number of changes, and not all at once. Entertainment costs that historically have been 50% deductible are no longer deductible after 2017. Meals that are provided on employer premises to employees have been fully or partially

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deductible historically, and will remain so until 2026, when they become non-deductible. Other meals that historically have been 50% deductible will remain unchanged. This, and other compensation and benefits changes resulting from the *Tax Cuts and Jobs Act*, are discussed in a related article.

Observation: Taxpayers that in the past have recorded meals and entertainment costs that were subject to the 50% limitation in the same income statement account should recognize that entertainment costs need their own category beginning with 1/1/18 entries. Otherwise, untangling the entries retroactively could be tedious a year from now when 2018 tax returns are being prepared.

Qualified transportation fringe benefits historically were deductible by employers and nontaxable to employees. Beginning in 2018, such costs are nondeductible by employers, but remain tax-free to employees. Examples include parking and commuter benefits.

Technical terminations of partnerships become a thing of the past. Under prior law, if ownership of 50% of a partnership or LLC changed hands in a 12-month period, the partnership or LLC was deemed to be terminated, with a new entity being "formed" as of that date. Certain elections were made at that time, which in turn unleashed specially-allocated deductions benefiting the new owner(s). Under the Act, the partnership will be treated as continuing, instead of terminating, and elections will not be needed or allowed.

Carried interest is a phrase that is incredibly misunderstood, as pointed out in another BNN article that explains what carried interest is, and more importantly, what it isn't. Its favorable treatment was lightly curtailed with the Act, by extending the holding period of ownership qualifying for the long-term gain rate from one year to three.

The cash method of accounting is not allowed for some taxpayers. The accrual method of accounting was generally required under prior law for most taxpayers whose average gross receipts exceeded $5,000,000. Below that, the cash method could be used. The Act increases that threshold to $25,000,000 after 2017, indexed for inflation.

An inventory method of accounting generally was forced upon any entity whose average receipts exceeded $1,000,000 under prior law. The Act increases that threshold to $25,000,000 after 2017.

Sec. 263A "UNICAP" rules caused direct and indirect costs under prior law to be included in inventory costs rather than expensed. This applied to certain entities with $10,000,000 or more in average receipts under prior law, but the threshold is increased to $25,000,000 after 2017 under the new law.

Long-term contract accounting rules under prior law required use of the percentage of completion method, except for businesses with average receipts of $10,000,000 or less. The Act increases this threshold to $25,000,000 after 2017.

IMPACT ON FINANCIAL STATEMENTS

An immediate financial statement effect precedes the Act's impact on tax returns. A key element of the tax reform is a reduced tax rate for C Corporations that takes effect in 2018. For corporations that publish financial statements in accordance with generally accepted accounting principles, this reduced tax rate should be used to measure a calendar year-end corporation's deferred tax assets and liabilities on temporary differences and operating loss carryforwards as of December 31, 2017. **Any changes in the deferred tax assets and liabilities resulting from the reduced corporate tax rate in 2018 should be reflected in the corporation's income tax expense for 2017**, regardless of when the timing difference is scheduled to reverse and regardless of whether the temporary difference is part of accumulated other comprehensive income. There are a number of other parts of the tax bill that could affect the income tax expense reported in your financial statements as well. We recommend careful coordination of tax and book reporting.

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ESTATE AND GIFT TAX

Although prior plans consistently called for repeal of the estate tax, the final version of the Act softens this approach significantly. The basic exclusion amount for both gift and estate tax purposes will be roughly doubled to $10,000,000 (indexed for inflation) beginning in 2018. However, this increased exclusion expires after 2025.

INTERNATIONAL

No areas of the Act approach the magnitude of changes more than those that impact foreign corporations doing business in the U.S., and entities and individuals holding investments in foreign entities. The changes are very broad and incredibly complex, and roll out a new regime that is somewhat of a hybrid between the "worldwide" income taxation scheme historically used in the U.S. and the "territorial" regime used by most of the rest of the globe.

This is covered in a separate article in more detail. A few characteristics of the new rules are as follows:

A new 8% or 15.5% "toll charge" may apply to owners of foreign corporations. This completely new tax is assessed on the "deemed repatriation" of accumulated foreign earnings of Controlled Foreign Corporations ("CFCs"). Entity owners that have been used to the ability to defer taxation until actual dividends are paid from their CFCs are in for a rude awakening, as the first round of this tax is due for calendar year filers by April 15, 2018 – whether or not any money is truly distributed. Also, the tax is based on an accumulated earnings amount that may involve tedious, cumulative computations that reach back to the date of an entity's inception.

In addition to the one-time tax, an annual tax may apply to companies that earn a high rate of return on overseas investments in intangible property. A new deduction is provided for U.S. companies that sell products or license services overseas. Both of these provisions are described as part of the Act's **"anti-base erosion rules."**

The changes are intended to encourage U.S. companies

to keep operations in the U.S., and bring money earned overseas back to the U.S. It does not ban "corporate inversions" (a practice that has been in the crosshairs of Congress for some time, and is explained in another BNN article), but the Act removes nearly all of the incentives for a company to use them.

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OTHER THOUGHTS AND CONCLUSIONS

The Act adds subjectivity and tremendous complexity to parts of the Internal Revenue Code. This is especially true for sections that impact business entities. However, it offers more simplicity to many 1040s by eliminating many itemized and other deductions in favor of an increased standard deduction. In its current form, it likely will allow more people to prepare their own 1040s. On the other hand, business tax returns and the 1040s filed by many of their owners will become more complex and time-consuming to prepare than ever before – significantly more so for those involved with multinational operations or flow-through entities.

We now await what is undoubtedly going to be a flurry of Treasury Regulations, which are IRS-penned, legally-binding supplements to the Congressionally-penned Internal Revenue Code. Hopefully that will provide some clarity to a number of ambiguous sections in the new law.

Finally, please note that it is unclear what these changes will do to state taxation. Some states base their rules on the federal laws in a manner that automatically updates states' laws for federal changes. Others reference federal law "as of" a certain date. Others use their own systems, but with careful attention to federal rules. They have a lot to work with, and it could be some time before we hear how they will react to these broad-reaching changes.

For those interested, please take a look at the articles that supplement this one. We hope they, and this, will help you gain a better understanding of the *Tax Cuts and Jobs Act*, and how it may impact you.

If you have any questions regarding the *Tax Cuts and Jobs Act*, please contact your BNN tax advisor at 1.800.244.7444.

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