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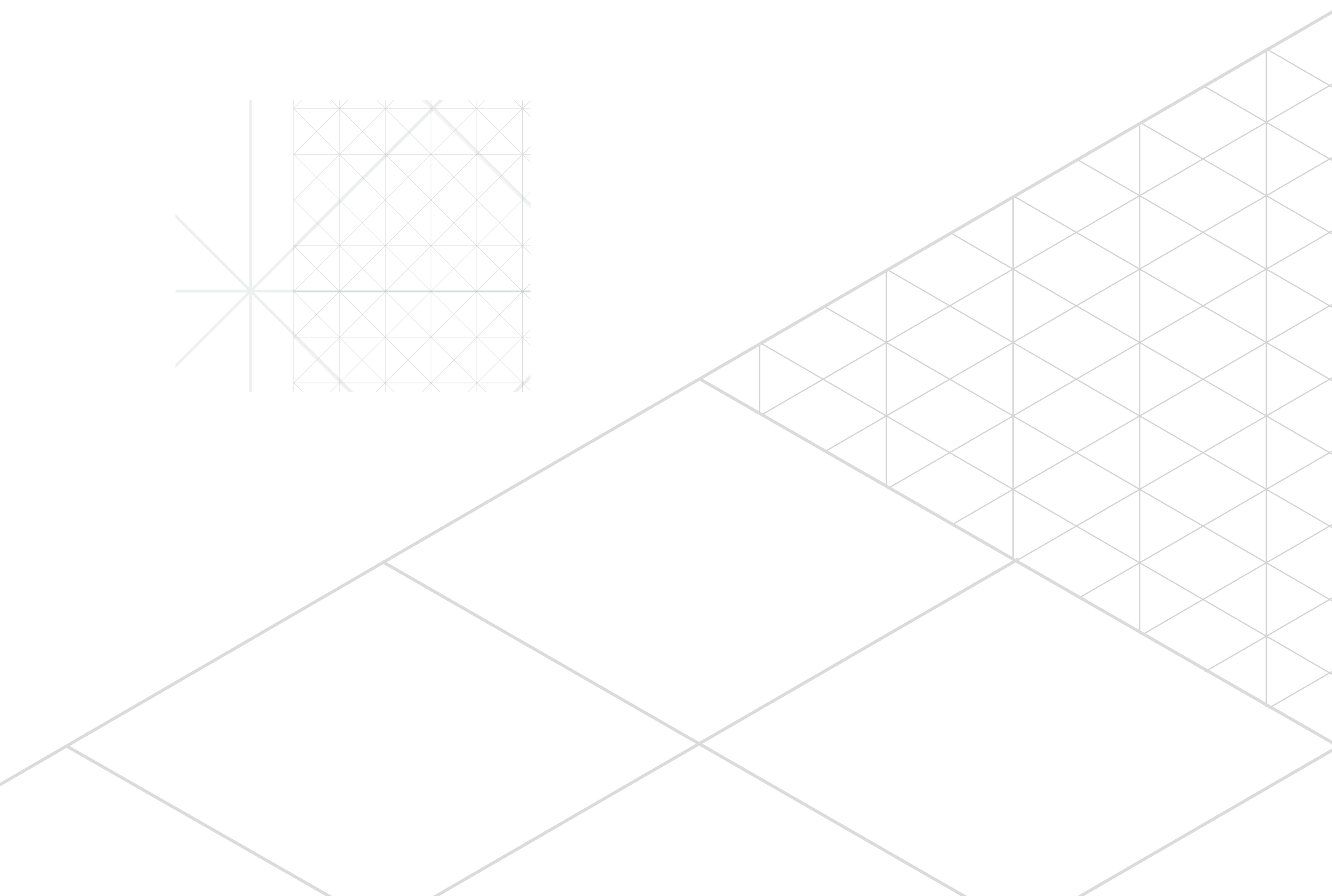
Industry-Specific Impact of Tax Reform



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Executive Summary

The sweeping changes under the 2017 tax act (Pub. L. No. 115-97) contain elements that will likely spur profits and growth across many industries, while also creating compliance challenges and traps for the unwary.

One thing is certain: The tax treatment of business and high-wealth individuals under the act has only increased in complexity, and taxpayers are likely to face trade-offs as they navigate the new provisions. Every business sector has reason to cheer a lower corporate tax rate and repeal of the corporate alternative minimum tax. Changes that will benefit most business sectors include:

- 21% corporate tax rate;
- Repeal of the corporate alternative minimum tax;
- 20% deduction for qualified pass-through income;
- 100% bonus depreciation; and
- Enhanced expensing.

But many must also contend with the repeal of popular write-offs, such as the domestic production activity deduction and a scaled-back version of other deductions, such as the deduction for corporate interest payments.

Changes that will likely pose challenges to most businesses include:

- Repeal of the domestic production deduction;
- Reduced deduction for net operating losses; and
- Disallowance of like-kind exchanges for transactions involving property other than real estate.

Basic assumptions, such as choice of entity, will need to be re-evaluated. Multinational corporations must employ a new calculus in weighing the relative tax costs of operating in the U.S. as compared to operating in other countries. Fewer high net worth individuals will be subject to the federal estate and gift tax, but the reprieve will only last through 2025.

To help businesses understand core concepts in preparation for tax planning, Bloomberg Tax analyzed the impact of the act on several major U.S. industries including those with a large multinational presence and those serving high-wealth individuals. For each industry, we addressed key considerations, identifying wins and losses, and highlighted planning points to call attention to potential hidden effects of the act's provisions.

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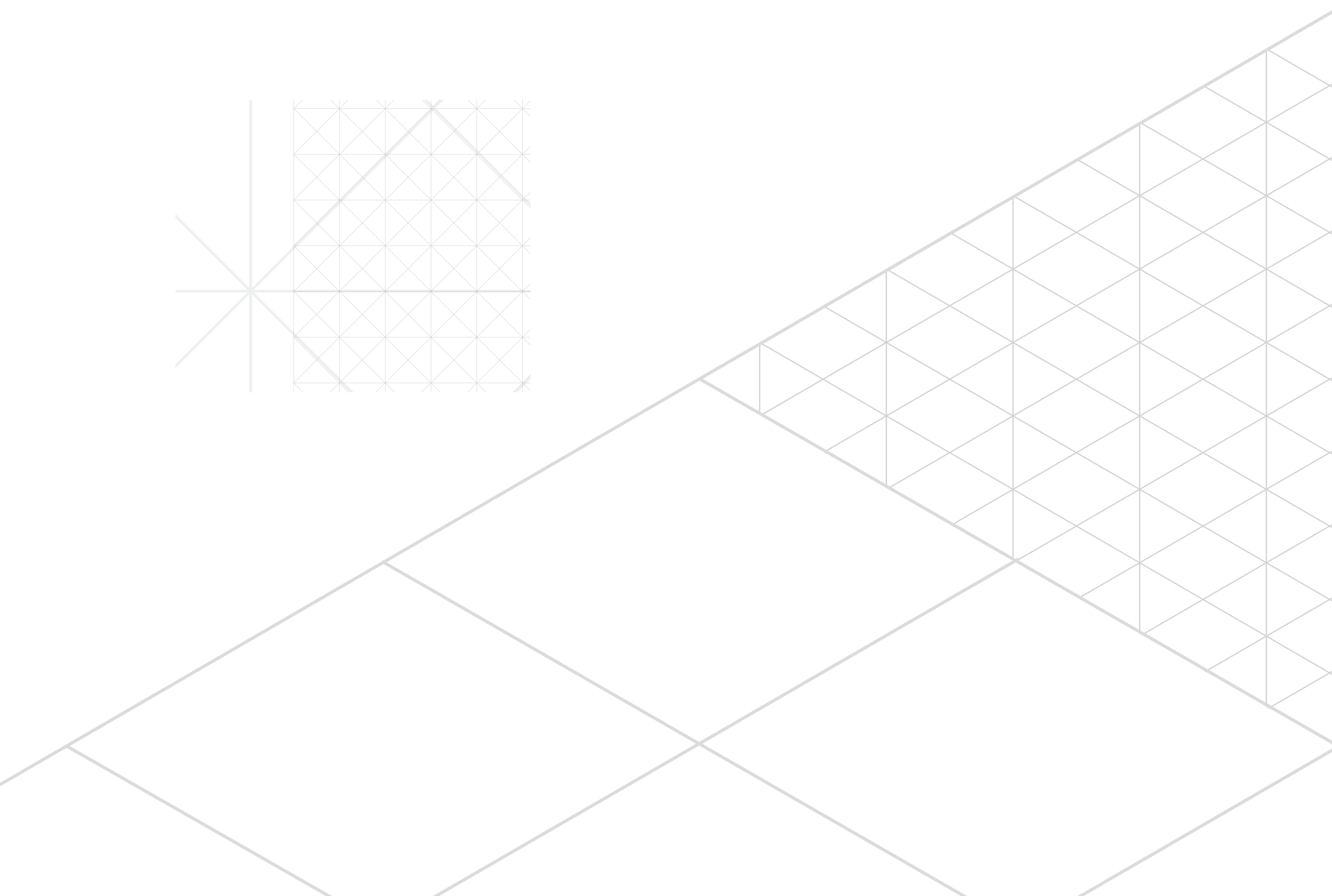
Banking and Financial Institutions



Executive Summary

Banks, with their current high effective tax rates, may be among the bigger winners in tax reform due to the reduced corporate tax rate in the 2017 tax act (Pub. L. No. 115-97).

"We estimate banks could see a 12% drop in their effective tax rates while earnings accrete 18% assuming no changes to competition" or other factors, Kevin Barker, a senior research analyst at investment banking firm Piper Jaffray & Co., stated about the impact of the House and Senate tax plans.

On the negative side of the ledger, a number of key deductions such as those for net operating losses and for FDIC premiums will be limited or unavailable for certain institutions. "Even the reduction in tax rates, oddly, can be seen as something of a negative for banks since many banks have net deferred tax assets," said Robert Willens, president of tax and consulting firm Robert Willens LLC in New York. A reduction in the corporate tax rate necessitates a write–down of deferred tax assets (DTA) – benefits included on a company's balance sheet, such as net operating loss carryforwards, foreign tax credits, and other deferred tax deductions that it expects to use to cut its future tax bills.

Key Considerations

- Reduced corporate tax rate.
- Repeal or limitation of key deductions.
- Deduction, special tax on overseas profits.
- Base erosion.

Reduced Corporate Tax Rate

The corporate income tax rate reduction will boost the bottom line of banks and financial companies. However it will also result in write–downs of DTAs in the year of enactment.

Banks and financial companies have been closely following the development and timing of the enactment of the cut in the corporate tax rate because it will immediately affect the remeasurement of DTAs, thereby impacting the financial statement earnings. At least one bank has recently provided an estimate of the noncash write–down of DTAs and the reduction in regulatory capital.

Planning Point: Deferred taxes carried by banks – partly a legacy of losses in the 2008–2009 financial crisis – will have to be adjusted immediately after any change in the corporate tax rate is enacted, Michael Gullette, the American Bankers Association's vice president for accounting and financial management, told Bloomberg Tax. Enactment of the act before December 31, 2017, required the effects of changes in tax rates and other provisions on DTAs to be recognized in the 4th quarter of 2017. This presented a significant challenge to model these changes, given the time of year and the lack of detailed guidance.

Repeal or Limitations of Key Deductions

Several provisions could be less positive for banks. A number of key deductions for banks are limited or repealed under the act.

FDIC

The act prevents banks with more than $50 billion in assets from deducting FDIC premium assessments as business expenses. Banks with $10 billion to $50 billion in assets will have their FDIC assessments prorated depending on their size.

Planning Point: "The large money center banks, which tend to have consolidated assets well in excess of $50 billion, will not be able to deduct any portion of the payment," Willens said. Frederick Cannon, director of research at investment banking firm Keefe, Burette & Woods Inc., called this change a "relatively minor offset" to the benefits banks would reap from tax reform.

NOL

The elimination of NOL carrybacks along with the reduced deduction of NOL carryforwards to 80% of current–year taxable income will have a significant effect on banks with NOLs. This provision may further impair a bank with net operating losses to avoid a write-down of its DTA balance.

Net Interest Expense

Effective for tax years beginning after 2017, the act limits the deduction for net interest expense incurred by a business in excess of 30% of the business's adjusted taxable income. (For more details, see *Limitation on Business Interest Expense Deduction* in Bookmarks.) Businesses with average annual gross receipts of $25 million or less are exempt from the limit.

Planning Point: These provisions will likely impact a bank's clients and customers in addition to the bank itself. Structuring and planning analysis of leasing versus purchase arrangements may need to be considered.

Compensation Deduction

The $1 million yearly limit on the deduction for compensation with respect to a covered employee of a publicly traded corporation is modified. The exceptions for commissions and performance–based compensation are repealed. "Covered employees" include the CEO, CFO, and the three highest paid employees. Once an employee qualifies as a covered employee, the deduction limitation applies to that person so long as the corporation pays remuneration to that person (or to any beneficiaries). The deduction limitation is applicable to tax years beginning after December 31, 2017.

Moving Expenses

The act eliminates the deduction for moving expenses for individuals. Large banks and financial institutions are known to relocate employees for business reasons. Employers reimburse their employees for moving expenses and gross–up these individuals for any taxes incurred to the extent of nondeductible moving expenses.

Planning Point: This provision would significantly increase a bank's cost of relocating its employees.

Deduction, Special Tax on Overseas Profits

The act provisions aimed at encouraging companies to "repatriate" offshore earnings to the U.S. could pose problems for multinational banks subject to regulatory capital requirements in other jurisdictions.

By allowing U.S. multinationals to deduct foreign dividends going forward, companies will have to bring back earnings already offshore and pay a "deemed repatriation" tax.

The act provides a split rate, for different kinds of assets. One rate is for liquid assets like cash and cash equivalents (15.5%) and the other is for noncash assets (8%).

Base Erosion

The act imposes a new 10% minimum tax base erosion anti–abuse tax. Banks and securities dealers will be subject to an increased tax rate of 11% and 13.5% after 2025. Tax equal to the base erosion minimum tax amount is imposed on base erosion payments paid or accrued by a taxpayer to a foreign related person. Under the act a qualified derivative payment is not treated as a base erosion payment. Derivatives include any option, forward contract, futures contract, short position, swap, or similar contract.

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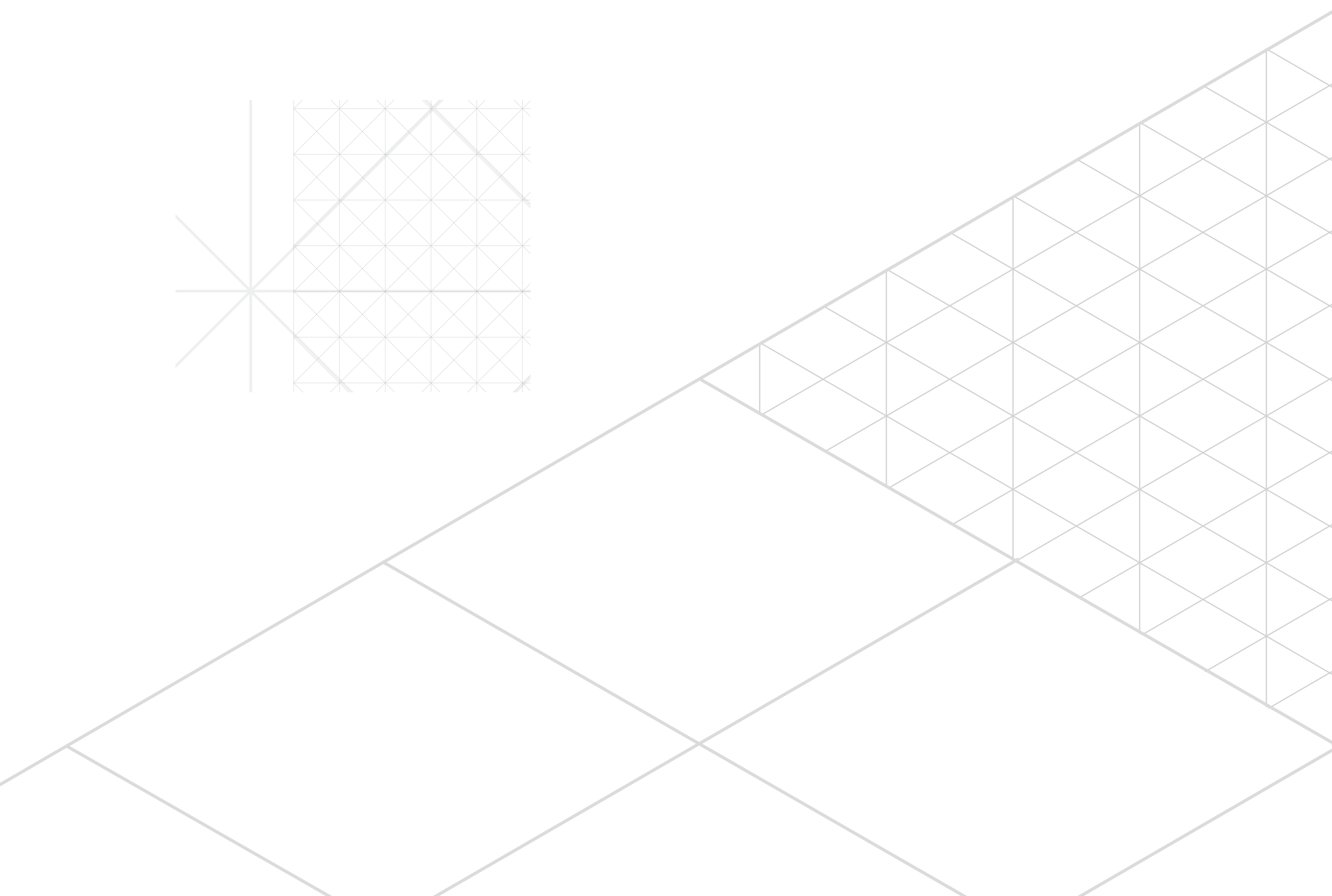
Energy and Mining



Executive Summary

Initially hard hit by both the House and Senate versions of tax reform, the energy and mining industry faces a more moderate result.

The 2017 tax act (Pub. L. No. 115-97) still, however, threatens a critical but esoteric source of wind and solar finance: tax equity. In tax–equity deals, renewable–energy developers sell portions of their projects' tax credits to corporations – often banks and some insurance companies – that can apply the credits to their own tax bills. That market is expected to total $12 billion this year, according to Bloomberg New Energy Finance. Additionally, many tax–equity investors are multinational companies. The act includes a provision that imposes a minimum tax on these companies' foreign transactions. If they have to pay a minimum tax instead of the regular income tax, they may not be able to use the credits acquired through tax-equity deals.

"It literally will grind our industry to a halt," said John Marciano, co–head of project finance at Akin Gump Strauss Hauer & Feld LLP. "Developers would be fighting for the few remaining investors."

Environmental groups have questioned the revenue figures and industry interest in drilling in Alaska's Arctic National Wildlife Refuge, a portion of which has been opened to oil and natural gas drilling under the act. Moreover, not every fossil–fuel producer is pleased with the legislation.

Cause for at least some optimism, the House bill had proposed modifications and cuts to credits that the energy and mining industry benefits from immensely. Those provisions did not make it into the final legislation, though, and so while the outlook is not great, it could have been far worse.

Key Considerations

Here are the top issues for the energy and mining industry:

- Reduced corporate tax rate.
- Bonus depreciation.
- Section 179 expensing.
- Current year inclusion of global intangible low–taxed income by United States shareholders.
- Non–tax–related provisions.

Reduced Corporate Tax Rate

Analysts initially warned that lowering corporate tax rates – a key component of the act – may discourage tax–equity deals because companies with lower tax bills will have less interest in buying tax credits from renewable–energy developers. Nevertheless, lowering the corporate tax rate to 21% will still help spur investment and create jobs, according to the American Petroleum Institute, the industry's main lobbying group.

Planning Point: Regular cash–basis developers might consider deferring revenue to the 2018 tax year to take advantage of the reduced corporate tax rate.

Bonus Depreciation

The act permits taxpayers to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for property with longer production periods). It also incrementally phases out the full expensing over a five–year period, beginning in 2023 (2024 for property with longer production periods). The act also removes the original use requirement for qualified property, allowing the 100% expensing for used machinery and equipment.

Planning Point: The Act only permits 100% bonus depreciation temporarily, so taxpayers should consider acquiring new machinery and equipment sooner rather than later.

Section 179 Expensing

The act increases the expensing limitation and phaseout amount for smaller companies and expands the types of property subject to the election. Businesses will be able to expense up to $1 million, subject to a phaseout of $2 million (both amounts indexed for inflation). The act also extends section 179 property to income qualified improvement property as well as many improvements (roofs, heating, ventilation, and air–conditioning property, fire protection and alarm systems, and security systems) to non–residential real property.

Current Year Inclusion of Global Intangible Low–Taxed Income by United States Shareholders

Before the act, foreign income earned by a foreign subsidiary of a U.S. corporation generally was not subject to U.S. tax until it was distributed to the U.S. parent corporation as a dividend. Such dividends, minus credits for foreign income taxes paid, were considered taxable income for the U.S. corporation. The main exception to deferral of U.S. tax was what is commonly called Subpart F income (certain foreign insurance income, certain passive investment income, and specified kinds of business income, as well as certain investments in U.S. property). A U.S. parent was generally subject to current U.S. tax on Subpart F income earned by its foreign subsidiaries, less any foreign income taxes paid on such income.

The act additionally imposes a minimum base erosion anti-abuse tax (BEAT) for certain taxpayers -- the calculation of which is based on the excess of 10% of the modified taxable income over the amount of regular tax liability, which is reduced by certain credits. The 10% rate is 5% for tax year beginning in calendar year 2018, and 12.5% for tax years beginning after December 31, 2025.

The act requires a U.S. shareholder of a controlled foreign corporation to currently include in income its global intangible low–taxed income in a manner similar to how it currently includes Subpart F income. This component is getting a significant amount of attention because it may discourage interest in tax–equity deals. Companies with lower regular tax bills or income subject only to the new minimum tax might have less interest in buying tax credits from renewable–energy developers. The provision was something quite unexpected.

Non–Tax–Related Provisions

The conference committee included some potentially controversial, non–tax provisions in the act. The act opens a portion of Alaska's Arctic National Wildlife Refuge to oil and natural gas drilling - a move that lawmakers estimate could yield $1 billion in revenue over the next decade. The act might also increase sales from the Strategic Petroleum Reserve to help boost short–term revenues.

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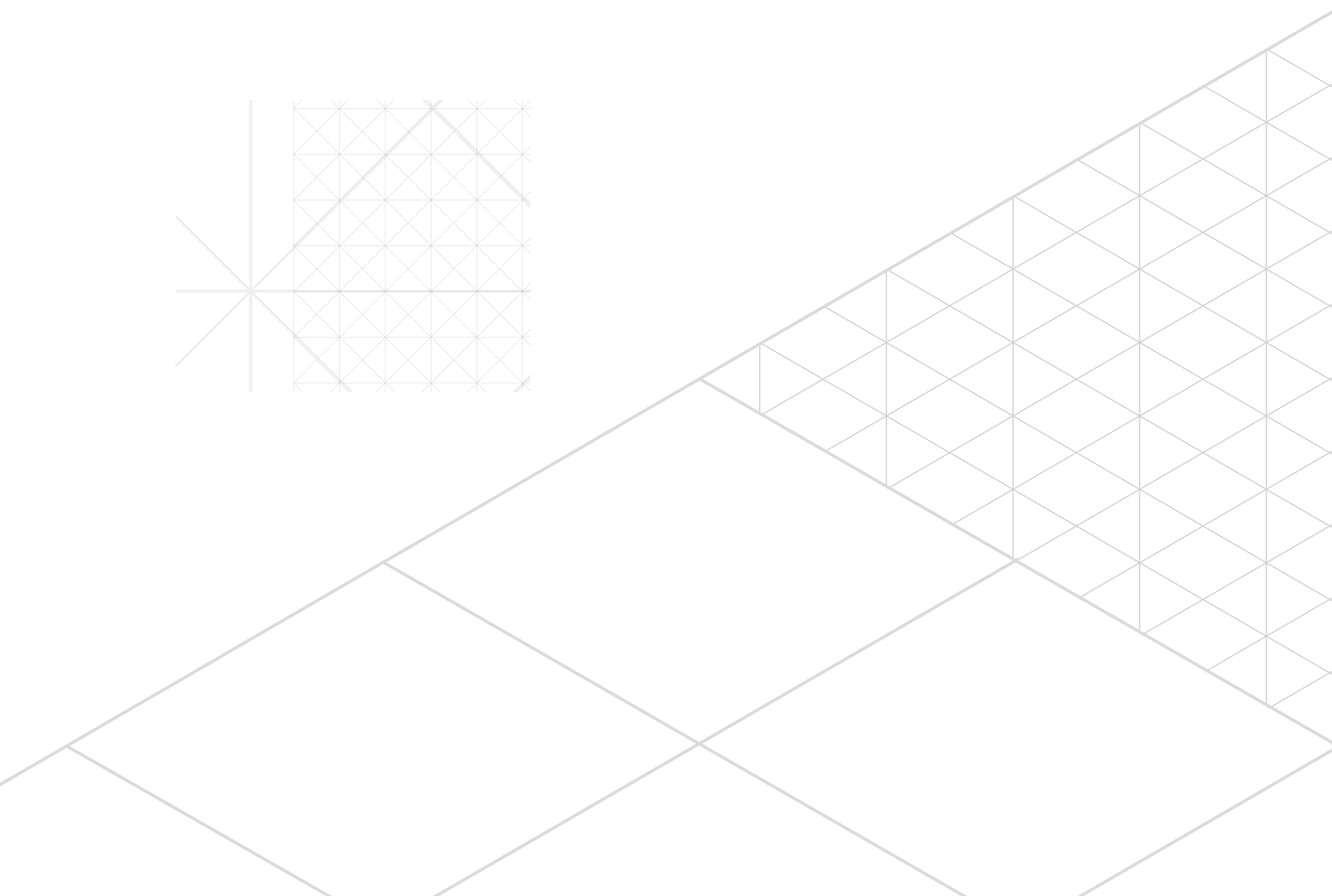
Health Insurance Sector



Executive Summary

The main driver of change for the health insurance industry in the 2017 tax act (Pub. L. No. 115-97) -- apart from changes to taxation that affect most large corporations -- is the effective removal of a linchpin to the Affordable Care Act (ACA).

The ACA individual mandate requires most individuals to have health insurance or pay a penalty, which consists of a percentage of income or a flat fee. The mandate was intended to help offset the risks and costs to insurance companies that are required to cover a larger pool of people and a wider range of benefits. The idea was to bring young, healthy people into the individual insurance market, in order to spread the insurance risk and thereby lower premiums.

The act does not repeal the tax Code section that includes the individual mandate. Instead, the act drops the penalty amount to $0.

The act has another provision that indirectly affects the health insurance sector – namely, a reduction in the medical expense deduction floor to 7.5% of adjusted gross income (from 10%) and elimination of the minimum tax preference.

Key Considerations

- Affordable Care Act, elimination of individual mandate.
- Reduction of medical expense deduction floor.

Affordable Care Act, Elimination of Individual Mandate

Even though the individual mandate technically survives under the act , the number of uninsured people will increase by 4 million in 2019 and 13 million in 2027 as a result of the change, according to the analysis from the Joint Committee on Taxation and the Congressional Budget Office (CBO). Average premiums would increase by roughly 10%, according to the CBO.

So, the prediction is that millions of health insurance customers will stop buying health insurance. This effect would occur mainly because, without the penalty and due to higher premiums, healthier people would be less likely to purchase health insurance, resulting in adverse selection.

Another factor at play is uncertainly as to the status of subsidy payments, known as "cost–sharing reductions" (CSRs), intended to help low-income people purchase coverage. The Trump administration cut off the payments in October 2017. Not paying the subsidies would result in a savings to the federal budget, which would help pay for the tax cuts in the act , but insurance premiums might rise. If premiums jump, purchasing health insurance would be more difficult even for those who do not qualify for the subsidies.

No vote was taken before the end of the 2017 session of Congress on legislation proposed by Sens. Lamar Alexander (R-Tenn.) and Patty Murray (D-Wash.) to reinstate the CSR funding, as well as on legislation proposed by Sen. Susan Collins (R-Maine) to provide $10.5 billion over two years for a reinsurance program.

The overall result for ACA–focused insurers is difficult. They may lose millions of customers and the people who continue to buy insurance likely will be sicker and more costly to cover.

Reduction of Medical Expense Deduction Floor

For tax years beginning after December 31, 2016, and ending before January 1, 2019, the act reduces the medical expense deduction floor to 7.5% of adjusted gross income (from 10%) and eliminates the minimum tax preference.

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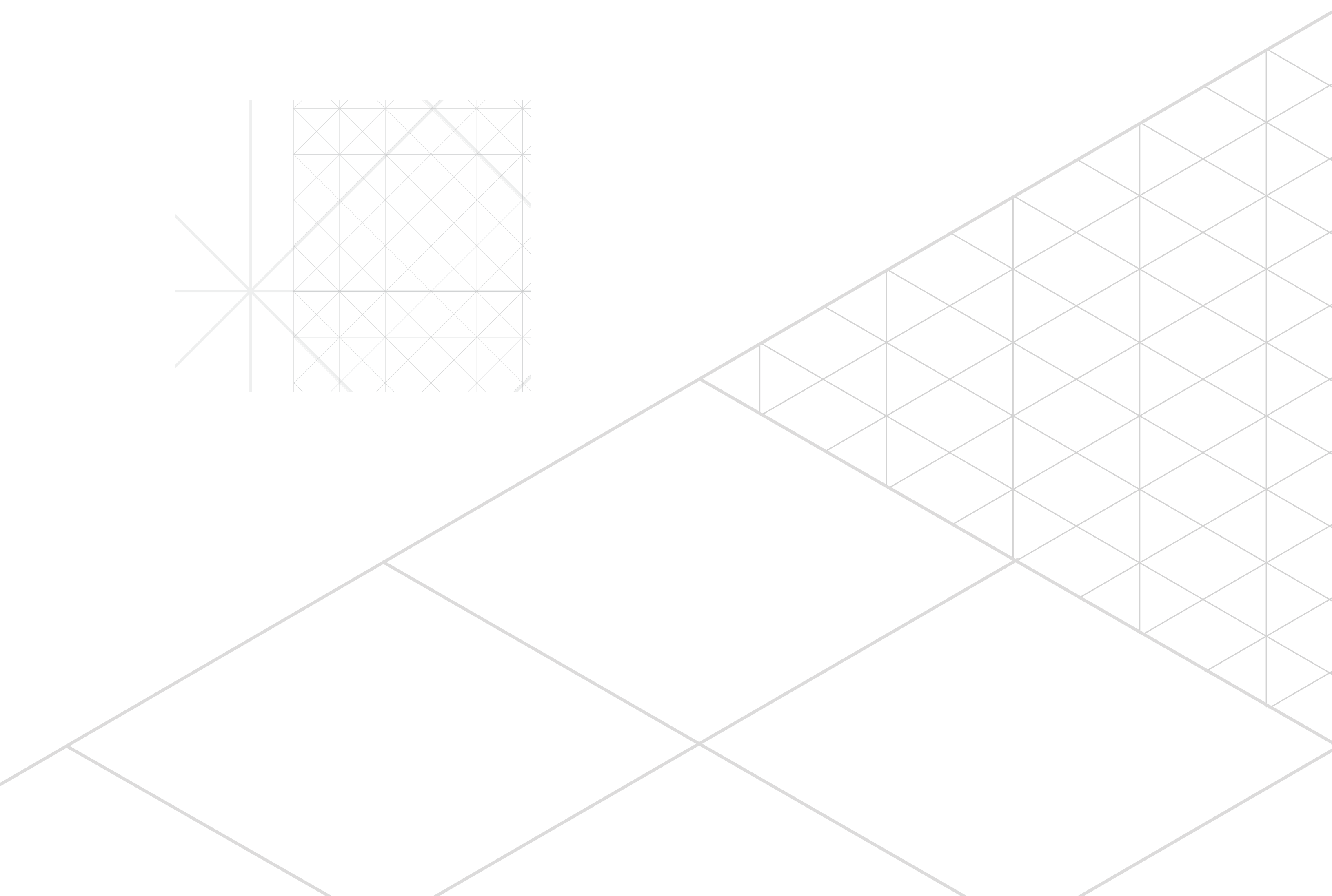
Hospitality



Executive Summary

The hospitality industry is composed of three segments: food and beverage, lodging, and travel and tourism. While certain provisions in the 2017 tax act (Pub. L. No. 115-97) will hurt businesses in the hospitality industry, overall all three segments of the hospitality industry could be winners in the tax reform game mostly due to the increased disposable income of potential travelers.

It has been reported that three out of five hotel companies are small businesses, and many of the reform proposals will benefit small businesses and pass-through entities. A November 2017 study conducted by Oxford Economics Ltd. on behalf of the American Hotel & Lodging Association (AHLA) analyzed the impact of tax policy changes. Although the study did not analyze the House or Senate bills directly, it did consider the impact of a $1.5 trillion tax cut over 10 years. The results show that tax cuts will stimulate the economy. As a result, the hotel industry (and, presumably the overall hospitality industry) can expect a boost caused by additional guest spending at hotels, restaurants, and stores. Additionally, the industry can expect increased hotel capital improvement investments.

Katherine Lugar, president and CEO of AHLA, stated, “With tax reform moving through Congress and becoming closer to a reality, we are pleased to see the potential for significant financial benefits to the industry, and the U.S. economy. From hotel operations, to our industry’s employees, to consumers enjoying their favorite travel destinations, tax reform enables further opportunity for financial growth and prosperity.”

Key Considerations

- Reduced corporate tax rate and repeal of the corporate alternative minimum tax.
- Reform of taxation of pass–through entity business income.
- Temporary 100% expensing for certain business assets.
- Depreciation deductions for nonresidential real property and residential rental property.
- Section 179 expensing.
- Entertainment expenses.

Reduced Corporate Tax Rate and Repeal of Alternative Minimum Tax

Any reduction in the corporate tax rate and repeal of the alternative minimum tax will help all businesses, including businesses in the hospitality industry.

The act reduces the corporate tax rate to a flat 21% for tax years beginning after December 31, 2017. The act also eliminates the corporate alternative minimum tax – corporations that were subject to the AMT in prior years will be able to use the prior year minimum tax credit to offset their tax liability over the next few tax years.

Reform of Taxation of Pass–Through Entity Business Income

As three out of five businesses in the hospitality industry are small businesses and many are run through pass–through entities, any reform that reduces the income tax on pass–through entities will help those entities.

The act alters the taxation of business income earned through pass–through entities (sole proprietorships, partnerships, LLCs, and S corporations). The effect of the changes will be to move such income away from being taxed under the individual income tax brackets of owners (which typically means taxation at higher marginal rates) towards a system more on par with the lower corporate rate included in the legislation.

The act allows for a 20% deduction for taxpayers with qualified income (generally, domestic business income derived from an active business enterprise plus investment interest, and certain gains). Taxpayers with taxable income exceeding $157,400 ($315,000 for married joint filers) are subject to certain limitations on the deduction coupled with a phase–in of the limits.

Temporary 100% Expensing for Certain Business Assets

Increasing the amount that is eligible for immediate expensing will help all businesses, including businesses in the hospitality industry.

Before the act , taxpayers were generally not permitted to expense the full cost of acquiring property for business use the year they purchase it. Instead they were required to take depreciation deductions over the “useful life” of the property. For certain property, taxpayers were permitted additional first–year depreciation of 50% of the adjusted basis of the property the year it is placed in service, if placed in service before January 1, 2020. If the property is manufactured or produced by the taxpayer, the manufacture or production was required to begin before January 1, 2020.

The act allows taxpayers to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The act further proposes to incrementally phase down the expensing though 2026 - taxpayers will only be able to immediately expense 20% of the cost of qualified property acquired and placed in service after December 31, 2026. The incremental phase down is one year longer for property with longer production periods. The act also expands the property that is eligible for this additional depreciation to include used property. Taxpayers will be allowed to elect 50% expensing in lieu of 100% expensing for qualified property placed in service during the first tax year ending after September 27, 2017.

Depreciation Deductions for Nonresidential Real Property and Residential Rental Property

Decreasing the recovery period for real property will help all businesses that deal in real property. The hotel industry, in particular, should benefit from any decrease in the depreciation recovery period.

The act eliminates the separate definitions of qualified leasehold improvement, qualified restaurant property, and qualified retail improvement property, and provides a general 15–year recovery period for qualified improvement property and a 20–year alternative depreciation system (ADS) recovery period for such property. The provision also requires a real property trade or business electing out of the limitation on the deduction for interest expense to use ADS to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property. The ADS depreciation period on nonresidential real property and qualified improvement property is 40 years. The act reduced the ADS depreciation period for residential rental property to 30 years. Given the differences in recovery periods, this election will require projection modeling of the tradeoff between interest expense and depreciation.

Section 179 Expensing

The immediate expensing of assets will provide a benefit to all businesses, including businesses in the hospitality industry.

Current law permits businesses to elect to expense up to $500,000, subject to phaseout if the costs exceed $2 million (both indexed for inflation).

The act increases the expensing limitation and the phaseout amount, and expands the types of property subject to the election. The act allows businesses to expense up to $1 million subject to a phaseout if the costs exceed $2.5 million (both indexed for inflation).

The act also permits the expensing of improvements to roofs; heating, ventilation, and air–conditioning property; fire protection and alarm systems; and security systems.

Entertainment Expenses

Obviously, the repeal of the meals and entertainment expense deduction could hurt the hospitality industry as employers may look to limit the expense accounts of employees.

Currently, if a taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50% of the amount otherwise deductible.

The act disallows deductions for entertainment, amusement, or recreation activities under all circumstances. In addition, the act disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

Taxpayers may still, generally, deduct 50% of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the act expands this 50% limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets the requirements for de minimis fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025 will not be deductible.

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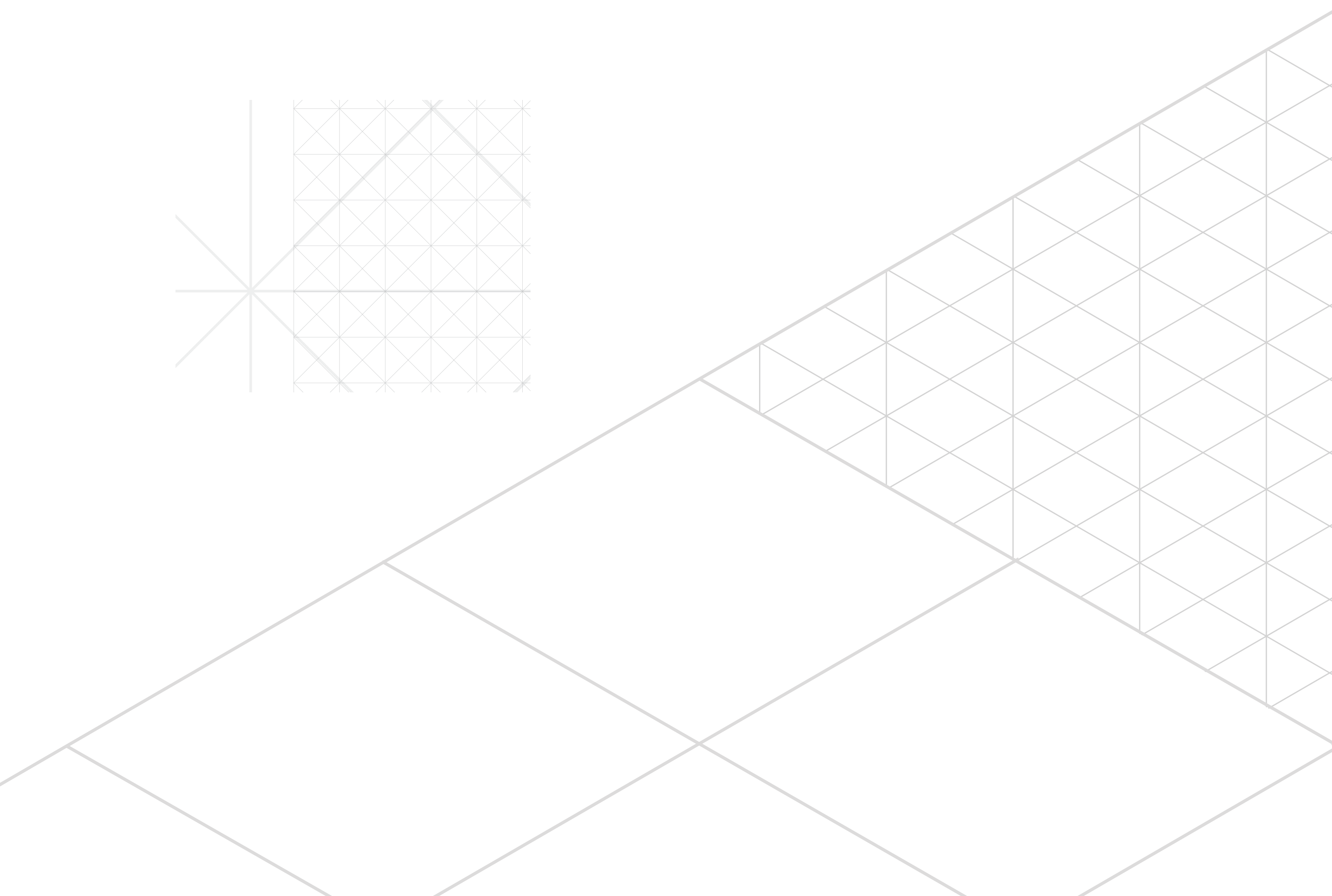
Manufacturing



Executive Summary

Manufacturers likely are happy with the 2017 tax act (Pub. L. No. 115-97) reduction in the corporate tax rate to 21%, although they may also feel like a target of tax reform, thanks to the repeal of the deduction for income attributable to domestic production activities. And it's been a long time coming – the deduction has been targeted for repeal since the GOP's 2016 "Better Way" blueprint.

The loss of the deduction, however, might be mitigated by the increased eligibility to expense otherwise depreciable assets. The act increases first–year depreciation (bonus depreciation) from 50% to 100% for property acquired and placed in service before January 1, 2023. While manufacturers have only limited time to take advantage of the increased bonus depreciation, the act also increases the limit for an election to deduct rather than capitalize and depreciate certain property (§179 property) the year it is placed in service. There is no sunset provision attached to the increase under this election.

In other small victories, small manufacturers will be permitted to treat inventories either as non–incidental materials and supplies, or conform to the taxpayer's financial accounting treatment. Certain manufacturers could change to the cash method of accounting and be exempt from the uniform capitalization rules.

A reduction in the corporate tax rate also has financial statement implications. Tax reduction could cause manufacturers to write down their deferred tax assets (DTAs) – benefits included on a company's balance sheet such as net operating loss carryforwards, foreign tax credits, and other deferred tax deductions. The enactment of tax reductions before December 31, 2017, will require the effects of changes in tax rates and other provisions on DTAs to be recognized in the 4th quarter of 2017 for financial statement purposes. This may present a significant challenge to model these changes, given the time of year and the lack of detailed guidance.

Key Considerations

- Reduced corporate tax rate and repeal of corporate alternative minimum tax.
- Tax treatment of pass–through entities.
- Repeal of the deduction for domestic production activities.
- Bonus depreciation increased from 50% to 100%.
- Expanded expensing of depreciable assets.
- Small business accounting method reforms.
- Research and development tax credit.
- International considerations.

Reduced Corporate Tax Rate and Repeal of Corporate Alternative Minimum Tax

A lower corporate tax rate may encourage manufacturers to remain in the United States.

The act reduces the corporate tax rate to a flat 21%, effective for tax years beginning after December 31, 2017. The act also repeals the corporate alternative minimum tax – corporations that were subject to the AMT in prior years will be able to use the prior year minimum tax credit to offset their tax liability over the next few tax years.

Tax Treatment of Pass–Through Entities

Many small manufacturers and some larger ones are organized as pass–through entities. For taxpayers with qualified business income from pass–through entities, the act provides a deduction for the lesser of such qualified business income or 20% of taxable income. Taxpayers above a certain income threshold will see their deduction also limited by the greater of (a) 50% of W–2 wages paid with respect to the trade or business or (b) 25% of W–2 wages paid with respect to the trade or business plus 2.5% of the unadjusted basis of all qualified property. The deduction is effective for tax years beginning after December 31, 2107, and expires after December 31, 2025.

Repeal of the Deduction for Domestic Production Activities

The act repeals a key deduction for manufacturers. Current law allows a deduction of 9% of the lesser of taxable income from qualified production activities (including but not limited to manufacturing) or 9% of taxable income. The deduction is further limited to 50% of the W–2 wages paid by the taxpayer. The deduction is repealed for tax years beginning after December 31, 2017.

Bonus Depreciation

The depreciation deduction is an important provision for manufacturers because they regularly buy machinery and equipment. Taxpayers are generally not permitted to expense the full cost of acquiring property for business use the year they purchase it. Instead they must take depreciation deductions allocated over the "useful life" of the property. For certain property, taxpayers are permitted additional first–year depreciation of 50% of the adjusted basis of the property the year it is placed in service, if placed in service before January 1, 2020. If the property is manufactured or produced by the taxpayer, the manufacture or production must begin before January 1, 2020.

The act permits taxpayers to immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The act will incrementally phase down the expensing though 2026 – taxpayers will only be able to immediately expense 20% of the cost of qualified property acquired and placed in service in 2026. The incremental phase down is one year longer for property with longer production periods. The act repeals the election to use prior year minimum tax credits in lieu of bonus depreciation effective for tax years beginning after December 31, 2017.

Planning Point: As bonus depreciation is set to phase down to lower than the current 50% for property placed in service after December 31, 2024, businesses with the financial ability should acquire new machinery and equipment sooner rather than later.

Expanded Expensing of Depreciable Assets

Recognizing the need for smaller manufacturers to immediately expense new machinery and equipment, current law permits businesses to elect to expense up to $500,000, subject to phaseout if the costs exceed $2 million (both indexed for inflation).

The act increases the expensing limitation and the phaseout amount, and expands the types of property subject to the election. Effective for property placed in service in tax years beginning after December 31, 2017, the act allows businesses to expense up to $1 million, subject to a phaseout of $2.5 million (both indexed for inflation).

Planning Point: Although bonus depreciation is set to phase down, manufacturers will continue to benefit from the immediate expensing of smaller purchases of new machinery and equipment.

In addition to the increased limitation, the act further permits the expensing of the following improvements made to nonresidential real property: roofs; heating, ventilation, and air–conditioning property; fire protection and alarm systems; and security systems.

Small Business Accounting Method Reforms

Special accounting rules will apply to small businesses engaged in manufacturing.

While taxpayers may use either a cash or accrual method of accounting, corporations and partnerships with corporate partners are generally prohibited from using the cash method unless they have less than $5 million average gross receipts over the prior three years. Businesses that are not otherwise prohibited from using the cash method of accounting may be exempt from the requirement to account for inventories if they have less than $10 million in average gross receipts over the prior three years. However, manufacturers are explicitly excluded from this exception and therefore only exempt from the requirement to account for inventories if they have less than $1 million average gross receipts over the prior three years. The uniform capitalization (UNICAP) rules require certain direct and indirect costs to be either included in inventory or capitalized. There is no exemption from the UNICAP rules available to manufacturers, though there is a de minimis rule for certain indirect costs.

The act sets out a uniform average gross receipts test for taxpayers to apply, regardless of industry or entity structure, which will permit smaller businesses to use the cash method of accounting and exempt them from the requirement to account for inventories and from the application of the UNICAP rules. Taxpayers making accounting changes will be subject to certain statutory adjustments in the year of the change.

Taxpayers with less than $25 million in average gross receipts over the prior three years, indexed for inflation, are permitted to switch to the cash method of accounting for tax years beginning after December 31, 2017.

Research and Development Tax Credit

The research and development credit has traditionally provided an incentive for businesses to boost innovation. But the amount by which manufacturers can benefit from this credit appears to be in jeopardy.

The act retains the current law research credit. However, it requires the capitalization and amortization of research and experimental expenses over five years (15 years for expenses attributable to research outside the United States), compared to deducting them currently as permitted under current law. This change will apply to software development expenditures as well. The change is effective on a cut off basis for tax years beginning after December 31, 2021.

International Considerations

The trend of manufacturers moving operations and profits overseas to save on taxes may be affected.

The act allows U.S. multinationals to deduct qualified foreign–source dividends going forward, in a move towards a territorial tax system for foreign operations. Companies would have to pay a "deemed repatriation" tax and manufacturers will need to consider this tax.

Additionally, the act provides a split repatriation tax rate, for different kinds of assets. One rate is for liquid assets like cash and cash equivalents (15.5%); the other is for illiquid (noncash) assets (8%). A taxpayer may make an election to pay the deemed repatriation tax over eight years.

Planning Point: The tax would apply to repatriated earnings, whether or not they are liquid, and could present cash flow issues.

Other international issues that may affect manufacturers with foreign operations and holdings include:

- additional proposals to limit base erosion; and
- changes to the controlled foreign corporation rules.

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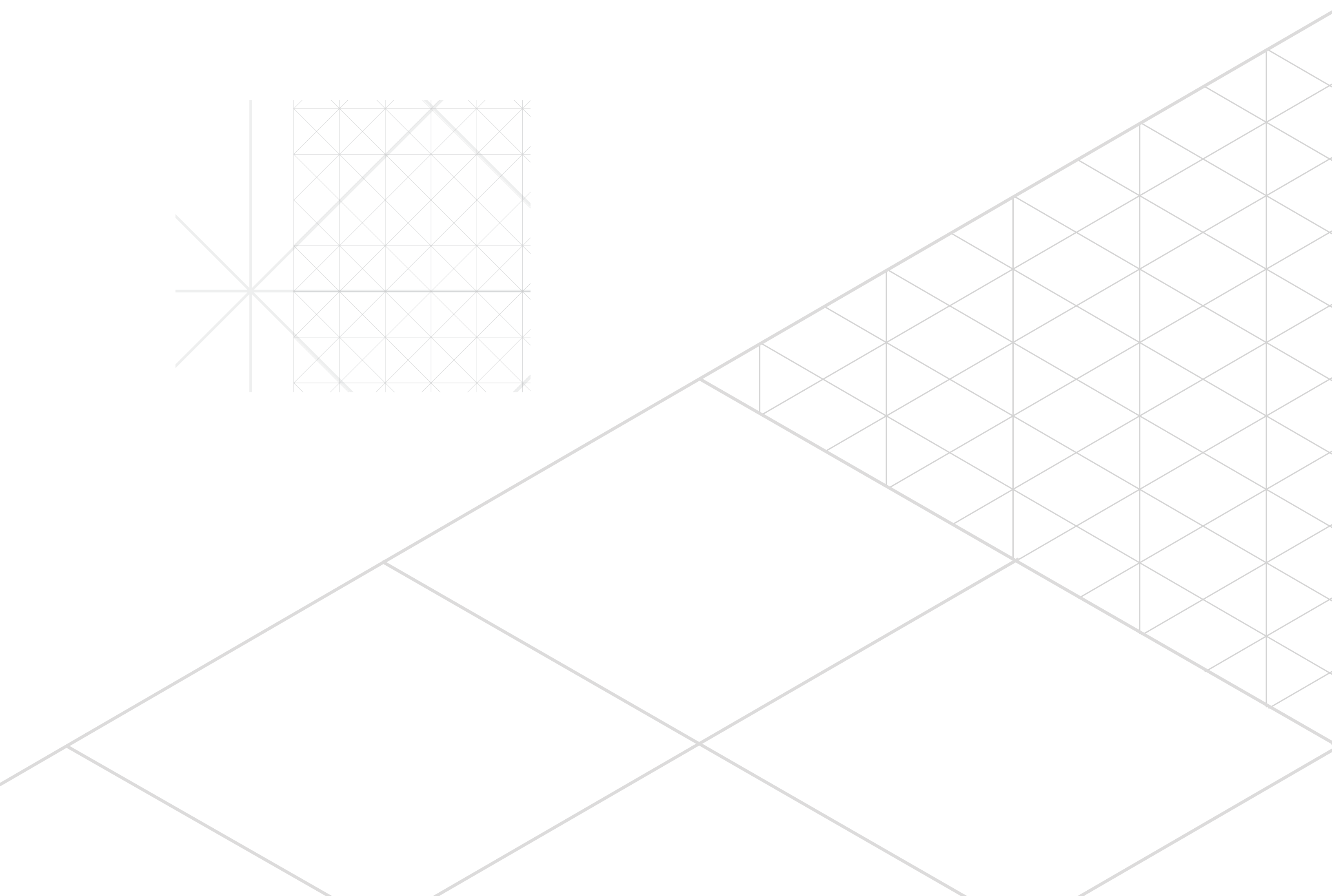
Private Equity Funds



Executive Summary

Private equity funds are faced with a mixed bag under the 2017 tax act (Pub. L. No. 115-97). While a reduction in the corporate rate is a boon for corporate portfolio companies, a potential reduction in the interest expense deduction is a significant loss in heavily leveraged buyouts.

Corporate portfolio companies may benefit from other provisions, however, including full and immediate expensing of plant and equipment.

Further, carried interest is taxed at ordinary income tax rates rather than long–term capital gains rates unless the gain is attributable to the sale of assets held for at least three years. This change, however, generally will not impact fund managers whose funds have investment horizons longer than three years.

The reduction in corporate tax rates also has financial statement implications. The reduced rate may cause corporate portfolio companies to write down their deferred tax assets (DTAs) – benefits included on a company's balance sheet such as net operating loss carryforwards, foreign tax credits, and other deferred tax deductions. The enactment of a tax reform bill before December 31, 2017, required the effects of changes in tax rates and other provisions on DTAs to be recognized in the 4th quarter of 2017. See SEC Staff Accounting Bulletin 118 (12/22/2017 - https://www.sec.gov/interps/account/staff-accounting-bulletin-118.htm).

Key Considerations

- Reduced corporate tax rates.
- Reduced tax rate for business income of pass–through entities.
- Recharacterization of profits from carried interest as ordinary income.
- Limitations on business interest expense deduction.
- Increased expensing.
- Transfer of partnership interest: source of gains.
- International issues.

Reduced Corporate Tax Rate

The current corporate tax rate is graduated, with a maximum marginal rate of 35%. The act permanently reduces the corporate tax rate from 35% to a flat rate of 21% for tax years beginning after 2017.

Funds must remeasure DTAs, thereby impacting the financial statement earnings.

Reduced Tax Rate for Business Income of Pass–through Entities

Under current law, a U.S. investor in a fund that is treated as a partnership for U.S. federal income tax purposes generally is taxed on the investor's allocable share of the fund's net business income at the investor's regular marginal tax rate.

The act reduces the effective tax rate on pass–through income for partners in certain partnerships. Under the act , a partner may deduct 20% of his or her allocable share of the partnership's "combined qualified business income," which is generally the sum of: 20% of the partnership's ordinary income from the conduct of a trade or business within the U.S., subject to a limit based either on wages paid or wages paid plus a capital element, and 20% of the aggregate of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income (subject to limitations).

Specifically, the limitation referenced above is the greater of:

- 50% of the wages paid with respect to the qualified trade or business; 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 (determined immediately after an acquisition) of all qualified property.

The deduction does not apply to wage–type income or income from a specified service business, e.g., law, accounting, consulting, financial services, investment management or any business that involves trading or dealing in securities, partnership interests, or commodities. The deduction may apply to all qualified business income, including income from specified service businesses, however, if the taxpayer's taxable income does not exceed $315,000 for joint filers ($157,500 for other individuals). This benefit is phased out over the next $100,000 of taxable income for joint filers ($50,00

The deduction generally is not that beneficial to fund investors. Private equity funds typically produce income that is outside the definition of qualified business income and do not pay significant W-2 wages. Individual investors in private equity funds that invest in portfolio companies organized as pass-through entities may be eligible for the 20% deduction (subject to applicable limitations) on qualified business income received with respect to such investments (subject to the rules for specified service businesses). Income received by individuals for managing the fund, however, will not be eligible for the deduction.

Recharacterization of Profits from Carried Interest

Investment professionals often hold interests in the general partner of private equity funds they manage. The general partner receives incentive compensation in the form of a "carried interest," which is typically a percentage (often 20%) of the fund's net profits above a specified rate of return. For private equity funds, profits allocated under the carried interest may consist almost entirely of long–term capital gains from

the sale of an asset. Because the carried interest is allocated to investment professionals in relation to their performance of services, it has been argued that the carried interest should be taxed at ordinary income rates.

The act generally recharacterizes a partner's distributive share of a partnership's net long–term capital gain as short–term capital gain where the gain is attributable to the sale of assets held for three years or less if the partnership interest is directly or indirectly transferred to (or is held by) the partner in connection with the performance of substantial services in any investment management business.

These changes are unlikely to have a significant effect on private equity funds because profits allocated to the carried interest by many private equity funds are generally attributable to the sale of portfolio stock that has been held for more than three years, which continue to be treated as long–term capital gain.

Limitations on Business Interest Expense Deductions

Under current law, business interest is generally allowed as a deduction in the tax year in which the interest is paid or accrued, subject to a number of limitations. Business interest expenses of a partnership generally "flow through" to the partners, and can be used to offset income earned from other sources.

For tax years beginning after 2017, act rolls back the interest expense deduction. Under the act, annual business interest expense deductions of a trade or business are limited to the sum of 30% of the business's adjusted taxable income; the business interest income; and the floor plan financing interest. Adjusted taxable income for purposes of this provision includes earnings before interest, taxes, depreciation, and amortization (EBITDA). For years beginning after 2021, however, the limitation will be significantly narrowed when adjusted taxable income includes a company's earnings before only interest and taxes. Businesses with average annual gross receipts of less than $25 million, certain public utilities and real estate businesses, and certain businesses that elect out are not subject to the limitation under this provision.

This limitation is determined at the partnership (fund) level so that U.S. fund investors generally will not be able to use the fund's disallowed business interest expense deductions to offset income earned from other sources.

Debt may become more expensive for highly leveraged portfolio companies as a result of this provision, however, funds should examine such effect alongside other factors, including the reduced corporate rate and increased expensing, when structuring future deals. Further, funds should pay close attention to any guidance from the IRS regarding this provision.

Increased Expensing

It is not all bad news, however, because full expensing of depreciable assets may offset the loss of the interest expense deduction for corporate portfolio companies. The act allows taxpayers to immediately expense 100% of the cost of depreciable assets (not including structures) purchased and placed into service after September 27, 2017, but begins to phase down the percentage that may be expensed for property placed in service after January 1, 2023 The act allows for full expensing of the cost of an asset if it is the taxpayer's first use, even if the original use of the property did not begin with the taxpayer.

Transfer of Partnership Interest: Source of Gains

The act overrides the Tax Court's recent decision in *Grecian Magnesite Mining v. Commissioner*, 149 T.C. No. 3 (July 13, 2017), and provides that a foreign partner with an interest in partnership that is engaged in a U.S. trade or business is subject to federal income tax on a sale of its partnership interest and is not treated as having sold a capital asset. This tax will be enforced through a 10% withholding requirement for transferees.

Under the act , a foreign partner's gain or loss from the sale of a partnership interest is treated as "effectively connected" with a U.S. trade or business (and thus subject to U.S. net income tax) to the extent that the foreign partner would have recognized effectively connected income had the partnership sold all of its assets at fair market value of the date of the sale (disregarding any special allocations for this purpose).

A purchaser of a partnership interest must withhold 10% of the sale price unless the seller certifies that it is not a nonresident alien or foreign corporation. If a purchaser of a fund interest fails to withhold at the time of purchase, then the fund may have an increased administrative burden as it is required to withhold 10% upon distribution.

International Issues

The act allows certain U.S. multinationals to deduct 100% of qualified foreign–source dividends going forward, but companies have to bring back earnings already offshore and pay a "deemed repatriation" tax for the last tax year of a foreign corporation beginning before January 1, 2018, based upon the greater of E&P measured at November 2, 2017, or December 31, 2017. Portfolio companies will need to consider this tax.

The act's deemed repatriation tax rate differs for different kinds of assets. One rate is for liquid assets like cash and cash equivalents (15.5%); the other is for illiquid (noncash) assets (8%). Taxpayers may elect to pay the deemed repatriation tax over eight years.

With a tax on "deemed repatriation" going into effect in 2017, funds and portfolio companies should watch for guidance from the IRS on issues including what should be treated as cash, how to measure—and avoid double counting—earnings and profits, how foreign tax credits can be used, and the treatment of pass-through entities like partnerships.

Other international issues that may affect private equity funds include:

- base erosion provisions;
- reduction of FIRPTA withholding rate; and
- changes to the treatment of controlled foreign corporation (CFC), including modification of the stock attribution rules that are used to determine CFC status.

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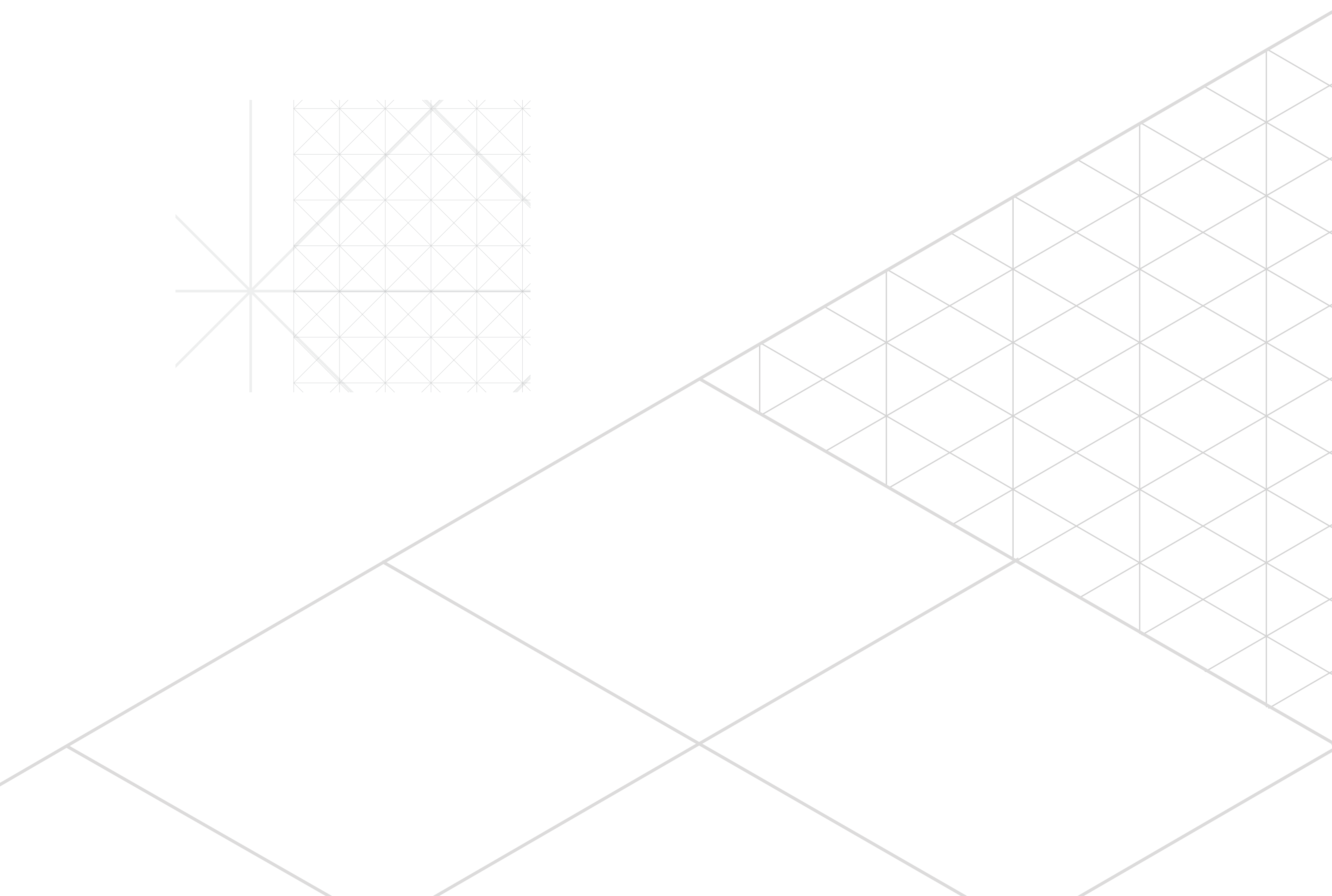
Real Estate



Executive Summary

The 2017 tax act (Pub. L. No. 115-97) presents a number of favorable, and several dramatic, tax changes that will impact the real estate industry. One recent economic model predicts that average real estate industry effective tax rates will drop from 26.5% in 2017 to 10.85% in 2018.[1]

Perhaps the biggest revision will create a new tax break for many pass–through entities –– a 20% deduction on qualified business income, subject to certain restrictions.

Key Considerations

Here are the top legislative developments affecting the real estate industry:

- Deduction for qualified business income of pass–through entities.
- Limitation on business interest expense deduction.
- Changes to the mortgage interest deduction.
- Restrictions on like–kind exchanges of real property.
- Revisions to the rehabilitation credit.
- Depreciation deduction for residential rental property nonresidential real property,and qualified improvement property.
- Temporary 100% bonus depreciation for certain business assets.

1 http://budgetmodel.wharton.upenn.edu/issues/2017/12/15/effective–tax–rates–by–industry
[Penn Wharton budget model (revised December 18, 2017)].

Deduction for Qualified Business Income of Pass–through Entities

A significant topic in the tax reform debate has been the treatment of pass–through entities. The act provides a new deduction for pass–throughs of 20% of qualified business income, with the deduction limited to the greater of:

- 50% of the W–2 wages paid with respect to the qualified trade or business, 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.

Qualified property is generally defined as tangible property that is subject to depreciation under §167, that is held by a qualified trade or business, and that is used in the production of qualified business income.

Limitation on Business Interest Expense Deduction

The act limits the deduction for net interest expenses incurred by a business to the sum of:

- Business interest income;
- 30% of the business's adjusted taxable income; and
- Floor plan financing interest.

The act provides that business interest not allowed as a deduction in a tax year can be carried forward indefinitely, and provides that adjusted taxable income is computed without regard to any deduction allowable for depreciation, amortization, or depletion, for tax years beginning before January 1, 2022.

The act allows real property trades or business using the alternative depreciation system (ADS) to elect not to be subject to the business interest deduction limitation.

Changes to the Mortgage Interest Deduction

The act limits the mortgage interest deduction to $750,000 of new acquisition indebtedness. Note that the $1 million limitation under current law will remain for preexisting acquisition indebtedness.

The act also eliminates the mortgage interest deduction for interest on home equity indebtedness for tax years beginning after December 31, 2017.

Restrictions on Like–Kind Exchanges of Real Property

The act limits §1031 deferral of gain in like–kind exchanges to real property not held primarily for sale. The act treats an interest in a partnership that has made a §761 election as an interest in each of the assets of the partnership and not as an interest in a partnership. It treats real property located in a foreign country as not like–kind to real property located in the United States.

Revisions to the Rehabilitation Credit

The act provides a 20% credit for qualified rehabilitation expenditures with respect to a historic structure. The credit is claimed ratably over a five–year period beginning in the tax year when a structure is placed in service.

The ammended rehabilitation credit applies to amounts paid or incurred after December 31, 2017, but with a transition rule applicable to qualified rehabilitation expenditures (for either a historic structure or a pre–1936 building), for any building owned or leased by the taxpayer at all times on or after January 1, 2018, through the 24–month period selected by the taxpayer (or the 60–month period selected by the taxpayer under the rule for phased rehabilitation) that is to begin not later than the end of the 180–day period beginning on December 22, 2017.

Depreciation Deduction for Residential Rental Property, Nonresidential Real Property, and Qualified Improvement Property

The act makes several changes to depreciation deductions for nonresidential real property,residential rental property, and qualified improvement property:

- Eliminates the separate definitions of "qualified leasehold improvement property", "qualified restaurant property", and "qualified retail improvement property;"
- Requires a real property trade or business electing out of the interest expense deduction limitation to use ADS to depreciate its nonresidential real property, residential rental property, and qualified improvement property ith class lives of 30 years, 40 years, and 20 years respectively, which effectively prevents an electing real property trade or business from deducting bonus depreciation on these classes of property;
- Lowers the ADS recovery period to 30 years for residential rental property.

Temporary 100% Bonus Depreciation for Certain Business Assets

The act allows 100% bonus depreciation for certain business assets acquired and placed in service after September 27, 2017, reducing the percentage that may be expensed for certain property placed in service in the future as follows:

- For property placed in service after September 27, 2017, and before January 1, 2023, 100% expensing;
- For property placed in service after December 31, 2022, and before January 1, 2024, 80% expensing;
- For property placed in service after December 31, 2023, and before January 1, 2025, 60% expensing;

- For property placed in service after December 31, 2024, and before January 1, 2026, 40% expensing; and
- For property placed in service after December 31, 2025, and before January 1, 2027, 20% expensing.

Property with Longer Production Periods

- For property placed in service after Sept. 27, 2017, and before January 1, 2024, 100% expensing;
- For property placed in service after December 31, 2023, and before January 1, 2025, 80% expensing;
- For property placed in service after December 31, 2024, and before January 1, 2026, 60% expensing;
- For property placed in service after December 31, 2025, and before January 1, 2027, 40% expensing; and
- For property placed in service after December 31, 2026, and before January 1, 2028, 20% expensing.

The act follows the present–law phase-down of bonus depreciation for property acquired before September 28, 2017, and placed in service after September 27, 2017.

The act allows used business property to qualify for full expensing, as long as it was not used by the taxpayer before the taxpayer acquired it.

The Act removes the reference to qualified improvement property from §168(k).

The Act makes the bonus depreciation deduction unavailable to any business that has floor plan financing if the floor-plan financing interest is deducted in full.

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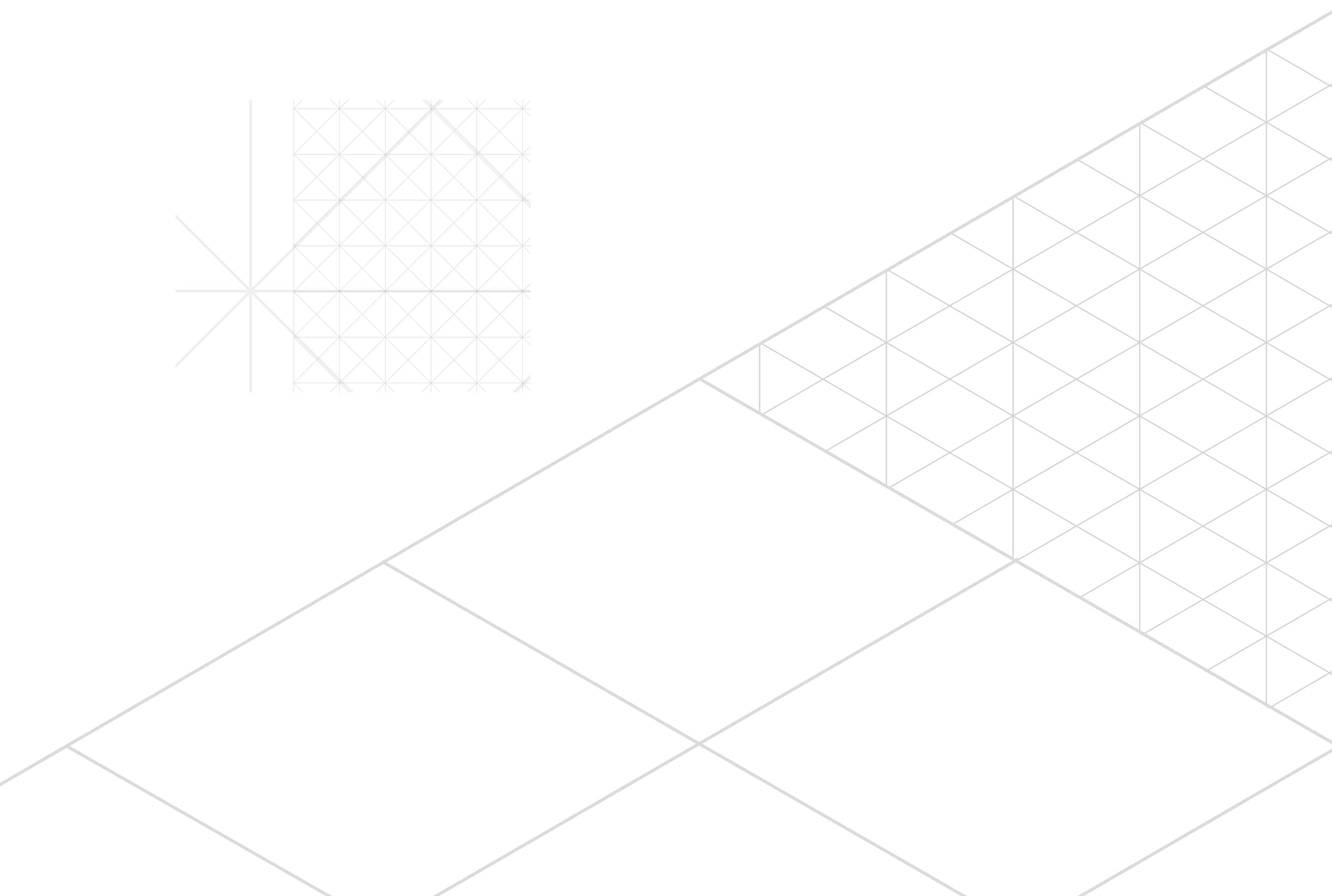
Retail



Executive Summary

The retail industry is a big winner under the 2017 tax act (Pub. L. No. 115-97). The most important change is the reduction in the corporate tax rate from the current 35% to 21% -- just a notch above the previously proposed 20% rate.

The slight increase will raise some revenue, but overall, a corporate tax reduction "helps boost earnings and cash flow" for retailers, said Poonam Goyal, a Bloomberg Intelligence senior U.S. retail analyst. An April Bloomberg Intelligence analysis found that on its own, lowering the corporate tax rate to 15% would provide an average 2017 earnings boost of more than 35% for 15 retailers with a 2016 tax rate of at least 35%. Cutting the rate to 21% instead of 15% though, is still likely to yield a significant upside.

Boosting the victory, the border adjustment tax (BAT) introduced by Paul Ryan in his "Better Way" tax plan last year was not included in either the Senate or House versions of tax reform. The provision would have exempted exports but levied a 20% tax on imports. The retail industry did not completely avoid international complications, however, as the act does include base erosion measures to keep companies from shifting income overseas.

Still, the message for retailers is mostly positive.

Key Considerations

Among the top issues for retailers are:

- Reduced corporate tax rate.
- Tax treatment of pass–through entities.
- Small business accounting method reforms.
- Section 179 expensing and depreciation.
- Base erosion.

Reduced Corporate Tax Rate

Retailers generally face higher effective tax rates than businesses in other industries and therefore are among the biggest beneficiaries of the reduction to the corporate tax rate, which the act sets at 21%.

For the retail industry, cutting the corporate tax rate could increase corporate earnings by billions of dollars. According to the NRF, reducing the corporate rate frees up enough money that employers could potentially create anywhere between 500,000 and 1.5 million new jobs. The NRF also said that "lowering the corporate tax rate encourages foreign retailers to invest more in their U.S. operations."

Planning Point: Regular cash–basis retailers might consider deferring what revenue they can to the 2018 tax year to take advantage of what will likely be a reduced tax rate.

Tax Treatment of Pass–Through Entities

A significant topic in the tax reform debate was the tax treatment of pass–through entities. The House and Senate bills varied significantly in their approach to reducing the tax burden on "mom and pop" retailers. The act generally allows a 20% deduction from a taxpayer's domestic qualified business income (QBI).

Small Business Accounting Method Reforms

Small business are often touted as the backbone of the American economy. Small retailers are no exception, but the tax code has multiple definitions for small businesses, often applying different gross receipts tests based on industry or entity structure. The retail industry, which by its nature keeps significant inventories, is subject to a relatively low $1 million three–year average gross receipts test to qualify for the cash method of accounting and for the exemption from the requirement to account for inventories.

The act sets out a uniform average gross receipts test for taxpayers to apply, which will permit smaller businesses to use the cash method of accounting and exempt them from the requirement to account for inventories and from the application of the uniform capitalization rules. Taxpayers making accounting changes will be subject to certain statutory adjustments in the year of the change.

The act applies a $25 million three–year average gross receipts threshold, indexed for inflation, effective for tax years beginning after December 31, 2017.

Section 179 Expensing and Depreciation

The act increases business expensing limitations under §179(b)(1) and §179(b)(2) to $1 million and $2.5million, respectively (indexed for inflation for tax years beginning after 2018), and of probable importance to many retailers when considering their retail space, extends §179 property to include qualified improvement property as well as many improvements (roofs, heating, ventilation, and air-conditioning property, fire protection and alarm systems, and security systems) to nonresidential real property.

relevant improvements. Because the new §179 expensing rules won't be effective for tax years beginning before December 31, 2017, retailers still on fiscal years beginning in 2017 might also consider deferring current projects and improvements until 2018.

The act also provides for temporary 100% expensing under §168(k) for certain business assets.

Base Erosion

The act includes base erosion measures to keep companies from shifting income overseas, and the retail industry has a real reason to be critical of border adjustments which raise prices on consumers because those sectors rely on goods made overseas.

Under the act , U.S. corporate shareholders of CFCs are subject to current U.S. taxation on 50% of "global intangible low–taxed income" (GILTI) with a deduction of 37.5% for foreign derived intangible income. GILTI is computed annually as the excess of each U.S. corporate shareholder's "net CFC tested income" over the shareholder's "net deemed tangible income return." The act also deems foreign taxes paid by domestic corporations that include amounts in gross income under §951A equal to 80% of §951A inclusion percentage multiplied by aggregate tested foreign income taxes paid or accrued.

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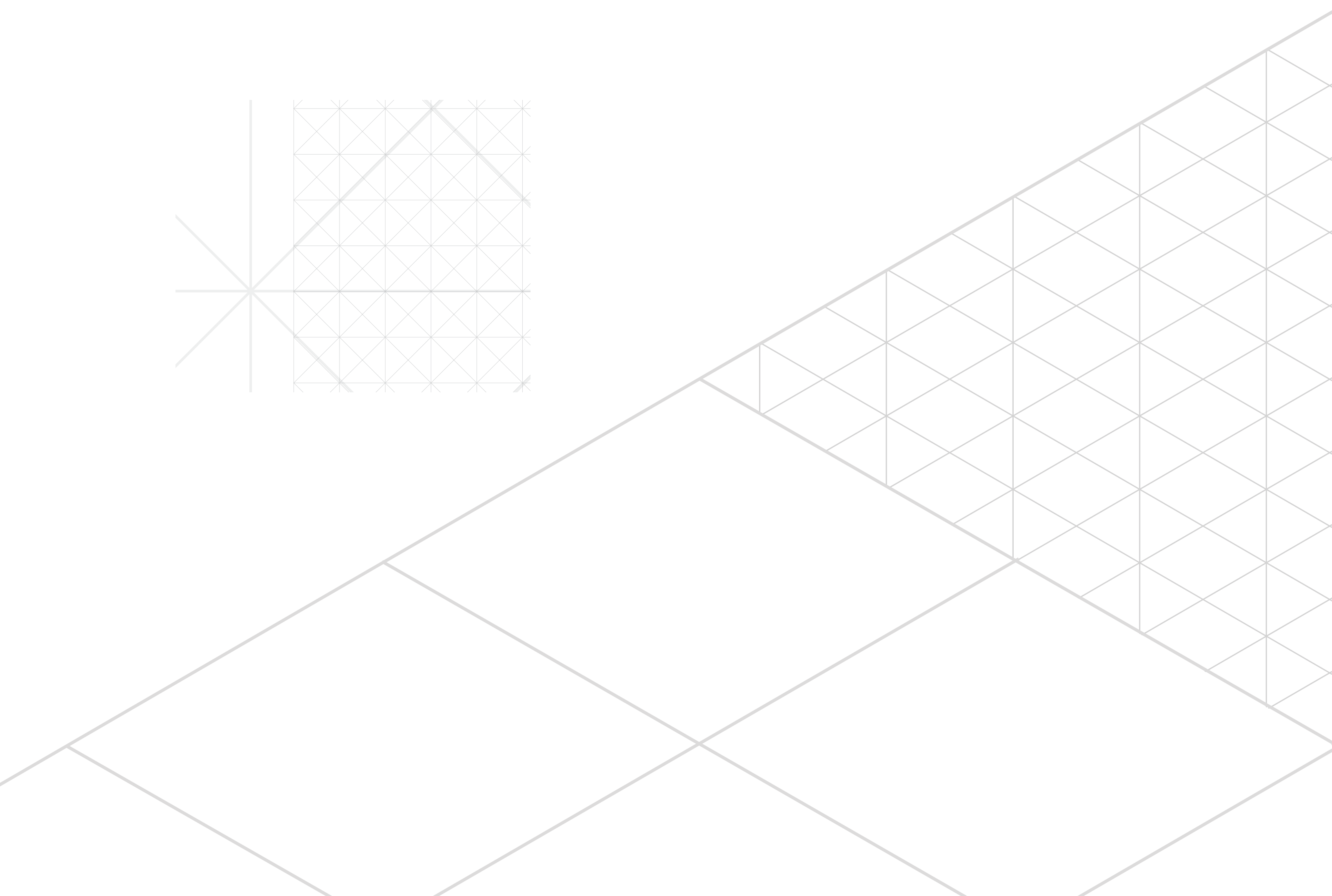
Wealth and Financial Planning



Executive Summary

Wealth planning professionals could be slight losers in the tax reform game; the 2017 tax act (Pub. L. No. 115-97), as passed and signed into law, doubles the estate and gift tax exemption amount, meaning fewer families will need extensive planning to avoid the tax. But that increased exemption sunsets after 2025, so the long-term outlook is mostly for transfer tax planning appears to be unchanged. In the short run, change itself will keep demand for advice high as clients sort out what the changes mean for them.

Pam Lucina, executive director of BNY Mellon Wealth Management's Advice, Planning and Fiduciary Services, stated that "people will have to create flexible plans that contemplate both having an estate tax and not having one," and emphasized that these steps should be taken regardless of the ultimate outcome because "permanent legislation is only permanent until the next Congress," a reference to the temporary repeal of the estate tax in 2010.

Wealth and financial professionals will generally have to wait before advising clients on either amending existing estate plans or employing new estate plans. Ronald D. Aucutt, a partner at McGuireWoods LLP and co–chair of the firm's Private Wealth Services Group, noted that the Treasury Department will need to draft regulations "to prevent a 'clawback'" because "the real gift tax at the time of the gift could be different from what gets calculated for the estate."

After some early rumors that the House bill would include limits on tax–advantaged retirement accounts, financial planners are breathing easier: the act leaves most individual retirement savings provisions intact.

A raft of changes to provisions impacting financial planners' core client base makes it difficult to parse the net effects on the industry, but the changes are likely positive as clients will need to seek advice on the new provisions and on how to adjust their plans accordingly.

Key Considerations

- Modifications to the estate, gift, and generation–skipping transfer taxes.
- Changes to S corporation elections and technical partnership terminations.
- Changes to Electing Small Business Trusts.
- Creation of Qualified Opportunity Zones.
- Reforms to retirement, savings, and compensation provisions.
- Reform of taxation of pass–through entity business income.

Modifications to the Estate, Gift, and Generation–Skipping Transfer Taxes

The act doubles the exemption amounts (as adjusted for inflation) from current law amounts of $5 million for individuals (as adjusted for inflation, $5.49 million in 2017) and $10 million for married couples using portability (as adjusted for inflation, $10.98 million in 2017).

The act does not repeal any of the transfer taxes, and sunsets the exemption increase effective in 2026, meaning the exemption will return to current law levels (with inflation adjustments through the interim period) absent further action by Congress. The act also directs the IRS and Treasury Department to draft regulations to deal with the sunset to ensure that there is no double taxation of gifts.

The exemption increase, though temporary (for now), will likely result in some increase in the demand for planning services as clients work to adjust their plans within the new parameters of the law to achieve desired objectives.

Changes to S Corporation Elections and Technical Partnership Terminations

The act allows S corporations to revoke their S elections during a two-year period starting on the date of enactment. S corporations taking advantage of the election will be able to treat distributions as paid from their accumulated adjustments accounts and earnings and profits. In addition, accounting method adjustments resulting from the revocation may be accounted for over a six-year period.

In addition, the act changes the rules regarding technical partnership terminations. The act repeals the technical termination rule, so a sale of 50% or more of the capital and profit interests in a partnership no longer results in a termination requiring new elections. In fact, new elections will not be permitted.

These provisions could have opposite effects. The partnership termination provisions could be a negative for planners and their clients as they will no longer be able to use technical terminations to reset partnership elections or make changes to those elections. However, the change to S corporation conversions could provide a valuable tool for those holding businesses in S corporation form who may find C corporation status more advantageous with the significant reduction in the corporate tax rate set by the act .

Changes to Electing Small Business Trusts

The act makes two changes to the rules regarding ESBTs. The first is to expand the range of permissible beneficiaries of such trusts to include nonresident aliens, effective in 2018. This is a significant change that could greatly expand the options available to planners and clients.

In addition, the act clarifies that ESBTs will be governed by the charitable contribution deduction rules applicable to individuals (including the income percentage limits and carryover provisions), rather than the rules applicable to trusts (which do not limit such deductions based on income).

The expansion of beneficiaries could make ESBTs a newly attractive structure, particularly for taxpayers who seek to provide for family members who are not U.S. citizens or residents. The charitable deduction changes are also likely to impact a number of plans as taxpayers may wish to seek trust modifications in order to bring charitable gift authority within permissible limits to avoid being prevented from enjoying deductions for such gifts

Creation of Qualified Opportunity Zones

The act designates low-income community tracts (determined based on census tracts) as "Qualified Opportunity Zones." Investment in such zones comes with significant advantages. Capital gains reinvested in such zones through qualified opportunity funds (a partnership or corporation investing in qualified opportunity zone property) will enjoy deferral from inclusion in gross income. In addition, capital gains on the sale of an interest in such a fund will be permanently excluded from income. Though both income exclusions will sunset at the end of 2026, even temporary treatment on such advantageous terms would make investments in these vehicles extremely attractive for high-income individuals and seems likely to drive demand for those planners who can develop a familiarity and expertise with the details of these new zones.

Reforms to Retirement, Savings, and Compensation Provisions

The act makes some changes to retirement, savings, and compensation provisions that are likely to affect the planning industry. A very significant change is that the act eliminates the exception from the $1 million deduction limit for employee compensation that allows employers to deduct commissions and performance-based compensation in excess of $1 million. Although compensation pursuant to binding contracts in effect on November 2, 2017, is not subject to the new provision, this change could result in alterations to the compensation structures offered to financial planning clients and would require adjustments to their current plans.

In addition, the act makes changes to the rules governing qualified equity grants by nonpublic companies that may make them less advantageous both from an employer perspective and as a mechanism to defer income recognition by the employee. Specifically, the act allows an income deferral election only where the grants are connected to the performance of services and are granted to at least 80% of the company's employees. Further, the deferral election will not be permitted to the four highest compensated employees or any 1% owner of the company, or any person who qualified as such an individual in any one of the preceding 10 years.

Having fewer options for income deferral and the avoidance of employer caps on deductions could narrow the range of compensation options and/or make clients feel less need for elaborate plans designed to meticulously arrange their paychecks around tax laws.

Reform of Taxation of Pass–through Entity Business Income

The act significantly alters the taxation of business income earned through pass-through entities (sole proprietorships, partnerships, LLCs, and S corporations), with the goal of moving away from taxing such income under the individual income tax brackets of owners (which typically means taxation at higher marginal rates) and towards a system that is more on par with the lower corporate rate set by the act .

The act allows a 20% deduction for taxpayers with qualified income (generally, domestic business income derived from an active business enterprise plus investment interest, and certain gains). Taxpayers with wages exceeding $157,500 ($315,000 for married joint filers) are subject to certain limitations on the deduction coupled with a phase-in of the limits.

The provisions create opportunities for wealth and financial planners as a significant portion of businesses are operated via pass-through legal structures, including many family and closely held businesses.

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