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TAX ALERT – JANUARY 5, 2018

U.S. Tax Reform
Provisions Related to Individuals and Pass-Through Entities

On December 22, 2017, President Trump signed into law the 2017 U.S. tax reform bill "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*," Public Law 115-97 (the "**Act**"), formerly known as the "*Tax Cuts & Jobs Act*." Most of the Act's provisions are effective January 1, 2018. The over 500 pages of legislation include provisions that have possibly unintended or ambiguous results that are subject to interpretation. The Department of Treasury and the Internal Revenue Service ("**IRS**") may take years to provide the necessary guidance. In the meantime, taxpayers and their tax advisors will be forced to interpret complex legislative language, creating challenges and planning opportunities.

The Act introduces the most significant changes to the U.S. tax system since 1986. This Tax Alert sets forth preliminary observations about selected provisions of the Act affecting individual taxpayer and pass-through entities (e.g., partnerships and S corporations). What follows is not an exhaustive discussion of every related tax provision in the Act. For those clients wishing a more specific analysis, interpretation and calculation of the impact of the Act, we are available to answer your questions.

Below is a brief snapshot of the provisions analyzed in this Tax Alert (with more detail immediately below).

Domestic Individual Tax Provisions

1. Individual Tax Rates and Alernative Minimum Tax ("AMT"). The Act alters the individual tax brackets and tax rates to provide a reduction in effective tax rates and increases the exemptions and thresholds for the application of the AMT. The provisions apply only through tax year 2025.

2. Standard Deduction, Personal Exemption and Child Tax Credit. The Act substantially increases the standard deduction, eliminates the personal exemption and increases the child tax credit. The provisions apply only through tax year 2025.

3. Deductions and Exclusions. Offsetting the rate reductions and standard deduction increase, the Act substantially suspends key deductions and exclusions. Most notably, the state and local non-business tax deduction is now capped at $10,000 and the deduction for interest on home equity loans is suspended. The provisions generally apply through tax year 2025.

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4. Certain Business Related Provisions. The Act introduces new benefits for certain equity award grants, applicable through tax year 2025, but reduces capital gain treatment on the sale of self-created intangibles.

5. Estate Gift and Generation Skipping Transfer ("GST") Tax Reform. The Act doubles the estate and gift tax exclusion from $5 million to $10 million, applicable through tax year 2025.

International Individual Tax Provisions

1. Tax on Repatriated Earnings. Individuals who own 10% or more of a foreign corporation will be subject in 2017 to a one-time tax on earnings of certain foreign corporations, at the rate of 8% or 15.5% depending on the amount of cash and cash equivalents. Unlike corporations, most individuals will not be able to offset such tax with deemed-paid foreign tax credits.

2. New Participation Exemption and Qualified Dividends. Individuals will not benefit from the new participation exemption regime applicable to dividends from foreign subsidiaries to corporate shareholders; however, long-term capital gains treatment on qualified dividends from qualifying foreign corporations remains unaffected,

3. Expansion of Definition of "U.S. Shareholder" Under the Controlled Foreign Corporaiotn ("CFC") Rules. A U.S. person who owns 10% or more of the *value* of shares in a CFC is now a U.S. shareholder, subject to Subpart F rules and compliance, even though such person may own less than 10% of the *votes*.

4. Rules for Low-Taxed "Intangible" Income. These rules could result in an additional tax on US individuals who are "U.S. shareholders" in CFCs subject to a foreign effective tax rate of less than 18.9%. Individuals will not benefit from the special tax deduction available to corporations that would otherwise significantly reduce this tax.

5. Sale by Foreign Person of Interest in a Partnership Engaged in a U.S. Trade or Business. The Act overrules a 2017 Tax Court case and taxes as effectively connected income ("**ECI**") gain from the sale of an interest in a partnership engaged in a U.S. trade or business. A withholding tax of 10% on the amount realized from the sale applies.

Pass-Through Entities Tax Provisions

1. Qualified Business Income Deduction. The Act introduces a new 20% deduction with respect to business income earned by individuals directly or from pass-through entities. Business income from many service businesses do not qualify for the deduction, and special caps on the deduction apply.

2. Business Loss Deduction Limitation. The Act limits the amount of excess business losses that can be deducted in the current year and carries forward such excess losses as part of a taxpayer's net operating loss carryforward.

3. Carried Interest Long-Term Capital Gains Limitation. The Act treats capital gains from carried interests attributable to assets held for less than three years as short-term capital gains. .

4. Other Partnership Provisions. The Act repeals the partnership technical termination rules triggered by the sale of more than 50% of the partnership's capital or profits within a 12-month period. Also, the Act modifies the rules relating to a partner's share of charitable contributions and foreign tax credits.

DETAILED EXPLANATION AND INTERPRETATION

DOMESTIC INDIVIDUAL TAX PROVISIONS

1. Individual Tax Rates and Alternative Minimum Tax

The Act modifies the current income tax rates and brackets under which individuals are taxed, generally resulting in lower tax rates for individuals. Previously, for married individuals filing jointly, the top tax bracket ($480,051 or more taxable income) was subject to a 39.6% rate, under the Act, the respective top tax bracket ($600,001 or more taxable income) is subject to a 37% rate. Conversely, for unmarried taxpayers, the modified tax rates and brackets may result in a higher tax. The Act also increases the exemption and phase out amount for the AMT. Following are the new tax rates and brackets that apply to individuals, according to their filing status[2].

Rate	Single	Married Filing Jointly
10%	Up to $9,525	Up to $19,050
12%	$9,526 to $38,700	$19,051 to $77,400
22%	$38,701 to $82,500	$77,401 to $165,000
24%	$82,501 to $157,500	$165,001 to $315,000
32%	$157,501 to $200,000	$315,001 to $400,000
35%	$200,001 to $500,000	$400,001 to $600,000
37%	over $500,000	over $600,000

[2] Different brackets apply to individuals filing as "head of household," "married filing singly" and "qualifying widow(er) with dependent child."

Effective Date - This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

2. Standard Deduction, Personal Exemption and the Child Tax Credit

The Act eliminates the personal exemption but significantly increases the standard deduction. For instance, the standard deduction for married individuals filing jointly increases from $13,000 to $24,000 under the Act. In addition the child tax credit increases from $1,000 to $2,000 per qualifying child.

Effective Date - This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

3. Deductions and Exclusions

3.A. Suspensions and Restrictions Affecting Key Itemized Deductions

The Act suspends and restricts key itemized deductions:

Deduction for State and Local Taxes: Under the Act itemized deductions for state and local income taxes, state and local property taxes, and sales taxes are limited to $10,000 in the aggregate (not indexed for inflation). The itemized deduction for foreign property taxes is eliminated. The provision does not apply to such taxes that are incurred in a trade or business or for the production of income. This provision is effective for taxable years beginning after December 31, 2017 and beginning before January 1, 2026.

Interest Deduction on Home Mortgage and Home Equity Debt: The Act limits the deduction available for mortgage interest by reducing the amount of eligible debt from $1,000,000 to $750,000 ($375,000 for married taxpayers filing separately) under the Act for taxable years beginning after December 31, 2017, and beginning before January 1, 2026 However, debt incurred before December 15, 2017 is not affected by the reduction and is grandfathered. The deduction for interest from home equity debt is suspended for years beginning after December 31, 2017. The suspension ends for taxable years beginning after December 31, 2025.

Miscellaneous Itemized Deductions: The Act suspends the miscellaneous itemized deductions subject to the two-percent floor under IRC §§62, 67 and 212. Affected expenses include, for instance, those incurred for the production or collection of income, tax preparation expenses, employee unreimbursed business expenses, and deductible investment expenses earned through a partnership. This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

Deduction for Personal Casualty and Theft Losses: The Act limits the deduction for personal casualty and theft losses to only those incurred in a federally declared disaster. This provision is

effective for losses incurred in taxable years beginning after December 31, 2017, but not to losses incurred in taxable years beginning after December 31, 2025.

Medical Expense Deduction Liberalized for 2017 and 2018: Notwithstanding the many suspensions and restrictions of itemized deductions, the medical expense deduction was liberalized for tax years 2017 and 2018. Previously, medical expenses were deductible only to the extent they exceeded 10% of adjusted gross income, with 10% threshold being reduced to 7.5% for individuals 65 or older. For 2017 and 2018 the threshold is 7.5% for all taxpayers. After 2018, the 10% threshold returns.

3.B. Other notable provisions affecting deductions and exclusions

Moving Expenses: The Act suspends the income exclusion for qualified moving expense reimbursements, the deduction for moving expenses, and the overall limitation on itemized deductions. These provisions are effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

Alimony Payments: The Act eliminates the deduction for alimony payments by the paying spouse (but the payee spouse need no longer include such payment in income). This provision is effective for any divorce or separation instrument executed after December 31, 2018, or executed on or before that date and modified after that date, if the modification expressly provides that the amendments made by this provision apply to such modification.

4. Certain Business Related Provisions

4.A. Qualified Equity Grants

The Act allows "qualified employees" (e.g., not top executives) to elect to defer income recognition for up to five years with respect to the stock of a privately held corporation received upon the (i) exercise of nonqualified stock options or (ii) settlement of restricted stock units. The election must be made no later than 30 days after the vesting date. The provision sets forth complex rules regarding eligible employees, written plan requirements, notification requirements, etc.

Effective Date - This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

4.B. Self-Created Intangibles

The Act excludes from the definition of a "capital asset" the following intangibles: a patent, invention, model or design, or a secret formula or process which is held either by the taxpayer who created the property (or for whom the property was created) or who has a substituted or transferred basis from such person. The impact of this provision is somewhat limited by the fact that the Act, as

finally enacted, does not repeal IRC §1235 relating to special capital gains treatment for certain patent transfers.

Effective Date - This provision is effective for dispositions after December 31, 2017.

5. Estate, Gift and GST Tax Reform

The Act doubles the estate and gift tax exemption by increasing the basic exclusion amount from $5 million to $10 million.

Effective Date - This provision is effective for decedents dying and gifts made after December 31, 2017 and before January 1, 2026.

INTERNATIONAL INDIVIDUAL TAX PROVISIONS

1. Tax on Repatriated Earnings To transition to the new participation exemption system (which does not apply for individuals), the Act imposes a "toll charge" that treats deferred foreign income of a U.S. shareholder of a "specified foreign corporation" ("**SFC**") as income, taxed at a special rate, for the year ended December 31, 2017.

An SFC is a foreign corporation that is a CFC.[3] It also applies to all foreign corporations (other than PFICs), in which a US person owns a 10% voting interest. However, in the case of a foreign corporation that is not a CFC, there must be at least one US shareholder that is a domestic. corporation. A US shareholder includes not only domestic corporations but also individuals, partnerships, trusts and estates that directly, indirectly, or constructively own 10% or more of an SFC's voting power. This means non-corporate shareholders are exposed to inclusions if the SFC is a CFC or any foreign non-CFC that has at least one domestic corporate US shareholder. [4]

Deferred foreign income is based on the aggregate post-1986 accumulated foreign earnings and profits ("**E&P**"), an amount that is roughly equivalent to a financial statement's retained earnings, as of November 2, 2017 or December 31, 2017, whichever is greater. Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's share of deficits for the same dates. The toll charge inclusion amount is treated as additional Subpart F income.

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[3] A CFC is any foreign corporation in which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or more than 50% of the total value of the stock is owned directly, indirectly, or constructively by US shareholders on any day during the taxable year of such foreign corporation.
[4] If the U.S. shareholder is an S corporation, there is an indefinite deferral of the tax that may apply until one of several triggering events is met.

For individual taxpayers, the income inclusion is reduced by a deduction (55.71% of cash E&P and 77.14% for residual E&P) so the net deferred foreign earnings attributable to cash and other liquid assets are taxed at an effective rate of 15.5%, and of 8%, on all other earnings. Cash or cash equivalents is the sum of cash, net accounts receivable (*i.e.*, accounts receivable in excess of accounts payable), plus the fair market value of marketable securities (*i.e.*, commercial paper, foreign currency, any obligation with a term of less than a year, etc.). The aggregate foreign cash position is the greater of: (i) the aggregate of the US shareholder's pro rata share of the cash position of each SFC determined at December 31, 2017; or (ii) one half of the sum of the aggregate described above for the years end December 31, 2015 and 2016.

Absent an IRC §962 election, non-corporate shareholders will not be afforded the benefit of foreign tax credits for any foreign tax imposed on the CFC's earnings.

A US shareholder can elect to pay the net tax liability in eight installments. The payments for each of the first 5 years equals 8% of the net tax liability, the 6th installment equals 15%, increasing to 20% for the 7th installment and the remaining balance of 25% is paid in the 8th year.

It is unknown how states will tax this income and whether the entire amount will be taxed in 2017 or taxed over a period of years.

Effective date – This provision is effective for the last taxable year of a foreign corporation that begins before January 1, 2018.

Action Steps: Those individuals with SFCs will need to analyze the undistributed E&P (net of any deficits) of their foreign corporations to determine the extent of the potential tax liability. The law requires the analysis be prepared for both November 2, 2017 and December 31, 2017. The use of the November 2nd date is likely to avoid an issue where certain foreign corporations took steps to reduce E&P prior to year-end in advance of legislation. If you do not expect much difference in activity between these two dates you might want to limit your analysis to merely December 31st to avoid additional work and complexity. Since the tax rate is dependent on the foreign corporation's "cash" position at year-end (and for year-end 2015 and 2016), you will also need to gather this information for a complete analysis.

2. New Participation Exemption and Qualified Dividends

Although the Act introduces a new participation exemption by providing a domestic corporation that is a US shareholder a 100% deduction for the foreign-source portion of dividends received from a 10% owned foreign corporation ("**DRD**"), the provision does not apply to individuals. However, under existing rules, these may be qualified dividends subject to tax at the lower capital gains rates which are likely either 15% or 20% depending on your tax bracket.

3. Expansion of Definition of "US Shareholder" Under the CFC Rules

Previously, a U.S. shareholder was defined as a U.S. person who owns directly, indirectly, or constructively 10% or more of the total combined voting power of all classes of stock entitled to vote in a foreign corporation. The Act expands the definition of U.S. shareholder for purposes of subpart F to include a U.S. person who owns 10% or more of the voting power *or* total value of shares of all classes of stock of a foreign corporation.

Effective Date: This change is effective for tax years of foreign corporations beginning after December 31, 2017, and, therefore, does not apply for purposes of the tax on repatriated earnings.

Action Steps: Individuals that own more than 10% of the value of foreign corporations will need to consider the impact of any subpart F income they might earn starting in 2018.

4. Rules for Low-Taxed "Intangible" Income

U.S. shareholders of CFCs could be subject to tax currently if the entity has "GILTI" income. GILTI is a new category of subpart F income that the Act creates. Although the name implies that it is for "intangibles," this is really a misnomer. You could easily be subject to this tax without having any intangibles or charging any royalties. The determining factor is the effective foreign income tax rate of the CFC. If the effective foreign income tax rate exceeds 18.9%, there is no GILTI and no liability. However, if the effective tax rate is less than 18.9% read on.

The GILTI inclusion is equal to the U.S. shareholder's share of: (i) the CFC's gross income (subject to certain exclusions, such as exclusions for highly-taxed foreign income); reduced by (ii) the excess of (i) 10 percent of the CFC's aggregate adjusted bases in depreciable tangible property used in its trade or business, over (ii) the CFC's net interest expense.

Although the Act provides deductions for corporations which results in an effective tax rate of 10.5%, there is no similar deduction available to individuals. Instead, any GILTI income is subject to regular individual tax rates.

U.S. shareholders of CFCs with relatively high interest expense and CFC shareholders with little basis in depreciable property, such as service providers and corporations with high value intangibles, could find that most of the CFC's income is treated as GILTI.

Effective Date – The provision is effective for taxable years beginning after December 31, 2017.

Action Steps – Individuals should review and document the tax rate they pay for each CFC. To the extent they are subject to a low tax rate for any entity (less than 18.9%), they should consider estimating a GILTI calculation to see if the minimum tax might apply.

5. Sale by Foreign Person of Interest in a Partnership Engaged in a U.S. Trade or Business

5.A. Income Inclusion

Based on a 1991 Revenue Ruling,[5] the IRS position was that gain derived by a non-US person from the sale or disposition of a partnership interest was ECI to the extent that the gain was attributable to partnership assets. This has often been a controversial provision and, in 2017, the US Tax Court rejected the IRS position and held that such gain was not subject to US tax.[6]

The Act codifies the 1991 Ruling. Specifically, the Act provides that gain or loss from the sale, exchange or other disposition of a partnership interest is ECI to the extent that the partner that is a foreign individual would have had effectively connected gain or loss if the partnership had sold all of its assets at fair market value on the date of the exchange. For this purpose, the gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as non-separately stated items of income or loss.[7]

5.B. Withholding Requirement

The Act also requires that the transferee of the partnership interest withhold 10% of the amount realized on the sale or exchange unless the transferor certifies that it is not a US person and provides a US taxpayer identification number.

Effective Date – The Act is effective for dispositions of partnership interests on or after November 27, 2017. The provision regarding withholding is effective for sales, exchanges and dispositions after December 31, 2017.

PASS-THROUGH ENTITIES TAX PROVISIONS

1. Qualified Business Income Deduction

The Act provides a deduction for "qualified business income" from a partnership, S corporation, or sole proprietorship of 20% of such qualified business income. In general, qualified business income is the net amount of qualified items of income, gain, loss, and deduction with respect to any "qualified trade or business" of the taxpayer. Qualified business income only includes income effectively connected with a U.S. trade or business (i.e., domestic income) and does not include

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[5] Rev. Rul 1991-1 C.B. 107.

[6] *Grecian Magnesite Mining, Industrial & Shipping Co., v. Commissioner*, 149 T.C. No. 3 (July 2017).

[7] The Act does not define "non-separately stated items" which could create some confusion in its application which could be addressed in forthcoming regulations. There is also broad regulatory authority granted to apply this provision to various non-recognition transactions.

investment type income (e.g., capital gains, dividends, and non-business interest), or reasonable compensation and guaranteed payments.

A qualified trade or business generally is any business other than (i) the business of being an employee or a (ii) a specified service trade or business (**"SSTB"**) A SSTB is a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees. An STB also includes investing and investment management, trading or dealing in securities, partnership interests, or commodities. However, otherwise qualified business income from an SSTB, up to certain income thresholds, can qualify for the deduction.

For individuals whose taxable income exceeds certain thresholds, the deduction is capped at an amount which is the greater of (a) 50% percent of the individual's allocable share of wages paid with respect to the qualified trade or business or (b) the sum of (i) 25% of the individual's allocable share of wages with respect to the qualified trade or business plus (ii) 2.5% of the unadjusted basis, immediately after acquisition, of "qualified property" (*i.e*, certain tangible, depreciable-type property used in the qualified trade or business). An individual's total deduction is also capped at an amount which is 20% of the excess of an individual's taxable income less net capital gains.

Effective Date – This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

2. Business Loss Deduction Limitation

Under the Act an individual's business losses in excess of business income plus a specified amount (*e.g*., $500,000 for married individuals filing jointly) are not deductible for the current tax year. They are carried forward and treated as part of an individual's NOL carryforward in subsequent taxable years (the NOL carryforward is allowed for a tax year up to amount equal to 90% of the taxpayer's taxable income). The limitation applies after application of the passive loss rules and is determined at the partner or shareholder level in case of partnership and S corporations. The effect of this loss limitation would be to limit the ability to offset large business losses against other income on an individual's return (*e.g*., interest, dividends and capital gains).

Effective Date – This provision is effective for taxable years beginning after December 31, 2017 but not to taxable years beginning after December 31, 2025.

3. Carried Interest Long-Term Capital Gains Limitation

The Act recharacterizes certain gains with respect to an applicable partnership interest from long-term capital gains to short-term capital gains to the extent such gains relate to property with a holding period not greater than three years.

In general, an applicable partnership interest is a partnership interest transferred to or held by a taxpayer in connection with the performance of services by the taxpayer in an "applicable trade or business." Excluded from the definition of applicable partnership interest are partnership interests held by a corporation and certain capital interests in a partnership. An applicable trade or business is generally the activity of raising or returning capital, and investing in (or disposing of) or developing "specified assets" (*e.g.*, securities, commodities, real estate, or partnership interests).

The Act does not recharacterize capital gains from carried interest as ordinary income as per past legislative proposals. While aimed at general partners of funds, this provision would not affect funds that hold investments for more than three years. In addition, the provision would affect certain transfers of carried interests.

Effective Date – The provision is effective for taxable years beginning after December 31, 2017.

4. Other Partnership Provisions

Partnership Technical Termination: This provision repeals IRC §708(b)(1)(B) providing for technical termination of partnerships resulting from the sale or exchange of more than 50% of the total capital or profits within a 12-month period. IRC §708(b)(1)(A) relating to the termination of a partnership if no part of any business is continued is unaffected. This provision applies to partnership taxable years beginning after December 31, 2017.

Distributive Share of Charitable Contributions and Foreign Tax Credits: A partner's distributive share of partner losses is allowed only to the extent of the partner's basis in the partnership interest. Formerly, the IRS's position was that a partner's share of partnership charitable contributions and foreign tax credits was not subject to the basis limitation. The Act now makes a partner's share of charitable contributions and foreign tax credits subject to the basis limitation. This provision applies to partnership taxable years beginning after December 31, 2017.

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