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Tax Alert: How the New Tax Laws Will Affect You Now and in the Future

Federal tax law reform is officially here and no, you will not be able to file your tax return on a post card. On December 22, 2017, in one of the fastest moving pieces of legislation to come across a President's desk, President Trump signed into law a bill generally known as the "Tax Cuts and Jobs Act" (the "Act") [the formal name of the Act is HR1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018], which will undoubtedly impact most individuals and businesses beginning with the 2018 tax year. Some of these changes are only temporary tax breaks set to expire while other changes are permanent reform measures. Some of the changes also affect tax reporting for returns filed in 2017. Although this Alert will not cover all of the tax reform changes contained in the Act, it highlights many of the major areas that affect you now and will likely affect you in the future. If there is an area that you are particularly interested in that is not covered below, please do not hesitate to reach out to us.

In reading this Alert you may click and jump to the area of interest listed below or read through the entire alert. Please note that due to the breadth of the Act, discussion in the "International Operations" section may actually affect entities and individuals domestically (e.g. the global intangible tax). We have attempted to highlight certain of these tricky areas in the discussion below.

This Alert discusses the following tax changes to:

1. Individual Taxation

Tax Rates – The Act continues to contain seven income tax brackets but lowers the tax rates. The rates range from 10% to the highest rate of 37%, which is down 2.6% from the highest top rate set in 2017. Like many of the provisions affecting individuals pursuant to the Act, these changes are not permanent but rather are set to expire on December 31, 2025. At that time, it will revert to its 2017 provisions. Future legislation would be required to make many of these sunset provisions effective beyond 2025.

The tax rate changes affect tax withholdings which will likely result in an immediate benefit for individuals who are employees. Those individuals will have less federal taxes withheld in their February paychecks and thus, have more available cash in hand. However, any actual tax benefit realized by individuals will really depend upon the impact of the other changes made by the Act such as the elimination of the personal exemption amounts as well as the complete elimination or reduction in many previously allowed itemized deductions.

Deductions – Although the Act removes the limitation on claiming itemized deductions based on income (the "Pease Limitation"), it severely limits the itemized deductions available to individuals. And for those who will continue to itemize, the fact that the Alternative Minimum Tax (AMT) was maintained may limit the benefit of repealing the Pease Limitation.

The deduction for state income, sales, or property taxes is capped at $10,000. This significantly impacts individuals residing in high tax states. The Act also changes the eligibility to claim the mortgage interest deduction for debt incurred after December 15, 2017 with respect to a home(s) having a mortgage amount of $750,000, while completely removing the interest deduction for home equity lines of credit. Acquisition indebtedness (but not home equity indebtedness) incurred before December 15, 2017, is not affected by the reduction and is therefore "grandfathered." Any debt incurred before December 15, 2017, but refinanced later, continues to be covered by current law to the extent the amount of the debt does not exceed the amount refinanced. For tax years after December 31, 2025, the $1 million limitation applies, regardless of when the indebtedness was incurred.

The Act expands the deduction for medical expenses for 2017 and 2018 only. For individuals who itemize, the Act allows them to deduct medical expenses that are 7.5% or more of income. The Act impacts other itemized deductions by eliminating the deduction for moving expenses except for active military and eliminating personal casualty losses unless the loss results from federally–declared disasters. The Act also suspends all miscellaneous itemized deductions currently subject to the 2% floor, including the deduction for claiming expenses attributable to a trade or business, of performing services as an employee, as well as the elimination of claiming tax preparation fees.

Although the Act does eliminate or reduce many of the previous allowed itemized deductions, it does increase the charitable contribution deduction from 50% to 60% of adjusted gross income for cash contributions BUT it has no benefit to individuals who do not itemize. Charities have expressed concern over losing potential charitable contributions due to the elimination or reduction of many of the itemized deductions. Charities fear that individuals may not make charitable contributions if those individuals no longer itemize their expenses.

With all these changes to itemized deductions, individuals may find themselves claiming the standard deduction rather than itemizing. For 2018, the standard deduction is nearly doubled from previous amounts. A single filer's deduction increases from $6,350 to $12,000. The deduction for Married and Joint Filers increases from $12,700 to $24,000. The Act does retain the AMT but increases the exemption amounts and the phase-out of exemption amounts for individuals.

Child Tax Credit/Family Tax Credit – The Act increases the child tax credit from $1,000 to $2,000. The Act further provides that the maximum amount of refundable credit per eligible child is $1,400, and also indexes the maximum amount refundable for inflation.

The new law also provides a $500 non-refundable credit for dependents other than qualifying children.

The Act increases the threshold modified adjusted gross income amount where the credit would begin to phase out to $400,000 for married taxpayers filing jointly, and to $200,000 for other taxpayers. This amount is not indexed for inflation.

Additionally, the Act requires that a taxpayer provide the social security number ("SSN") of each qualifying child that is claimed on a tax return in order to receive the child tax credit. This requirement does not apply to the $500 non-refundable credit for a non-child dependent. This means that a qualifying child who is ineligible to receive the child tax credit due to not having a SSN is still eligible for the non-refundable $500 credit, including children with an Individual Taxpayer Identification Number rather than a Social Security Number.

Education – The Act makes permanent changes to 529 plans by providing that elementary and secondary school expenses of up to $10,000 per year are qualified expenses for qualified tuition programs. These expenses apply on a per-student basis, rather than on a per-account basis. The Act also excludes from income the discharge of student loan indebtedness on the death or disability of a student. This change is for indebtedness discharged after 12/31/17 but before 1/1/2026. The Act preserves tuition waivers for graduate students and also retains the $250 deduction for out of pocket expenses incurred by teachers.

Individual Mandate – In addition, the Act repeals the individual mandate in the Patient Protection and Affordable Care Act by removing the penalty for individuals who do not purchase health insurance that qualifies as minimum essential coverage, starting in 2019. This has the potential to lead to many uninsured individuals and/or higher insurance premiums. And while the penalty has been eliminated the 3.8% Net Investment Income Tax remains.

Alimony – While many of the provisions for individuals are temporary and will expire beginning with the 2026 tax year, the Act permanently changes the landscape for individuals who are in the process of seeking a divorce. Alimony and separate maintenance payments will no longer be deductible by the payor spouse and will no longer be includible in the income of the payee spouse. This provision is effective for any divorce or separation agreement executed after December 31, 2018, and for any agreement executed before but modified after that date if the modification expressly provides that this new provision applies to such modification.

Capital Gains/Qualified Dividends – The new law maintains the current system whereby net capital gains and qualified dividends are generally subject to tax at a maximum rate of 20% or 15%, (plus in many cases the addition of the 3.8% Net Investment Income Tax) with higher rates for gains from collectibles and unrecaptured depreciation.

Estate and Gift Tax – The Act increases the federal estate and gift tax unified credit basic exclusion amount to $10 million (adjusted annually for inflation from 2010 as the base year), effective for decedents dying and gifts made after 2017 and before 2026. The Act increases the federal GST exemption amount to $10 million (adjusted annually for inflation from 2010 as the base year), effective for generation-skipping transfers made after 2017 and before 2026. According to our inflation calculations (which are subject to change based on the IRS's implementation of a new inflation measure under the Act), both the unified credit and GST exemption levels will total $11.18 million in 2018. That means if you are married today, you can transfer an estimated $22.36 million of assets without incurring federal estate, gift or generation-skipping transfer taxes. Because these thresholds are not permanent, you should still review planning and gifting ideas prior to 2026. Further, for our Connecticut clients, a surprise "gift" in the recently passed Connecticut budget was an increase in the Connecticut estate tax exemption. The exemption amount for 2018 is $2.6 million, for 2019 is $3.6 million and then in 2020 it will match the federal estate and gift tax exclusion amount.

Step-Up in Basis of Property Acquired from Decedent – While the Act changes many provisions of the Tax Code, Congress chose not to alter the existing statute allowing heirs to take a step-up in the tax basis of property that they acquire from a decedent. This step-up in basis generally allows heirs to claim the fair market value of the property on the date of the decedent's death as the tax basis of the property for income tax purposes when the heirs later go to sell it. Because inherited property often has a low basis, the result of this provision frequently is a lower taxable gain for heirs who sell inherited property.

Self-Created Property – Under current law, property held by a taxpayer (whether or not connected with the taxpayer's trade or business) is generally considered a capital asset. However, certain assets are specifically excluded from the definition of a capital asset, including inventory property, depreciable property, and certain self-created intangibles (e.g., copyrights, musical compositions). The Act provides that for dispositions after January 1, 2018, IRC Section 1221(a)(3) is amended to exclude patents, inventions, patented or non-patented models or designs, and secret formulas or processes, which are held either by the taxpayer who created the property or by a taxpayer with a substituted or transferred basis from the taxpayer who created the property, from the definition of a “capital asset.” Thus, any gain will be taxed at ordinary income rates.

2. Corporate/Business Taxes

Tax Rates – The Act provides significant benefits to corporate taxpayers. It drastically cuts the corporate income tax rate from 35% to a flat 21% rate effective January 1, 2018. Professional service corporations receive the same tax break by being subject to the general corporate tax rate. A professional service corporation is a C corporation of which (i) substantially all of the activities consist of the performance of services in fields such as accounting, health, law, etc., and (ii) of which employees performing services for the corporation in the identified fields own, directly or indirectly, substantially all of its stock. Of course, for all corporate income, there is still the second tax that must be paid on distributions from the corporation to its shareholders. In most cases this will make the effective tax rate 39.5%.

Corporate AMT – The Act completely eliminates the alternative minimum tax for corporations. For tax years beginning in 2018, 2019, and 2020, to the extent that AMT credit carryovers exceed regular tax liability (as reduced by certain other credits), 50% of the excess AMT credit carryovers are refundable (a proration rule with respect to short tax years). Any remaining AMT credits will be fully refundable in 2021.

Deductions/Credits – The new law changes the 80% dividends received deduction (for dividends from 20% owned corporations) to 65% and the 70% dividends received deduction (for dividends from less than 20% owned corporations) to 50%, effective for tax years beginning after 2017.

In addition, the Act increases first-year “bonus” depreciation deductions to 100%, which allows for an immediate write off for the cost of acquisitions of plant and equipment for property acquired and placed in service after September 27, 2017, and before 2023. This expensing allowance provides for bonus depreciation to both new and used acquired property. The 100% bonus depreciation rule applies through 2022, and then ratably phases down over the succeeding five years. Bonus depreciation is not available for businesses providing electrical energy, water or sewage disposal serves, gas or steam through a local distribution system or transportation of gas or steam by pipeline.

The Act changes the use of net operating losses (“NOLs”) by limiting the NOL deduction to 80% of taxable income for losses arising in tax years beginning after December 31, 2017. The Act eliminates carrybacks (except for farming NOLs, which would be permitted a two-year carryback) and allows unused NOLs to be carried forward indefinitely.

The Act makes changes to the section 179 expensing election by increasing the maximum amount that may be deducted to $1 million (up from $500,000 under present law) (the “dollar limit”). The dollar limit is then reduced dollar-for-dollar to the extent the total cost of section 179 property placed in service during the tax year exceeds $2.5 million (up from $2 million). These limits will be adjusted annually for inflation. The changes are effective for property placed in service in tax years beginning after 2017.

The Act limits the deduction for net interest expenses incurred by a business to (i) the sum of business interest income, (ii) 30% of the business’s adjusted taxable income, and (iii) floor plan financing interest. Businesses with average annual gross receipts of $25 million or less are exempt from this limit. In addition, businesses engaged in a “real property trade or business (as defined in IRC Section 469(c)(7)) can avoid this limitation but only if they agree to depreciate their residential and non-residential real estate and qualified improvement property under the less favorable ADS depreciation method. However, if the real estate business is heavily leveraged electing to avoid the interest expense limitation may be worth giving up the accelerated depreciation benefits.

The Act eliminates the deductions for entertainment, amusement, and recreation when directly related to the conduct of a taxpayer's trade or business. The new law generally retains the 50% deduction for food and beverage expenses associated with a trade or business, effective for amounts paid or incurred after December 31, 2017. The new law also applies the 50% limitation to certain meals provided by an employer that are currently 100% deductible.

In addition to the disallowance of deductions for entertainment expenses, businesses can no longer claim a deduction for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payment is subject to a nondisclosure agreement. The provision is effective for amounts paid or incurred on or after December 22, 2017. Further businesses cannot deduct payments of fines or other penalties to the government or governmental entity. This means for example that fines paid to the SEC to settle securities law claims would not be deductible. Certain restitution payments identified in a court order or settlement would be deductible, as would remediation of property payments. Restitution for failure to pay taxes assessed under the IRC would be deductible only to the extent that their payment would have been allowable if it had been timely paid.

The Act adds a credit for paid family leave credit. The provision allows employers to claim a general business credit equal to 12.5% of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50% of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. The provision is effective for wages paid in taxable years beginning after December 31, 2017, and would not apply to wages paid in taxable years beginning after December 31, 2019.

Research Credits – Currently, companies can claim a 50% tax credit for qualified clinical testing expenses incurred in testing certain drugs for rare diseases or conditions for disease populations with fewer than 200,000 individuals nationally, generally referred to as "orphan drugs." The tax bill reduces the credit rate to 25% of qualified clinical testing expenses effective in 2018. The new law retained the deduction for research and development expenses but now requires that such costs are amortized over a period of five years rather than being deducted in full in one year.

Accounting Method Changes – Under the new law, accrual method taxpayers must recognize income no later than the tax year in which the item is recognized as revenue on an applicable financial statement. The new law codifies the current deferral method of accounting for advance payment for goods and services provided under Revenue Procedure 2004-34, which allows taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes. The special rules for tax year of inclusion may cause an acceleration in the recognition of income for many taxpayers. For example, under the new law, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes, as opposed to when the services are actually completed or at the time that the taxpayer has the right to bill. Additionally, advance payments for goods and revenue from the sale of gift cards can only be deferred for one tax year; and income from credit card fees (such as late-payment, cash advance, and interchange fees) would generally be accelerated.

Under current law, with certain exceptions, a C corporation or partnership with a C corporation partner may use the cash method of accounting only if, for each prior tax year, its average annual gross receipts (based on the prior three tax years) do not exceed $5 million. Pursuant to the Act, the threshold under the three-year average annual gross receipts test is increased to $25 million. The three-year average test is applied annually.

Businesses that are required to use an inventory method must also use the accrual method of accounting for tax purposes under current law. An exception from the accrual method of accounting is provided for certain small businesses if for each prior tax year its average annual gross receipts (based on the prior three tax years) do not exceed $1 million, and a second exception is provided for businesses in certain industries if for each prior tax year their average annual gross receipts (based on the prior three tax years) do not exceed $10 million. The Act permits additional businesses with inventories to use the cash method by increasing this threshold to $25 million. Under the provision, businesses with average annual gross receipts of $25 million or less (based on the prior three tax years) are permitted to use the cash method of accounting even if the business has inventories. Under the provision, a business with inventories that otherwise qualifies for and uses the cash method of accounting is able to treat inventory as non-incidental materials and supplies or conform to its financial accounting treatment.

Another relaxation of the accounting rules in the Act allows businesses with less than $25 million average annual gross receipts (up from $10 million) to use the completed-contract method (or any other permissible exempt contract method) rather than the percentage-of-completion accounting method for long-term contracts to be completed within two years.

3. Taxation of Pass-Through Entities

New Deduction – For tax years after 2017 and before 2026, the new law permits certain non-corporate owners (i.e., owners who are individuals, trusts, or estates) of certain partnerships, S corporations and sole proprietorships to claim a 20% deduction against "qualified business income". This can be a significant benefit to individuals who are owners of these businesses and are in a high tax bracket. For a taxpayer who is in the highest tax bracket under the new law of 37%, this provision reduces the tax rate on "qualified business income" to 29.5%.

There are numerous limitations on the income that is eligible to qualify for this deduction. First, the income must be "qualified business income." "Qualified business income" is all domestic business income other than investment income (e.g., dividends (other than qualified REIT dividends and cooperative dividends)), investment interest income, short-term capital gains, long-term capital gains, commodities gains, foreign currency gains, etc. Qualified business income does not include an amount paid to the taxpayer by an S corporation as reasonable compensation. Further, it does not include a payment by a partnership to a partner in exchange for services (regardless of whether that payment is characterized as a guaranteed payment or one made to a partner acting outside his or her partner capacity.

Qualified business income also does not include income from a "specified service trade or business." A specified service trade or business is any trade or business activity involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services; any trade or business of which the principal asset is the reputation or skill of one or more of its owners or employees; or any business that involves the performance of services that consist of investment and investment managing trading or dealing in securities, partnership interest, or commodities. There is a question regarding whether architecture and engineering companies are included since at the last minute these industries were dropped from the specified list, but still could fall under the general catch-all provision. However, the deduction may apply to income from a specified service trade or business if the taxpayer's taxable income does not exceed $315,000 (for married individuals filing jointly or $157,500 for other individuals). Under the new law, this benefit is phased out over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

For each qualified trade or business, the taxpayer is allowed to deduct 20% of the qualified business income for that trade or business. Generally, the deduction is limited to 50% of the W-2 wages paid with respect to the business. Alternatively, capital-intensive businesses may get a higher benefit under a rule that takes into consideration 25% of wages paid plus a portion of the business's basis in its tangible assets. Each business is treated separately and so it appears that taxpayers will not be able to aggregate separate business units in computing W-2 wages and/or capital basis. Although the benefit may be limited, this provision does allow the 20% deduction if a taxpayer's taxable income is below the threshold amount of $157,500 for individuals and $315,000 for joint filers.

The 20% deduction is not used in computing adjusted gross income. Rather the deduction is allowed as a deduction reducing taxable income. Thus, the deduction does not affect limitations based on adjusted gross income. Moreover, the deduction is available to taxpayers that itemize deductions, as well as those that do not.

Partnership Terminations – Another change affecting pass-through entities includes the elimination of the technical termination rules for partnerships with tax years beginning after December 31, 2017. Under current law, a partnership had a technical termination if 50% or more of the total interests in partnership capital and profits were sold or exchanged within a 12-month period. Thus, the partnership's taxable year closed, any partnership-level elections terminated, and the partnership's depreciation recovery periods were restarted. The new law changes these rules by treating the partnership as continuing even if more than 50% of the total capital and profit interests of partnership are sold or exchanged. New elections would not be required or permitted.

Gain on the Sale of a Partnership Interest – For partnerships with foreign partners, the Act requires withholding on the sale or exchange of an interest in a partnership engaged in a U.S. trade or business. These sales are treated as generating income effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Thus, for sales and exchanges of an interest in a partnership engaged in a US. trade or business after December 31, 2017, the transferee is required to withhold 10% of the amount realized.

Carried Interest – The Act also made changes to the taxation of a "carried interest." "Carried interest" refers to the share of profits or gains from investment received by a manager of a private equity fund, hedge fund, or similar investment vehicle, which is typically unrelated to any capital investment by the manager. Currently, carried interest is generally taxed at favorable long-term capital gain rates. Under the Act, the holding period in order to realize the favorable capital gain treatment is increased from 12 months to 3 years. Failure to satisfy the 3-year holding requirement results in treatment as short-term capital gain.

S Corporation Conversion to C Corporation – The Act provides beneficial tax treatment to an "eligible terminated S corporation", which is any C corporation: (i) that was an S corporation on the day before the date of enactment and revokes its S election in the two-year period beginning on the date of such enactment (so, applicable to revocations in 2018 and 2019); and (ii) the owners of the stock of which (determined on the date on which such revocation is made) are the same and such owners hold the stock in the same proportions as on the date of enactment.

Under the new law, an eligible terminated S corporation would receive a more favorable IRC Section 481 adjustment arising from an accounting method change attributable to the corporation's revocation of its S corporation election. Prior to the Act, an S corporation that converted to a C corporation was required to include any income resulting from that change over four tax years. Pursuant to the Act, income recognition is stretched out and taken into account ratably during the six-year tax period beginning with the year of the method change.

In addition, the Act revises the treatment of distributions made by S corporations following their conversion to C corporation status. Prior to the Act, distributions by an S corporation made within a certain time period known as PTTP, (the period which ends on the later of one year from the last day the corporation was an S corporation, or the due date for filing the last return of the S corporation) generally are treated as coming first from the S corporation's accumulated adjustments account ("AAA"), which is an account that tracks the income of the S corporation that already has been taxed to its shareholders but has not yet been distributed to its shareholders. Once AAA is reduced in its entirety by the distribution, then any excess distribution is treated as coming from any earnings and profits ("E&P") of the corporation generated when it was a C corporation. For a shareholder, distributions out of AAA generally are more favorable, as such distributions are tax-free to the extent of the shareholder's basis in its S corporation stock and then as giving rise to capital gain for the shareholder whereas distributions out of E&P are treated as dividends.

The Act extends the beneficial treatment of distributions for eligible terminated S corporations beyond the PTTP. Pursuant to the Act, when there is a distribution of money by an eligible terminated S corporation, the accumulated adjustments account is allocated to such distribution, and the distribution is chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account to the amount of the accumulated earnings and profits.

Substantial Built-in Loss Rules – Prior to the Act, a partnership does not automatically adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made an election under IRC Section 754 to make the basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer. If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect just to the transferee partner.

Prior to the Act, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds the fair market value of the partnership property by more than $250,000. The Act modifies the definition of a substantial built-in loss to include a situation where the transferee of a partnership interest would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value. This new definition takes into consideration whether the transfer of the interest has the effect of transferring a loss in excess of $250,000 to the transferee, rather than just whether the partnership itself has an overall loss in its assets. Therefore, even if the partnership has an overall gain upon the sale of all of its assets, if the transferee would be allocated more than $250,000 in losses, as a result of its share of gain or loss with respect to particular assets, then a mandatory adjustment is required.

Basis Limitation on Partner Losses – The basis limitation on the deductibility of partner losses applies to a partner's distributive share of charitable contributions and foreign taxes, which were previously excluded prior to the Act.

Limitation of Excess Business Losses – The Act changes the treatment of losses of taxpayers other than C corporations. Under the new law, an excess business loss is disallowed for the tax year. An "excess business loss" for the tax year is $500,000 for married individuals filing jointly or $250,000 for other individuals. Any excess business loss of the taxpayer is treated as part of an NOL and carried forward to subsequent tax years.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Therefore, each partner or shareholder's share of the items of the entity is taken into account in calculating the partner or shareholder's limitation.

4. Compensation and Benefits

For a discussion of the Act's changes to the compensation and benefits area, please see our **Employee Benefit and Executive Compensation Group's analysis**.

5. Beer, Wine, and Distilled Spirits

The Act makes numerous temporary changes to how beer, wine, and distilled spirits are taxed. The changes are only effective for the 2018 and 2019 tax years.

UNICAP – A significant change to how beer, wine and distilled spirits are taxed includes changes to the modification of the Uniform Capitalization ("UNICAP") rules under section 263A, which require certain direct and indirect costs allocable to real or tangible personal property produced (or acquired for resale) to be included in inventory or capitalized into the basis of the related property. In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property's production period and that is allocable to property: (1) with a class life of at least 20 years; (2) that has an estimated production period exceeding two years; or (3) that has an estimated production period that exceeds one year and a cost exceeding $1,000,000.

For property that is customarily aged such as wine and whiskey, before it is sold, the production period includes the aging period. Pursuant to the provisions of the new law, the aging periods for beer, wine, and distilled spirits are now excluded from the production period for purposes of the UNICAP interest capitalization rules. Consequently, producers of beer, wine, and distilled spirits are able to deduct interest expense (subject to any other applicable limitation) attributable to a shorter production period.

Excise Tax (Beer) – The Act also makes changes to the federal excise tax imposed on brewers and importers of beer. The Act reduces the tax on beer from $18 per barrel to $16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. Beer brewed or imported in excess of the six million barrels would be taxed at $18 per barrel.

For small brewers producing less than 2 million barrels of beer, tax would be reduced from $7 per barrel to $3.50 per barrel for the first 60,000 barrels. The additional barrels would be taxed at $16 per barrel.

Special rules apply for determining controlled groups and allocation of the reduced tax rates among members of the controlled group. Moreover, it provides that two or more entities (whether or not under common control) that produce beer under a similar brand, license, franchise, or other arrangement are to be treated as a single taxpayer for the reduced rates.

Excise Tax (Wine Producer Credit) – The Act also modifies the credit for small domestic producers of wine. The new law allows the credit to be claimed by foreign and domestic producers of wine, regardless of the gallons of wine produced. The new law also allows the credit for sparkling wine producers.

Under the new law, the credit for wine produced in, or imported into, the United States during the calendar year would be:

• $1.00 per wine gallon for the first 30,000 wine gallons; plus

• $0.90 per wine gallon for the next 100,000 wine gallons; plus

• $0.535 per wine gallon on the next 620,000 wine gallons.

The Act provides special credit rates for hard cider, as well as rules for allowing foreign producers of wine to assign the credit to importers of the wine. In addition, the new law provides a two-year, $0.50 per wine gallon rate reduction for still wines with an alcohol content of more than 14% but less than 16%. Mead and sparkling wines are taxed at the lowest rate applicable to "still wine".

Excise Tax (Distilled Spirits) – The excise tax on distilled spirits is also modified and taxed at a tiered rate. Under the law, the first 100,000 proof gallons of distilled spirits are taxed at a rate of $2.70 per proof gallon. The tax rate for proof gallons greater than 100,000 but less than 22,130,000 proof gallons would be $13.34 per proof gallon, and the rate for 22,130,000 proof gallons or more would be $13.50 per proof gallon. Further distilled spirits can be transferred in bond between bonded premises in containers other than bulk containers without payment of tax.

6. Tax-Exempt Organizations

UBTI – Under the new law, a tax-exempt organization is required to calculate separately the net unrelated business taxable income ("UBTI") of each unrelated trade or business. Any loss derived from one unrelated trade or business may not be used to offset income from another unrelated trade or business, and NOL deductions are allowed only with respect to the trade or business from which the loss arose. This change does not apply to any NOLs arising in a tax year beginning before January 1, 2018, and such pre-2018 NOLs may be applied to reduce aggregate UBTI arising from all unrelated businesses. The Act also subjects exempt organizations to UBTI on the amount of certain fringe benefits for which a deduction is disallowed. These include qualified transportation fringe benefits, any parking facility used in connection with qualified parking, and on-premises athletic facilities. The provision does not apply to the extent that the amount is directly connected with a regularly carried-on unrelated trade or business.

New Excise Tax – The new law imposes a 1.4% excise tax on the net investment income of private colleges and universities with at least 500 students (more than 50% of which are located in the United States) and non-exempt use assets with a value at the close of the preceding year of at least $500,000 per full-time student. A university's assets include assets held by certain related organizations (including supporting organizations to the university and organizations controlled by the university), and a university's net income includes investment income derived from those assets. State colleges and universities are not subject to this new tax.

Athletic Seating – The Act eliminates the charitable contribution deduction for payments made for the benefit of a higher education institution that grant the donor the right to purchase seating at an athletic event in the athletic stadium of such institution. Prior to this provision, a deduction of 80% of the value of the payment was allowed.

Executive Compensation – The Act treats tax-exempt organizations on par with corporations with respect to certain compensation payments made to specific individuals. The new law imposes an excise tax (new IRC Section 4960) equal to corporate tax rate of 21% on compensation in excess of $1 million paid to an applicable tax-exempt organization's five highest-paid employees for a tax year (or any person who was such an employee in any tax year beginning after 2016). The excise tax also applies to parachute payments exceeding the portion of the base amount (defined as the average annual compensation of the employee for the five tax years before the employee's separation from employment) that is allocated to the payment. The tax on excess parachute payments applies only to payments made to employees who are highly compensated individuals as defined in the IRC.

Bond Provisions – The Act eliminates advance refunding bonds but retains the ability of a tax-exempt organization to issue tax-exempt private activity bonds through a state government conduit. Advance refunding is a means by which an issuer may refinance tax-exempt bonds issued more than 90 days previous by issuing more tax-exempt bonds at a lower interest rate and using the proceeds to repay the outstanding bonds. Private activity bonds cannot be refunded, but other bonds can be refunded one time. The Act eliminates this one time rule, with the result that issuers must use taxable bonds (with correspondingly higher interest rates) for advance refunding purposes. The Act repeals the rules relating to, and prospective authority to issue, tax credit and direct-pay bonds, after December 31, 2017. Tax credit bonds replace a portion of the interest on bonds with a tax credit, or, in the case of "direct-pay bonds," with a payment of interest from the federal government.

Local Lobbying Expenses – The Act amends IRC Section 162(e) to repeal the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian Tribal governments. The removal of this exception means that Section 501(c)(4), 501(c)(5), and 501(c)(6) organizations will need to account for these expenses in evaluating the proxy tax, the deductibility of membership dues, and nonprofit information reporting under IRC Section 6033.

Standard Deduction and Estate Tax – Although the Act retains the charitable contribution itemized deduction, as described above, the Act also approximately doubles the standard deduction for taxable years beginning after December 31, 2017 and before January 1, 2026, which is expected to reduce the number of taxpayers who itemize their deductions during those years. In addition, since the new law doubles the estate tax exemption for estates of decedents that die after December 31, 2017 and before January 1, 2026, the expansion of the standard deduction and estate tax exemption could have a significant impact on charitable giving.

7. International Taxation

The Act makes dramatic and far-reaching changes to the U.S. international tax rules by: (1) permitting tax-free repatriations of future foreign profits of foreign corporations to their 10 percent U.S. shareholders that are domestic corporations; (2) imposing an immediate tax at a reduced rate on all U.S. shareholders on accumulated earnings of foreign corporations that are controlled foreign corporations ("CFCs") or have 10 percent U.S. shareholders in a one-time deemed repatriation of those earnings; (3) imposing a current tax, similar to subpart F, on a U.S. shareholder's "global intangible low-taxed income" of a CFC; (4) modifying certain aspects of the "subpart F" anti-deferral rules, and (5) enacting several new provisions intended to prevent erosion of the U.S. tax base.

Dividend Received Deduction – The Act changes the taxation of domestic corporations from a worldwide tax system to a more territorial tax system. The new law allows for a domestic corporation to claim a 100% deduction for the foreign-source portion of a dividend received by such domestic corporation from a "specified 10%-owned foreign corporation," in which such domestic corporation is a "United States shareholder." For this purpose, a "specified 10%-owned foreign corporation" is any foreign corporation (other than a passive foreign investment company ("PFIC") that is not a controlled foreign corporation ("CFC")) and a United States shareholder is a United States person that owns (directly or constructively) stock of the foreign corporation representing 10% of the combined voting power and value of a foreign corporation. The deduction is allowed only to a C corporation that is not a regulated investment company or a real estate investment trust.

In addition to owning 10% of the voting power of the foreign corporation, a domestic corporation needs to satisfy a holding period requirement. Specifically, a domestic corporation is not permitted a 100% dividend deduction with respect to a dividend paid on any share of stock that is held for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the dividend is paid. Additionally, the foreign corporation must qualify as a specified 10% foreign corporation and the domestic corporation must likewise qualify as a 10% shareholder at all times during the period.

Under the Act, if a domestic corporation transfers substantially all of the assets of a foreign branch to a specified 10%-owned foreign corporation, with respect to which it is a United States shareholder after the transfer, then the domestic corporation must recapture, as U.S. source income, any net branch losses incurred after December 31, 2017, and before the transfer and with respect to which the domestic corporation took a deduction. This provision applies to transfers after December 31, 2017.

Mandatory Repatriation – The Act amends Section 965 to require a United States shareholder (which for this purpose includes domestic corporations, partnerships, trusts, estates, and U.S. individuals that own 10% of the voting power) of CFCs and other specified foreign corporations to include in income, for the last taxable year of such foreign corporation beginning before January 1, 2018, such shareholder's pro rata share of the deemed repatriation amount. Other specified foreign corporations are non-CFC, non-PFIC foreign corporations with a corporate United States shareholder (which for this purpose includes domestic corporations that own 10% of the voting power of such foreign corporation). The deemed repatriation amount is the greater of such foreign corporation's post-1986 deferred foreign income as of (i) November 2, 2017 or (ii) December 31, 2017 and that was not previously subject to U.S. tax (but excluding earnings and profits that were accumulated prior to the foreign corporation becoming a CFC or having a 10% U.S. shareholder). The deemed repatriation amount generally is unreduced by distributions made by the foreign corporation during the taxable year.

This deemed repatriation generally will be taxed at a 15.5% rate to the extent the underlying foreign earnings are attributable to the U.S. shareholder's cash position and an 8% rate for all other amounts. The "cash position" is defined to include cash, net accounts receivable, and the fair market value of similarly liquid assets.

The Act eliminates the active trade or business exception, which generally disallows nonrecognition treatment for transfers of property to a foreign corporation and also eliminates a domestic corporation from being able to claim an indirect foreign tax credit with respect to dividends it receives from a foreign corporation in which it owns 10% of the voting stock. The Act provides an election to increase the percentage of domestic taxable income offset by overall domestic loss treated as foreign-source income.

Global Intangible Low Taxed Income – The Act adds new Code Section 951A, which requires a United States shareholder of a CFC to include in income, as a deemed dividend, the global intangible low-taxed income ("GILTI") of the CFC. After factoring in a deduction that a domestic corporation will be entitled to claim with respect to such income inclusion, a domestic corporation will be subject to U.S. tax on GILTI at an effective rate of 10.5% (that is, 50% of the U.S. corporate tax rate of 21%). But U.S. shareholders who are not C corporations (such as domestic partnerships and their partners) will not be eligible for the 50% deduction and so will end up paying tax on GILTI of approximately 37%. They will not be able to take the 20% deduction on GILTI since that income is foreign income and the 20% deduction is only for domestic income. See the discussion under Section Three, "Taxation of Pass-Through Entities," above.

"GILTI" is defined as the excess of the U.S. shareholder's net CFC tested income over a net deemed tangible income return. "Net CFC tested income" generally means a CFC's gross income, other than income that is subject to U.S. tax as effectively connected income; Subpart F income (including income that would be Subpart F income but for the application of certain exceptions); and foreign oil and gas extraction income, less allocable deductions. The "net deemed tangible income return" generally is an amount equal to (i) 10% of the aggregate of the United States shareholder's pro rata share of a CFC's qualified business asset investment (generally, a quarterly average of the CFC's tax basis in depreciable property used in its trade or business) over (ii) the amount of interest expense taken into account to determine such U.S. shareholder's net CFC tested income.

Special Subpart F Changes – The Act first modifies the rules regarding which corporations are treated as CFCs. The new law expands the stock attribution rules by attributing stock of a foreign corporation owned by a foreign person to a related U.S. person for purposes of determining whether the related U.S. person is treated as a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. For example, a U.S. entity with a foreign shareholder may be treated as owning stock in a foreign corporation that is owned by its foreign shareholder. Accordingly, foreign sister companies of U.S. corporations with a common foreign parent corporation generally are treated as CFCs. This change is effective beginning in the last taxable year of foreign corporations beginning before January 1, 2018 and thus applies for purposes of the deemed repatriation described above. The Act also expands the definition of a U.S. shareholder to include U.S. persons who own 10% or more of the total value of a foreign corporation (rather than basing the determination solely on voting power).

Base Erosion – The new law imposes a minimum tax on a domestic corporation's "modified taxable income." The provision is aimed at domestic corporations that significantly reduce their U.S. tax base by making large deductible payments, such as royalties or interest, to foreign related parties. The tax imposed is equal to the excess of: 10%of the corporation's "modified taxable income," reduced by the tax otherwise imposed on the corporation, after reduction for credits, but adding back (i) 100% of IRC Section 41(a) research credit and (ii) 80% of the lesser of (a) the low-income housing credit, the renewable electricity production credit, and certain investment credits allocable to the energy credit, or (b) the minimum tax amount imposed by this provision (determined without regard to the addition of 80% of such credits).

The 10% rate is reduced to 5% for the single taxable year beginning in 2018 and increased to 12.5% for taxable years beginning in 2026. The add-back for certain credits is also eliminated for taxable years beginning in 2026. Each rate is increased by 1% for taxpayers that are members of an affiliated group that includes a bank or a securities dealer.

A corporation's modified taxable income is the corporation's taxable income, increased by certain "base erosion payments." These "base erosion payments" include deductible payments or payments for depreciable property that the corporation makes to a foreign related party, but do not include payments that are subject to tax under IRC Sections 871 or 881 and on which the full amount of tax has been withheld under IRC Sections 1441 and 1442.

The minimum tax is imposed on U.S. corporations and on the income of foreign corporations that is effectively connected with the conduct of a U.S. trade or business. Related parties are treated as a single person for purposes of determining certain aspects of the application of the minimum tax. In order for the minimum tax to apply, the corporation must not be a regulated investment company, real estate investment trust or S corporation; must have average annual gross receipts of at least $500 million for the three preceding taxable years; and must be making base erosion payments that represent 3% or more of all of its deductions, excluding NOL deductions, the new foreign DRD, and the foreign-derived intangible income and GILTI deductions (or, for members of an affiliated group that includes a bank or securities dealer, this applicable threshold is decreased to 2%).

8. Like-Kind Exchanges

Prior to the new law, property eligible to be exchanged in a tax-free like-kind exchange included not only real property but also personal property, including intangible personal property such as patents and other intellectual property. Now, under the new rules tax-free like-kind exchanges only apply to real property and the real property cannot be held primarily for sale (i.e., the equivalent of inventory). This means that no gain or loss is recognized on the exchange of real property that is held for productive use in a trade or business or for investment if the real property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment.

Exchanges of personal property and intangible property no longer qualify as tax-free under IRC Section 1031 for exchanges completed after December 31, 2017. Exchanges of machinery, equipment, vehicles, cybercurrency, patents and other intellectual property, artwork, collectibles, and other intangible business assets will no longer be eligible for tax-free like-kind treatment.

However, there is a transition rule for forward exchanges or reverse exchanges that occur prior to January 1, 2018. In a forward exchange, if the taxpayer disposes of the relinquished property before January 1, 2018 or in a reverse exchange, if the taxpayer receives the replacement property before January 1, 2018, then the old rules still apply and the property can qualify for tax-free like-kind exchange treatment if all the other requirements under IRC Section 1031 are satisfied. Therefore, personal property could qualify under the transition rule. By way of example, under an exchange agreement, A transfers equipment (relinquished property) to a qualified intermediary (QI) on December 30, 2017. The QI has to acquire like-kind equipment (replacement property) identified by A within 45 days and transfer the equipment to A within 180 days after the transfer of the relinquished property. Here, the exchange of personal property presumably will qualify as a tax-free like-kind exchange if the other requirements provided under the prior law are satisfied.

Conclusion

The Act has made substantial changes to the tax laws. There are many “glitches” in the Act that will need to be addressed in technical correction legislation. Since technical correction legislation requires a 60% vote in the Senate (it cannot come under reconciliation rules), there will need to be bi-partisan cooperation to fix the problems that such fast paced passage of the Act produced. Second, technical corrections require unanimous consent by both the majority and minority staffs of the House Committee on Ways and Means and the Senate Finance Committee. If anyone disagrees about the legislative intent of a provision and whether the statute reflects that intent, then the provision is not a technical correction but, rather, a change in policy. Thus it may take quite a while for any technical correction legislation to be passed.

Effective tax planning including choice of entity structures will be made based on the new laws that are now in effect. Only time will tell how these changes will impact individuals, businesses, and the economy.

If you have any particular area of interest or concern regarding how these changes directly affect you or your business, please feel free to contact our tax attorneys, Cheryl Johnson at **cjohnson@verrilldana.com** or Jen Green at **jgreen@verrilldana.com**.