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National Tax Advisory®
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TO: All Professional Tax Personnel - NTA-1006

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DATE: December 19, 2017

RE: Highlights of the Tax Cuts and Jobs Act

Background

On 12/20/17, both the House and Senate passed H.R. 1—commonly referred to as the Tax Cuts and Jobs Act (TCJA). (Originally, this was the bill's short title; however, the Senate Parliamentarian ruled that it violated the Byrd rule. For matters of convenience, this release refers to the bill as the TCJA.) The bill has been sent to President Trump, who is expected to sign it into law. Hailed as the largest major tax reform in over three decades, the TCJA contains a whole host of tax provisions that impact individuals and businesses. With a few rare exceptions, the provisions of the TCJA affect 2018 tax returns. However, now is the time to become familiar with this massive and groundbreaking act.

Note: To keep our coverage manageable, we opted to highlight the provisions that will most likely affect your clients. Also, our coverage is limited to high-level summaries. Future releases will go into greater detail on key individual, business, and international tax provisions. Sample client letters also will follow, so stay tuned.

Individual Tax Provisions

The TCJA modifies various provisions applicable to individual taxpayers. Here are some key changes.

Income Tax Rates and Exemptions

New Tax Rates and Brackets. For tax years 2018–2025, seven tax brackets apply for individuals: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The specific brackets and the income levels at which they apply, compared to prior law, are shown in the provided table [IRC Sec. 1(j)(1) and (2), as added by Act Sec. 11001(a)].

View Table

Kiddie Tax Modified. Under pre-TCJA law, pursuant to the "kiddie tax" provisions, the net unearned income of a child was taxed at the parents' tax rates if the parents' tax rates were higher than the tax rates of the child. The remainder of the child's taxable income [i.e., earned income, plus unearned income up to $2,100 (for 2018), less the child's standard deduction] was taxed at the child's rates.

For tax years 2018–2025, the taxable income of a child attributable to earned income is taxed under the rates for single individuals, and taxable income of a child attributable to net unearned income is taxed according to the brackets applicable to trusts and estates. This rule applies to the child's ordinary income and his or her income taxed at preferential rates [IRC Sec. 1(j)(4), as added by Act Sec. 11001(a)].

Personal Exemption Deduction Eliminated. Under pre-TCJA law, the deduction for each personal exemption was $4,150 for 2018, subject to a phaseout for higher earners. For tax years 2018–2025, the deduction for personal exemptions is eliminated [IRC Sec. 151(d), as modified by Act Sec. 11041(a)].

Standard and Itemized Deductions

Standard Deduction Increased. Under pre-TCJA law, for 2018, the standard deduction amounts were to be: $6,500 for single individuals and married individuals filing separately, $9,550 for heads of household, and $13,000 for married individuals filing jointly (including surviving spouses). Additional standard deductions may be claimed by taxpayers who are elderly or blind.

For tax years 2018–2025, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years after 2018. No changes are made to the current-law additional standard deduction for the elderly and blind [IRC Sec. 63(c)(7) , as added by Act Sec. 11021(a)].

Medical Expense Deduction Threshold Temporarily Reduced. For tax years 2017–2018, the threshold for medical expense deductions is reduced from 10%-of-AGI to 7.5%-of-AGI for all taxpayers [IRC Sec. 213(f) , as amended by Act Sec. 11027(a)]. In addition, the rule limiting the medical expense deduction for Alternative Minimum Tax (AMT) purposes to the excess of such expenses over 10%-of-AGI doesn't apply to those tax years [IRC Sec. 56(b)(1)(B), as amended by Act Sec. 11027(b)].

State and Local Tax Deduction Limited. For tax years 2018–2025, a taxpayer's itemized deduction for state and local taxes is limited to $10,000 ($5,000 for a married taxpayer filing a separate return) of the aggregate of (1) state and local property taxes and (2) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the tax year [IRC Sec. 164(b)(6) , as added by Act Sec. 11042].

Warning: The provision also includes a rule stating that an individual may not claim an itemized deduction in 2017 on a pre-payment of income tax for a future tax year in order to avoid the dollar limitation applicable for tax years beginning after 2017.

Mortgage and Home Equity Indebtedness Interest Deduction Limited. Under pre-TCJA law, taxpayers could deduct as an itemized deduction qualified residence interest, which included interest paid on a mortgage secured by a principal residence or a second residence. The underlying mortgage loans could represent acquisition indebtedness of up to $1 million, plus home equity indebtedness of up to $100,000.

For tax years 2018–2025, the deduction for interest on home equity indebtedness is eliminated and the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately) [IRC Sec. 163(h)(3)(F), as added by Act Sec. 11043(a)].

Note: The new lower limit doesn't apply to any acquisition indebtedness incurred before 12/15/17.

Charitable Contribution Deduction Limitation Increased. For contributions made in tax years after 2017, the 50% limitation under IRC Sec. 170(b) for cash contributions to public charities and certain private foundations is increased to 60% [IRC Sec. 170(b)(1)(G) , as added by Act Sec. 11023]. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling.

Charitable Contribution Deduction for College Athletic Seating Rights Eliminated. Under pre-TCJA law, a taxpayer could treat 80% of a payment as a charitable contribution where: (1) the amount was paid to or for the benefit of an institution of higher education (i.e., generally, a school with a regular faculty and curriculum and meeting certain other requirements); and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution. For tax years after 2017, no charitable deduction will be allowed for any payment to an institution of higher education in exchange for the right to purchase tickets or seating at an athletic event [IRC Sec. 170(l), as amended by Act Sec. 13704].

Casualty and Theft Loss Deduction Eliminated. For tax years 2018–2025, the personal casualty and theft loss deduction is eliminated, except for personal casualty losses incurred in a federally-declared disaster [IRC Sec. 165(h)(5), as amended by Act Sec. 11044]. However, where a taxpayer has personal casualty gains, the loss suspension doesn't apply to the extent that such loss doesn't exceed gain.

Note: The TCJA includes special relief provisions for tax years 2018–2025 for taxpayers who incurred losses from certain 2016 major disasters.

Gambling Loss Limitation Modified. For tax years 2018–2025, the limitation on wagering losses under IRC Sec. 165(d) is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings [IRC Sec. 165(d) , as amended by Act Sec. 11050].

Miscellaneous Itemized Deductions Eliminated. For tax years 2018–2025, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is eliminated [IRC Sec. 67(g), as added by Act Sec. 11045].

"Pease" Limitation on Itemized Deductions Eliminated. Under pre-TCJA law, higher-income taxpayers who itemized their deductions were subject to a limitation on these deductions (commonly known as the "Pease limitation"). For tax years 2018–2025, the

"Pease limitation" on itemized deductions is eliminated [IRC Sec. 68(f), as added by Act Sec. 11046].

Income and Losses

New Deduction for Business Income from Pass-through Entities and Sole Proprietorships. For tax years 2018–2025, an individual generally may deduct 20% of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20% of aggregate qualified Real Estate Investment Trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Special rules apply to specified agricultural or horticultural cooperatives. The 20% deduction is not allowed in computing Adjusted Gross Income (AGI), but rather is allowed as a deduction reducing *taxable* income [IRC Secs. 199A , "Deduction for Qualified Business Income," as added by Act Sec. 11011(a) and 62(a) , as modified by Act Sec. 11011(b)].

A limitation based on W-2 wages paid is phased in for married filing joint taxpayers with taxable income of $315,000 or more ($157,500 for other individuals). A disallowance of the deduction with respect to specified service trades or businesses also is phased in above these threshold amounts of taxable income. A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, 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 or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities [IRC Sec. 199A , as added by Act Sec. 11011(a)].

Treatment of Carried Interest. Under pre-TCJA law, carried interests were taxed in the hands of the taxpayer (i.e., the fund manager) at favorable capital gain rates instead of as ordinary income. For tax years beginning after 2017, the TCJA imposes a three-year holding period requirement in order for certain partnership interests received in connection with the performance of services to be taxed as long-term capital gain rather than ordinary income [IRC Sec. 1061, "Partnership Interests Held in Connection with Performance of Services," as added by Act Sec. 13309(a)].

New Limitations on "Excess Business Loss." Under pre-TCJA law, IRC Sec. 469 provides a limitation on excess farm losses that applies to taxpayers other than C corporations. An excess farm loss for a tax year means the excess of aggregate deductions that are attributable to farming businesses over the sum of aggregate gross income or gain attributable to farming businesses plus the threshold amount. The threshold amount is the greater of (1) $300,000 ($150,000 for married individuals filing separately), or (2) for the five-consecutive-year period preceding the tax year, the excess of the aggregate gross income or gain attributable to the taxpayer's farming businesses over the aggregate deductions attributable to the taxpayer's farming businesses.

For tax years 2018–2025, the TCJA provides that the excess farm loss limitation doesn't apply, and instead a noncorporate taxpayer's "excess business loss" is disallowed. Under the new rule, excess business losses are not allowed for the tax year, but are instead carried forward and treated as part of the taxpayer's Net Operating Loss (NOL) carryforward in subsequent tax years. This limitation applies *after* the application of the passive loss rules [IRC Sec. 461(l), as added by Act Sec. 11012].

An excess business loss for the tax year is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a tax year is $500,000 for married individuals filing jointly and $250,000 for other individuals, with both amounts indexed for inflation [IRC Sec. 461(l)(3), as added by Act Sec. 11012]. In the case of a partnership or S corporation, the provision applies at the partner or shareholder level.

Self-created Property Not Treated as Capital Asset. Under pre-TCJA law, property held by a taxpayer (whether or not connected with the taxpayer's trade or business) is generally considered a capital asset under IRC Sec. 1221(a) . 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 and musical compositions).

Effective for dispositions after 2017, the TCJA amends IRC Sec. 1221(a)(3) , resulting in the exclusion of patents, inventions, models or designs (whether or not patented), 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 (or for whom the property was created), from the definition of a "capital asset" [IRC Sec. 1221(a)(3) , as amended by Act Sec. 13314].

Alimony Deduction by Payor and Income Inclusion by Payee Repealed. For any divorce or separation agreement executed after 2018, or executed before that date but modified after it (if the modification expressly provides that the new amendments apply), alimony and separate maintenance payments are not deductible by the payor spouse and are not included in the income of the payee spouse [Former IRC Secs. 215, 61(a)(8), and 71, as stricken by Act Sec. 11051].

Moving Expense Deduction and Reimbursements Eliminated. For tax years 2018–2025, the deduction for moving expenses and the income exclusion for qualified moving expense reimbursements is eliminated, except for members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station [IRC Secs. 132(g), as amended by Act Sec. 11048 and 217(k) , as added by Act Sec. 11049].

AMT

AMT Retained with Increased Exemption Amounts. The TCJA retains the individual AMT but with increased exemption amounts and phase-out thresholds for years 2018–2025 (indexed for inflation), as shown in the following table [IRC Sec. 55(d)(4), as added by Act Sec. 12003(a)]:

View Table

Tax-advantaged Savings Accounts

ABLE Account Changes. The TCJA makes several changes to the rules governing ABLE accounts established for the benefit of certain disabled individuals. Effective for tax years beginning after the enactment date and before 2026, the contribution limitation to ABLE accounts with respect to contributions made by the designated beneficiary is increased. After the overall limitation on contributions is reached (i.e., the annual gift tax exemption amount; for 2018, $15,000), an ABLE account's designated beneficiary can contribute an additional amount, up to the lesser of (1) the federal poverty line for a one-person household; or (2) the individual's compensation for the tax year [IRC Sec. 529A(b), as amended by Act Sec. 11024 (a)].

Saver's Credit Eligible. The designated beneficiary of an ABLE account can claim the saver's credit under IRC Sec. 25B for contributions made to his ABLE account [IRC Sec. 25B(d)(1) , as amended by Act Sec. 11024(b)].

Rollovers from Qualified Tuition Programs (QTPs). For distributions after the date of enactment and before 2026, amounts from QTPs (also known as 529 accounts) are allowed to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family [IRC Sec. 529(c)(3), as amended by Act Sec. 11025). Such rolled-over amounts are counted towards the overall limitation on amounts that can be contributed to an

ABLE account within a tax year, and any amount rolled over in excess of this limitation is includible in the gross income of the distributee.

QTPs Expanded. Under pre-TCJA law, the earnings on funds in a QTP could be withdrawn tax-free only if used for qualified higher education expenses at eligible schools. Eligible schools included colleges, universities, vocational schools, or other postsecondary schools eligible to participate in a student aid program of the Department of Education.

For distributions after 2017, "qualified higher education expenses" is expanded to include tuition at an elementary or secondary public, private, or religious school, up to a $10,000 limit per tax year [IRC Sec. 529(c)(7) , as added by Act Sec. 11032(a)].

Other Significant Items

Child Tax Credit Increased. For tax years 2018–2025, the child tax credit is increased from $1,000 to $2,000 per qualifying child under the age of 17, and other changes are made to phase-outs and refundability during this same period, as outlined in this section [IRC Sec. 24 (h)(2) , as added by Act Sec. 11022(a)].

Under pre-TCJA law, the credit phased out by $50 for each $1,000 of modified AGI over $75,000 for single or head of household filers, $110,000 for married joint filers, and $55,000 for married individuals filing separately. Under the TCJA, the income level at which the credit phases out is increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers) (not indexed for inflation) [IRC Sec. 24(h)(3), as added by Act Sec. 11022(a)].

Nonchild Dependents. A $500 nonrefundable credit is provided for certain nonchild dependents [IRC Sec. 24(h)(4), as added by Act Sec. 11022(a)].

Refundability. The amount that is refundable is increased to $1,400 per qualifying child, and this amount is indexed for inflation, up to the $2,000 base credit amount. The earned income threshold for the refundable portion of the credit is decreased from $3,000 to $2,500 [IRC Sec. 24(h)(5) and (6), as added by Act Sec. 11022(a)].

Affordable Care Act Individual Mandate Repealed. Under pre-TCJA law, the Affordable Care Act required individuals, who were not covered by a health plan that provided at least minimum essential coverage, to pay a "shared responsibility payment" (also referred to as a penalty) with their federal tax return ($695 for 2018). Unless an exception applied, the tax was imposed for any month that an individual did not have minimum essential coverage.

For months beginning after 2018, the amount of the individual shared responsibility payment is permanently reduced to zero [IRC Sec. 5000A(c) , as amended by Act Sec. 11081].

Recharacterization of Roth Conversions Eliminated. For Roth conversions in tax years beginning after 2017, the TCJA repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. Thus, recharacterization cannot be used to unwind a Roth conversion, but is still permitted with respect to other contributions [IRC Sec. 408A(d), as amended by Act Sec. 13611].

Estate and Gift Tax Retained with Increased Exemption Amount. Under pre-TCJA law, the first $5 million (as adjusted for inflation in years after 2011) of transferred property was exempt from estate and gift tax. For estates of decedents dying and gifts made in 2018, this "basic exclusion amount" was $5.6 million ($11.2 million for a married couple).

For estates of decedents dying and gifts made after 2017 and before 2026, the TCJA doubles the base estate and gift tax exemption amount from $5 million to $10 million [IRC Sec. 2010(c)(3), as amended by Act Sec. 11061(a)]. The $10 million amount is indexed for inflation occurring after 2011 and is expected to be approximately $11.2 million in 2018 ($22.4 million per married couple).

Entity-specific Tax Provisions

Under the TCJA, C corporations, S corporations, partnerships, and nonprofit organizations will see dramatic changes. Here are some of the more notable ones.

C Corporations

Tax Rates. Currently, C corporations are used to graduated tax rates, with a top rate of 35% if taxable income exceeds $10 million. [See IRC Sec. 11(b) .] In addition, personal service corporations are taxed at a flat rate of 35% [IRC Sec. 11(b)(2)]. For tax years beginning after 12/31/17, the TCJA lowers the corporate tax rate to a flat 21%. This applies to personal service corporations as well. According to the GOP, a significantly lower corporate tax rate is needed to promote economic growth and global competitiveness.

Dividends Received Deduction. Corporations are generally permitted a special deduction for dividends received (IRC Sec. 243). If the corporation owns at least 20% of another corporation, an 80% dividends received deduction is permitted. Otherwise, the deduction is limited to 70%. If the payor and recipient corporations are members of the same affiliated group, a 100% dividends received deduction is allowed. Under the TCJA, the 80% dividends received deduction is reduced to 65%, and the 70% deduction is reduced to 50%. This applies to tax years beginning after 12/31/17.

AMT. The TCJA repeals the corporate AMT for tax years beginning after 12/31/17. For tax years beginning after 2017 and before 2022, the AMT credit is refundable and can offset regular tax liability in an amount equal to 50% (100% for tax years beginning in 2021) of the excess of the minimum tax credit for the year over the amount of the credit allowable for the year against regular tax liability. This means the full amount of the minimum tax credit will be allowed in tax years beginning before 2022.

Contributions to Capital. IRC Sec. 118 excludes contributions to the capital of a corporation from the corporation's gross income. The TCJA provides that the term *contributions to capital* does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).

S Corporations

Conversion to C Corporation Status. In general, distributions to C corporation shareholders are first treated as dividends to the extent of earnings and profits. However, a special Post-termination Transition Period (PTTP) provides relief to the shareholders of a corporation that has terminated its S status. During the PTTP, any distribution of money by the corporation is first applied to reduce the basis of the shareholder's stock to the extent the distribution does not exceed the Accumulated Adjustments Account (AAA) [IRC Sec. 1371(e)(1)].

The TCJA changes these rules with respect to *eligible terminated S corporations*. These are C corporations that (1) were S corporations before the TCJA's enactment date; (2) revoked their S corporation elections during the two-year period beginning on the enactment date; and (3) had the same owners on the enactment and revocation dates. Distributions from such corporations are treated as paid from AAA and earnings and profits on a prorata basis.

Electing Small Business Trusts. Under IRC Sec. 1361(c)(2)(A)(v) , Electing Small Business Trusts (ESBTs) are allowed to own stock in an S corporation. Effective 1/1/18, the TCJA permits a nonresident alien individual to be a potential current beneficiary of an ESBT.

Partnerships

Technical Terminations. A partnership is considered to terminate for tax purposes if, within a 12-month period, there is a sale or exchange of 50% or more of the partnership's capital and profits interests [IRC Sec. 708(b)(1)(B)]. This rule is repealed under the TCJA for partnership tax years beginning after 12/31/17. As such, new elections are not required or permitted following technical termination under prior law.

Substantial Built-in Loss Rule. In general, a partnership must adjust the basis of its property following the transfer of a partnership interest if it has a *substantial built-in loss*. A substantial built-in loss exists if the partnership's adjusted basis in the property exceeds its fair market value by more than $250,000 [IRC Sec. 743(d)]. Under the TCJA, a substantial built-in loss also exists if the recipient of the interest would be allocated a net loss in excess of $250,000 upon a hypothetical disposition of all partnership assets in a fully taxable transaction for cash equal to the assets' fair market value immediately after the transfer of the interest. The provision applies to transfers of partnership interests after 12/31/17.

Charitable Contributions and Foreign Taxes. For partnership tax years beginning after 12/31/17, a partner's distributive share of the partnership's charitable contributions and foreign taxes is taken into account in determining the amount of his or her loss. However, in the case of a charitable contribution of property with a fair market value that exceeds its adjusted basis, the partner's distributive share of the excess is not taken into account.

Nonprofit Organizations

New Excise Tax on Excess Executive Compensation. The TCJA imposes a new 21% excise tax on tax-exempt organizations that pay excessive compensation to their top executives, effective for tax years beginning after 12/31/17. The tax applies to the sum of (1) compensation in excess of $1 million paid to a covered employee and (2) any excess parachute payment made to a covered employee. A *covered employee* is one of the five highest compensated employees of the tax-exempt organization for the tax year or was a covered employee of the organization (or a predecessor) for any preceding tax year beginning after 12/31/16. Special rules apply to compensation paid to licensed medical professionals.

New Excise Tax on Private Colleges and Universities. For tax years beginning after 12/31/17, the TCJA imposes a new 1.4% excise tax on the net investment income of certain private colleges and universities. The college or university must have at least 500 students, more than 50% of which are located in the U.S. In addition, the college or university must have assets (other than those used directly in carrying out the institution's exempt purpose) of at least $500,000 per student.

Calculation of Unrelated Business Taxable Income. For tax years beginning after 12/31/17 (but subject to a transition rule for NOLs arising in a tax year beginning before 1/1/18), losses from one unrelated trade or business may not be used to offset income derived from another unrelated trade or business. Therefore, the TCJA requires nonprofit organizations to separately calculate and apply their unrelated business gains and losses.

General Business Tax Provisions

Many of the tax incentives businesses have grown accustomed to have been repealed, modified, or limited in some way. Here are the more relevant provisions.

Expensing and Depreciating Property

Section 179 Deduction. Under pre-TCJA law, the maximum Section 179 deduction was scheduled to be $520,000 for 2018. In addition, the qualifying property phase-out threshold was scheduled to be $2,070,000. The TCJA increases the maximum Section 179 deduction and phase-out threshold to $1 million and $2.5 million, respectively, for property placed in service in tax years beginning after 12/31/17. For tax years beginning after 2018, these amounts will be indexed for inflation. The TCJA also expands the definition of Section 179 property to include certain tangible personal property used predominantly to furnish lodging and certain improvements to nonresidential real property (roofs, HVAC, fire protection and alarm systems, and security systems).

Immediate Expensing of Qualifying Business Assets. The TCJA establishes a 100% first-year deduction for qualified property acquired and placed in service after 9/27/17 and before 1/1/23 (1/1/24 for certain property with longer production periods). This applies to new and used property. In later years, this first-year deduction phases down as follows:

- 80% for property placed in service in 2023.
- 60% for property placed in service in 2024.
- 40% for property placed in service in 2025.
- 20% for property placed in service in 2026.

Note: For qualifying property placed in service after 9/27/17, business owners can take advantage of this provision on their 2017 tax returns. Or, under a first-year transition rule, they can stick with current law and claim 50% bonus depreciation.

Increased Luxury Automobile Depreciation Limits. IRC Sec. 280F limits the annual amount of depreciation that can be claimed for passenger autos. For passenger autos placed in service after 12/31/17 for which bonus depreciation is not claimed, the maximum amount of allowable depreciation is increased to $10,000 for the placed-in-service year, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years. These amounts will be indexed for inflation for autos placed in service after 2018. For passenger autos eligible for bonus first-year depreciation, the increase to the first-year depreciation limit remains $8,000.

Shortened Recovery Period for New Farming Equipment. The TCJA shortens the recovery period of new machinery or equipment placed in service after 12/31/17 and used in a farming business (other than any grain bin, cotton ginning asset, fence, or other land improvement) from seven to five years. In addition, use of the 150% declining balance depreciation method for these assets will no longer be required.

Shortened Recovery Period for Real Property. For property placed in service after 12/31/17, the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property are eliminated. The TCJA imposes a general 15-year recovery period (20 years for ADS) and straight-line method for qualified improvement property. In addition, the ADS recovery period for residential rental property is shortened from 40 to 30 years.

General Deductions, Exclusions, and Credits

Interest Expense. Regardless of its form, every business will be subject to a net interest expense disallowance. For tax years beginning after 12/31/17, net interest expense in excess of 30% of the company's adjusted taxable income will be disallowed. *Adjusted taxable income* is generally defined as taxable income computed without regard to deductions for depreciation, amortization, depletion, or the Section 199 deduction. However, taxpayers (other than tax shelters) with average annual gross receipts for the prior three years of $25 million or less are exempt from this limitation.

NOLs. The TCJA generally repeals the two-year carryback rule for NOLs. (The rule still applies to certain losses incurred in a farming business.) For losses arising in tax years beginning after 12/31/17, the NOL deduction is limited to 80% of taxable income. With the exception of property and casualty insurance companies, NOLs can be carried forward indefinitely. Property and casualty insurance companies can carry their NOLs back two years and forward 20 years to offset 100% of taxable income.

Section 199 Deduction. IRC Sec. 199 allows a deduction equal to a percentage of the income earned from certain manufacturing and other production activities conducted within the U.S. For tax years beginning after 12/31/17, the Section 199 deduction is repealed.

Like-kind Exchanges. The TCJA limits the like-kind exchange rules so they apply only to real property that is not held primarily for sale. However, under a special transition rule, the like-kind exchange rules continue to apply to exchanges of personal property if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before 12/31/17.

Research and Experimental Expenses. Pre-TCJA law allowed taxpayers to currently deduct Research and Experimental (R&E) expenses paid or incurred in connection with a trade or business (IRC Sec. 174). Alternatively, taxpayers could capitalize their R&E expenditures and amortize them ratably over the useful life of the research (not to exceed 60 months) or a period of 10 years. For amounts paid or incurred in tax years beginning after 12/31/21, the TCJA requires specified R&E expenses to be capitalized and amortized ratably over five years (15 years if R&E is conducted outside of the U.S.). *Specified R&E expenses* include costs for software development and exploration for ore and other minerals. Note that the R&E tax credit is expressly preserved in the TCJA Policy Highlights.

Deduction for Fringe Benefits. The TCJA makes the following adjustments to the fringe benefit rules (for amounts paid or incurred after 12/31/17):

- Disallows deductions for entertainment expenses.
- Expands the current 50% limit on the deductibility of business meals to those provided in an in-house cafeteria or otherwise on the employer's premises.
- Denies a deduction for employee transportation fringe benefits. However, the TCJA retains the exclusion from income for such benefits received by an employee.
- Eliminates a deduction for transportation expenses that are the equivalent of commuting for employees, except as provided for the safety of the employee.

For amounts paid or incurred after 12/31/25, the TCJA disallows an employer's deduction for expenses associated with meals provided for the convenience of the employer on its business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

Excessive Employee Compensation. An employer's compensation deduction may be limited by IRC Sec. 162(m), which generally provides a deduction limit of $1 million for compensation paid by a publicly-held corporation during any tax year to a covered employee.

However, there are exceptions for commissions, performance-based compensation (including stock options), payments to a tax-qualified retirement plan, and amounts that are excludable from the executive's gross income. For tax years beginning after 12/31/17, the exceptions for commissions and performance-based compensation are repealed. These changes do not apply to written binding contracts that were in effect on 11/2/17 (unless the contract is materially modified).

New Credit for Employer-paid Family and Medical Leave. For tax years beginning after 12/31/17 and before 1/1/20, the TCJA allows businesses 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 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%. All qualifying full-time employees have to be given at least two weeks of annual paid family and medical leave.

Accounting Method Changes

Inclusion Year. For tax years beginning after 12/31/17, an accrual-method taxpayer is generally required to recognize income no later than the tax year in which such income is taken into account on an Applicable Financial Statement (AFS) or other financial statement under rules specified by the IRS. This rule is subject to an exception for long-term contract income under IRC Sec. 460. If an accounting method change is needed to conform to this new rule, such change will be treated as initiated by the taxpayer and made with the IRS's consent.

Expansion of Cash Method of Accounting. For tax years beginning after 12/31/17, the cash method may be used by taxpayers (other than tax shelters) that satisfy a $25 million gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. In addition, such taxpayers are not required to account for inventories under IRC Sec. 471 or 263A. Instead, they may treat inventories as nonincidental materials and supplies or conform to their financial accounting treatment of inventories.

Long-term Contracts. Generally, construction companies with average annual gross receipts of $10 million or less in the prior three years are exempt from the Percentage of Completion Method (PCM). The TCJA expands this exemption to contracts for the construction or improvement of real property if the contract (1) is expected to be completed within two years and (2) is performed by a taxpayer that meets the $25 million gross receipts test discussed earlier. This change is effective for contracts entered into after 12/31/17.

International Tax Provisions

Perhaps the most drastic changes found in the TCJA involve the Code's international tax provisions. As you know, pre-TCJA law taxed the worldwide income of domestic corporations. This created the potential for double taxation if the country in which the corporation operated also taxed the income. The foreign tax credit was one way to alleviate this burden. One of the goals of the TCJA was to move away from a worldwide system of taxation to a territorial system. Several provisions were included to achieve this goal.

Deduction for Foreign-source Portion of Dividends. The TCJA essentially provides an exemption for certain foreign income. This is accomplished through a 100% deduction for the foreign-source portion of dividends received from 10%-owned foreign corporations. No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the deduction. The deduction is available only to C corporations and does not apply to Regulated Investment Companies (RICs) or REITs. The provision applies to distributions made after 12/31/17.

If a domestic corporate shareholder sells foreign corporation stock held for one year or more, any amount that is treated as a dividend for purposes of IRC Sec. 1248 is treated as a dividend for purposes of the special dividends received deduction. In addition, if a domestic corporate shareholder benefits from the foreign dividends received deduction, it must reduce its adjusted basis in the stock of the 10%-owned foreign corporation by the amount of the deduction. This is done only for the purpose of determining losses on future sales or exchanges of the stock.

Deemed Repatriation Tax. To transition to a new territorial system, the TCJA imposes a deemed repatriation tax. This requires U.S. shareholders owning at least 10% of a foreign subsidiary to include in income their prorata share of the subsidiary's post-1986 earnings and profits. The portion of earnings and profits made up of cash or cash equivalents is taxed at 15.5%, while noncash assets are taxed at 8%.

The U.S. shareholder may elect to pay the deemed repatriation tax over eight years. The payment for each of the first five years equals 8% of the net tax liability. The sixth installment equals 15% of the net tax liability. The seventh installment increases to 20% of the net tax liability, while the remaining balance of 25% is due in the eighth year.

The TCJA provides a special rule for S corporations. S corporation shareholders are allowed to elect to maintain deferral on such foreign income until the S corporation (1) changes its status, (2) sells substantially all of its assets, or (3) ceases to conduct business. Deferral also may be maintained until the electing shareholder transfers its S corporation stock.

Foreign Intangible Income. The TCJA provides C corporations with a reduced tax rate on Foreign-derived Intangible Income (FDII) and Global Intangible Low-taxed Income (GILTI). FDII is generally intangible income that is derived from serving foreign markets. GILTI is the domestic corporation's portion of foreign earnings that exceed an amount equal to a standard rate of return on the foreign company's assets. GILTI does not include effectively connected income, subpart F income, foreign oil and gas income, or certain related party payments. The effective tax rate on FDII is 13.125% in tax years beginning after 2017 and before 2026 and 16.406% after 2025. The effective tax rate on GILTI is 10.5% in tax years beginning after 2017 and before 2026 and 13.125% after 2025.

Base Erosion Anti-abuse Tax (BEAT). A base erosion payment is generally any deductible amount paid or accrued by a taxpayer to a related foreign person. Under the TCJA, certain corporations with average annual gross receipts of at least $500 million are required to pay a BEAT with respect to base erosion payments paid or accrued in tax years beginning after 12/31/17. The tax is generally 10% (12.5% for tax years beginning after 12/31/25) of the modified taxable income of the taxpayer over an amount equal to the regular tax liability of the taxpayer for the year. Members of affiliated groups that include a bank or securities dealer will be taxed at 11%, increasing to 13.5% after 2025. Amounts paid or incurred for services are excluded from the BEAT if those services meet the requirements for the services cost method under IRC Sec. 482 .

Related Party Payments. Under the TCJA, deductions for certain related-party payments are denied. These include interest or royalty payments to a related party if (1) the related party does not report the payments as income under the laws of the resident country, or (2) the related party is allowed a deduction with respect to the payments. These are generally known as *hybrid transactions* . For tax years that begin after 12/31/17, amounts paid or accrued pursuant to a hybrid transaction are disallowed.

Conclusion

Phew—there you have it. As you can see, the TCJA is going to bring a lot of changes (both good and bad) to individual and business taxpayers. On the plus side, this means more planning opportunities for you. Clients will look to you for answers as they navigate through uncertain territory. As we said earlier, this release only touches the surface of one of the biggest tax overhauls in the nation's history. Stay tuned for future articles that will dive deeper into the legislative details.

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