The Final Tax Bill: A Thoughtful Analysis

by Saba Ashraf and Adam S. Wallwork | December 20, 2017

Earlier today, both the House and the Senate passed the Tax Cuts and Jobs Act of 2017 (the final bill). With the signature of President Donald J. Trump, it will become law. The tax legislation represents the biggest overhaul to the U.S. tax system since the tax reform enacted in 1986 under President Ronald Reagan.

Our previous alerts have closely tracked and compared the bills as they were proposed and moved through the House and Senate. This alert focuses more on the final version of the legislation and provides our initial analysis as we begin tax planning under the new rules. We expect to engage in and issue broader and deeper analysis in the coming days and weeks. Please stay tuned.

The hyperlinks in the table of contents will allow you to navigate to any part of the chart below.

In reviewing the discussion below, one organizing principle that is helpful in understanding the new rules is as follows: Income generally arises from three sources: (1) wages/labor, (2) capital and (3) debt. The final bill has a strong bias in favor of income from capital as opposed to from wages or debt. Underlying the bill is the basic assumption that we should encourage investment in corporations and other capital intensive businesses. The purported logic is that if corporations and other businesses have low taxes, then (a) an investment in them would be more attractive, and (b) they would use a portion of their savings and spend them on wages, research or other expenses that will in turn be good for everyone (including wage earners).

That said, given that the final bill was written and passed so quickly—and some of its changes are so big in comparison to the existing rules—the truth is that we will not know for months if particular groups with particular factual situations are favored or disfavored. The final bill likely will have a lot of intended and unintended consequences. As one state Republican legislator stated: "We're affected in different ways by different pieces. We're waiting to get excited about it until we figure out what's in it moving forward." One thing is certain: The final bill provides numerous tax planning possibilities, or "loopholes" as some call them—particularly in the early days before any such loopholes may be closed.

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A. CORPORATE TAX & PASS-THROUGH PROVISIONS

A. 1.	**Corporate Tax Rate Cut**

Under the final bill, effective for taxable years beginning after December 31, 2017, the tax rate is a flat 21%. This rate would apply to all C corporations, including personal service corporations.

Under current law, most corporations generally pay 34% or 35% tax on their taxable income. Lower tax rates apply for corporations with income under $335,000 annually. Personal service corporations (those whose principal activity is the performance of personal services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting) may not use rates below 35%.

Observations:

- Star of the show. The corporate tax rate cut is the centerpiece of the final bill. The tax cut represents a 40% rate reduction. This is a pretty big rate cut, and significantly higher than any rate cuts provided individuals.
- Permanent. Unlike many of the individual tax changes, and the tax cut on pass-through income, this rate reduction is enacted as permanent.
- Rates considered in the past. As a presidential candidate, Donald Trump campaigned on a corporate tax rate of 15% rate, the House Republican Blueprint, the Republican plan circulated prior to the 2016 election—proposed a corporate tax rate of 20%. Previously, prominent Republicans such as Dave Camp, former chairman of the House Committee on Ways and Means, and ex-Massachusetts Governor Mitt Romney, had proposed rate reductions to 25%. Although the final rate of 21% is slightly higher than the 20% rate in the previous bills passed by the House and Senate a few weeks ago, it is still a very low tax rate. Had the corporate tax cut incorporated in the final bill been smaller, there would have been greater opportunity to provide more tax benefits to a broader spectrum of individuals.
- 2018 Effective date takes away previous opportunity. The new corporate tax rate will go into effect in 2018. The previously passed Senate bill would have given it a delayed effective date of one year—and, thus, afforded corporations a tax planning opportunity to take deductions in a year when the applicable tax rate was 35%, but have any resulting income pushed to years in which the rate would be 20%. The acceleration of the effective date takes away the planning opportunity to accelerate tax deductions to a high tax year (making the tax deductions more valuable). Given that the final effective date is only a couple of weeks away, there is little time to plan to accelerate deductions – yet corporations with the flexibility, would want to do so.
- Impact on choice of entity. For years, the conventional wisdom has been that in order to avoid high double-taxation, an entity should be formed as a limited liability company or other pass-through entity. Is this a game changer? Maybe. See our earlier advisory on this topic. At a minimum, the low rate certainly means that a pass-through entity is no longer a no-brainer. With the corporate tax rate being so much lower than the highest tax rate applicable to individual income, even with double taxation, the effective tax rate on corporate income is slightly lower than the highest rate on an individual's ordinary income. Compare 37% with 36.8% (21% + (79%*20%)). Further, the effective corporate tax rate may be lower than 21% given that some deductions, such as state and local taxes, would be

deductible by the corporation but not by an individual. (See discussion below.) However, factors that should be considered in the full evaluation of corporation versus pass-through entity include:

- Is this a situation where the lower tax on pass-through income could apply?
- What are the applicable state tax rates on the corporate and individual income? If a high state tax rate is applicable, the effective tax rate with double taxation may be considerably higher. As an aside, we note that as we have written about before, these tax changes raise important questions as to state taxation: Will states continue to follow federal tax treatment as to computation of income? Will they increase rates? Will they become more aggressive in pursuing revenues?
- Is there risk that the distribution from the corporation to the shareholder would be taxed as something other than a dividend—perhaps compensation? If so, since compensation would be subject to a 37% rate (higher if employment taxes are considered) rather than the 20% that qualified dividends are subject to, the effective tax rate could be much higher than 37%.
- Will the income of the business need to be withdrawn by the owners of the business in the near term? Where there is no need to take the cash out, a corporation may make sense. The longer earnings can stay in a corporation, the greater the resulting value of the deferral will be.
- If the entity is a corporation, is it possible that the stock of the corporation could qualify as qualified small business stock under Section 1202 of the Internal Revenue Code? If so, there may be a 0% tax rate on the gain from the sale of the stock. Is it possible that no earnings need to be withdrawn until the death of the shareholders – in which case the stock would pass with a stepped up tax basis to the shareholder?
- Advisors are going to have to start considering the accumulated earnings tax, and the personal holding company tax – both taxes designed to ensure a corporation does not retain too much cash.

- Diminished value of deductions, NOLs and similar tax benefits. Since a tax deduction or loss when the tax rate is 35% yields a greater savings than a deduction or loss when the tax rate is 21%, the cut in the corporate rate also means that corporations will place less value going forward on such deductions or losses.
- Creative Tax Planning Strategies. The rate differential between the corporate rate and the individual rate will likely cause many taxpayers to implement creative tax planning strategies – especially where taxpayers can afford for the corporation to be a vehicle that serves to save earnings—thus at a minimum providing deferral of the 2nd level of tax. The bottom line is that the corporate rate is low enough that in many cases there is not enough of a disincentive to not try creative tax planning strategies. The worst-case scenario may be that even if the strategy fails, an individual would be paying tax that is roughly equal to the tax that would have been payable if she or he had not tried the strategy at all.
- Future repeal of 21% rate? Finally, one has to consider the possibility that once the Democrats control Congress, there will be a push to increase the corporate tax rate.

A. 2.	**Corporate Alternative Minimum Tax (AMT) Repeal**

Repealed by the final bill.

Observations:

- As we've written about previously, the House bill repealed the corporate AMT, as did the original version of the Senate bill. The later passed version of the Senate bill retained the corporate AMT, but at the 20% rate, which was the same as the proposed corporate rate. This meant that corporations would pay the higher of the regular tax and the AMT—at the same rate, thus making the corporate AMT the default tax. Needless to say, there was a backlash to the retention of the corporate AMT, and it is no surprise that it is repealed in the final bill.

A. 3.	**Pass-through Income: Temporary Rate Cut**

Main rule: We'd call this rule another star of the show. An individual may deduct 20% of "qualified business income" from a sole-proprietorship or pass-through entity (including a partnership and S corporation). Qualified business income does not include any amount that is treated as "reasonable compensation" of the investor or guaranteed payments for services.

Who cannot take advantage? Individual owners of sole proprietorships or pass-through entities that are engaged in a "specified service trade or business"—which means a 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 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. Inexplicably, the final bill spares architects and engineers from this category.

> -The deduction does apply with respect to income from such entities below a threshold amount ($157,000 for single, and $315,000 in the case of a joint return). In order to take the deduction, the owner of a business or pass-through entity would have to receive amounts from the business other than as compensation.

What is the limit on the deduction? For each qualified trade or business that the individual receives income from, the amount deductible is limited to:

> (1) 50% of the W-2 wages paid with respect to the qualified trade or business or
>
> (2) the sum of 25% of the W-2 wages paid with respect to the qualified trade or business + 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property (generally, depreciable property used in the production of qualified business income).
>
> -Note that the limit does not apply to income under the threshold amounts described above ($157,000 for single, and $315,000 in the case of married, filing jointly).

Effective Date: The provision applies to taxable years beginning after December 31, 2017 and before January 1, 2026.

Observations:

- Effective tax rate. To the extent the deduction applies, the income is effectively taxed at a top rate of 29.6% instead of a top rate of 37% (37% * (100% - 20%)). This represents a 25%

rate reduction of the current rate (1 – (.296/.396))—smaller than the rate reduction provided corporations, but still significantly larger than the rate reductions provided individual wage earners.

- Ideal candidate. Who would be the ideal candidate to take this deduction? It would not be those involved in an identified services business, since they are not able to qualify for the rate (except to the extent of the income is below the $157,000 and $315,000 thresholds described above). It would also not be investors in a business that generates capital gains (such as a private equity fund). Those investors already pay a low tax rate of 20% on their income. The ideal candidate would be a passive investor in a business, which business generates ordinary income, but is not a "bad" services business. The primary candidate that comes to mind is an investor in real estate – including investors in large real estate development partnerships as well as ordinary people investing in rental real estate). Most real estate partnerships present three key required facts: (i) the business would generate gain from the sale of property which would not qualify as capital gain, (ii) the owners are not receiving income as compensation, and (iii) it pays either high wages, or has made significant investments in depreciable property (generally buildings are depreciable property)
- Creative Tax Planning Strategies. We expect this rule to be viewed as containing many "loopholes." For example, employees that have wages under the requisite thresholds may seek to convert status to "partner." Service partnerships may attempt to convert a portion of their service income to other income. For example, partners in a "bad" service partnership might contribute depreciable property (including perhaps a purchased building) to a new partnership. The new partnership might lease the property to the service partnership, generating income, which could be offset by the deduction on qualifying income (since the new partnership would not be engaged in a "bad" service). There are many other possible planning opportunities here. It remains to be seen whether these structures would work—but there is not much to stop people from trying to fall within the scope of the provision.
- Temporary. This rate reduction is temporary.

B. OTHER BUSINESS PROVISIONS

B. 1.	**Cap on Deductibility of Interest**

Generally, the deduction for interest paid or accrued on debt allocable to a trade or business will be limited to the sum of:

1. the interest income of the taxpayer allocable to a trade or business, and
2. 30% of the adjusted taxable income of the taxpayer for the taxable year.

Adjusted taxable income means the taxable income, computed without taking into account any business interest income, or the net operating loss deduction, and taking into account and therefore reduced by depreciation, amortization, or depletion.

-Exception: For taxable years beginning after December 31, 2017 and before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion (i.e., those items are added back in these years).

-Exempted from the limitation are taxpayers with average annual gross receipts for the preceding

three-year taxable year period that do not exceed $25 million.

-Real property trades or businesses that use the Alternative Depreciative System (ADS) to depreciate property could elect not to be subject to the limit on interest deduction.

-Unused interest deductions may be carried forward indefinitely.

Observations:

- End of encouragement by tax rules to borrow? The tax deduction for interest under current law lowers the effective cost of obtaining capital and has long been a part of our tax system. For years, U.S. taxpayers have been encouraged by existing tax rules to leverage their purchases and operations. If the proposals are enacted, this would change.
- Increase in cost of capital. The rule would mean an increase in the cost of capital going forward for many taxpayers. It'll be interesting to see what implications the limit on the deductibility of interest may have for interest rates.
- Final bill restrictive. Both the earlier passed versions of the House and Senate bills contained limits on interest deductions. However, the House bill was more favorable in that it allowed the deduction of up to 30% of EBITDA (earnings before interest, taxes and depreciation and amortization.) The Senate bill allowed the deduction at 30% of EBIT (same as house, but subtracting depreciation and amortization from the limit.). The Senate number was a lower number, and therefore interest deductions would be more limited. The final bill takes the House approach for the first 4 years, and then switches to the more restrictive Senate approach.
- Discourages investment in depreciable property. After the first 4 years, if a business invests in depreciable property, its interest deduction cap would be lowered.

B. 2.	**Temporary Full Immediate Expensing** **Increased Section 179 Limit**

Immediate expensing/full deduction of new equipment placed in service. This would be temporary. While the bill would initially allow full expensing for property placed in service between September 28, 2017, and December 31, 2022, it would begin to phase out the applicable percentage of business property that may be immediately expensed, generally (i) to 80% for property placed in service in 2023, (ii) to 60% for property placed in service in 2024, (iii) to 40% for property placed in service in 2025 and (iv) to 20% for property placed in service in 2026. Since 50% of business property is currently allowed to be depreciated during its first year, it appears that the tax benefits received by businesses before 2025 will effectively be reversed thereafter.

The final bill allows the immediate expensing deduction for purchased new and used property. In other words, the deduction is not limited to original use property.

The final bill also increases the expensing limitation under Section 179 from $510,000 currently to $1 million, which would apply to property placed in service in taxable years beginning after December 31, 2017.

Observations:

- The temporary nature of this provision will mean that many businesses will have a very low tax rate in the near future, which will increase once this provision sunsets.

B. 3.	**Decreased NOL Deduction**

The deduction of NOLs will be limited to 80% of taxable income (determined without regard to the deduction) for losses arising in taxable years beginning after December 31, 2017.

B. 4.	**Repeal of Section 199 Domestic Manufacturing Deduction**

Repealed for non-corporate taxpayers for taxable years beginning after December 31, 2017. Corporate taxpayers get an extra year. For them, it is repealed for taxable years beginning after December 31, 2018.

C. INTERNATIONAL TAX PROVISIONS

C. 1.	**Exemption of Dividends from Foreign Subsidiaries**

Going forward, a dividend exemption for 100% of foreign-source dividends from foreign subsidiaries would apply to 10-percent U.S. shareholders, subject to a 731-day holding period (beginning 365 days before the shares of the foreign corporation become ex-dividend).

Observations:

- Quasi-territorial system. Given that the House Blueprint and the Unified Framework for Tax Reform suggested that U.S. multinationals would be taxed on a territorial rather than worldwide basis, Republicans surprised many by retaining significant elements of worldwide taxation in a hybrid system (which are discussed below in this Section C.) For many months, House Ways and Means Committee Chairman Kevin Brady insisted on a border-adjusted cash flow tax, designed by Berkely economist Allan Auerbach, which was marvelously simple: imports would have been subject to a border-adjustment tax, while exports would have been exempt from U.S. tax. That idea, however well modeled, did not sit well with powerful retailers like Walmart and Target who effectively killed it, following President Trump's election and determination that border adjustment was too complex.

  Neither the House nor the Senate produced a bill that was genuinely territorial, so it is no surprise that The Tax Cuts and Jobs Act is not truly territorial. While the final bill's 100% deduction for dividends received from a foreign corporation by a 10% U.S. owner certainly moves the U.S. tax system in the direction of territoriality, the final legislation retains Subpart F's basic framework for taxing foreign income of U.S. multinationals, which conservatives have been trying to repeal since, at least, the Reagan era.

C. 2.	**One-Time Tax on Earnings Deemed Repatriated**

A one-time tax would be imposed on accumulated post-1986 deferred foreign income of all foreign corporations (other than passive foreign investment companies (PFICs)), in which a U.S. person owns a 10% voting interest, including, but not limited to, controlled foreign corporations (CFCs), would be taxed at the following rates:

(1) 15.5% on foreign earnings held in the form of cash and cash equivalents (defined with certain modifications described below) and

(2) 8% on all other foreign earnings (i.e., foreign earnings invested in assets such as real

estate).

Observations:

- Deemed repatriation even if no actual repatriation. The 15.5% tax and the 8% tax are imposed on foreign earnings, regardless of whether they are actually brought back.
- Rate of taxation on repatriation. The House and Senate bills started with relatively modest repatriation rates on foreign accumulated earnings of foreign corporations controlled by U.S. shareholders, which gradually rose. At the outset of the drafting process, the House Ways and Means Committee started with a 10% repatriation rate on cash-backed earnings of CFCs, which rose to 14%, by the time the bill passed the House two weeks later to 14.5% in the Senate's final bill and eventually to 15.5% in the Conference Committee's final version of the legislation.
- Encouragement of leaving profits offshore? Even though the rate may be higher than the one initially floated, commentators note that the repatriation provisions reward companies that keep profits abroad by allowing them to bring back profits at a lower tax rate than would have otherwise applied. This special tax rate is still lower than the rate that would have otherwise applied after all. Further, there is no requirement for corporations to invest the repatriated earnings in wages, R&D etc. in the U.S. in order to be able to be taxed at the low rate. A similar repatriation holiday was offered in 2004, and did not result in corporations hiring new people or making new investments.

C. 3.	**10% Minimum Tax on Foreign Source Intangible Income (GILTI)**

Global Intangible Low-Taxed Income Rule: This rule imposes a minimum tax on a U.S. multinational's foreign earnings that exceed an amount equal to a specified rate of return on the foreign company's assets.

Despite the tax bill's international provisions being called "territorial," U.S. shareholders of a CFC will be required to include in income their pro rata share of the CFC's global intangible low-taxed income (GILTI) – generally, foreign source intangible income. Specifically, GILTI is equal to the excess of (a) the shareholder's pro rata share of certain foreign profits of the CFC over (b) a deemed return of 10% of the shareholder's pro rata share of the CFC's average aggregate bases of tangible property used to produce such profits, as of the close of each quarter of the taxable year.

Between 2018 and 2025, 50% of a domestic corporation's GILTI income will be deductible, reducing their effective rate of tax on GILTI to 10.5%. Beginning in 2026, domestic corporations' GILTI deduction will be reduced to 37.5% from 50%, increasing the effective U.S. tax rate on GILTI to 13.125% after 2025.

C. 4.	**Special Low Rate on Export Income in the U.S. – FDII Regime**

Foreign-derived intangible income Rule: This rule is similar to a patent box, and applies a reduced tax rate to export income from U.S. held intangibles.

There is essentially a lower tax rate of 13.125% as opposed to 21% imposed on taxpayer's income from exports of property or services. That is: U.S. corporations will be taxed on their foreign-derived intangible income (FDII), which is the portion of a domestic corporation's income, determined on a formulaic basis, which is derived from serving foreign markets.

Between 2018 and 2025, 37.5% of domestic corporations' FDII will be deductible, bringing their effective U.S. tax rate on FDII before 2026 to 13.125%. Beginning in 2026, only 21.875% of domestic corporations' FDII will be deductible, increasing their effective U.S. tax rate on FDII to 16.40625%.

C. 5.	**Base Erosion and Anti-Abuse Tax (BEAT) Regime**

In order to ensure that the U.S. profits are not shifted overseas by way of deductible payments to related foreign corporations, the final bill imposes a minimum tax liability on an expanded tax base (which adds back certain deductible payments between a U.S. subsidiary and a related foreign entity).

D. INDIVIDUAL TAX PROVISIONS

D. 1.	**Temporary Decrease In Individual Marginal Tax Rates**

The new tax brackets are changed as noted below in blue. The rates in earlier passed bills from the House and Senate are also included below for comparison.

Tax Brackets – Single Individual							
Existing Brackets		**House Bill**		**Senate Bill**		**Final Bill**	
10%	$0 to $9,325	12%	$0 to $45,000	10%	$0 to $9,525	10%	$0 to $9,525
15%	$9,326 to $37,950			12%	$9,526 to $38,700	12%	$9,526 to $38,700
25%	$37,951 to $91,900	25%	$45,001–$200,000	22%	$38,701 to $70,000	22%	$38,701 to $82,500
28%	$91,901 to $191,650			24%	$70,001 to $160,000	24%	$82,501 to $157,500
33%	$191,651 to $416,700	35%	$200,001–$500,000	32%	$160,001 to $200,000	32%	$157,501 to $200,000
35%	$416,701 to $418,400			35%	$200,001 to $500,000	35%	$200,001 to $500,000
39.6%	Over $418,400	39.6%	Over $500,000	38.5%	Over $500,000	37%	Over $500,000

Tax Brackets – Married Filing Jointly							
Existing Brackets		**House Bill**		**Senate Bill**		**Final Bill**	
10%	$0 to $18,650	12%	$0 to $90,000	10%	$0 to $19,050	10%	$0 to $19,050
15%	$18,651 to $75,900			12%	$19,051 to $77,400	12%	$19,051 to $77,400
25%	$75,901 to $153,100	25%	$90,001–$260,000	22.5%	$77,401 to $120,000	22%	$77,401 to $165,000
28%	$153,101 to $233,350			25%	$120,001 to $290,000	24%	$165,001 to $315,000
33%	$233,351 to $416,700	35%	$260,001–$1,000,000	32.5%	$290,001 to $390,000	32%	$315,001 to $400,000
35%	$416,701 to $470,700			35%	$390,001 to $1 million	35%	$400,001 to $600,000
39.6%	Over $470,700	39.6%	Over $1,000,000	38.5%	Over $1 million	37%	Over $600,000

The brackets will be adjusted annually according to the "chained CPI," rather than the normal or plain CPI, which is used under existing law. The effect of this is that gradually, every year more people would be pushed into higher tax brackets.

Effective date: Taxable years beginning after December 31, 2017. The rates sunset for taxable years beginning after December 31, 2025. However, the use of the chained CPI is permanent.

Observations:

- Modest initial cuts. The final tax bill's top income tax rate applies to marginal income in excess of the amount that the current highest rate applies to – but the rate is 37% rather than the current top rate of 39.6%. This represents a modest decrease. However, the combination of the tax cuts being temporary and the chained CPI being used instead of the plain CPI currently used will mean that 53% of Americans would pay higher taxes by 2027.
- Temporary? It appears that the supporters of the temporary rate cuts on individuals are making the calculation that in 2026, when the temporary tax cuts expire, the party controlling Congress will not have the political will to let them expire and will instead extend them. And therefore, while termed "temporary," they'll effectively be permanent. Time will tell if this bet pays off.

D. 2.	**Capital Gains & Other Investment Income Rates Remain the Same**

These generally remain the same. The top tax rates on income of individuals is set forth below:

Long-term capital gains – 20%

Qualified dividend income – 20%

The 3.8% net investment income tax (NIIT) imposed on investment income of individuals with income above certain thresholds is retained.

D. 3.	**Temporary Increase of Standard Deduction & Temporary Repeal of Personal Exemption**

Under present law, an individual who does not elect to itemize deductions may reduce his or her adjusted gross income (AGI) by the standard deductions to arrive at taxable income. In addition, an individual taxpayer is allowed to take a personal exemption (currently in the amount of $4,050 per person) for him or herself, his or her spouse and dependents.

The standard deduction would be temporarily nearly doubled, and be $12,000 for single filers, and $24,000 for married, filing jointly.

Effective Date: Taxable years beginning after December 31, 2017. Would sunset for taxable years beginning after December 31, 2025. The deduction would be indexed using the chained CPI, which would not be temporary.

The personal exemption allowed taxpayers, his or her spouse and dependents (currently in the amount of $4,050 per person) is temporarily repealed.

Effective Date: Taxable years beginning after December 31, 2017. Would sunset for taxable years beginning after December 31, 2025.

Observations:

- Decrease in individuals itemizing deductions. As we've noted in earlier advisories, the doubling of the standard deduction will not net much of a benefit given that simultaneously, the personal exemptions will be taken away. However, the increase in the standard deduction, combined with the limitations imposed on the taking of certain itemized deductions, will lead fewer individuals to choose to itemize deductions, since for many people the standard deduction would exceed itemized deductions.
- Modest decrease in taxes of individuals that do not itemize. As a general matter, individuals that do not itemize their deductions currently are likely to see a cut under the new tax rules. However, the number of dependents also have to be factored in.

D. 4.	**Temporary Limit on Home Mortgage Interest Deduction**

For taxable years beginning after December 31, 2017 and before January 1, 2026, a taxpayer may continue to deduct mortgage interest with respect to a qualified residence as an itemized deduction—however only to the extent of debt not exceeding $750,000.

> -In the case of debt incurred before December 15, 2017 (or the refinancing of debt incurred before this date), the limit continues to be $1 million ($500,000 in the case of single or married filing separately).

For taxable years beginning after December 31, 2025, the limit is $1 million.

For taxable years beginning after December 31, 2017 and before January 1, 2026, the deduction for interest on home equity indebtedness is suspended. The suspension ends for taxable years beginning after December 31, 2025.

Observations:

- Compromise between House and Senate. The Conference Committee resolved the

difference between the House and Senate bills over the mortgage interest deduction by literally splitting the difference. The House would have set the limit on acquisition indebtedness that can generate mortgage interest deductions at $500,000 and the Senate would have retained the $1 million limit.

- Effective date: The $750,000 limitation as top debt on which mortgage interest deductions are allowed sunsets after 2025 but is retroactively applicable as of December 15, 2017, to prevent prospective home buyers from obtaining new mortgages between the date the conference report was released and the Act's January 1, 2018, effective date. This effort to reduce tax planning on the individual side is somewhat surprising given the lack of such a limitation in the corporate tax area, as discussed below.

D. 5.	**Temporary Limit on Deductibility of State Taxes by Individuals**

Generally, under current law, individuals are permitted a deduction for the following taxes, whether or not incurred in a taxpayer's trade or business: (1) state, local and foreign real and personal property taxes, (2) state and local income taxes.

Under the final bill, an individual can deduct state, local and foreign property taxes only when paid or accrued in carrying on a trade or business. Thus, for example, an individual may deduct property taxes only if they were imposed on business assets (such as residential rental property).

> -Exception: An individual may claim an itemized deduction of up to $10,000 ($5,000 for married filing separately) for the aggregate of (1) state and local property taxes even if not incurred in a trade or business, and (2) state and local income taxes paid or accrued in the taxable year.

Effective date: For taxable years beginning after December 31, 2017 and beginning before January 1, 2026.

Observations:

- State or local taxes incurred in a business? The final bill continues to permit corporations and pass-through entities the ability to deduct state and local taxes paid or accrued in carrying on a trade or business or in an activity related to the production of income. Although open to interpretation, the text of the final bill may be read as allowing investors in pass-through entities (such as partners in a partnership), or self-employed individuals to deduct state and local income taxes they pay on their allocable income from the pass-through entity or business.
- Prepayments of 2018 state taxes. Certainly final payments of any state taxes for the 2017 tax year should be accelerated and made in 2017 rather than 2018 to ensure the cap does not apply. As to taxes for 2018, the final bill says "an amount paid in a taxable year beginning before January 1, 2018, with respect to a state or local *income* tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed." Notably, only prepayments of income tax are explicitly prohibited, suggesting that prepayments of non-income taxes in 2017 may escape the cap.

D. 6.	**Temporary Greater Limitations On Usability of Losses**

Under the final bill, if individuals and other non-corporate taxpayers have "excess business losses" (i.e., deductions attributable to a trade or business over the sum of income from the trade or business plus a threshold amount), then the excess business losses are carried forward and treated as part of the taxpayer's net operating loss (NOL). NOLs will be subject to a cap of 90% of taxable income of the taxpayer (or 80% for taxable years beginning after December 31, 2022). The passive loss limitation rules will still apply. This limit applies in addition to such limit.

Effective Date: Taxable years beginning after December 31, 2017 and before January 1, 2026.

D. 7.	**Charitable Contribution Deduction**

The deduction is retained but with an increase in the income-based percentage limit for charitable contributions of cash to public charities from 50% to 60%.

Deductions for payments made in exchange for college athletic event seating rights are denied.

Effective Date: For taxable years beginning after December 31, 2017

Observations:

- Fewer itemizing deductions may mean less charitable contributions. While the deduction is retained, the concern is that with the standard deduction being increased substantially, fewer people will be itemizing deductions, which will lead to a decrease in charitable contributions being made.

D. 8.	**Temporary Changes to Individual AMT**

The final bill would reduce the number of individuals subject to the AMT by temporarily increasing both the exemption amount and the exemption amount phase-out thresholds. For taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the AMT amount for married taxpayers filing a joint return will be increased to $109,000 for married taxpayers filing a joint return. The phase-out thresholds will be increased to $1 million for married taxpayers filing a joint return, and $500,000 for all other taxpayers.

D. 9.	**Temporary Doubling of Estate Tax Exemption**

For taxable years beginning after December 31, 2017 and before January 1, 2026, the final bill doubles the current exemption (currently about $5.5 million for single and $11 million for married individuals). It is interesting to note that as recently as 2001, the exemption level was $675,000.

D. 10.	**Repeal of Individual Healthcare Mandate**

The final bill repeals the penalty that is imposed under current law on individuals that fail to obtain minimum healthcare coverage (also known as the individual mandate).

Effective Date: This provision is effective with respect to health coverage status for months beginning after December 31, 2018.

Observations:

- The final bill's repeal of the tax penalty imposed on individuals who fail to obtain adequate healthcare coverage under the Affordable Care Act (ACA) removes the ACA's economic lynchpin. Without that provision, the ACA's central mechanism for avoiding adverse selection in the insurance markets has been removed. As a result, individuals seeking insurance in the marketplace created under the ACA will be predictably sicker and costlier for insurance companies to cover and such companies will increase their rates accordingly. Thus, as Mitch McConnell said recently: "It is not a total replacement but it takes the heart out of Obamacare."

E. SPARED: WHAT IS NOT IN THE FINAL BILL?

The following, which at some point were discussed as being in final tax reform, did not make it—for the good or bad:

- Limits on deductions for medical expenses
- Limits on student loan interest
- Repeal of deduction for educators who buy their own school supplies
- Weakening of rules that prohibit religious organizations from endorsing political candidates
- The "first-in, first-out" provision, requiring investors to sell their longest held stock first

And if we go a little further back:

- Border adjustment tax
- An even greater limit on interest deduction
- Much broader immediate expensing
- Repeal of 3.8% net investment income tax
- Taxation of carried interests as ordinary income
- Border Adjustment Tax

In the coming days and weeks, our tax group will be examining the details in greater detail. Please keep a close eye on our Tax Reform Alert Center for updates.

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