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Understanding the Tax Cuts and Jobs Act

What Business Owners, Real Estate Investors, and Their Advisors Need to Know

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Agenda

I. Overview of the Tax Cuts and Jobs Act and Future Outlook
II. Business and Pass-through Taxation
III. International Taxation
IV. Estate and Gift Tax Planning
V. Individual and Trust Taxation
VI. Top Takeaway Points

The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (Pub. L. No. 115-97)

- Tax Cuts and Jobs Act: Timeline
  - November 2: Introduced in the House (HR 1)
  - November 6-9: House Ways and Means Committee marks up and reports out HR 1
  - November 13-16: SFC marks up and reports out its tax reform bill
  - November 14: House Rules Committee adopts rule for House consideration of HR 1
  - November 16: House of Representatives passes HR 1
  - November 28: Senate Budget Committee passes SFC tax reform bill
  - December 2: Senate passes HR 1 (with Senate amendment)
  - December 13: House-Senate Conferees meet in public session
  - December 19: House passes Conference Report
  - December 20: Senate passes Conference Report with modifications (51-48, Sen. McCain absent)
  - December 20: House passes modified conference report (224-201, 11 “blue state” Republicans plus Rep. Jones (R-NC) joining 189 Democrats voting against the measure)
  - December 22: Signed into law

- Tax Reform Act of 1986: Timeline
  - First significant W&M Committee vote occurred on October 15, 1985
  - Signed into law on October 22, 1986

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Early Implementation Guidance

- IRS
  - IRS Advisory 2017-210: Deductibility of prepayment of state and local property taxes
  - Notice 2018-7: Guidance describing sec. 965 "toll tax" of accumulated foreign earnings
  - Notice 2018-8: Suspension of WH obligations for dispositions of PTP interests
  - Notice 2018-13: Additional guidance describing sec. 965 "toll tax"
  - IR 2018-05 (and Notice 1036): Updated 2018 Withholding Tables
  - Notice 2018-14: Guidance on Withholding Rules

- SEC
  - Staff Accounting Bulletin #118: While companies must reflect the income tax effects in the reporting period in which the Act was enacted if the accounting analysis is **complete**, companies can report as **provisional amounts** those effects that can be **reasonably estimated**. If no reasonable estimate is available, companies would continue to apply current law and provide a reasonable estimate in the first reporting period as determinable (with one year to complete).

- FASB meeting (Jan. 10)
  - SEC SAB #118 can be used by private companies and nonprofits
  - Discounting of tax liability for sec. 965 and AMT credits
  - Other accounting issues related to HR 1

- Much more to come…

What to Expect Next

- Critical need for corrections and guidance
  - Corrections range from typos to very substantive errors
  - Specific issue areas
    - 20% deduction for pass-through businesses
    - Transition to, and adoption of, international territorial system
    - Global minimum tax and base erosion measures

- Legislative path
  - Technical corrections bill
  - Tax extenders legislation?
  - Joint Committee on Taxation's "Blue Book"
  - Other approaches

- IRS/Treasury Implementation Guidance
  - Limited resources
  - Political environment
  - IRS Commissioner

What To Expect Next (cont'd)

- "Big Picture" Political Hurdles
  - Funding federal government for remainder of FY 2018 (Sept. 30, 2018)
    - Government funding extended through March 23
    - Issues include DACA and immigration reform and the border wall
    - Debt limit suspended through March 1, 2019
  - The unknowns
    - International threats
    - Ongoing investigations
  - Looming 2018 Elections

Business and Pass-through Taxation

Introduction – Impact of Pass-through Changes

- The recent enactment of the Tax Cut and Jobs Act has dramatically changed the tax landscape for all taxpayers, but the legislation has a particularly significant impact on pass-through entities and their owners.
- While the new rules certainly create many opportunities for tax savings, careful planning is necessary to ensure that pass-through entities and their owners take maximum advantage of these new opportunities.
- Given the speed with which the legislation was passed, there are many unanswered questions regarding how the new rules will apply.
- This presentation will assist practitioners in understanding how to best navigate these new rules, and will include planning tips and ideas to maximize use of the new 20% pass-through deduction, as well as an in-depth analysis of the impact of the new rules on the "choice-of-entity" decision.

C-Corporation Changes

- Corporate income tax rate is permanently lowered to 21% beginning in 2018
- Corporate AMT permanently repealed
- Dividends received deduction reduced

Pass-through Deduction – In General

- New “below the line” deduction for “qualified business income” from pass-through entities and sole proprietorships
- Maximum deduction is 20% of the taxpayer’s qualified business income
- Non-corporate taxpayers (including estates and trusts) are eligible to claim the deduction
- Effectively reduces the rate on pass-through income to eligible taxpayers to 29.6%
- Sunsets in 2026

Pass-through Deduction – Qualified Business Income

- Generally, the ordinary income, gain, deduction, or loss of a qualified trade or business
  - What is a "qualified trade or business"?
    - Any business other than a specified service business or the trade or business of performing services as an employee
    - Specified service business – a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services, or where the principal asset of the business is the reputation or skill of one or more of its employees, or which involves the performance of services that consist of investing and investment management, or trading or dealing in securities, partnership interests, or commodities.
- Excluded items: the taxpayer's wages (or reasonable compensation), guaranteed payments, and investment-type income (capital gains, interest, dividends)

Pass-through Deduction – Calculation

Subject to certain limits and thresholds, the deduction generally is the sum of:

- The lesser of:
  - 20% of the taxpayer's qualified business income; or
  - The greater of:
    - 50% of the W-2 wages with respect to the business, or
    - 25% of the W-2 wages with respect to the business plus 2.5% of the unadjusted basis of all qualified property
- Plus 20% of REIT dividends and distributions from publicly traded partnerships

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Pass-through Deduction – Limits

Availability and/or calculation of the deduction is subject to limits based on the taxpayer's income and the type of business conducted:

Total Taxable Income	Not Exceeding Threshold (Single - $157,500 / Joint - $315,000)	Threshold Plus Phase In	Over Threshold (Single - $207,501 / Joint - $415,001)
Specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-out, W2/basis limit phased in	No deduction permitted
Non-Specified Service	Full 20% deduction, no W2/basis limit	20% deduction subject to phase-in of W2/basis limit	20% deduction permitted but fully subject to W2/basis limit

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Pass-through Deduction – Example

- **Example 1:** A wholly owned business purchases an office building for $6M ($3M building, $3M land). The building generates annual rental income of $500,000. The maximum potential allowable pass-through deduction would be $100,000 (20% of $500,000). If the business paid no wages, the business would qualify for a deduction of only $75,000 (2.5% x $3M = $75,000).

Pass-through Deduction – Example

- **Example 2:** Same facts as Example 1, but assume $4M is allocated to the building. The deduction would not be limited and thus the full $100,000 (2.5% x $4M = $100,000) would be deductible.

Pass-through Deduction – Example

- **Example 3:** Same facts as Example 1, but assume the business pays $100,000 of W-2 wages. The full $100,000 pass-through deduction would now be available, calculated as follows:
  - 25% x $100,000 of W-2 wages = $25,000
  - 2.5% x $3M unadjusted basis = $75,000
  - $25,000 + $75,000 = $100,000

Pass-through Deduction – Taxable Income Limit

- Deduction is limited to 20% of the excess of taxable income over net capital gain.
- Example: $100,000 of QBI, $200,000 of long-term capital gain, and $50,000 of itemized deductions, resulting in taxable income of $250,000.
- Before application of this limit, deduction is equal to 20% of QBI of $100,000, or $20,000.
- Taxable income less net capital gain is $50,000 ($250,000 – $200,000 = $50,000).
- So the deduction will be reduced under this limit from $20,000 to 20% of $50,000, or $10,000.
- Note that dividends are not subtracted, even though taxed at capital gain rate.

Pass-through Deduction – Open Issues

- Is rental real estate a "qualified trade or business"?
- Aggregation/grouping issues – multiple projects under common ownership
  - Real estate management company model – do management company wages count?
  - Two buildings, one fully depreciated, with high income, the other brand new, with no or little income
  - If treated as separate businesses, no 20% deduction available
  - If they can be aggregated, full 20% deduction available
- When is a principal asset of the business "the reputation or skill of one or more of its employees"?
- Will "reasonable comp" principles apply to partnerships?

Pass-through Deduction – Planning Opportunities

- Switch from W-2 employee to 1099 independent contractor (IC)
  - Loss of employee benefits (e.g., health insurance, 401k, etc.)
  - IC must pay all self-employment taxes
  - Employer may prefer paying W-2 employees in order to "max out" on its pass-through deduction
  - Need to revisit employee vs. IC classification criteria
- Can a "specified service business" "spin off" qualifying portions of its business (e.g., HR, IT, IP)?
- Separate books and records for two lines of business, one a "specified service business" and the other a "qualified trade or business"?

Pass-through Deduction – Planning Opportunities

- “Multiply” $157K per person threshold through children and trusts
- Switch from guaranteed payments (which don’t qualify) to preferred interests (which do qualify)
- S corp vs. LLC
  - Wages paid to S corp owners “count” toward W-2 limit, guaranteed payments to LLC don’t because of K-1 rule
  - Possible solution – use tiered structure, employed at lower tier, own equity through upper tier
  - “Reasonable comp” requirement for S corps
- Switch from 1099 (IC) to W-2 employee to increase W-2 limit

Choice of Entity – Effective Rates

As a result of the new lower corporate rate, should taxpayers reconsider their choice of entity?

	C-Corporation	Pass-through
Income Tax Rate	21%	29.6% (effective)
Dividend/Exit Tax Rate	20% + 3.8% = 23.8%	0%
Aggregate Tax Rate	39.8%	29.6%
State/Local Tax Deduction	100%	Property taxes deductible, SALT income taxes not deductible

Choice of Entity – Other Considerations

- Potential for future changes
- Easy to move into C-corp status, but difficult to move out
  - Triggering of Section 311(b) gain on conversion/liquidation
  - But S corp election possible after potential 5-year wait
- Limits on ability to defer distributions
  - Cash needs of shareholders
  - Accumulated earnings tax
  - Personal holding company rules
- Many disadvantages to C-corp status

Choice of Entity – REITs

- REITs do especially well:
  - Only one level of tax
  - Shareholders entitled to a 20% qualified business income deduction for ordinary distributions – with no W2/basis limits
- But REIT compliance and maintenance rules are onerous

Interest Expense Limitation

- Generally, no deduction for interest expenses that exceed 30% of the taxpayer's adjusted taxable income
- For pass-through entities, the limit applies at the entity (not the owner) level
- Applies to new and existing debt
- Real estate business can elect out of the limit, but in exchange, depreciation periods extended and no bonus depreciation except for TPP and land improvements

Bonus Depreciation

- 100% bonus depreciation deduction for qualified property, whether new or used, acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023
- Phases down beginning in 2023 and sunsets in 2026
- If a real estate business elects out of the interest expense limit, depreciation periods extended and no bonus depreciation except for TPP and land improvements
- In addition, Section 179 deduction increased to $1M and now indexed for inflation

Like-Kind Exchanges

- Like-kind exchanges are still permitted for real estate
- No property other than real estate can be exchanged in a like-kind exchange
- What about TPP included in real estate? Will this always constitute taxable "boot"? Will there be a *de minimis* exception?

Carried Interest

- New 3-year holding period for certain long-term capital gains
- Holding period applies to sale of either underlying asset or partnership interest
- Applies only to businesses that raise capital from third-party investors for certain types of investments (e.g., securities, commodities, rental real estate)

NOL Limitations

- No NOL carrybacks, only carryforwards
- Carryforward is indefinite
- Amount of an NOL carryforward that is deductible in any taxable year is limited to 80% of that year's taxable income

Excess Business Loss Limitation

- Taxpayers cannot claim business losses in excess of threshold amounts ($250,000 for single filers / $500,000 for joint filers)
- Previously, concern was generally whether a taxpayer was “passive” or “active” with respect to the business activity
- Now, even “active” losses cannot be used to offset wages or investment income
- Income and loss from all businesses first netted against each other
- Excess loss not suspended until sale, but “rolls into” NOL carryforward, subject to “80% limit” annually
- Taxpayers no longer able to pay “zero tax”

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Technical Terminations of Partnerships

- Under former Section 708(b)(1)(B), a partnership terminated upon a sale or exchange of 50% or more of a partnership's equity within 12 months
- This provision is now repealed – no restart of depreciation periods, no filing short-year return on termination, and no "clean slate" for elections

Other Considerations

- Deduction for meals and entertainment
  - Entertainment
  - Client meals
  - Business meals
- Sexual harassment settlements

International Tax Implications

International Tax Implications

- Limited Territorial Tax Regime and Participation Exemption
- Expansion of U.S. Shareholder Ownership Rules
- Mandatory Repatriation (Transition Tax)
- Global Intangible Low-Taxed Income (GILTI)
- Foreign-Derived Intangible Income (FDII)
- Base Erosion and Anti-Abuse Tax (BEAT)
- Interest Deductibility Limitations
- Modifications to Foreign Tax Credits
- Hybrid Payments
- PFIC Insurance Exception
- And more…

Limited Territorial Tax Regime

Limited Territorial Tax Regime

Prior Law

- *Worldwide* Tax Regime
  - U.S. individuals and entities are generally taxable on their worldwide income regardless of where the income is derived
  - Foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is repatriated

New Law

- *Limited Territorial* Tax Regime
  - U.S. <u>corporate</u> taxpayers are generally taxable only on their income generated within the U.S.
  - Achieved via the **participation exemption** (discussed herein)
  - Does <u>not</u> apply to U.S. individuals or pass-through entities

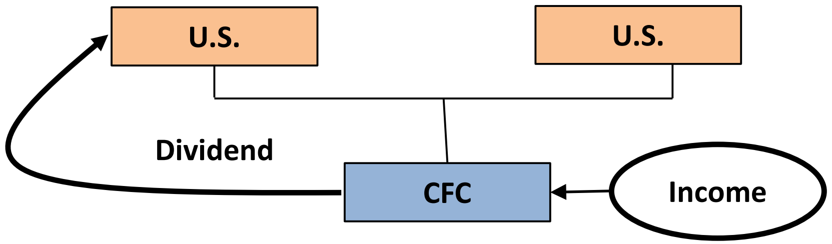
Participation Exemption

- Participation Exemption
  - 100% deduction for the foreign-sourced portion of a dividend received by a **U.S. C-corporation** from a foreign corporation
  - Applies to distributions made after December 31, 2017
  - Requirements:
    - U.S. C-corporation owns **10% or more** of the foreign corporation
    - **One-year** holding period
    - Foreign corporation is **not a PFIC** (unless it is a PFIC **and** a CFC)
    - **Not a “hybrid” dividend** from a CFC
    - U.S. C-corporation is not a REIT or a RIC

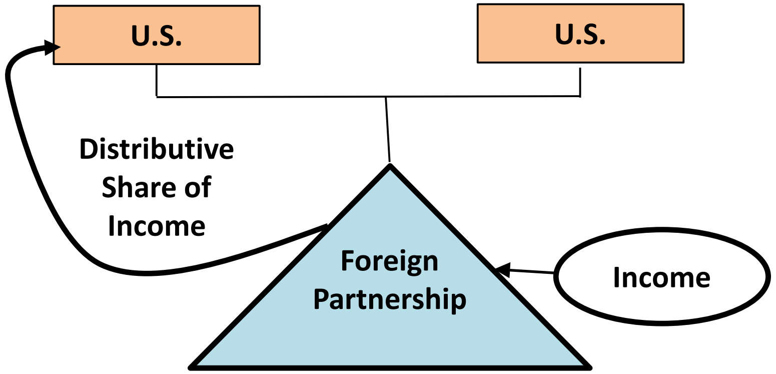
Participation Exemption for Foreign Corporations Only

- A 100% dividends received deduction (DRD) is available for dividends paid by "a specified 10 percent owned foreign corporation."
- Foreign income derived from partnerships therefore appears to be fully taxable. A similar result is expected for branches and disregarded entities.
  - Note section 901 FTCs are still available for the U.S. partners.
    - Under the Act, there is a separate FTC limitation or branch income (including income earned through a partnership if the partnership constitutes a qualified business unit (QBU) under section 989(a)).
    - Note the special pass-through deduction applies only to **domestic** qualified business income.
  - For outbound investments after 2017, consider balancing section 721(a) deferral in partnership form vs. section 367 (as amended by the Act) and new section 91 (certain foreign branch losses transferred to specified 10 percent owned foreign corporations) combined with the participation exemption and GILTI (with the new section 250 foreign-derived intangible income deduction). See discussion on GILTI, FDII, BEAT, and IP MIGRATION.

Participation Exemption Applies

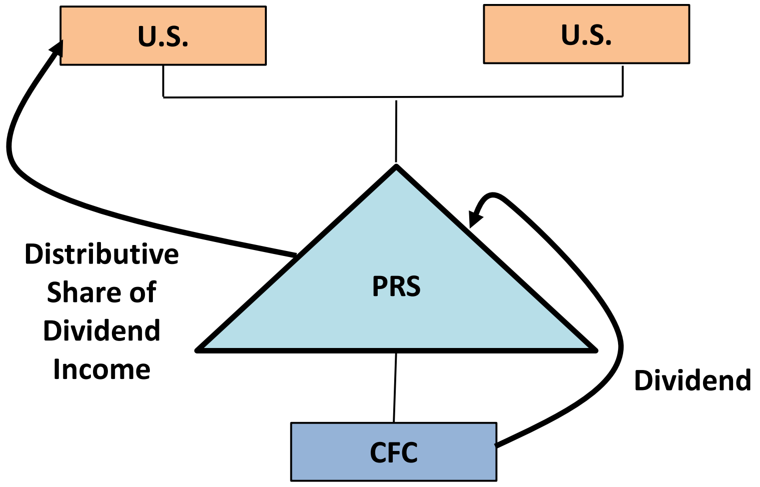


Participation Exemption Does Not Apply - Taxable



Participation Exemption for Foreign Corporations Owned through Partnerships

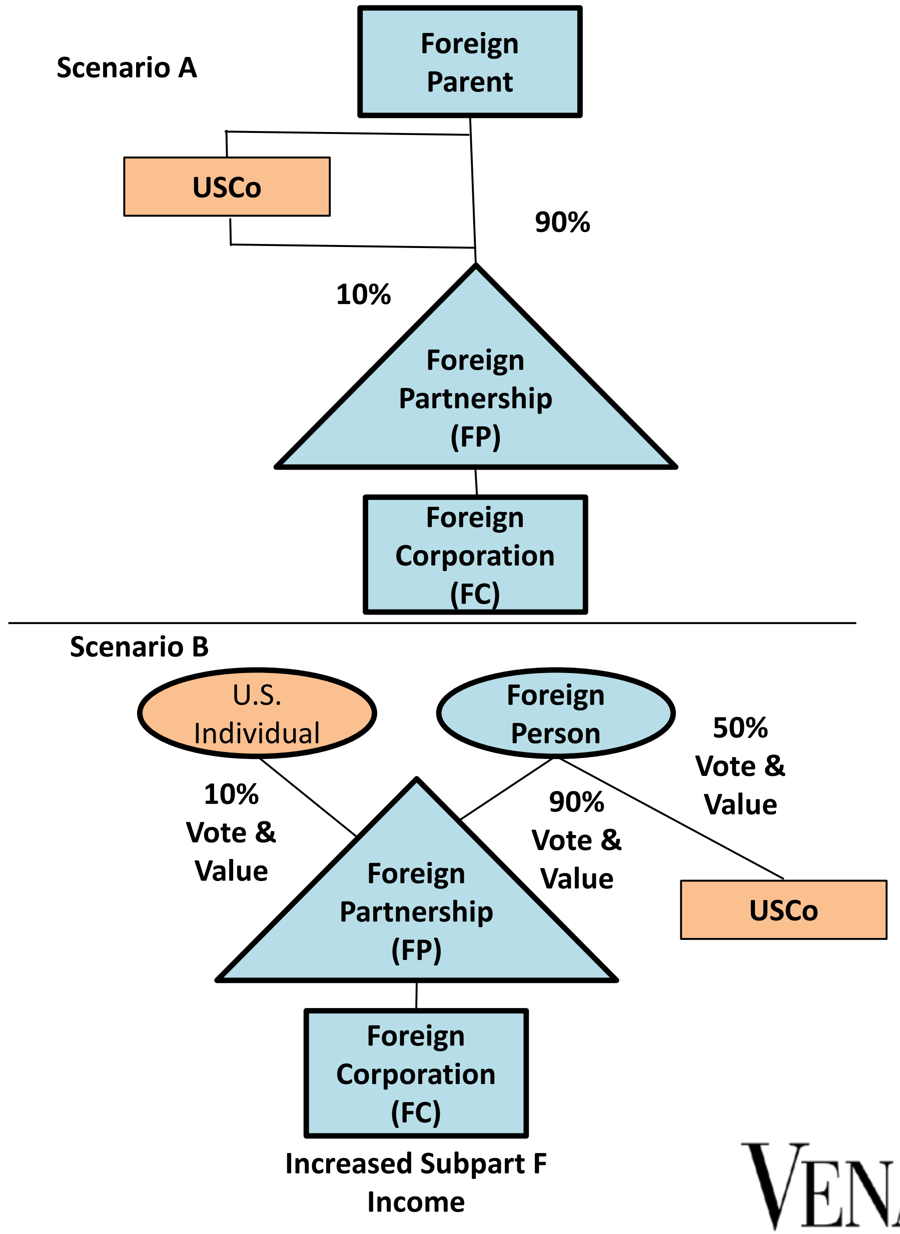
- The DRD is available for dividends paid by a specified 10 percent owned foreign corporation and *received by a domestic corporation* which is a U.S. shareholder with respect to such foreign corporation.
- An example in the Conference Report provides (at p. 599):
  - If a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership's dividend from the foreign corporation.
  - An identical example is included in the House bills section of the Conference Report (at p. 595).
- The Act provides regulatory authority to address the treatment of U.S. shareholders owning stock of a specified 10 percent owned foreign corporation through a partnership.



Expansion of U.S. Shareholder Ownership Rules – U.S. Tax Return Implications

Change to Attribution of Ownership Rules

- Section 958(b) imports section 318 attribution rules into subpart F, but section 958(b)(4) previously barred section 318(a)(3)(c) attribution, where the result would be to treat stock owned by a foreign person as owned by a U.S. person.
- The Act removes the rule that prohibits downward attribution from a foreign person to a U.S. person in section 958(b)(4) (as applicable prior to the Act).
- As a result, in **Scenario A**, Foreign Parent's 90% interest in FC is attributed to USCo and FC is now a CFC. Similarly, under the Act's expanded attribution rules, FC stock held by FP in **Scenario B** is attributed to USCo (under the unmodified rules of section 318(a)(3)(A)).
- For a Notice discussing reporting obligations relating to the modifications of section 958(b)(4), see Notice 2018-13.



Transition Tax: Transition to Participation Exemption

"§ 965" or "transition tax":	Notes & Observations

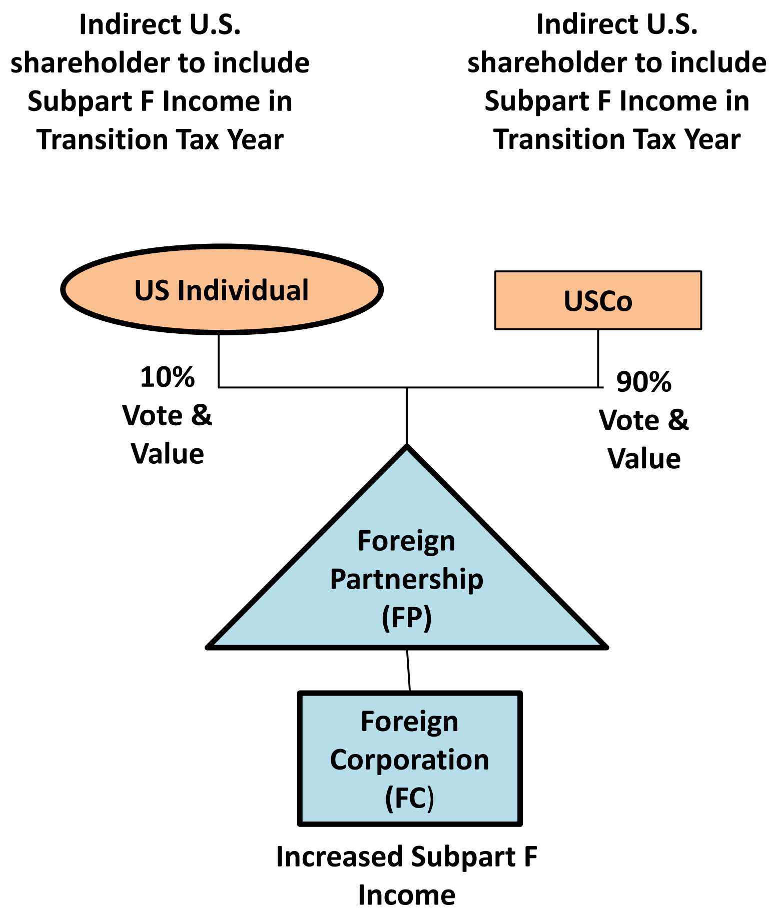
Last taxable year of a **specified foreign corporation (SFC) beginning before** January 1, 2018:
• Subpart F income increased by SFC's **accumulated post-1986 deferred foreign income** as of <u>Nov. 2</u> or <u>Dec. 31</u>, whichever is greater
  • SFC: Any foreign corporation that is a CFC *or* has at least one U.S. corporate shareholder as a U.S. shareholder, except that it excludes PFICs that are not also CFCs.
A portion of the § 965 inclusion is **deductible**, resulting in a reduced effective rate of tax. The deduction rate depends on the extent of U.S. shareholder's pro rata share of SFC cash assets:
  • Effective corporate rates of
    – **15.5%** (to extent of U.S. shareholder's pro rata share of SFC cash assets)
    – **8%** (remainder)
  (deduction rate based on the highest rate of tax applicable to corporations in the taxable year of inclusion, even if the U.S. shareholder is an individual; thus individuals who do not make a section 962 election face a potentially higher rate)
FTC for deemed-paid taxes **disallowed** at the same rate as the deduction
Full 35% tax imposed if U.S. company inverts within 10 years after enactment
	• Election to pay in increasing installments over 8 years
	• Additional timing accommodations relating to S corporations and REITs
	• Applies to **individuals** and corporations, as long as there is one corporate U.S. shareholder (direct or indirect)
	• Regulatory guidance expected on a number of issues, including:
	  – CTB elections and accounting method and year-end changes
	  – PTI and basis
	• For regulatory guidance see Notices 2018-7 and 2018-13.

Transition Tax: S Corporation Exception

- S corporations that are U.S. shareholders of a foreign corporation may defer the deemed repatriation tax until
  - the S corporation liquidates, or
  - a sale of substantially all of the S corporation's assets, or
  - the S corporation ceases doing business, or
  - the stock of the S corporation is transferred (including by reason of death).

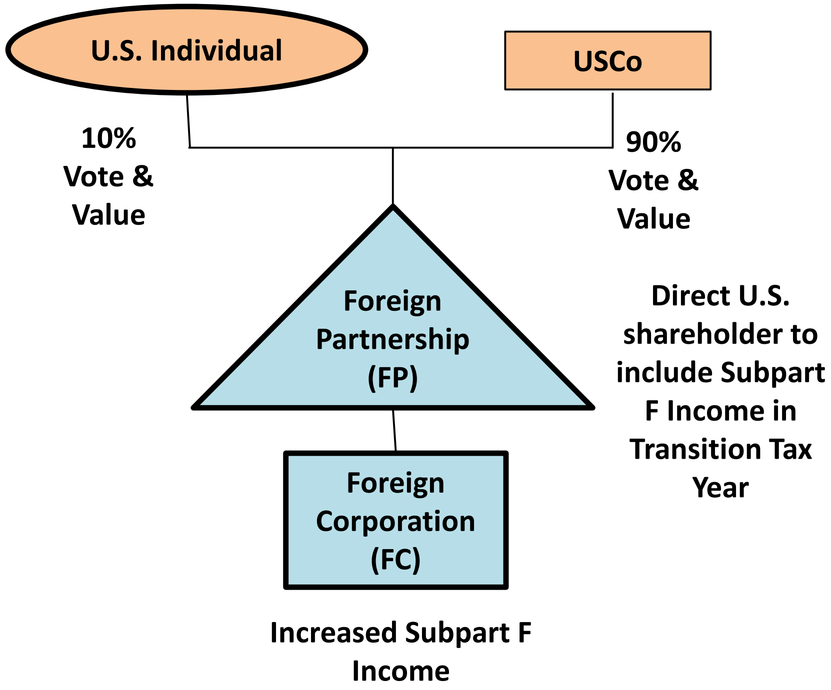
Transaction Tax: Application to Shareholders of CFCs

- Here, FC is a CFC and therefore is a SFC. Both U.S. individual and USCo are indirect U.S. shareholders. Thus, U.S. Individual and USCo have transition tax inclusions.
- Note this example is not limited to ownership of FC through FP; a similar result would occur if USP and USCo directly owned FC stock.



Transaction Tax: Application to Shareholders of CFCs

- Here, FC is a CFC and therefore is a SFC. PS is a direct U.S. shareholder. Thus, PS has a transition tax inclusion.
  - PS has an additional income inclusion under subpart F that gets allocated to U.S. Individual and USCo.
- The Act provides an election to pay the transition tax liability over 8 years; however, it is not clear who makes the election – PS (the U.S. shareholder) or the partners (who are liable for the tax).
- U.S. Individual cannot claim an indirect FTC under section 960.
  - Consider an election under section 962 for a U.S. Individual to be treated as a domestic corporation, which would entitle it to a deemed paid credit for FC's foreign taxes.
  - Note: Section 962(d) requires inclusion in income of PTI distributions in excess of taxes paid with respect to section 951(a) inclusions subject to section 962.



GILTI, FDII, BEAT, AND IP MIGRATION

IP Migration Options

- IP migration structures derived significant tax and deferral benefits pre-December 2017
- The new rules substantially modify the U.S. international tax rules, especially for individual taxpayers:
  - U.S. tax treatment of some post-Act structure would result in current taxation of most or all foreign earnings at U.S. federal tax rates of up to 37%, plus state and local tax
- In order to address the change in law, an alternative structure can be developed for individual U.S. taxpayers
- As an example, U.S. Holdco Structure:
  - U.S. federal income tax should be deferred until profits are distributed out of the U.S. corporate holding companies
  - Foreign earnings distributed to the U.S. corporate holding companies may be redeployed by those companies in the U.S. or elsewhere without triggering U.S. federal income tax
  - Profits distributed to the U.S. corporate holding companies could be subject to U.S. state and local taxation; this needs to be considered if profits are expected to be distributed to the U.S. holding companies

Global Intangible Low-Tax Income (GILTI)

Inclusion for U.S. Shareholders of CFCs;
Deduction and Credit for Domestic “C”-Corporations

Global Intangible Low-Tax Income (GILTI)

GILTI = Net CFC Tested Income – (10% x QBAI) – (int. exp. > int. income)

New Code §951A imposes annual inclusion of GILTI on each person who is a U.S. shareholder of a controlled foreign corporation (CFC). This applies to taxable years of foreign corporations beginning after 12/31/2017 and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

GILTI inclusions are generally treated in the same manner as inclusions under IRC 951(a)(1)(A) for purposes of Code §§168(h(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4).

- "**Net CFC Tested Income**" consists of the CFC's tested income, minus tested loss.
- "**Tested Income**" is gross income minus:
  - Income effectively connected with U.S. trade or business (ECI) under §952(b);
  - Subpart F income;
  - High tax kickout under §954(b)(4) foreign base company income and insurance income;
  - Dividends from related persons defined in §954(d)(3); and
  - Foreign oil and gas extraction income defined in §907(c)(1).

- "**Tested Loss**" means the excess, if any, of deductions (including taxes) properly allocable to gross income (without regard to tested income exceptions) over the tested income. Allocations are to be made under rules similar to §954(b)(5). To deny double benefit of losses, §952(C)(1)(A) increases the E&P of the CFC by the tested loss.
- "**Qualified Business Asset Investment**" consists of the CFC's average aggregate adjusted bases in specified tangible property used in the trade or business and of a type with respect to which a deduction is allowable under IRC 167.
- **Interest Expense** is subtracted from net CFC tested income to the extent interest income attributable to such expense is not taken into account.

Foreign Derived Intangible Income (FDII)

Deduction for Domestic “C”-Corporations

Foreign-Derived Intangible Income (FDII)

FDII = Deemed Intangible Income x $\frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$

For domestic "C"-corporations that are not RICs or REITs, New Code §250, in addition to providing a deduction for GILTI of CFCs, also provides a deduction for foreign-derived intangible income (FDII). The deduction for FDII is 37.5% from January 1, 2018 through December 31, 2025, and thereafter is 21.875%. Based on a 21% corporate income tax rate, and after application of this deduction, the effective tax rate on FDII is 13.125% through December 31, 2025, and thereafter is 16.406%.

- "**Deemed Intangible Income**" means the excess, if any, of the domestic corporation's deduction eligible income, over its deemed tangible income return expressed as 10% of qualified business asset investment:

  Deduction Eligible Income – (10% x QBAI)

  QBAI is based on the average aggregate adjusted bases determined quarterly in specified tangible property described in §167, determined using alternative depreciation using §168(g).

- "**Foreign-Derived Deduction Eligible Income**" is any deduction eligible income derived in connection with:
  - Property sold, leased, licensed, exchanged, or otherwise disposed to any person that is not a U.S. person for use, consumption, or disposition not within the U.S.; or
  - Services provided to any person, or with respect to any property, not located within the U.S.

  Special rules for determining foreign use apply to transactions involving property or services to domestic intermediaries or related parties.

- "**Deduction Eligible Income**" means gross income minus:
  - Subpart F income determined under §951;
  - GILTI;
  - Financial services income defined in §904(d)(2)(D);
  - Dividends from CFCs;
  - Domestic oil and gas extraction income;
  - Foreign branch income defined in §904(d)(2)(J); and

  then subtracting deductions (including taxes) properly allocable to such gross income.

Foreign-Derived Intangible Income (FDII)

Amount of Deduction

- Deduction equal to 37.5% of FDII (plus 50% of GILTI, if any) for taxable years beginning after December 31, 2017, and before January 1, 2026.

- At a 21% corporate income tax rate, the effective rate on FDII would be 13.125% through December 31, 2025.

- Deduction equal to 21.875% of FDII (plus 37.5% of GILTI, if any) for taxable years beginning after December 31, 2025.

- At a 21% corporate income tax rate, the effective rate on FDII would be 16.406% after January 1, 2026.

- The Joint Explanatory Statement of the Conference Committee, footnote 1524, provides that deductions for FDII and GILTI are not available to S corporations, RICs, or REITs.

Foreign-Derived Deduction Eligible Income (FDII)

"Foreign Derived"

- *Property* that is sold (including leased, licensed, exchanged, or disposed) to any person who is not a United States person and that the taxpayer establishes is for a foreign use; or

- *Services* provided by the taxpayer that the taxpayer establishes are provided to any person, or with respect to property, not located within the United States.

Foreign-Derived Deduction Eligible Income (FDII)

Related Parties

- If a taxpayer sells or otherwise disposes of **property** to a related foreign party, the sale is not treated as for a foreign use unless the property is sold or disposed of by the related foreign party to another person who is unrelated and is not a U.S. person and the taxpayer establishes that such property is for a foreign use.

- Income derived in connection with **services** provided to a related party who is not located in the U.S. is not treated as foreign-derived unless the taxpayer establishes that such services are not substantially similar to services provided by the related party to persons located within the U.S.

- A "**related party**" means any member of an affiliated group as defined in §1504(a) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to § §1504(b)(2) and 1504(b)(3). Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member, with control being determined under the rules of §954(d)(3).

Estate and Gift Taxation

Individual and Trust Income Tax Considerations

Transfer Taxes – (Much) More of the Same

	Federal Estate and Gift Tax Exemption	Federal Generation-Skipping Transfer (GST) Tax Exemption
2011	$5,000,000	$5,000,000
2012	$5,120,000	$5,120,000
2013	$5,250,000	$5,250,000
2014	$5,340,000	$5,340,000
2015	$5,430,000	$5,430,000
2016	$5,450,000	$5,450,000
2017	$5,490,000	$5,490,000
2018	~$11,180,000*	~$11,180,000*

* We are awaiting confirmation of the exact exemption amount for 2018. In 2019 and thereafter, the exemption is scheduled to increase for changes in the "chained CPI." The increased exemption sunsets on December 31, 2025; starting January 1, 2026, the exemption will be equal to the 2011 exemption, subject to the inflation adjustments.

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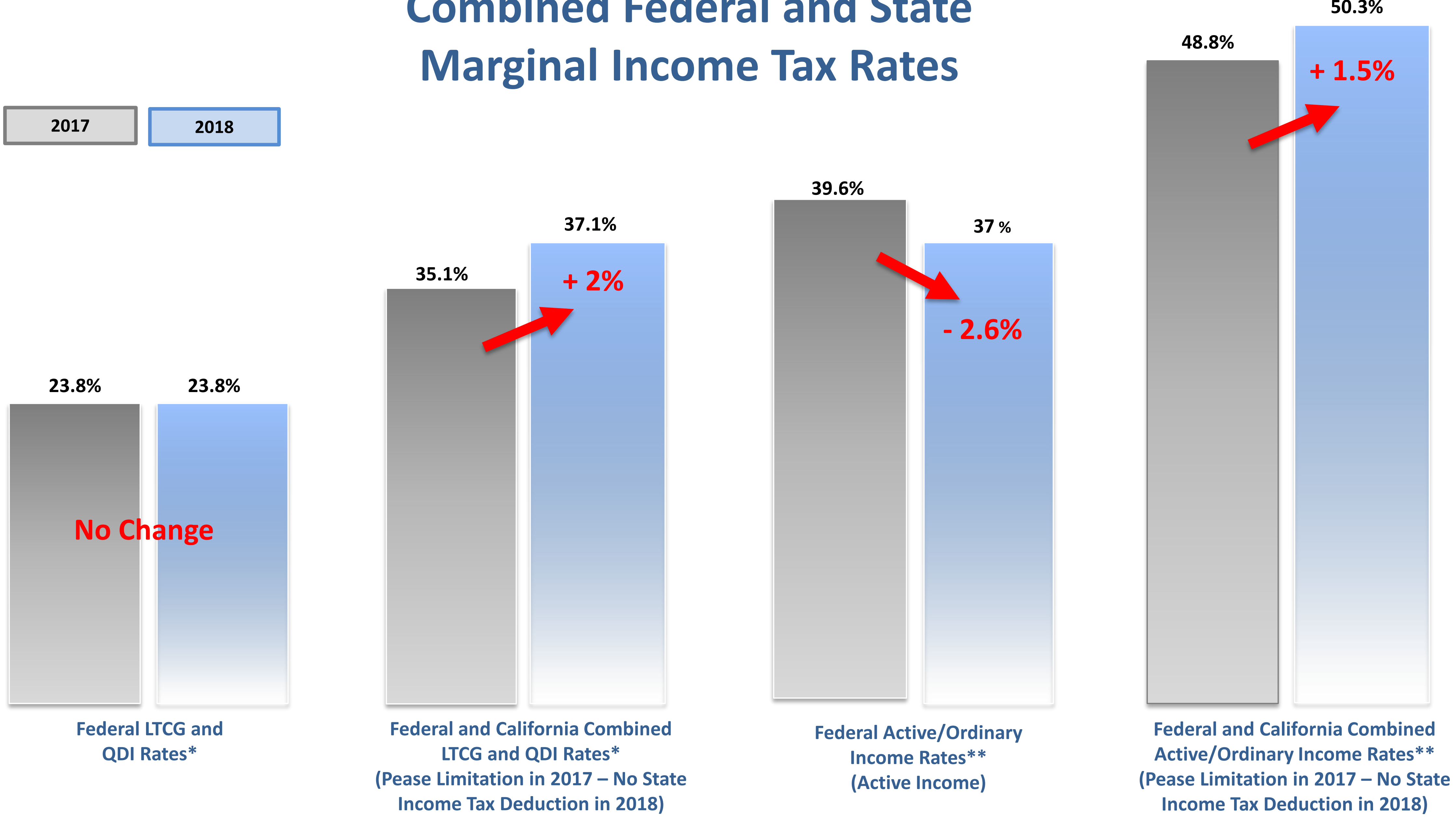
Estate Planning Considerations

- Review formula allocations in existing testamentary plans
- Bypass trust vs. QTIP trust vs. outright gift to surviving spouse
  - Reverse QTIP
  - Clayton election
  - Disclaimer
- Testamentary CLUTs and CLATs
- Lifetime transfers
  - Lock-in larger exemption before sunset
    - <u>But</u> consider loss of step-up on low-basis assets
  - Exercising substitution powers in grantor trusts
  - "Reverse" estate planning to obtain step-up in basis on death of a parent
  - Clawback?

Personal Income Tax Changes

- Miscellaneous itemized deductions
- $10,000 cap on SALT deductions
- Alternative minimum tax
- Section 529 plans
- Alimony
- Mortgage interest deduction
- Section 121 gain exclusion on sale of residence
- Medical expenses

Combined Federal and State Marginal Income Tax Rates



* 3.8% net investment income (NII) tax

** No NII tax

Limitation on Deduction of State and Local Taxes

- Federal deduction for state and local taxes (SALT) capped at $10,000
- California College Access Tax Credit
  - 50% tax credit on personal income taxes in exchange for contribution to College Access Tax Credit Fund (administered by California Educational Facilities Authority) – On October 6, 2017, AB 490 was enacted to extend the availability of the credit through 2022.
- California SB 227 – California Excellence Fund
  - 85% tax credit on personal income taxes in exchange for a contribution to a new California Excellence Fund.
  - Original proposal of 100% tax credit was amended amid concerns that a dollar-for-dollar tax break could more easily be challenged by the IRS.
  - Bill introduced in early January 2018, cleared the California Senate 27-7, and has moved to the Assembly for consideration.
  - *See http://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201720180SB227.*

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Trust Migration to No-Tax State

Example – California resident trustee replaced by Delaware trustee

<u>Non-Grantor Trust</u> *$3M LTCG/QDI and* *$2M active ordinary income*	California Trustee	Delaware Trustee	Income Tax Savings
2017 Combined State and Federal Taxes*	$2,030,102 (40.6%)	$1,506,000 (30.1%)	$524,102
2018 Combined State and Federal Taxes*	$2,119,000 (42.4%)	$1,454,000 (29.1%)	$665,000 (+140,898)

* Applying maximum marginal rates

Loss of Miscellaneous Itemized Deductions

- Modification of Code Section 67
  - Subsection (a) – Miscellaneous itemized deductions allowable only to the extent they exceed 2% of AGI
  - Subsection (b) – Miscellaneous itemized deductions means ALL itemized deductions other than those expressly identified (e.g., Section 163 interest, Section 164 taxes, Section 170 charitable contributions)
  - Subsection (e) – AGI of an estate or trust computed in the same manner as an individual, except that (1) deductions for costs paid or incurred in connection with administration of an estate or trust and which would not have been incurred if the property were not held in such trust or estate, and (2) deductions allowable under sections 642(b), 651, and 661, are treated as allowable in arriving at AGI
  - *NEW Subsection 67(g) – "Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026."*

Reducing Trust Taxation

- Non-Grantor Trusts
  - Completed gift trusts
  - NINGs and DINGs?
- Private Trust Company
- Directed Trusts and Special-Purpose Entities
- Family Office Profits Interest

Charitable Planning

- Batch charitable deductions with donor advised fund
- Transfer IRA funds after age 70½
- Limit for deduction on cash donations increased to 60% of AGI

Questions?

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