Individual tax planning

It's a brand-new day. Move forward with confidence.

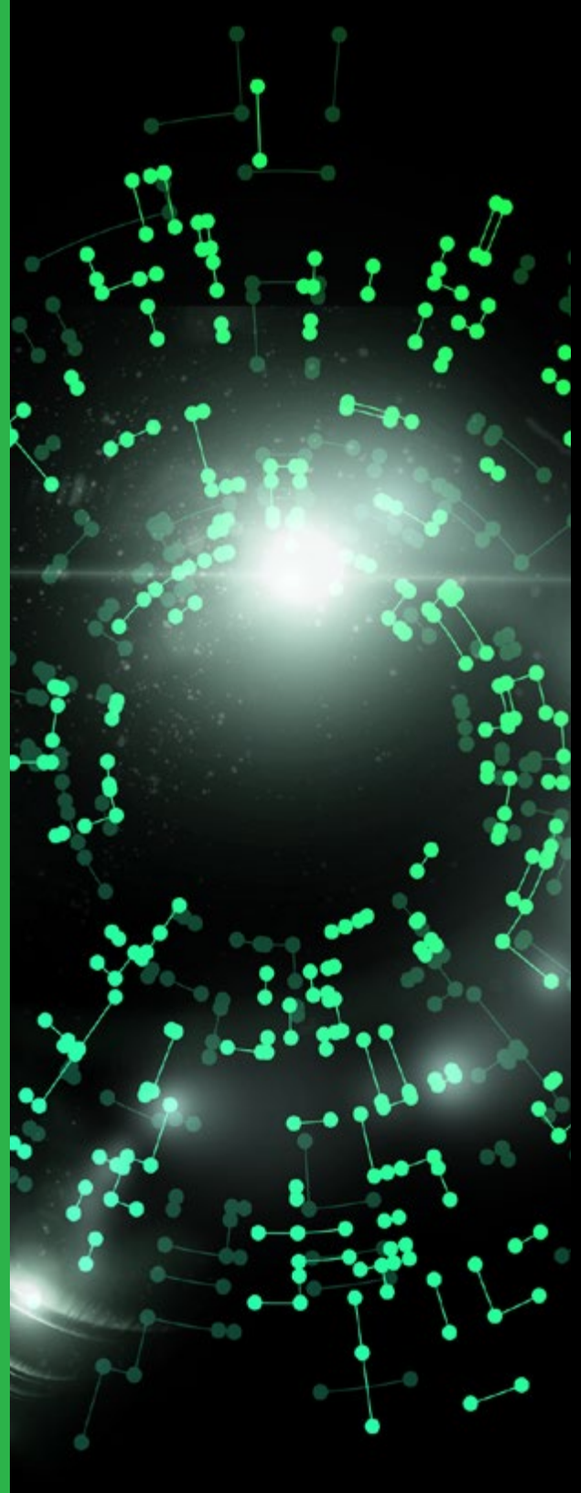
In recent years, while there may have been volatility in tax rates, the basic income tax landscape for individuals, trusts, and estates has remained relatively constant. The passage of the 2017 Tax Act[1] at the close of 2017 significantly altered the planning landscape for 2018 and beyond. This new terrain has prompted advisers and taxpayers alike to pause, look around, become familiar with these new surroundings, and rethink how to navigate in this new tax environment.

As you plot a course forward, you may encounter new sights along the path, such as the qualified business income deduction. Views that seem familiar from afar may look a little different upon closer inspection, such as the increased ability to offset income with charitable contributions or the decreased ability to deduct state and local income taxes. Finally, you may begin to notice that there are things that are now missing, such as personal exemptions, miscellaneous itemized deductions, and alimony.

Of note, many tax reform provisions will be around for a relatively short period of time. Most provisions described herein will sunset on December 31, 2025, at which time this new tax planning landscape will revert back to the landscape we were familiar with before the enactment of the 2017 Tax Act.

This chapter of the *Guide* addresses the new tax planning landscape in order to chart a path toward an efficient tax result.

[1] P.L. 115-97, known informally as the Tax Cuts and Jobs Act and officially as *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.*

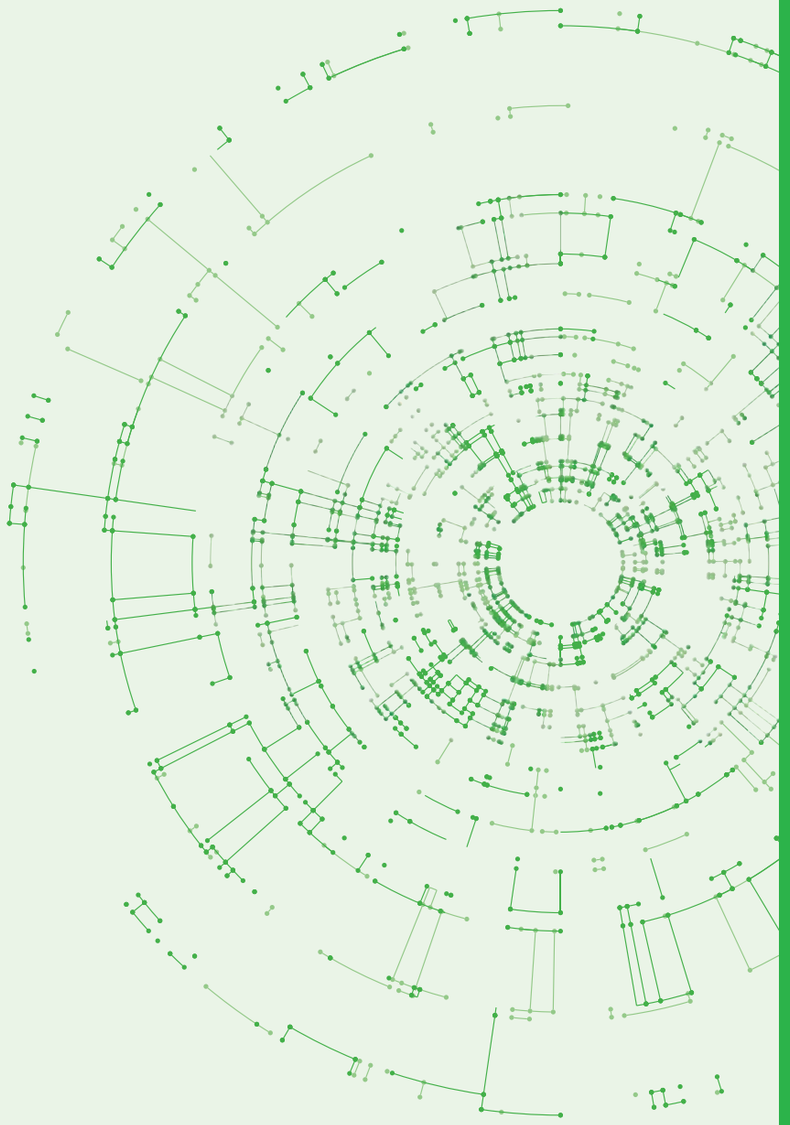


What's new?

The first twist in the road is that the 2017 Tax Act created several new tax planning considerations that should be highlighted, such as:

- Lower overall rates,
- The new deduction for domestic qualified business income,
- The new limitation on business interest expense,
- Qualified opportunity zone planning incentives, and
- A variety of new international tax provisions.

While no one provision can stand on its own when making important decisions—such as what type of entity structure to use in forming a business—collectively, these new planning considerations may alter the analysis that should be undertaken when determining how to move forward.



What's new?

Tax rate modifications

The 2017 Tax Act maintained seven brackets as in prior law, though it reduced the highest tax bracket from the prior level of 39.6 percent to 37 percent for single filers with taxable income over $500,000. Notably, the threshold for the 37 percent bracket for married filing joint taxpayers is only $600,000 and, as a result, these new rate tables reestablish the so-called "marriage penalty." The 2017 Tax Act also retains the 20 percent special tax rate for long-term capital gains and qualified dividend income, the 3.8 percent tax rate on certain levels of net investment income (NII), and the 0.9 percent FICA-HI tax rate on certain levels of earned income that were in effect under prior law.

The following table illustrates how the tax rates under the 2017 Tax Act compare to prior law.

Individual and fiduciary ordinary income tax rates

NEW LAW FOR TAX YEARS 2018–2025

	Single		Married couples filing jointly		Trusts/estates	
Ordinary income tax rate	Taxable income over	But not more than	Taxable income over	But not more than	Taxable income over	But not more than
10%	-	$9,525	-	$19,050	-	$2,550
12%	$9,525	$38,700	$19,050	$77,400	N/A	N/A
22%	$38,700	$82,500	$77,400	$165,000	N/A	N/A
24%	$82,500	$157,500	$165,000	$315,000	$2,550	$9,150
32%	$157,500	$200,000	$315,000	$400,000	N/A	N/A
35%	$200,000	$500,000	$400,000	$600,000	$9,150	$12,500
37%	$500,000		$600,000		$12,500	

PREVIOUS LAW FOR 2018 TAX YEAR

	Single		Married couples filing jointly		Trusts/estates	
Ordinary income tax rate	Taxable income over	But not more than	Taxable income over	But not more than	Taxable income over	But not more than
10%	-	$9,525	-	$19,050	N/A	N/A
15%	$9,525	$38,700	$19,050	$77,400	-	$2,600
25%	$38,700	$93,700	$77,400	$156,150	$2,600	$6,100
28%	$93,700	$195,450	$156,150	$237,950	$6,100	$9,300
33%	$195,450	$424,950	$237,950	$424,950	$9,300	$12,700
35%	$424,950	$426,700	$424,950	$480,050	N/A	N/A
39.6%	$426,700		$480,050		$12,700	

What's new?

Domestic qualified business income deduction

Looking at tax rates alone does not reveal the whole picture, especially if qualified business income is part of your tax landscape. The 2017 Tax Act created a new 20 percent deduction for certain qualified income for individuals, estates, and trusts. Under new Internal Revenue Code section 199A, qualifying taxpayers generally may deduct the sum of:

- 20 percent of the domestic qualified business income with respect to a qualified trade or business from a partnership, S corporation, or sole proprietorship (subject to certain limitations based on W-2 wages and unadjusted basis immediately after acquisition of qualifying property, collectively, the "wage and basis limitations"), and
- 20 percent of aggregate qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership (PTP) income.

The above tentative deduction is subject to an overall limitation of 20 percent of the taxpayer's taxable income without regard to net capital gain, which for this purpose includes any qualified dividend income.

Qualified business income for a taxable year means the net amount of domestic qualified items of income, gain, deduction, and loss with respect to the taxpayer's qualified trades or businesses (that is, any trade or business other than specified service trades or businesses [SSTBs], defined below).

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation to the taxpayer. Similarly, qualified business income generally does not include any amount allocated or distributed by a partnership to a partner for services rendered with respect to the trade or business, and does not include any amount that is a guaranteed payment for services to the extent that the payment is in the nature of remuneration for those services. The final regulations under section 199A provide that the deductible portion of the tax on self-employment income, the self-employed health insurance deduction, and the deduction for contributions to qualified retirement plans are taken into account as deductions to the extent the income is included in the gross income from the trade or business for section 199A purposes.

In addition, qualified business income does not include certain investment-related income, gain, deductions, or loss. The final regulations provide clarity on items treated as capital gain or loss, including removing the reference to section 1231, and provide that any items of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss—including any item treated as one of these such items under any other provision of the Code—is not considered as a qualified item of income, gain, deduction, or loss for computation of qualified business income.

The computation of domestic qualified business income with respect to a qualified trade or business does not include income from an SSTB. SSTBs are not qualifying trades or businesses. The final regulations provide further clarification, definitions, and examples regarding the determination of whether a trade or business is an SSTB. An SSTB is any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees 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. An SSTB, however, does not include a trade or business involving engineering or architecture.

What's new?

Domestic qualified business income deduction (cont.)

Examples of specific guidance provided by the final regulations regarding what is a qualified trade or business versus a specified service trade or business

Qualified trade or business	Specified service trade or business
architecture or engineering services	stock brokerage
broadcasting or disseminating video or audio of professional sports or performing arts	financial services, including arranging lending transactions
retail banking, including taking deposits or making loans	medical services, including those not directly provided to patients
insurance brokerage	dealing in securities, commodities, or partnership interests
payment processing and billing services	pharmacist providing medical services
real property management	investment management
pharmaceuticals or medical devices	consulting services
operators of emergency care centers, urgent care, surgical centers	sports teams
lab services with no proximity to patients	investment banking
health clubs and spas	veterinary services
consulting that is embedded or ancillary to the sale of goods	

What's new?

Domestic qualified business income deduction (cont.)

For taxpayers with taxable income below a threshold amount—$157,500 for single filers and $315,000 for joint filers—the wage and basis limitations do not apply to the 20 percent deduction for qualified business income. The threshold amount is determined by reference to the taxpayer's taxable income, which may include income from other sources. These taxpayers under the threshold amount also are not subject to the limitation on SSTBs, described above.

For taxpayers with income above a threshold amount—$207,500 for single filers and $415,000 for joint filers—the wage and basis limitations apply. With respect to each qualified trade or business, the amount of the deduction is limited the deduction is limited to the lesser of 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or the greater of:

- 50 percent of the W-2 wages with respect to the qualified trade or business, or
- 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

For taxpayers with income between the upper and lower threshold amounts—$157,500 to $207,500 for single filers and $315,000 to $415,000 for joint filers—the wage and basis limitations are phased in.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner in a partnership takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. Each partner's allocable share of W-2 wages is required to be determined in the same manner as the partner's share of wage expenses. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the shareholder's pro rata share of W-2 wages of the S corporation. A partner's allocable share (or an S corporation shareholder's pro rata share) of the unadjusted basis of a partnership's (or S corporation's) qualified property is determined in the same manner as the partner's (or shareholder's) allocable or pro rata share of depreciation from the partnership (or S corporation).

In response to comments, the final regulations permit aggregation of the trades or businesses a partnership or S corporation operates directly or through lower-tier entities if certain conditions are met. Individuals, trusts, and estates may also aggregate trades or businesses if certain conditions are met but must adhere to any aggregation made by an S corporation or partnership.

With respect to trusts and estates, rules similar to the rules under section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital. The final regulations further clarify that the taxable income for a trust, for purposes of computing the threshold, is measured after the income distribution deduction.

In addition to a 20 percent deduction for a taxpayer's qualified business income, a 20 percent deduction is also available for:

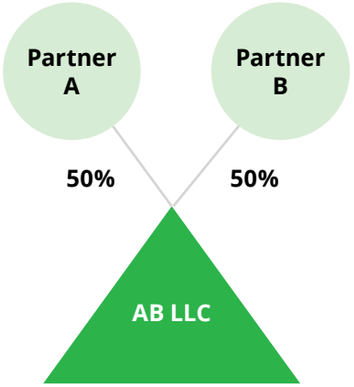
- Dividends from a REIT (other than any portion that is a capital gain dividend),
- Qualified cooperative dividends, and
- Qualified PTP income (generally including domestic business income allocated from a PTP and excluding investment-related items from PTPs).

What's new?

Domestic qualified business income deduction (cont.)

Illustration of overall limitation

As stated previously, after determining the tentative deduction allowed under section 199A based on the above criteria, an overall limitation of 20 percent of the taxpayer's taxable income without regard to net capital gain, which for this purpose includes any qualified dividend income, is applied to determine the final deduction amount available for each taxpayer. The potential impact of the overall limitation is best illustrated with an example:



Partners A and B each receive their 2018 Schedule K-1 from AB LLC.

Schedule K-1 footnotes include the following information (for each partner):

- Qualified business income (QBI) allocated to owner: $1,000,000
- W-2 wages allocable to owner: $500,000
- Unadjusted basis immediately after acquisition (UBIA) of qualified property allocable to owner: $2,000,000
- Income from SSTB: None
- Aggregate qualified REIT dividends and qualified PTP income: None

Personal tax return attributes	Partner A	Partner B
Ordinary rate income	$1,000,000	$0
Qualified dividend income (QDI) and/or long-term capital gain (LTCG) income (20% rate income)	$0	$1,000,000
Total Taxable Income	**$1,000,000**	**$1,000,000**

While the new qualified business income deduction may provide taxpayers with an opportunity to reduce their overall effective tax rate, the computations are complex and require additional information gathering and analysis in order to accurately compute the deduction.

Tentative section 199A deduction before the overall limit		
The lesser of:	A	B
• 20% of QBI	$200,000	$200,000
Or		
• The greater of:	$250,000	$250,000
- 50% of W-2 wages paid by the qualified trade or business (QTB)	$250,000	$250,000
- Sum of 25% of W-2 wages paid by QTB and 2.5% of UBIA of qualified property	$175,000	$175,000
Tentative deduction (the "combined QBI" under the statute)	**$200,000**	**$200,000**

Overall limit application		
The lesser of:	A	B
• Tentative deduction from above	$200,000	$200,000
Or		
• Taxable income limitation		
- Taxable income before 199A	$1,000,000	$1,000,000
- Less: Net QDI/LTCG taxed at preferential rate	$0	($1,000,000)
Taxable income	$1,000,000	$0
Multiplied by 20%	$200,000	$0
Section 199A deduction allowed on Form 1040	**$200,000**	**$0**

What's new?

Business interest expense limitation

The 2017 Tax Act imposes a new limitation on the deduction for business interest. For any tax year beginning after December 31, 2017, the deduction for "business interest" is limited to the sum of:

- Business interest income (any interest income properly allocable to a trade or business; does not include investment interest income);
- 30 percent of the adjusted taxable income (ATI), which excludes non-trade or business items of income, gain, deduction, or loss, business interest expense or income, net operating loss (NOL) deductions, section 199A deductions, and, for tax years beginning before January 1, 2022, depreciation, amortization or depletion deductions; and
- Floor plan financing interest (FPFI), which is generally interest expense related to the acquisition of motor vehicles, including boats and farm equipment, held for sale or lease.

Disallowed business interest deductions can be carried forward indefinitely. Certain trades or businesses are exempt from the business interest limitation, including performing services as an employee, certain utility businesses, electing real property trades or businesses, and electing farming businesses. In addition, the limitation does not apply to "small businesses"—those with average gross receipts of less than $25 million over a three-year period. Unlike many other provisions impacting individuals, the new business interest limitation does not sunset.

In the case of a partnership or an S corporation, the business interest expense limitation applies at the entity level, not the owner level. To the extent a partnership or S corporation has excess capacity (excess taxable income) for purposes of the deduction limit, the excess is passed through to the partners or shareholders so it may be used by the partner or shareholder in computing their ATI. This addition to a partner's or shareholder's ATI assists them in being able to deduct other interest expense that they may have incurred directly (at the partner or shareholder level). Note, however, that excess ATI allocated to a partner or shareholder for any tax year must be used against excess business interest expense from that entity for all tax years before it may be used against any other business interest expense. Also, excess ATI that goes unused cannot be carried forward to a future tax year.

Factors creating a potential business interest expense limitation:

- Higher levels of business interest
- Steady stream of cash flow providing debt service
- Low levels of ATI compared to business interest expense
- Limited amount of business interest income
- Location of leverage
  - International structures
  - Tiered partnerships
- Pass-through rules may create unexpected results
  - Impact of tiered partnerships
  - Financing at pass-through entities

What's new?

Qualified opportunity zone incentives

A particularly interesting new planning alternative provided in the 2017 Tax Act is the new qualified opportunity zone (QOZ) incentives. A QOZ is an economically distressed community where new investments, under certain conditions, may be eligible for preferential tax treatment. Taxpayers may defer and partially reduce capital gains tax due on the disposition of existing property by reinvesting the capital gains into a QOZ through a qualified opportunity fund (QOF).

Three types of potential benefits:

Deferral of gain from a sale or exchange of prior investments
Taxpayers may elect to temporarily defer from inclusion in gross income certain capital gains from the sale or exchange of property to the extent of the aggregate amount invested in a QOF during the 180-day period beginning on the date of the sale or exchange. Note that a special rule applies to investors in the context of certain flow-through entities where the 180-day tolling period begins on the last day of the taxable year of the flow-through entity. The deferral lasts until the earlier of the sale or exchange of the QOF investment or December 31, 2026.

Reduction of deferred gain from the sale or exchange of prior investments
After holding investments in a QOF for a specified period of time, taxpayers may receive a permanent reduction of the deferred gain originally realized equal to 10 percent (if the QOF investment is held at least five years) or 15 percent (if the QOF investment is held at least seven years) through a partial basis step-up (see example).

Exclusion of gain from the sale or exchange of investments in QOFs
After holding investments in a QOF for a period of at least 10 years, taxpayers may elect to receive a permanent exclusion of the appreciation of the QOF investment through a full basis step-up to the fair market value of the QOF investment on the date such investment is sold or exchanged. However, the investor may only make the basis step-up election on the sale or exchange of a QOF investment occurring on or before December 31, 2047. Any additional appreciation after December 31, 2047 will not be available for the step-up election.

Example:

2018: Individual has $100,000 capital gain from sale or exchange of property.
2019: Individual makes $100,000 investment in QOF and QOF makes $100,000 investment in QOZ property.
2019 through 2029: Individual holds QOF investment.
2029 through 2047: Individual has a sale or exchange of its QOF investment.

FRONT-END BENEFITS FOR DEFERRED GAINS

2018	2024	2026	12/31/2026	2029 to 2047
Defer paying tax of $23,800 ($100,000 x 23.8%; 20% capital gain rate + 3.8% NII)	$2,380 (10%) of tax forgiven at 5-year holding period by virtue of $10,000 basis step-up	$1,190 (5%) of tax forgiven at 7-year holding period by virtue of $5,000 basis step-up	Regardless of holding period must pay tax of $20,230 on deferred gain (effectively 17% capital gain rate + 3.23% NII, or 20.23%)	

BACK-END BENEFITS FOR QOF INVESTMENT

2019	2024	2026	12/31/2026	2029 to 2047
$100,000 investment in QOF made within 180 days; zero outside basis	$10,000 QOF outside tax basis increase	$5,000 QOF outside tax basis increase	$85,000 QOF outside tax basis increase	QOF outside basis increased to $500,000 FMV at time of sale or exchange of QOF investment

What's new?

Qualified opportunity zone incentives (cont.)

Key terms and definitions

A **QOZ** is generally a state-designated low-income community. Click on the QOZ Designation Map to identify a QOZ in your area. A **QOF** is a self-certified entity that holds 90 percent of its assets in QOZ property. **QOZ property** includes QOZ stock, QOZ partnership interests, or QOZ business property.

- **QOZ stock** must be held in a domestic corporation, acquired at original issue after December 31, 2017 solely in exchange for cash, issued by a QOZ business; during the fund's holding period, the corporation must be a QOZ business.
- The rules are similar for a **QOZ partnership interest**, except the partnership does not need to be newly formed (***i.e.***, no original issue requirement).
- A **QOZ business** is a trade or business in which substantially all (70 percent or more) of the tangible property owned or leased is QOZ business property and that satisfies the following requirements:
  - Must derive 50 percent or more of total gross income from the active conduct of the trade or business in the QOZ;
  - Must utilize a substantial portion of the intangible property in the active conduct of the trade or business in the QOZ;
  - Attribute less than 5 percent of the average of the aggregate unadjusted bases of the property held by the business to nonqualified financial property; and
  - Is not a prohibited business, including: golf courses, country clubs, massage parlors, hot tub facilities, suntan facilities, facilities used for gambling, or any store that primarily sells alcohol for consumption off premises.

To become a QOF, an eligible taxpayer self-certifies—no approval or action by the IRS required—by completing a form and attaching it to the taxpayer's timely filed federal income tax return for the taxable year. If a QOF fails to meet the requirement to hold 90 percent QOZ property, the QOF must pay a penalty for each month it fails to meet the requirement, unless the taxpayer can show reasonable cause. The 2017 Tax Act does not require any particular economic outcome by the QOF.

What's new?

International tax implications

The international tax landscape has changed dramatically as a result of the 2017 Tax Act. Under prior law, federal tax on unremitted earnings of certain foreign corporations was generally deferred until the earnings were repatriated. The 2017 Act created new anti-deferral provisions. These new the new rules triggered an initial tax on untaxed earnings of certain foreign corporations (the "transition tax") and also imposed an annual tax on global intangible low-taxed income (GILTI) of controlled foreign corporations (CFCs).

The transition tax (enacted in new section 965) is imposed on a one-time deemed repatriation of accumulated post-1986 net earnings of the relevant foreign corporation. Transition tax applies to US shareholders owning 10 percent or more of a foreign corporation that is a CFC, or 10 percent owners of foreign corporations where at least one domestic corporate shareholder is a direct, indirect, or constructive owner. For individuals and trusts, the effective transition tax rate is 17.54 percent to the extent the foreign corporation's accumulated earnings consists of cash and cash equivalents and 9.05 percent for noncash assets. Taxpayers may elect to spread the payment of the tax over eight years. A special rule permits deferral of the payment of the transition tax liability for S corporation shareholders until a triggering event occurs.

GILTI requires an annual computation and may cause a portion of the CFC's earnings to be included in a US shareholder's income tax return. Application of the GILTI provisions can be adverse to individuals and trusts for several reasons:

- The income inclusion will frequently be "phantom income" (a tax attribute not represented by a cash distribution),
- Individuals cannot claim underlying foreign tax credits to offset the US tax liability, and
- The income inclusion does not qualify for the 20 percent qualified dividend tax rate.

In addition, the 2017 Tax Act included changes to the definitions of "US shareholder" and "controlled foreign corporation" that impact not only GILTI and transition tax rules, but also traditional Subpart F inclusion rules.

We will explore international topics in greater depth in a future release of the *Guide*. In the meantime, learn more about changes in the international tax landscape on the Deloitte US Tax Reform—New tax law readiness | International: New tax provisions page. From BEAT, FDII, and GILTI to international structures, supply chains, and compliance impacts, your tax adviser can help you consider a path through the complexity.

What's new?

Choice of entity and addressing entity conversion considerations: Key provisions to consider

Considering all of these changes, if you have an existing business venture or are contemplating a new one, then you may be motivated to reconsider the structure of the business. However, it is important to think through a wide variety of consequences, including the tax consequences, before making a conversion.

Consider, for example:

- The entity's likely future distributions policy,
- The likelihood and potential timing of a sales transaction as the exit strategy, and
- Whether such a sale is likely to be an asset sale or a sale of an equity interest.

In our *2018 essential tax and wealth planning guide*, installment two, we reviewed the choice of entity analysis and addressed entity conversion considerations.

For more information on this topic, please revisit the Choice of entity section.

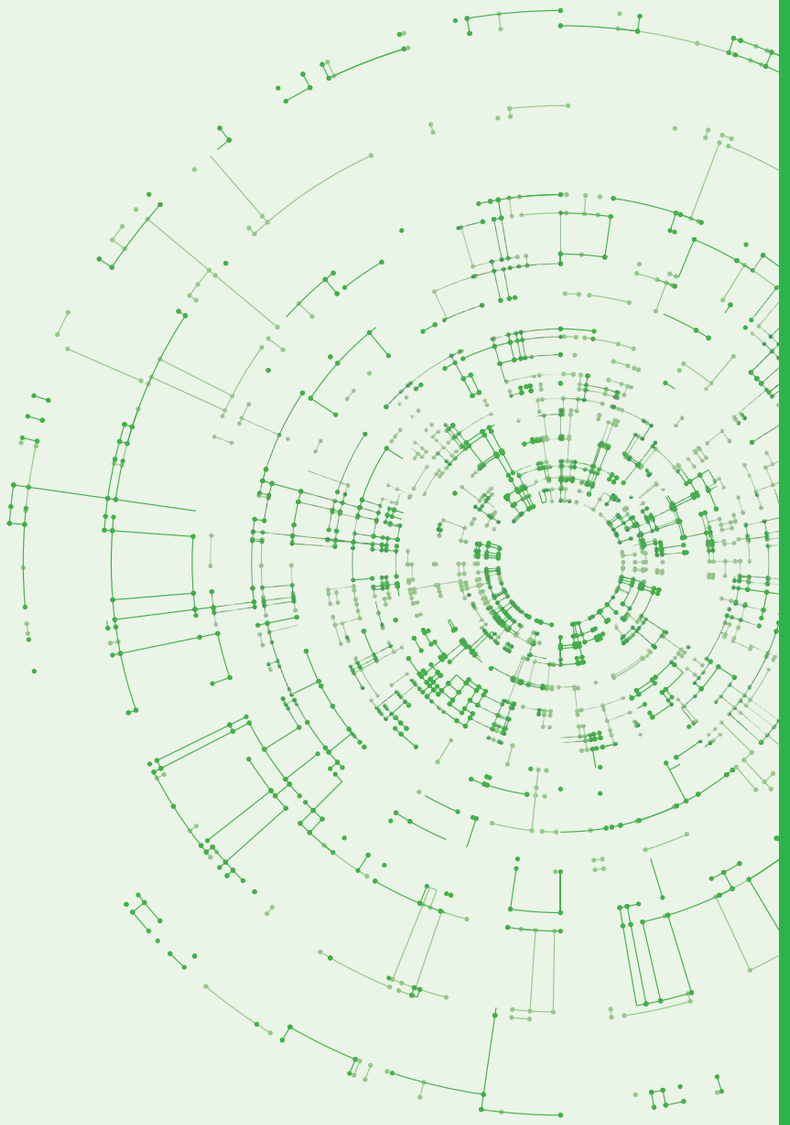
Sample considerations for analyzing a conversion from pass-through to C corporation

- Annual distributions—now and into the future
- Qualification for section 199A deduction
  - US-sourced vs. non-US-sourced income
  - QBI
- Character of income recognized
  - LTCG and qualified dividends
  - Section 212 portfolio deductions
- Owners of the company
- Growth of the business assets vs. growth of cash distributed
- Section 351 considerations
- International considerations
  - Structure
  - Foreign tax credit planning
  - Certain gain recognition provisions such as overall foreign loss recapture and section 367
  - Impact on dual consolidated loss rules
- Potential future changes in tax law
- Carryforward attributes of partners
- Accumulated adjustments account distribution planning for terminated S corporations
- Estate planning
- Implications of section 7519 payments for fiscal year filers
- Exit strategy considerations
  - Sale of partnership interest
  - Stock vs. asset deal of corporation
  - Holding period upon exit
  - Purchase price considerations
- State tax implications
  - State sourcing and income tax rates
  - Investment partnership rules
  - Compliance costs
  - State tax footprint of the entity
  - State tax footprint of the owners

Individual tax planning

What looks the same—but is really different?

Some aspects of the 2017 Tax Act stand out as new in the tax landscape. As you continue to move forward, you may encounter more changes than you originally expected. While certain tax planning considerations initially look the same, in practice, they may be much different.



What looks the same—but is really different?

Alternative minimum tax (AMT)

The AMT is imposed at a nearly flat rate of 28 percent on an adjusted amount of taxable income above a certain threshold, which is also known as an exemption. In years prior, the AMT regime had evolved into an unwieldy system that impacted millions of unsuspecting taxpayers and, as a result, the repeal of AMT was frequently debated as part of potential tax reform. However, the 2017 Tax Act maintained the AMT for individual and fiduciary income taxpayers, albeit with a higher exemption amount—$70,300 for single filers and $109,400 for joint filers for the 2018 tax year. Further, the 2018 exemption phase-out thresholds are increased to $500,000 and $1 million for single and joint filers, respectively. Both the exemption and phase-out threshold amounts are indexed annually for inflation. Additionally, as will be discussed in more depth below, the four primary factors that pulled individuals into AMT were eliminated or reduced:

- Personal exemptions,
- Miscellaneous itemized deductions,
- The deduction for state and local taxes, and
- Limitations on NOLs.

Due to the decrease in the differential between ordinary income tax rates and the relatively flat AMT tax rate, and the reduction of tax attributes that often pull taxpayers into AMT, fewer taxpayers will be subject to the AMT going forward. Moreover, for those with pre-2018 AMT credit carryforwards, these and other changes may assist such taxpayers with realizing such carryforwards.

What looks the same—but is really different?

Excess business and net operating losses

Another aspect that may appear familiar, but now has different rules applicable to its application is the ability to freely deduct business losses against all other income sources.

First, under the 2017 Tax Act, an excess business loss is not allowed in the current year and is carried forward and treated as an NOL in subsequent years. An excess business loss exists when a taxpayer's aggregate trade or business deductions exceeds the sum of the taxpayer's aggregate trade or business gross income and gain plus a threshold amount of $250,000 (or $500,000 for a married filing joint return).

In determining an excess business loss, each partner's distributive share, each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss from trades or businesses of the partnership or S corporation, and the taxpayer's income or loss from sole proprietorships is taken into account in applying the limitation for the taxable year. An excess business loss is computed after applying the passive loss rules; thus, a loss permitted by reason of the full disposition of a passive loss activity to an unrelated person may give rise to or increase the excess business loss for that year.

Second, the 2017 Tax Act altered the NOL ruleset such that:

- With limited exceptions, NOLs arising in tax years beginning after 2017 may only be carried forward (not back up to two years as under prior law),
- NOLs may be carried forward indefinitely (as opposed to up to 20 years under prior law), and
- In any given year, an NOL carryforward originating in or subsequent to 2018 cannot exceed 80 percent of regular taxable income. For AMT purposes, the limitation remains at 90 percent of AMT income.

The combined impact of these provisions can have a significant impact on owners of businesses that produce losses. In any year where a taxpayer has material losses from an active trade or business, an income tax liability may now occur if income from other classes exceed the allowed loss (*i.e.*, the lesser of the actual loss or the applicable $250,000/$500,000 threshold) despite the absence of net income or cash flow. In addition, the business owner can no longer immediately carry back an NOL if the owner had taxable income in one or more of the two prior tax years to generate an offsetting tax refund. Instead, the taxpayer must wait until a future year with net taxable income to take the loss. As a result, financing the tax liability in the face of the cash flow constraints inherent in a loss situation may be an issue.

Additional complexities may arise when considering how these rules will interplay with the rules of the qualified business income deduction. However, altering the timing of controllable events may lessen the impact of these loss limitations in some situations (see example on the following page). Seeking assistance from a tax professional is recommended when navigating this terrain.

What looks the same—but is really different?

Excess business and net operating losses (cont.)

Excess business loss and NOL limitations example—timing matters

OBSERVATIONS:

This example shows the impact of the new excess business loss and NOL provisions. These new provisions impact the timing of the deductibility of the loss generated by trade or business (T/B) B. For simplicity, assume there are no itemized deductions and ignore the standard deduction.

In year 1, the current-year loss is limited under the excess business loss provision and creates an NOL.

In year 2, the example shows the impact of the new NOL limitations limiting the deductibility of the NOL to 80 percent of the current year's taxable income.

In each year represented, these new provisions show the resulting taxable income, where under prior law there would be no such taxable income resulting.

Facts for a married filing joint (MFJ) taxpayer

	2018	2019	2020
T/B A	1,000,000	1,000,000	3,000,000
T/B B	(5,000,000)	(1,000,000)	(1,000,000)
Long-term capital gain (LTCG)	1,000,000	4,000,000	1,000,000
	(3,000,000)	**4,000,000**	**3,000,000**

	2018 Tax Year	2019 Tax Year	2020 Tax Year
Aggregate T/B deductions	(5,000,000)	(1,000,000)	(1,000,000)
Aggregate T/B income	1,000,000	1,000,000	3,000,000
MFJ threshold	500,000	N/A	N/A
Excess business loss	**(3,500,000)**	**N/A**	**N/A**
Allowed T/B loss	**(1,500,000)**	**(1,000,000)**	**(1,000,000)**
LTCG	1,000,000	4,000,000	1,000,000
T/B income	1,000,000	1,000,000	3,000,000
Allowed T/B loss	(1,500,000)	(1,000,000)	(1,000,000)
Tentative taxable income	**500,000**	**4,000,000**	**3,000,000**
NOL allowed (up to 80% of taxable income)	N/A	(3,200,000)	(300,000)
Taxable income	**500,000**	**800,000**	**2,700,000**
NOL carryforward	**(3,500,000)**	**(300,000)**	**0**

What looks the same—but is really different?

Increased charitable deduction

The changes regarding charitable deductions may also alter the tax landscape for those who are charitably inclined. Under the 2017 Tax Act, a charitable deduction is no longer available for payments made in exchange for college athletic event seating rights. When it comes to the adjusted gross income (AGI) limitations on cash contributions to public charities, the 2017 Tax Act increased the AGI limit for cash contributed to public charities and certain other organizations from 50 percent to 60 percent. All other limits based on AGI remain unchanged. If you make charitable contributions in excess of the applicable AGI limit, including the new 60 percent limitation, you are still able to carry the excess amount forward for up to five years.

One note of caution: As shown in the example, noncash contributions may impact a taxpayer's ability to fully utilize the new 60 percent AGI limitation on cash contributions. This is because charitable contributions of noncash property to public charities are only allowed to the extent the aggregate of those contributions does not exceed the lesser of (1) 30 percent of the taxpayer's contribution base (generally, the taxpayer's AGI) or (2) the excess of 50 percent of the taxpayer's contribution base over the allowed amount of cash gifted to public charities. There has been commentary indicating that this issue may be addressed via a technical corrections bill, but when or if such a legislative change will occur is uncertain.

Again, it is important to consider the overall impact of these new provisions. For example, while the increased allowable charitable contributions may be valuable, recall that charitable contributions offset the highest tax rate income first, leaving income that is taxed at preferential lower rates. Further recall that income taxed at preferential rates cannot be offset with the section qualified business income deduction. Thus, if the tax efficacy of your charitable contributions is a factor in your determination of the amount or character of the charitable contributions you make, your charitable planning may be more complicated under the new tax regime.

Example:

Facts

$10M	$4M	$4M
AGI	cash gift to public charity	stock gift to public charity

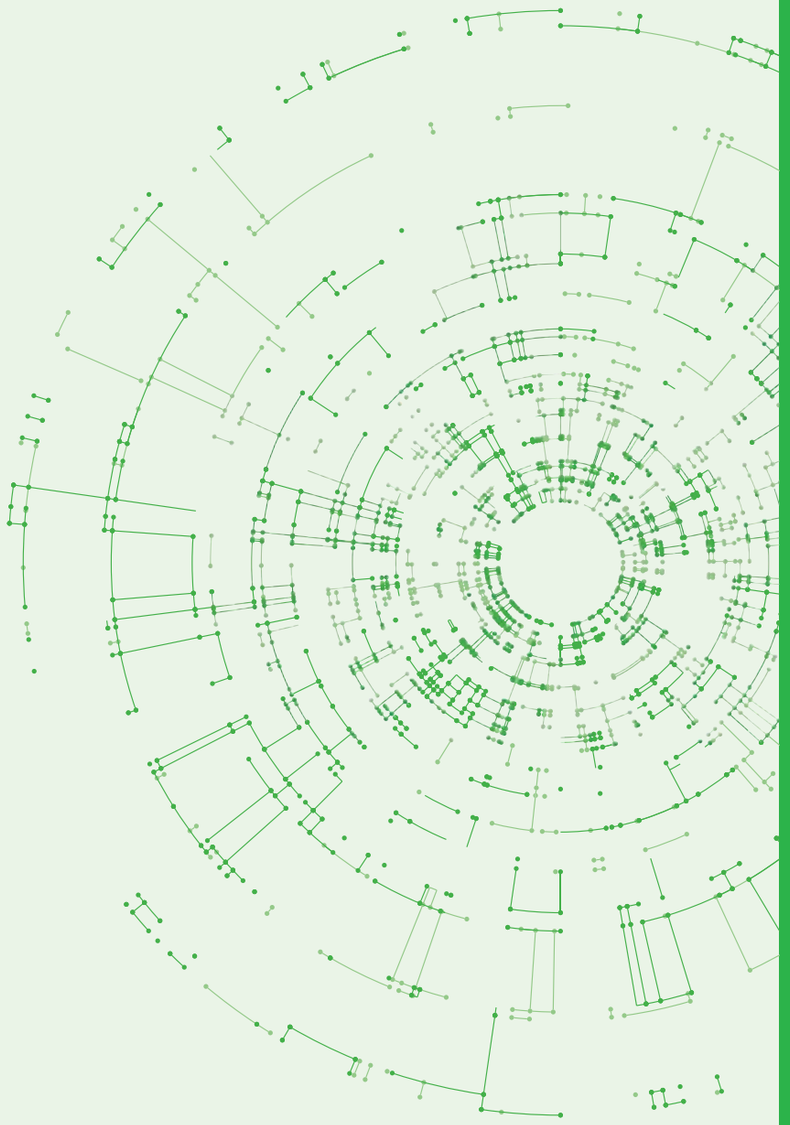
Result

Full deduction for **$4M** cash donation, but only **$1M** of the stock donation is allowed as a deduction. Carryforward of **$3M**.	Noncash contribution deduction is the lesser of: **30% x $10M = $3M** or **(50% x $10M) – $4M cash gift = $1M**

Don't forget about substantiation!
Charitable deductions are always dependent on meeting strict substantiation requirements. Take great care with noncash gifts, as final regulations issued in 2018 impose new substantiation requirements, including more exacting rules for qualified appraisals.

What has significantly changed?

As you become better acquainted with the new tax environment, you may begin to notice what's missing, such as the availability of several deductions. The 2017 Tax Act substantially increased the standard deduction—to $12,000 for single filers and $24,000 for joint filers—and maintained the prior-law additional standard deduction for the blind and elderly, which will allow many individuals to avoid itemizing their deductions. However, those individuals who may still itemize will find that the deduction landscape has changed in several notable respects.



What has significantly changed? (cont.)

State and local income (or sales) and property tax deductions limited

An itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of nonbusiness (1) state and local property taxes, and (2) state and local income taxes or sales taxes is permitted. Nonbusiness foreign real property taxes are no longer deductible. It does not appear that the $10,000 limitation is indexed for inflation.

Mortgage interest deduction reduced

The mortgage interest deduction is limited to interest on $750,000 ($375,000 for married filing separate taxpayers) of acquisition indebtedness on a taxpayer's primary and secondary residences. Mortgages existing on or before December 15, 2017 (including ones that are refinanced at or below their current balance, and certain others where there is a binding contract to purchase property before December 15, 2017) are grandfathered under the prior $1 million threshold. The interest deduction for home equity indebtedness is repealed.

Medical and dental expense deduction expanded

Unreimbursed medical and dental expenses are deductible subject to the extent they exceed 7.5 percent of AGI in 2017 and 2018. The threshold for the deduction reverts back to 10 percent of AGI in 2019. The threshold applies to both the regular and alternative minimum tax.

Miscellaneous itemized deductions eliminated

The 2017 Tax Act eliminated all miscellaneous itemized deductions that are not listed in section 67(b).

- Note that investment interest expense is less likely to be limited due to the repeal of miscellaneous itemized deductions.
- Recent IRS guidance has clarified that, for fiduciary taxpayers, a deduction continues to be available for their administrative expenses (for example, trustee fees, investment management and custodial fees, and attorney/accounting fees).

Deductions related to hobby income eliminated

Deductions previously permitted in determining net hobby income are now generally disallowed.

Personal casualty losses limited

The 2017 Tax Act provides that personal casualty losses are deductible only if the losses were incurred in federally declared disaster areas. Allowable losses are not subject to an AGI threshold (as was the case under prior law), but must exceed $500 per casualty.

Pease limitation repealed

The reduction for overall itemized deductions for higher income taxpayers is eliminated.

Other individual income tax items

Other deductions and exclusions

The 2017 Tax Act also significantly modifies other deductions and exclusions. For example, the 2017 Tax Act repeals the deduction for personal exemptions. It also repeals the exclusion from gross income and wages for qualified moving expense reimbursements and repeals the moving expense deduction other than for members of the US Armed Forces moving on military orders. Finally, effective for any divorce or separation instrument executed after December 31, 2018 (or modified after December 31, 2018, to conform with this provision), alimony payments will neither be taxable to the recipient nor deductible by the payer.

Interestingly, while Congress debated modifying the exclusion of gain from sale of principal residence provisions to expand the time period during which a taxpayer needed to have resided in the home, the 2017 Tax Act contains no such provision. As a result, a taxpayer may continue to exclude up to $250,000 of gain (if single) or $500,000 (if married filing jointly) from gross income if the home was used as the taxpayer's principal residence for two of the past five years.

Credits

The 2017 Tax Act increases the child tax credit to $2,000 per qualifying child, double the amount under prior law. Of the $2,000 credit, $1,400 per qualifying child is refundable. The child tax credit begins to phase out for married filing joint taxpayers with AGI in excess of $400,000. The 2017 Tax Act also provides for a $500 nonrefundable credit for qualifying dependents other than children. Additional family-oriented provisions that were retained include the dependent care credit and the adoption credit. The exclusion from gross income of up to $5,000 annually for employer-provided dependent care assistance also remains.

Miscellaneous provisions

Other noteworthy provisions with significant changes affecting individual taxpayers are described below.

Carried interest holding period expanded

The 2017 Tax Act expands the holding period requirement to three years for gains on qualified carried interests to be taxed at preferential long-term capital gain rates.

Section 529 plans expanded

The 2017 Tax Act allows section 529 plan funds to be used in connection with elementary or secondary public, private, or religious school tuition and eligible expenses. However, these distributions are limited to $10,000 per year on a per student basis.

Individual mandate penalty eliminated

The 2017 Tax Act reduces the penalty to zero for individuals who do not maintain qualifying health insurance coverage under the Patient Protection and Affordable Care 2017 Tax Act (the "individual mandate"). The reduced penalty is effective for months beginning after December 31, 2018. Unlike other individual provisions in the bill, this one does not sunset after the end of 2025.

Filing requirements adjusted

The 2017 Tax Act clarifies that an individual is not required to file an income tax return if the taxpayer's gross income for the taxable year does not exceed the applicable standard deduction.

Estate, gift, and generation-skipping transfer (GST) tax provisions

While this chapter is focused on the new income tax landscape, we would be remiss not to mention the changes with respect to transfer tax. The pre-enactment tax regime with respect to the estate, gift, and GST taxes and the income tax basis adjustment to fair market value at death remain unchanged under the 2017 Tax Act. However, the estate and gift tax exclusion—the amount that each US citizen is entitled to transfer without incurring a transfer tax during life or, if otherwise unused, at death—is doubled from $5 million to $10 million per person, before adjusting for inflation. The inflation-adjusted exclusion amount for 2019 transfers is $11.4 million (up from $11.18 million in 2018). The GST tax exemption—the amount that may be transferred to skip persons outright or in trusts that may benefit skip persons without giving rise to a present or future GST tax—is tied to the estate tax exemption amount and therefore is also increased to $11.4 million per person for 2019.

The increased exemption amounts allow taxpayers to plan with certainty now, but the status of wealth transfer taxes remains a concern when the increased exemption amounts sunset. On January 1, 2026, the estate and gift tax exclusion amount and the GST exemption will return to $5 million per taxpayer (albeit increased for inflation adjustments from 2012 through 2025). Failure to utilize the increased exemption amounts prior to their lapse in 2026 represents an opportunity cost since any later transfer that might have been exempt from tax under the higher exclusion will instead be subject to a 40 percent tax (assuming the current transfer tax rates continue).

Planning in the new tax landscape

Now that we have explored the changes to your tax environment, it is time to move forward with confidence. You should work with your tax adviser to analyze the impact of the 2017 Tax Act on your tax planning. While it may be tempting to focus on one provision that appears to affect you the most, it is important to understand how all of the changes interact to understand the impact to your goals and circumstances. For example:

1. Various aspects of how to operate or structure a private company may need to be (re)considered.
2. If you are motivated to leave a charitable legacy, consider how new tax rates and other deductions may affect the timing of a contribution or the appropriate charitable planning vehicle.
3. If deductions or losses that you have been accustomed to taking are reduced or no longer available to you, consider the impact to your bottom line and your cash flow.

All of these issues must be contemplated in terms of overall cost and opportunities.

While some familiar paths may be blocked or changed, new roads are available. Determining which path to choose may feel overwhelming at first, but if you work with your tax adviser to understand what lies ahead, you can chart a course toward your desired destination in a tax-efficient manner.