TAX BULLETIN 2018-1

TAX REFORM SIGNED INTO LAW

NATIONAL WEALTH PLANNING STRATEGIES GROUP, U.S. TRUST

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OVERVIEW

Without much fanfare but with typical political controversy, the House and Senate successfully reconciled their respective tax bills and the new tax legislation (the "Act"), was signed into law by President Trump on December 22, 2017. House and Senate conference committee members leaned in favor of many provisions contained in the Senate proposal. A significant move in that direction was retaining the elimination of the Affordable Care Act's individual mandate (the penalty for failing to maintain minimum essential health care coverage) and using the Senate's methodologies for taxing income from pass-through businesses (though some elements of the House bill entered into the computation). In other circumstances, the committee reached a true compromise, such as meeting in the middle on modifications to mortgage interest deductibility.

In order to abide by Senate budget reconciliation rules and ensure the Act does not result in budget deficits outside the 10-year budget window, the Act makes almost all changes to individual income tax provisions temporary – nearly all expire at the end of 2025. No doubt, this will create tax complexity and political difficulties. On the other hand, most corporate provisions are permanent. This Tax Bulletin 2018-1 summarizes for informational purposes certain provisions of the Act and adds observations on income, estate and pass-through taxation.[1] Neither Merrill Lynch nor any of its affiliates or advisors provide legal, tax or accounting advice. Clients should consult with their legal and/or tax advisors before making any financial decisions.

INDIVIDUAL TAXES

	2017 Law[2]	2018 Law[3]
Individual Tax Rates	10, 15, 25, 28, 33, 35, 39.6%	10, 12, 22, 24, 32, 35, 37% Top rate would apply to income over $600,000 for married filing jointly; $500,000 for single[4]
Standard Deduction	$12,700 ($6,350 if single)	$24,000 ($12,000 if single), enhanced for elderly and blind[4]
Kiddie Tax	Unearned income of a child taxed at parents' tax rate if higher than child's rate	Simplifies kiddie tax by applying trust rates to unearned income of a child[4]
Personal Exemption	$4,050, subject to phase-out	Eliminates; merged with higher standard deduction[4]
Child / Dependent Tax Credits	$1,000, per qualifying child subject to phase-out beginning at $110,000 (married) and $75,000 (single taxpayers)	$2,000 per qualifying child $500 per non-child dependent; subject to phase-out beginning at $400,000 (married) and $200,000 others[4]
Top Capital Gains/Dividend Tax Rate	20% (plus 3.8% surtax)	Maximum rate of 20% is retained; same breakpoints as current law

INDIVIDUAL TAXES (continued)

	2017 Law	2018 Law
Itemized Deductions	Under the "Pease" limitation, up to 80% of most itemized deductions are lost when adjusted gross income exceeds $313,800 ($261,500 for single taxpayers)	Repeals the Pease limitation on itemized deductions Mortgage interest deduction: $750,000 limit on acquisition indebtedness retained (principal or secondary residence); deduction for home equity loan repealed Deduction for state and local income, sales tax and real property taxes limited to $10,000 in aggregate ($5,000 for married filing separately); deduction allowed for state and local taxes on trade or business or if related to production of income. Payment of income taxes in 2017 for a subsequent year would not be deductible in 2017.[4] Deduction for medical expenses retained and liberalized for 2017 and 2018.[4]
Retirement Savings	Contributions can be placed into deferred account, up to contribution cap	Unchanged
AMT	Parallel tax calculation with top rate of 28% and $84,500 exemption for married taxpayers ($54,300 others); phase out of exemption begins at $160,900 for married taxpayers ($120,700 others)	Retains and modifies AMT; exemptions raised to $109,400 (married) and $70,300 (others); phase-out of exemption begins at $1 million for married taxpayers ($500,000 others).[4]
Carried Interest	Retains character as capital gain and eligible for preferential tax rates	Requires three-year holding period to attain long-term capital gains rate
Investment Surtax	3.8% tax on "net investment income"	Unchanged – continues to apply

OBSERVATIONS – INDIVIDUAL TAXES

Under the Act, there will be winners and losers on the personal income tax side. Generally, wage earners from no-tax states[5] could see tax savings under the Act. For instance, a Florida taxpayer earning $1 million with moderate itemized deductions may see a tax savings of about $30,000 under the Act. A similar taxpayer in New York State may see a savings of about $3,500 according to our preliminary analysis.[6]

Conversely, very high-wage earners from high-tax states could see a higher tax bill. A taxpayer earning $3 million in New York City may see a significant tax increase: $44,000 under the Act, due in part to the loss of significant deductions. A similar taxpayer in Florida could see a tax savings of about $91,000 under the Act (primarily due to the lower top rate, elongated 35% tax bracket and regaining itemized deductions that are no longer phased-out), according to our preliminary analysis.

Married couples could fare worse than two single taxpayers with a similar amount of income. The so-called marriage penalty hits particularly hard under the new tax brackets. The penalty is also exacerbated by permitting married couples only a $10,000 state income/real estate tax deduction, but allowing each of two single filers a deduction in the same amount ($20,000 combined). Under the changes, a single taxpayer with $500,000 of wages living in a state that imposes a state income tax (and $10,000 of charitable deductions) could be expected to pay a federal tax of about $143,690. Two single taxpayers could be expected to pay a total of twice that, or $287,380. However, if these two taxpayers were married, their joint tax liability could potentially jump to $298,280, an increase of $10,900. It appears that state of residence, type of income (wages versus new "qualified business income"), and mortgage interest will be among the most important factors for determining whether one is better or worse off under the Act.

Capital Gains. Although income tax rates and tax brackets will significantly change in 2018, the long term capital gains rate will remain the same. The income limits for imposing the 15% and 20% capital gain rates will also remain the same; the 20% rate will apply when taxable income exceeds $479,000 (for married filing jointly). However, the Act's combination of lower rates and fewer deductions could mean that a taxpayer's "taxable income" could rise in 2018, meaning the taxpayer would potentially expose more capital gain to the 20% bracket.

3.8% Surtax**.** The Act does not directly change the 3.8% surtax imposed on "net investment income." However, it indirectly changes it. When calculating a taxpayer's net investment income, a taxpayer may be able to deduct investment expenses (after application of the 2% floor) and deductible state income taxes, to the extent those are properly allocable to net investment income. The deductibility of those two expenses changes in 2018 — investment expenses are nondeductible, and state income taxes (with other state taxes) are limited to $10,000. Those expenses might not reduce net investment income in 2018, and as a result the 3.8% surtax might increase.

WEALTH TRANSFER TAXES

	2017 Law	2018 Law
Estate / Gift / GST Tax	40% rate, $5,490,000 exemption (indexed for inflation)	Commencing 2018, exemption for estate, gift and GST tax doubled from $5.6 million to $11.2 million (indexed for inflation) Enhanced exemption expires end of 2025
Tax Basis Upon Death	Step-up for estate property	Same as current; step-up for estate property

OBSERVATIONS – WEALTH TRANSFER

The transfer tax changes in the Act extend the already limited reach of the federal estate, gift and GST taxes to even a smaller subset of only the wealthiest of taxpayers. There is a temporary doubling of the exemptions until the end of 2025, reverting to current law in 2026. The step-up in basis at death continues the entire time. Given the high exemption amounts ($11.2 million for individuals and $22.4 million for a married couple in 2018), that would seemingly repeal the tax for most people. This change could have a significant effect on both testamentary and lifetime estate planning.

Testamentary planning. It is common for wills and other testamentary documents (such as revocable trusts) to contain dispositions that reference the estate (and GST) exemptions that are in effect at death. These so-called "formula" provisions would automatically adjust for changes in the exemption amounts. While this may achieve a beneficial tax result, the temporary doubling of the exemptions may also cause unintended consequences to the dispositive plan. For example, a common plan is to leave an amount equal to the estate exemption to a bypass trust, and the balance for the surviving spouse, either outright or in a marital trust. For a hypothetical $10 million estate, if death occurred in 2017 that could potentially result in roughly half to the bypass trust and half to the spouse. However, if death occurs in 2018 to 2025, that could result in the entire estate being left to the bypass trust. Complications could further arise for individuals living in certain states which impose their own estate tax. Wills and other testamentary documents should be reviewed to make certain they accurately reflect the testator's wishes. As always, documents should be drafted with flexible provisions that can be adjusted for future changes.

Lifetime planning. Lifetime gifts are often made in order to reduce the estate tax that would otherwise be incurred at death. While the doubling of the exemptions may avoid the need for lifetime gifting for certain individuals, that may only be the case if death occurs before 2026. Accordingly, the tax consequences of making a current gift may have to be compared with alternative estate tax scenarios. The temporary nature of the increase in transfer tax exemptions also raises the issue of whether it is advisable to lock-in the higher exemption by making a lifetime gift before 2026. (Similar issues arose in 2012, when there was uncertainty whether the $5 million estate exemption would continue in 2013.) This raises the question of whether the gift could be structured in a manner that could be "undone" if the higher exemption is made permanent. It also raises the question of whether there would be recapture (so-called "clawback") if a lower exemption is in effect at death. In that regard, it appears that the new legislation could eliminate the concern about recapture. In sum, the uncertainty of the estate exemption amount at death will make lifetime planning more challenging.

CORPORATE TAXES

	2017 Law	2018 Law
Top C-Corporate Rate	35%	21% (effective 2018)
AMT	Parallel tax calculation with top rate of 20%	Eliminates corporate AMT
Business Investments	Limited immediate expensing; balance subject to depreciation	Immediate expensing for new and used qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023 (Jan. 1, 2024 for certain property) and partial expensing for other property acquired after 2022 and before 2027.
Interest Expense	No limitation	Limited to business interest *income*, plus 30% of a business's adjusted taxable income (EBITDA for 2017-2021 and EBIT thereafter); with special rules for "floor plan financing indebtedness"; full deduction for small businesses with gross receipts of $25 million or less

PASS-THROUGH ENTITY TAXES

	2017 Law	2018 Law
Top Rate: Pass-Through Entities (S-corporations, LLCs, LLPs and Partnerships) / Sole Proprietorships	Subject to tax at individual rates up to 39.6%	An individual taxpayer generally may deduct 20% of domestic qualified business income from a partnership, S corporation, or sole proprietorship[4] In the case of a taxpayer who has qualified business income from a partnership, S corporation or sole proprietorship, the amount of the deduction is limited to the greater of (i) 50% of the W-2 wages paid by business or (ii) sum of 25% of W-2 wages paid by business and 2.5% of business capital. This wage limitation (i) does not apply if taxpayer's taxable income is less than $157,500 ($315,000 for joint return); (ii) applies fully if taxable income exceeds $207,500 ($415,000 for joint return); and (iii) applies proportionately if taxable income is between those two limits Trusts and estates that own business interests qualify for this deduction Deduction is a post-AGI item, even for taxpayers not itemizing deductions
Pass-Through Entities – Service Businesses	Subject to tax at individual rates up to 39.6%	For "specified service business," (i) the 20% deduction applies fully if taxpayer's taxable income is less than $157,500 ($315,000 for joint return); (ii) there is no deduction if taxable income exceeds $207,500 ($415,000 for joint return); and (ii) there is a partial deduction if taxable income is between those two limits. [4] Service business includes accounting, law, consulting, investing, etc., but excludes engineering and architecture services

OBSERVATIONS – PASS-THROUGH ENTITIES

As originally proposed, the House and Senate took fundamentally different approaches to the taxation of pass-through entities (sole proprietorships, partnerships, LLCs, LLPs and S-corporations). While they differed from each other, they shared the goal of creating preferential treatment for certain pass-through business income. The Act largely took the Senate's approach but adopted a few elements of the House's approach. The Act approaches small business relief by permitting a non-itemized deduction of 20% of qualified business income; the remaining 80% would then be subject to normal tax rates. Therefore, the top tax rate for business income would be 29.6% (80% x 37% = 29.6%). The provision is riddled with a host of complex limitations. For taxpayers not in the top income tax bracket, the value of the deduction will depend on the marginal bracket that would otherwise be imposed on the income.

Owners of service businesses (e.g., law, accounting and consulting, etc.) generally would be eligible for the 20% deduction unless taxable income exceeds $315,000 for married filing jointly ($157,500 for others). Once those thresholds are exceeded, the benefit of the 20% deduction is phased out and fully eliminated over the next $100,000 of taxable income for married filing jointly ($50,000 for others). Engineering and architecture businesses are excepted from this special rule. That is, owners of an engineering or architecture business are eligible for the 20% deduction even if taxable income exceeds these thresholds (assuming all the other requirements are met). The following is a simple example for a pass-through entity.

EXAMPLE

H and W file a joint return on which they report taxable income of $200,000 (determined without regard to this provision). H has a sole proprietorship that is a qualified business and is a "specified service business." W is an employee and receives only W-2 wages from her job.

H's qualified business income is $150,000. 20 percent of the qualified business income is $30,000. Because H and W's taxable income is below the $315,000 threshold amount for a joint return, (i) the wage limit would not be expected to apply to H's qualified business, and (ii) the limitation applicable to specified service businesses would seemingly not apply. H's deductible amount for qualified business income could potentially be $30,000.

On their joint return, H & W may qualify for a $30,000 deduction, potentially reducing their taxable income from $200,000 to $170,000. That taxable income would then be subject to ordinary income rates.

While upper-income wage earners in high-tax states generally are not expected to fare well under the Act, taxpayers with substantial income from pass-through businesses could see a tax benefit compared with current law, since the weighted average rate of business income would be approximately 30%. Capital gains, dividends, and other preferential income from a business are not expected to be considered "business income" and could potentially continue to be taxed at preferential tax rates.

Under the initial Senate version, the pass-through deduction was not available to trusts or estates. Under the Act, however, trusts and estates can potentially benefit from the pass-through deduction.

CORPORATE INTERNATIONAL TAXES

	2017 Law	2018 Law
International Corporate Tax – Scope	Worldwide with deferral available	100% of foreign-source portion of dividends paid by foreign corporation to U.S. corporate shareholder (that owns at least 10%) would be exempt from U.S. taxation
One-Time Deemed Repatriation of Foreign Earnings	No	U.S. shareholders owning at least 10% of a foreign corporation would be taxed on post-1986 net foreign earnings and profits (15.5% on earnings and profits comprising cash or cash equivalents; 8% on remaining earnings and profits); may elect to pay tax over a period of up to 8 years, in annual installments that allow more to be paid at the back end

OTHER PROVISIONS

There are other provisions of note that are not included in the charts above.

- **Roth recharacterization no longer allowed.** Under 2017 law, if you converted a traditional IRA to a Roth IRA, you could "recharacterize" that conversion within certain time limits, in effect undoing it. For tax years beginning after 2017, the Act repeals this rule, meaning you can no longer recharacterize a Roth conversion. From the current language of the effective date, it is unclear whether this would prevent a 2017 Roth conversion from being recharacterized in 2018.

- **Taxation of alimony.** Under 2017 law, alimony and separate maintenance payments were deductible by the payor and includible in income by the recipient. (Child support payments are not treated as alimony.) The House bill proposed to reverse this treatment, making alimony and separate maintenance payments non-deductible to the payor and non-taxable to the recipient. The Senate bill had no similar provision. The Act generally follows the House bill but delays the effective date by one year, generally being effective for any divorce or separation instrument executed after December 31, 2018.

- **Sale of principal residence exclusion.** Under 2017 law, up to $250,000 of gain ($500,000 if filing jointly) on the sale of a principal residence could be excluded from income. Among the requirements is that the principal residence be owned and used as your principal residence for two out of the last five years. You could use this rule only once every two years. This exemption was available regardless of income. Both the House and Senate Bills proposed that (i) the principal residence must be owned and used as your principal residence for five out of the last eight years and (ii) you can use this rule only once every five years. The House proposal also contained a limit to the exclusion if income exceeded a certain amount. In a surprise, none of these modifications were included in the Act. As a result, no changes were made to the principal residence exclusion rules.

- **Identification of securities sold, exchanged and gifted.** Gain or loss generally is recognized for Federal income tax purposes on the sale of property. A taxpayer's gain or loss on a disposition of property is the difference between the amount realized on the sale and the taxpayer's cost basis in the property. Under 2017 law, if a taxpayer has acquired stock in a corporation on different dates or at different prices and sells or transfers some of the shares of that stock, and the lot from which the stock is sold or transferred is not adequately identified, the shares sold are deemed to be from the earliest acquired shares (the "first-in-first-out" rule; FIFO). However, under 2017 law, if a taxpayer specifically identifies the shares of stock to be sold, the shares of stock treated as sold are the shares that have been identified. The same rules apply to charitable gifts and gifts to trusts or family members. Although the Senate bill had proposed eliminating the ability to specifically identify lots and mandating that the FIFO rule be used, the Act makes no changes; the 2017 rules will remain in place.

- **Like-kind exchanges**. Under 2017 law, real estate and personal property can qualify for a tax-deferred like-kind exchange. The property must be held either for investment or for use in a trade or business. Under the Act, like-kind exchanges will be available only for real estate, not personal property. This would be expected to end, for example, like-kind exchanges of art. This new rule is effective for transfers after 2017. However, there is a transition rule to allow like-kind exchanges of personal property to be completed on a tax-free basis if you either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

- **529 Savings Plans.** Under 2017 law, funds in 529 Saving Plans could be withdrawn tax-free if used for higher education expenses. The Act expands the type of expense that can be paid via a 529 Savings Plan and allows up to $10,000 per year to be used for elementary and high school tuition and specifically allows funds to be used for private and religious schools. A provision that would have also allowed funds to be used for home schooling was dropped at the last minute and is not in the final legislation.

- **Charitable gifts.** A charitable contribution deduction is limited to a certain percentage of the individual's adjusted gross income (AGI), and this limitation varies depending on the type of property contributed and the type of exempt organization receiving the property. Under 2017 law, cash contributed to public charities, private operating foundations, and certain non-operating private foundations generally could be deducted up to 50% of the donor's AGI. Under the Act, this 50% limitation is increased to 60%. The provision retains the 5-year carryover period to the extent that the contribution amount exceeds 60% of the donor's AGI.
- **Investment expenses and investment interest.** Under 2017 law, investment expenses were deductible as a "miscellaneous itemized deduction" if, and to the extent, they exceed 2% of AGI. The Act repeals the deduction for "miscellaneous itemized deductions" that are subject to the 2% AGI limitation, such as investment management expenses. Under 2017 law and current law, investment interest is not a "miscellaneous itemized deduction." Therefore, the deduction for investment interest remains untouched and continues to be deductible to the extent of investment income.

CONCLUSION

Given the significant tax changes for 2018, planning will be a challenge. It is important to understand the implications that the Act can have on your particular tax situation. Accordingly, investors should work with their tax advisors to understand the impact of tax reform relevant for them.

[1] Tax Bulletin 2017-5 summarized the key tax provisions in HR1, known as the Tax Cuts and Jobs Act (the "House Bill"), which was passed (227-205) by the House on November 16, 2017. Tax Bulletin 2017-6 summarized the key tax provisions in the initial Senate bill HR1, also known as the Tax Cuts and Jobs Act, which was subsequently amended and passed (51-49) by the full Senate on December 2, 2017. The final Senate version was similarly summarized in Tax Bulletin 2017-7. Tax Bulletin 2017-8 summarized the reconciled bill agreed to by both chambers. Tax Bulletin 2017-9 summarized the final legislation, including some year-end planning ideas that are no longer relevant.

[2] Inflation-adjusted amounts for 2017.

[3] The name "Tax Cut and Jobs Act" had to be removed; this legislation was signed into law by President Trump on December 22, 2017.

[4] This proposed change would be effective starting in 2018 and would not apply to taxable years beginning after December 31, 2025 (e.g. sunsets at the beginning of 2026).

[5] There are nine states that impose no state income tax: AK, FL, NH, NV, SD, TN, TX, WA and WY (NH and TN impose a tax only on dividends and interest).

[6] This illustration assumes the following itemized expenses: charitable gifts $10,000, real estate tax $30,000 (limited to $10,000 under the proposal), mortgage interest of $15,000, and appropriate state income taxes, where applicable.

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