**Tax Reform: Summary of Tax Cuts and Jobs Act**

December 28, 2017

The Tax Cuts and Jobs Act of 2017 (the “Act”) was signed into law by President Donald Trump on December 22, 2017.  The Act changes many provisions of the Internal Revenue Code, from individual and business provisions, to matters affecting pass-through and tax-exempt organizations.  The Act is generally effective starting in 2018.  In this summary, we address the major issues that will affect our clients and their industries in the years to come.  If you have any questions regarding the Act, please contact a Schwabe attorney.

**SUMMARY OF THE TAX CUTS AND JOBS ACT**

[Individual Tax Changes](https://www.schwabe.com/newsroom-publications-14837#I)

[Business Tax Changes](https://www.schwabe.com/newsroom-publications-14837#II)

[Pass-Throughs](https://www.schwabe.com/newsroom-publications-14837#III)

[Tax-Exempt Organizations](https://www.schwabe.com/newsroom-publications-14837#IV)

[Accounting Method Changes](https://www.schwabe.com/newsroom-publications-14837#V)

**I. INDIVIDUAL TAX CHANGES**

**Tax rates and brackets for individuals and trusts and estates have been updated.** Before the Act, individuals were subject to the following tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% and estates and trusts were subject to five different tax brackets: 15%, 25%, 28%, 33%, and 39.6%. Individuals are now subject to the following tax brackets: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. Estates and trusts are now subject to four tax brackets: 10%, 24%, 35%, and 37%. Corresponding tax rates have been replaced with new rate tables. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025, and the previous brackets and rates for individuals, trusts, and estates will once again be in effect.

**Temporary increase of the basic standard deduction for individuals across all filing statuses.** The basic standard deduction varies depending on the taxpayer’s filing status. For 2017, the basic standard deduction dollar amounts were $12,700 for joint filers and surviving spouses, $9,350 for heads of household, and $6,350 for singles and marrieds filing separately.

Under the Act, the standard deduction is increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers, adjusted for inflation in tax years beginning after 2018. No changes are made to the additional standard deduction for the elderly and blind. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Personal exemptions suspended.** For 2017, the (inflation-adjusted) amount deductible for each personal exemption was $4,050. Under the Act, the deduction for personal exemptions is effectively suspended by reducing the exemption amount to zero. This change is effective beginning after Dec. 31, 2017. Barring further legislation, these changes will expire after 2025.

**Chained CPI-U ("C-CPI-U") replaces CPI-U in inflation adjustments.** Various tax parameters under the Code are adjusted annually for inflation. Previously, inflation was indexed by reference to the Consumer Price Index for all urban consumers ("CPI-U"). Under the Act, C-CPI-U is required instead of CPI-U.

The C-CPI-U, like the CPI-U, is a measure of the average change over time in prices paid by urban consumers. But the C-CPI-U reflects people’s ability to lessen the impact of inflation by buying fewer goods or services that have risen in price and buying more goods and services whose prices have risen less, or not at all. Thus, C-CPI-U is a slower-growing method of calculating cost of living adjustments. Using a slower rate of inflation to calculate tax brackets means taxpayers will more quickly slip into the next higher tax bracket, and may pay more in taxes over time. This change is effective beginning after Dec. 31, 2017. This change, unlike many provisions in the Act, is permanent.

**Kiddie tax modified to apply estates’ and trusts’ ordinary and capital gains rates to child’s net unearned income.** Before the Act, children with unearned income (investment income) were taxed at their parents’ tax rate on any unearned income over $2,100 for 2017. Children with earned income are taxed under the rates for unmarried taxpayers. The Act only modifies the treatment of a child’s unearned income.

Under the Act, the child’s tax will no longer be affected by the tax situation of the child’s parent or the unearned income of any siblings. Children with unearned income are taxed at rates for estate and trust ordinary and capital gains. Applying the estate and trust tax rates under the kiddie tax rules will produce a higher tax bill because the income ranges under the new kiddie tax schedule are much smaller than those for individuals. For example, the top 37% income tax rate applies to married joint filers at $600,000, but it applies to a child’s unearned income at $12,500. This change is effective beginning after Dec. 31, 2017. Barring further legislation, these changes will expire after 2025.

**Modifications to capital gain provisions.** The Act generally retains present-law maximum rates on net capital gains and qualified dividends. The adjusted net capital gain of an individual, estate, or trust is taxed at maximum rates of 0%, 15%, or 20%. It retains the breakpoints that exist under pre-Act law, but indexes them for inflation using C-CPI-U. The change is effective after Dec. 31, 2017. Barring further legislation, these changes will expire after 2025.

**Certain gains from partnership profits interests held in connection with performance of investment services are short-term capital gains if held for three years or less**. Before the Act, gains from a profits interest in a partnership (sometimes referred to as a carried interest) typically passed through an investment partnership as long-term capital gains and, thus, were taxed in the hands of the taxpayer at more favorable rates. Thus, for the wealthiest citizens who fell into the 39.6% bracket, long-term capital gains were generally taxed at a rate of 20%.

The Act changes the tax treatment of gains from a profits interest in a partnership (carried interest) held in connection with the performance of services by providing that if one or more “applicable partnership interests” are held by a taxpayer at any time during the tax year, the excess (if any) of (1)  the taxpayer’s net long-term capital gain with respect to those interests for that tax year, over (2)  the taxpayer’s net long-term capital gain with respect to those interests for that tax year by substituting “three years” for “one year,” will be treated as short-term capital gain. Thus, the Act provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer. If the three-year holding period is not met with respect to an applicable partnership interest held by the taxpayer, the taxpayer’s gain will be treated as short-term gain taxed at ordinary income rates. These changes are effective beginning after Dec. 31, 2017.

**Excess business loss disallowance rule replaces limitation on excess farm loss for non-corporate taxpayers.**  Before the Act, if a non-corporate taxpayer received any applicable subsidy, the taxpayer’s excess farm loss for the tax year was not allowed. The amount of losses that could be claimed by an individual, estate, trust, or partnership were limited to a threshold amount if the taxpayer had received an applicable subsidy. Any excess farm loss was carried over to the next tax year.

The Act provides that for a non-corporate taxpayer, the limitation on excess *farm* loss does not apply. Instead, the taxpayer’s excess *business* loss, if any, for the tax year is disallowed.  In other words, the Act expands the limitation on excess farming loss to other non-corporate taxpayers engaged in any business. Under the new rule, excess business losses are not allowed for the tax year but are instead carried forward and treated as part of the taxpayer’s net operating loss ("NOL") carryforward in subsequent tax years. This limitation applies *after* the application of the passive loss rules. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Deduction for personal casualty and theft losses are suspended unless attributable to a federally declared disaster.** Before the Act, losses of property not connected with a trade or business or a transaction entered into for profit were deductible as personal casualty losses if the losses were the result of fire, storm, shipwreck, or other casualty, or of theft. Aggregate net casualty and theft losses are deductible only to the extent they exceed 10% of an individual’s adjusted gross income ("AGI"). The 10%-of-AGI threshold is applied after the per-casualty floor.

Under the Tax Cuts and Jobs Act, the personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a federally declared disaster. However, where a taxpayer has personal casualty gains, the loss suspension does not apply to the extent that such loss does not exceed the gain. The loss deduction is subject to the $100-per-casualty and 10%-of-AGI limitations.  A taxpayer may deduct the portion of the personal casualty loss not attributable to a federally declared disaster to the extent the loss does not exceed the personal casualty gains. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Gambling loss limitation is broadened: deduction for *any* expense incurred in gambling—not just gambling losses—is limited to gambling winnings.** Before the Act, nonwagering expenses of a gambling business were not included in “gambling losses,” so these expenses were not subject to the rule limiting gambling losses to gambling gains, and were deductible business expenses.

The Act provides that the limitation on wagering losses is modified to provide that *all* deductions for expenses incurred in carrying out wagering transactions, and not just gambling losses, are limited to the extent of gambling winnings. Losses sustained from wagering transactions are allowed only to the extent of the gains from those transactions. Thus, under the Act, those in the trade or business of gambling may no longer deduct non-wagering expenses, such as travel expenses or fees, to the extent those expenses exceed gambling gains. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Child tax credit is increased to $2,000 and expanded.** Before the Act, individuals could claim a maximum child tax credit ("CTC") of $1,000 for each qualifying child under the age of 17. The CTC phased out for taxpayers with modified AGI above certain threshold amounts ($110,000 for joint filers, $75,000 for single filers and heads of household, and $55,000 for married taxpayers filing separately). The allowable CTC was reduced by $50 for each $1,000 (or fraction thereof) by which the taxpayer’s modified AGI exceeded the applicable threshold amount.

The Act modifies the CTC by increasing the credit amount, increasing the threshold amounts for the phaseout, and allowing a partial credit for dependents who do not qualify for a full CTC. Under the Act, the child tax credit is increased to $2,000. The income levels at which the credit phases out are increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers) (not indexed for inflation). In addition, a $500 nonrefundable credit is provided for certain non-child dependents. The amount of the credit that is refundable is increased to $1,400 per qualifying child, and this amount is indexed for inflation, up to the $2,000 base credit amount. The earned income threshold for the refundable portion of the credit is decreased from $3,000 to $2,500. These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**State and local tax deduction limited to $10,000.** Before the Act, individual taxpayers were allowed an itemized deduction for state and local taxes ("SALT") and foreign taxes, even though not incurred in a taxpayer’s trade or business.

Under the Act, individual taxpayers may not deduct foreign real property tax, other than taxes paid or accrued in carrying on a trade or business. A taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for marrieds filing separately) for the aggregate of (a) state and local property taxes not paid or accrued in carrying on a trade or business and (b) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the tax year. Foreign real property taxes may not be deducted under the $10,000 aggregate limitation rule.  These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Mortgage interest deduction acquisition debt maximum is lowered to $750,000; deduction for home equity interest is suspended.** Taxpayers may claim an itemized deduction for “qualified residence interest” ("QRI") (the mortgage interest deduction). Before the Act, deductible QRI was interest paid or accrued on acquisition indebtedness that is secured by a qualified residence, or, home equity indebtedness that was secured by a qualified residence. Prior to the Tax Cuts and Jobs Act, the maximum amount treated as acquisition indebtedness was $1 million ($500,000 for married taxpayers filing separately). The amount of home equity indebtedness could not exceed $100,000 ($50,000 for a married individual filing separately).

Under the Act, the deduction for mortgage interest is limited to underlying indebtedness of up to $750,000 ($375,000 for married taxpayers filing separately), and the deduction for interest on home equity indebtedness is suspended. Taxpayers may not claim a deduction for interest on home equity indebtedness. The Act’s $750,000/$375,000 limit on acquisition indebtedness does not apply to any indebtedness incurred on or before Dec. 15, 2017. Therefore, acquisition indebtedness incurred before Dec. 15, 2017, is limited to $1,000,000 ($500,000 for marrieds filing separately). These changes apply to tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

**Medical expense deduction threshold is reduced to 7.5% of AGI, is retroactively extended through 2018 and is applied to all taxpayers.** A deduction is allowed for unreimbursed expenses paid during the tax year for the medical care of the taxpayer, the taxpayer’s spouse, and the taxpayer’s dependents to the extent the expenses exceed a threshold amount. Before the Act, the threshold was generally 10% of ("AGI"). But for tax years 2013-2016, a 7.5%-of-AGI floor for medical expenses applied if a taxpayer or the taxpayer’s spouse had reached age 65 before the close of the tax year. The medical expense deduction rules applied for alternative minimum tax ("AMT") purposes, except that medical expenses were deductible only to the extent they exceeded 10% of AGI. Taxpayers could not take advantage of the lower 7.5% threshold for AMT purposes, even if they qualified for it for regular tax purposes.

Under the Act, for tax years beginning after Dec. 31, 2016 and ending before Jan. 1, 2019, the threshold on medical expense deductions is reduced to 7.5% for all taxpayers, and the rule limiting the medical expense deduction for AMT purposes to 10% of AGI does not apply. For tax years ending after Dec. 31, 2018, medical expenses will be subject to the 10% floor for both regular tax and AMT purposes.

**Limitations on deductions for charitable contributions are increased.** An individual’s charitable contributions deduction is limited to percentages of the taxpayer’s “contribution base.” An individual’s contribution base is AGI, but without deducting any net operating loss carryback to that year. Before the Act, an individual could take an itemized deduction up to 50%, 30%, or 20% of the individual’s contribution base depending on the type of organization to which the contribution was made, whether the contribution was made “to” or merely “for the use of” the donee organization, and whether the contribution consisted of capital gain property. If an individual’s charitable contributions exceed the applicable contribution-base percentage limit, then the excess may be carried forward and deducted for up to five years.

Under the Act, the 50% limitation for cash contributions to public charities and certain private foundations is increased to 60%. Contributions exceeding the 60% limitation are allowed to be carried forward and deducted for up to five years, subject to the later year’s ceiling. Although the Act increases the percentage limit for cash contributions to charities, more taxpayers are expected to take advantage of the increased standard deduction rather than itemizing deductions. Taxpayers who no longer itemize will not be able to deduct any of their charitable contributions. The Act also repeals the donee-reporting exception from the contemporaneous written acknowledgement requirement.  These changes come into effect after December 31, 2017. Barring further legislation, these changes will expire after 2025.

**Alimony no longer deductible starting in 2019.** Under current law, alimony is deductible to the payor and includable in gross income by the recipient.  For divorce or separation agreements signed after December 31, 2018, alimony is no longer deductible for the payor or includable in the income of the recipient under the Act.

**Deductions for moving expenses, unreimbursed employee expenses, tax preparation fees, and investment expenses are suspended until 2026**.  **The deduction for teacher expenses increased to $500.**  Under current law, certain moving expenses and certain unreimbursed expenses for employees are deductible.  Some of those deductions, like certain moving expenses and certain expenses paid by teachers, were deductible regardless of whether the taxpayer itemized.  Other expenses were deductible only to the extent such deductions exceeded 2% of the taxpayer’s adjusted gross income.

Under the Act, the above-the-line moving expenses deduction is limited only to active duty members of the Armed Forces in certain situations.  The above-the-line deduction for certain expenses paid by teachers is increased from $250 to $500 regardless of whether the taxpayer itemized (called “above-the-line” deductions) .  All of the miscellaneous itemized deductions previously subject to the 2% of AGI limitation, including the deductions for unreimbursed employee business expenses (employee mileage, home office expenses and the like), investment expenses, expenses for the production or collection of income, tax determination expenses and hobby loss expenses, are suspended until 2026.

**Overall limitation on itemized deductions suspended until 2026.**  Current law reduces the itemized deductions that certain higher-income taxpayers may claim.  For taxpayers with income over certain amounts ($261,500 for a single filer in 2017, $313,800 for joint filers in 2017), their itemized deductions were limited by 3% of the amount their AGI exceeded these thresholds, up to a reduction of 80% of their deductions.  Itemized deductions of higher-income taxpayers are no longer reduced under the Act.

**Individual Insurance Mandate penalty reduced to zero.** Under current law, taxpayers who fail to carry health insurance for themselves and certain dependents that provides at least minimum essential coverage are required to report that information on their tax return and pay a penalty (the “individual mandate”).  The Act reduces this penalty to $0 beginning in 2019, essentially eliminating the impact of the individual mandate.

**Higher thresholds for individual AMT.** The individual AMT remains intact but contains several adjustments. The AMT system provides an exemption that a taxpayer deducts from the alternative minimum taxable income before calculating the taxpayer’s ultimate AMT liability. The exemption amounts for 2017 are $84,500 for jointly filing or surviving spouse taxpayers, $54,300 for single taxpayers and $42,250 for married filing separately. The Act raises those exemption amounts to $109,400 for joint filers and surviving spouses, $70,300 for single taxpayers and $54,700 for married filing separately. Currently, the AMT exemption begins to phase out for taxpayers with the following AMT liability: (1) $160,900 for married filing jointly or surviving spouses, (2) $120,700 single taxpayers and (3) $80,450 for married filing separately. The Act raises the phaseout thresholds to $1 million for married filing jointly and surviving spouses and $500,000 for all other taxpayers other than trusts and estates. The phaseout threshold for trusts and estates remains unchanged at $75,000. These changes come into effect in 2018, and all of these amounts are adjusted for inflation under the new inflation adjustment calculations.

**Certain self-created property no longer qualifies as capital assets.**  Effective for dipositions after December 31, 2017, patents, inventions, models or designs (whether or not patented), secret formulae or processes are no longer considered capital assets if held by the taxpayer who created the property or by a taxpayer with a substituted basis from the taxpayer who created the property.  This can result in less-favorable tax treatment on the disposition of the property.

**Federal estate tax exemption doubles in 2018.** For decedents dying in 2018 through 2025, the federal estate and gift exemption is double from what it was set at in 2011 ($5,000,000 indexed for inflation). This means that instead of a $5.6 million exemption in 2018, decedents can pass $11.2 million ($22.4 million for a married couple) estate and gift tax free. Keep in mind, this has no effect on state estate taxes.

**Education**

**(1) Student loan discharged due to death or disability exclusion.**Student loans that are discharged as a result of death or disability are excluded from taxable income for tax years 2018 through 2025.

**(2) 529 Account funding for elementary and secondary education.**Beginning in 2018, up to $10,000 per year can be withdrawn from 529 plans for tuition expenses to attend elementary and secondary schools, including public, private and religious schools.

**NOTE: The student loan interest deduction remains the same.**

Current law imposes a nine-month limitations period for the IRS to return wrongfully-levied property (including proceeds of sale of wrongfully-levied property), and for taxpayers to sue the government to recover wrongfully-levied property.  For levies made after the date of enactment, and for levies made prior to the date of enactment if the nine-month period has not expired as of that date, the limitations period is extended to two years from the date of the levy.

**II. BUSINESS TAX CHANGES**

**Corporate tax rate drops to a flat 21%.**  Under current law, the corporate tax rate is graduated starting at 11% up to a top rate of 35%.  The Act reduces the income tax rate for corporations to a flat 21%, beginning in 2018.  Due to the change in these rates, certain businesses may want to evaluate whether converting into a corporation would offer tax advantages.

**Reduction of dividends-received deduction percentages.** Current law provides a corporate deduction of 80% of dividends received if the corporation owns at least 20% of the distributing corporation, and 70% otherwise.  These deductions are reduced to 65% and 50%, respectively.

**Corporations no longer subject to the AMT.** The current AMT system applies a 20% tax rate to a C corporation’s alternative minimum tax base. This tax does not apply to “small corporations,” defined as a corporation with average annual gross receipts for the previous three tax years that do not exceed $7,500,000. The Act repeals the corporate AMT effective January 1, 2018. Unlike many other provisions of the Act, there is no “sunset” provision for the repeal of the corporate AMT.

**Section 179 deduction limits increased.** For tax years beginning after December 31, 2017, the annual deduction limit for Section 179 property has been increased from $500,000 to $1 million, and the limit on purchases has been increased to $2.5 million (from $2 million).  These amounts are now indexed for inflation beginning in 2018.  The definition of Section 179 property has been expanded to include certain tangible personal property used in furnishing lodging as well as roofs, heating, air conditioning, and ventilation systems, fire protection, alarm and security systems installed on non-residential real property that has already been placed in service.

**Temporary 100% cost recovery of qualifying business assets.** For qualifying business assets acquired and placed in service after September 27, 2017, and before January 1, 2023, a 100% deduction for the adjusted basis of the assets is allowed.  This repeals the current 50% deduction previously scheduled to go into effect after December 31, 2017.  Starting on January 1, 2023 through December 31, 2027, this temporary bonus first year depreciation rate is reduced by 20% each year (80% for 2023, 60% for 2024, etc.) until it sunsets for years after 2026.

**Limits for "luxury" automobile depreciation increased.**For passenger automobiles placed in service after December 31, 2017 (and for which the first-year depreciation deduction under Section 168(k) is not claimed), the maximum depreciation deduction is increased from $3,160 to $10,000 in the year in which the car is placed in service, from $5,100 to $16,000 in the second year, from $3,050 to $9,600 in the third year, and from $1,875 in the fourth and later years to $5,760.  These new limits are indexed for inflation.

**New property used in a farm business is now deductible over a five-year period.**  Under current law, the time period over which property used in a farm business is deductible depends on the type of property and is subject to the 150% declining balance method.  Under the Act, certain property used in a farm business and placed in service in 2018 or later is deductible over a five year period and is not subject to the 150% declining balance method.  The ability to deduct the cost of new farm equipment and machinery over a shorter period of time may make such purchases more attractive, beginning in 2018.

**Shortened recovery period for certain real property.**  For property placed in service after December 31, 2017, the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail property are eliminated.  Such property is now generally depreciable over a 15-year period using the straight-line and half-year convention.  For residential property placed in service after December 31, 2017, the alternative depreciation system (“ADS”) recovery period has been reduced to 30 years, from 40 years.  Finally, also beginning after December 31, 2017, a farming business electing out of the limitation on the deduction for interest must use ADS to depreciate any property with a recovery period of 10 years or more.

**Deduction for business interest limited.**  For tax years beginning after December 31, 2017, net interest expense is generally limited to 30% of the business’s adjusted taxable income.  Although this limitation is generally determined at the tax-filer level, in the case of pass-through entities, the determination is made at the entity level.  For purposes of applying these limitations through January 1, 2022, adjusted taxable income is computed without regard to depreciation, amortization, or depletion deductions.

**NOL deduction modified.**  For NOLs arising in tax years after December 31, 2017, the two-year carryback rule is repealed, other than in cases involving certain losses incurred in a farming-related trade or business.  Moreover, for NOLs arising in tax years after December 31, 2017, the NOL deduction is generally limited to 80% of taxable income.  NOLs may generally be carried over to future years without limitation.

**Like-kind exchange treatment to be limited to real property.**  For transactions consummated in 2018 and later, tax-free exchange treatment under Section 1031 no longer includes personal property and is limited to real property.

**Five-year write-off of specified research and experimentation (“R&E”) expenses.** For amounts paid or incurred in tax years beginning after December 31, 2021, “specified R&E expenses” must be capitalized and amortized ratably over a 5-year period (15 years if conducted outside the United States), beginning with the midpoint of the tax year in which the specified expenses were paid or incurred.  These expenses include, for example, expenses for software development, as well as exploration expenses incurred for ore or other minerals, including oil and gas.

**Nondeductible penalties and fines.** For amounts paid or incurred on or after the date of enactment of the Act, no deduction is allowed for any otherwise deductible amount paid (or incurred) to, or at the direction of, a government or specified nongovernmental entity if that payment relates to the violation of any law or the investigation by such governmental entity into the potential violation of any law.  Certain exceptions may apply, but only if the taxpayer establishes that the payments are either restitution (including remediation of property) or are required to come into compliance with any law that was violated or involved in the investigation, and that are so identified in the court order or settlement agreement.  Government agencies are required to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered in which the aggregate amount to be paid or incurred to the government is at least $600.

**“Excessive employee compensation” deduction limitation.**  For tax years beginning after December 31, 2017, exceptions to the $1 million deduction limitation for certain employee compensation are repealed.  The applicability of the limitation is applied against the principal executive officer, the principal financial officer, and the three other highest-paid officers, as well as any employee that was considered a “covered employee” as of a tax year starting after December 31, 2016.

**Limitations placed on rehabilitation credit.**  Starting with amounts paid or incurred after December 31, 2017, the 10% credit for qualified rehabilitation expenditures is repealed.  A 20% credit is now provided for certain qualified rehabilitation expenditures, and that credit can be claiming ratably over a five-year period.

**III. PASS-THROUGHS**

**New deduction for certain pass-through income.** Currently, income that “passes through” a partnership, S corporation or sole proprietorship to a partner, shareholder or sole proprietor is taxed at that individual’s marginal income tax rate.  The Tax Act adds a new section to the code, Section 199A, which provides a 20% deduction from individual income tax rates for “qualified business income” ("QBI") from a partnership, S corporation or sole proprietorship to non-corporate taxpayers, including trusts and estates.  QBI is generally the net income from a business minus any reasonable compensation, guaranteed payments, or other payments to partners/owners that are for services other than as a partner/owner.  QBI is determined on a per-business (not individual) basis.

Generally, for businesses whose owners have individual income of less than $157,500 or file jointly with income below $315,000 (the threshold amounts), the deduction is simply 20% of QBI.  For owners with income above these amounts, how the deduction is treated depends on the type of business they are in.  For those in a “specified service trade or business,” which includes service businesses in healthcare, law, consulting, athletics, financial services, or where the principle asset of the business is the reputation or skill of the business’s owners or employees, such owners will see their deduction begin to be reduced starting at the threshold amounts until completely phased-out (and no deduction available) for individual income of $207,500 or $415,000 for married filing jointly.  The formula for determining the reduction in the deduction calculation is based on W-2 wages paid by the business and a portion of the business’s capital assets.

For businesses that are not in a specified service trade or business, the wage and capital limits also begin to apply at the threshold income amounts and apply fully at $207,500 for individuals and $415,000 for married filing jointly.  However, unlike for specified service trades or businesses, the deduction is not eliminated above these amounts.  This section will be effective for tax years starting after December 31, 2017 and before January 1, 2026.

**Repeal of partnership technical termination.** For partnership tax years starting January 1, 2018, Section 708(b)(1)(B) is repealed so that the sale of 50% or more of the total interest in partnership capital or profits within 12 months does not automatically terminate the partnership.

**Look-through rule applied to gain on sale of partnership interest.**For sales and exchanges on or after November 27, 2017, gain or loss from the sale or exchange of a partnership interest is “effectively connected” with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange.  Any gain or loss from the hypothetical asset sale by the partnership must be allocated to interests in the partnership in the same manner as non-separately stated income and loss.

For sales, exchanges and dispositions after December 31, 2017, the transferee of a partnership interest must withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

**Modification to partnership “substantial built-in loss”.**For transfers of partnership interests after December 31, 2017, the definition of a “substantial built-in loss” is modified for purposes of IRC § 743(d).  In addition to the present law’s definition (a substantial built-in loss exists if the partnership’s adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property), a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all of the partnership’s assets in a fully-taxable transaction for cash equal to the assets’ fair market value, immediately after the transfer of the partnership interest.

**Treatment of S corporation converted to C corporation.**The Act provides that any IRC § 481(a) adjustment of an “eligible terminated S corporation” attributable to the revocation of its S corporation election (i.e., a change from the cash method to an accrual method) is taken into account ratably during a six-tax-year period beginning with the year of change.  An eligible terminated S corporation is any C corporation that (1) is an S corporation the day before the date of enactment; (2) during the two-year period beginning on the date of enactment revokes its S corporation election; and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of enactment.

In the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount of the accumulated earnings and profits.

**Certain nonresident alien individuals may qualify as electing small business trust (“ESBT”) beneficiaries.**  Effective as of January 1, 2018, nonresident alien individuals may qualify as a potential current beneficiary of an ESBT.  Care should be given to the consequences of naming such an individual the beneficiary of an ESBT.

**Changes to charitable contribution deduction rules pertaining to ESBTs.**  For tax years beginning after December 31, 2017, the charitable contribution deduction of an ESBT is determined using the rules applicable to individuals, instead of trusts.

**Repeal of IRA contribution recharacterization.**  Currently, taxpayers can convert a standard (pre-tax) IRA into a Roth IRA, paying income taxes on the money that is converted.  If the taxpayer changes his or her mind, he or she has until October 15 of the next year to elect to undo the conversion and recharacterize it.  This option to undo the conversion has been repealed for tax years beginning January 1, 2018.

**Extended rollover period for rollover of plan loan offset amounts.** Currently, if an employee has a retirement plan he or she has borrowed money from and the employee loses his or her employment, his or her loan payoff due date can be accelerated.  If he or she fails to pay the amount due, the loan can be cancelled and the account balance offset by the amount owed on the loan.  This plan loan offset amount is treated as an actual distribution to the employee but is eligible for a tax-free rollover into a new retirement plan within 60 days.  Under the new Act, for “qualified plan loan offset amounts” distributed after December 31, 2017, taxpayers have until the due date (including extensions) for filing their income tax return for the year the plan loan offset occurred to complete a tax-free rollover of such amount.  Qualified plan loan offset amounts are plan loan offset amounts treated as distributed from a qualified retirement plan, a Section 403(b) plan or a governmental Section 457 plan solely because the plan was terminated or the failure to repay the loan was due to the employee’s separation from service.

**IV. TAX-EXEMPT ORGANIZATIONS**

**Tax-exempt organizations subject to excise taxes for highly paid individuals.**  Under current law, the compensation of executives of tax-exempt organizations is subject to a reasonableness requirement and private inurement limits, but there are not set dollar limitations on compensation of such executives.  The Act imposes an excise tax on compensation to an executive over $1 million and certain “parachute payments” made to such executive.  The excise tax is imposed on the tax-exempt organization and is imposed at the same rate as the corporate income tax (21% under the Act).  Tax-exempt organizations that currently pay compensation to any individual executive in excess of $1 million should contact their advisor to evaluate options for minimizing the impact of this tax.

**Tax-exempt organizations must separately compute unrelated business taxable income.**  Under current law, a tax-exempt organization computes its unrelated business taxable income on an aggregate basis, which effectively allows it to use deductions from one business activity to offset income for a different business activity.  Under the Act, tax-exempt organizations must now separately compute their unrelated business taxable income for each trade or business, which eliminates the ability to offset income from one activity with deductions from a separate activity.

**V. ACCOUNTING METHOD CHANGES**

**Taxable year of inclusion**. Generally, for tax years beginning after December 31, 2017, a taxpayer is required to recognize income no later than the tax year in which such income is taken into account on an applicable financial statement or other financial statement under rules specified by the IRS (subject to an exception for long-term contract income under Section 460).

**Cash method of accounting changes.** For tax years beginning after December 31, 2017, taxpayers whose average gross receipts for the three prior tax years do not exceed $25 million (indexed for inflation for tax years beginning after December 31, 2018) may use the cash method of accounting, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor.  Qualified personal service corporations, partnerships without C corporation partners, S corporations and other pass-through entities may use the cash method of accounting without regard to whether they meet the gross receipts test, so long as the use of the method clearly reflects income.

**Acounting inventories modified.**For tax years beginning after December 31, 2017, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under Section 471, but may instead use an accounting method for inventories that either (1) treats inventories as non-incidental materials and supplies; or (2) conforms to the taxpayer’s financial accounting treatment of inventories.

**Capitalization and inclusion of certian expenses in inventory costs.**The Act expands the gross receipts exemption from the uniform capitalization ("UNICAP") rules by providing that, for tax years beginning after December 31, 2017, any producer or re-seller that meets the $25 million gross receipts test (up from $10 million under current law) is exempted from the application of Section 263A.  Exemptions not based on a taxpayer’s gross receipts are retained.

**Accounting for long-term contracts.**Under current law, construction companies with average annual gross receipts of $10 million or less in the preceding three years are exempted from the requirement to use the percentage-of-completion (“PCM”) method.  The Act expands that exemption by providing that, for contracts entered into after December 31, 2017 in tax years ending after that date, use of the PCM is not required for contracts for the construction or improvement of real property if the contract (1) is expected (at the time it is entered into) to be completed within two years of its commencement; and (2) is performed by a taxpayer that (for the tax year in which the contract was entered into) meets the $25 million gross receipts test.

**Exclusions from contributions to capital.**Under current law, if property is contributed to a corporation by someone other than a shareholder as such, the basis of the property is zero.  If the contribution consists of money, the corporation must reduce the basis of any property acquired with that money within the following 12-month period, and must then reduce the basis of other property held by the corporation.

The Act amends Section 118 to provide that, effective for contributions made after the date of enactment, the term “contributions to capital” does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer; and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such).