In brief

On December 20, Congress gave final approval to the House and Senate conference committee agreement on significant tax reform legislation.

The House passed the bill by a vote of 224 to 201, with 12 Republicans voting no along with House Democrats. The Senate passed the bill by a party-line vote of 51 to 48, with Senator John McCain (R-AZ) missing the vote due to illness. The timing of President Trump’s signature is unclear as restrictions related to the Pay-As-You-Go (PAYGO) Act of 2010 could require mandatory cuts to Medicare and other spending items because of the projected increase to the deficit from the bill. Congress may waive the restrictions related to PAYGO as part of a temporary funding bill to avoid a government shutdown later this week. If a waiver is not obtained and the bill is signed in 2017, those cuts would be required in January 2018. Delaying the signing to 2018 would delay those cuts until 2019 and give Congress additional time to negotiate a possible waiver of the cuts.

The final conference committee agreement (Conference Agreement or Agreement) would lower permanently the US federal corporate income tax rate from 35 percent to 21 percent. The Conference Agreement also would temporarily reduce the current 39.6-percent top individual income tax rate to 37 percent and revise other individual income tax rates and brackets. Most changes under the Agreement would be effective for tax years beginning after December 31, 2017.

For a detailed discussion of the broader impact of overview of the TCJA, please see PwC’s Tax Insight, Congress gives final approval to tax reform conference committee agreement.

In detail

This Insight focuses on provisions that may be most relevant to high net worth individuals with some planning ideas.

Except where specifically noted, the Conference Agreement would sunset nearly all individual provisions (including pass-through business tax relief provisions discussed below) after 2025, in order to comply with Senate budget reconciliation rules.

Individual tax rates and brackets
The Conference Agreement would retain the current bracket structure of seven individual tax rates, but would lower the top rate to 37 percent and make additional modifications to the income levels for some brackets. Individuals would reach the top marginal bracket at taxable income of $500,000 (single) and $600,000 (married joint). Trusts reach the top tax bracket at $12,500 of taxable income. The Agreement would adjust individual tax brackets and certain other individual provisions for inflation based on chained CPI (the chained CPI adjustment is not subject to sunset).
Planning idea: With the lower top tax rate, taxpayers may consider deferring income to the new year. However, with some of the other tax changes, in some situations, accelerating income may actually be the better outcome. Modeling for each taxpayer’s specific situation would be advisable.

Investment income
Like the House and Senate bills, the Conference Agreement retains the present-law maximum rate of 20 percent on net long term capital gains and qualified dividends. The Agreement also leaves in effect the Affordable Care Act’s 3.8-percent net investment income tax and the 0.9-percent additional Medicare tax that apply to higher-income individuals.

The Conference Agreement drops a Senate proposal to require recognition of gain for sale of securities on a first-in, first-out (FIFO) basis.

Standard deduction and personal exemptions
The standard deduction for 2018 would be increased to $24,000 for joint filers, $12,000 for individual filers, and $18,000 for single filers with at least one qualifying child. Amounts would be adjusted for inflation for tax years beginning after 2018.

Personal exemptions would be repealed. This provision of the Agreement is not meaningful to higher income taxpayers, since personal exemptions were phased out under current law beginning at incomes above $320,000

New deduction for qualified pass-through business income
The Conference Agreement generally adopts the Senate bill’s approach to reducing taxes on certain qualified business income of an individual, effective for tax years beginning after December 31, 2017. The Agreement would provide a 20-percent deduction for qualified business income from a partnership, S corporation, or sole proprietorship (down from 23 percent in the Senate bill). The 20-percent deduction combined with a top ordinary income tax rate of 37 percent would result in a top rate of 29.6 percent for such income in the absence of other limitations. The Agreement also provides that trusts and estates are eligible for the 20-percent deduction.

In general, qualified business income is the net amount of qualified items of income, gain, loss, and deduction with respect to any qualified trade or business of the taxpayer. Qualified items generally are items of income, gain, loss, and deduction effectively connected with the conduct of a qualified trade or business in the United States. Qualified business income does not include investment-type income (e.g., capital gains, dividends, and non-business interest) or reasonable compensation and guaranteed payments. A qualified trade or business generally is any business other than a ‘specified service trade or business’ (defined below) or the trade or business of performing services as an employee.

Under the Conference Agreement, in the case of an individual whose taxable income exceeds the relevant income thresholds noted below, the deduction of each qualified business’s income is capped at the greater of (a) 50 percent of the individual’s allocable share of W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the individual’s allocable share of 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 (the ‘W-2 wage limitation’). The W-2 wage limitation does not apply to qualified REIT

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<td>Single</td>
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<td>15%</td>
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dividends, cooperative dividends, and publicly traded partnership income, regardless of the individual recipient’s taxable income.

Under the Conference Agreement, the W-2 wage limitation does not apply to an individual whose taxable income is less than $157,500 for a single filer ($315,000 for a joint filer). Above these thresholds, the W-2 wage limitation phases in over the next $50,000 of income ($100,000 for joint filers). The thresholds in the Conference Agreement were reduced from $250,000 and $500,000, respectively, in the Senate bill.

The Agreement defines ‘specified service trade or business’ as 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. In addition, a specified trade or service business includes investing and investment management, trading, and dealing in securities, commodities, or partnership interests. The Agreement removes engineering and architecture services from the list of specified service businesses.

**Observation:** Future choice of entity decisions must factor in the changes to the corporate tax rate alongside a business owner’s (or owners’) expected ability to claim this new pass-through business deduction. Among many considerations, a business owner must examine the nature of the business (service based, number of employees); the owners’ desire or need to extract cash from the business; the services, if any, the owner will perform for the business; and the owners’ expected taxable income. Consideration also should be given to whether multiple businesses held in the same entity could be separated to allow one to claim the deduction.

Applying this provision to the owners of existing pass-through entities will require additional compliance at both the entity and individual level. For example, the entity will need to report separately all of the items an owner will need to calculate the amount each owner may claim as a deduction. This means all of the qualified business income, the owner’s applicable share of the business’s W-2 wages, and the owner’s applicable share of the qualified property’s ‘unadjusted basis’ must be calculated for each entity each year due to the uncertainty surrounding the ultimate owner’s ability to claim the deduction. Moreover, because the deductible amount is calculated separately for each trade or business, the W-2 wage amounts and basis amounts cannot be reported in the aggregate for entities with more than one trade or business.

**Observation:** The Conference Agreement clarifies that the 20-percent deduction is not allowed in computing adjusted gross income, but instead is allowed as a deduction reducing taxable income. The Conference Agreement also clarifies that the deduction is available to both non-itemizers and itemizers. Since many states adopt adjusted gross income as their starting point for determining the tax base for individuals, conformity issues can arise. Taxpayers are advised to consider the differing starting points for determining the state tax base.

**Planning idea:** With a 21 percent rate for corporations, owners of S corporations may want to model their taxes as a C corporation to determine whether a conversion would be advisable. Provisions to lessen the burden of a conversion are also part of the Agreement.

**Pass-through business losses**
For taxable years beginning after December 31, 2017 and before January 1, 2026, business losses in excess of business income plus $500,000 (married filing a joint return) would not be deductible for the current tax year. Such losses would be treated as a Net Operating Loss (NOL) carryforward to subsequent taxable years. This limitation would apply after the application of the passive loss rules under Section 469. Business losses covered by this provision would include pass-through losses as well as sole proprietor and farm losses. In the case of partnership and S corporation losses, the limitation is applied at the partner or shareholder level.

**Observation:** This provision would limit the ability of taxpayers to use large business losses to offset other income in their returns (e.g., wages, interest, dividends, capital gains). It appears that the limitations applicable to NOLs would apply to the carryover loss in subsequent years, but additional guidance may be needed for this provision.

**State and local tax deductions**
The Conference Agreement would permit individual taxpayers to deduct up to $10,000 for any combination of state and local income taxes, property taxes, and sales taxes.

**Observation:** With the pending limitation on the deduction of state and local income taxes, many taxpayers had considered prepaying 2018 state and local income taxes before year-end. The final bill
contains a provision intended to eliminate the ability to deduct such income tax prepayments.

**Observation:** States vary widely in how they treat itemized deductions for individual taxpayers under their income tax laws. To the extent that state law conforms to federal deductions, the repeal of various itemized deductions proposed by the Conference Agreement could impact a taxpayer’s state income tax liability.

**Planning idea:** Although prepaying 2018 state and local income taxes cannot be taken as a deduction, prepaying fourth quarter 2017 state and local income taxes may still be advisable.

**Planning idea:** With the cap on the state and local income tax deduction, some taxpayers may re-evaluate their residency and decide to move to a state with a lower or no income tax. Although the property tax rate of the desired locale should be considered as well.

**Mortgage interest**
For any acquisition indebtedness incurred after December 14, 2017, interest would only be deductible for loan amounts not exceeding $750,000 (for married filing jointly). As under current law, the acquisition debt limit applies in aggregate on up to two personal residences. Existing mortgages as of December 14, 2017 continue to be subject to the current $1,000,000 limitation. Interest would no longer be available next year. In some cases, paying off home equity debt and using the interest tracing rules to establish investment debt might be a more tax effective way to borrow.

**Charitable donations**
The Conference Agreement would preserve the itemized deduction for charitable contributions, with certain modifications. The Agreement would increase from 50 percent to 60 percent the income limit for charitable contributions of cash to public charities. The 30 percent income limit for contributions of appreciated securities was not changed. The Agreement also would deny a charitable deduction for payments made in exchange for college athletic event seating rights and repeal the substantiation exception for certain contributions reported by the donee organization.

**Planning idea:** In general, many taxpayers will accelerate charitable contributions to 2017 since their marginal rates will be lower in 2018. However, taxpayers who may be impacted by the 50 percent limit could defer some charitable contributions to the following year when the limit will be increased (and when the Pease limitation would also be repealed).

**Planning idea:** Taxpayers who have college athletic event seating rights may want to prepay for those rights before year-end.

**Other itemized deductions**
The Agreement eliminates the ‘Pease’ limitation on overall individual itemized deductions.

Deductions for miscellaneous itemized deductions subject to the two percent floor (including tax preparation fees, investment expenses, and unreimbursed business expenses) would be repealed.

**Observation:** It is not clear how the repeal of miscellaneous deductions would affect deductions that trusts are normally able to take without the two percent floor (such as tax preparation fees that would not be incurred but for the trust). Guidance may be needed.

**Planning idea:** Taxpayers who have significant miscellaneous deductions may consider prepaying these expenses.

**Child credits**
The Conference Agreement would increase the child tax credit from $1,000 under current law to $2,000 per child and increase the refundable portion of the credit to $1,400. At the same time, the Agreement drops the Senate proposal to increase the age limit for a qualifying child from under 17 to under 18 years old so the age limit remains as under current law. The Agreement would provide a $500 nonrefundable credit for a qualifying dependent other than a qualifying child (such as a parent). The Agreement also would increase the phaseout threshold gross income levels for claiming the credit, to $400,000 from $110,000 (under current law) for joint filers and $200,000 from $75,000 (under current law) for all other filers.

**Education**
The Agreement would modify Section 529 education savings plan rules to allow distributions of up to $10,000 annually for tuition expenses incurred in connection with enrollment or attendance of a student at a public, private, or religious elementary or secondary school. Unlike most other individual tax provisions, this specific provision does not include any sunset language. If a student loan is discharged based on the death or total disability of a student, any income resulting from the discharge would be excluded from taxable income if the loan is discharged after 2017 and before 2026.
The Agreement drops certain House proposals affecting higher education, including proposals to Consolidate the American Opportunity Tax Credit, the Hope Scholarship Credit, and the Lifetime Learning Credit into the American Opportunity Tax Credit; repeal the exclusion for qualified tuition reductions; and repeal the deduction for qualified tuition and related expenses.

**Planning Idea:** With more options available for using 529 plans, taxpayers could consider contributing additional funds to existing accounts or setting up new 529 plans. Although contributions are not eligible for a federal income tax deduction, many states offer state income tax deductions.

**Recharacterization of Roth IRA conversion**

Although the Agreement does not affect conversions to a Roth IRA, it does end the ability to recharacterize a conversion after the fact. Unlike previous House and Senate versions, it does not affect the ability to recharacterize other contributions. This provision does not sunset.

**Planning Idea:** With the lower tax rates for 2018, if the Roth IRA has not appreciated significantly in value, taxpayers could consider recharacterizing a conversion made earlier in the year and re-converting to Roth status in a future year under the lower rate. Such recharacterization must be done before year-end.

**Other exclusions**

Qualified moving expenses will no longer be excluded from income and reimbursement for employment-related moving expenses will no longer be tax-free after 2017. In addition, alimony payments would not be deductible by the payor or includible in the income of the payee for divorce or separation instruments executed or modified after December 31, 2018. Note that prior divorce decrees are not impacted, and that the alimony provision does not sunset.

**Planning Idea:** Taxpayers may want to incur deductible moving expenses or push for reimbursement of such moving expenses before the end of the year. For taxpayers in the middle of a separation or divorce, a taxpayer who would need to pay alimony may want to finalize the agreement before the end of 2018.

**Individual alternative minimum tax**

The Conference Agreement retains a modified AMT, with increased exemption amounts and phase-out thresholds. Under the Agreement, the AMT exemption amount is increased to $109,400 for joint filers and $70,300 for all other taxpayers (other than estates and trusts). The phase-out thresholds are increased to $1 million for joint filers and $500,000 for all other taxpayers (other than estates and trusts).

**Observation:** The AMT had a significant effect for taxpayers living in states with high income taxes because the deduction for state and local income taxes was not allowed in the AMT computation. With the increased exemption, the $10,000 limitation on the state and local tax deduction, and the repeal of miscellaneous itemized deductions, fewer taxpayers will be impacted by the AMT.

**Like-kind exchanges**

Under current law, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a ‘like kind’ that is held for productive use in a trade or business or for investment. In a qualifying like-kind exchange, the basis in the new property equals the taxpayer’s adjusted basis in the exchanged property, thus deferring any gain inherent in the exchanged property. The Conference Agreement would limit the applicability of the gain deferral rules to like-kind exchanges of real property, effective for exchanges completed after December 31, 2017. This provision does not sunset.

A transition rule would allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property beginning before 2018 would not be subject to this limitation and instead would be subject to current-law rules. The bill generally would eliminate the carryback of NOLs arising in a tax year ending after 2017 and instead would permit such NOLs to be carried forward indefinitely. This provision does not sunset.

**Observation:** There is a discrepancy between the Agreement language and official explanations that may affect fiscal year taxpayers. We expect further guidance on this matter shortly and will discuss with impacted clients.

**Observation:** Most state NOL rules differ from federal NOL rules, with a few exceptions (e.g., Delaware, Missouri, Virginia). States that conform to federal NOL provisions generally, and carryforward periods in particular, may need to address the ramifications of the Conference Agreement.

**Net operating losses**

Current law generally permits a taxpayer to carryback a NOL two years and carry forward a NOL 20 years to offset taxable income in such years. Effective for losses arising in tax years beginning after 2017, the Conference Agreement would limit a taxpayer’s ability to utilize a NOL deduction to 80 percent of taxable income (determined without regard to the deduction). NOLs arising in tax years beginning before 2018 would not be subject to this limitation and instead would be subject to current-law rules. The bill generally would eliminate the carryback of NOLs arising in a tax year ending after 2017 and instead would permit such NOLs to be carried forward indefinitely. This provision does not sunset.
or acquired replacement property on or before December 31, 2017.

**Observation:** Taxpayers should consider state conformity matters to the extent individual states do not follow federal tax law.

**Planning idea:** Taxpayers who are considering exchanging assets other than real property may consider using a qualified intermediary to dispose of the property being relinquished or acquire the replacement property before the end of the year in order to take advantage of the transitional rule.

**Elected Small Business Trust (ESBT) changes**

The Conference Agreement would modify the S corporation shareholder limitations by permitting non-resident aliens to be potential current beneficiaries of an electing small business trust (ESBT), effective January 1, 2018. Non-resident aliens (NRAs) individuals would not be eligible shareholders except through an ESBT. In addition, ESBTs would be permitted to claim charitable contribution deductions under rules applicable to individuals as opposed to those governing trusts, effective for tax years beginning after December 31, 2017. These provisions do not sunset.

**Observation:** The NRA provision allows greater flexibility for ESBTs. The change regarding charitable contributions passed through to the ESBT from the S corporation will impose lower income limitations on the use of the deduction, but will provide the flexibility of a contribution carryforward.

**Carried interest**

The Agreement would recharacterize certain gains with respect to an applicable partnership interest from long-term capital gains to short-term capital gains to the extent such gains relate to property with a holding period not greater than three years, effective for tax years beginning after December 31, 2017.

In general, an applicable partnership interest is a partnership interest transferred to or held by a taxpayer in connection with the performance of ‘substantial services’ by the taxpayer in an ‘applicable trade or business.’ An applicable trade or business is generally the activity of raising or returning capital, and investing in or developing securities, commodities, real estate, or partnership interests. Excluded from the definition of ‘applicable partnership interest’ are partnership interests held by a corporation and certain capital interests in a partnership. Additionally, the Agreement provides that if a taxpayer holding an applicable partnership interest transfers such interest to a related person, then the taxpayer is required to recognize as short-term capital gain its share of long-term capital gain ‘with respect to such interest attributable to’ assets not held for more than three years. This provision does not sunset.

**Observation:** The provision raises a number of questions that may need to be answered with regulations including how it applies to the sale of exchange of the applicable partnership interest and how it applies to mixed profits and capital interests.

**Estate and gift tax provisions**

The Conference Agreement would maintain the estate, gift, and generation-skipping transfer taxes (currently at a 40 percent tax rate). The final bill would double the exemption for all three taxes from $5,600,000 to $11,200,000 per person. The gift and estate tax exemptions would remain unified so any use of the gift tax exemption during lifetime would decrease the estate tax exemption available at death. The current law allowing a ‘step-up’ in basis to fair market value at date of death will continue.

The current gift tax exclusion for annual gifts of up to $15,000 per donee (in 2018 as adjusted for inflation) would be retained, as well as the provisions for unlimited transfers directly to educational institutions and health care providers.

**Planning idea:** With the increased exemption amounts, taxpayers should consider additional wealth transfers to family members and dynasty trusts in 2018. However, the scheduled sunset raises possible ‘clawback’ concerns that must be taken into account.

**Planning idea:** Taxpayers should examine their current estate planning documents and determine what changes might be warranted with this significant increase in the exemption amounts.

**The takeaway**

There are a number of provisions in the tax reform legislation that will affect high net worth individuals, owners of closely-held businesses, and hedge fund and private equity investors. It is expected that many of the provisions will require guidance in order to determine how to implement the new laws.

As the new law generally will take effect almost immediately (January 1, 2018), taxpayers should not delay in
Determining how the new tax provisions will affect them and what planning should be done to take advantage of the favorable provisions and to minimize the negative effect of the unfavorable ones.

Let’s talk

For a deeper discussion on how tax reform may affect you, please contact:

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