SULLIVAN & CROMWELL LLP

January 8, 2018

U.S. Tax Reform

Individual Taxation

SUMMARY

The Tax Cuts and Jobs Act of 2017 (the "Act"), which was enacted into law last December, represents the most significant reform of the U.S. tax code in over 30 years.

This memorandum describes some of the important features of the legislation that will affect the taxation of individuals. Most of the provisions described below become effective for years beginning after 2017 and ending on or before December 31, 2025. Those with different effective dates are noted.

Individual Taxes (Income, AMT, Estate & Gift):

- **Individual Tax Rates.** The seven marginal tax rates for individuals are modified, with a top rate of 37% for income in excess of $500,000 for individuals and $600,000 for married couples. The changed individual tax rate structure does not apply to the maximum rates on net capital gain and qualified dividends, which remain unchanged.
- **Individual AMT Not Eliminated.** The Act retains the individual AMT, although with increased exemption amounts (the amount of alternative minimum taxable income ("AMTI") exempt from the AMT) and phaseout thresholds (the cap on total AMTI that may be subject to the AMT). However, the exemption amount continues to phase out if AMTI exceeds certain threshold amounts. With these changes, in addition to the limitations on the deductibility of state and local taxes discussed below and the elimination of deductions for most miscellaneous itemized deductions, the AMT is expected to apply to fewer taxpayers while the temporary changes are effective. These increases do not apply to estates or trusts.
- **Estate, Gift, and Generation-Skipping Transfer Taxes.** The Act doubles the estate, gift, and generation-skipping transfer tax exclusion amount (to approximately $11.2 million per person (or $22.4 million for a married couple) in 2018, adjusted annually for inflation), but does not repeal the estate, gift, and generation-skipping transfer taxes. No other changes are made to the estate and gift tax regime. Because the exclusion amount is only doubled through 2025, individuals should consider making larger gifts that use the exclusion amount before January 1, 2026.

Deductions and Exclusions for Individuals:

- **Doubled Standard Deduction and Eliminated Personal Exemptions.** The standard deduction is doubled to $12,000 for an individual and $24,000 for married couples. Personal and dependency exemptions, on the other hand, are eliminated.
- **Changes to Itemized Deductions.** All "miscellaneous itemized deductions" that previously could have been claimed to the extent their aggregate amount exceeded 2% of the taxpayer's adjusted gross income are eliminated (e.g., deductible investment expenses from passthrough entities). The limitation on the total amount of itemized deductions for high-income taxpayers (known as the "Pease" limitation) is repealed. The Act eliminates the deduction for moving expenses, but retains, at least in part, many of the deductions that the House bill would have eliminated (e.g., interest on student loan indebtedness, medical expenses, personal casualty losses). For tax years beginning after December 31, 2016 and before January 1, 2019, medical expenses of a taxpayer or such taxpayer's spouse or dependents are deductible if they exceed 7.5% of a taxpayer's adjusted gross income (rather than 10% under prior law).
- **State and Local Tax Deduction.** Individuals may deduct state and local property taxes and either income or sales taxes up to an aggregate of $10,000. While the limitation applies to state and local income taxes imposed on a taxpayer's allocable share of income earned in a trade or business, there is no limitation on the deduction of state and local taxes paid or accrued by a trade or business itself (such as the New York City unincorporated business tax), or on property held for the production of income.
- **Charitable Deduction.** The Act preserves the charitable deduction and increases the limitation on cash donated to public charities to 60% of adjusted gross income computed without regard to any net operating loss carryback, up from 50% under prior law.
- **Mortgage Interest Deduction.** The Act preserves the mortgage interest deduction for existing mortgages, and maintains the deduction for newly purchased homes (first and second homes) up to an aggregate of $750,000 for acquisition debt incurred after December 15, 2017 ($375,000 if married filing separately), but eliminates the deduction for interest on home equity indebtedness.
- **No Deduction for Alimony.** Under prior law, alimony payments were deductible to the payor and includible in the income of the recipient. The Act reverses prior law by eliminating the deduction for alimony payments and not including such payment in the income of the recipient. Because alimony is often paid by the higher-earning party, this will often result in higher overall tax liability. These changes only apply to agreements executed after December 31, 2018 or executed on or before such date and modified after such date, provided that the modification expressly provides that the updated rules of the Act apply. These changes do not sunset after December 31, 2025.
- **Elimination of Certain Employee Exclusions and Deductions.** The exclusion for qualified moving expense reimbursement, as well as the qualified bicycle reimbursement, is eliminated. Notably, however, the exclusions for adoption assistance programs and dependent care programs are untouched.
- **No Further Limits on Exclusion of Gain From Sale of Principal Residence.** The Act does not change the rules regarding the exclusion of gain on the sale of a principal residence.
- **Investment Interest Expense Deduction.** The Act does not change the rules regarding the deductibility of investment interest expense.
- **Excess Business Losses Disallowed.** The Act disallows "excess business losses" (losses attributable to trades or businesses of a taxpayer other than a corporation in excess of a $250,000 threshold amount, or $500,000 for a joint return), and carries such losses forward as part of the taxpayer's net operating loss in subsequent taxable years. The passive activity loss rules must be applied before the excess business loss rules. For partnerships and S corporations, the limit on excess business losses is applied at the partner or shareholder level.

Investments of Individuals:

- **Deduction for Passthrough "Domestic Qualified Business Income."** The Act allows a taxpayer other than a corporation to deduct the lesser of (i) 20% of that taxpayer's share of any "domestic qualified business income" of a passthrough (e.g., a partnership, S corporation, or sole proprietorship) and (ii) the greater of (a) 50% of the domestic wages paid with respect to the trade or business and (b) the sum of 25% of such wages and 2.5% of the unadjusted basis of all qualified property used in such trade or business. The qualified property component means that a taxpayer may be able to claim the deduction even if the trade or business has few or no employees, if such business generates income using depreciable tangible assets. Assuming the full 20% deduction, the effective marginal rate is 29.6% in respect of such income for the highest earners. The deduction does not apply to income from certain services businesses (e.g., accounting, law, health, financial services, and other businesses for which the skill or reputation of the owner or employees is the principal asset), except in the case of individuals whose taxable income does not exceed $207,500 ($415,000 for joint returns). Also, qualified business income does not include investment-related income (other than certain dividends from REITs).
  - A noncorporate taxpayer is allowed the qualified business income deduction for qualified REIT dividends (REIT dividends other than capital gain dividends or dividends that qualify as qualified dividend income).
  - In an attempt to discourage aggressive use of this provision, the Act reduces the minimum understatement percentage before certain accuracy penalties apply.
  - The deduction is allowed in calculating "taxable income" but not in calculating "adjusted gross income." As discussed above, thresholds for certain deductions (e.g., medical expenses and casualty losses) are determined by reference to adjusted gross income rather than taxable income. Moreover, this may be significant for state and local income tax purposes.
  - The 3.8% Medicare tax on net investment income and the 3.8% FICA tax on net earnings from self-employment are both calculated without regard to the deduction.
- **Net Operating Losses.** Net operating losses arising after December 31, 2017 are deductible only to the extent of 80% of the taxpayer's taxable income, and can be carried forward indefinitely but generally cannot be carried back. Net operating losses that arose before January 1, 2018 will not be subject to the 80% limitation.
- **Application of Self-Employment Tax to Allocations of Passthrough Income.** The Act retains the prior rules on the application of self-employment tax to amounts received through a passthrough entity.
- **No Changes to Identification of Specified Securities.** The Act does not contain the provision in the Senate bill that would have required lots of specified securities purchased at different prices to be sold on a first-in first-out ("FIFO") basis.
- **Like-Kind Exchanges Limited to Real Property.** Deferral of gain on like-kind exchanges is only permitted with respect to real property. However, deferral of gain is still available for like-kind exchanges with respect to property other than real property if the property disposed of by the taxpayer is disposed of before January 1, 2018, or the property received by the taxpayer is received before January 1, 2018. This transition rule allows taxpayers to complete a deferred or reverse like-kind exchange that involves property other than real property. While this could result in gain recognition of a trade-in of a depreciated asset such as an aircraft, the gain may be offset by bonus depreciation if the aircraft is used in a trade or business. Moreover, deferral of loss is similarly restricted to like-kind exchanges with respect to real property, which could create a tax benefit for taxpayers engaging in "trade-ins" of assets that are worth less than their adjusted basis. This change does not sunset after December 31, 2025.
- **Self-Created Intangibles Not Capital Assets.** The Act excludes certain self-created intangibles (patents, inventions, models or designs, or secret formulas or processes) from the definition of a "capital asset" so that any gain or loss on the sale or exchange of such property will not receive

capital gain treatment. This provision does not apply to goodwill. This change does not sunset after December 31, 2025.

- **Controlled Foreign Corporation 30-Day Holding Period Eliminated.** The Act eliminates the requirement that a corporation must be controlled for an uninterrupted period of 30 days to be a controlled foreign corporation. This is particularly relevant for U.S. heirs who receive shares representing 10% or more of the vote or value of non-U.S. corporations from non-U.S. individual decedents.

- **Expanded Controlled Foreign Corporation Attribution Rules.** The Act expands the controlled foreign corporation attribution rules to include "downward attribution" from a foreign person to a related U.S. person. As a result, individual- and family-owned businesses may be controlled foreign corporations when they would not have been under prior law.

Miscellaneous:

- **Elimination of Individual Mandate.** The Act reduces to zero the individual shared responsibility payment imposed under the Affordable Care Act for failure to maintain essential health coverage (the "individual mandate"). This change does not sunset after December 31, 2025.
- **No Mandatory "Rothification" of Retirement Accounts.** The Act preserves the tax treatment of traditional defined contribution plans (e.g., 401(k)s), which allow the employee to invest pre-tax money (only subject to tax on withdrawal).
- **Non-Qualified Deferred Compensation.** The Act does not change the taxation of non-qualified deferred compensation. There were earlier proposals that would have effectively eliminated deferred compensation by replacing the current law treatment of deferred compensation with a new section that generally would have required income inclusion by the employee when the compensation vests (rather than when the compensation is paid), but these proposals were not included in the Act.

Questions regarding the Act may be directed to any member of the Tax Group or the Estates and Personal Group. Contact information is available on the final page of this memorandum.

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