UBS

The Tax Cuts and Jobs Act

Congress has passed the Tax Cuts and Jobs Act, the most sweeping tax reform since 1986.

In today's world, pursuing your life's goals is being challenged in new ways. Which makes now the perfect time to review your goals in terms of "Advice. Beyond investing." Because when we collaborate on what matters most to you, we can create a plan tailored for you.

On December 22, 2017, President Trump signed into law what was originally called the Tax Cuts and Jobs Act (the Act). The Act is the most sweeping tax legislation since 1986.[1]

The following summarizes many of the key provisions of the Act that affect individuals and businesses. It should be noted that most of the provisions affecting individuals will sunset starting in 2026, while those affecting businesses are generally permanent. We have provided insight into some potential planning opportunities and considerations. Clients should discuss with their tax and legal advisors how the Act will impact their individual situations.

Individual income tax

The Act retains seven brackets, but lowers the rates and increases the thresholds for taxable years 2018 through 2025 as follows:

Single

Taxable income is				
Over	But not over	Pay	Plus % on excess	Of the amount over
$0	$9,525	0%	10%	$0
$9,525	$38,700	$952.50	12%	$9,525
$38,700	$82,500	$4,453.50	22%	$38,700
$82,500	$157,500	$14,089.50	24%	$82,500
$157,500	$200,000	$32,089.50	32%	$157,500
$200,000	$500,000	$45,689.50	35%	$200,000
$500,000 and over		$150,689.50	37%	$500,000

Married filing jointly

Taxable income is				
Over	But not over	Pay	Plus % on excess	Of the amount over
$0	$19,050	0%	10%	$0
$19,050	$77,400	$1,905.00	12%	$19,050
$77,400	$165,000	$8,907.00	22%	$77,400
$165,000	$315,000	$28,179.00	24%	$165,000
$315,000	$400,000	$64,179.00	32%	$315,000
$400,000	$600,000	$91,379.00	35%	$400,000
$600,000 and over		$161,379.00	37%	$600,000

Deductions. The following are the key provisions impacting individual income tax deductions, effective for taxable years 2018 through 2025:

– The standard deduction has been doubled to $24,000 for married couples ($12,000 for individuals) and the personal exemption is eliminated.

– Miscellaneous itemized deductions that were subject to the 2% floor (e.g., certain unreimbursed employee business expenses, tax-related expenses and investment-related expenses) are suspended.

Clients should discuss with their tax advisors whether they can accelerate the payment of any items that would qualify as miscellaneous itemized deductions by year-end 2017.

– The overall limitation on itemized deductions is eliminated.

– The Alternative Minimum Tax (AMT) for individuals is maintained with a higher exemption level of $109,400 for married couples ($70,300 for individuals). Additionally, AMT exemption phase-out thresholds are increased to $1,000,000 for married couples ($500,000 for individuals). Given the increased exemption and phase-out thresholds as well as the limitation of certain itemized deductions, many clients may find that they are no longer subject to AMT.

Clients who hold incentive stock options (ISOs) may benefit from exercising those options in years when they do not have AMT liability.

– The deduction for state and local taxes (SALT) has been limited. Taxpayers can deduct up to $10,000 in the aggregate for property, income and sales tax. The Act states that taxpayers may not take a deduction in 2017 for prepayment of state or local income tax imposed for taxable years beginning after December 31, 2017.

Clients should discuss with their tax advisors whether they could benefit from prepaying real estate taxes in 2017. Clients should also discuss whether they could benefit from paying unpaid 2017 state income taxes by year-end 2017.

– The mortgage interest deduction has been limited.

a) Taxpayers can deduct interest on mortgage debt up to $750,000 of acquisition indebtedness for a newly acquired principal or second home.

b) Existing mortgages are grandfathered up to the current $1 million limit. A mortgage will be considered grandfathered into the $1 million limit if: (1) with respect to a principal or second home, the debt was incurred on or before December 15, 2017, or (2) *with respect to a principal residence only*, (a) the taxpayer entered into a written binding contract on or before December 15, 2017 to close on the purchase of such residence before January 1, 2018, (b) the home is actually purchased before April 1, 2018, and (c) the debt is incurred on or before April 1, 2018.

If a mortgage incurred on or before December 15, 2017 is refinanced, the refinanced debt will also be considered grandfathered into the $1 million limit up to the amount of the original mortgage outstanding at the time of the refinancing, subject to certain limitations relating to the term of the indebtedness.

c) Interest on home equity loans or home equity lines of credit (new or existing) is no longer deductible.

Clients should consult with their tax advisors regarding the deductibility of any new or refinanced mortgage indebtedness.

– The medical expense deduction has been retained. Such expenses are deductible to the extent they exceed 7.5% of adjusted gross income for 2017 and 2018. The adjusted gross income limitation increases to 10% in 2019 and thereafter.

– The child tax credit has been increased to $2,000 per child, refundable up to $1,400.

– For taxpayers who sign divorce agreements after December 31, 2018, alimony will no longer be deductible by the payor or taxable to the recipient. For existing agreements that are modified after that date, the parties may expressly choose to adopt this new rule. If they do not, alimony on agreements entered into before December 31, 2018 but modified after will continue to be deductible by the payor and taxable to the recipient.

Clients may wish to consult with family law counsel to determine whether a divorce decree may be modified to take into account the new tax law relating to alimony payments.

– The deduction for charitable gifts is retained and expanded to allow taxpayers to deduct up to 60% of their adjusted gross income for gifts of cash to public charities.

Clients who are charitably inclined, but who will not have sufficient itemized deductions in future years to exceed the increased standard exemption may wish to make a large charitable gift prior to year-end in order to maximize the charitable income tax deduction in 2017. For the same reason, in future years, clients may also benefit by bunching multiple years of charitable gifts into a single year. This strategy may work particularly well for clients who give annually as they may contribute the charitable sum to a Donor Advised Fund (DAF) and then make grants periodically in future years according to their original giving plan.

– The personal theft loss deduction is repealed and the personal casualty loss deduction is limited to losses incurred in disaster areas.

– Moving expenses are only deductible for individuals who are on active military duty and move pursuant to a military order.

Other provisions

529 Plans expanded. Effective for distributions made after December 31, 2017, 529 accounts may distribute up to $10,000 per student per year for tuition at a public, private or religious elementary or secondary school.

Carried interest. Any capital gain recognized by a taxpayer upon the sale or exchange of an "applicable partnership interest" that was received in connection with the performance of services will be treated as short term capital gain unless the taxpayer has held the partnership interest for at least three years. The language of the Act also suggests that a taxpayer's share of capital gain attributable to the sale of an underlying asset held by the partnership for less than three years will be treated as short term capital gain. Finally, the Act appears to contain anti-abuse rules intended to prevent the taxpayer from transferring the partnership interest to a related party in order to circumvent these provisions.

Repeal mandate for individual health insurance. The law imposing a penalty on individuals who don't purchase healthcare insurance coverage is effectively repealed by reducing the penalty to zero. This change does not take effect until 2019.

1031 exchanges. The law continues to permit the deferral of taxes on the proceeds of the sale of real property when those proceeds are properly reinvested in similar property ("like-kind exchanges"). Beginning in 2018 this deferral is not available for other types of property.

Roth IRA re-characterizations. Beginning in 2018, a conversion from a traditional IRA to a Roth IRA can no longer be re-characterized back to the traditional IRA.

Provisions impacting individuals that were NOT affected by the Act

The following are items that were proposed and discussed but are **NOT** affected by the Act:

- Treatment of sale or disposition of a partial position of securities (investors may still choose specific shares or lots to sell and will not be required to use FIFO treatment)
- Tax-free treatment of employer-sponsored health insurance
- Tax-free treatment of graduate student tuition waivers
- Deduction for student loan interest
- Exclusion of gain from the sale of a principal residence remains at $250,000 ($500,000 for married filing jointly) and the home must have been occupied two out of the last five years)
- The 3.8% tax on net investment income is retained.

Example

A married couple with three children lives in a rental apartment in New York City, with a joint annual income of $650,000. The below chart illustrates how their deductions would look in 2017 vs. 2018:

	2017	2018	
Charitable*	$10,000	$10,000	
State and local income taxes	$70,000	$10,000	capped at $10,000 in 2018
Investment expenses	$25,000	-	miscellaneous itemized deductions not deductible in 2018
Limitation on itemized deduction	($10,086)	-	limitation on itemized deductions not applicable in 2018
Total provisional deductions	$94,914	$20,000	
Standard deduction	$12,700	$24,000	
Final deductions taken	**$94,914**	**$24,000**	
Lost deductions		**$70,914**	

**In both years, the couple made their charitable contribution with appreciated securities held long term. The cost basis of these securities was $2,000. The couple avoided paying capital gains or net investment income taxes on the $8,000 of appreciation. The new law continues to allow the couple to designate which shares they are donating to the charity, rather than requiring the earliest-purchased shares to be used (as was proposed in the Senate's version of the bill).*

Additionally, if the couple had a mortgage on a primary residence with $40,000 annual interest due, the picture would change as below:

	2017	2018
Charitable	$10,000	$10,000
State and local income taxes	$70,000	$10,000
Investment expenses	$25,000	-
Mortgage interest	$40,000	$40,000
Limitation on itemized deduction	($10,086)	-
Total provisional deductions	$134,914	$60,000
Standard deduction	$12,700	$24,000
Final deductions taken	**$134,914**	**$60,000**
Lost deductions		**$74,914**

It is now worthwhile for the couple to continue to itemize, but they have still lost the economic benefit of some of their deductions (most notably state and local income taxes). Some benefit is regained because the limitation on itemized deductions does not apply.

Estate and gift tax

Estate and gift taxes remain a part of the U.S. tax code. However, the exemptions have been doubled to $11,200,000 per transferor in 2018 ($22,400,000 for married couples). Inheritors will continue to receive the benefit of a "step up in basis" on assets included in a decedent's estate to date of death value. The gift tax annual exclusion rises to $15,000 per year per recipient (this is not a change from current law–it simply happens due to inflation adjustment).

Sunset. This provision "sunsets" for decedents whose deaths occur after December 31, 2025. On January 1, 2026, the estate and gift tax exemption will revert to $5 million per person, adjusted for inflation after 2011.The Act directs that regulations be implemented to prevent the additional exemption used from being "clawed back" at death, even if the increase in exemption sunsets as it is scheduled to do.

State estate taxes. Many states assess their own estate taxes, and those state estate tax systems will not be affected by the Act. Clients who live in states with a state estate tax may want to consider making lifetime gifts since the federal exemption amounts sunset. In doing so, however, clients should also consider whether the potential estate tax savings of lifetime gifts outweigh losing the "basis step-up" for assets held at death.

On the death of the first spouse, many estate plans call for the creation of a trust funded with the maximum amount that can pass free of federal estate tax. The doubling of the federal estate tax exemption could result in a significant (and surprising) state level estate tax. Clients should consider whether a revision to their estate plan is appropriate. The following table reflects how much state estate tax would be due in each state that has an estate tax, assuming death on January 1, 2018 for taxable estates of $11.2 million and $22.4 million.

Effect of State Estate Taxes Based on the New Federal Estate Tax Exemption

Assumes death on January 1, 2018[1]

State	State Estate Tax @ $11.2M Taxable Estate	State Estate Tax @ $22.4M Taxable Estate
CT[2]	$880,200	$2,224,200
HI[3]	-	-
IL	$1,085,172	$2,630,000
MA	$1,258,800	$3,050,800
MD	$1,152,000	$2,944,000
ME[3]	-	-
MN	$1,159,800	$2,939,000
NY	$1,258,800	$3,050,800
OR	$1,294,500	$3,086,500
PA[4]	$504,000	$1,008,000
RI	$1,192,120	$2,984,120
VT	$1,258,800	$3,050,800
WA	$1,495,600	$3,735,600

[1] Some state exemptions are adjusted annually by inflation and those 2018 adjustments may not be reflected in these results.

[2] The Connecticut exemption is set to match the federal exemption amount starting January 1, 2020. Note that Connecticut is the only state that imposes a state level gift tax.

[3] Uses an exemption equal to the federal exemption. Consider whether the state may change its approach in light of the new federal exemptions.

[4] Inheritance tax assuming children are the beneficiaries.

Provisions affecting businesses

Corporate income tax rate. The corporate income tax rate is permanently lowered to 21% beginning in 2018.

AMT. The corporate alternative minimum tax is repealed beginning in 2018.

Pass Through Companies. Individuals, trusts and estates are allowed to deduct 20% of "qualified business income" (as defined in the statute) received from a "pass through" company. S corporations, LLCs, partnerships and sole proprietorships are all examples of pass throughs. At a 37% top federal tax rate, the 20% deduction approximates a 29.6% marginal federal rate, but is subject to many limitations. Only domestic business income qualifies. Deductibility is restricted for taxpayers above $315,000 for married taxpayers filing jointly and $157,500 for individuals (indexed for inflation).

Above these thresholds some of the limitations to this deduction include:

a) The deduction cannot exceed the greater of:
   1. 50% of W-2 wages paid by the qualified business, or
   2. 25% of wages paid plus 2.5% of the unadjusted basis of tangible depreciable assets used in the business. Note: This provision allows real estate business with large capital investments but low wages paid to employees to still take advantage of the deduction.

b) The deduction is not available for "specified service business" including:
   1. Health
   2. Law
   3. Accounting
   4. Actuarial science
   5. Performing arts
   6. Consulting
   7. Athletics
   8. Financial services
   9. Brokerage services
   10. Businesses in which the principal asset is the reputation or skill of one or more of its employees or owners
   11. Businesses involving the performance of services that consist of investing and investment management trading or dealing in securities, partnership interests or commodities

c) Multiple businesses are aggregated and the deduction is allowed against the total net qualified business income.

Qualified business income specifically excludes investment income such as long-term capital gains, dividends, interest income (other than when properly allocable to a trade or business), and amounts received under an annuity contract.

Sunset. The provision affecting pass through entities "sunsets" for tax years beginning in 2026.

As a result of this new deduction for pass throughs on qualified business income, clients should consult with their tax advisors to see if they could take advantage of this provision for their pass through businesses. In addition, clients in states with higher state income tax rates may consider *with their tax advisors whether they should reorganize their business as a C corporation as opposed to an S corporation or other pass through entity. The SALT deduction remains available to C corporations without the limitations imposed on individuals. Any analysis should take into consideration the double taxation of C corporations when making dividends to shareholders, the potential for trapping appreciated property in a corporation, and the sunset provision of the pass through rules under the Act.*

MLPs. Master Limited Partnerships (MLPs) qualify for the tax reduction associated with small businesses and pass through entities under the new law. The tax reform act allows a 20% deduction for qualified business income, and net income from an MLP is deemed qualified business income. At the highest individual tax bracket of 37% (excluding the 3.8% ACA Medicare surcharge), investors owning pass through securities with qualified business income would be eligible for a 29.6% tax rate (excluding 3.8% ACA Medicare surcharge). This reduces the tax rate on an MLP investor's annual pro-rata share of net income.

Annual distributions from MLPs continue to be deemed a return of capital and hence remain tax deferred while an investor's tax basis in the MLP investment is greater than the distribution. After an investor's tax basis is zero, distributions would continue to be deemed either a capital gain or as ordinary income.

At final sale or disposition of the investment, an MLP investor's taxable gain (the difference between the sale price and the tax basis) continues to be a capital gain unless it is treated as ordinary income under the recapture rules. Any amount subject to recapture benefits from the 20% deduction permitted for pass through securities, which reduces the tax rate on recaptured amounts to 29.6% tax rate (excluding 3.8% ACA Medicare surcharge) for the highest individual tax bracket of 37% (excluding the 3.8% ACA Medicare surcharge).

International. The text changes the taxation of foreign based income from a worldwide income system to a territorial based system, including deemed repatriation with tax at 15.5% tax on cash and equivalents and 8% on illiquid assets.

Conclusion

We expect further guidance, additional rules and regulations in 2018 that will help clarify and expand on the framework of the Act. Given that many of the changes made by the Act are effective in 2018, clients should reach out to their tax and legal advisors quickly to understand how the Act impacts their individual situations.

The **Advanced Planning Group** of UBS provides comprehensive planning, advice and education to ultra high net worth individuals and families. The team consists of professionals with advanced degrees, extensive planning experience and various areas of expertise. Through our publications, the Advanced Planning Group features the intellectual capital of UBS in wealth planning, estate tax and philanthropy and evaluates how changes in the legislative and tax landscape might impact our clients' planning.

Our CIO Americas team dives into the market, economic, and investment implications of the new tax bill in the latest POTUS 45 report.

See important notes and disclosures on the next page.

[1] The name of the legislation was amended. It is now "To provide for reconciliation to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

This report is provided for informational and educational purposes only.

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Market fluctuation, account and administrative fees, and other charges will impact the amounts ultimately available for distribution from a donor-advised fund or private foundation.

529 plans are sold via Program Descriptions (sometimes called Program Brochures), which contain detailed information regarding the plan, risks, charges and tax treatment. Clients can obtain a free Program Description of their choice from the investment management company sponsoring a 529 plan or a Financial Advisor. Read the Program Description carefully before investing. 529 college savings plans are issued by individual states. Tax implications, as well as investment choices, of 529 plans may vary significantly from state to state. Most states offer their own tuition programs, which may provide advantages and benefits exclusively for their residents and taxpayers. By contributing to the plan issued by the state in which the client is a resident, clients may gain state, as well as federal, income tax advantages. However, taxes are only one issue to consider. Different 529 plans impose different fees, offer different investment approaches, and have a range of past performance records. Withdrawals not used for higher education costs will trigger state and federal tax as well as withdrawal penalties. The ability to withdraw earnings free of federal taxes may be impacted by changes in the tax exemptions.

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