WRMarketplace

An AALU Washington Report

The WR Marketplace is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone. WR Marketplace #17-50 was written by Shareholders Jonathan M. Forster, Marvin Kirsner, Rick Melnick, Ian A. Herbert, Steven B. Lapidus and Associate Jennifer M. Smith.**

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TOPIC: Decoding Tax Reform: Tax Legislation Headed for Enactment – Initial Insights.

MARKET TREND: With enactment of the tax reform legislation likely just days away, there will be a host of new laws and planning opportunities for advisors and clients to review.

SYNOPSIS: The tax reform legislation (the "Act") is headed to the President to be signed into law. The Act varies from the Senate's recently passed version of the bill, including: (1) lowering the top individual rate from 38.5% to 37%, (2) increasing the corporate tax rate to 21% and repealing the corporate alternative minimum tax ("AMT"), (3) lowering the deduction for business income from pass-through entities from 23% to 20%, and (4) allowing a state and local tax ("SALT") deduction of up to $10,000 for property or income taxes (House's version of the bill only allowed deduction for property). The Act, however, keeps the Senate bill's approach to transfer taxes by doubling the gift/estate and GST tax exemption but it leaves other transfer tax provisions the same. Apart from the permanent adoption of corporate changes and the

use of a "chained" index for making inflation adjustments to indexed tax exemptions, thresholds, and other amounts, almost all other changes will sunset in 2026.

TAKE-AWAYS: The Act will be signed into law by year-end and will have a significant effect on individuals and businesses at all income levels for years to come. The breadth and complexity of the changes will require time to analyze before advisors and clients can fully understand the complete impact of tax reform on planning. Initial insights, however, indicate that there will be continued and unique opportunities for life insurance, legacy, and business succession planning, particularly involving the use of the higher transfer tax exemptions and the tax rules for the treatment of pass-through businesses.

As enactment of the tax reform legislation (the "**Act**") before year-end now appears certain, below is a snapshot of how notable tax provisions of the Act compare to current tax law, and a summary of initial insights into the potential planning implications and recommendations for clients.

SNAPSHOT COMPARISON: NOTABLE PROVISONS

Note that: (1) highlighted areas indicate items of change from prior proposals in the Senate's bill and (2) provisions noted as expiring will revert to current law at the start of the specified year.

INDIVIDUAL TAXES						
Provisions	**Current Law**			**The Act (Expire in 2026)**		
		Single	Married/Joint		Single	Married/Joint
Income Tax Rates & Brackets*	10%	$0-$9,525	$0-$18,650	10%	$0-$9,525	$0-$19,050
	15%	$9,525-$38,700	$18,650-$75,900	12%	$9,525-$38,700	$19,050-$77,400
	25%	$38,700-$93,700	$75,900-$153,100	22%	$38,700-$82,500	$77,400-$165,000
	28%	$93,700-$195,450	$153,100-$233,350	24%	$82,500-$157,500	$165,000-$315,000
	33%	$195,450-$424,950	$233,350-$416,700	32%	$157,500-$200,000	$315,000-$400,000
	35%	$424,950-$426,700	$416,700-$470,700	35%	$200,000-$500,000	$400,000-$600,000

INDIVIDUAL TAXES						
Provisions	**Current Law**			**The Act (Expire in 2026)**		
	39.6%	$426,700 and over	$470,700 and over	37%	$500,000+	$600,000+
Capital Gains Rates	0%, 15%, and 20%			Same as current law		
AMT	On income over certain thresholds (e.g., $54,300 (single) and $84,500 (joint))*			Retained with increased exemptions (e.g., $70,300 (single) and $109,400 (joint)) and phase-outs ($500,000 (single) and $1,000,000 (joint))*		
Business Income from Pass-Through Entities	Taxed at individual income tax rates			**20% deduction** for individuals **and trusts and estates** on domestic "qualified business income" from pass-through entities, subject to various restrictions and limitations. Wages paid to owners and certain income from specified services businesses are excluded from deduction		
Standard Deduction*	$6,350 (single) $12,700 (joint)			$12,000 (single) $24,000 (joint)		
Personal Exemption	$4,050*			$0		
SALT Deduction	Allowed			Allowed for individual state and local taxes up to $10,000, but no 2017 deductions allowed for prepayment of 2018 state and local taxes		
Mortgage Interest	Allowed on total mortgages up to $1 million on a first and/or second home and for interest on up to $100,000 of a home equity line			Allowed on total mortgages of up to $750,000 for a first and/or second home purchased under contracts dated after **Dec. 14, 2017**. Home		

INDIVIDUAL TAXES		
Provisions	**Current Law**	**The Act (Expire in 2026)**
Deduction		loans incurred on or before Dec. 15, 2017 and those under contract before Dec. 15, 2017, scheduled to close before Jan. 1, 2018, and actually closed by Apr. 1, 2018 are grandfathered under the $1 million limit No deduction for interest on home equity credit lines, whether new or existing
Gain on Sale of Principal Residence	Exclusion allowed for gain of up to $250,000 (single) / $500,000 (joint) on sale of a residence used as principal residence for 2 of last 5 years	Same as current law
Charitable Contributions	Charitable cash contribution limit is 50% of adjusted gross income (**AGI**)	Increases AGI limit to 60%
Sales of Stock	For shares purchased at different times/costs, individuals can select which shares to sell first	Same as current law
Individual Mandate	Individuals must have minimum health insurance coverage or pay a penalty	Eliminates the coverage/penalty requirement as of 2019 (does **not** expire in 2026)
Inflation Indexing	Applies the Consumer Price Index for All Urban Consumers (**CPI-U**)	Applies the "chained" CPI-U (**C-CPI-U**) but does **not** expire in 2026

*Subject to annual inflation indexing.

TRANSFER TAXES		
Provision	**Current Law**	**The Act**
Rates	40% top rate (flat rate for GST tax)	Same as current law
Gift/Estate & GST Tax Exemptions	$5 million basic exclusion amount* ($5.49 million in 2017; $5.6 million in 2018) for the unified gift/estate and GST tax exemptions	Doubled basic exclusion amount ($10 million)* starting **2018** ($11.2 million, inflation adjusted). Expires in 2026, when exemptions revert to $5 million, as inflation adjusted from 2010 to 2026
Basis Step Up at Death	Yes	Same as current law (does **not** expire)
Inflation Indexing	CPI-U	C-CPI-U. Does **not** expire in 2026

*Subject to annual inflation indexing.

CORPORATE TAXES		
Provision	**Current Law**	**The Act**
C Corp. Rate	35% max rate (flat rate for personal service corporations (**PSCs**))	21% flat rate (including for PSCs) effective starting **2018.** Does **not** expire in 2026
Corporate AMT	Applied to C corporations	**Repealed**. Does **not** expire in 2026

INITIAL INSIGHTS

The Act makes significant and, in many cases, complex revisions to the tax code that will require in-depth review and analysis to understand their full scope, as well as their potential impact and possibilities for planning. In the coming weeks, AALU will provide additional reports that drill down into these details and planning nuances. With a January 1, 2018 effective date for many changes, however, here are some initial insights on planning.

Estate, Gift, & GST Tax Changes (Until 2026)

- **Doubling of Exemptions.** The Act doubles the "basic exclusion amount" from $5 million to $10 million for gift, estate, and GST tax purposes. This represents the

threshold amount that is then annually adjusted for inflation from a base year of 2010 to determine the applicable exemption amount in each year.[1]

- ***For 2018, the inflation adjusted basic exclusion amount should equal $11.2 million ($22.4 million per married couple***).
- ***On January 1, 2026, the basic exclusion amount will return to $5 million, as indexed for inflation from 2010 to 2026.***

- **Slower Inflation Adjustments**. The Act changes the standard used to make inflation adjustments for various amounts and thresholds, including the basic exclusion amount, to a "chained" index, the C-CPI-U.[2] While difference in growth between the traditional CPI versus the chained CPI is a few tenths of a percentage point, the difference adds up over time. Thus, the change generally will result in slower and smaller inflationary adjustments to indexed amounts, increasing the basic exclusion amount more slowly in the years after 2017. The actual amount of the increase will depend on future inflationary trends.
  - ***Example:*** Using the traditional CPI, the basic exclusion amount has increased roughly by an average 1.7% annually, which would result in an inflation-adjusted exclusion amount of over $6.5 million in 2026 (indexed from 2010). If we assume a 1.5% annual adjustment under the chained CPI, the inflation-adjusted exclusion amount in 2026 would be around $6.3 million, about $200,000 less.
  - ***<u>This change does not sunset</u>***, meaning the chained CPI will remain the standard for inflation adjustments to the basic exclusion amount and other inflation-indexed amounts.
- **Same Rates**. All transfer tax rates remain the same, with a 40% top rate for the gift and estate taxes and a 40% flat rate for the GST tax.
- **Basis Step-Up**. Estate assets will continue to receive a step-up in income tax basis to their fair market value at a decedent's passing.
- **No "Clawback" Likely.** The potential for an increase and then drop in the available federal estate tax exemption has previously raised the issue of "clawback," which arguably results in greater estate tax liability if lifetime gifts are made using a higher unified gift/estate tax exemption, but the donor later dies when the unified gift/estate tax exclusion has decreased.[3] The Act seems to provide a proactive resolution of this issue by giving the IRS authority to prescribe regulations to address any difference between the basic exclusion amount at the time of any gifts by a decedent and the basic exclusion amount at the decedent's death.[4] So it

appears families should not be overly-concerned about using their full lifetime gift tax exemptions before 2026.

- **Planning Considerations:**
  - Although the federal estate tax appears now to apply to a very small percentage of taxpayers (e.g., far less than 1%), legacy and life insurance planning remain critical for most families. There is nothing permanent about these transfer tax changes, as they are set to expire in eight years, if they are not changed in the interim under a different administration. Failing to plan is at a family's peril, since the success of most legacy planning relies on a disciplined long-term approach that hedges against mortality and preserves insurability, both of which are at risk for those who choose to wait.
  - Also remember that families with estates below the federal estate tax exemption but who reside in decoupled states with estate tax exemptions lower than the federal estate tax exemption or who have an inheritance tax can still face state tax exposure, and states with estate exemptions tied to the federal amount may reconsider these provisions due to the potential lost revenue.
    - As of 2018, states with a separate estate tax include Connecticut, D.C., Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington. States that impose an inheritance tax include Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania.
  - Further, tax considerations, alone, should never drive legacy planning, as it also can address critical, practical concerns that many families face, including: (1) centralized wealth management, (2) confidentiality and creditor protection for family members, (3) control of the flow of information and assets to younger beneficiaries, (4) business succession and family governance of shared assets, and (5) asset consolidation to facilitate the transfer of diverse investments among generations without creating fractional ownership.
  - Given the above, irrevocable trust planning will remain important, as trusts provide customizable, multi-purpose planning vehicles that offer control, creditor protection, flexibility, family support, and wealth stewardship over multiple generations. The use of irrevocable trusts also ensures that trust assets remain outside of a taxable estate, as the grantor pays the income tax on trust assets, which is particularly important given the lower exemptions in 2026 and the uncertainty around additional estate tax changes before that time. Trusts that offer lifetime benefits to the donor's spouse (i.e., spousal lifetime access trusts or "**SLATs**") can allow the donor to indirectly benefit from a trust during life, if needed.

- Families whose estates are unlikely to exceed the new exemptions could use the higher gift tax exemption to exit existing planning transactions, such as installment sales to grantor trusts or split-dollar arrangements.

- For families who continue to be affected by the federal estate tax, ***the increased and immediately available gift and GST tax exemptions present an exceptional opportunity to implement substantial lifetime planning over the next few years,*** particularly dynastic planning through trusts and business succession planning for those with concentrated positions in closely-held businesses. The use of large gifts to fund life insurance acquisitions eliminates the administrative hassles of other funding approaches (e.g., annual gifts).

- Making substantial transfers to grantor trusts can provide additional legacy transfer opportunities as the grantor pays the income tax on the trust assets, particularly in high income tax states. The trust assets and the compound growth thereon will still be excluded from the taxable estate when the Act's provisions sunset. Thus, it may make greater sense to lock in the transfer of appreciation from the estate and manage basis through the approaches discussed below rather than retain assets for a basis step-up.

- As basis-step up is still available for assets held by a decedent, however, basis planning will remain critical. For basis management, trusts can provide the trust creator ("**grantor**") with a power to substitute assets of equivalent value for the trust assets. This allows a grantor to decide, based on current economic conditions and family needs, whether to exchange the low basis assets in the trust for higher basis assets. Any assets held by the grantor after exercise of the power would be eligible for a basis step up in the grantor's estate at passing. Additionally, for flexibility, the trust could provide powers of appointment to return the trust assets to the grantor or another individual if that makes greater sense.

- Estate freeze plans that result in minimal or no taxable gifts and rely on current interest rates for their hurdle rates (e.g., the 7520 rate and the applicable federal rate) can still offer legacy planning benefits without eliminating the ability for basis step-up planning at death (e.g., zeroed-out GRATs, installment sales to grantor trusts). These approaches:

    - Take advantage of current low interest rates ***that are on the rise.***
    - ***Transfer only future appreciation,*** returning the initial value of the transferred assets to the grantor (plus growth at the applicable hurdle rate), so the family does not have to permanently part with a significant portion of their wealth.

- Allow clients to ***retain a predictable income stream*** from the transferred asset.
- ***Preserve estate tax exemptions*** for basis step-up planning, if and as needed.

Split-dollar arrangements provide similar benefits and can still make sense for large cases as the arrangements leverage client funds to pay premiums at fairly minimal costs, especially while interest rates remain low.

- Even with tax uncertainty, life insurance will remain prudent for accomplishing multiple legacy plan objectives.
  - Personal cash value life insurance may serve as a vehicle for providing cash accumulation and retirement savings during life, as well as earnings replacement and family security in the event of an untimely death.
  - Life insurance, especially trust-owned, can: (1) minimize family conflicts, (2) allow equalization among active and non-active heirs with regard to a family business, and (3) provide long-term wealth and tax management (e.g., allow for the grantor's substitution of trust assets).
  - Post-tax reform, growth within a life insurance policy during the insured's life and payment of the policy death benefit upon the insured's passing will still not be subject to income or capital gains tax. Further, a policy owner may be able to access cash value through policy loans or withdrawals (up to the owner's basis in the policy) without current income tax (assuming the policy is not a modified endowment contract). If held in an irrevocable trust, the policy death benefits also should remain outside of the insured's taxable estate.
  - Many high cash value life insurance products also can provide diversification in a client's asset allocation, whether held directly or through a trust. For instance, current assumption universal life and whole life products are not directly correlated to stock market performance and typically benefit from a rising interest rate environment. Analyzing a policy's internal rate of return ("**IRR**") relative to life expectancy ("**LE**") for a policy's death benefit, as well as the IRR of the policy cash value (during the insured's life) relative to LE can help demonstrate how life insurance can complement a client's broader asset allocation and investment goals.
  - Accordingly, given the above and the on-going potential for estate tax changes, clients should not be too quick to eliminate their life insurance coverage. Coverage reviews, however, should be conducted to determine

if changes in the type or amount of coverage are needed, or if there are better products to meet the family's goals in light of the new tax laws.

- Most families should revisit their legacy plans to review how changes in the estate and GST tax exemptions could impact their estate distributions, as many plans rely on exemption-based formulas to fund family bequests and trusts. With the enactment of increased exemptions, individuals may want to cap such funding. To address the possibility of further changes in the transfer tax laws, flexibility also should be built into legacy plans, such as: (1) including multiple options in documents regarding distributions, beneficiary powers of appointment, and the apportionment of tax liabilities that are triggered by then-existing tax laws, (2) giving clients powers of substitution over grantor trusts to reacquire low basis assets, (3) including "decanting" provisions that allow trustees to distribute assets to a new trust with different provisions, and (4) using trust protectors to make various discretionary tax elections or trust modifications.

Individual Income Taxes

- **Lower Rates**. While seven brackets remain, all but the lowest rate bracket has been reduced, and the bracket thresholds increased. The top rate will now be 37% for single filers with over $500,000 of income and joint filers with over $600,000 of income.[5]

- **Continued AMT**. High-income earners will still need to deal with the AMT, although with higher exemption and phase-out amounts.[6]

- **Exemptions & Deductions**. The Act doubles the standard deduction for individuals, but it repeals the personal exemption and eliminates or significantly limits most itemized deductions, including notably:[7]

  - ***SALT Deduction***. The Act limits the SALT deduction to an aggregate of $10,000 for (1) property taxes on homes used for personal purposes and (2) either state income or sales taxes.[8] For example, if a taxpayer pays $8,000 in property taxes on her personal residence and $6,000 in state income taxes, the SALT deduction will be limited to $10,000. The SALT limitation does **not** apply to property taxes on real property held for rental or to sales taxes paid in connection with a business, although it does apply to state income taxes paid on income from a business. For example, if an investor owns a rental property and pays $20,000 in property taxes on the property, those property taxes can be deducted, but the state income taxes resulting from this rental business would be subject to the $10,000 overall SALT deduction limitation.

- *Note - No Acceleration of 2018 SALT Deductions*. It will not be possible to take a deduction in 2017 for any prepayment of 2018 state income taxes in 2017, as the Act expressly prohibits such tax planning. However, it may be possible to take a deduction in 2017 for a prepayment of real property taxes if applicable state law provides a mechanism to prepay them.

- ***Home Mortgage Interest***. The home mortgage interest deduction will be allowed for total mortgages of up to $750,000 (down from $1 million) for a first and/or second home purchased under contracts dated after December 14, 2017. Home mortgages incurred on or before December 15, 2017 and those for homes under contract before December 15, 2017, scheduled to close before January 1, 2018, and actually closed on by April 1, 2018 are ***grandfathered under the current loan limit of $1 million***. However, the Act eliminates the deduction for interest on home equity lines of credit, without any grandfathering, so no deduction will be allowed even if the home equity line of credit was in place before December 15, 2017.[9]

    - *Note - Refinancings:* A home mortgage grandfathered under the $1 million limit may be refinanced but only in an amount up to the existing outstanding balance. For example, assume a taxpayer has a grandfathered mortgage with an original face amount of $1,000,000, on which all the interest is deductible. If the homeowner refinances this mortgage when the outstanding principal balance is $900,000, interest would be deductible only on $900,000 of the newly-refinanced amount.

- ***Other Itemized Deduction Changes***. Notably, the Act also:

    - Eliminates all miscellaneous itemized deductions that are subject to the 2% floor (including tax preparation and investment management fees), the deduction for moving expenses (except by Armed Forces members), and the above-the-line deduction for alimony payments for divorce decrees or separation agreements entered into or modified ***on or after January 1, 2019***,[10]

    - Reduces the medical expense deduction floor to 7.5% (from 10%) of AGI and eliminates it as a minimum tax preference beginning after ***December 31, 2016, and ending before Jan. 1, 2019***,[11] and

    - Increases the AGI limitation on charitable cash contributions from 50% to 60%.[12]

- **Planning Considerations:**
  - The combination of significant reductions in income tax rates, retention of the AMT, doubling of the standard deduction, and substantial changes to the availability of itemized deductions requires families and advisors to "run the numbers" to determine whether they should move tax deductions and losses into this year and postpone income into next. For example, should a long-term capital gain on appreciated stock be recognized in 2017 rather than 2018 to be able to deduct the state income tax on the gain by making an estimated payment of the state tax prior to year-end? Also, can and should state and local real property taxes be prepaid in 2017 for the deduction? Checking the numbers will be the only way to make this decision.
  - Many individuals likely will no longer itemize deductions, which may impact the tax advantages of charitable giving after 2017 unless the size of the gift, combined with the other itemized deductions still available under the Act, can generate a greater benefit through itemization as compared to simply taking the increased standard deduction.
  - Making planned charitable gifts before year-end may have additional benefits, since this year's income tax rates will be high relative to the future.
  - Many high-income earners or those who own significant real property, particularly in high income and/or property tax states, may not see substantial tax reductions. These individuals likely will continue to be interested in life insurance for asset allocation or deferred compensation purposes, as the income tax treatment of life insurance remains unchanged, based on long-standing and appropriate tax principles.

Pass-Through Businesses[13]

- **20% Deduction for Qualified Business Income**. The Act allows a 20% deduction for "qualified business income" from a non-excluded trade or business conducted by a sole proprietorship or pass-through entity (partnership, LLC, or S corporation). The deduction will be limited in many cases based on the amount of W-2 wages paid by the business or the tangible depreciable assets owned by the business (as discussed below). If all income is eligible for the 20% deduction, an effective top tax rate of 29.6% would apply to the qualified business income, whether received by an active or passive partner. However, due to the limitations discussed below, many taxpayers will not be eligible for the full 20% deduction, resulting in a top tax rate of greater than 29.6%.
- **Eligible Businesses**. This deduction is generally **not** allowed for specified businesses, defined as health, law, accounting, actuarial science, performing arts,

consulting, athletics, financial services, brokerage services, or any business where the principal asset is the reputation or skill of one or more of its employees, although owners of architecture and engineering firms **<u>would be eligible</u>** for the 20% deduction. However, the 20% deduction would be available to an owner of such a personal services business whose entire taxable income (including taxable income from the pass-through business) is less than $157,500 (single filer) or $315,000 (married, joint filer). The benefit is phased out completely once the taxable income exceeds $207,500 (single filer) or $415,000 (married joint filer).

- **Non-Qualified Income**. Several types of income from a business are **<u>not</u>** eligible for the 20% deduction, including: (1) reasonable compensation paid to a subchapter S shareholder of the business, guaranteed payments to a partner in the business, and any payment to a partner other than in his capacity as a partner for services rendered with respect to the business, (2) income from a business outside of the U.S. or Puerto Rico (unless the income is effectively connected with a U.S. trade or business), (3) net long-term capital gains, (4) dividends (except REIT dividends), (5) interest from investments, (5) gains from trading commodities, foreign currency transactions, or notional principal contracts, and (7) amounts received from an annuity.

- **Wage/Asset Limitations on Deduction**. The 20% deduction will be limited by the greater of: (1) 50% of W-2 wages paid by the business, or (2) 25% of W-2 wages plus 2.5% of the unadjusted basis of tangible depreciable assets ("**TD assets**") used by the business and which were placed in service within the depreciable period for such assets, or, if greater, 10 years.

    - ***Example***: If the eligible income from the business is $500,000, the 20% deduction would be $100,000. However, if the business has paid only $150,000 in W-2 wages and has no TD assets, then the deductible amount would be limited to $75,000 (50% of the W-2 wages).

  For purposes of this test, only wages timely reported by the business on a Form W-2 are eligible; ***compensation reported on a Form 1099 does not count***. Further, if compensation was reported on a Form 1099, the business can only change to W-2 reporting for this compensation if it files an ***amended information return within 60 days of the original deadline*** for filing these returns. In calculating the 2.5% TD assets limitation, the unadjusted basis of the TD assets are taken into account, meaning that the assets are not reduced for depreciation for this test.

    - ***Example***: Assume the business purchased computer equipment used in the business nine years ago for $1 million. Although the basis of the equipment has been depreciated to $0, the amount taken into account for the 2.5% TD assets test would still be $1 million (the unadjusted basis of the equipment). If, however, the computer equipment was placed into service 11 years earlier

(assuming a five-year depreciable life), the amount for TD asset purposes would be $0, because the equipment was used after the depreciable period expired.

Note that the wage/TD asset limitation does **not** apply to an individual business owner with taxable income of less than $157,500 (single filer) or $315,000 (married, joint filer). This limitation is fully phased-in in full for an owner with taxable income of $207,500 (single filer) or $415,000 (married joint filer).

Since the deduction is taken by the owners and not the business entity, the statute provides that a pass through entity's W-2 wages and unadjusted basis of TD assets must be allocated to the owners. The statute prescribes the following methods of allocation:

- W-2 wages and unadjusted basis of TD assets held by an S corporation are allocated to the shareholders in proportion to their stock ownership.

- In a partnership or LLC, W-2 wages are allocated to the owners in proportion to the way in which the entity agreement allocates such wages among owners, and the unadjusted basis of TD assets is allocated to them in proportion to the way in which the entity agreement allocates depreciation among owners.

- **Trusts & Estates**. Trusts and estates who are owners in pass-through businesses may take advantage of the 20% deduction (not allowed under the prior Senate Bill).

- **Planning Considerations**.

  - Pass-through business owners and their advisors will need to carefully review the business' organization as a pass-through entity to determine how the wage and TD asset limits impact their business, as well as perform a numerical analysis of the tax treatment of the owners as the holder of a pass-through business versus a C corporation, given the reduced C corporation rates. While the 20% deduction for pass-through business income should lower the overall effective tax rate to the business owner, the numerous limitations and phase-outs can constrain the actual reduction, and the deduction sunsets in 2026.

  - On the other hand, while the corporate rate is permanently reduced to 21%, corporate shareholders must pay a second level of individual taxes on dividends received from the C corporation. Further, a pass-through typically offers a more flexible structure for making distributions or selling the business. So business owners must navigate these new rules carefully and proceed cautiously before making significant changes to their business operations and organizations.

- Most high-income service professionals organized in pass-through entities (e.g., lawyers, doctors, accountants) may not see significant benefits from this deduction. Life insurance should continue to appeal to these professionals for both deferred compensation and retirement planning.

Reportable Sales of Life Insurance Policies[14]

- **Life Settlement Transactions.** In a life settlement transaction, a life insurance policy owner sells the policy to a third party who is willing to pay more for the insurance policy than the issuing insurance company is willing to offer as a cash surrender value. For example, the health or financial circumstances of a policy owner may have changed so that the death benefit is on longer needed, and a third party may find more value in the policy.

  Life settlement transactions do trigger transfer for value rules that subject the new owner of the policy to tax on a portion of the death benefit. However, the IRS has had difficulty tracking these transactions, as the purchase and change in ownership are not reportable events.

- **Reportable Policy Sale.** To address this issue, the Act defines a "reportable policy sale" as the acquisition of any direct or indirect interest in a policy when the acquirer has no substantial family, business, or financial relationship with the insured apart from the policy purchase (also includes the purchase of an interest in a partnership, trust, or other entity holding the policy).

- **Reporting Requirements.** For reportable policy sales:

  - The buyer must report to the IRS, each seller, and the issuing carrier: (1) the name, address, and tax identification number ("**TIN**") of the buyer and any recipient of sale payments ("**seller**"); (2) the sale date, (3) the name of the issuing carrier and the policy number, and (4) each payment amount (the carrier does not need to be provided with this information).

  - Upon receipt of the buyer's statement above, the issuing carrier must report to the IRS and each seller (1) the name, address, and TIN of the seller, (2) the seller's investment in the contract (policy basis), and (3) the policy number.

- **No Exceptions for Transfer for Value (TFV).** The TFV rule taxes otherwise non-taxable death benefits paid under a policy transferred for value (e.g., sold by the initial insured/owner) to the extent those proceeds exceed the purchaser's basis in the policy (i.e., consideration and subsequent premiums paid by the purchaser). Under the Act, ***a reportable policy sale will no longer qualify for any exception to the TFV rule***, meaning a portion of the policy death benefits will likely be subject to tax. However, the Act provides that the purchaser's basis in the

policy will not be reduced by the cost of insurance, a departure from the IRS's current position in Rev. Rul. 2009-13.

- **Planning Considerations.**
  - AALU is aware of several questions about the potential secondary impacts of this provision. We are working to clarify these finer points. We will follow-up with a detailed piece on this issue in January—if you have questions, please call us: 202.742.4638.

Executive Compensation/Retirement Benefits

- **Deduction for Excessive Remuneration.**[15] The Act repeals the exceptions for commissions and performance-based compensation from the $1 million yearly limit on the deduction for compensation with respect to a covered employee of a publicly traded corporation. A "covered employee" includes the CEO, CFO, and the three highest paid employees of the corporation.

- **IRA Conversions**. The ability of individuals to recharacterize a conversion of a traditional IRA to a Roth IRA goes away after 2017.[16]

- **Planning Considerations:**
  - ***Ensure Deductibility of Performance-Based Compensation Paid to Covered Employees in 2017*.** Public companies should ensure they have taken all actions necessary to accrue the liability for the payment of performance-based compensation to be paid for 2017.
  - ***Review IRA Conversion Planning*.** Any desired recharacterization of a prior conversion to a Roth IRA back to a traditional IRA ***needs to be done before year-end***. With the lowering of tax rates under the Act, the desirability of a Roth IRA may be diminished, so a recharacterization may be suggested, particularly for older individuals.

TAKE-AWAYS

It appears almost certain that the Act will be signed into law by year-end, and will have a significant effect on individuals and businesses at all income levels for years to come. The breadth and complexity of the changes will require time to analyze before advisors and clients can fully understand the complete impact of reform on planning. Initial impressions, however, indicate that there will be continued and unique opportunities for life insurance, legacy, and business succession planning, particularly involving the use of the higher transfer tax exemptions and the tax rules for the treatment of pass-through and other closely-held businesses.

NOTES

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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[1] Act §11061.
[2] Act §§11061, 11002.
[3] The issue arises due to the fact that determination of the federal estate tax involves a technical calculation that includes gifts in the tentative taxable estate, and then provide a credit for the amount of gift tax that would have been payable with respect to gifts if the rate schedule in effect at the decedent's death had been applicable at the time of the gifts. The applicable statutes do not say whether to use the gift credit amount that applied at the time of
the gift or at the time of death — and this is what leads to the uncertainty according to some commentators. The resolution would likely specify both the tax rates and the credit amount that should be used in the calculation, if the exclusion amounts differ between the time of the gifts and the time of death.
[4] The applicable section of §11061 of the Act specifically reads as follows: "MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS" - The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out [the section increasing the basic exclusion amount] with respect to any difference between (A) the basic exclusion amount under [IRC] section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.''
[5] Act §11001.
[6] Act §12003.
[7] See Act §§11021,11041.
[8] Act §11042.
[9] Act §11043.
[10] Act §§11045, 11027, and 11051.
[11] Act §11027
[12] Act §11023.
[13] Act §11011.
[14] Act §§13520, 13521, 13522.
[15] Act §13601.
[16] Act §13611.