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2017 New Tax Law: Individual Tax Reform

*This client alert is part of a special series on the Tax Cuts and Jobs Act and related changes to the tax code, where Blank Rome's lawyers share their analysis of different provisions in the Act and how they may affect you and your business, along with specific action items. To see the full list of client alerts in this series, please click **here**.*

On December 20, 2017, Congress passed its comprehensive tax reform bill, the Tax Cuts and Jobs Act ("the Act" or "the Bill"), which was signed into law by President Trump on December 22, 2017. The Bill represents one of the most extensive modifications to the U.S. tax code in recent history, significantly modifying U.S. taxation for individuals and businesses. Most provisions in the Bill took effect on January 1, 2018.

SALT DEDUCTION LIMITATION

One of the more controversial and hotly-contested elements of the Act is the $10,000 cap on the state and local tax ("SALT") deduction. Common SALT deductions include state and local income taxes paid by individuals, as well as local real estate taxes, and state and local sales and use taxes. Prior to the Act, SALT deductions were not capped, which was thought to benefit individuals residing in high-taxing jurisdictions. However, although the SALT deduction was allowed for purposes of calculating the regular tax liability, SALT deductions were not permitted for purposes of calculating the alternative minimum tax (the "AMT"). As a consequence, taxpayers with significant SALT deductions often found themselves required to pay AMT, negating the benefit of their SALT deduction.

In addition to the cap on the SALT deduction, the Bill increases the standard deduction from $6,350 for individuals and $12,700 for married couples filing jointly, to $12,000 for individuals and $24,000 for married couples filing jointly. Because the increased standard deduction exceeds the SALT deduction limitation, many individual filers may no longer need to itemize their deductions at all. The combined impact of the cap on SALT deductions and the increase in the standard deduction means that the SALT deduction benefit is capped at $3,700 (i.e., the highest federal income tax rate of 37 percent multiplied by the SALT deduction cap of $10,000). With this new cap, taxpayers are now, more than ever, focused on ways to reduce their SALT exposure.

Taxpayers in high tax jurisdictions with portable occupations may be tempted to move to low-tax or no-tax jurisdictions, such as Florida or Texas. Taxpayers with such lofty ambitions, however, may be disappointed to learn that high tax jurisdictions, such as California and New York, do not make it easy to move a tax domicile. Those states generally will require both physical and mental manifestations of an intention to move, and will require something more than a Florida summer home. The analysis of domicile often turns on where the taxpayer's family, business, home, and other

relationships reside, and whether the taxpayer planned on making a permanent move to another domicile. Careful planning is necessary to ensure that a taxpayer's move to a low-tax or no-tax jurisdiction will be respected as a change of tax domicile.

The Act provides various opportunities for taxpayers to reduce their total tax burden. Taxpayers with children in private school looking for a tried and true way to reduce their SALT burden may consider the Act's expansion of Section 529 plans. Many states offer a state income tax deduction for contributions made to Section 529 plans, which are education savings plans that, prior to the Act, were only permitted to be used to pay for college and post-graduate educations. The Act now allow taxpayers to use Section 529 savings plans to pay up to $10,000 per year, per student, in K-12 expenses.

Taxpayers with genuine charitable intentions may also take advantage of those state tax credit programs, similar to those considered in a non-binding IRS Chief Counsel Memorandum (CCM 201105010) (the "CCM"), which provide a state tax credit incentive for making charitable contributions. For reasons described in more detail below, it is important that these state tax credit programs have been established well in advance of the Act, rather than those programs established in direct response to the Act.

Finally, taxpayers with businesses that are operated through a pass-through entity may consider converting to a C corporation, especially given the fact that corporate income tax rates have been substantially reduced under the Act from the highest rate of 35 percent, to a flat rate of 21 percent. In addition to the lower corporate income tax rate, corporations are not subject to the same cap on SALT deductions as individuals (including individuals who operate businesses through pass-through entities). The incentive to operate a business through a C corporation may be further enhanced for taxpayers who own service businesses and are not eligible for the new 20 percent deduction on pass-through income.

STATE'S ATTEMPTS AT A SALT CAP WORKAROUND

With the federal government no longer subsidizing SALT rates via a full federal income tax deduction, high-tax states and localities are formulating strategies to ease the SALT burden of their citizens while maintaining SALT revenue neutrality. States such as California and New York view this as imperative as they otherwise risk losing many high-income taxpayers.

In New York, the New York Department of Taxation and Finance presented Governor Cuomo with a 37-page report detailing a plethora of these SALT cap mitigation strategies. One strategy that has been proposed is to increase the New York payroll tax for employers, while providing a complementary wage tax credit to New York employees. There are legitimate questions as to whether such plan would result in unintended consequences from a macroeconomic perspective, and state legislators may find such a plan to be too risky to implement.

In California, Senate leader Kevin de León introduced legislation to allow Californians to make a charitable donation to a state-controlled fund—the California Excellence Fund—in exchange for a dollar-for-dollar state tax credit. Charitable contributions are not subject to any cap, and the plan, in effect, would permit taxpayers to trade their SALT deduction subject to a cap, for a charitable contribution deduction without a cap. The California plan is an interesting, although not necessarily novel, idea, as there are several examples of states offering a state tax credit for a charitable contribution.

But, given the spirit of the Act, de León's plan is likely to face significant challenge from the IRS (the "Service") if it were ever implemented, and courts, despite the court holdings cited in the CCM, may be more critical of plans, such as de León's that are implemented in spite of the Act, rather than for legitimate charitable purposes. The crux of the Service's argument would most certainly be that (1) a charitable contribution in exchange for a state tax credit constitutes a quid pro quo, and (2) a taxpayer does not have the requisite donative intention to categorize their contribution as a charitable one. The fact that the California Excellence Fund would likely be administered by the California government deteriorates the optics of the structure as well, as the flow of cash ends up being circular, with no economic effect to either the State or the individuals, except that the individual obtains a greater federal income tax benefit.

Without further clarity, it is difficult for taxpayers to feel comfortable that the service and courts will respect their claiming of a charitable contribution in this type of structure. Taxpayers may be better off at this point considering other strategies to minimize their SALT liability. However,

one important note is that the Bill is replete with unclear provisions and it is unlikely that the service, given its lack of resources, will be in a position to issue Treasury Regulations any time soon or to litigate debatable positions under the present text of the Bill. Therefore, 2018 may indeed be the year in which individual taxpayers decide to be aggressive with their tax planning and positions.

OTHER PERSONAL INCOME TAX CHANGES TO NOTE

In addition to the controversial SALT cap previously discussed, individuals should note that a variety of other changes that were made to the personal income tax laws, many of which are favorable to taxpayers and most of which are currently scheduled to sunset at the end of 2025. First, the Act maintained seven tax brackets, but modified the income subject to each bracket, and lowered the highest marginal tax rate to 37 percent. As a result, it is expected that the effect will be an overall reduction in personal income tax rates.

The Act retained favorable tax rates on dividends and capital gains, and both increased and expanded the child tax credit to a broader set of higher income taxpayers who previously would have been "phased-out" from being able to take such credit. The Act made modifications to the AMT by increasing the AMT exemption amount (which, in turn, reduces the number of taxpayers subject to AMT and mitigates the AMT impact for many taxpayers). Another significant change impacting taxpayers who are invested in pass-through entities provides that taxpayers may receive a 20 percent tax deduction on certain allocated business income (but such deduction does not apply to service-centric businesses like medical practices, law firms and accounting firms).

Republican lawmakers, however, needed to offset these tax favorable changes in order to ensure the Bill would pass through budget reconciliation, without the threat of a Democrat filibuster. For example, the Bill provides that mortgage interest can only be taken on mortgage debt of up to $750,000, rather than the previous cap of one million dollars, and interest on home equity lines are no longer deductible. In addition, the cap on the SALT deduction discussed above is a significant revenue raiser for the Bill, and the personal exemption has been repealed. While not a huge revenue raiser ($6.9 billion over 10 years, per an estimate by the Joint Committee on Taxation), the Bill's elimination of the deduction for alimony paid and corresponding income inclusion for divorces or separation agreements executed after December 31, 2018, is a significant shift in personal income tax considerations surrounding divorces and separations.

Finally, the Bill scaled back the ability to enter into so-called "like-kind" exchanges under Section 1031 of the Internal Revenue Code, which allowed taxpayers to exchange all types of property for similar, "like-kind," property on a tax-deferred basis. Historically, many high net worth individuals would use these provisions to exchange high value artwork for other high value artwork on a tax-deferred basis. These types of exchanges are now taxable, as under the Bill only real estate is eligible for a like-kind exchange.

There are several other notable provisions of the Bill that may affect a taxpayer's personal income taxes. Individuals are urged to consult with a tax advisor to understand the full scope of the Bill's impact on their personal situation.

Clients who would like more information about their specific circumstances should contact a member of Blank Rome's Tax, Benefits, and Private Client practice group.

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