



303 East Seventeenth Avenue Suite 600
Denver, Colorado 80203
Phone: (303) 830-1120
Fax: (303) 830-8130

MEMORANDUM

To	Michael Rothenberg	Date	1/16/18
Re	Tax Reform	From	Scott Grimm & Bryan Adam

Through the passage of the Tax Act in December of 2017 there was sweeping changes to the tax code which will impact nearly every taxpayer in the US. We have summarized a few that will likely have the biggest impact to your investors.

The following items directly relate to your limited partners investment(s):

- For tax years beginning after December 31, 2017, partners and shareholders of S corporations and LLCs may deduct up to 20 percent of their qualified business income from the partnership or S Corporation. For taxpayers in a service business (e.g., law or accounting), no deduction is permitted unless their taxable income is less than \$157,500 (\$315,000 if married filing a joint return).
 - ***Passive investors will be entitled to a 20% deduction from their earnings through their investments in the R&R properties.***
- Taxpayers are eligible to take 100% bonus depreciation on qualified assets placed in service.
 - ***To the extent that there are qualified improvements at any of the properties there would be immediate expensing.***

The Individual tax reform items below do not directly relate to their investment(s), but could be of interest to their personal tax situation.

- The top individual rate will be 37 percent for joint filers with more than \$600,000 of taxable income and single filers with more than \$500,000 of taxable income. The current top rate is 39.6 percent for joint filers with taxable income over \$466,951 and single filers with taxable income over \$415,051.
- The standard deduction will be increased to \$24,000 for joint filers and \$12,000 for single filers. The personal exemption is repealed through 2025.
- The adjusted gross income limitation for cash contributions to certain charitable organizations is increased to 60 percent.
- The itemized deduction for medical expenses is made more available for taxpayers under age 65 by reducing the adjusted gross income floor for 2017 and 2018 to 7.5 percent for all taxpayers.
- The itemized deduction for state and local taxes has been limited to \$10,000 for the aggregate sum of real property taxes, personal property taxes, and either (i) state or local income taxes or (ii) state and local sales tax.
- The itemized deduction for mortgage interest has been reduced to only permit the deduction of interest on acquisition indebtedness not exceeding \$750,000. The additional interest deduction for home equity indebtedness is repealed through 2025.



- All miscellaneous itemized deductions subject to the two percent adjusted gross income floor have been repealed through 2025. This includes the miscellaneous itemized deductions for investment fees and expenses, tax preparation fees, and unreimbursed
- The lifetime exemption for estate and gift taxes is increased to \$10,000,000 as of 2011 (and adjusted forward from there for inflation). As a result, taxpayers making gifts, and the estates of decedents dying, in 2018 would have a roughly \$11,000,000 basic exclusion amount.
- The individual alternative minimum tax (AMT) has been retained with higher exemption amounts having been increased to \$109,400 for joint filers and \$70,300 for single filers.

A handwritten signature in blue ink, appearing to read 'Scott P. Grimm'.

Scott P. Grimm
Tax Partner
Anton Collins Mitchell LLP
Direct: 303.318.6657
Cell: 509.251.4597
E-mail: sgrimm@acmllp.com

A handwritten signature in blue ink, appearing to read 'Bryan Adam'.

Bryan Adam
Tax Partner
Anton Collins Mitchell LLP
Direct: 303.318.6620
Cell: 303.204.8301
E-mail: badam@acmllp.com

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Individual Taxes

The conference report includes a reduction of individual rates, which are generally effective January 1, 2018, and expire December 31, 2025. For individuals:

- ▶ The top individual rate will be 37 percent for joint filers with more than \$600,000 of taxable income and single filers with more than \$500,000 of taxable income. The current top rate is 39.6 percent for joint filers with taxable income over \$466,951 and single filers with taxable income over \$415,051.
- ▶ The standard deduction will be increased to \$24,000 for joint filers and \$12,000 for single filers. The personal exemption is repealed through 2025. Currently, the standard exemption is \$12,600 for joint filers and \$6,300 for single filers.
- ▶ The Child Tax Credit is increased to \$2,000 per qualifying child, with up to \$1,400 being fully refundable. An additional \$500 credit may be available for other dependents. The Credit begins to phase out for joint filers with adjusted gross income exceeding \$400,000 and single filers with adjusted gross income exceeding \$200,000. Currently, the Child Tax Credit is \$1,000 per qualifying child and is nonrefundable. The Child Tax Credit currently phases out for joint filers with adjusted gross income exceeding \$110,000.
- ▶ The adjusted gross income limitation for cash contributions to certain charitable organizations is increased to 60 percent. Currently, the adjusted gross income limitation for cash contributions to public charities is 50 percent.
- ▶ The itemized deduction for medical expenses is made more available for taxpayers under age 65 by reducing the adjusted gross income floor for 2017 and 2018 to 7.5 percent for all taxpayers. Currently, the adjusted gross income floor is 10 percent for taxpayers under age 65 and 7.5 percent for taxpayers over age 65.
- ▶ The itemized deduction for state and local taxes has been limited to \$10,000 for the aggregate sum of real property taxes, personal property taxes, and either (i) state or local income taxes or (ii) state and local sales tax. Currently, each of those state and local taxes is a separate itemized deduction with no limitation. Further, the bill prohibits a deduction in excess of the \$10,000 limitation for 2018 state and local taxes actually paid in 2017.
- ▶ The itemized deduction for mortgage interest has been reduced to only permit the deduction of interest on acquisition indebtedness not exceeding \$750,000. The additional interest deduction for home equity indebtedness is repealed through 2025. Currently, taxpayers can take a combined acquisition and home equity indebtedness interest expense deduction on \$1,100,000 of debt. Debt incurred on or before December 15, 2017, is grandfathered in to the current limitations. Further, taxpayers who entered into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchase such residence before April 1, 2018, are also eligible for the current higher limitations.
- ▶ All miscellaneous itemized deductions subject to the two percent adjusted gross income floor have been repealed through 2025. This includes the miscellaneous itemized deductions for investment fees and expenses, tax preparation fees, and unreimbursed employee business expenses among others.
- ▶ The overall limitation on itemized deductions enacted in 1990, often called the "Pease limitation" (named after former Congressman Donald Pease) has been repealed through 2025.
- ▶ For any divorce or separation agreements entered into after December 31, 2018, the deduction for alimony or separate maintenance payments is repealed. Recipients of alimony or separate maintenance payments will no longer be required to include the alimony payments in their gross income. Under the new provisions, alimony or separate maintenance payments will be treated similar to child support, in that they are not accounted for in the tax system (no deduction and no inclusion). Existing alimony and separate maintenance agreements are grandfathered in as are any modifications to existing agreements unless, however, the parties to a modification expressly provide that the new rules should apply to the modified agreement.
- ▶ Prenuptial agreements are not grandfathered in and taxpayers may wish to revisit those agreements in light of these new provisions.
- ▶ The lifetime exemption for estate and gift taxes is increased to \$10,000,000 as of 2011 (and adjusted forward from there for inflation). As a result, taxpayers making gifts, and the estates of decedents dying, in 2018 would have a roughly \$11,000,000 basic exclusion amount. (Estate, gift, and generation-skipping transfer taxes are not repealed; the House bill would have repealed estate and generation-skipping transfer taxes.)

- ▶ The shared responsibility payment for individuals failing to maintain minimum essential health insurance coverage has been reduced to \$0 beginning after December 31, 2018.
- ▶ The individual alternative minimum tax (AMT) has been retained. However, the exemption amounts have been increased to \$109,400 for joint filers and \$70,300 for single filers. The current exemptions are \$83,800 and \$53,900 for joint and single filers, respectively. (The House bill would have repealed the individual AMT.)
- ▶ The earlier Senate proposal to require the basis of specified securities be determined on a first-in, first-out basis is not included in the conference report. The Senate had sought to prevent taxpayers from specifically identifying the lot sold in the sale of specified securities.

Corporate tax

For corporations:

- ▶ The corporate tax rate has been reduced by forty percent—from thirty-five to twenty-one percent. The corporate AMT has been repealed. The net interest deduction limit has been kept at 30 percent of adjusted taxable income with an indefinite carryforward period. Small businesses with less than \$25 million in annual gross receipts over a three-year period are exempted from the interest limitation. While the conference agreement does repeal the section 199 domestic production deduction, the effective date of the repeal is not until December 31, 2018.
- ▶ Net operating losses (NOLs) are limited to 80 percent of taxable income and may only be carried forward, indefinitely. NOLs are likely to increase based on expanded expensing of capital investments in certain property – including property that had previously been used by, and provided benefit to, another taxpayer. The property must be placed in service between September 27, 2017, and January 1, 2023, to be fully deducted. The 100-percent allowance is phased down by 20 percent per year beginning in 2023.
- ▶ Certain capital contributions from state and local governments will no longer be excluded from income under section 118. Section 108(e)(6), however, will not be altered for computations of cancellation of debt income. And the meaningless gesture doctrine will continue to apply to section 351 exchanges of wholly-owned corporations in which no shares are issued. Like-kind exchanges under section 1031 will be limited to real property. The 70 and 80 percent dividend received deduction amounts for corporations have been reduced to 50 and 65 percent, respectively.
- ▶ Under the conference report, shareholders of S corporations may obtain a deduction equal to the lesser of 20 percent of qualified business income, which requires a complex computation, with respect to such trade or business, or 50 percent of the W-2 wages with respect to such business. Further, a nonresident alien individual may now be an indirect shareholder of an S corporation as a potential current beneficiary of an electing small business trust.

Taxation of Partnerships and Pass Through Entities

- ▶ For tax years beginning after December 31, 2017, partners and shareholders of S corporations and LLCs may deduct up to 20 percent of their qualified business income from the partnership or S Corporation. For taxpayers in a service business (e.g., law or accounting), no deduction is permitted unless their taxable income is less than \$157,500 (\$315,000 if married filing a joint return).
- ▶ Under the conference agreement, application of Section 1031 is limited to transactions involving the exchange of real property that is not held primarily for sale. The like-kind exchange rules will no longer apply to any other property, including personal property that is associated with real property. This provision will be effective for exchanges completed after December 31, 2017. However, if the taxpayer has started a forward or reverse deferred exchange prior to December 31, 2017, section 1031 may still be applied to the transaction even though completed after December 31, 2017.
- ▶ The technical termination rules under section 708(b)(1)(B) are repealed for tax years beginning after 2017. No changes are made to the actual termination rules under section 708(b)(1)(A).
- ▶ Under general rules, gain recognized by a partnership upon disposition of a capital asset held for at least one year is characterized as long-term capital gain. Further, the sale of a partnership interest held for at least one year will generate long-term capital gain, except to the extent section 751(a) applies. Under the conference agreement, long-term capital gain will only be available with respect to "applicable partnership interests" to the extent the capital asset giving rise to the gain has been held for at least three years.

International Tax

The conference report contains provisions relating to the establishment of a participation exemption for the taxation of foreign income. These new rules include:

- ▶ A dividend exemption system, which generally provides for a 100 percent dividend received deduction for the foreign-sourced portion of dividends received by a domestic C corporation (other than a RIC or REIT) from specified 10-percent owned foreign corporations with respect to which the domestic corporation is a U.S. shareholder when certain conditions are satisfied;
- ▶ Sales or transfers involving specified 10-percent owned foreign corporations (including rules relating to (a) limiting losses on certain sales or exchanges of such foreign corporations in situations involving a domestic corporation eligible for the dividends received deduction; (b) treating as a dividend for purposes of applying the participation exemption any amount received by a domestic corporation which is treated as a dividend for purposes of section 1248 in the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more; (c) the interaction of section 964(e), the subpart F rules and the participation exemption in the case of certain sales by a CFC of a lower-tier CFC; (d) requiring branch loss recapture in certain cases when substantially all of the assets of a foreign branch are transferred by a domestic corporation to specified 10-percent owned foreign corporations with respect to which the domestic corporation is a U.S. shareholder subject to certain limitations; and (e) the repeal of the foreign active trade or business exception under section 367(a));
- ▶ An election to increase percentage of domestic taxable income offset by overall domestic loss treated as foreign source (modifies section 904(g)); and
- ▶ A transition tax generally requiring U.S. shareholders of "specified foreign corporations" (as specifically defined in section 965) to include as subpart F income their pro rata shares of deferred foreign income of such foreign corporations. The total deduction from the amount of the section 951 inclusion is the amount necessary to result in a 15.5-percent rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and eight percent rate of tax on all other earnings. The calculation is based on the highest rate of tax applicable to corporations in the taxable year of inclusion, even if the U.S. shareholder is an individual. There are numerous rules relating to the application of the transition tax (e.g., rules for allowing a reduction of the amount included in income of a U.S. shareholder when there are specified foreign corporations with deficits in earnings and profits). There is an election to pay the liability relating to the

inclusion in eight installments at certain specified percentages along with a special election for S corporation shareholders to defer the payment of the liability until certain events. Additionally, the IRS has regulatory authority to carry out the intent of the provision, including the ability to prescribe rules or guidance in order to deter tax avoidance through use of entity classification elections and accounting method changes, or otherwise.

- ▶ There are provisions in the conference report that provide for a deduction for domestic C corporations (that are not RICs or REITs) for certain specified percentages of foreign-derived intangible income of the domestic corporation and global intangible low-taxed income which is included in income of such domestic corporation subject to certain limitations (this provision generally follows the Senate amendment with certain clarifications and modifications).

The conference report also modifies the foreign tax credit system in several ways, including:

- ▶ Repealing the section 902 indirect foreign tax credit and providing for the determination of the section 960 credit on a current year basis (the conference report generally follows the House bill with certain modifications);
- ▶ Sourcing income from the sales of inventory solely on the basis of production activities; and
- ▶ Providing a separate foreign tax credit limitation basket for foreign branch income.

Additionally, the conference report includes a number of significant modifications to the CFC subpart F rules including:

- ▶ The repeal of an inclusion based on the withdrawal of previously excluded subpart F income from qualified investment;
- ▶ The elimination of an inclusion of foreign base company oil-related income;
- ▶ The modification of the stock attribution rules for determining status of a foreign corporation as a CFC (this modification would make it more likely for a foreign corporation to be treated as a CFC as a result of stock of certain related foreign persons being attributed downward to a U.S. person);
- ▶ The modification of the definition of U.S. shareholder by incorporating a 10 percent value test in determining who is a U.S. shareholder (thus, making it more likely for a person to be a U.S. shareholder and a foreign corporation to be a CFC);
- ▶ The elimination of the requirement that a corporation be a CFC for 30 days before subpart F inclusions apply; and

- ▶ A provision providing that a U.S. shareholder of any CFC must include in gross income for a taxable year its “global intangible low-taxed income” in a manner generally similar to inclusions of subpart F income (complex calculation). The Conference Report generally adopts the Senate amendment with clarifications and modifications).

Moreover, the conference report includes a number of provisions designed to address base erosion, including rules relating to:

- ▶ Providing for a base erosion minimum tax, which requires certain corporations to pay additional corporate tax in situations where such corporations have certain “base erosion payments” and certain threshold conditions are satisfied (the conference report follows the Senate amendment with certain modifications);
- ▶ Limiting income shifting through intangible property transfers (including treating goodwill and going concern value and workforce in place as section 936(h)(3)(B) intangibles and, with respect to aggregate basis valuation, requiring the use of that method of valuation in the case of transfers of multiple intangible properties in one or more related transactions if the Secretary determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach.);
- ▶ Disallowing a deduction for certain related party interest or royalty payments paid or accrued in certain hybrid transactions or with certain hybrid entities under certain circumstances. The conference report generally follows the Senate amendment, but provides that the Secretary shall issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision for branches (domestic or foreign) and domestic entities, even if such branches or entities do not meet the statutory definition of a hybrid entity; and
- ▶ Not permitting shareholders of surrogate foreign corporations to be eligible for reduced rates on dividends under section 1(h). The conference report follows the Senate amendment with a modification providing that the provision applies to dividends received from foreign corporations that first become surrogate foreign corporations after date of enactment.

The conference report also contains rules relating to:

- ▶ Restricting the insurance business exception to the PFIC rules;
- ▶ Repealing the fair market value method of interest expense apportionment; and
- ▶ Codifying Rev. Rul. 91-32 and providing withholding rules relating to a foreign person’s sale of a partnership interest where the partnership engages in a U.S. trade or business.

Some notable provisions that were included in the House bill, Senate amendment, or both, that were not included in the conference report include (but are not limited to) the following provisions relating to:

- ▶ Excepting domestic corporations that are U.S. shareholders in CFCs from the application of section 956;
- ▶ Generally permitting transfers of intangible property from controlled foreign corporations to United States shareholders in a tax efficient manner;
- ▶ Accelerating the election to allocate interest, etc., on a worldwide basis;
- ▶ An inflation adjustment of de minimis exception for foreign base company income;
- ▶ Making permanent the controlled foreign corporation look-thru rule of section 954(c)(6);
- ▶ Current year inclusion of foreign high return amounts by United States shareholders of controlled foreign corporations (but see provision relating to “global intangible low-taxed income” provision discussed above),
- ▶ Limiting deductions of interest by domestic corporations which are members of an international financial reporting group (House Bill) or worldwide affiliated group (Senate amendment),
- ▶ Imposing an excise tax on certain amounts paid by certain U.S. payors to certain related foreign recipients to the extent the amounts are deductible by the U.S. payor (but see provision above relating to the base erosion minimum tax), and
- ▶ Possessions of the United States.

Cost Recovery Provisions

- ▶ Property defined under section 168(k) and placed in service after 2007 and before 2020 is currently allowed a 50 percent deduction for the taxable year in which the property is placed in service. The conference report would allow full expensing for the property placed in service after September 27, 2017, for a five-year period. There would be a phase down of the full expensing by 20 percent per year for property placed in service after January 1, 2023 (January 1, 2024 for longer production period property). Bonus property previously had only been allowed for new property. The conference report expands bonus property to include used property.
- ▶ Annual depreciation limitations for luxury automobiles under section 280F is currently \$3,160 in the first year, \$5,100 in the second year, \$3,050 in the third year, and \$1,876 in the fourth and later years. The conference report was significantly increased under the conference report to \$10,000 in the first year, \$16,000 in the second year, \$9,600 in the third year, and \$5,740 in the fourth and later years.

- ▶ Computer or peripheral equipment is removed from the definition of listed property and no longer subject to the heightened substantiation requirements currently required.
- ▶ Depreciable property used in a farming business currently has special recovery periods, such as seven years for certain machinery and equipment, grain bins, and fences, as well as cotton ginning assets. The life was reduced to a five-year recovery period for property placed in service after 2008 and before 2010. The conference report renews the five-year recovery period. Also, the required use of 150 percent declining balance method currently required for property other than real property and trees or vines bearing fruits or nuts would be repealed for property with lives of 10 years or less.
- ▶ Under the conference report, the MACRS recovery periods maintains the present law general recovery MACRS recovery periods of 39 years for nonresidential real property and 27.5 years for residential rental property. The Senate amendment had lowered the life to a 25-year recovery period for all real property.
- ▶ Definition of qualified improvement property eliminates the separate definitions for "qualified leasehold improvement", "qualified restaurant property", and "qualified retail improvement property". The 15-year recovery period remains unchanged.
- ▶ Generally, under section 179, business taxpayers may elect to deduct the cost of qualifying property with an annual limit of \$500,000 through 2015, after which the amount was adjusted for inflation. The \$500,000 limitation is reduced by the amount of which the cost of the property placed in service during the taxable year exceeds \$2 million. The conference report increases the expensing limitation from \$500,000 to \$1 million. Further, the phase out under the conference report would begin when the amount of the property exceeds \$2.5 million, up from the \$2 million dollar amount.
- ▶ The section 179 definition of qualified real property under the conference report is expanded to include improvements to nonresidential real property including roofs, heating, ventilation, air conditioning, fire protection, alarm systems, and security systems.

Tax Accounting Method Provisions

- ▶ Under section 448, C corporations, a partnership with a C corporation partner, or a tax shelter generally may not use the cash method of accounting. There are exceptions, one of which is for C corporations or partnerships with a C corporation partner with average annual gross receipts of not more than \$5 million dollars over the prior three years. The conference report increases the three-year average gross receipts threshold from \$5 million to \$25 million.
- ▶ Section 447 generally requires that corporations or partnerships with a corporate partner engaged in farming must use the accrual method of accounting. The conference report permits farms that meet the \$25 million average three-year gross receipts threshold to use the cash method, even if it is a corporation or partnership with a corporate partner.
- ▶ Taxpayers subject to the UNICAP provisions under section 263A are required to capitalize all direct costs and an allocable portion of most indirect costs that are associated with production or resale activities. Under the conference report, businesses which meet the \$25 million average annual gross receipts test would be exempt from the UNICAP requirements.
- ▶ Under section 471, inventory accounting is normally required to clearly reflect income. Under the conference report, businesses that meet the \$25 million average annual gross receipts test would be exempt from inventory reporting. Taxpayers would be permitted to use a method of accounting that either treats inventories as non-incidental materials and supplies or conforms to the taxpayer's financial accounting.
- ▶ Section 460 generally requires percentage-of-completion accounting for long-term contracts. One exception is for construction contracts that are expected to be completed within a two year period and have annual average gross receipts over the preceding three years of \$10 million or less. Under the conference report, the exception would increase the \$10 million annual average gross receipts over the prior three years to \$25 million.

- ▶ Under a special rule for income inclusion, an accrual basis taxpayer is now required to recognize an item into income no later than the year in which the item is taken into account on the applicable financial statement. Thus, an accrual method taxpayer with an applicable financial statement would include an item in income under section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. An exception would apply for any item of income for which a special method of accounting is used. If a contract has multiple performance obligations, taxpayers may allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement. Also, the conference report codifies the current deferral method of accounting for advance payments for goods, services, and other specified items under Rev. Proc. 2004-34.
- ▶ Under section 199, a deduction of nine percent of the lesser of qualified production activities income or taxable income is generally permitted. The deduction for section 199 – domestic production activities deduction – has been repealed.
- ▶ Taxpayers may elect to currently deduct the amount of certain reasonable research or experimental expenditures paid or incurred in connection with a trade or business under section 174, or elect to capitalize and amortize such expenditures over not less than 60 months. Alternatively, a taxpayer may elect to amortize research or experimental expenditures over ten years. Under the conference report, specified research or experimental expenditures, including software development, would be required to be capitalized and amortized over a five-year period (15 years if expenditures are attributable to research conducted outside of the United States) and no longer currently deductible. Land acquisition and improvement costs, and mine (including oil and gas) exploration costs would be exempt from this rule. Upon retirement, abandonment or disposition of the property, any remaining basis would continue to be amortized over the remaining amortization period. The provision would apply for expenditures paid or incurred in tax years beginning after December 31, 2022.

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