Memo

To: Clients and Friends

From: Capital Enhancement LLC

Date: December 18, 2017

Subject: Final Tax Bill

The purpose of this memo is to summarize tax provisions in the tax bill agreed to by the conference committee. One key item to note is that the individual provisions generally expire in 2025 and the corporate provisions are mostly permanent. Here are the highlights:

Rates, Standard Deductions and Personal Exemption

The tax brackets under the proposals are as follows:

Rate	Married Joint	Single	Head of Household	Dividends & Capital Gains*
10%	First $19,050	First $9,525	First $13,600	0%
12%	Next $58,350	Next $29,175	Next $38,200	0%
22%	Next $87,600	Next $43,800	Next $30,700	15%
24%	Next $150,000	Next $75,000	Next $75,000	15%
32%	Next $85,000	Next $42,500	Next $42,500	15%
35%	Next $200,000	Next $300,000	Next $300,000	15%**
37%	Over $600,000	Over $500,000	Over $500,000	20%

*For income over $200,000 single/$250,000 married, the 3.8% Obamacare surtax applies as well.

**The 20% capital gains bracket starts at taxable income of $479,000 married joint, $452,400 head of household, and $425,800 single. Those brackets have not changed from 2017 levels.

Overall, this is a slight decrease in rate for those making less than $200,000 and those making more than $600,000. Upper middle class taxpayers with incomes over $400,000 will reach the 35% bracket sooner.

The Standard Deduction, which is your minimum level of itemized deductions, is increased to $24,000 married joint and $12,000 single. Since there are fewer deductions under this bill, many more taxpayers will be claiming the standard deduction going forward.

The roughly $4,000 personal exemption is repealed. Under current law, this exemption is phased out, so many of our clients currently receive no benefit from this.

Tax Credits

- The child tax credit is increased from $1,000 to $2,000 per child. More taxpayers will be eligible for the credit as the phaseouts now start at higher incomes. For a married couple filing jointly, for example, the phaseout begins at $400,000 of adjusted gross income, and each child is phased out in income increments of $40,000 (phaseout for 1 child is $440,000, two-children $480,000 and three children $520,000). For head of household, the phase-out amounts are at half the married level.

Deductions

- The 3% "haircut" or reduction in itemized deductions for incomes above a certain limit is eliminated.

- Mortgage interest expense on new debt for primary and second home purchases would be deductible only on the first $750,000 of debt. Currently, it is deductible on $1 million of debt. We believe refinanced debt and current debt are grandfathered and still deductible up to $1 million.

- The real estate tax, state income and sales tax deduction is capped at $10,000 in total.

- Personal casualty losses would no longer be deductible. Currently, they are deductible if they exceed 10% of income. Business casualty and theft losses continue to be deductible, and personal casualty losses associated with disaster relief legislation (such as Irma and Maria) would continue to be deductible.

- Cash contributions to charities would now be deductible in the current year up to 60% of your adjusted gross income. Currently, the limit is 50% of income. The 5-year carry forward for excess contributions is unchanged.

- Tax preparation fees are no longer deductible. For some of you, we are already deducting our fees against consulting income or partnership income.

- All other miscellaneous itemized deductions, including investment advice, and flow through money management fees from investment partnerships are no longer deductible if they are subject to the 2% threshold.

- Employee business expenses are no longer deductible. If you have out-of-pocket business expenses, and you are an employee, you can no longer deduct these.

- Alimony payments for divorces after 2018 would no longer be deductible to the payor and

taxable to the recipient. The net effect will be to reduce the amount paid to a former spouse since he or she is receiving the money tax-free. Current alimony payments for past divorces continue to be deductible to the payor and taxable income to the recipient.

- Moving expenses in connection with starting a new job are no longer deductible. Also, employer paid moving expenses would be taxable (if your employer moves you, you should ask the employer to pay the tax).

- You will now be able to use $10,000 per year from a 529 plan to pay tuition before a child's college years (private school tuition and homeschooling).

Retirement

- The 401(k) deduction is unchanged.

- Roth IRA recharacterizations for previous year Roth contributions are prohibited (your Roth contributions lost money so you recharacterize it as a traditional IRA contribution). We believe regular taxable conversions from a traditional IRA to a Roth will still be allowed.

Estate, Gift Tax and Generation Skipping Tax (GST)

- The 2018 estate exemptions at $5.6 million per person and $11.2 million per couple are doubled to $11.2 million and $22.4 million per couple.

- The step up in basis remains unchanged. If you inherit property from someone who died, the capital gains cost basis is the fair market value of the asset at death. You get the step up even if the decedent paid no estate taxes.

Alternative Minimum Tax (AMT)

The AMT continues to exist, but the exemption from AMT tax is increased to $109,400 for joint filers and $70,300 for all others. Given that most of the items that caused the AMT have been disallowed (state income taxes, property taxes and miscellaneous deductions), the AMT should not affect many taxpayers in the future. Presumably, the AMT credit still exists and those with carryforward credits should be able to continue to utilize them.

20% Deduction for Qualified Business Income of Pass Through Entities

Currently, normal operating income from an LLC, partnership, S corporation or sole proprietorship is taxed at your normal marginal tax rate. Generally, under this bill, 20% of the net business income after expenses from these entities is excluded from income tax. If you have qualified business income and are in the top 37% tax bracket, that income is taxed at 29.6%. Foreign businesses owned by a US taxpayer do not qualify for this deduction.

The 20% deduction is treated similarly to an itemized deduction. If you are claiming the standard deduction instead of your actual itemized deductions, it appears the 20% deduction gets added to your standard deduction. The deduction is only for income tax purposes, and it appears it does not reduce the 3.8% Obamacare tax or the self-employment tax.

An important concept in computing this deduction is the Threshold Amount. For single taxpayers, the threshold amount is taxable income of $157,500 (before computing this deduction) and for married joint filers, the threshold amount is $315,000 of taxable income.

Professional service passthroughs are generally prohibited from benefiting from this 20% deduction, but we will address the exceptions below. For operating businesses besides professional services, if your overall taxable income on your tax return is less than the threshold amount above, your deduction is 20% of your net business income. If it is above the threshold amount, the 20% deduction for your net business income can be limited to the greater of (a) 50% of the W-2 wages paid to employees of the business, or (b) 25% of the W-2 wages plus 2.5% of business equipment purchased in the last 10 years.

For example, if you are married filing joint with taxable income above the threshold amount plus $100,000 ($415,000), you get no deduction if you do not have employees or your business is not purchasing equipment. The intent seems to be to reward businesses that invest in equipment or businesses that employ others.

"Specified service" or professional service businesses are generally precluded from taking the 20% deduction. However, engineering and architecture services are excluded from this definition of "specified services". Moreover, if the taxable income of a specified service providers is less that the threshold amount ($157,500 single and $315,000), the 20% deduction against business income seems to apply.

There is a phaseout for computing this 20% deduction for specified service businesses. If you are single and your taxable income is $50,000 above the $157,000 threshold amount, you are not entitled to any part of the 20% deduction. If you are married filing jointly and your taxable income is $100,000 above the threshold amount ($415,000), you are not entitled to any part of the 20% deduction.

This phaseout also works for operating businesses mentioned above. If you are married with taxable income over $315,000, the W-2 and equipment rules become a factor.

There will be numerous details to add for future guidance to avoid abuse of this deduction.

C Corporation Tax Changes

A C corporation is a company that pays its own income taxes at the company level. Any payments from the company to its owners is usually treated as a dividend and these dividends are usually taxed at long-term capital gains rates. This results in two levels of tax, unlike flow through companies, which are only subject to tax on the owner's tax return.

Under the bill, the maximum corporate tax rate declines from 35% to 21%.

Deferred foreign cash would be taxed at 15.5%, deferred foreign earnings (non-cash) would be taxed at 8%.

The US would not tax foreign earnings of a foreign subsidiary of a US company. Rather, only US earnings are taxed. All of these changes are designed to place US companies on a level playing field with foreign companies.

Expensing of Capital Assets Used In Business

The bill would allow 100% expensing of any property placed in service between September 27, 2017 and December 31, 2022. This provision does not apply in a real property trade or business (you cannot immediately expense a rental property, for example).

Business Interest Expense

Under the bill, any interest expenses paid or accrued by a business that exceeds 30% of taxable income would be disallowed. This rule does not apply to businesses with average gross receipts of less than $25 million per year. The intent is to stop large multinationals from reducing US taxable income by borrowing to shift profits to lower tax jurisdictions.

Net Operating Loss Changes

For an individual, a net operating loss usually occurs when a rental property is sold at a huge loss or when a flow through business owned by the taxpayer produces losses in excess of other income such as wages, interest and dividends. The loss can currently be carried back 2 years or carried forward 20 years.

For losses arising after 2017, there is generally no carryback but just a carryforward, which now has no time limit to be used against future income. However, you can only use your NOL to offset 80% of your taxable income in a year (you still have to pay some tax each year). The NOL carryforward gets increased each year for inflation.

Like Kind 1031 Exchanges

Currently, you can defer tax on the sale of business property if you exchange it for other business property and follow a number of other rules. Going forward, like kind exchanges can only be used for real property exchanges (and not personal property such as rental cars). Since business can expense new property purchases under the bill, this provision does not have substantial impact.

Meals, Entertainment, and Employee Fringe Benefits

Currently, business meals and entertainment expenses are 50% deductible. Employee fringe benefits such as transportation and parking passes and gym or other social memberships are

deductible to the business but are not taxable to the employee. Work related meals incurred in business travel would continue to be 50% deductible, but any business entertainment is no longer deductible. The employee fringe benefits mentioned above would no longer be deductible to the business unless the value is included in the employee's wages. The rationale is that some entertainment expenses and fringe benefits do not have a clear business purpose, and can be personal in nature.

Geothermal and Solar Credits

There is no change from current laws. The geothermal credit has expired and the solar credit expires in 2021.

Tax Exempt Municipal Bonds

While the interest on already issued bonds and future municipal bonds will continue to be tax exempt, when a government entity "pre refunds" an existing bond issue with another issue at a lower interest rate, the interest on the new issue is taxable. This appears to eliminate the attractiveness of pre refunding in the future.

Non-Qualified Deferred Compensation

For the most part, non-qualified deferrals and excess 401(K) plans remain unchanged. Section 409A continues to govern the rules around these plans.

There are new, complex rules around the grant of stock and stock options to employees of privately held companies. This potentially could be used in the private equity portfolio company space, and the rules allow deferral of income of up to 5 years when illiquid stock is received.

There are a number of provisions. It seems the stock plan must cover 80% of the employees to be eligible. The CEO, CFO, highest four compensated officers, 1% owners, and family members are excluded from being able to make the deferral election.

In addition, the new law increases the excise tax to 20% on the value of specific stock compensation of corporate insiders of companies that expatriate from the US for corporate tax purposes.

Executive Compensation In Excess of $1 Million

Currently, public companies cannot deduct compensation in excess of $1 million for corporate tax purposes for their 5 executives listed in the annual proxy filing. There is an exception for performance based compensation, which at most companies, includes the annual bonus, and long term incentives such as stock options and performance shares. Under the bill, performance-based compensation would no longer be an exemption, meaning much more executive compensation would be non-deductible. Additionally once an executive is part of the proxy reporting, his/her compensation is subject to the rule until leaving the company. There is an exception to this rule for compensation provided under a written contract in effect on November

2, 2017, which is not modified.

For tax exempt organizations, executive compensation over $1 million per person would be subject to a 21% excise tax.

Private Charities

Private colleges and universities with endowments of more than $500,000 per student would be subject to an additional excise tax of 1.4% on investment income.

What Has Not Changed?

Based on our initial reading, the following provisions appear to have survived:

- The Adoption tax credit and exclusion
- Investment interest expense
- Claim of right deductions (typically when expatriates reimburse employers under a tax equalization agreement)
- Student loan interest
- The medical expense deduction for expenses exceeding 7.5% or 10% of your income.
- Self-employed health premium deductions
- Health Savings Accounts
- "Stretch" payout rules on post death IRA distributions to children and grandchildren, allowing for years of tax deferral
- Carried interest rules for hedge fund managers except an asset must be held by the fund for 3 years to qualify as long term gains to the manager
- Educational tax credits
- The "Cadillac" tax on certain high value medical insurance plans
- The $7,500 plug in credit for electric cars

Planning Considerations

Very few items are now deductible. The typical married client gets a standard deduction of $24,000, meaning unless their actual deductions exceed this amount, their taxable income gets reduced by $24,000.

With the real estate deduction and state income taxes being capped at $10,000 and no longer deductible over that limit, it might make sense for someone without a mortgage to make their

charitable contributions every two years. The idea would be that one year you would get the $24,000 standard deduction, and the next year you would get your actual deductions, which would be higher since they include two years of charitable contributions. Alternatives are to prefund a donor-advised fund in 2017, or if you are over 70 ½, contribute to charity from your required minimum IRA distribution in the future.

If you are not in the AMT in 2017 (check with us), you should prepay any state income taxes and real estate taxes.

Conclusion

While we have tried to address the proposed individual changes comprehensively, there is no substitute for discussing your personal situation with us.