NORTHERN TRUST

THE TIME IS NOW: TAX PLANNING 2018

On December 22, 2017, the President signed the tax bill known informally as the Tax Cuts and Jobs Act (H.R. 1) (the "Act") into law. Now the work of unpacking the Act and determining its impact on you, your family and the broader community begins in earnest.

Flexibility and focus on goals are key to financial wealth planning under the Act. Why flexibility? Because the Act provides many changes that impact individuals and businesses that will be effective at the start of 2018, but are not permanent. Why focus on goals? Because tax laws change, and goals endure.

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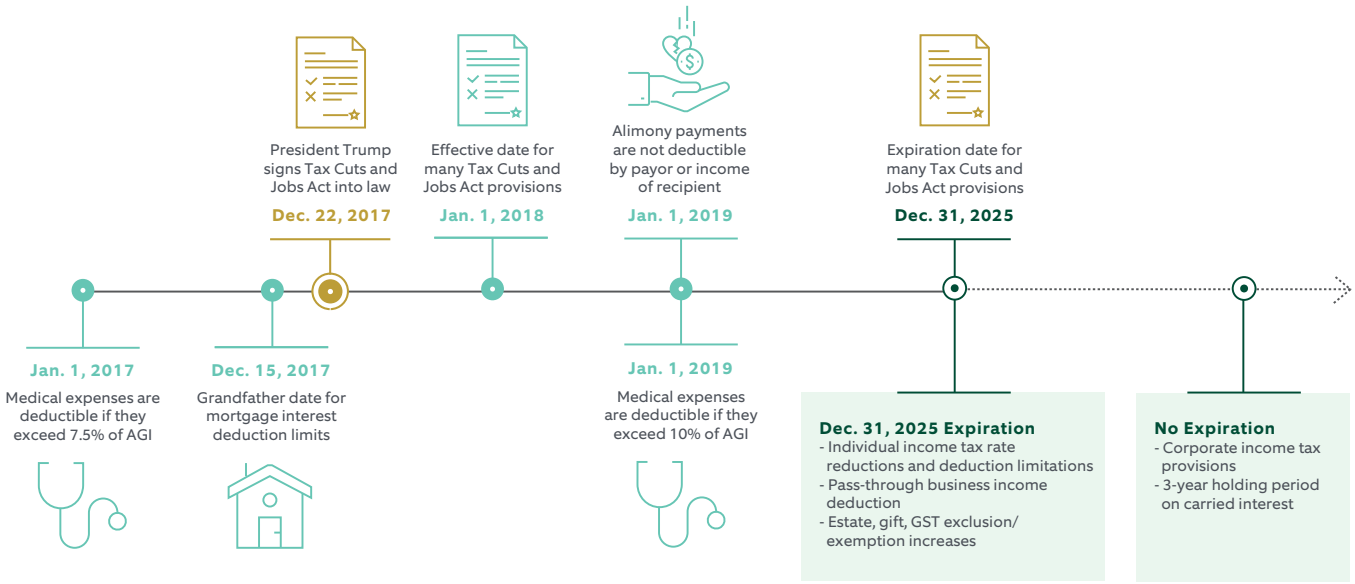
WHAT'S NEXT?

The starts and stops under the Act can be a bit confusing. And no sooner will provisions of the Act come into effect in the New Year, than Congress and Treasury will begin the work of addressing technical corrections and writing the regulations to provide guidance for new provisions. Here are a few of the relevant milestones to keep in mind.



ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAXES

Planning for family wealth transfer is first and foremost a question of goals. Taxes are just one of the many considerations to take into account in achieving your goals. The Act did not repeal the estate, gift and generation-skipping transfer taxes as originally proposed. It only increases the exclusion and GST exemption amounts for the next eight years (from $5 million to $10 million, adjusted for inflation).

The Act does not modify the current income tax basis rules related to gifts and transfers at death. The recipient of a lifetime gift of appreciated property receives the donor's basis in the property (carryover). The recipient of property transferred at death receives a new fair market value basis in the property. Why is this important? If you give a beneficiary a low-basis appreciated asset during life and she sells it, she will incur a capital gain. If you give the same property to the same beneficiary at death and she sells it at that time, she will not incur a capital gain.

Planning for family wealth transfer with temporary tax rules adds an additional layer of complexity to tax-sensitive planning. This complexity is heightened when it incorporates estate, gift and generation-skipping transfer tax considerations as well as income tax considerations. If this was not enough, there are both federal and state level taxes to take into account. Having a wealth transfer plan that builds in flexibility is highly beneficial when dealing with a changing landscape and complexity.

There are a number of planning approaches that provide flexibility in an overall wealth transfer plan, including, for example:

- **Powers of appointment** — When transferring property in trust, consider providing a beneficiary whose judgment you trust with the power to redirect the disposition of property in the trust. For example, give a surviving spouse the power to appoint trust property held for her benefit during her lifetime to your descendants at her death. This allows her to take the needs and circumstances of children and grandchildren that arise after your death into account.
- **Disclaimers** — If you would like to plan in the alternative, so to speak, consider providing that property will pass to a named beneficiary at your death, but if the beneficiary chooses not to receive the property (disclaims), it will pass to an alternate taker you designate in your will or trust agreement.
- **Tax elections** — There are certain tax elections your executor can exercise to achieve desired tax results (both federal and state). Your estate plan can incorporate a trust designed to include the flexibility these elections offer. Property passing to a surviving spouse in a trust referred to as a "qualified terminable interest property" or a "QTIP" trust is one example of a trust that offers tax-related election flexibility.

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ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAXES

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
Wanting to leave an inheritance to your loved ones	The top estate tax rate is 40%. The basic exclusion amount is $5 million per individual, adjusted for inflation ($5.49 million in 2017).	The top estate tax rate remains 40%. The basic exclusion amount is doubled to $10 million per individual, adjusted for inflation (approximately $11.2 million in 2018).	Effective January 1, 2018 Expires December 31, 2025	**Moderate**
Wanting to leave an inheritance to your grandchildren	The top generation-skipping transfer tax rate is 40%. The GST exemption amount is $5 million per individual, adjusted for inflation ($5.49 million in 2017).	The top generation-skipping transfer tax rate remains 40%. The GST exemption amount is doubled to $10 million per individual, adjusted for inflation (approximately $11.2 million in 2018).	Effective January 1, 2018 Expires December 31, 2025	**Moderate**
Wanting to give money to those you care about while you are still around to see them enjoy it	The top gift tax rate is 40%. The basic exclusion amount is $5 million per individual, adjusted for inflation ($5.49 million in 2017).	The top gift tax rate remains 40%. The basic exclusion amount is doubled to $10 million per individual, adjusted for inflation (approximately $11.2 million in 2018).	Effective January 1, 2018 Expires December 31, 2025	**Moderate**

PASS-THROUGH BUSINESS INCOME TAX DEDUCTION

The Act creates a new income tax deduction for individuals, trusts and estates that own pass-through businesses. Pass-through businesses include sole proprietorships, partnerships, limited liability companies taxed as partnerships and S-corporations. The deduction equals 20% of qualified business income and is taken against the pass-through owner's taxable income. For example, if Mary is a partner in a partnership and she is allocated $100 of the partnership's net profits, her deduction is $20 (subject to limitations discussed below).

The overarching policy here is that, because the Act cuts the income tax rate for corporations that are taxed separately ("C-corporations") from 35% to 21%, pass-through businesses also deserve some tax relief. The 20% deduction means that the maximum effective income tax rate for pass-through income is 29.6% for a taxpayer in the top 37% income tax bracket.

The 20% pass-through deduction is not automatic. There are six limitations on a taxpayer's ability to take the deduction:

1. **U.S. business** — The pass-through income must be "effectively connected" with the conduct of a U.S. trade or business (including Puerto Rico). There is no deduction for foreign business income. This rule is designed to reward businesses operating in the U.S., rather than abroad.
2. **Non-investment income** — Investment income earned through a pass-through entity, including capital gains, dividends and interest, does not give rise to a deduction. This means that a taxpayer cannot simply transfer his investment portfolio into a pass-through entity in order to get a lower tax rate.
3. **Non-compensation income** — If the owner of the pass-through entity receives wages, a guaranteed payment or other form of reasonable compensation from the entity, this compensation income does not give rise to a deduction. This rule reinforces the idea that the 20% deduction only applies for business income, not compensation income.
4. **Income threshold for services business** — If the owner of a pass-through entity (a) earns income from a service business and (b) has taxable income over $207,500 (single / married filing separately) or $415,000 (married filing jointly), adjusted for inflation, then he does not get the 20% deduction. If the pass-through owner's taxable income is between $157,500 and $207,500 (single / married filing separately) or $315,000 and $415,000 (married filing jointly), adjusted for inflation, he can take a partial deduction, but not the full 20% deduction. This rule reflects the notion that tax reform incentivizes small businesses and capital investment, rather than returns to labor.

   A services business is "any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners." It also includes any trade or business which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests or commodities. Engineers and architects were originally included

20%

PASS-THROUGH BUSINESS INCOME TAX DEDUCTION IS NOT AUTOMATIC

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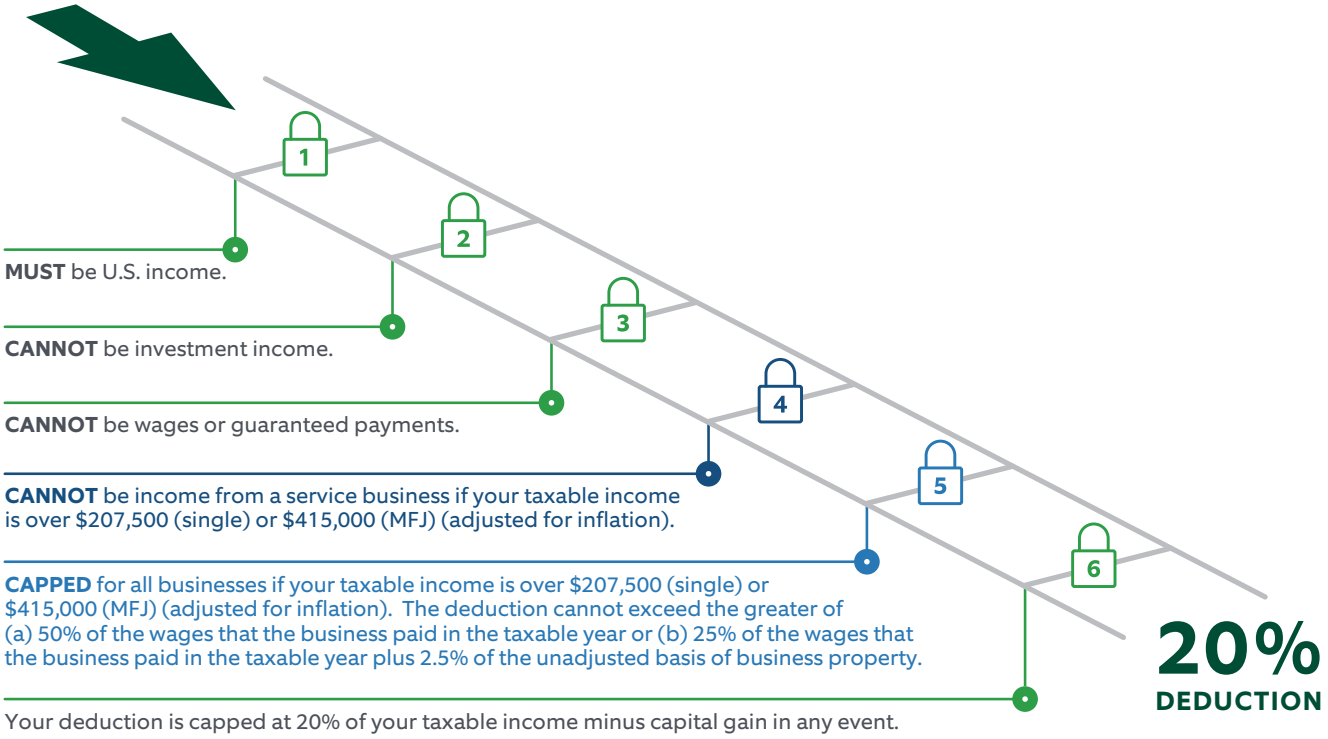
in the list of services businesses, but they were removed from the final version of the Act.

5. **Income threshold for all businesses** — If the owner of a pass-through entity has taxable income over $207,500 (single / married filing separately) or $415,000 (married filing jointly), adjusted for inflation, then his 20% deduction is capped. The deduction cannot exceed the greater of (a) 50% of the wages that the business paid in the taxable year or (b) 25% of wages that the business paid in the taxable year plus 2.5% of the unadjusted basis of business property. If the pass-through owner's taxable income is between $157,500 and $207,500 (single / married filing separately) or $315,000 and $415,000 (married filing jointly), adjusted for inflation, the cap still applies, but is a little more generous. This rule reflects the notion that tax reform incentivizes small businesses creating jobs and making investments domestically.

6. **Overall limitation** — In any event, the 20% deduction is capped at 20% of the pass-through owner's taxable income (excluding capital gain income). This rule is designed to prevent erosion of the tax base.



Thus far, this discussion has focused on pass-through businesses that operate at a profit. But what about pass-through businesses that generate losses, either because there is an economic downturn or because the business is starting up and re-investing to grow its business? Under the Act, individuals, trusts and estates that receive net business losses in excess of $250,000 (single / married filing separately) or $500,000 (married filing jointly), adjusted for inflation, cannot use the loss in the current taxable year. Instead, the individual, trust or estate must carry the loss forward to future taxable years under the net operating loss ("NOL")

rules. Thus, in those future years, the deduction would not be limited to $250,000/$500,000 but instead would be limited to 90% of taxable income (determined before the loss deduction reduces taxable income) under the NOL rules. This limitation drops to 80% of taxable income for 2023 and beyond.

A taxpayer that receives (a) real estate investment trust ("REIT") dividends, (b) qualified cooperative dividends, and/or (c) qualified publicly traded partnership income like income earned through a master limited partnership also may be eligible for a deduction of up to 20%. However, for a REIT, only ordinary REIT dividends give rise to the deduction. Capital gain dividends from a REIT and qualified dividends from a REIT are not eligible for a deduction.

INDIVIDUAL INCOME TAX

When we think of individual income taxes we quite understandably focus on the balance due. But there is more to the story. Taxes raise revenue and promote policy objectives that, broadly speaking, reflect a common core of principles. Provisions of the tax law, old and new, are intended to encourage saving, investment, entrepreneurship, education and philanthropy.

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The tax law continues to provide for reduced tax rates for qualified dividends and long-term capital gains, with a top rate of 20%. The new pass-through business income deduction discussed above is intended to promote capital investment. Saving for retirement by deferring compensation to fund 401(k) accounts and individual retirement accounts remains available.

The Act preserves and even enhances a number of education-related tax provisions. The American Opportunity credit and Lifetime Learning credit remain for eligible individuals. Discharge of student loans for taxpayers working in certain professions and areas with unmet needs remains income tax free. 529 education savings accounts are expanded to permit tax-free distributions for primary and secondary tuition (subject to annual limits) in addition to higher-education. And the list goes on.

In addition to its many non-tax benefits, charitable giving continues to have many tax-related benefits as well. Unlimited amounts may be given to charity during life or at death with an unlimited gift and estate tax deduction. In addition, lifetime gifts to charity continue to qualify for an income tax deduction for those who itemize their deductions, with some modest increases in long-standing limitations based on the donor's adjusted gross income.

Wondering about the 3.8% net investment income tax? It remains in effect without change.

INDIVIDUAL INCOME TAX

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
A married individual	Income tax rates and brackets are as follows: $0 to $18,650 **10%** $18,651 to $75,900 **15%** $75,901 to $153,100 **25%** $153,101 to $233,350 **28%** $233,351 to $416,700 **33%** $416,701 to $470,700 **35%** $470,701+ **39.6%**	New income tax rates and brackets are as follows: $0 to $19,050 **10%** $19,051 to $77,400 **12%** $77,401 to $165,000 **22%** $165,001 to $315,000 **24%** $315,001 to $400,000 **32%** $400,001 to $600,000 **35%** $600,001+ **37%**	Effective January 1, 2018 Expires December 31, 2025	**Moderate**
The parent of a child with investment income	"Kiddie tax" on net unearned income of children taxed at the parents' tax rates.	Ordinary and capital gains tax rates applicable to trusts applied to the net unearned income of a child.	Effective January 1, 2018 Expires December 31, 2025	**Significant**
Someone who pays the alternative minimum tax ("AMT")	The AMT is in effect. The exemption amount for 2017 is $54,300 (single) or $84,500 (married).	The AMT exemption amount is increased to $70,300 (single) or $109,400 (married) (adjusted for inflation).	Effective January 1, 2018 Expires December 31, 2025	**Moderate**

INDIVIDUAL INCOME TAX (CONTINUED)

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
Invested in municipal bonds	Private activity bond interest is tax-exempt. Interest on bonds issued to retire outstanding debt also is tax-exempt.	Advance refunding bond interest is taxable. Private activity bond interest is tax-exempt.	Effective January 1, 2018 No expiration date	Moderate
An owner of investment property who wants to exchange it for similar investment property on a tax-deferred basis (a "Section 1031 exchange")	Property that is (1) held for productive use in a trade or business or (2) held for investment can be exchanged for property of a "like kind." No gain is recognized on the exchange. Instead, gain is deferred until the replacement property is sold. Under current law, taxpayers can exchange not only like-kind real estate, but also like-kind personal property (cars, airplanes, etc.).	Section1031 exchanges are limited to real property that is not held primarily for sale. Personal property is not eligible.	Effective January 1, 2018 No expiration date	Significant
Paying penalties for not having adequate health insurance ("shared responsibility payments")	An individual who fails to maintain adequate health insurance for any given month is subject to a penalty. For 2017, the monthly penalty is a maximum of $272 per individual and $1,360 for a family of five or more.	There are no shared responsibility payments.	Effective January 1, 2019 No expiration date	Significant

INDIVIDUAL INCOME TAX (CONTINUED)

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
An investment manager whose compensation includes a preferred return ("carried interest")	Capital assets held for more than one year generate long-term capital gain income when they are sold. The top tax rate is 23.8%, including the 3.8% net investment income tax.	For capital assets held in connection with a carried interest, the Act imposes a three year (not one year) holding period requirement before the gain on the capital asset is taxed at the reduced 23.8% rate, including the 3.8% net investment tax.	Effective January 1, 2018 No expiration date	**Significant**
An individual or a family	Every individual receives a personal exemption. The exemption is $4,050 in 2017. A married couple would claim two personal exemptions ($8,100 in 2017). A typical family of four would claim four personal exemptions ($16,200 in 2017).	Personal exemptions are repealed.	Effective January 1, 2018 Expires December 31, 2025	**Significant**
An individual or a family with deductions	An individual or married couple evaluates whether their itemized deductions, added together, are greater than the standard deduction; the individual or couple will then claim their itemized deductions or the standard deduction, whichever is greater. The standard deduction for 2017 is $6,350 for single taxpayers and $12,700 for married taxpayers filing jointly.	The standard deduction is increased to $12,000 for single taxpayers and $24,000 for married taxpayers filing jointly.	Effective January 1, 2018 Expires December 31, 2025	**Significant**

INDIVIDUAL INCOME TAX (CONTINUED)

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
An individual or family who itemizes deductions	The "Pease limitation" says that taxpayers lose the benefit of up to 80% of their itemized deductions if their income exceeds $261,500 (for individuals) or $313,800 (for married taxpayers).	The "Pease limitation" is repealed.	Effective January 1, 2018 Expires December 31, 2025	**Significant**
Someone who pays state and local taxes and itemizes deductions (rather than claiming the standard deduction)	State and local income or sales taxes plus property taxes are deductible.	The itemized deduction for state and local taxes is limited to $10,000. The limitation does not apply to state and local taxes for trade, business or production of income activities.	Effective January 1, 2018 Expires December 31, 2025	**Significant**
Someone who pays or someone who receives alimony or separate maintenance payments	Alimony and separate maintenance payments are deductible by the payor spouse and included in income by the recipient spouse.	Alimony and separate maintenance payments are not deductible by the payor spouse and not income to the recipient spouse.	Effective for divorce or separation agreements signed (or modified if express reference is made to the Act), after December 31, 2018 No expiration date	**Significant**
Someone who saves for education expenses using a 529 plan	529 plans are designed for saving for qualified higher education expenses.	529 plans are expanded to provide for K-12 education expenses, with a $10,000 annual per beneficiary limit on these distributions.	Effective January 1, 2018 No expiration date	**Significant**

INDIVIDUAL INCOME TAX (CONTINUED)

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
A homeowner who pays mortgage interest and itemizes deductions (rather than claiming the standard deduction)	Interest on up to $1 million of mortgage debt on a principal residence and a second residence is deductible. Interest on $100,000 of a home equity line of credit ("HELOC") is deductible.	Interest on up to $750K of mortgage debt on a principal residence and a second residence is deductible. Interest on a HELOC is not deductible.	Effective January 1, 2018 Expires December 31, 2025 Mortgage debt (not HELOC) incurred before December 15, 2017 is grandfathered under the existing rules, as are certain homes under contract before December 15, 2017.	**Significant**
A philanthropist who makes cash contributions to public charities	Cash contributions to public charities are deductible up to 50% of adjusted gross income ("AGI").	Cash contributions to public charities are deductible up to 60% of AGI.	Effective January 1, 2018 Expires December 31, 2025	**Moderate**
An investor who pays investment fees and expenses	Investment fees are deductible, but only if they exceed 2% of AGI (the "2% AGI floor").	Investment fees are no longer deductible.	Effective January 1, 2018 Expires December 31, 2025	**Significant**
An individual with significant medical expense	Medical expenses are deductible, but only if they exceed 10% of AGI.	Medical expenses are deductible if they exceed 7.5% of AGI for 2017 and 2018 for regular tax and the AMT.	Effective January 1, 2017 Expires December 31, 2018	**Moderate**

CORPORATE INCOME TAX

One of the hallmark provisions in the Act is the change in tax rates for C-corporations. C-corporations, unlike pass-through entities, have two layers of income tax. First, the corporation itself pays income tax on its net income. Under the Act, the maximum income tax rate for C-corporations drops from 35% to 21%. There is no expiration date for the new 21% rate. The second layer of tax comes when a C-corporation pays a dividend to a shareholder and the shareholder pays income tax on the dividend at his personal income tax rate.

Domestic and international businesses will need to evaluate whether it makes sense to operate as a pass-through entity (such as a partnership or S-corporation) or whether a C-corporation makes sense. Considerations include: whether the business is generating gains or losses; exit strategy and potential for a tax-deferred exchange or tax-free liquidation; state and local income taxes; the 20% accumulated earnings tax and 20% personal holding company tax on corporations that do not make adequate distributions; the number of shareholders; and the impact of the new 20% pass-through business deduction and associated limitations.

IF YOU ARE...	2017 LAW	THE ACT	EFFECTIVE DATES AND EXPIRATION DATES	CHANGE FROM 2017 LAW
A C-corporation	The top tax rate is 35%.	There is a flat 21% corporate tax rate. The dividend received deduction is reduced accordingly.	Effective January 1, 2018 No expiration date	**Significant**
A C-corporation subject to the AMT	The corporate AMT is in effect.	The corporate AMT is repealed.	Effective January 1, 2018 No expiration date	**Significant**
A U.S. C-corporation receiving dividends from a foreign subsidiary	Worldwide system. Dividends from foreign subsidiaries generally are subject to U.S. income tax.	Territorial system. 100% exemption for dividends from foreign subsidiaries.	Effective January 1, 2018 No expiration date	**Significant**
A U.S. shareholder of a specified foreign corporation with post-1986 retained earnings abroad	Earnings generally are not taxed in the U.S. until they are repatriated.	Deemed repatriation of accumulated post-1986 offshore earnings held at transition. Cash and cash equivalents tax rate 15.5%. Other assets tax rate 8%.	Effective January 1, 2018 No expiration date	**Significant**

CONCLUSION

The effects of the Act will not be immediately apparent for all affected individuals, families and businesses at the same time. Some may experience an impact with their first paycheck in 2018 if their withholding changes. Others may see adjustments in their 2018 estimated tax payments. Some may experience effects of the new law directly, others indirectly. All affected individuals, families, businesses and their advisors will continue to gain greater insight into the new law as technical corrections and new regulations emerge. We will address areas of specific focus in ongoing updates.

FOR MORE INFORMATION

As a premier financial firm, Northern Trust specializes in Goals Driven Wealth Management backed by innovative technology and a strong fiduciary heritage. Our Wealth Planning Advisory Services team leverages our collective experience to provide financial planning, family education and governance, philanthropic advisory services, business owner services, tax strategy and wealth transfer services to our clients. It is our privilege to put our expertise and resources to work for you.

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