

## Alert | Tax



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### Highlights of the Tax Cuts and Jobs Act

On Dec. 20, 2017, the House and Senate passed the Tax Cuts and Jobs Act, H.R.1, and this bill is on its way to President Trump for signature. When signed into law, the Tax Cuts and Jobs Act would have a wide impact on various aspects of U.S. federal individual, corporate, partnership, international, and trust and estate taxation. This GT Alert provides a summary of certain key provisions of the Tax Cuts and Jobs Act as reflected in the Conference Committee Report. The changes described below will generally take effect as of Jan. 1, 2018. The GT Tax Department will publish additional Alerts on specific aspects of the legislation.

The changes will be discussed under the following headings:

- Key Individual Tax Provisions
- Estate Planning and the Taxation of Trusts and Estates
- Key Home Mortgage Interest Provisions
- Key Business Tax Provisions
- Business Tax Credit and Opportunity Zones
- Key U.S. International Tax Provisions

## Key Individual Tax Provisions

**Individual Tax Rates:** For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, there will be seven individual income tax rate brackets: 10 percent, 12 percent, 22 percent, 24 percent, 32 percent, 35 percent, and 37 percent. Net capital gains and qualified dividends will continue to be taxed at the current rates of zero percent, 15 percent, and 20 percent. Capital gains and qualified dividends will also continue to be subject to the 3.8 percent net investment income tax.

**Standard Deduction:** Beginning in 2018, the standard deduction will nearly double to \$24,000 for married taxpayers filing jointly and \$12,000 for single filers. The increased standard deduction amount will expire after Dec. 31, 2025.

**Suspension of Personal Exemptions Deduction:** For tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the deduction for personal exemptions is suspended.

**Individual AMT:** For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, the individual AMT exemption amounts will be increased to \$109,400 for married taxpayers filing jointly and \$70,300 for single filers. The AMT thresholds for the phase-out of the exemption amounts will be increased to \$1,000,000 for married taxpayers filing jointly and \$500,000 for single taxpayers.

**Limitation on Deduction for State and Local Taxes:** The deduction for state and local taxes is limited to an aggregate amount of \$10,000 for both property taxes on homes used for personal purposes, and either state income taxes or sales taxes. For example, if a taxpayer pays \$8,000 in property taxes on her personal residence and \$6,000 in state income taxes, the deduction will be limited to \$10,000. It will not be possible to take a deduction in 2017 for 2018 state income taxes by prepaying such taxes in 2017, as the legislation expressly prohibits such tax planning. It would be possible to get a deduction in 2017 for a prepayment of real property taxes if the state law provides a mechanism to prepay them. The limitation on deduction of property taxes does not apply to real property held for rental, or for sales taxes paid in connection with a business. However, the \$10,000 limitation would apply to state income taxes paid on income from a business. For example, assume an investor owns a rental property, and pays \$20,000 in property taxes on the property. The \$20,000 in property taxes can be deducted, but the state income taxes resulting from this rental business would be subject to the \$10,000 overall limitation on the deduction for state and local taxes.

**Charitable Contributions:** The limitation on an individual taxpayer's deduction for charitable contributions of nonappreciated property or cash made to certain charitable organizations will be increased from 50 percent to 60 percent of the taxpayer's adjusted gross income for contributions made in taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

**Itemized Deductions:** For taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026, (i) all miscellaneous itemized deductions subject to the 2 percent floor are suspended and (ii) the overall limitation on itemized deductions is suspended.

## Estate Planning and the Taxation of Trusts and Estates

**Estate, Gift and GST Taxes:** The gift and estate tax applicable exclusion amount, and generation skipping transfer (GST) tax exemption amount, apply to shelter taxable transfers from the respective taxes. For the calendar years 2018 to 2025, the gift, estate, and GST tax shelters are doubled from \$5 million per person to \$10 million per person, indexed for inflation beginning after 2010. The inflation adjustment factor has been changed to the so-called "chained CPI," which increases more slowly than the regular CPI. It appears to be intended that the inflation adjustment of shelters would relate back to the calendar year 2010, although the language is not entirely clear. If that were the case, then the shelters for the calendar year 2018 should be approximately \$11 million per person, \$22 million per couple, reduced by prior taxable transfers. The increased shelters sunset in 2026, reverting back to \$5 million, indexed for inflation. The proposal requires the Secretary of the Treasury to issue regulations to address the future reduction in the shelters, presumably to avoid penalizing taxpayers who use the increased shelters during

the period they are available. No changes are made to the rules relating to a “step-up” in basis for assets included in an individual’s estate on death. Accordingly, assets included in an individual’s estate will continue to be entitled to a basis step-up on the individual’s death as under current law, even if an estate tax is not imposed on those assets. A step-up in basis in an asset eliminates the taxable gain in the asset that existed at the time of death.

**Marginal Rate for Estate and Trusts:** The top marginal income tax rate for estates and trusts is reduced to 37 percent from 39.6 percent, for taxable income above \$12,500.

**Application of Deduction for Qualified Business Income:** The Conference Committee Report indicates that the new 20 percent deduction for qualified business income from pass-through entities will apply to interests in pass-through entities held by trusts and estates, with rules apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the applicable limitations.

**ESBTs:** A trust that elects to be an “electing small business trust” is a permitted shareholder of an S corporation. Under current law, a trust that had a nonresident alien as a potential current beneficiary of the trust does not qualify as an electing small business trust. Pursuant to the legislation, a trust that includes a nonresident alien as a potential current beneficiary of the trust will now qualify as an “electing small business trust” (if the other requirements are met).

**Expansion of Permitted Distributions Under 529 Plans:** Under current law, tax-free distributions from 529 Plans are permitted only for tuition and certain expenses for college. Under the legislation, tax-free distributions from 529 Plans would be expanded to permit distributions for tuition and certain other expenses of elementary or secondary public, private, or religious schools, but not to exceed \$10,000 per person in any year.

**Planning Considerations:** For individuals with estates expected to exceed the current gift, estate, and GST shelters, planning should continue. The increased shelters are temporary, and are scheduled to revert, creating a substantial estate planning opportunity for many. Importantly, none of the available transfer tax reduction techniques will be adversely affected by the legislation. Valuation discounts remain intact, as do many of the popular wealth transfer techniques, such as Grantor Retained Annuity Trust (GRATs), Qualified Personal Resident Trusts (QPRTs), and installment sales. Therefore, techniques that will shift post-transfer appreciation outside of the transferor’s taxable estate will continue to be effective, and are in fact facilitated by the increased shelters, permitting large transfers to be made without the application of any transfer tax.

In view of the reduction in the ability to deduct state income taxes for federal tax purposes, techniques that reduce state income taxes will be important. By shifting the situs of trusts to states that do not impose a state income tax, effective tax rates can be reduced. A trust for your own benefit that avoids the application of state income taxes without causing a current gift tax (so-called DING trust) may also be considered.

As with all lifetime planning, the potential effect on future income taxes requires careful consideration. Since the estate tax was not repealed, not only does the basis adjustment at death remain intact, but so does portability, a provision which allows a surviving spouse to inherit the unused estate tax shelter of a predeceased spouse. Flexible lifetime and estate planning that allows future adjustment to mitigate the potential application of income taxes, while still achieving a substantial reduction in transfer taxes, continues to be important.

### **Key Home Mortgage Interest Provisions**

**Home Mortgage Interest Deduction Limitation:** The home mortgage interest deduction will be limited to the interest paid on \$750,000 of debt, down from \$1 million under existing law. This \$750,000 indebtedness limitation will be effective for homes purchased under a contract that is dated after Dec. 14, 2017, so this limitation will not apply to an existing mortgage. If a binding contract to purchase a home

was dated prior to Dec. 14, 2017, scheduled to close before Jan. 1, 2018, then the new limitation would not be effective so long as the closing actually occurs before April 1, 2018. An existing mortgage that has been grandfathered-in under the \$1 million limit may be refinanced, but the amount that is refinanced must not be greater than the existing outstanding balance. For example, assume a taxpayer has an existing mortgage with an original face amount of \$1,000,000, which is grandfathered-in under the old rule so that all of the interest is deductible. If the homeowner refinances this mortgage when the outstanding principal balance has been paid down to \$900,000, then interest would be able to be deducted only on \$900,000 of the newly refinanced amount.

**Mortgage Interest on Second Home:** The legislation leaves in place the existing rule allowing mortgage interest to be deducted on a first and second home – subject to the \$750,000 total debt limitation (interest is deductible on the first \$750,000 of aggregate debt on both homes).

**Home Equity Line of Credit:** The legislation eliminates the deduction for interest on a second mortgage securing a home equity line of credit up to \$100,000. There is no grandfather provision for the elimination of this deduction, so a deduction will not be allowed even if the home equity line of credit was already in place prior to Dec. 15, 2017.

### Key Business Tax Provisions

**Reduction in Corporate Tax Rate:** The corporate tax rate will be reduced to a flat 21 percent for all tax years beginning after Dec. 31, 2017 (currently, the top marginal rate is 35 percent). The 80 percent and 70 percent dividends received deductions will be reduced to 65 percent and 50 percent to account for the reduced corporate tax rate. The reduced corporate tax rate may affect the choice of entity and structuring considerations. In addition, corporations may wish to consider measures to accelerate deductions (*e.g.*, for bonus accruals, welfare benefits, and pension contributions) into the current year in order to obtain the benefit of those deductions against the higher corporate tax rate.

**New 20 Percent Pass-Through Deduction:** Individuals, estates, and trusts generally will be permitted to deduct up to 20 percent of “qualified business income” received from a sole proprietorship, partnership, or S corporation. Qualified business income generally includes net income from domestic sources, but generally excludes (1) investment-related income (*e.g.*, capital gains, dividends, interest), (2) any amounts treated as reasonable compensation to the taxpayer (*e.g.*, actual or deemed salary), and (3) income from any trade or business (A) in health, law, consulting, financial services, brokerage services, or (B) where the principal asset is the reputation or skill of one or more of its employees or owners. However, the owner of a professional service business would be eligible for the 20 percent deduction if total taxable income, including income from such business, is less than \$157,500 for a single filer, or \$315,000 in the case of a joint return, which is phased out once taxable income reaches \$207,500 (for a single filer) or \$415,000 (in the case of a joint return). The deductible amount is limited, for each underlying trade or business, to the greater of (1) 50 percent of W-2 wages paid by the business and (2) 25 percent of W-2 wages paid by the business plus 2.5 percent of the business tangible capital assets, though this limitation is phased-in for income exceeding \$157,500 (\$315,000 in the case of a joint return), with phase-out over the next \$50,000 of taxable income (\$100,000 in the case of a joint return). This deduction will reduce the cash tax costs for many pass-through businesses, but partnership agreements should be reviewed to determine the impact under existing tax distribution provisions. Due to the new corporate rate, current cash tax costs will be lower for corporate businesses if cash is not being distributed to shareholders. The deduction for qualified business income is subject to sunset after 2025.

**New Holding Period Requirement for Carried Interest:** A three-year holding period requirement will be imposed on an investment professional who holds a “carried interest” in order to qualify for the long-term capital gains rate, *i.e.*, the underlying asset held by the partnership must be held for three years (rather than one year), in order for the investment professional to receive long-term capital gains treatment in respect of his/her carried interest. This requirement will apply to partnership interests received in exchange for services in any activity that consists in whole or in part of (1) raising or returning capital and (2) either (A) investing in or disposing of “specified assets,” or (B) developing specified assets. Specified assets include securities (*e.g.*, stock, partnership interests, LLC units, notes, bonds), commodities, real estate held for rental or investment, cash, or derivatives relating to any specified asset.



The holding period requirement will not apply to an interest in a partnership held directly or indirectly by a corporation. This requirement may have limited impact on private equity sponsors given the long-term investment strategies used by most private equity funds. Investment funds with short-term investment strategies should consider the impact of this new holding period requirement.

**Expanded First Year Depreciation Deductibility and Expensing for Acquisition of Capital Assets:** The legislation expands first year accelerated depreciation for investment in qualified tangible property, including many categories of equipment and non-real estate capital assets, under Section 168(k) of the Code from 50 percent to 100 percent of all new investments in assets acquired and placed in service after Sept. 27, 2017, subject to a phase-down schedule following Dec. 31, 2022. Similarly, the legislation increases the amount a taxpayer may immediately expense under Section 179 of the Code from \$500,000 to \$1,000,000 in the year such property is placed in service with a phase-out provision increasing from \$2,000,000 to \$2,500,000. The expensing provision applies to qualified tangible property and is elected by the taxpayer in lieu of accelerated depreciation. These two provisions in concert are intended to increase capital investment back into businesses and grow the production of income from such investment.

**Limitations on Deduction of Business Interest:** Deductions for business interest will be limited to the sum of business interest income plus 30 percent of adjusted taxable income. For tax years prior to Jan. 1, 2022, adjusted taxable income will be computed without regard to any deduction allowable for depreciation, amortization, or depletion. This limitation will be subject to certain exceptions, including exceptions for certain small businesses (*e.g.*, taxpayers with average gross receipts for the three-taxable-year period ending with the prior tax year that do not exceed \$25 million) and any real property trade or business, including real property development, construction, acquisition, or leasing.

**Limitations on Deduction for Net Operating Losses:** Deductions for net operating losses (NOLs) will be limited to 80 percent of taxable income for losses arising in tax years beginning after Dec. 31, 2017. Under current law, NOLs may be carried back two taxable years and carried forward 20 taxable years. Under the bill, carryforward of NOLs will be permitted indefinitely but carryback of NOLs will not be permitted after 2017.

### **Business Tax Credit and Opportunity Zones**

**Qualified Opportunity Zones:** The legislation adopts a new tax incentive for deferring up to one 100 percent of capital gains tax upon a sale or disposition of property when such gains are invested into qualified long-term investments in low-income communities. This new incentive provision may provide significant planning opportunities for many investors and is intended to generate additional long-term investment in areas most needing redevelopment and business growth.

**Affordable Housing and Low-Income Housing Tax Credits:** The Low-Income Housing Tax Credits (LIHTC) program was preserved along with Private Activity Bonds for utilization in LIHTC projects requiring tax exempt bond issuance. The LIHTC program will be subject to adjustments in tax equity pricing based upon reductions in corporate income tax rates.

**New Markets Tax Credits:** New Markets Tax Credits (NMTC) are subject to tax equity pricing adjustments because of corporate rate reductions. However, the NMTC 39 percent tax credit is allocated over a seven year tax credit compliance period, lessening the impact of an immediate corporate rate decrease. Under the legislation, the pool of corporate taxpayers investing in NMTC transactions may be limited due to the tax credits' ineligibility to offset the Base Erosion and Anti-abuse Tax (BEAT) in the legislation, a minimum tax on foreign-owned corporations or corporations with substantial foreign operations.

**Historic Rehabilitation Tax Credit:** The legislation preserves the 20 percent Rehabilitation Tax Credit (HTC) and eliminates the 10 percent tax credit, subject to transition rules. Currently the 20 percent HTC may be claimed at "placed in service" for the certified historic structure, but the legislation provides the HTC will be ratably claimable over the five year compliance period following the certified historic structure's status as "placed in service." Both the elimination of the 10 percent credit and the

implementation of the longer claim schedule for HTCs are subject to a transition rule whereby a property owned by the taxpayer at all times after Jan. 1, 2018, and with rehabilitation construction commencing before or within 180 days of the reconciled legislation's enactment will be eligible to have the HTC claimed by the taxpayer under prior law for a period of 24 months (or 60 months in the case of a phased rehabilitation project). While the property must be acquired and owned by the taxpayer, the Treasury Department or Internal Revenue Service must provide guidance on the transition rules as they relate to whether all of the owners or investors in a taxpayer must be in place prior to Dec. 31, 2017.

The HTC is subject to tax equity pricing adjustments because of corporate rate reductions, but the ratable spread of the credit over five years may lessen the one year impact. The spread of the claim of the HTC over five years should result in lower tax equity pricing due to the diminished present value of the credits. Under the reconciliation tax legislation, the pool of corporate taxpayers investing in HTC transactions may be limited due to the tax credits not offsetting the BEAT in the reconciled bill, a minimum tax on foreign-owned corporations or corporations with substantial foreign operations.

### Key U.S. International Tax Provisions

**Participation Exemption:** A new “participation exemption” regime would be adopted for dividends received by a U.S. corporation from its foreign subsidiaries. The exemption would apply to the foreign source portion of dividends received from a foreign corporation by a U.S. corporation that owns 10 percent or more of the foreign subsidiary. To qualify for the exemption, a one year holding period and certain other conditions must be satisfied. The exemption would not apply to dividends received from a passive foreign investment company that is not a controlled foreign corporation.

The participation exemption regime generally will not apply to capital gain realized on the sale of a foreign subsidiary. However, to the extent that the gain on sale of a foreign subsidiary is characterized as a dividend under the rules of Section 1248 (*i.e.*, because the foreign subsidiary has retained earnings which have not been subject to U.S. federal income tax), such gain would generally qualify for the participation exemption.

As part of the migration to a participation exemption regime, the legislation includes a mandatory deemed repatriation tax on earnings and profits which have accumulated in controlled foreign companies (CFCs). The repatriation tax would be imposed at two different rates. A 15.5 percent tax would be imposed on earnings and profits to the extent of foreign cash and other liquid assets, and an eight percent tax would be imposed on all other earnings and profits. Foreign tax credits would be partially available to offset the repatriation tax. A U.S. shareholder may elect to pay the tax over a period of eight years. An S corporation may elect to defer the payment of the deemed repatriation tax until certain events occur, such as liquidation or sale of the company, termination of the S election, or transfer of shares of the S corporation.

**Subpart F regime:** The Subpart F regime would remain, and thus “U.S. Shareholders” of a CFC will continue to be subject to current tax on their pro rata share of passive income and certain kinds of business income earned by a CFC, such as foreign base company sales income and foreign base company services income. The bill eliminates foreign base company oil related income as a category of Subpart F income.

Certain definitional changes will be made to the CFC regime. In general, a CFC is a foreign corporation whose stock is more than 50 percent owned (by vote or value) by “U.S. Shareholders.” Under current law, a “U.S. Shareholder” is a U.S. person who held 10 percent or more of the voting stock of a foreign corporation. Under the new regime, a “U.S. Shareholder” will also include a U.S. person who owns 10 percent or more of the value of all classes of stock of a foreign corporation. The bill amends the constructive ownership rules so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is treated as a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC.

In addition, the 30 day rule, which requires that a foreign corporation be a CFC for more than 30 days before inclusions under Subpart F income apply, will be repealed.

**Dispositions of Partnership Interests by Foreign Persons:** The bill codifies that a foreign partner's gain from the disposition of an interest in a partnership will be treated as effectively connected income to the extent the partnership's disposition of its assets would be triggered as effectively connected income of the foreign partner. In addition, the bill imposes a 10 percent withholding tax (on the amount realized) if any portion of the gain (if any) on a foreign partner's disposition of the partnership interest would be triggered as effectively connected with a U.S. trade or business.

**Global Intangible Low-Taxed Income:** The legislation expands Subpart F and introduces the inclusion of a minimum tax on "global intangible low-taxed income" (GILTI). Thus, a U.S. parent of a CFC will be taxed currently on a CFC's GILTI, which generally equals the aggregate net income of a CFC reduced by 10 percent of the CFC's aggregate basis in associated tangible business property. Foreign tax credits will be available to shelter up to 80 percent of the foreign taxes imposed on GILTI, and a separate foreign tax credit basket will be created for GILTI. However, certain tax benefits for "foreign-derived intangible income" would be available for the amount of GILTI, which will amount to a deduction for 50 percent of the GILTI (to be reduced after 2025).

**Foreign Tax Credits:** Section 902, the general indirect foreign tax credit regime, will be repealed. That section provided a U.S. corporation that owned at least 10 percent of the voting stock of a foreign corporation a deemed-paid foreign tax credit for foreign income taxes paid by the foreign corporation when the U.S. corporation received a dividend from the foreign corporation. Also, the indirect credit under Section 960 (which treats Subpart F inclusions as dividends received from CFCs for purposes of the indirect foreign tax credit regime) would generally no longer be available, except to the extent foreign taxes are imposed on Subpart F income that is included in a U.S. shareholder's income.

**Foreign Derived Intangible Income:** The legislation provides substantial benefits to a U.S. corporation that sells goods and services to foreign customers. A U.S. corporation would receive a deduction equal to 37.5 percent of the foreign-derived intangible income (FDII) for the taxable year. In addition, 50 percent of the GILTI amount, if any, which is included in the gross income of the U.S. corporation under the Subpart F rules (described above), is allowed as a deduction. Assuming a 21 percent corporate tax rate, the effective tax rate for FDII is 13.125 percent and the effective rate for GILTI is 10.5 percent for taxable years beginning after Dec. 31, 2017, and before Jan. 1, 2026. For taxable years that commence after Dec. 31, 2025, the amount of the deduction will decrease to 21.875 percent of the FDII of the U.S. corporation, and 37.5 percent of the GILTI amount included in the gross income of the U.S. corporation. This will result in an increase in the effective rate for FDII and GILTI earned in taxable years beginning in 2026 or later.

**Transfer of Assets to a Foreign Corporation in a Nonrecognition Transaction:** The foreign active trade or business exception, which generally allows for the tax-free transfer of active foreign business assets (other than intangibles, foreign currency, and certain other assets) to a foreign corporation, will be eliminated.

Under current law, a transfer of intangibles by U.S. person to a foreign corporation in a nonrecognition transfer (*i.e.*, a Section 351 or Section 368 transaction) is treated as a sale of such property for payments contingent on the property's use, productivity, or disposition. The U.S. transferor includes an amount in income each year over the useful life of the property, generally as a declining balance royalty. To address certain controversies that have come up in connection with the valuation of intangible property, the legislation treats goodwill (both foreign and domestic), going concern value, and workforce in place as intangible property.

**Base Erosion Test:** A new base erosion tax is introduced, which would apply to U.S. corporations with average annual gross receipts of over \$500 million, and which have made related party payments which are deductible and which total three percent or more of the corporation's total deductions for the year. The payments which will be subject to this regime (*i.e.*, royalties, interest, management fees) generally will include deductible payments to a related foreign person, as well as the acquisition of property from a foreign related person which is subject to an allowance for depreciation or amortization. Amounts paid or

incurred for services are excluded if those services meet the requirements for the services cost method under Section 482 (excluding the requirement that the services not contribute significantly to fundamental risks of business success or failure).

**Interest Deduction Limitation:** Under current law, section 163(j) generally may disallow a deduction for disqualified interest paid or accrued by a U.S. corporation to a foreign affiliate in a tax year if: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1.0; and (2) the payor's net interest expense exceeds 50 percent of its adjusted taxable income. This provision generally applies when the interest paid qualifies for a reduced withholding tax rate under a tax treaty. Under the legislation, every business (over a certain size) is generally subject to a disallowance of a deduction for net interest expense in excess of 30 percent of the business's adjusted taxable income. Certain electing real estate businesses will be exempt from this rule.

## Authors

This was prepared by the **Greenberg Traurig Tax Practice**. Questions about this information can be directed to:

- [Claire Arritola](mailto:arritolac@gtlaw.com) | +1 954.468.1748 | [arritolac@gtlaw.com](mailto:arritolac@gtlaw.com)
- [Chang Won Choi](mailto:choic@gtlaw.com)<sup>‡</sup> | +1 703.749.1314 | [choic@gtlaw.com](mailto:choic@gtlaw.com)
- [David Dalton](mailto:daltond@gtlaw.com) | +1 415.655.1297 | [daltond@gtlaw.com](mailto:daltond@gtlaw.com)
- [Marvin A. Kirsner](mailto:kirsnerm@gtlaw.com) | +1 561.955.7630 | [kirsnerm@gtlaw.com](mailto:kirsnerm@gtlaw.com)
- [James O. Lang](mailto:langjim@gtlaw.com) | +1 813.318.5731 | [langjim@gtlaw.com](mailto:langjim@gtlaw.com)
- [Noam Lipshitz](mailto:lipshitzn@gtlaw.com) | +1 954.768.5209 | [lipshitzn@gtlaw.com](mailto:lipshitzn@gtlaw.com)
- [Paul B. McCawley](mailto:mccawleyp@gtlaw.com) | +1 954.768.8269 | [mccawleyp@gtlaw.com](mailto:mccawleyp@gtlaw.com)
- [William R. Siegel](mailto:siegelw@gtlaw.com) | +1 305.579.0820 | [siegelw@gtlaw.com](mailto:siegelw@gtlaw.com)
- [Robert D. Simon](mailto:simonr@gtlaw.com)<sup>†</sup> | +1 202.331.3118 | [simonr@gtlaw.com](mailto:simonr@gtlaw.com)
- [Kevin Zaragoza](mailto:zaragozak@gtlaw.com) | +1 212.801.6501 | [zaragozak@gtlaw.com](mailto:zaragozak@gtlaw.com)
- [Diana Zeydel](mailto:zeydeld@gtlaw.com) | +1 305.579.0575 | [zeydeld@gtlaw.com](mailto:zeydeld@gtlaw.com)
- Or your **Greenberg Traurig** attorney

<sup>\*</sup>Admitted to practice in New York. Not admitted in Virginia. Practice is limited to federal tax practice.

<sup>†</sup>Admitted in Colorado, New Jersey, New York and the District of Columbia. Not admitted in Virginia. Practice limited to federal tax practice.

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