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TAX ALERT

TO: Our Clients and Friends

FROM: Grossman Yanak & Ford LLP

DATE: November 2017

REGARDING: Tax Reform

LEVEL OF IMPORTANCE: High

GENERAL OVERVIEW OF THE TAX REFORM

The House of Representatives, by a vote of 227-205, approved its sweeping tax reform package, the Tax Cuts and Jobs Act (HR 1) that had been released out of the House Ways and Means Committee on November 2. Thirteen House Republicans voted against the bill, mostly from states with high income tax rates. No Democrat voted for the bill. The exceptionally speedy mark up and vote moves the Republicans one step closer to achieving a signature legislative victory.

The focus now turns to the Senate, which is in the process of preparing its own tax reform package. The continuing process requires passage of a bill specific to the Senate, after which the two competing bills will require a reconciliation process to forge a single piece of legislation that will then require a final vote in each chamber of Congress. If passed in both chambers, the bill will then move to the President's desk for signature and enactment into law.

The tax bill passed by the House and the Senate plan, as currently published, will have far-reaching implications for taxpayers. We would expect that nearly every taxpayer, whether business or individual, will likely see changes on a level not experienced since the passage of the Tax Reform Act of 1986, more than three decades ago. The House bill, as well as the current Senate plan will produce tax savings for many but as with all tax bills, there are likely to be those who will pay more!

The tax reform package is certainly at the top of the political talk show and news programs hit lists, driving endless commentary on what is still a very preliminary set of changes and modifications to the current Internal Revenue Code. However, it is useful to understand the current provisions as they are set forth in the House bill and the current Senate plan.

Currently, both versions of the tax reform plan include provisions that reduce the individual and corporate tax rates, repeal a number of tax credits and deductions (especially "itemized" deductions), eliminate the "hated" and onerous alternative minimum tax (AMT), and expand and enhance the child tax credit. Both tax reform plans also expand and increase the expensing of business assets through the allowance of greater write-offs and an expansion of the "Section 179" provision.

Mr. Trump and the administration have come out as supporting the House bill, and Republicans hope to have the tax plan to the President before the Christmas holiday. However, there are many barriers that may impede this objective, including cohesive and strong opposition from the Democrats and, as always, intense lobbying efforts from interested parties to preserve tax breaks slated for elimination, especially the state and local income tax deduction available under current law.

Interestingly, there are a number of significant differences between the House bill and the current Senate proposal. These differences are also likely to slow down the reconciliation process necessary to forge a single bill, and could provide a further obstacle to quick passage and enactment.

Republican leaders in the Senate expected that the Senate Finance Committee (SFC) to finish their mark-up of the tax reform package before recessing for the Thanksgiving holiday, however, they did not meet that deadline and are currently working to finalize a bill that will be presented to the Senate for a final vote in the near future. The provisions of the final House bill are very close to the original bill introduced on November 2.

It is noteworthy that the proposed changes in both plans are primarily forward-looking (after 2017) and focused on the 2018 tax year and beyond. Few provisions are expected to be of benefit for calendar tax year 2017. Unfortunately, because this process is not expected to be complete until late in the calendar year, it will prevent any substantive planning for 2017, in any case.

The primary provisions of the House bill and how they compare to the current Senate plan are detailed below.

PROVISIONS AFFECTING INDIVIDUALS

Income Tax Rates

- The final House bill proposes four marginal tax rates: 12%, 25%, 35% and 39.6% after 2017. The Senate plan calls for seven rates: 10%, 12%, 22.5%, 25%, 32.5%, 35% and 38.5% after 2017.
  - Under current law, individual income tax rates are 10%, 15%, 25%, 28%, 33%, 35% and 39.6%.
- Under the House bill, the benefit of the 12% rate would be phased out for taxpayers in the 39.6% bracket.

It is noteworthy that neither the final House bill nor the current Senate plan change the current tax treatment of qualified dividends and capital gains. Thus, in both bills, the top tax rate applicable to those two classifications of income will be 20%.

Neither House bill nor the current Senate plan repeal the Affordable Care Act's taxes. The net investment income (NII) tax, the additional Medicare tax, the medical device excise tax, and a number of other assessments imposed under the Affordable Care Act remain intact at this point in time without any proposed modifications.

Standard Deduction/Itemized Deductions

- The House bill nearly doubles the standard deduction to $24,400 for married taxpayers filing jointly, and to $12,200 for single filers, as adjusted for inflation using a chained CPI for 2018. Under the bill, heads-of-households can claim a standard deduction of $18,300.
- The current Senate plan calls for these amounts to move to $24,000, $12,000, and $18,000, respectively.

Under current law, the standard deduction for 2018, absent any changes will be $13,000 for joint filers, $9,550 for heads of households, and $6,500 for single filers. The Senate plan would retain the additional standard deduction for the elderly and blind. Thus, the expansion of the standard deduction is at the center of the proposed tax reform plan legislation.

Both the House bill and the current Senate plan eliminate the deduction for personal exemptions ($4,050 per personal exemption and/or dependent in 2017) and the personal exemption phase-out (known as the “Pease” limitation). These limitations did, under current law, work to limit higher income taxpayers from enjoying the full tax benefits of their itemized deductions.

Additional changes to deductions include the following:

- The home mortgage interest deduction (a taxpayer favorite) would be retained, but modified under both proposals. For most debt incurred after the proposed effective date of November 2, 2017, the current $1 million limitation would be reduced to $500,000 under the House bill. The Senate plan retains the home mortgage interest deduction, but eliminates the home equity interest deduction.
- In the House bill, the deduction for state and local income taxes would be completely repealed after 2017. This provision remains a sensitive issue for House members representing taxpayers in “high tax rate” states. Similarly, taxpayers would no longer be able to elect to deduct state and local sales taxes in lieu of state and local income taxes. In a concession to the real estate industry lobbies, the House bill would allow property taxes up to $10,000 to be deducted.
- The current Senate plan also eliminates the state and local tax deduction. Interestingly, the Senate plan provides no exception for real estate and property taxes as the House bill does. Thus, all state and local taxes would no longer be deductible under the Senate plan.
- While the House bill repeals the medical expense deduction, the Senate plan preserves the medical expense deduction.

Family Incentives

To provide a tax break to middle- and lower-income taxpayers in light of taking away personal exemptions and those for dependents, the House bill increases the child tax credit to $1,600 and adds a provision allowing temporary credit of $300 for non-child dependents. A temporary “family flexibility credit” of $300 would be allowed with respect to the taxpayer (each spouse in the case of a joint return) who is neither a child nor a non-child dependent. The Senate plan increases the child tax credit to $1,650 and allows a $500 credit for non-child dependents.

Under the amended (and final) version of the House bill approved by the Ways and Means Committee, the adoption credit is now proposed to be retained, while the Senate plan makes no changes to the adoption credit. The maximum amount of the credit in 2017 is $13,570, and is scheduled to increase to $13,840 in 2018.

Both the House bill and the Senate plan retain the earned income tax credit (EITC). This credit has been vital to lower-income taxpayers in the past, but is also the subject of significant taxpayer abuse and improprieties.

Education

The House bill would consolidate, after 2017, a number of education incentives available under current law, including the American Opportunity Tax Credit (AOTC) and Lifetime Learning Credit. The Senate plan currently makes no changes to education credits

The House bill would repeal the popular student loan interest deduction and would not revive the tuition and fees deduction, which expired after 2016. The Senate plan retains the student loan interest deductions.

Retirement

With limited exceptions, the House bill retains the current rules for IRC §401(k) and other retirement plans. The House bill provides for the repeal of the rule allowing taxpayers to re-characterize Roth IRA contributions as traditional IRA contributions, as well as the rule allowing conversion of traditional IRA contributions to Roth IRA contributions. Additionally, rules for hardship distributions would be modified, among other changes. The actual conversion of a regular IRA account to a Roth IRA account remains unchanged.

The Senate plan would align contribution limits under Sections 401(k), 403(b) and 457 plans. The Senate plan would also make early withdrawals from 457 plans subject to the early withdrawal penalty. Finally, and importantly, the current Senate plan would eliminate "catch-up" contributions for employees with compensation in excess of $500,000.

Federal Estate Tax

The current maximum federal estate tax rate is 40%, with an inflation-adjusted $5 million exclusion ($5.49 million in 2017), which married couples can combine for a $10 million exclusion ($10.98 million in 2017).

The House bill provides for doubling the federal estate tax exemption and then completely eliminating the estate tax for all decedents dying after 2024. The Senate plan would keep the federal estate tax, but increase the basic exclusion to $10 million for individuals, subject to inflation adjustments. No mention has been made in either bill of modifications to the basis "step-up" rules for property held by a decedent at death.

Alternative Minimum Tax (AMT)

Both the House bill and the Senate plan call for permanently abolishing the AMT. This parallel tax computation regime (the AMT) has existed for the stated purpose of ensuring that individuals, corporations, estates, and trusts with substantial income do not fully avoid tax liability. Its usefulness in accomplishing that purpose has long been waning and, as currently structured, the AMT tends to impose the tax on many taxpayers that were never intended to be assessed the AMT.

PROVISIONS AFFECTING BUSINESSES

Corporate Taxes

The approved House bill calls for a 20% corporate tax rate beginning in 2018. The current Senate plan also calls for a 20% corporate tax rate, but delays the effective date to 2019.

The maximum corporate tax rate currently tops out at 35%. As the average corporate tax rate in all industrialized countries is 22.5%, a proposed rate of 20% should serve to enhance the competitiveness of doing business in the United States.

Business Tax Benefits

There are a number of proposed changes to various business incentives in both the House bill and the current Senate plan.

A key provision is the one effectively allowing 100%, immediate expensing of qualified property for a five-year period (qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023, with an additional year for certain longer production period property). Note that this provision, in particular, may prove helpful for businesses in calendar 2017, if the effective date is not modified before enactment.

The House bill also temporarily increases the Section 179 expensing limitation to $5 million and the phase-out amount to $20 million for tax years beginning before 2023. Offering a new twist at revenue raising, the House bill modifies the rules for deducting business interest and the rules for net operating losses (NOLs).

The Senate plan generally tracks the House approach to immediate expensing, though the Section 179 expensing limitation is proposed to be permanently increased to $1 million, with a $2.5 million phase-out amount.

Deductions and Credits

A substantial number of business tax credits and deductions would be eliminated after 2017 under both the House bill and the Senate plan. These include the Section 199 Domestic Production Activities Deduction, non-"real property" like-kind exchanges and the Work Opportunity Tax Credit. The rules for business meals and client/customer entertainment would also be revised.

The House bill retains the research and development (R&D) credit, but requires a five-year amortization of research and development expenditures. The proposed Senate plan makes no similar changes to R&D incentives.

Interest Deductions

Both the House bill and Senate plan cap the deduction for net interest expenses at 30% of adjusted taxable income. Exceptions would exist for small businesses (with average annual gross receipts less than $25 million).

Pass-Through Businesses

Currently, owners of partnerships, S corporations and sole proprietorships pay taxes at the individual rates, with the highest rate, as noted earlier, at 39.6%.

The House bill proposes a 25% tax rate for pass-through income after 2017, with a 9% rate for certain small businesses. The Senate plan takes a different approach, providing a 17.4% deduction of pass-through or sole proprietorship income. The desired effect of the Senate deduction approach is to yield a result that effectively applies a tax rate to the taxable income earned by these businesses of approximately 32%.

A number of Senate Republicans are concerned by the pass-through business provisions, arguing that the plan does not go far enough to help these businesses, often owned by the country's small business people.

Energy Incentives

The House bill repeals many of the current energy tax incentives, including the marginal well tax credit and the credit for plug-in electric vehicles. Other energy tax preferences, such as the residential energy efficient property credit would be modified under the House bill.

The Senate plan does not currently address energy incentives.

Exempt Organizations

The House bill makes several changes to the rules governing exempt organizations, including a modification of the so-called "Johnson amendment," which generally restricts Section 501(c)(3) organizations from certain political campaign activity. In addition, the House bill also revises reporting requirements for donor-advised, fund-sponsoring organizations and imposes an excise tax on the investment income of certain colleges and universities, among other changes.

The current Senate plan proposes to repeal tax-exempt status for professional sports leagues, among other changes. This provision is certain to draw national attention.

International Taxes

Nowhere has the United States tax system caused more problems as of late than in the International tax provisions. To address these problems, the House bill would create a dividend-exemption system for taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. Further, the foreign tax credit rules would be modified, as would the Subpart F rules. The look-through rule for related controlled foreign corporations would be made permanent under the House bill.

Repatriation

A portion of deferred overseas-held earnings and profits (E&P) of subsidiaries would be taxed at a reduced rate of 14% (7% for illiquid holdings) under the House bill, as amended by and approved by the Ways and Means Committee. Under the Senate plan, these amounts are 10% and 5%, respectively.

Under both the House bill and the Senate plan, foreign tax credit carryforwards would be fully available, and foreign tax credits triggered by the deemed repatriation would be partially available to offset the U.S. tax.

IN CONCLUSION

While the passage of the bill in the House represents a major step in getting the reform package closer to law, much work remains. The next important step is concluding the Senate mark-up, and getting the Senate to approve the plan through a floor vote. It remains to be seen if this step can be accomplished.

Grossman Yanak & Ford LLP will continue to monitor the progress of this legislation as it progresses towards enactment. In the interim, questions and comments can be directed to Bob Grossman and Don Johnston at 412-448-9300.