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Tax Notes

First Look at the Tax Cuts and Jobs Act

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On November 2, 2017 the U.S. House of Representatives and House Ways and Means Committee issued a draft of its long-awaited tax reform legislation for individuals and businesses in the Tax Cuts and Jobs Act (HR 1). The goal of this 429-page Tax Act is to create tax cuts for the middle class and create economic and job growth.

Policy highlights include consolidation of individual tax brackets, larger standard deductions, reduced mortgage interest deductions and removal of the state and local tax deduction. In addition, the estate tax would be repealed over time and the corporate tax rate is permanently reduced. Unless specifically stated otherwise, the provisions would be effective for tax years beginning after December 31, 2017.

The House Ways and Means Committee could revise the bill next week as the Republicans move toward passage in the House later in the month. The bill would still need to go through Senate review and deliberation which would have to be reconciled with the House version before ultimate sign-off. In all likelihood, the final version may look very different from the highlights outlined below.

Provisions Affecting Individuals

Standard Deduction: Doubles to:

- $24,400 for married taxpayers filing jointly
- $18,300 for head of household
- $12,200 for single filers

Personal Exemptions: Repealed.

Tax Rates: Currently, there are seven tax brackets; the Act consolidates them into four brackets. Below are the rates and tax brackets for **married filing jointly**:

	From	To
12%	$ 0	$ 90,000
25%	90,001	260,000
35%	260,001	1,000,000
39.6%	1,000,001	and above

The bracket thresholds for single filers will be one-half of those for married joint filers. In addition, the 12% rate will be phased-out for certain high income individuals (AGI > $1.2 million for joint and $1.0 million for single).

Note: Currently, the 35% bracket is $416,701 - $470,700, and the 39.6% bracket is $470,701 or more.

Child Tax Credit: Increases from $1,000 to $1,600.

Family Flexibility Credit for Non-Child Dependents: A new $300 non-refundable credit is provided for the taxpayer, a spouse and any non-child dependents. Additionally, the income levels at which the Child Tax Credit begin to phase-out will be increased from $110,000 to $230,000 for joint filers and from $75,000 to $115,000 for single filers.

Education-Related Provisions:

- The current education credit programs will be combined into one Enhanced American Opportunity Tax Credit and the Hope Scholarship and Lifetime Learning Credit programs will be repealed.
- New contributions to Coverdell education savings account will no longer be permitted, but you will be allowed tax-free rollovers of existing accounts to Section 529 plans. Elementary and high school expenses of up to $10,000 per year would be qualified expenses for 529 plans and "qualified expenses" would be expanded to cover expenses related to apprentice programs.
- The deduction for interest on education loans, qualified tuition and related expenses, and employer-provided education assistance programs is repealed.

Retirement Accounts:

- Currently, the structure of 401(k) plans and Individual Retirement Accounts remain unchanged. Only minor changes are proposed.
- The current rule that allows for the re-characterization of traditional and Roth IRA contributions is repealed as is the re-characterization of conversions of a traditional IRA to a Roth IRA by October 15th of the year following the conversion.

Alimony: The current deductibility of alimony payments is repealed and would not be taxable income to the recipient. This provision will be effective for any divorce decree or separation agreement executed after 2017 and to any modification after 2017 of an existing agreement.

Moving Expenses: The current above-the-line deduction for moving expenses is repealed.

Archer Medical Savings Accounts (MSA): Deductions for contributions to MSAs will be repealed along with the exclusion from taxable income for employer-provided contributions. Tax-free rollovers from MSAs to Health Savings Accounts will continue to be allowed.

Exclusion of Gain from Sale of Principal Residence: The current $500,000 (joint) and $250,000 (single) gain exclusions remain, but to qualify as a principal residence, the period of time used as a principal residence has been increased from two of the previous five years to five of the previous eight years.

Repeal of Various Employer-Provided Assistance: There is a repeal of tax-free employer provided assistance for: employee achievement awards, dependent care, qualified moving expenses and adoption assistance programs.

Individual Alternative Minimum Tax (AMT): Repealed. It is worth noting that many of the deductions that would cause a taxpayer to be in the AMT are to be repealed. Individuals with existing minimum tax credit carryforwards will be able to claim a refund of 50% of their remaining credits.

Carried Interest: Worth noting that the carried interest provisions are not mentioned.

Itemized Deductions:

- The overall limitation on itemized deductions is repealed. This is known as the "Pease limitation."
- Deductions for charitable contributions remains unchanged. However, the 50% of Adjusted Gross Income (AGI) limitation is increased to 60% for cash contributions and the five-year carryover period will be retained.
- Mortgage interest: The interest expense related to debt incurred after November 2, 2017 may be deducted on new home purchases up to $500,000 of indebtedness. Currently, an individual may deduct interest expense up to $1,000,000 of indebtedness and up to $100,000 of home equity indebtedness. The deduction for home mortgage interest for existing mortgages would remain intact. Interest would only be deductible on a taxpayer's principal residence.
- Deduction for State and local income tax is repealed but individuals will continue to deduct state and local income or sales taxes paid or accrued in carrying on a trade or business or producing income.
- Deduction for personal casualty loss deduction is repealed, but the deduction for personal casualty losses associated with special disaster relief legislation would not be affected.
- Deduction for medical expenses is repealed.
- Deduction for tax preparation fees is repealed.
- Deduction for unreimbursed employee expenses is repealed.
- Real property taxes are deductible up to a $10,000 cap.

Estate and Generation-Skipping Taxes: The lifetime exclusion amount is doubled from the 2011 level of $5,000,000 to $10,000,000 per person. This amount will be indexed for inflation. Beginning after 2023, the estate and GST taxes are fully repealed while the beneficiaries retain a step-up in basis.

Gift Tax*:* The gift tax is lowered to a top rate of 35% from the current 40% and retains the 2017 annual exclusion of $14,000 and uses the increased lifetime exclusion of $10,000,000.

Businesses Tax Reform

Maximum Rate on Business Income of Individual: Currently, all of the income attributable to sole proprietors, partnerships, LLCs and S Corporations are generally treated as "pass-through entities" for Federal income tax purposes; therefore, the income is subject to tax at the individual level at a top tax rate of 39.6%. The Act creates a top pass-through rate of 25 percent on small business income with safeguards against abuse. The special 25% rate will not apply to businesses involving the performance of services in the fields of law, accounting, consulting, engineering, financial services, or performing arts.

Tax Rate for Corporations: The current four bracket graduated rates of 15%, 25%, 34% and 35% are condensed to one flat corporate tax rate of 20%. There will also be one flat rate of 25% for personal service corporations. Also, eliminates the corporate AMT.

"Expensing" of Capital Investments: Allows businesses to immediately write-off (or "expense") in the form of bonus depreciation the cost of qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. Property qualifying for this immediate expensing has been expanded with the repeal of the requirement that the original use of the property begin with the taxpayer. The new provision defines qualifying property as property "first used by the taxpayer." Also, Section 179 would be increased from the current $500,000 to $5,000,000 and the phase-out would be increased to current year property placed in service in excess of $20 million.

Accounting Methods for Business with Gross Receipts of Less than $25 million:

- **Cash Method Accounting:** The $5 million gross receipts threshold for corporations and partnerships with a corporate partner to be able to use the cash method of accounting for tax purposes is increased to $25 million and will be indexed for inflation.

- **Accounting for Inventories:** Businesses with average gross receipts of $25 million or less will be permitted to use the cash method of accounting for tax purposes even if the business has inventories.

- **Capitalization of Certain Inventory Costs:** Businesses with average gross receipts of $25 million or less will be fully exempt from the UNICAP rules. This exemption would apply to real and personal property acquired or manufactured by such business.

- **Accounting for Long-Term Contracts:** The $10 million average gross receipts exception to the percentage of completion method would be increased to $25 million. Businesses that meet the increased average gross receipts test would be permitted to use the completed-contracts method (or any other permissible method).

Interest Expense: The deduction for net interest expense is capped at 30 percent of adjusted taxable income, except for small businesses with average gross receipts of less than $25 million. For this purpose, adjustable taxable income is determined without regard to business interest income and expense, net operating losses, depreciation and amortization and depletion. This interest expense limitation is calculated at the filer level (a partnership as opposed to its partners) and any disallowed interest could be carried forward for five years and would be an attribute of the business.

Net Operating Losses (NOL): Taxpayers will be able to deduct an NOL carryover or carryback only to the extent of 90% of the taxpayer's taxable income for such year. Generally, there will be a repeal of all NOL carryback with the exception of a special one-year carryback for small business and farms in the case of certain casualty and disaster losses.

Like-Kind Exchanges: The special rule allowing the deferral of gain on like-kind exchanges would be modified to allow only like-kind exchanges of real property.

Contributions to Capital: The gross income of a corporation will now include contributions to its capital, to the extent the amount of money and FMV of property contributed to the corporation exceeds the FMV of any stock that is issued in exchange for such money or property. Similar rules would apply to contributions to the capital of any non-corporate entity, such as a partnership.

Meals and Entertainment Expenses: No deduction will be allowed for entertainment, amusement or recreational activities, facilities, or membership dues relating to such activities or other social purposes. The 50% limitation under current law would apply only to expenses for food and beverage and to qualifying meals, with no deduction allowed for other entertainment expenses.

Repeal of Technical Termination of Partnerships: A partnership will no longer be considered to be terminated if more than 50% of the total capital and profits interests were sold or exchanged within a 12-month period.

Nonqualified Deferred Compensation: An employee will now be taxed on compensation as soon as there is no substantial risk of forfeiture with regard to that compensation rather than when it is paid or distributed to such employee.

Business Credits: Many credits are repealed including employer-provided child care credit, rehabilitation credit, work opportunity credit and the new markets tax credit. Some of the energy credits are intact, but modified. Low income housing and research and development credits have been retained as well.

Repatriation of Foreign Earnings: he Act allows for the temporary repatriation of foreign earnings at a 12 percent rate (5 percent for noncash holdings).

Foreign Earnings: Under the exemption system, 100 percent of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent or more of the foreign corporation would be exempt from U.S. taxation. No foreign tax credit or deduction would be allowed for any foreign taxes.

The House Ways and Means Committee has scheduled a markup of the Tax Cuts and Jobs Act for November 6, 2017. It is likely to last several days and amendments are expected.

Contact Us

There is a long way to go before the Act is introduced into law. In the coming weeks, we will issue more in-depth analysis of various provisions of the House tax bill as well as keep you updated on new developments as the legislative process continues. In the meantime, please let us know if you have any questions about your particular tax situation.

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