Tax Notes

Senate Passes Tax Reform Bill

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Early morning, December 2, 2017, the Senate passed its version of tax reform legislation after key compromises were made to the Tax Cuts and Jobs Act H.R. 1 which affects all taxpayers. The Senators worked into the midnight hours to gain the needed votes for passage and win support from those who had concerns about adding to the federal deficit. Similar to the House reform bill, passed in November (see our e-newsletter), the goal of this 479-page Tax Act is to stimulate the economy and create job growth. The Trump Administration has stated that these measures would provide massive tax cuts that benefit all taxpayers. However, as is the case in all tax legislation, there will be winners and losers.

This final Senate bill differs in several key aspects from the House version, and these differences must now be reconciled in order to have the final piece of legislation sent to the President by Christmas, as promised. Policy highlights include temporary lower tax rates for individuals and pass-through entities, offset by lost and/or reduced itemized deductions and credits. The bill also lowers the corporate tax rate starting in 2019 and preserves the estate tax with an increased exemption amount.

While the House and Senate chambers of Congress must agree on the ultimate and final bill, the $1.5 trillion tax cut package is poised for passage. It appears that the major differences in the two bills that will have to be reconciled are the:

- Proposed treatment of pass-through entities
- Individual rate structure and the "bubble rate"
- Treatment of the estate tax, and
- Treatment of mortgage interest

In this alert, we take a look at some of the highlights of the Senate bill.

Provisions Affecting Individuals

Please note that the individual provisions are temporary in nature. All of the individual provisions listed below, as well as the estate tax provision, will expire at the end of 2025 and sunset to the law that exists today unless the law is extended.

Standard Deduction: Doubles to:

- $24,000 for married taxpayers filing jointly
- $18,000 for head of household
- $12,000 for single filers

Personal Exemptions: Repealed.

Child Tax Credit: Increases from $1,000 to $2,000.

Capital Gain/Dividend Rates: No change from current law in terms of the tax rate.

3.8% Tax on Net Investment Income: No change from current law and remains in place.

Tax Rates: The seven tax brackets that currently exist are maintained; the Act just lowers the rates. Below are the rates and tax brackets for **married filing jointly.** The single brackets are half of these amounts.

Rate	From	To
10%	$ 0	$ 19,050
12%	19,050	77,400
22%	77,400	140,000
24%	140,000	320,000
32%	320,000	400,000
35%	400,000	1,000,000
38.5%	1,000,000	and above

*__Note:__ Currently, the 35% bracket is $416,701 - $470,700,and the 39.6% bracket is $470,701 or more

Retirement Accounts: Currently, the structure of 401(k) plans and Individual Retirement Accounts remain unchanged.

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

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.

Individual Alternative Minimum Tax (AMT): Is not repealed, and will remain intact with higher exemption amounts.

Deduction for Teacher and Educator Expenses: Increased from $250 to $500.

529 Accounts: Allow people to use up to $10,000 from tax-advantaged 529 savings accounts to fund tuition at private and religious K-12 schools or certain educational expenses for home schooled students. Currently only allowed for higher education.

Itemized Deductions

- The overall limitation on itemized deductions is repealed. This is known as the "Pease limitation."
- All miscellaneous itemized deductions that are subject to the 2% floor are repealed.
- Deductions for charitable contributions remain 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 deduction retains the current limit for the home mortgage interest deduction to interest paid on the first $1 million of the loan. Home equity interest would no longer be deductible.

- 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.
- Real property taxes are deductible up to a $10,000 cap.
- Deduction for personal casualty losses is repealed unless it is related to, or associated with, a federally declared disaster.
- Deduction for medical expenses is allowed for 2017 and 2018 up to 7.5% of adjusted gross income.

Estate and Generation-Skipping Taxes: The exemption for estate tax is doubled, going to $11,000,000 per person. No repeal. This amount will be indexed for inflation.

Business Tax Reform

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%.** The Senate version of the bill delays the effective date of the 20% rate to 2019. The bill retains the corporate Alternative Minimum Tax.

For 2018, there will also be one flat rate of 25% for personal service corporations. After 2018, the special rate of 25% will be eliminated for personal service corporations.

Business Deduction in Lieu of Maximum Tax Rate for Income from Pass-Through Entities: A 23% deduction would be available for taxpayers who have domestic "qualified business income" (QBI) from a partnership, S corporation, or sole proprietorship. QBI would be defined as all domestic business income other than investment income. The deduction would generally be limited to 50% of the taxpayer's allocable or pro rata share of "W-2 wages" paid by the partnership or S corporation, or 50% of sole proprietorship income, but would not apply to a taxpayer with taxable income less than $500,000 (for married filing joint taxpayers).

"Expensing" of Capital Investments: The bill would temporarily allow 100% first-year additional depreciation for qualified property placed in service after September 27, 2017 and before January 1, 2023 (January 1, 2024 for long production period property). Taxpayers could elect to take 50% in lieu of 100% first-year additional depreciation for qualified property placed in service during the first tax year ending after September 27, 2017. Qualified property would exclude property used in a real property trade or business, but would be expanded to include qualified film, television, and live theatrical productions initially released, broadcast, or staged live after September 27, 2017 and before January 1, 2023.

Section 179 Expensing: The bill would increase the amount that a taxpayer may expense under §179 to $1,000,000. The bill would also increase the phase-out threshold to $2,500,000. These amounts would be indexed for inflation for tax years beginning after 2018. The $25,000 cost limitation for SUVs would also be indexed for inflation beginning in 2019.

Depreciation Limitation for Luxury Automobiles and Personal Use Property: The bill would increase the depreciation limitations for passenger automobiles placed in service after December 31, 2017 to $10,000 for the year in which the vehicle is placed in service; $16,000 for the second year; $9,600 for the third year; and, $5,760 for the fourth and later years. The bill provides that the amounts will be indexed for inflation for automobiles placed in service after 2018.

Depreciation Deductions for Nonresidential Real Property and Residential Rental Property

The bill would:

- Shorten the recovery period for nonresidential real property and residential rental property under both §168 and §467(e) to 25 years;
- Provide a 10-year recovery period for qualified improvement property;
- Eliminate the separate definitions of "qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property;"

- Provide a 20-year ADS recovery period for all qualified improvement property;
- Require a real property trade or business electing out of the interest expense deduction limitation to use ADS to depreciate its nonresidential real property, residential rental property, and qualified improvement property; and
- Lower the ADS recovery period to 30 years for residential rental property.

Accounting Methods for Business with Gross Receipts of Less than $15 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 $15 million and will be indexed for inflation.
- **Accounting for Inventories:** Businesses with average gross receipts of $15 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 $15 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 requirement to use the percentage-of-completion accounting method for long-term contracts to be completed within two years would be increased to $15 million (indexed for inflation) for contracts entered into after 2017, and businesses that meet such exception would be permitted to use the completed-contract method (or any other permissible exempt contract method).

Interest Expense: The bill would limit the deduction for net interest expenses incurred by a business in excess of 30% of the business' adjusted taxable income. Businesses with average annual gross receipts of $15 million or less would be exempt from the limit. Disallowed interest could be carried forward indefinitely.

Net Operating Losses (NOL): The bill would limit the NOL deduction to 90% (80% in tax years beginning after December 31, 2022) of taxable income and provide that amounts carried to other years be adjusted to account for the limitation for losses arising in tax years beginning after December 31, 2017 and allowing indefinite carry forward for NOLs generated after 2017.

Like-Kind Exchanges: The bill would limit the nonrecognition of gain for like-kind exchanges to real property that is not held primarily for sale. The bill would generally apply to exchanges completed after December 31, 2017. However, an exception would be provided for any exchange if either the property being exchanged or the property received is exchanged or received on or before December 31, 2017.

Meals and Entertainment Expenses: The bill would repeal the exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50% limit).

Deduction for 50% of food and beverage expenses associated with operating a trade or business generally would be retained. The bill would disallow deductions for expenses associated with providing any qualified transportation fringe to employees, and except for ensuring employee safety, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

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.

International Tax Provisions

100% Deduction for Foreign-Source Portion of Dividends: The bill would provide a 100% deduction for foreign-source portion of dividends received from "specified 10-percent owned foreign corporations" by

U.S. shareholders, subject to a one-year holding period. No foreign tax credit would be permitted for foreign taxes paid or accrued with respect to a qualifying dividend. Deduction would be unavailable for "hybrid dividends."

Foreign Tax Credit: The bill would repeal the indirect "deemed paid" foreign tax credit under §902.

Repatriation of Foreign Earnings: Accumulated foreign earnings held in cash or cash equivalents and in illiquid assets would be deemed repatriated and taxed at 14.5% and 7.5% respectively. Taxpayer may elect to pay resulting liability over eight-year period.

Base Erosion: A minimum tax equal to "base erosion minimum tax amount" would be imposed on "base erosion payments" paid or accrued by a taxpayer to a foreign related person. Base erosion minimum tax amount would be the excess of 10% of the modified taxable income of the taxpayer for the tax year over the taxpayer's regular tax liability.

Contact Us

There is a still quite a bit of negotiation that must take place, but it seems that we will see some tax legislation passed by year-end. It is important to note that any changes may not affect your 2017 tax return directly; however, planning may be beneficial to best take advantage of deductions and credits that may be disappearing.

In the coming weeks, we will issue more in-depth analysis of various provisions of the pending 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. We are here to help you.

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