The Tax Cut and Jobs Act

After months of anticipation and expectation, on November 2, 2017 the House Ways and Means Committee released a bill to provide the most substantial reform of the tax code since 1986. Here is an overview and summary of the major components of this first step in the tax reform process.

Overview

The Tax Cut and Jobs Act approaches tax reform by broadening the tax base and eliminating loopholes in order to provide some tax rate reductions. In addition to these rate reductions there are other changes and "reforms" that speak to GOP priorities. Based on the summary below, it seems obvious that with tax reform one person's loophole is another person's tax incentive.

Rate Reduction and Other Reform Items (The Goodies)

Individuals

» Reduces the number of tax brackets from seven to four: 12%, 25%, 35%, and 39.6%. For married taxpayers filing jointly, the 25% bracket threshold would be $90,000 of taxable income, the 35% bracket threshold would be $260,000, and the 39.6% bracket threshold would be $1 million.

H+C Observation - There are many moving parts for individuals in this proposed tax Act (increase in standard deduction, reduction of itemized deduction and loss of personal exemptions). Therefore, other than for taxpayers who earned over $420,000 of taxable income it is difficult to determine at a glance whether it will benefit a specific taxpayer.

Income Tax Bracket	Income Amount – Joint	Income Amount - Individuals
12%	$0 to $89,999	$0 to $44,999
25%	$90,000 to $259,999	$45,000 to $129,999
35%	$260,000 to $999,999	$130,000 to $499,999
39.6%	$1,000,000 and above	$500,000 and above

» Increases the standard deduction to $24,000 for married couple filing jointly and $12,000 for single filers.

H+C Observation - This provision will reduce the impact of the elimination of most itemized deductions by reducing the number of taxpayers benefitting from itemized deductions

» For business income taxed at the individual level (sole proprietor or owner of a pass-through entity), there is a convoluted calculation that arbitrarily defaults to taxing 30% of "business profit" at no more than 25% and the remaining 70% at the applicable statutory rate. Taxpayers can elect an alternative formula that is based on invested capital multiplied by the short-term applicable federal rate plus 7%. Certain industries, like health, financial, and professional services can only use the invested capital formula to determine "business income." All income from passive activities (as determined under the current Section 469 rules) will be taxed at a maximum 25% rate.

H+C Observation - This provision is an attempt to provide a rate reduction to businesses other than regular corporations. However, it seems overly complicated and may miss the mark since there are some small business owners that would be subject to the lower 25% rate anyway without this provision.

» Retains lower rates on capital gain income and pretax contribution amounts to 401(k) plans.
» Repeals the alternative minimum tax (AMT).
» Retains the charitable contribution deduction and increases the adjusted gross income (AGI) limitation for cash donations to 60%.
» Repeals the 3% AGI limitation on itemized deductions, also known as the "Pease limitation."
» Consolidates the three existing higher education tax credits (American Opportunity Tax Credit [AOTC], Hope Scholarship Credit [HSC], and Lifetime Learning Credit [LLC]) into a new, enhanced AOTC. The new AOTC is the same as the current AOTC but would also be available for a fifth year of post-secondary education at half the rate as the first four years.

Business

» Creates a flat corporate income tax rate of 20%. Personal service corporations would be subject to a flat 25% rate.

H+C Observation - This rate reduction is made permanent through this bill. This is the most expensive provision of the act.

» Repeals the corporate AMT.
» Permits full expensing. One hundred-percent expensing is allowed for qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023. The "new property" requirement is removed and replaced with a taxpayer's first-use rule. Any property used in a real property trade or business is not eligible for expensing.

H+C Observation - Effectively expands and extends bonus depreciation.

» Increases Section 179 expensing for five years. The small business expensing limitation would be increased to $5 million, and the phase-out amount would be increased to $20 million.
» Retains the research and development tax credit.
» Cash method of accounting, increases the $5 million average gross receipts threshold for corporations and partnerships with corporate partners to $25 million (indexed for inflation) and extends it to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations. The requirement of meeting the test for all prior years is repealed.
» Permits businesses with average gross receipts of $25 million or less to use the cash method of accounting even if the business has inventories as long as it treats inventory as non-incidental materials and supplies or the method of accounting conforms to the taxpayer's applicable financial statements.

International Tax

» Creates exemption for foreign-sourced dividends. One hundred percent of the foreign-source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder who owns 10% or more of the foreign corporation would be exempt from U.S. taxation. This applies to distributions made after 2017. Neither the foreign tax credit nor the deduction is allowed.

Estate Taxes

» The basic $5 million exemption amount is doubled, effective in 2018. Further, the estate tax will be eliminated beginning after 2023 while the beneficiaries' step-up in basis would be maintained.

H+C Observation - This provision does not appear to generate economic growth or create jobs. There is potential for the elimination of this change to make the act more applicable to the middle class.

»

Broadening the Tax Base and Elimination of Loopholes (The Spinach)

Individuals

» Eliminates the deductions for personal exemptions and for state and local income or sales taxes.

H+C Observation - The loss of the personal exemption deduction may result in an increased tax bill for large families. The elimination of the state and local deduction is not a provision that is easy to support for Republicans in high tax states such as California, Illinois and New Jersey.

» Retains the deduction for property taxes but only up to $10,000.
» Retains the deduction for interest expense on acquisition indebtedness of up to $1million on existing mortgages. Interest on acquisition indebtedness incurred after November 2, 2017, is limited to $500,000 and can be claimed only on the taxpayer's principal residence.
» Eliminates most other itemized deductions along with the employee moving expense deduction, educator expense deduction, and exclusions for employer-provided dependent care programs, among others.
» Repeals the special rule allowing the re-characterization of a traditional IRA contribution as a ROTH IRA contribution.
» The $500,000 exclusion on gain from a principal residence would be retained but modified. The exclusions would be phased out by one dollar for every dollar that a taxpayer's average modified AGI for a three-year period (including the year of the sale) exceeds $500,000 ($250,000 for single filers).
» Further, to qualify for the gain exclusion, the residence has to be the taxpayer's principal residence for five out of eight years, compared to two out of five under current law.

H+C Observation – This could have a negative effect on the residential real estate market, and may create a problem for some of the folks on HG TV's House Hunters!

Business

» Limits interest expense. The deduction for net interest expense incurred by a business is limited to 30% of the business's adjusted taxable income. Adjusted taxable income is taxable income computed before net interest expense or income, net operating losses, depreciation, amortization, and depletion. Any disallowed interest expense can be carried forward up to five years. Real property trades or businesses are not subject to this limitation because they are not eligible for the full expensing rules. Small business interest expense exception - businesses with average gross receipts of $25 million or less would be exempt from the interest limitation rules.

H+C Observation – This seems to be another provision that is not true tax simplification and may lead to more potential manipulation.

» Modifies net operating loss (NOL) deduction limitations. An NOL carryover or carryback will be limited to 90% of the taxpayer's taxable income. In addition, all carrybacks will be repealed except for a special one-year carryback for small businesses and farms in the event of certain casualty and disaster losses arising in tax years beginning after 2017.
» Eliminates the Section 199 (DPAD) manufacturing deduction and several credits such as the New Market Tax Credit, Work Opportunity Tax Credit, and rehabilitation credit.

H+C Observation – The elimination of the DPAD decreases the benefit of the rate reduction for farmers and manufacturers. Those types of businesses are not offered any incentives beyond those offered to similarly situated distributors and retailers.

» Limits the use of like-kind exchanges. Section 1031 deferral of gain on like-kind exchanges will be available only for real property.

H+C Observation - The removal of tax deferred exchanges for personal property will likely impact construction and transportation companies.

» Disallows the entertainment deduction. No deduction (50% currently allowed) would be allowed for entertainment, amusement, or recreation activities, facilities, or membership dues relating to such activities. The 50% deduction for meals is retained.

H+C Observation - Since almost all businesses have meals and entertainment expenses this provision will increase taxable income for most business taxpayers.

International Tax

» Modifies taxation of deferred foreign profits. Accumulated foreign earnings held in cash or cash equivalents and in illiquid assets are deemed repatriated and taxed at 12% and 5%, respectively. Taxpayers may elect to pay the resulting liability over an eight-year period in equal annual installments of 12.5% of the total tax liability due.

H+C Observation – It seems likely that most multi-national corporations will be reluctant to make this contribution to the US Treasury.

Conclusion

» These proposals should be viewed a starting point from which the Republican leadership will attempt to garner the support of a majority of Representatives and Senators; the Senate Finance Committee is scheduled to release its plan on Friday November 10, 2017.
» The fact that the rate reduction is not paid for and increase the deficit may be a key factor in determining whether this initial proposal will succeed.
» The percentage of the rate reduction going to corporation and high income earners will also be a key factor in selling or failing to sell the plan to the public.
» So, it appears there may be enough Spinach in the act to ruin everyone's appetite. The question is are there enough Goodies to make the Act worth swallowing!

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