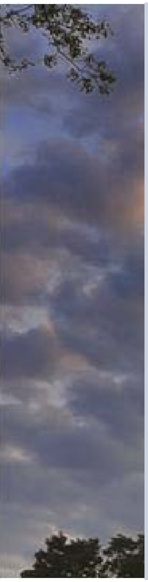

Eye on Washington

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Proposed Legislation Under Tax Cuts and Jobs Act of 2017.

Dispensing with the tradition of overwrought titles and unwieldy acronyms for tax legislation, the U.S. Congress passed initial versions of promised tax reform in both the House and the Senate in recent weeks under the banner of the relatively benign sounding Tax Cuts and Jobs Act of 2017. The breadth of reform contained within the bills is largely in line with the ambitious promises made by Republicans during the 2016 election, though the ultimate shape of tax reform, now in the hands of a House-Senate conference committee, will likely be scaled back in an effort to retain the already thin vote majorities in each chamber.

Further complicating matters are pesky budgetary limitations and a desired year-end enactment which leaves little time for extensive debate and thoughtful consideration of difficult and complicated subject matter. Nonetheless, the bills press ahead, and it appears likely some form of legislation will be enacted, leaving anxious taxpayers, with their eyes all aglow, inquiring whether Santa Congress has marked them "naughty" … or "nice."

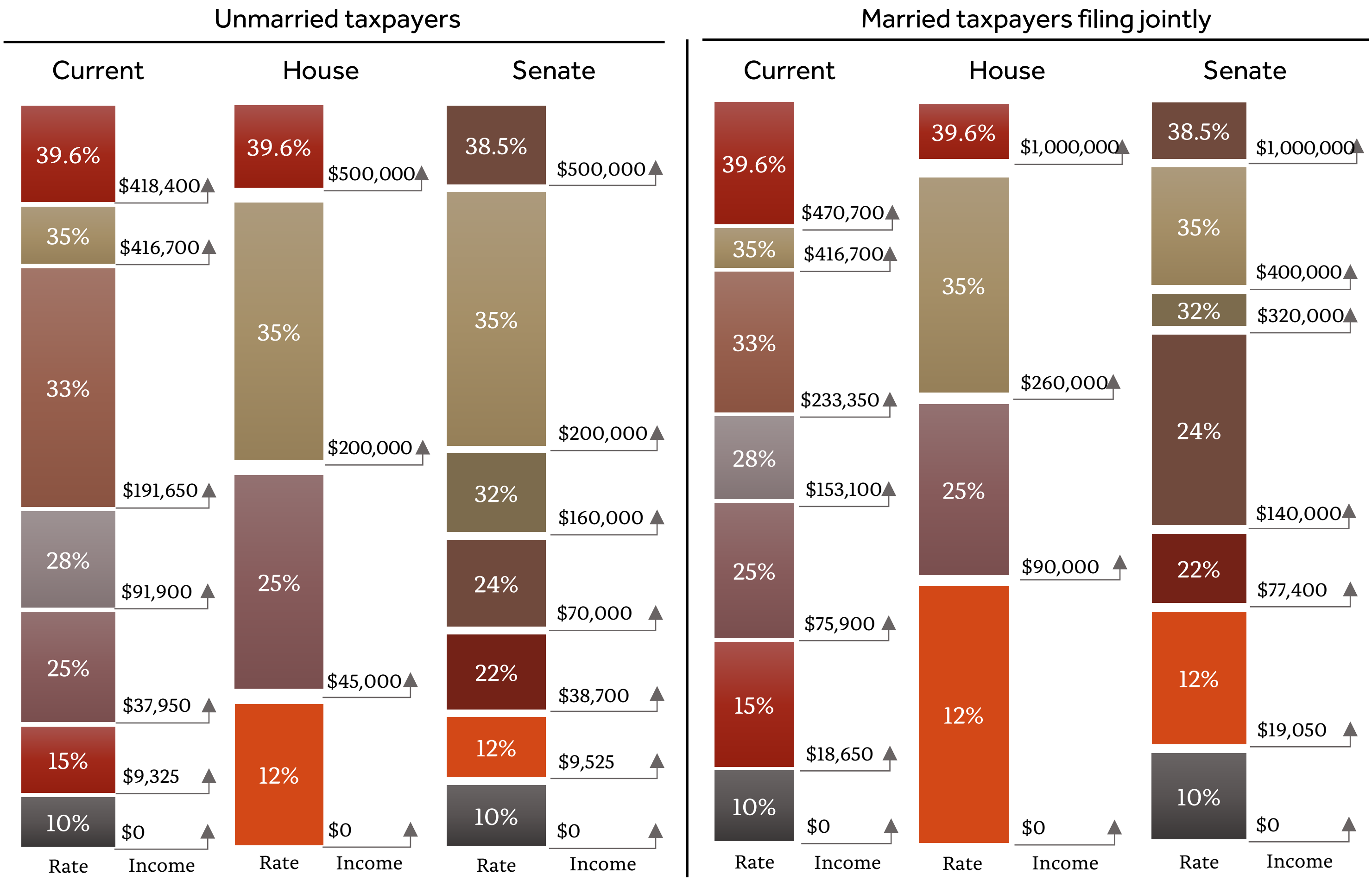
The bills contain broad scale reform and simplification (to an extent) of the individual and corporate tax codes, as well as changes to gift and estate tax laws.

Individual Income Taxes

Changes to the individual income tax code adhere to the stated goal of eliminating many popular tax benefits and deductions in exchange for broadly lowered rates.

The House bill replaces the current seven-bracket structure with four brackets, though retains the current highest 39.6% federal tax rate (and includes a window for a marginal rate of 45.6% for high income earners to eliminate the benefit of the 12% bracket for such taxpayers). The Senate bill retains the seven-bracket structure with reduced rates at certain thresholds, also reducing the top marginal rate to 38.5%.

The following chart depicts the proposed tax rates and income levels of the House and Senate bills in relation to the current tax rates and income levels, for both single and married taxpayers.



In addition to a lower effective rate at many income brackets, the standard deduction has been increased significantly—from the current $6,350 single/$12,700 married to $12,200 single/$24,400 married under the House version. (The Senate version includes slight differences.) In an effort to simplify the tax preparation process, the percentage of taxpayers who itemize deductions is expected to go from one-third of all taxpayers under current law to fewer than 10%. The increased standard deduction comes with one important caveat:

- The **personal exemption** is repealed, eliminating the ability for individuals (and particularly those with many dependents) to obtain additional tax deductions. The increased standard deduction (and family tax credits discussed below) is expected to offset this loss for many taxpayers.

Those who continue to itemize can expect to see many itemized options eliminated or reduced, including:

- **Mortgage interest deduction** under the House bill is reduced to $500,000 of acquisition debt (reduced from $1 million); additionally, the home equity interest deduction for up to $100,000 of home equity debt is eliminated. Under the Senate version, the $1 million limit on debt is preserved, though the home equity deduction is eliminated as well.

- The deduction for **state and local income (or sales) taxes** is eliminated (through 2025)—this is expected to be one of the most contentious aspects of the individual code changes, as many individuals in high income tax jurisdictions may see their effective income taxes increase significantly if this deduction is lost; and
- The deduction for **property taxes** is preserved, though capped at $10,000 annually. For many low or no income tax states, property taxes are a primary source of revenue, and therefore higher as a result.

Note as well that the deduction for **charitable contributions** is largely preserved in its current form, however, the Adjusted Gross Income (AGI) limit for cash contributions would increase from 50% to 60%.

Other deductions and tax rules impacting individuals include:

- Individual AMT - repealed under House bill, preserved under Senate bill with higher thresholds ($70,300 single/$109,400 married).
- Pease limitation on itemized deductions generally repealed.
- Gain on Sale of Principal Residence – the current gain exclusion of $250,000 single/$500,000 married so long as the residence is used as a principal residence during 2 of last 5 years, changed to 5 out of 8 years. The House bill notably phases out exclusion for taxpayers with average annual income over 3 years in excess of $250,000 single/$500,000 married. The Senate bill grandfathers residences under contract prior to 1/1/2018.
- The Senate bill requires that the cost basis of specified securities sold, exchanged or disposed be determined on a first-in first-out (FIFO) basis.
- Roth IRA re-characterizations (i.e., when a Roth conversion proves to be unwise) are eliminated.
- Deduction for medical care expenses - repealed under the House bill, but preserved under the Senate bill, with a lower 7.5% AGI threshold for 2017 and 2018 only;
- Deduction for alimony (repealed under House bill, yet not addressed in Senate bill) - under House bill, recipient of alimony would not recognize income on payments.
- Elimination in many respects of personal casualty loss deductions.
- Limits on the Section 1031 “like-kind exchange” rules to real property.
- The preferred rate for **“carried interest”** (capital gains treatment for partnership profits interests) would require a three-year holding period rather than the current one year for certain partnerships engaged in capital market transactions.

The House and Senate bills both provide enhanced **child tax credits** to offset the loss of the personal exemption. The House version provides a child tax credit of $1,600 per dependent child under 17, while the Senate bill provides $2,000 per child. Furthermore, the income exclusion limits for eligibility have been increased: $115,000 single/$230,000 married under the House version; $500,000 under the Senate version.

Note that current rates on capital gains and dividends, as well as the applicable income thresholds, are not generally impacted by the tax bills, nor is the imposition of the 3.8% Medicare surtax on net investment income. As a result, the 20% rate on capital gains and dividends will remain tied to the highest marginal tax bracket threshold under current law (i.e., $425,800 single/$479,000 married). The Medicare net investment tax likewise applies at levels above $200,000 single/$250,000 married.

Pass Through Business Tax Relief

While high income earners may not experience notable tax relief under the individual income tax provisions, owners of higher income pass-through businesses may enjoy a reduced tax rate.

The House bill provides for a highest tax rate of 25% for certain pass-through income of S corporations, partnerships, LLCs, and sole proprietorships, though not all entities qualify, and the percentage of income subject to the preferred rate may be limited. More specifically:

- A 70/30 default rule is applied to the preferred rate—70% of pass-through income will generally be treated as wage income taxable at ordinary rates, while 30% will be treated as business income subject to the preferred rate.
- Owners will have the ability to alter the 70/30 division based on a determination of income relative to capital investment in the business.
- Certain preferred rates will apply at lower income thresholds as well, but would be phased out as business income increases.
- Note that the preferred rates apply to passive "business activities"—as opposed to passive "investment income"—as such rent, royalties, etc., received by a pass-through will not be eligible for the preferential rate.
- Note as well that certain professional service firms (physicians, attorneys, architects, accountants, financial service professionals, etc.) will not be eligible for the preferred rate.

The Senate bill, by contrast, does not establish a specific preferred rate, but rather offers a deduction of 23% of "qualified business income," essentially lowering the top ordinary tax rate to 30.5%. More importantly, the Senate version broadens the applicability of the deduction to all domestic business income, other than investment income; however, the deduction is limited to 50% of the taxpayer's allocable share of W-2 wages paid by the business.

- As an example: a business with $1 million of pass-through income to the owners pays $1 million in wages to the employees of the business. Half a million dollars of the pass-through income will therefore be eligible for the 23% deduction, generally allocated by an owner's ownership interest.
- Note that the W-2 limit will not apply to taxpayers with taxable income under $250,000 single/$500,000 married, and will be phased in as income exceeds such levels. Additionally, the deduction will be available to taxpayers with income from specified service businesses where income is under such thresholds.

Estate and GST Tax Repeal

The campaign promises to eliminate the "death tax" have been scaled back to some extent under the bills. The House version doubles the federal gift, generation skipping transfer (GST), and estate tax exemptions under current law, and repeals the estate and GST tax starting in 2025. Note that such repeal must therefore theoretically survive beyond the next three election cycles (2018, 2020 and 2022), creating a similar situation to the estate tax repeal (sunset though it did) in 2010. Needless to say, the estate tax survived that onslaught, and may yet survive this potential attempt as well.

A benefit of the higher exemptions may be the tax-free step-up in basis heirs would achieve, eliminating taxation (estate or capital gains) on estates up to approximately $22 million for married couples. This may alter the estate planning landscape to a large extent, favoring arrangements that retain assets with the senior generation rather than many common trust planning arrangements.

In spite of potential repeal, the gift tax would remain in place (at a 35% rate post repeal per House) in an effort to discourage income shifting to family members in lower brackets. High gift exemptions, however, may provide opportunities to shift for income tax planning purposes nonetheless.

Large lifetime exemptions may also provide a strong incentive for the wealthy to undertake wealth shifts during life to guard against future changes in the transfer tax laws which could be far less favorable than the current environment. The large generation skipping transfer tax (GST) exemptions (and potential GST repeal post 2024) may also provide a large incentive for the wealthy to establish dynastic trust arrangements to similarly guard against future changes in transfer tax laws.

Notable Caveat under Senate Bill for Individual and Estate Tax Changes

The public has grown accustomed to tax bills that automatically sunset after some prescribed period, and in this sense, the Senate version does not disappoint. The vast majority of the tax law changes applicable to individual income taxes as well as estate, gift and GST "sunset" starting in 2026 (at which point current law snaps back into effect). The House version contains no sunset, but the Senate bill, by virtue of the "Byrd Rule," sunsets the changes to avoid creating budget deficits beyond the 10-year window. This is also done in an effort to provide "permanence" for many of the corporate tax changes described below. Note as well that, in an effort to fit within the budgetary framework, the Senate bill essentially repeals the "individual mandate" (the requirement to have health insurance) as required under Obamacare by reducing the penalty tax to 0%. While the failure to collect a tax would not normally provide a revenue boost for CBO purposes, the savings on subsidies provided under the federal health insurance exchanges (due to fewer sign-ups) are estimated to be substantial. This controversial provision may factor significantly in the conference process moving forward. Note as well that the Senate version does not sunset the repeal of the individual mandate in 2026.

Corporate Tax Changes

A major emphasis within the Trump administration and the broader Republican caucus has been corporate tax reform, focused largely on reducing the corporate income tax rate (applicable to C corporations) in an effort the make the U.S. tax system more competitive on an international scale. Both bills in Congress currently have a maximum tax rate of 20%, compared to the current 35% rate. The bills differ in two key respects, however:

- The House bill imposes the rate starting in 2018, and completely repeals the corporate Alternative Minimum Tax (AMT).
- The Senate bill delays the start of the new rate to 2019, and leaves the corporate AMT in place. The AMT provision has been controversial in light of the fact that the AMT rate is also 20%, which will essentially leave many companies facing the AMT liability in all future tax years.

In light of potential budgetary pressures related to the Byrd Rule described above, it is possible that the final bill will include a slightly higher rate (the President has signaled a willingness to accept a 22% rate).

In exchange for the corporate rate reduction, certain common deductions will now be disallowed, including deductions for most forms of entertainment, recreation, etc. (though the House and Senate bill differ in many of the details).

Other notable provisions include:

- Modification of the threshold for accrual basis accounting for corporations from $5 million in gross receipts to $25 million (House)/$15 million (Senate);
- Certain business assets will be eligible for 100% expensing on a temporary basis that scales down incrementally;
- Repeal of the domestic production activities deduction (DPAD);
- Increase in the Section 179 expense limit and applicable threshold;
- Elimination of Net Operating Loss (NOL) carrybacks, and limit on deduction to 90% of taxable income;
- A limitation on net business interest expense deductions to 30% of adjusted taxable income (though businesses with revenues under certain thresholds will be exempt);
- The Senate bill provides for enhanced depreciation deductions for certain non-residential real property and residential rental property; and
- The House bill repeals certain tax credits available to oil producers.

Conclusion

For some taxpayers, the tax changes will be akin to a nicely wrapped present under the tree; for others, unwelcome coal in their stockings. Given the public's dour attitude towards certain purveyors of entertainment, the House bill notably disallows tax-exempt status for bond issues that finance professional sports facilities (naughty). The Senate bill by contrast (and perhaps in an attempt at mirth and merriment) lowers the general tax rates on beer brewers and importers alike (nice).

In any case, an extremely complex tax system is not in any danger of becoming easier to decipher under current proposals. An astute planning team will remain essential for many taxpayers to both navigate new rules and identify tax-saving opportunities moving forward.