Current Federal Tax Developments

Nichols Patrick CPE a Division of the Loscalzo Institute

November 6, 2017

LOSCALZO INSTITUTE

A KAPLAN COMPANY

©2017 Loscalzo Institute, a Kaplan Company

Comprehensive Tax Reform Proposal Released

HR1 Tax Cuts and Jobs Bill, November 2, 2017

On November 2, the first draft of the proposed comprehensive tax reform was released. The bill, HR1 Tax Reform and Jobs Act, is an attempt to enact the most significant tax legislation since the Tax Reform Act of 1986. At the time of its released, Congressional leadership were hoping to have a version of the bill passed by both the House and Senate by the Thanksgiving recess, with a conference committee convening in December. The goal is to have a bill ready for the President's signature by Christmas.

However there are a number of hurdles the bill must clear before that would happen. Most taxpayers will find the bill has some provisions that appeal to the taxpayer, but other provisions are far less palatable.

In this section we summarize the original proposal. A detailed summary was released by the Ways and Means Committee staff (*Tax Cuts and Jobs Act H.R.1 Section by Section Summary*) and a longer analysis was published by the Joint Committee on Taxation (*JCX-50-17 Description Of H.R.1, The "Tax Cuts And Jobs Act"*).

Standard Deduction and Personal Exemptions

The standard deductions is nearly doubled

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

But the law eliminates the personal exemptions that served as an additional deduction

The net effect of this is to raise "zero tax bracket" by 15%

Individual Tax Rates and Brackets

The new law makes significant changes to the individual tax brackets, along with introducing a new "bubble" tax bracket.

The new rates applicable to ordinary income (other than passthrough business income discussed later) are:

Tax Brackets	Married Filing Joint	Head of Household	Married Filing Separate	Single	Estate/Trust
12%	0	0	0	0	0
25%	90,000	67,500	45,000	45,000	2,550
35%	260,000	200,000	130,000	200,000	9,150
39.6%	1,000,000	500,000	500,000	500,000	12,500

The capital gain brackets are as follows:

Capital Gain Brackets	Married Filing Joint	Head of Household	Married Filing Separate	Single
0%	0	0	0	0
15%	77,200	51,700	33,600	33,600
20%	479,000	452,400	239,500	425,800

The bill would add a new 6% tax that is used to remove the benefit of the 12% bracket from higher income individuals.

An individual's tax is increased by 6% of excess of adjusted gross income over applicable dollar amount (ADA) which is set at:

- $1,200,000 for married filing joint
- $1,000,000 all others

This addition is taxed is capped at lesser of 27.6% of

- Taxpayer's taxable income or
- 25% threshold amount.

Kiddie Tax Reform

The "kiddie tax" would no longer be tied to the parents' tax rates, but rather taxed at rates for trusts and estates without the 12% bracket. Only a child's taxable income in excess of net unearned income is taxed at 12% bracket to the extent it is less than that bracket for the child.

Alternative Minimum Tax

The alternative minimum tax would be repealed under the bill. The bill also provides a special recovery rule for any unused minimum tax credit a taxpayer might have coming into 2018.

To the extent the credit cannot be used to reduce a taxpayer's tax to zero, it is used:

- 50% remaining unused in each year from 2019-2021 is refundable for that year (note that it's half of the remainder each year)
- Balance refunded in 2022.

Itemized Deduction and Other Deduction Issues

The Pease limitation on itemized deductions is repealed by the bill.

Mortgage interest will only be allowed on debts up to $500,000 (reduced from $1,000,000) and no deduction for home equity indebtedness incurred after 11/2/17. Loans in place on 11/2/17 will be grandfathered under the old rules.

Also, a mortgage interest deduction is only allowed for principal residence (no second residence).

The only state and local taxes that can be deducted as an itemized deduction are real estate taxes (up to $10,000).

Generally, the bill repeals deduction for personal casualty losses. But the bill allows such a deduction for hurricane losses from Hurricanes Harvey, Irma, or Maria. Congress would have to act to allow such special relief for any future disasters (or even the California wildfires).

All gambling expenses (not just wagering losses) are limited to gambling income.

A number of changes are proposed for charitable contributions, though they will still be valid itemized deduction. One piece of good news is that the percentage of adjusted gross income limit would be increased from 50% to 60% of AGI. Other changes include:

- Remove 80% deduction for athletic event seating rights
- Index charitable mileage for inflation
- Require contemporaneous acknowledgment for all charitable contributions (no $250 limit)
- Removed option to have charity report the gift for substantiation

Other changes to itemized and other individual deductions include:

- Repeal deduction for tax preparation expenses
- Repeal deduction for medical expenses
- Repeal deduction for alimony payments and income inclusion for recipients (post 2017 decrees and modifications only)
- Repeal deduction for moving expenses
- Terminate contributions to MSAs (does not affect HSAs)

Employee Business Expenses

The bill would remove the deduction for most employee business expenses:

- Repeal deduction for all "below the line" deductions
- Also repeal all above the line deductions (including for teachers) except deduction for expenses of members of armed forces reserves
- Can still exclude expenses reimbursed under qualified expense reimbursement program

Employer Provided Housing

The bill would limit exclusion for employer provided housing

- $50,000 maximum ($25,000 if MFS)
- Phases out beginning at $120,000

Exclusion for Gains on Sale of a Principal Residence

The law would make a number of "taxpayer unfriendly" changes to the exclusion for the sale of a principal residence:

- Ownership/use goes to five of prior eight years
- Only use once every five years
- The exclusion phases out as a taxpayer's adjusted gross income exceeds $500,000 ($250,000 for MFS) on a dollar for dollar basis.

Municipal Bonds

The following municipal bond interest would now be taxable:

- Private activity bonds
- Bonds issued to build sports stadiums issued after date of introduction of the bill.

Employee Benefits

Certain employee benefits would no longer be excluded from the income of the employee:

- Employee achievement awards
- Dependent care assistance programs
- Qualified moving expense reimbursements
- Adoption assistance programs.

Nonqualified Deferred Compensation

Nonqualified deferred compensation would become taxable as soon as there is no substantial risk of forfeiture (performance of future services).

Not considered to be a risk of substantial forfeiture would be

- Covenant not to compete
- An agreement that purports to be other than compensation

The new law would cover services performed after 2017 immediately. Existing pre-2017 deferred compensation would be grandfathered until 2026, at which time it would be subjected to tax.

Retirement Program Changes

The following changes would be made to retirement programs:

- No option to recategorize Roth IRA contribution as traditional IRA contribution
- In service distributions can begin for all defined benefit plans at age 59 ½
- Allow those taking hardship distributions to continue to contribute to plan
- Plan could allow earnings and employer contributions in hardship distributions
- Rollovers for deemed plan distributions extended to due date of employee's tax return

Child and Dependent Tax Credits

Child tax credit

- Would be increased to $1,600
- Would eventually be fully refundable

Dependent tax credit and family tax credit

- $300 credit for non-child dependent or other "non-dependent"
- Not refundable
- Effective through 2022

All three would phase out at higher adjusted gross income levels.

Education Tax Provisions

Education credits

- Would consolidate American Opportunity Tax Credit, Hope Credit and Lifetime Learning Credit into revised AOTC
- 100% credit on first $2,000, 25% credit for next $2,000
- Adds fifth year available at ½ of rate of first four years with up to $500 being refundable.

Other Education Savings Rules

- No new Coverdell ESA contributions will be allowed
- Can do tax free rollover from ESA to 529 plan
- Up to $10,000 of elementary/high school expenses would be qualified 529 expenses
- Funds may be used for certain expenses in registered apprenticeship program
- Could establish 529 plan for unborn child (but not one you expect to eventually have)
- Repeal deduction for student loan interest, tuition and fees deduction, interest on U.S. savings bonds, qualified tuition reductions and employer provided education assistance

Repeal of Various Individual Tax Credits

The following credits would be repealed:

- Over 65 credit from Schedule R
- Adoption credit
- Mortgage credit certificate credit
- Qualified electric plug in vehicle.

Residential Energy Efficient Property Credit

The bill would modify and eventually phase out residential energy efficient property credit

- Credit extended to all qualified property placed in service prior to 2022
- Reduced rates
    - 26% for property placed in service during 2020
    - 22% for property placed in service during 2021

Estate and Generation Skipping Transfer Taxes

The estate and GST tax modifications would be phased-in over time.

- Exclusion initially increased to $10 million, indexed for inflation
- Beginning in 2023, the estate and GST taxes are repealed
- Retain step-up in basis for inherited property.

Corporate Tax Rates

A principal goal of this reform is to bring U.S. corporate income tax rates down to be competitive with other major industrialized countries. The bill would make the following changes:

- Single flat 20% tax rate (note this is an increase for C corporations with income below $50,000)
- Personal service corporations would have a rate of 25%

Passthrough Tax Rates

One of the most complex areas of the new law will involve special tax treatment given to pass through business income reported by individual taxpayers.

There would be a maximum passthrough business rate of 25% for individuals

- Would apply to proprietorships, partnerships, and S corporations
- Would only apply to “business income”
  - Passive activity = 100% business income
  - Other activities must determine the business income portion as opposed to the amount representing compensation for services.

To compute the amount that represents business income

- Can use 30% safe harbor or
- Capital rate (5 year election)
  - Rate of return of 7% plus federal short term rate
  - Capital invested in business.

For the elective alternative calculation noted above

- (Capital rate X Asset Balance) – interest expense deduction allowed is the business income
- Asset balance = Adjusted basis of property used in the activity at end of taxable year not taking into account basis adjustment for bonus depreciation or Section 179

Other special provisions for the passthrough business income computation:

- Personal service businesses cannot use the 30% option (PSC list plus additional items)
- But can use the invested capital calculation
- Additional “anti-abuse” rules to prevent wages from being classified as 25% income
- 25% rate would also apply to certain dividends of REITs
- Also have carryover of business losses to reduce future 25% eligible business income (not used for any other purpose—so even if loss fully offset by other non-passthrough income in prior year, it would still reduce the 25% income for the following year)

The passthrough rules would also make massive changes to the computation of self-employment income.

- Self-employment tax only applies to labor portion of flow through income
- Eliminate exception for limited partners
- Eliminate exception for rental real estate and rental of property leased with real estate
- Would also apply self-employment tax to labor portion of S corporation flow through income

Bonus Depreciation

The bill would increase and expand bonus depreciation as follows:

- 100% bonus depreciation for qualified property placed in service
    - After September 27, 2017 and before
    - January 1, 2023
- No longer have original use requirement for this bonus
- Rather must be taxpayer's first use of the property
- Additional first year auto bonus raised from $8,000 to $16,000
- Would not include property
    - Used in a regulated utility or
    - Used in a real property trade or business

Section 179 Expense

The bill would make the following changes to Section 179 expensing:

- Increased to $5 million annually
- Phase out rises to $20 million
- Would include qualified energy efficient heating and cooling equipment, effective 11/2/17
- However, in 2023 would revert to older, lower limits
- Not really a big deal given most items would qualify for the 100% write off and it ends when that ends.

Small Business Accounting Issue Relief

The bill would provide the following liberalized accounting issue relief to small businesses:

- $25 million threshold (rather than $5 million) for accrual basis
- Also such businesses could be cash basis even with inventories
- Cash basis can be used by all such businesses except tax shelters
- Business with gross receipts of <$25 million exempt from UNICAP
- $10 million long term contract limit would be raised to $25 million
- Gross receipts < $25 million exempt from interest limitations provided for in this bill

Net Interest Expense Deduction Limitation

The bill would also reduce interest deductions for most businesses. The net interest deduction rules are as follows:

- Net interest in excess of 30% of businesses' adjusted taxable income is disallowed
- At filer level (so at partnership/S corporation level)
- Disallowed interest carried forward for up to five years
- Exemptions
  - Small businesses
  - Regulated utilities
  - Real property trade or businesses

Net Operating Loss Revisions

The bill would make taxpayer unfriendly changes to net operating losses. The changes are as follows:

- Can only offset 90% of taxable income (adopting AMT rule)
- Generally will repeal all carrybacks except for one year carryback for certain casualty and disaster losses of
  - Small businesses ($5,000,000 3 year average annual gross receipts)
  - Farms
- To compensate for inability to use the losses in a carryback, carried forward NOLs increased by an interest factor each year

Like Kind Exchanges for Real Estate Only

Like kind exchange rules will be changed as follows:

- Could only be used for real property
- However special rule for exchanges in process at end of 2017 for personal property to allow them to be completed

Other Miscellaneous Business Changes

The following additional changes are made to business taxes:

- Repeal exclusion for capital contributions in excess of FMV of stock issued

- No deduction for local lobbying expenses
- Repeal Section 199 deduction

Disallowance of Business Related Entertainment Expenses

The following changes would be made to entertainment deductions:

- No deduction for entertainment, amusement or recreational activities
- No deduction for
    - Transportation fringe benefits
    - On premises gym and athletic facilities
    - Amenities provided to employee that are personal in nature
- 50% continues to apply to
    - Food and beverages
    - Qualifying meals
- Disallowed amounts would be added to UBIT for tax exempt entity

Patents, Copyrights, Etc.

The law would make the following changes related to the dispositions of patents and copyrights:

- Self-created patents, invention, model or design are no longer eligible to be treated as a capital asset
- Also repeals elective capital gain treatment for musical compositions and copyrights in music works
- Repeals Section 1235 so sale of patent rights now tested under standard tests to see if it is a capital asset

No More Technical Terminations for Partnerships

The bill makes the following changes to partnership terminations:

- Repeal of technical terminations for partnerships
- No longer issue if have change of 50% interests
- Note that the Joint Committee on Taxation scores this as raising revenue

Business Credits Repealed

The following business credits are repealed:

- Credit for clinical testing expenses for certain drugs for rare diseases or conditions
- Credit for employer-provided child care
- Rehabilitation credit
- Work opportunity tax credit
- Deduction for certain unused business credits
- New markets tax credits
- Credits to provide access to disabled individuals

Modification to Tip Credit

The following modifications would be made to the tip credit:

- Amount above which credit allowed moved to current minimum wage instead of that in place on 1/1/07
- All employers (not just those with more than 10 employees) claiming this credit would have to report allocations to employees to the IRS

Worldwide Taxation System

The following international tax changes (along with a number of others) would be made:

- Replace current system with dividend exemption system – 100% exemption for dividends if own at least 10%
- No foreign tax credit on any exempt dividend
- No tax on foreign earnings reinvested in U.S. property
- Basis reduced in shares for loss (but not for gain) by exempt dividends
- In transition, would tax earnings and profits of foreign entity in which taxpayer owns more than 10% interest
    - Cash and equivalents taxed at 12%
    - Remainder taxed at 5%
    - Payable over up to 8 years