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HWH Tax Alert

HIGHLIGHTS OF THE 2017 HOUSE TAX REFORM BILL

On November 2, 2017, the House Ways and Means Committee ("W&M") Chairman Kevin Brady (R-TX) released the first draft of its tax reform bill, H.R. 1, titled the Tax Cut and Jobs Act (the "bill"), providing an initial glimpse at what the tax code may look like after its anticipated overhaul by the current Congress. Most of the bill is scheduled to take effect on January 1, but, if negotiations continue into 2018, a new effective date could be set, or provisions could be made retroactive.

The bill contains numerous discrete changes to the current tax code, as well a number of modifications that are more fundamental from planning and policy perspectives. Overarching themes of rate reduction and simplification characterize many of the proposed revisions.

The following material is intended only as a brief summary of certain aspects of the bill. Because the bill likely will undergo significant change prior to any enactment, advisors and their clients should stay posted for news of future modifications. Both the W&M's mark-up of the bill and the Senate's tax reform proposal are expected to be circulated later this week, and there is a strong push to pass legislation by year-end. We will be monitoring changes in the reform proposals as they move through the legislative process and intend to provide further information as significant events occur.

BUSINESS TAXATION

Reduction of corporate tax rate to 20%. The corporate income tax rate generally would be reduced from the current maximum marginal rate of 35% to a flat 20% rate, although personal service corporations would be taxed at a 25% rate. One potential negative ramification from the rate reduction is that net operating loss carryovers and other deferred tax assets may have to be written down for financial statement purposes.

Business income of individuals subject to a 25% tax rate. A proposed change having more complex implications is the creation of a new category of "qualified business income" applicable to individuals conducting business either directly or through pass-through entities. Business income would be taxed at a 25% rate — only slightly higher than the maximum corporate tax rate of 20%. Generally, the 25% rate would apply to income from business activities that are "passive" (and thus more akin to income earned through a separate C corporation), as well as the portion of "active" business income that is deemed to result from capital investment. The portion of business income attributable to capital would be determined by application of a "capital percentage" of either 30% or such greater percentage, determined under a formula, that is supported by the taxpayer's particular facts and circumstances. The new rules piggyback off of rules in section 469 of the current tax code to define activities and classify them as "passive" or "active." These rules generally focus on whether the taxpayer "materially participates" in a given activity. Income from various personal service businesses (e.g., accounting, law, health, financial services) typically would be treated as wholly attributable to sweat equity (and not capital investment), making such income generally ineligible for the 25% rate.

Planning opportunities may arise to the extent it is possible to characterize activities as "passive" or "active" (including through grouping or segregation of activities), depending upon whether such activities are expected to generate net income (preferably subject to the 25% rate) or loss (which could offset other more highly taxed individual income).

Foreign provisions. The bill incorporates several major changes to the taxation of U.S. companies' offshore profits. In particular, the bill adopts a territorial tax system by providing a 100% deduction for dividends received by domestic corporations from foreign corporations in which they own at least a 10% stake. In connection with the shift to territorial taxation, the bill also would impose a one-time tax on the post-1986 undistributed (and not previously taxed) earnings of 10%-owned foreign corporations at a rate of 12% for earnings held in cash (and equivalents) and 5% for earnings represented by illiquid assets. The transition tax could be paid over a period of up to eight years. Furthermore, in an effort to stem erosion of the U.S. tax base going forward, the bill subjects a U.S. parent corporation to tax on 50% of its "foreign high returns," measured as the excess of its foreign subsidiaries' aggregate net income over a deemed routine return on their aggregate adjusted bases in depreciable tangible property, after downward adjustment for interest expense. U.S. shareholders that become subject to such taxes will receive a foreign tax credit for only 80% of the foreign taxes paid with respect to such income. Other important changes to the tax code's international provisions would include the repeal of a rule treating investments in U.S. property as dividends, elimination of foreign tax credits associated with exempt dividends, repeal of the rule requiring 30 days of minimal U.S. ownership before a foreign corporation is treated as a controlled foreign corporation, and various other modifications to the subpart F rules.

Enhanced deductibility for capital investments. Under the bill, taxpayers would become entitled to 100% immediate cost recovery for all "qualified property" placed in service before January 1, 2023, without regard to whether the taxpayer is the first user of the property, although expanded deductibility would not apply to property used by public utilities or in a real estate trade or business. Similarly, prior to 2023, previously applicable limits and phase-outs applicable to Code section 179 expensing (i.e., "bonus depreciation") will be 10 times as great as they are currently, with the overall expensing limit increased from $500,000 to $5,000,000 and the level at which phase-out occurs increased from $2 million to $20 million (both such amounts indexed for inflation). By facilitating capital investment, these provisions would increase accessibility to the new 25% tax rate applicable to individuals' business income that is based on capital investment, as described above.

Limited deductibility of interest. The deductibility of a business' net interest expense would be disallowed to the extent that it exceeds 30% of the business' "adjusted taxable income," as determined at the level of the tax filer (e.g., at the partnership level), although this rule would not apply to regulated public utilities and real estate businesses (which also would not benefit from the enhanced cost recovery provisions discussed above) or to small businesses having average gross receipts less than or equal to $25 million. Disallowed amounts would be subject to a 5-year carryforward.

Limitations on net operating loss (NOL) usage. The bill limits NOL usage to 90% of taxable income and generally eliminates the current 2-year carryback period for NOLs. However, under the proposal, NOLs could be carried forward indefinitely (rather than for only 20 years), and NOL carryforwards would be increased by an interest factor to protect their value if used on a deferred basis.

Repeal of the corporate alternative minimum tax (AMT). The bill eliminates the corporate AMT, one feature of which has been a limitation on the use of NOLs to an amount equal to 90% of taxable income. A taxpayer having AMT credit carryforwards could claim a refund of 50% of the remaining credits (to the extent they exceed regular tax for the year) in each of 2019, 2020, and 2021, and could claim a refund of all remaining credits in the tax year beginning in 2022.

Limited availability of like-kind exchanges. Under the bill, tax deferral with respect to exchanges of like kind property will be limited to exchanges of real estate, in contrast to prior law which also allowed like-kind exchanges of personal property held either for investment or for use in a trade or business. A transition rule would allow the completion of like-kind exchanges commenced on or before December 31, 2017.

Elimination of tax benefits for entertainment expenses and various employee fringe benefits. Under the bill, businesses would no longer be able to deduct expenses for various expenses relating to entertainment activities, and deductions for fringe benefits related to transportation, athletic facilities, and other personal amenities that involve property or services not directly related to the employer's trade or business would be prohibited unless such benefits are included in employee compensation.

Elimination of other business tax incentives. The bill would eliminate a number of other business tax incentives, including the domestic production activities deduction, the exclusion from income for contributions to capital, the work opportunity tax credit, and the new markets tax credit. The research and development ("R&D") credit and low income housing credit would be retained.

TAXATION OF INDIVIDUALS

Reduction of number of individual tax brackets. The bill would reduce the number of tax brackets for individuals to four (12%, 25%, 35%, and 39.6%) from seven, with the highest marginal rate applicable to income above $1 million for joint filers. The 12% rate would be phased out for couples earning more than $1.2 million, effectively creating a band of individual income subject to a marginal tax rate of approximately 45%.

Increase in standard deduction and family-related credits. The bill would nearly double the standard deduction, would significantly increase the child tax credit and would introduce a new family flexibility credit. Income levels at which phase-out of the foregoing credits occurs are also increased. It is expected that significantly fewer individuals would itemize deductions under the provisions of the bill due to the enhanced standard deduction and the reduced value of itemization due to the limitation on the state and local tax deduction described below.

Elimination of personal exemptions. The bill would repeal the deduction for personal exemptions.

State and local tax deductions. The bill would repeal the itemized deduction for state and local income and sales taxes, but would allow individuals to deduct state and local property taxes of up to $10,000 per year.

Mortgage interest deduction. The bill would continue the current mortgage interest deduction for existing mortgages (and refinancings thereof), but would limit the deduction to the amount of interest incurred on acquisition indebtedness of up to $500,000 (rather than the current $1 million) for debt incurred after November 2, 2017 (but only for the taxpayer's principal residence).

Repeal of the individual AMT. One aspect of the bill touted by its sponsors is its elimination of the individual AMT, an alternative tax regime that computed individuals' tax liabilities on a base of income that excluded personal exemptions, the state and local tax deduction, and other tax preference items. Under the bill, repeal of the AMT is coupled with the elimination of certain of such tax benefits previously allowed for purposes of computing regular tax liability.

Elimination of certain deductions and credits. The bill would eliminate certain deductions, including the medical expense deduction, the deduction for tax preparer expenses, the deduction for unreimbursed business expenses, the moving expense deduction, and the alimony deduction. The bill would also eliminate certain nonrefundable credits (e.g., adoption tax credit, plug-in electric drive motor vehicle credit, etc.).

Limitation on and modification of other deductions. Although not entirely eliminated by the bill, certain deductions, including those for personal casualty losses and gambling-related expenses, would be further limited. In addition, the bill would make several changes to the rules applicable to charitable deductions.

Reduction and repeal of the estate tax. The bill would double the basic exclusion amount for the estate tax, with eventual repeal of the estate tax beginning after 2023.

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Contacts

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Information

A copy of the proposed Tax Cuts and Jobs Act (H.R. 1) is available here.

A copy of the Ways and Means Committee's section-by-section summary of the bill is available here.

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