SPECIAL REPORT

Senate Passes Tax Code Overhaul; Conference Looms

The Senate, on December 2, 2017, approved a sweeping tax reform package - the Tax Cuts and Jobs Act (HR 1) - by a vote of 51 to 49, moving the GOP one step closer to achieving a signature legislative victory. The House previously approved its version of HR 1, also along party lines. Now, the game plan for GOP leaders in the House and Senate appears to be to work out the differences in the two bills in conference. GOP leaders are aiming to reach an agreement quickly on a final bill and secure passage in the House and Senate before year-end.

Both the House bill and Senate bill would impact virtually every individual and business on a level not seen in over 30 years. As with any tax bill, however, there would be “winners” and “losers.” Both versions call for lowering the individual and corporate tax rates, repealing countless tax credits and deductions, enhancing the child tax credit, boosting business expensing, and more.

The White House has signaled its support for tax legislation before year-end. Possible roadblocks to ultimately getting a bill to the President’s desk before year-end are unified opposition from Democrats, intense lobbying efforts to preserve tax breaks slated for elimination, and the significant differences in the House and Senate bills. Nevertheless, there remains the outside possibility that the House would bypass the conference-committee stage and bring the Senate version directly to the House floor for a vote.

IMPACT. Many of the changes to the Internal Revenue Code in the Senate bill are temporary. The House bill, in contrast, calls for permanent changes to the Internal Revenue Code. This important difference between the two bills will be high on the agenda of any conference to iron out a final bill.

IMPACT. Taxpayers need to plan for several possible contingencies: passage of a final tax reform bill before year-end, passage of the bill in early 2018, or the bill failing to move forward. The proposed changes in both the House bill and the Senate bill are forward-looking (after 2017) for the most part.

INDIVIDUALS

Tax Rates

The House bill proposes four tax rates: 12, 25, 35, and 39.6 percent after 2017. The Senate bill calls for seven rates: 10, 12, 22, 24, 32, 35, and 38.5 percent after 2017.
Under current law, individual income tax rates are 10, 15, 25, 28, 33, 35, and 39.6 percent.

**IMPACT.** The rate changes in the Senate bill would expire after 2025. The House bill proposes permanent changes.

**COMMENT.** The Trump/GOP Tax Reform Framework released in September contained a three-bracket structure of 12, 25, and 35 percent. The House bill would keep the current top rate of 39.6 percent. The Senate bill calls for a top rate of 38.5 percent.

**IMPACT.** The House bill and the Senate bill include proposed income ranges for their respective proposed brackets.

### Proposed House Bill Brackets

<table>
<thead>
<tr>
<th>Rate</th>
<th>Joint Return</th>
<th>Individual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>12%</td>
<td>$0 - $90,000</td>
<td>$0 - $45,000</td>
</tr>
<tr>
<td>25%</td>
<td>$90,000 - $260,000</td>
<td>$45,000 - $200,000</td>
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<tr>
<td>35%</td>
<td>$260,000 - $1 million</td>
<td>$200,000 - $500,000</td>
</tr>
<tr>
<td>39.6%</td>
<td>over $1 million</td>
<td>over $500,000</td>
</tr>
</tbody>
</table>

### Proposed Senate Bill Brackets

<table>
<thead>
<tr>
<th>Rate</th>
<th>Joint Return</th>
<th>Individual Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$0 - $19,050</td>
<td>$0 - $9,525</td>
</tr>
<tr>
<td>12%</td>
<td>$19,050 - $77,400</td>
<td>$9,525 - $38,700</td>
</tr>
<tr>
<td>22%</td>
<td>$77,400 - $140,000</td>
<td>$38,700 - $70,000</td>
</tr>
<tr>
<td>24%</td>
<td>$140,000 - $320,000</td>
<td>$70,000 - $160,000</td>
</tr>
<tr>
<td>32%</td>
<td>$320,000 - $400,000</td>
<td>$160,000 - $200,000</td>
</tr>
<tr>
<td>35%</td>
<td>$400,000 - $1 million</td>
<td>$200,000 - $500,000</td>
</tr>
<tr>
<td>38.5%</td>
<td>over $1 million</td>
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</tr>
</tbody>
</table>

**IMPACT.** Under both the House bill and the Senate bill, income levels would be indexed for inflation for a “chained CPI” instead of CPI.

**IMPACT.** Under the House bill, the benefit of the 12-percent rate would be phased out for taxpayers in the 39.6-percent bracket.

**COMMENT.** Neither the House nor the Senate bill changes the current tax treatment of qualified dividends and capital gains.

**IMPACT.** The House bill and the Senate bill do not repeal the Affordable Care Act’s taxes. Left untouched are the net investment income (NI II) tax, the additional Medicare tax, the medical device excise tax, and more.

### Standard Deduction

The House bill calls for a near doubling of the standard deduction to $24,400 for married filing jointly and $12,200 for single filers, as adjusted for inflation using a chained CPI for 2018. Heads-of-households could claim a standard deduction of $18,300. Similarly, the Senate bill calls for these amounts to be $24,000, $12,000, and $18,000, respectively, but only temporarily. Under current law, the standard deduction absent any changes will be $13,000 for joint filers, $9,550 for heads of households, and $6,500 for single filers. The Senate bill would retain the additional standard deduction for the elderly and blind.

**IMPACT.** Under both the House bill and the Senate bill, income levels would be indexed for inflation for a “chained CPI” instead of CPI.

**IMPACT.** Under the House bill, the benefit of the 12-percent rate would be phased out for taxpayers in the 39.6-percent bracket.

**IMPACT.** One goal of a higher standard deduction is to simplify tax filing through cutting, by more than half, those taxpayers who would otherwise do better itemizing deductions. Of course, that group would realize less of a net tax benefit than those taxpayers who do not now itemize. Supporters argue that, in addition to simplification, it effectively creates a more broadly applicable “zero tax bracket” for taxpayers earning less than the standard deduction amount.

**IMPACT.** The doubling of the standard deduction would effectively eliminate most individuals from claiming itemized deductions other than higher-income taxpayers. For example, if the standard deduction for married filing jointly is $24,400, as under the House bill, then for the vast majority of individuals, only those with allowable mortgage interest, property taxes, and charitable deductions in excess of $24,400 would claim them as itemized deductions. With fewer individuals claiming those deductions, this could have broad impact on both real estate prices and charitable organizations despite retaining those two deductions, in modified form.

**IMPACT.** Both the House bill and the Senate bill eliminate the deduction for personal exemptions and the personal exemption phase-out. That repeal, as scored by the Joint Committee on Taxation, would raise between $1.22 trillion and $1.56 trillion in revenue over the next ten years (depending upon whether a 2025 sunset to repeal is triggered). That repeal would reduce the net benefit of the standard deduction for most taxpayers. An enhanced child
and family tax credit is positioned to make up some of the difference, being scored at saving taxpayers between $584 million and $640 million for the Senate and House bills, respectively.

**Deductions and Credits**

Both the House bill and Senate bill would make significant changes to some popular individual credits and deductions. The changes in the Senate bill, however, generally would be temporary, expiring after 2025 in order to keep overall revenue costs for the bill within budgetary constraints.

**IMPACT.** The loss of many itemized deductions would channel an even greater number of taxpayers to the standard deduction. Big losers may include state and local governments that depend upon the federal itemized deductions for state and local income taxes and real estate taxes as an indirect subsidy for those taxes. Limitations on the mortgage interest deduction would also likely hurt the housing industry. Second-home properties would also take a hit under the House bill after the November 2, 2017 cut-off date covering new mortgages.

The home mortgage interest deduction would be retained, but modified under both bills. For most debt incurred after the proposed effective date of November 2, 2017, the current $1 million limitation would be reduced to $500,000 under the House bill. The House bill would also eliminate the mortgage deduction for second homes under the November 2, 2017 cut-off date. The Senate bill retains the home mortgage interest deduction, but both the House and Senate bills would eliminate the home equity interest deduction.

Under both the House and Senate bills, the deduction for state and local income taxes would be repealed (with the Senate bill technically reinstating this deduction under its sunset provision). Similarly, taxpayers would no longer be able to elect to deduct state and local sales taxes in lieu of state and local income taxes. Property taxes up to $10,000 could be deducted under the House bill. The Senate bill also provides a carve-out for property taxes.

The House bill repeals the medical expense deduction. The Senate bill preserves the medical expense deduction and temporarily lowers the AGI threshold to 7.5 percent (the pre-ACA threshold).

**IMPACT.** Once again, the concessions for retaining some deductions are valuable only to those taxpayers who would do better continuing to itemize deductions than taking the higher standard deduction.
Family Incentives

Under the House bill, the child tax credit would increase to $1,600 from its current $1,000 level and expanded to children under the age of 17. A temporary credit of $300 would be allowed for non-child dependents. The Senate bill would temporarily increase the child tax credit to $2,000 (of which $1,000 would be refundable), expand it to children under the age of 18, and allow a $500 credit for non-child dependents.

Under the House bill, a temporary family flexibility credit of $300 would also be allowed with respect to the taxpayer (each spouse in the case of a joint return) who is neither a child nor a non-child dependent, irrespective of whether he or she has children or a non-child dependent.

**IMPACT.** Under the House bill, the phase out for the combined child credit, the non-child dependent credit, and the credit for a non-child or non-child dependent would increase to $230,000 for married couples filing joint returns and $115,000 for single individuals. Under the Senate bill, these amounts are increased to a flat $500,000 for both joint and single filers. The current phase-out levels for the child tax credit are set at $75,000 and $110,000, respectively.

Both the House bill and the Senate bill preserve the adoption credit. The House bill and the Senate bill also retain the earned income tax credit (EITC).

Education

The House bill would consolidate the American Opportunity Tax Credit (AOTC) and Lifetime Learning Credit after 2017. The Senate bill makes no changes to these education credits.

The House bill would repeal the student loan interest deduction. The Senate bill would retain the student loan interest deduction. Neither bill revives the tuition and fees deduction, which expired after 2016.

**Comment.** The Senate bill would double the deduction to $500 for educator expenses while the House would repeal the deduction. The Senate bill would also exclude from income debt forgiveness on student loans discharged on account of death or disability.

Affordable Care Act

The Senate bill repeals the Affordable Care Act (ACA) individual shared responsibility requirement after 2018, making the payment amount $0. The House bill makes no changes to the ACA’s individual mandate.

**Comment.** The IRS has cautioned that, under current law, for tax year 2017, it will not consider a return complete and accurate if the taxpayer does not report full-year coverage, claim a coverage exemption, or report a shared responsibility payment on the return.

BUSINESSES

Corporate Taxes

The House bill calls for a 20-percent corporate tax rate beginning in 2018. The Senate bill calls for a 20-percent corporate tax rate beginning in 2019. Both bills make the...
new rate permanent. The maximum corporate tax rate currently tops out at 35 percent.

**COMMENT.** Although the current maximum corporate tax rate is 35 percent, many corporations now pay an effective tax rate that is considerably less.

**COMMENT.** Shortly after the Senate passed its version of HR 1, President Trump appeared to signal being open to a 22 percent corporate tax rate.

Under the House bill, the 80-percent and 70-percent dividends received deductions under current law are reduced to 65-percent and 50-percent, respectively. Under the House bill, the alternative minimum tax (AMT) on corporations would be repealed. The Senate bill would retain it.

**Business Tax Benefits**

A number of proposed changes to various business incentives are in the House bill and Senate bill. Chief among them is bonus depreciation and Section 179 expensing.

**Bonus Depreciation**

Both the House and Senate would increase bonus depreciation to 100 percent but for different time frames. Under the House bill but not the Senate bill, used property with first-use by the taxpayer, as well as new property, would now qualify. The Senate bill adds qualified film, television and live theatrical productions to the list of qualifying property.

**IMPACT.** The bonus depreciation rate has fluctuated wildly over the last 15 years, from as low as zero percent to as high as 100 percent. It is often seen as a way to incentivize business growth and job creation.

**Vehicle Depreciation**

The Senate bill would raise the cap placed on depreciation write-offs of business-use vehicles. The new caps would be $10,000 for the first year a vehicle is placed in service (up from a current level of $3,160); $16,000 for the second year (up from $5,100); $9,600 for the third year (up from $3,050); and $5,760 for each subsequent year (up from $1,875) until costs are fully recovered. (No additional accommodation appears to be made, however, for added first-year bonus depreciation, which is currently capped at $8,000.)

**Section 179 Expensing**

The House bill would also enhance Section 179 expensing, raising it from the current $500,000 level with a $2 million phase-out threshold to $5 million and $20 million thresholds, respectively. The Senate version would increase the maximum Section 179 expensing to $1 million, with a $2.5 million phase-out threshold, but would be permanent.

**IMPACT.** Although the differences between bonus depreciation and Section 179 expensing would now be narrowed if both offer 100-percent write-offs for new or used property, some advantages/disadvantages for each would remain. For example, Section 179 property is subject to recapture if business use of the property during a tax year falls to 50 percent or less; but Section 179 is allows a taxpayer to elect to expense only particular qualifying assets within any asset class.

**Deductions and Credits**

Numerous business tax preferences would be eliminated after 2017 under the House and Senate bills. These include the Code Sec. 199 domestic production activities deduction, non-real property like-kind exchanges, and more. Additionally, the rules for business meals would be revised.

The House bill leaves the research and development credit in place, but requires five-year amortization of research and development expenditures. The Senate bill generally tracks the House bill. The Senate bill, but not the House bill, provides a temporary credit for employers paying employees on family and medical leave.

**Interest Deductions**

Both the House bill and Senate bill would cap the deduction for net interest expenses generally at 30 percent of adjusted taxable income, among other criteria. Exceptions would exist for small businesses, with the House exempting from the rules businesses with average gross receipts of $25 million or less and the Senate setting the exemption at less than $15 million during the three preceding years.

**IMPACT.** This provision is an attempt to “level the playing field” between businesses that capitalize through equity and those that borrow.

**Pass-Through Businesses**

Currently, owners of partnerships, S corporations, and sole proprietorships – as “pass-through” entities – pay tax at the
individual rates, with the highest rate at 39.6 percent. The House GOP bill proposes a 25-percent tax rate for certain pass-through income after 2017, with a nine-percent rate for certain small businesses. The Senate bill generally would allow a temporary deduction in an amount equal to 23 percent of qualified income of pass-through entities, subject to a number of limitations and qualifications. In both bills, the remaining portion of net business income – subject to a variety of anti-abuse rules – would be treated as compensation subject to ordinary individual income tax rates.

**IMPACT.** The House bill proposes rules that would prevent pass-through owners—particularly service providers such as accountants, doctors, lawyers, etc.—from converting their compensation income taxed at higher rates into profits taxed at the 25-percent level. Generally, under the House bill, the formula that would reduce the business income of pass-through owners to achieve a 25-percent rate is effectively negated. Similarly, the Senate bill eliminates its 23-percent deduction for specified service providers with income in excess of threshold amounts.

On the other hand, the Senate bill would lift its 50 percent-Form W-2-income cap on its 23-percent deduction for taxpayers with taxable income not exceeding certain thresholds.

**ENERGY**

The House bill would repeal many current energy tax incentives, including the marginal well tax credit and the credit for plug-in electric vehicles. Other energy tax preferences, such as the residential energy efficient property credit, would be modified. The Senate bill does not address these incentives.

**EXEMPT ORGANIZATIONS**

The House bill would modify the so-called “Johnson amendment,” which generally restricts Code Sec. 501(c)(3) organizations from political campaign activity. The House bill would also revise reporting requirements for donor advised fund sponsoring organizations and impose an excise tax on the investment income of certain colleges and universities, among other changes.

**INTERNATIONAL**

The House and Senate bills would create a dividend-exemption system for taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when the earnings are distributed. The foreign tax credit rules would be modified as would the Subpart F rules. The look-through rule for related controlled foreign corporations would be made permanent, among other changes.

**Repatriation**

A portion of deferred overseas-held earnings and profits (E&P) of subsidiaries would be taxed at a reduced rate. Under both bills, foreign tax credit carryforwards would be fully available and foreign tax credits triggered by the deemed repatriation would be partially available to offset the U.S. tax.

**IMPACT.** The lower corporate tax rate may also provide an incentive for businesses to not shift operations overseas going forward.