HUSCH BLACKWELL

The Tax Cuts and Jobs Act: An Executive Summary

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On November 6, 2017, the House Ways and Means Committee began its markup of H.R. 1, the Tax Cuts and Jobs Act (TCJA or the Bill). This is the first step in congressional consideration of tax reform legislation that would overhaul both individual and business taxes. This committee, which has jurisdiction over tax reform, is expected to vote on different amendments to the Bill throughout the week in a process known as "marking up" the legislation. It is expected that the House Ways and Means Committee will pass this legislation later in the week. Thereafter, H.R. 1 will be scheduled and debated on the House floor, where it is likely to pass.

The current bill contains the following components, among others:

- The corporate tax rate would be lowered.
- The pass-through rate for business income would be lowered.
- A new territorial system would be imposed on international business.
- Private Activity Bonds would be repealed.
- Use of tax-exempt bonds to construct professional sports stadiums would be prohibited.
- New Markets Tax Credits would not be allocated after December 31, 2017.
- Historic Building Rehabilitation Credits would be repealed.

The current goal on the Hill is to pass tax reform legislation through a process called budget reconciliation, which was initiated over the last few weeks. Reconciliation allows a bill to pass the Senate with a simple majority, meaning it evades being crippled by use of the filibuster. The budget legislation allowed for up to a $1.5 trillion tax revenue reduction, and the Joint Committee on Taxation estimates that the TCJA would come in just under that threshold at $1.487 trillion in reduced revenue over the next 10 years. However, because the Bill appears to lose money after 10 years, it will likely need to be amended to comply with reconciliation rules, which also precludes any revenue loss outside the 10-year window.

The majority staff of the Senate Finance Committee is expected to release its proposed tax reform package soon. The Senate Finance Committee will then consider this legislation. It is important to keep in mind that the House bill is simply the opening act in the tax reform debate, and it is anticipated that the final legislation, if any, will be significantly different from the Bill. Our team in D.C. will continue to monitor the important developments related to tax reform.

Below is a more detailed summary of some of the significant proposals in the Bill.

Business Provisions

20 Percent Permanent Corporate Tax Rate. The TCJA creates a flat corporate tax rate of 20 percent beginning in 2018. Personal service corporations would be subject to a flat 25 percent rate. Contrary to earlier reports, there is no phase-in.

25 Percent Pass-through Rate. The Bill provides a special 25 percent rate for "business income" that passes through to individuals. Net income from a passive business activity would be fully eligible for the 25 percent rate. Owners receiving income from an active business would determine their business income by reference to their "capital percentage" of net income. For active owners, qualified income is determined by reference to the "capital percentage" of net income. The rules are relatively complex, though active owners can elect to apply 30 percent as a safe-harbor capital percentage. The rules do not apply to certain service providers such as doctors or lawyers.

Limitation on Business Interest. The TCJA proposes to limit business interest deductions to 30 percent of adjusted taxable income, roughly defined to be earnings before interest, tax, depreciation and amortization (EBITDA). The limit does not apply to certain small businesses (gross receipts less than $25 million), investment interest and to real property trade or businesses (such as a real estate investment trust). The provision would be effective beginning in 2018.

Like-Kind (1031) Exchanges. Significantly, and contrary to earlier reports, the TCJA does not propose to repeal or change the rules relating to like-kind exchanges of real property. It does, however, propose to end like-kind exchanges for personal property.

Contributions to Capital. The Bill proposes to tax contributions to capital of a corporation. Income would not be recognized to the extent of the fair market value of any stock that is issued. The Bill seems targeted at non-owner contributions but applies to all contributors, even existing owners. This rule is also extended to other types of entities (i.e., partnerships).

Cost Recovery. The TCJA would allow immediate expensing of certain tangible personal property placed into service after September 27, 2017, and before January 1, 2023. The limitation on section 179 expensing would be increased from $500,000 to $5 million and the phase-out increased from $2 million to $20 million, adjusted for inflation.

Limitation on Use of Net Operating Losses. The TCJA would limit deductions for net operating losses (NOLs) to 90 percent of taxable income for a taxable year. NOLs would be carried forward indefinitely to future taxable years, rather than expiring after 20 years, as under current law. NOL carrybacks would generally be disallowed, with exceptions for certain disaster losses. Unlike the current rules, carryforwards would be increased by the applicable federal rate plus 4 percent each year.

Lobbying Expenses. The TCJA would repeal the deduction for local lobbying expenses. The deductibility of local lobbying expenses has been an exception to the general rule restricting deductions for lobbying.

Section 199 Deduction. The Bill would repeal the so-called DPAD deduction under IRC section 199, effective for tax years beginning after 2017.

Denial of Deduction for Entertainment Expenses. Entertainment expenses would no longer be deductible, although business meals would remain partially deductible.

Treatment of Certain Self-Created Property. The Bill would exclude patents, inventions, models or designs, or secret formulas or processes as qualifying as a capital asset under section 1221. Under current law, these items are treated as capital assets.

Compensation and Benefit Matters

Nonqualified Deferred Compensation. The Bill proposes to repeal section 409A and proposes new section 409B. Under the new provision, services performed after 2017 would be taxed as soon as there is no substantial risk of forfeiture with regard to the compensation. This is a significant proposal expected to impact a wide variety of compensation plans. Existing deferrals for services performed before 2018 would become subject to tax in 2026, unless vesting occurs later.

401(k) Plans. The TCJA does not propose the expected changes to 401(k) plans. The proposal does include other changes, however, including repealing the rule that allows for re-characterization of traditional IRA contributions into Roth and vice versa.

High Compensation. The Bill amends section 162(m). Under this provision, the performance exception for imposing a $1 million compensation deduction limit is eliminated and the persons covered by the rules are expanded.

Miscellaneous Benefit Changes. The Bill would eliminate tax-favored dependent care assistance programs. Additionally, employer-provided moving expense reimbursement, tuition reductions by educational institutions, educational assistance, and adoption assistance programs would now be taxable to employees.

Private Activity Bonds and Credits

Repeal of Private Activity Bonds. Prohibition on Use of Tax-Exempt Bonds to Construct Professional Sports Stadiums. The Bill would repeal tax-exempt interest for all private activity bonds (i.e., loans to private parties). The Bill would also prohibit the use of tax-exempt bonds to construct professional sports stadiums.

Historic Building Rehabilitation Credit. The TCJA proposes to repeal the rehabilitation credit under section 47 for the restoration of old and historic buildings. The credit would continue to apply to qualified expenditures through the end of a 24-month period, which is required to begin within 180 days after January 1, 2018.

New Markets Tax Credits. The TCJA provides that no additional New Markets Tax Credits be allocated after December 31, 2017. Credits that have already been allocated may be used over the course of up to seven years.

Oil and Gas Credits. The TCJA would repeal the current-law credit of up to 15 percent of qualifying enhanced oil recovery available under section 43. The Bill also would repeal the credit under section 45 for producing oil and gas from marginal wells. These provisions would be effective for tax years beginning after December 31, 2017.

International Provisions

Dividends Received Deductions. The TCJA would replace the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed. Under the proposed rules, 100 percent of the foreign source portion of dividends paid by a foreign corporation to a U.S. corporate shareholder that owns 10 percent or more of the foreign corporation would be exempt. No foreign tax credit or deduction would be allowed for any foreign taxes (including withholding taxes) paid or accrued with respect to any exempt dividend. The provision would be effective for distributions made after 2017.

Deemed Repatriation of Deferred Income. To encourage repatriation of prior earnings, the Bill provides that U.S. shareholders owning at least 10 percent of a foreign subsidiary would include in income for the subsidiary's last tax year beginning before 2018 the shareholder's pro rata share of the net post '86 historical earnings and profits (E&P) of the foreign subsidiary that have not been previously subject to U.S. tax. The portion of the E&P comprising cash or cash equivalents would be taxed at 12 percent, while any remaining E&P would be taxed at 5 percent. At the election of the U.S. shareholder, the tax liability would be payable over a period of up to eight years, in equal annual installments.

Foreign High Returns. The TCJA proposes that a U.S. parent of a foreign subsidiary include 50 percent of its foreign high returns. Such returns are defined as the foreign subsidiary's aggregate net income over a "routine" rate (the federal short term rate, plus 7 percent). This would begin for tax years after 2017.

Excise Tax or Custom Payments. The Bill would impose a new excise tax on payments to related foreign corporations. The tax would apply to payments that are deductible (directly, over time or in the event of sales) for U.S. purposes. The rules only apply to large, international financial reporting groups (as defined in the Bill) with payments totaling more than $100 million annually.

Individual Provisions

Brackets of Tax. While the TCJA reduces the overall tax brackets to four (from seven), it retains the same long-term capital gain rate, as well as the 3.8 percent tax on certain net investment income. The Bill proposes significant changes to the income thresholds applicable to the brackets. For example, currently the top rate (39.6 percent) applies to income of more than $480,000. Under the TCJA, it would apply to income of more than $1 million. The TCJA retains the top rate of 39.6 percent.

Increased Standard Deduction. Repeal of Personal Exemptions. The Bill would increase the standard deduction from $6,350 to $12,000 for individuals and from $12,700 to $24,000 for married couples. This simplifies tax filings for millions of low- and middle-income families. The Bill would also repeal the personal exemption ($4,050 for each personal exemption in 2017). This increase is offset by the repeal of many deductions, set forth below.

Deductibility of Local Taxes. The Bill would repeal the itemized deduction for state and local income taxes. In addition it would limit the deduction for state and local property taxes to $10,000.

Limitation on Home Mortgage Interest Deduction. Under the Bill, for mortgages entered into after November 2, 2017, mortgage interest deductibility would be limited to loans of $500,000 versus $1 million currently. Second-home interest and home equity interest would no longer be deductible.

Increased Charitable Deductible. Under current law, cash contributions to a public charity are deductible only to the extent of 50 percent of the taxpayer's adjusted gross income. The percentage would be increased to 60 percent.

Repeal of Limitations on Itemized Deductions. The Bill would repeal the 3 percent AGI limitation on itemized deductions.

Repeal of Other Deductions. The Bill would repeal the deduction for certain medical expenses, the deduction for student loan interest and the tax credit for adoption. In addition, no deduction would be permitted for moving expenses, and employment achievement awards would be taxable.

Transfer Taxes

Phase-out of the Estate Tax. The Bill would immediately double the estate tax exemption and repeal the estate tax and the generation-skipping transfer tax in 2024. The Bill would retain the gift tax but would lower it to 35 percent, and would retain the $10 million lifetime gift tax exclusion and the annual exclusion of the $14,000. The "step-up" in basis of assets on death would be retained.