

A Review of the Tax Bill

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Practice Area: Business and Corporate Law & Tax

This *Legal Update* will provide an overview of relevant sections of both the House and Senate versions of the Tax Cuts and Jobs Act, illustrate the potential impacts, and provide a comparison of the two Bills.

As both of these Bills work their way through Congress, expect them to change substantially.

Though neither of the Acts may pass and are subject to change, it is important to prepare now. Legislatures intend to enact tax reform before the end of the year. If they are successful, certain tax provisions could go into effect as soon as January 1, 2018 leaving taxpayers with very little time to plan and prepare.

Fifteen of the most important provisions are summarized below. Provisions 1-6 apply to **individual income taxes**. Provisions 7-15 apply to **corporate and business taxes**. This review summarizes the current law, explains the House's proposed changes, explains the Senate's proposed changes, and discusses the potential impact of both Bills.

Individual Income Tax¹

1. Tax Rates – Individuals

- **Current Law:** There are seven regular individual income tax brackets: 10%, \$932.50 plus 15% of the excess over \$9,325, \$5,226.25 plus 25% of the excess over \$37,950, \$18,713.75 plus 28% of the excess over \$91,900, \$46,643.75 plus 33% of the excess over \$191,650, \$120,910.25 plus 35% of the excess over \$416,700, and \$121,505.25 plus 39.6% of the excess over \$418,400. I.R.C. § 1
- **House Bill:** The House Bill would reduce the number of tax brackets to four: 12%, 25%, 35%, and 39.6%. For married taxpayers filing jointly, the tax bracket thresholds would be set at: \$90,000 for the 25% tax bracket, \$260,000 for the 35% tax bracket, and \$1 million for the 39.6% tax bracket.
 - **Potential Impact:** Reducing the number of individual tax brackets could lead to a simpler tax structure and may affect choice of legal entity
- **Senate Bill:** The Senate Bill retains the number of brackets, but alters the percentage and base rates to: 10%, \$9,525.50 plus 12% of the excess over \$9,525, \$4,453.50 plus 22% of the excess over \$38,700, \$9,246 plus 24% of the excess over \$70,000, \$30,496 plus 32% of the excess over \$160,000, \$46,746 plus 35% of the excess over \$200,000, \$153,496 plus 38.5% of the excess over \$500,000. The bracket thresholds have also been adjusted for inflation.
 - **Potential Impact:** Reducing the percentage and base rates would reduce the amount of taxes owed. However, the adjustment for inflation may change the bracket an individual is subject to and may increase an individual's tax rate.

Current		Senate Bill		House Bill	
Taxable Income is:	Income Tax equals:	Taxable Income is:	Income Tax equals:	Taxable Income is:	Income Tax equals:
Not over \$9,325	10%	Not over \$13,600	10%	is less than or equal to \$45,000	12%
\$9,325 - \$37,950	\$932.50 plus 15% of the excess over \$9,325	\$13,600 - \$51,800	\$9,525.50 plus 12% of the excess over \$9,525	\$45,000 - \$200,000	25%
\$37,950 - \$91,900	\$5,226.25 plus 25% of the excess over \$37,950	\$51,800 - \$70,000	\$4,453.50 plus 22% of the excess over \$38,700	\$200,000 - \$500,000	35%
\$91,900 - \$191,650	\$18,713.75 plus 28% of the excess over \$91,900	\$70,000 - \$160,000	\$9,246 plus 24% of the excess over \$70,000	Over \$500,000	39.6%
\$191,650 - \$416,700	\$46,643.75 plus 33% of the excess over \$191,650	\$160,000 - \$200,000	\$30,496 plus 32% of the excess over \$160,000		
\$416,700 - \$418,400	\$120,910.25 plus 35% of the excess over \$416,700	\$200,000 - \$500,000	\$46,746 plus 35% of the excess over \$200,000		
Over \$418,400	\$121,505.25 plus 39.6% of the excess over \$418,400	Over \$500,000	\$153,496 plus 38.5% of the excess over \$500,000		

2. Standard Deductions

- **Current Law:** Taxpayers have the option of claiming the standard deduction or itemizing their deductions. The amount a taxpayer may claim as their standard deduction depends on how the taxpayer files their returns (e.g., individually, as a head of household, or jointly). In 2017, individuals could claim a \$6,350 standard deduction, a head of household could claim \$9,350, and married individuals filing a joint return could claim \$12,700. I.R.C. § 63. In addition, taxpayers can claim a personal exemption for the taxpayer, the taxpayer's spouse, and any dependents.
- **House Bill:** The House Bill would double the amount of the standard deduction. Individuals could claim a standard deduction of \$12,000, single filers with at least one qualifying child could claim a standard deduction of \$18,000 and married individuals filing a joint return could claim a standard deduction of \$24,000. Personal exemptions would be repealed.
 - **Potential Impact:** The House Bill increases standard deductions, but it does so at the expense of personal exemptions and itemized deductions, many of which are eliminated. Like many tax matters, the impact of this new structure can only be determined on a case-by-case basis. See the section below on itemized deductions you may lose. Often small businesses receive significant benefits from itemized deductions.
- **Senate Bill:** The Senate Bill is consistent with the House Bill.

3. Itemized Deductions

- **Current Law:** Taxpayers may choose to itemize their deductions rather than claiming the standardized deduction. Common itemized deductions include mortgage interest paid on homes, state and local income or sales tax, property taxes, medical expenses, and charitable deductions. I.R.C. § 63
- **House Bill:** Certain itemized deductions would be eliminated under the House Bill, and others would be capped. The House Bill eliminates the deduction for state and local income taxes, but taxpayers would continue to receive a deduction for state and local income or sales taxes paid or accrued in carrying on a trade or business. The deduction for interest payments on new mortgages (those entered after November 2, 2017) would be limited to the first \$500,000. Individuals would continue to be allowed to claim an itemized deduction for real property taxes up to \$10,000.
 - **Potential Impact:** As mentioned above, the House Bill re-works the current tax structure by increasing the standard deduction and eliminating or limiting other deductions, exemptions and tax credits. Eliminating the need for itemized deductions (e.g., home mortgage interest and charitable deductions) may lead to a simplified tax filing process (one goal of the tax reform is to create a system where individuals and families can file their taxes on a form as simple as a postcard).
- **Senate Bill:** The Senate Bill also eliminates the state and local tax income deductions for individuals. But, unlike the House Bill, it also eliminates property deductions for individuals and all miscellaneous itemized deductions that are subject to the two-percent floor under present law. The Senate Bill retains mortgage interest and medical expense deductions. In addition, it repeals the overall limitation on itemized deductions.
 - **Potential Impact:** As stated above, the elimination and limitation of deductions may lead to a simplified tax filing process. However, it also may make it more difficult for individuals to reduce their gross income and taxes owed.

4. Death Tax (Estate Tax)

- **Current Law:** Commonly referred to as the "Death Tax," property in an estate worth more than \$5.49 million for individuals, or \$10.98 million for married couples, may be subject to a tax rate of 40% before it passes to the estate's beneficiaries. I.R.C. § 2001- § 2210
- **House Bill:** The House Bill seeks to eliminate the federal Estate Tax in two strokes. First, the House Bill would immediately increase the basic exclusion amount from \$5.49 million to \$10 million. Second, the House Bill would repeal the Death Tax completely after six years. The House Bill maintains provisions for "basis step-up." Basis step-up rules provide that the tax basis of an asset held until death is readjusted to fair market value, which allows heirs to sell the asset without realizing any taxable gains.

The Estate Tax, Gift Tax and Generation Skipping Transfer Tax (GSTT) are currently written to work hand in hand. Changes to the Estate Tax most likely will require change in the Gift Tax and GSTT. Close attention should be paid to what happens with the Gift Tax and GSTT if the Estate Provisions make it to the final Bill.

- **Potential Impact:** Repealing the Estate Tax will prevent families from being double or triple taxed on property as it passes from generation to generation, though few businesses pay the Estate Tax. For example, in the farming industry, it is estimated that 80 farms and closely held businesses nationwide will pay the tax in 2017. The step-up in basis is an important feature that can provide estate planning benefits but also reduce capital gains taxes in the event an heir decides to sell the assets that received the step-up in basis.
- **Senate Bill:** Unlike the House Bill, the Senate Bill does not repeal the Estate Tax. It only increases the basic exclusion amount from \$5.49 million to \$10 million. Portability would remain.
 - **Potential Impact:** Since the Estate Tax is not repealed, families may still be double and triple taxed on property as it passes to the next generation. However, the increase of the exclusion amount will allow a greater amount of property to be sheltered from the Estate Tax.

5. Self-Employment

- **Current Law:** Currently, rental income is not subject to self-employment tax.
- **House Bill:** The first version of the House Bill expanded the types of income subject to self-employment tax, including for rental of land. This provision was later removed from the final version of the House Bill.
 - **Potential Impact:** Owners of land who are renting it would have experienced a substantial increase in taxes under the first version of the House Bill. There was heavy lobbying against the provision and Committee members responded by removing the provision altogether, thus helping land owners avoid a significant tax increase.
- **Senate Bill:** The Senate Bill is silent on the subject of rental income and the self-employment tax.

6. Alternative Minimum Tax

- **Current Law:** The alternative minimum tax closes loopholes and deductions that allow individuals to owe very low or no taxes. If an individual qualifies, then their gross income is calculated with more limited deductions.
- **House Bill:** The House Bill would eliminate the alternative minimum tax for tax years after 2017. Businesses who have Alternative Minimum Tax Credits from prior years may claim a refund of 50% of their remaining credits in 2019, 2020, and 2021. A business may then claim 100% of their remaining credits in 2022.

- **Potential Impact:** Eliminating the alternative minimum tax would allow taxpayers, through careful planning, to significantly reduce their taxes and not be at risk for recalculation under a different set of terms. This provision would encourage careful tax planning and utilization of deductions. However, due to the elimination of many deductions and gross income reduction provisions in the new Bill, there may be little advantage offered to taxpayers.
- **Senate Bill:** The Senate Bill is consistent with the House Bill.

Business and Corporate Tax

7. Corporate Tax Rate

- **Current Law:** Corporations are taxed on a graduated rate of 15%, 25%, 34%, and 35%. Personal service corporations are taxed at a 35% rate. I.R.C. § 11
- **House Bill:** The House Bill provides for a flat corporate tax rate of 20%.
 - **Potential Impact:** The flat corporate rate of 20% should prompt a review of the choice of legal entity. For some partnerships, the corporate form of governance and its tax structure may provide benefits that would outweigh the benefits of a partnership form of taxation.
- **Senate Bill:** The Senate Bill also provides for a flat corporate tax rate of 20%, but delays the start date to January 2019.
 - **Potential Impact:** The impact of this Bill will be the same as the House Bill's impact. However, the delayed start will delay the benefit, but also allow businesses time to determine what the most beneficial business structure will be before the law is in effect.

8. Business Income of Sole Proprietorships and Pass-through Entities (i.e. LLCs)

- **Current Law:** S-Corporations are "pass-through" corporations. Rather than paying taxes at the corporate level, these entities pass through corporate income, losses, deductions, and credits to the owners and shareholders, who pay taxes at the individual level. The net income earned by owners of these entities is subject to ordinary income tax rates.
- **House Bill:** The House Bill sets a maximum rate on pass-through business income. Business income from sole proprietorships and pass-through entities would be subject to a maximum tax rate of 25% rather than applicable individual rates. The House Bill distinguishes between passive business activities and active business activities. Net income from a passive business activity would be subject to the 25% rate. Net income from an active business activity would be determined by referencing the capital percentage of net income. Specifically, owners or shareholders receiving distributions from active business activities could elect to either: (1) treat 30% as business income (subject to pass-through rate) and 70% as wage income (subject to individual rates), or (2) apply a formula based on the facts-and-circumstances of their business to determine a capital percentage of greater than 30%. Income received from REITS and patronage dividends would be taxed at a maximum tax rate of 25%.
 - **Potential Impact:** The Tax Code is currently set up to provide favorable tax treatment to family business entities set up as S-Corporations. The House Bill levels the tax rates for S-Corporations and C-Corporations. The presence of this provision may tempt businesses to jump ship and re-organize as C-Corporations. Businesses should be cautious before they do so as the House Bill contains certain anti-abuse rules to prevent such actions.
- **Senate Bill:** The Senate Bill provides a 17.4% deduction for non-wage domestic qualified business income. If the taxpayer has a taxable income of \$500,000 for married individuals or \$250,000 for other individuals, then the deduction is limited to 50% of their wages.

- **Potential Impact:** Unlike the House Bill, the Senate Bill still treats S-Corporations more favorably than C-Corporations. Additionally, the amount of taxes owed for this form of income will likely be less than under the current system.

9. Section 179 Expensing

- **Current Law:** Small businesses may immediately expense up to \$500,000 of the cost of certain property placed in service each year. I.R.C. § 179. The property must be "tangible, depreciable, personal property which is acquired for use in the active conduct of a trade or business." Businesses that place more than \$2 million of property in service in a year are subject to certain limitations.
- **House Bill:** The threshold for the small business expensing limitation under Section 179 would be increased from \$2 million to \$5 million. The definition of "property" under Section 179 would be expanded to include qualified energy efficient heating and air-conditioning property.
 - **Potential Impact:** The expansion of Section 179 expensing is beneficial to businesses with the potential to incur costs that would normally be expensed over many years, creating a current year decrease in taxable income. For example, Section 179 expansion will allow small businesses to continue expensing the costs of new equipment. Businesses that make capital improvements should also be cognizant of the cost segregation rules that allow the expensing of certain items on a shorter depreciation schedule than the 39 years typically associated with real property improvements. These improvements may include the electrical and plumbing installed in a building that serves personal property. With the construction of a new building and utilizing cost segregation techniques, it may be possible to increase the front end of depreciation expense and thereby reduce current year taxable income.
- **Senate Bill:** The Senate Bill increases the amount businesses may expense from \$500,000 to \$1 million. The expensing limitation would increase from \$2 million to \$2.5 million. The definition of property would be expanded to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging. It also expands the definition of qualified real property to include the following improvements to nonresidential real property: roofs, heating, ventilation, air-conditioning, fire protection and alarm systems, and security systems.
 - **Potential Impact:** The benefits from this provision would be similar to those under the House Bill. But, because the increase in the expensing limitation is not as significant, the impact will be smaller. However, under the Senate's Bill, a business may deduct more money up front, allowing the business to reap the tax benefits more quickly.

10. Interest Deductions

- **Current Law:** Generally, business interest is allowed as a deduction in the taxable year in which the interest is paid or accrued (subject to various limitations). I.R.C. § 163
- **House Bill:** The House Bill would limit business interest deductions to 30% of a business's adjusted taxable income ("ATI"). ATI is income computed before interest income, net operating losses, depreciation, amortization, and depletion. Any interest that is disallowed would be carried forward five years. The limitation would not apply to small businesses (businesses with average gross receipts of \$25 million or less).
 - **Potential Impact:** Businesses with gross revenue exceeding \$25 million and high interest expense deductions relative to revenue should immediately determine their ratio of interest expense to ATI. If the taxpayer's interest expense is more than 30% of ATI, a planning strategy should be considered.

- **Senate Bill:** The Senate Bill restricts the interest deduction for businesses to 30% of adjusted taxable income. Under this Bill, interest disallowed would be carried forward indefinitely. However, particular rules apply to certain industries. For example, a farming business qualifying under section 263A(e)(4) can elect to be exempt from the limitation. But, the farming business must use the alternative depreciation system to depreciate any property with a 10 or more year recovery.
 - **Potential Impact:** A qualifying business may elect to be exempt and could continue to deduct otherwise allowable interest costs. However, extending the depreciable life of real property improvements and personal property should be taken into consideration because it will minimize the amount of the immediately available deduction. In a farm situation where the farming business elects not to be excluded, the impact would be similar to that under the House Bill. But, since the interest disallowed can be carried forward indefinitely rather than just 5 years, a business will never "lose" this deduction and theoretically can use it at some future date.

11. Net Operating Loss Deduction

- **Current Law:** A Net Operating Loss (NOL) is the amount a taxpayer's current year business deductions exceed its current year gross income. Generally, NOLs are allowed to offset all of their taxable income. NOLs can be carried back two years and carried forward twenty years. Special rules apply in certain circumstances. For instance, a special five-year carryback applies to NOLs arising from a farming loss. I.R.C. § 172
- **House Bill:** Under the House Bill, the NOL rules would change substantially. However, there are certain exceptions for small businesses. First, NOLs would be allowed to offset only 90% of taxable income. Second, NOLs would be able to be carried forward indefinitely (rather than only twenty years). Finally, NOLs would no longer be carried back to offset income in prior years and a limited exception provides small businesses with a special one-year carryback in the event of casualty and disaster losses.
 - **Potential Impact:** Where a taxpayer has experienced an NOL greater than current year income, there has historically been some benefit in that the taxpayer can obtain a refund of tax paid in the prior two years. The Bill eliminates the current benefit. A tax refund would not be available to raise cash, which is often needed where there is an NOL situation.
- **Senate Bill:** Similar to the House Bill, NOLs are limited to offsetting only 90% of taxable income and are able to be carried forward indefinitely. The percentage will decrease to 80% of income in 2023. The Bill also repeals the two-year carryback and special carryback provisions, but provides two-year carryback for certain losses incurred in a trade or business.
 - **Potential Impact:** The impact of this provision would be the same as under the House Bill, except that a taxpayer can still benefit from a refund of tax paid in the prior two years for certain losses incurred in a trade or business.

12. Cash Accounting

- **Current Law:** The cash method of accounting allows a business to recognize income and deduct expenses when the cash is received or paid. Sole proprietorships, partnerships (without a corporate partner), and S-Corporations may use the cash method of accounting. Corporations and partnerships with a corporate partner may only use the cash method of accounting if its average gross receipts do not exceed \$5 million for all prior years. Special rules apply in certain industries. For example, farm corporations or farm partnerships with a corporate partner may only use the cash method of accounting if their gross receipts do not exceed \$1 million in a year. Another exception applies to certain family farm corporations which may use cash accounting if their gross receipts do not exceed \$25 million. I.R.C. § 448
- **House Bill:** Under the House Bill, the threshold for all entities would increase to \$25 million.
 - **Potential Impact:** The House Bill will allow many industries to use the cash method of accounting. Cash accounting is preferred in many industries, such as agriculture and retail, as it provides flexibility and reflects the realities of a volatile market.
- **Senate Bill:** Under the Senate Bill, the threshold for all entities would increase to \$15 million. This Bill retains the \$25 million threshold for certain farming corporations.
 - **Potential Impact:** The Senate Bill also expands the universe of businesses that can use the cash method of accounting, but not as broadly as the House Bill does.

13. Domestic Production Activities Deduction (Cooperatives)

- **Current Law:** The Tax Code provides a domestic production activities deduction (DPAD). I.R.C. § 199. The DPAD applies to proceeds from agricultural products that are manufactured, produced, grown, extracted or marketed by and through cooperatives. Special provisions in the Tax Code allow cooperatives to keep the deductions at the entity level or pass the benefit of the deduction directly through to their members.
- **House Bill:** The House Bill would repeal the Domestic Production Activities Deduction.
 - **Potential Impact:** Eliminating Section 199 could raise taxes for members of cooperatives. The cooperative would lose the DPAD and thereby increase the income tax paid. We are still analyzing the impact the repeal would have on the agriculture industry, but initial calculations suggest the value is substantial, over \$50 million a year in certain states.² This provision will likely be the source of debate in the coming weeks. The deductibility of patronage dividends would be maintained.
- **Senate Bill:** The Senate Bill would also repeal the Domestic Production Activities Deduction, but the repeal would be effective for tax years beginning after December 31, 2018.
 - **Potential Impact:** The impact is the same under the Senate Bill as it is under the House Bill.

14. Like-Kind Exchanges

- **Current Law:** The Tax Code allows taxpayers to avoid paying taxes on trades of certain property provided the taxpayer acquires similar property. Currently, the like-kind exchange rule applies to a wide range of property from real estate to tangible personal property. I.R.C. § 1031
- **House Bill:** The House Bill would limit like-kind exchanges to real property. The House Bill would provide a transition rule to allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017.

- **Potential Impact:** Taxpayers would no longer be allowed to use Section 1031 exchanges to exchange equipment, livestock or other non-real property assets. If this section of the House Bill is enacted as is, taxpayers will need to act quickly to complete exchanges before the end of the year to take advantage of the favorable tax treatment for personal property before it is taken away.

- **Senate Bill:** The Senate Bill is consistent with the House Bill.

15. Changes Unique to farming under the Senate Bill

a. Excess Farm Loss Rules

- **Current Law:** If a taxpayer is not a C-Corporation and receives a subsidy for the taxable year, the amount of excess farm loss is carried forward as a deduction in the next taxable year.
- **Senate Bill:** Rather than treating the excess farm loss as a deduction, it will be treated as a part of the taxpayer's NOL carryforward and be subject to the new restrictions, noted above, on NOLs.
 - **Potential Impact:** Since this loss is no longer a deduction, taxpayers will no longer see the immediate tax benefit of these types of losses. In addition, because these losses are subject to the NOL restrictions, the taxpayer will not fully recover the loss in the current year.

b. Modifications of Treatment of Certain Farm Property

- **Current Law:** Capitalized property used in a farming business is able to be deducted. These deductions are subject to assigned recovery periods. With some exceptions, the recovery period assigned for machinery or equipment is 7 years. All property (except real property, residential rental property, and trees or vines that bear fruit or nuts) used in a farming business is subject to the 150-percent declining balance method in determining a depreciation schedule.
- **Senate Bill:** Under the Senate Bill, the recovery period is reduced to 5 years for machinery or equipment (excluding grain bin, cotton ginning asset, fence, or other land improvement). It also repeals the required use of the 150-percent declining balance method for 3- to 10-year property. It continues to apply to 15- and 20-year property.
 - **Potential Impact:** Under this Bill, the taxpayer will be able to benefit from larger deductions. However, they will benefit from these deductions for a shorter amount of time.

¹ All Individual Income Tax Reform strategies outlined in the Senate Bill will expire after December 31, 2025. Therefore, the potential impacts will be slightly more limited.

² NCFC Press Release, <http://ncfc.org/press-release/house-tax-proposal-raise-taxes-americas-farmers/>

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