US Tax Reform

What you need to know

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by

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Agenda

I. House - Tax Cuts and Jobs Act
   – Individual Provisions
   – Corporate & Business Provisions
   – Updated for Senate Bill provisions

II. The Tax Reform Process
I. House - Tax Cuts and Jobs Act
   – Individual Provisions
## Individual Tax Rates

<table>
<thead>
<tr>
<th>Income taxed</th>
<th>Current rates</th>
<th>Proposed rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>More than $480,050</td>
<td>39.6%</td>
<td>39.6%</td>
</tr>
<tr>
<td>$424,950 to $480,050</td>
<td>35%</td>
<td>35%</td>
</tr>
<tr>
<td>$237,950 to $424,950</td>
<td>33%</td>
<td>$260,000 to $1 million</td>
</tr>
<tr>
<td>$156,150 to $237,950</td>
<td>28%</td>
<td>25%</td>
</tr>
<tr>
<td>$77,400 to $156,150</td>
<td>25%</td>
<td>$90,000 to $260,000</td>
</tr>
<tr>
<td>$19,050 to $77,400</td>
<td>15%</td>
<td>12%</td>
</tr>
<tr>
<td>$0 to $19,050</td>
<td>10%</td>
<td>$0 to $90,000</td>
</tr>
</tbody>
</table>

Income thresholds are for married couples filing jointly. | Sources: Internal Revenue Service; House Ways and Means Committee
Individual Tax Rates

- Whether individuals will pay more or less will depend on a variety of factors, including whether they take the standard deduction or take targeted tax deductions like mortgage interest or state and local taxes.

- Senate Bill – seven brackets, with a top rate of 38.5% on income over $1 million (if married) and $500,000 (if single). Senate bill’s lowest bracket is at 10% for individuals (House bill raises it to 12%).
Standard Deduction

• The House Republican plan proposes roughly doubling the standard deduction ($12,200 and $24,400 for a single individual and a married couple, respectively).
  – A change Republicans believe will lead many more Americans to take the standard deduction rather than itemize their deductions.
Standard v. Itemized Deduction

Deductions taken by income group

20 million tax filers

15 –

10 –

5 –

More tax filers choose the standard deduction

Higher income filers tend to itemize deductions

$1K $5 $10 $15 $20 $25 $30 $40 $50 $75 $100 $200 $500

Adjusted gross income in thousands

Source: Tax Policy Center | Based on 2014 data.
Personal Exemptions and Child Tax Credit

• The Plan also proposes to eliminate the $4,050 per-household-member personal exemption, which could mean large families might not see a net tax benefit.

• But, as long as the family’s total income is under $230,000, it would also be eligible for a larger $1,600 per child tax credit and a $300 credit for each taxpayer and non-child dependent.
Exemptions, Credits, Standard Deduction

• Senate Bill – The same $12,200 / $24,400 as the House Bill. The child care credit would rise to $1,650.
Mortgage Interest

• Still deductible, but there’s a new cap on the mortgage interest deduction for newly purchased homes – up to $500,000 in loan debt (after November 2, 2017).

• Deduction no longer eligible for second homes or home equity lines of credit.

• Fiercely opposed by the real estate industry

• Senate Bill retains the $1 million limit.
Mortgage Interest

Percentage of mortgages originating 2012 to 2015 that were over $500,000

Includes owner-occupied buildings with up to 4 units

Source: National Low Income Housing Coalition
State and Local Tax Deduction

• People will still be able to deduct up to $10,000 of property taxes but they will no longer be able to deduct the other taxes they pay to state or local governments for federal tax purposes.

• This is a compromise from an earlier version of the Republican proposal that would not have allowed any deduction for state or local tax payments.

• Republican representatives (20) whose residents pay high state and local taxes – e.g., New York, New Jersey – voted against the budget resolution.

• Senate Bill eliminates all state and local tax deductions.
State and Local Tax Deduction

On the margins
Top marginal individual income tax rates. States in gray have no income tax.
Additional Provisions – Repealed

• Individual AMT

• Estate, gift and generation-skipping taxes initially would be retained with a doubled $10 million basic exclusion.
  – Estate and generation-skipped taxes would be repealed after 2023 (with a stepped-up basis in property).
  – Top rate on the gift tax would be reduced to 35%.
  – Senate Bill – doubles the exemption but does not propose a full repeal.

• Deductions for medical expenses, casualty losses, tax preparation fees, alimony payments, moving expenses and medical savings account contributions.
  – Senate Bill – retains the deduction for medical expenses, alimony and casualty losses (that happen during an event that the president later officially declares to be a disaster).
Additional Provisions – Retained

• 401(k), although considered.

• Net capital gains and qualified dividends would continue to be taxed at their current 0%, 15% and 20% rates, and also would continue to be subject to the 3.8% net investment income tax.
I. House - Tax Cuts and Jobs Act
   – Corporate & Business Provisions
Corporate Tax Rate

• Reduces the corporate tax rate from 35% to 20%.

• Senate Bill – imposes a one-year delay on lowering the rate.
Effective Corporate Tax Rate

Effective corporate tax rates in 2012, among G-20 countries

Note: Italy (not shown) had a negative corporate effective tax rate in 2012. Source: Congressional Budget Office
Capital Expensing

• Taxpayers would be able to expense **100% of the cost of qualified property** acquired and placed in service after September 27, 2017 and before January 1, 2023.
  
  – Excludes property used by a regulated public utility or any property used in a real property trade or business.

• **Section 179 expanded** by increasing the dollar limitation from $500,000 to $5 million and increasing the phase-out amount from $2 million to $20 million.
Capital Expensing

- **Senate Bill**
  - Small business Section 179 increased to $1 million.
  - 100% bonus depreciation from September 27, 2017 to December 31, 2022.
  - Real property depreciation reduced to 25 years (from 39 years, 27.5 years in the case of residential real estate).
  - Leasehold improvements, restaurants and retail properties go from being deductible under Section 179 to a 10-year straight line, mid-month recovery.
Interest Expense

• Section 163(j) would be revised to limit net interest expense of all businesses that exceeds **30% of adjusted taxable income**.
  – Small business exception ($5 million gross receipts).

• New section 163(n) would be added to limit the net interest expense of domestic corporations that are part of a worldwide group (based on a comparison of the domestic corporation’s EBITDA to the worldwide EBITDA of the group).
Pass-through Tax Rate

- No postcard filing here! Generally -
  - 70% of pass-through income will be taxed at the rate of the business owner’s individual tax rate (i.e., 25%, 35% or 39.6%).
  - The remaining 30% will be taxed at a new low rate of 25% - i.e., qualified business income (QBI) tax rate.
  - Senate Bill – takes a different approach, creating a new 17.4% deduction for pass-through businesses along with other incentives to promote investment.
Specified Service Activities

• Subject to an exception for capital-intensive activities, active business income from specified service activities would not be eligible for the QBI rate.

  – Specified services activities to include, in part, health, law, accounting, consulting, financial services – i.e., any trade or business whose principal asset is the reputation or skill of one or more of its employees or owners (per Section 1202(e)(3)(A)).
Capital Percentage

• The capital percentage must be determined for each active business activity.

• For specified services activities, the capital percentage would be zero unless the activity qualified for an exception for capital-intensive specified services activities.
  – In any year, a taxpayer could elect this exception only if the taxpayer’s “applicable percentage” is at least 10%.
  – If elected, the taxpayer’s capital percentage would be the “applicable percentage”.

• For all other businesses, the capital percentage is 30% unless the taxpayer elects to use the applicable percentage.
  – Once a taxpayer makes the election for a non-specified service activity, it would apply for the current tax year and the four succeeding tax years (and could not be revoked).
Applicable Percentage

• Equals the taxpayer’s “specified return on capital” from the activity for the tax year divided by the taxpayer’s net business income from the activity for that tax year.

• Specified return on capital would be the taxpayer’s share of the active business activity’s “asset balance” multiplied by a deemed rate of return reduced by deductible interest expenses attributable to the activity.
  – Asset balance would be the taxpayer’s adjusted basis of the property used in connection with the active business activity as of the end of the tax year (without regard to bonus depreciation and Section 179).
  – Deemed rate of return is the Federal short-term rate, plus 7%.
Additional Provisions - Repealed

• Corporate AMT
• Section 199 deduction
• Various credits (e.g., employer-provided childcare).
Additional Provisions - Retained

- R&D Credit
- Low-income housing credit
- Like-kind exchanges (but limited to those involving real property only)
- LIFO
I. House - Tax Cuts and Jobs Act
Transition to a Territorial System

• **100% exemption of foreign-source dividends** received by a US corporation from a foreign corporation in which the US corporation owns at least a 10% stake.

• One-time transitional tax on accumulated foreign earnings (as of November 2 or December 31, whichever is higher) at **12% for cash and 5% for illiquid assets**, payable over **8 years**.

  – Senate Bill – 10% for cash and 5% for illiquid assets.
Accumulated Foreign Earnings

The wealth abroad
Total estimated earnings reinvested overseas, by year
$2.8 trillion

Source: SEC filings, Audit Analytics, Capital Economics
Anti-base erosion provisions

- Current US tax on 50% of a US shareholder’s aggregate net CFC income in excess of extraordinary returns from tangible assets (7% + Fed short-term rate of the CFC’s aggregate basis in depreciable tangible property, minus interest expense).
  - 80% of foreign taxes paid allowed as a FTC

- All deductible payments except interest paid to a related foreign company would be subject to a 20% excise tax unless the related foreign company elected to treat those payments as effectively connected income (ECI) and thus taxable in the US.
  - The excise tax would not be deductible if the election is not made
  - Would apply to covered amounts paid by domestic corporations after December 31, 2018.
  - Subsequently tweaked during the Ways & Means Committee’s amendment process.
Anti-base erosion provisions

• Senate Bill – will impose a 12.5% tax on foreign revenue from intellectual property.
II. The Tax Reform Process
Four Steps to Republican Tax Reform

1. Pass Budget Resolution - *Done*
2. Overcome Key Policy Disagreements
3. Go Through Regular Order?
4. Get the Bill through the Senate Budget Rules
Pass Budget Resolution

- Congressional Republicans are planning to pass their tax plan through “budget reconciliation” – which allows Congress to pass a bill with a simple majority (51 votes) and bypass the threat of a Democratic filibuster.

- A budget resolution is a nonbinding agreement that establishes “instructions” for reconciliation bills.

- Republicans in both the House and Senate passed the same budget – effectively allowing a $1.5 trillion increase to the deficit over the next 10 years.
  - Republican holdouts
    - Senate – Rand Paul (KY)
    - House – 20 “no” votes but mostly representatives from NY and NJ in a symbolic vote against the state and local tax deduction.
Overcome Key Policy Disagreements - House

• The House Ways & Means Committee began a multi-day markup of the tax bill on November 6th.
• The panel's members will have the opportunity to propose changes and then will ultimately vote to send the bill to the floor.
• Ahead of the markup, Chairman Kevin Brady (R-Tex.) will prepare a revised bill that could include changes negotiated with members outside the committee that would smooth the Bill's passage. Further changes could be made after committee passage but before the bill is brought to the floor.
• House Speaker Paul D. Ryan (R-Wis.) has said he wants the legislation through the House by Thanksgiving.
Overcome Key Policy Disagreements - Senate

- The Senate Finance Committee released its bill on November 9th and will launch a parallel process. The two chambers hope to resolve any differences and pass a final bill before year's end.
Go Through Regular Order?

- Republicans have until the end of the next fiscal year – September 28, 2018 – to pass tax reform with the set of reconciliation instructions established by the House and Senate instructions.
  - Stated goal is to pass legislation this calendar year
- House and Senate leadership have promised that tax reform will go through full committee treatment
  - An open process means long committee meetings to debate and “mark up” and tax reform bill, and include many amendments.
  - Eventually committees will have to vote on the bills and then they will go to the full chamber floors.
Go Through Regular Order?

- If the House and Senate end up disagreeing and passing different bills, then they will have to form yet another “conference committee” to negotiate and create a new bill that both the House and Senate will have to pass again.
  - Or, one chamber could simply take the other chamber’s bill and pass it.
Senate Budget Rules

• Budget reconciliation process does not allow tax cuts to increase the deficit outside the first 10-year window (“Byrd Rule”).

• Four scenarios
  1. Tax cuts that sunset in 10 years (similar to the Bush tax cuts of 2001).
  2. Pass much smaller tax cuts that are permanent. If this is determined to be more of a priority, Republicans could find enough revenue raisers and offsets to pass permanent, but substantially smaller, tax cuts. Unlikely as conservative members likely will not support a bill with corporate tax rates in excess of 20%.
Senate Budget Rules

• Four scenarios – cont:

3. Split the bill into three separate titles
   • A temporary, Republican-led effort that would pursue aggressive tax cuts that would sunset in 10 years
   • A permanent bill that would comply with Senate rules; and,
   • A permanent bipartisan proposal needing 60 votes (finding consensus around issues like the child tax credit).

Senate Budget Rules

• The CBO’s score of the bill will play a key role in estimating the effect of the tax package, and how the Senate parliamentarian, whose role it is to advise whether or not bills adhere to budgetary procedure, will rule.
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