FEDERAL TAX REFORM

Will Grand Political Statements Results in a Tax Cut for You?

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November 13 Update

House Republicans unveiled their tax reform bill on Nov. 2, 2017 and the Senate revealed their plan last week; however, there are some major differences between the two.

While both cut the corporate tax rate to 20% to incentivize companies to do business in the United States, the Senate pushed back the start date to 2019, a year later than the House. The House plan also calls for four tax brackets for individuals, while the Senate plan calls for seven. The Senate plan allows write offs for major medical expenses, while the House has a firmer line on this.

You can feel confident if you are worried about keeping your 401K plan safe, because both plans agreed on that point. If you have college debt, the Senate bill does allow you to keep student loan deductions. Both plans are causing heartburn for the real estate industry. The House bill only allows mortgage interest to be deducted on the first $500,000 of mortgage debt, but allows property tax up to $10,000 to be deducted (all other state taxes would no longer be deductible). The Senate bill keeps the mortgage interest deduction as it is currently, but fully repeals the state tax deduction; meaning, you would not be able to deduct state income tax, sales tax or property tax.

In essence, both the House bill and the Senate bill appear to increase taxes on the middle class (depending on your definition of 'middle class') while cutting taxes for large businesses. The verdict is still out on how either bill will actually impact small businesses and pass-through entities.

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Simplicity may mean more

Who will win and who will lose?

Will it Pass? It's been 30 years since the last comprehensive tax reform law. The goal is to pass tax reform before December 31. **Only time will tell.** The good news is that we are closer to tax reform than we have been in a longtime.

When it comes to tax reform, everybody says they want simplicity. The problem is that simplicity may not a reduction in taxes. Simplicity may also mean new bright-line tests and the elimination of tax rules we have grown accustomed to and utilized to our benefit. When the rules are changed and the benefits go away, will you pay less or more?

The other problem with tax reform for taxpayers is that when a government reduces taxes, they still have to pay for it through other tax increases, or increase the national debt. Tax reductions for some may mean tax increases for others.

Generally, everyone is for tax reform unless it makes them pay more taxes. Who will win and who will lose is still undecided. The good news is that we are closer to tax reform than we have been in a long-time.

Where We Begin – The Framework

Good principles, but….

It's complicated

The Trump Administration, House Committee on Ways & Means, and Senate Committee on Finance released a "Tax Reform Framework" on September 27, 2017. The framework is supposed to improve the efficiency and effectiveness of federal tax law.

The overriding principles of the tax reform framework consists of making tax compliance simpler and fairer, allowing Americans to keep more of what they make, leveling the playing field for American businesses and workers, and bringing back trillions of dollars that are currently kept offshore to reinvest in the American economy.

The principles sound good, but problems remain. Since the framework was released, adjustments and changes to the framework have been discussed daily (and will continue until enacted). Like Kevin Brady told reporters on October 11, 2017, "All this is complicated."

Business Tax Reform

What are the changes?

Businesses

The framework outlines the following business tax changes.

- Cutting C corporation tax rate to 20%
- Creating a separate 25% rate on business income from pass-through entities with rules to ensure compensation remains taxed as compensation
- Full business expensing for depreciable assets other than structures for at least 5 years, while limiting interest deduction for C corporations
- Shifting to a territorial tax system with 100% dividends received deduction for foreign subs owned at least 10% by a U.S. parent
- Deduction for interest expense incurred by C corporations will be partially limited (interest deduction for non-corporate taxpayers to be determined)
- Eliminates corporate AMT and domestic production deduction (Sec. 199)
- R&D credit and low-income housing credit to be continued
- Other credits to be reviewed and status will be based on budgetary limitations
- Tax rules for special industries to be modernized to reflect economic reality and reduce opportunity for tax avoidance

Pass-through Entities

The new 25% maximum tax rate for pass-through entities has raised concerns and questions**.** For example, will the new 25% rate apply to large-pass through businesses? Will this benefit wealthy individuals who invest in real estate?

Democrats fear the wealthy will abuse the use of a lower rate to treat compensation as profits. However, the framework provides that rules will be created to ensure the reduced rate does not apply to what should be treated as compensation. The House favors a bright line test that designates 70% of pass-through income as compensation and 30% as business income. Many business owners dislike this idea arguing that it doesn't reflect economic reality.

Other questions have been raised as to whether the new 25% rate is really necessary. Since the new middle individual tax bracket of 25% is the same rate, only pass-through individual filers wealthy enough to fit into the highest individual tax bracket would seem to benefit from the change. In addition, according to a small-business study, 9 out of 10 pass-through entities already pay tax at 25%.

C Corporations

The new maximum rate of 20%, down from 35%, would reduce the negative impact of double-taxation. According to the framework, additional rules may also be adopted to reduce the double-taxation of corporate earnings even further.

Immediate Expensing of Assets

The immediate expensing of the cost of new investments in depreciable assets other than structures is simply 100% bonus depreciation. House Republicans originally pushed for permanent full-expensing. The framework applies the immediate expensing to assets purchased after September 27, 2017 for at least 5 years.

According to a National Association of Manufacturers survey, 65% of manufactures would increase capital spending because of tax reform. Some manufactures have already started simply based on the framework being released.

International Tax Reform

According to Congress, there is $2.5 trillion of income sitting overseas because we currently have a deferral tax system where no tax is paid until income is repatriated back to the U.S. Consequently, tax reform is intended to assess a one-time tax on deemed repatriation at a lower rate, and permanently shift to a territorial tax system. The new system would let foreign countries tax a business' income, and the U.S. would not tax the income again when it comes back to the U.S.

According to the framework, the goals of international tax reform are to transform the current “offshoring model” to an American model, end the incentive to keep foreign profits offshore by exempting them when they are repatriated to U.S., and replace a worldwide system with a 100% exemption for dividends from foreign subs (in which the U.S. parent owns at least 10%). The House and Senate are also considering a foreign minimum tax on overseas corporate earnings (based on recent discussions, not in the Framework).

The transition from the current model to the new model would allow companies to treat foreign earnings that have accumulated overseas as repatriated at a lower tax rate. The Senate is considering a flat 10% tax on accrued foreign derived earnings. Accumulated foreign earnings held in illiquid assets may be subject to a lower tax rate than foreign earnings held in cash or cash equivalents. The Senate is considering a bifurcated 3.5% tax to repatriate non-cash assets and an 8.75% tax to repatriate cash. Payment of the tax liability would be spread out over several years.

Individual Tax Reform

What are the changes?

Individuals

The framework has outlined the following individual tax changes:

- Doubling the standard deduction / eliminating personal exemptions
- Consolidated the current 7 tax brackets into 3 brackets
- Eliminating most itemized deductions
- Retaining home mortgage interest and charitable contributions deduction
- Eliminating the state tax itemized deduction
- Repealing AMT
- Repealing the estate tax and generation skipping tax

Consolidating Current 7 Tax Brackets into 3

The framework proposes to consolidate the current 7 tax brackets (10%, 15%, 25%, 28%, 33%, 35% and 39.6%) into 3 brackets (12%, 25% and 35%). There has also been discussion about creating an additional top rate to apply to the highest-income taxpayers.

The detail that is missing, which will determine the ultimate impact of this change, is the income ranges that will fall into each bracket. Depending on the income ranges, an individual's tax may decrease or increase. The tax rate reduction must be big enough to offset the elimination of deductions and exemptions to ultimately reduce an individual's tax.

State Tax Deduction

The elimination of the state tax deduction is currently under debate and facing extreme criticism that will most likely result in some form of compromise. Several possibilities have been proposed, including capping the amount of the deduction for taxpayers at a certain income level. That 'income level' is also under debate, as some have proposed capping it for taxpayers who have $200,000 to$250,000 in adjusted gross income. Some had proposed $400,000.

Others have proposed modifying the mortgage-interest deduction by capping it at home loans of up to $650,000 or $750,000.

Next Steps

Now what?

Wait and see what happens.

The Senate will take the House Ways and Means Committee bill and make changes. Then it goes to conference committee to reconcile differences between House and Senate bills.

The goal is to pass a tax reform bill by December 31, 2017.

Potential Outcomes

Which way will it go?

Stall? More changes?

There are several potential outcomes at this point. Tax reform discussions could stall and not pass. For example, legislation may pass the House Ways & Means Committee and the full House, but stall in the Senate (similar to proposed changes to the Affordable Care Act earlier this year).

A more limited bill comprised of a middle-income tax cut, and changes to the treatment of off-shore income might be enacted.

Last, but not least, we could end up with a deadlock due to perceived 'losers' outnumbering perceived 'winners.'

QUESTIONS?

For more information or to see how these proposed reforms might impact you, contact Brian McCuller at bmcculler@lbmc.com or 615-690-1971.
Or visit www.lbmc.com for more information.

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