EMERGING TAX AND REGULATIONS ALERT UPDATE

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House and Senate tax bills head to reconciliation

Early in the morning on December 2, the U.S. Senate passed its version of the Tax Cuts and Jobs Act by a vote of 51 to 49. The U.S. House of Representatives passed its own version of the tax bill on November 16, and a conference committee of representatives from both houses of Congress is scheduled to begin work on a reconciled final bill this week.

The goal is to get that bill to President Trump's desk for signature before Christmas, with most of the changes taking effect for 2018. The two bills already agree on many matters, but several notable differences must be resolved.

Where the bills agree

Important **individual provisions** where the bills are in agreement include the following:

Inflation adjustments. Both bills calculate inflation adjustments, where applicable, using the chained consumer price index. This index will increase tax bracket thresholds, the standard deduction, certain exemptions and other figures at a slower rate than the consumer price index currently used, potentially pushing taxpayers into higher tax brackets more quickly.

Personal exemptions and standard deduction. Under current law for 2017, taxpayers can claim a personal exemption of $4,050 each for themselves, their spouses and any dependents. Both tax bills eliminate personal exemptions beginning in 2018. But the bills also nearly double the standard deduction amounts to $12,200 for single filers and $24,400 for married couples filing jointly (for 2018 with inflation adjustments).

State and local tax deductions. The deduction for state income or sales taxes is eliminated under both bills. They retain a deduction for property taxes, but cap the deduction at $10,000.

Adoption credit. Early drafts of the House bill eliminated the adoption credit, but both of the passed bills preserve it.

Deductions and credits. Both bills generally get rid of the deductions for moving expenses, tax preparation fees and personal casualty losses.

Principal residence gain exclusion. The bills allow the exclusion from income on gains from the sale of a principal residence of up to $250,000 for single filers and $500,000 for married couples. In both cases, it's necessary to own the home and have used it for five of the previous eight years (compared with two out of the previous five years now).

Here are some **key business provisions** where the bills agree:

Corporate tax rates. The House and Senate bills permanently reduce the current maximum corporate rate from 35% to 20%.

Depreciation. The bills allow businesses to fully and immediately expense 100% of the cost of qualified property acquired and placed in service after September 27, 2017, and before January 1, 2023.

Foreign income. The bills adopt a "territorial" taxation system for multinational companies — in other words, they generally limit U.S. income taxes to income earned in the United States. They also impose a one-time tax on repatriated offshore earnings, with a 14% rate for liquid assets (for example, cash, stocks and bonds) and a 7% rate on illiquid assets (such as factories).

Where the bills diverge

Among the areas where the bills' **individual provisions** differ are the following:

Tax brackets. The House bill consolidates the seven current individual income tax brackets of 10%, 15%, 25%, 28%, 33%, 35% and 39.6% into four brackets of 12%, 25%, 35% and 39.6%. The Senate bill maintains seven brackets but changes them to 10%, 12%, 22%, 24%, 32%, 35% and 38.5%.

In addition, while the changes to individual tax rates are permanent in the House bill, they're only temporary in the Senate bill, set to expire at the end of 2025.

Family tax credits. The House bill provides a family tax credit that includes a larger child tax credit ($1,600 for each child under age 17 or under, up from the current $1,000), a $300 credit for each nonchild dependent and a $300 family flexibility credit for the taxpayer or, on a joint return, each spouse who isn't a child or nonchild dependent. The family tax credit begins phasing out at income of $230,000 for joint filers.

The child tax credit in the House bill isn't adjusted for inflation. And the nonchild dependent and family flexibility credits end after 2022, effectively raising taxes in 2023 if not renewed.

The Senate bill, on the other hand, increases the child tax credit to $2,000 for each child under age 18 (although it reverts to under age 17 in 2025, a year before the increase expires). And the bill dramatically expands eligibility for the credit by increasing the phaseout for joint filers from the current $110,000 to $500,000. It also provides a $500 credit per dependent.

Alternative minimum tax (AMT) and estate tax. The House bill repeals the AMT and doubles the estate tax exemption base from $5 million to $10 million and repeals the estate tax (as well as the generation-skipping transfer tax) after 2024. The Senate bill keeps the AMT but reduces the number of taxpayers who pay it by increasing the exemption. Similarly, the Senate increases the estate tax exemption, but it doesn't repeal the estate tax.

Some other deductions and credits. The House bill eliminates the medical expense deduction. The Senate bill retains it and, for 2017 and 2018, allows taxpayers to claim it when their expenses exceed 7.5% of adjusted gross income, compared to 10% currently. It also keeps the deduction for student loan interest and doesn't tax graduate students on tuition waivers, unlike the House bill.

Affordable Care Act individual mandate. The Senate's bill repeals the individual mandate — thereby ending penalties for failing to have health insurance. The House bill doesn't repeal the mandate.

Mortgage interest deduction. Both bills retain the mortgage interest deduction. However, the House bill limits the deduction to home mortgage debt of $500,000 or less received after 2017, compared with $1 million now. The Senate bill leaves the current cap in place. (Both bills eliminate the current deduction for home equity loans.)

The House and Senate bills also differ on these significant **business provisions**:

Corporate tax rate timing and AMT. Under the House bill, the reduced corporate tax rate kicks in for 2018. The Senate bill delays the reduction until 2019. Also, the House bill repeals the corporate AMT while the

Senate bill retains it.

Pass-through entity tax rates. Currently, owners and shareholders of pass-through entities (sole proprietorships, partnerships, limited liability companies and S corporations) pay taxes on their net income at ordinary income tax rates as high as 39.6%. The House bill generally treats up to 30% of such net income as "business income" subject to a maximum rate of 25%, with the balance subject to the personal income tax rates. It also adopts a new 9% rate on the first $75,000 ($37,500 for single filers) in net business income passed through to an active owner earning less than $150,000 ($75,000 for singles) in taxable income. The 9% rate phases in over five years — 11% in 2018 and 2019, 10% in 2020 and 2021, and 9% in 2022.

The Senate bill creates a 23% deduction on pass-through income (excluding most professional services firms). Salaries paid to pass-through owners and partners are taxed at ordinary income tax rates. Several "guardrails" apply, though. For example, to prevent taxpayers from re-characterizing wage income as profits, the bill limits the deduction to half of the pass-through entity's W-2 wages or its share to the individual taxpayer. This limit doesn't apply if the taxpayer's taxable income is under $250,000 for single filers or $500,000 for married couples filing jointly.

Depreciation sunsetting. The House provision allowing immediate and full expensing expires in 2023. The Senate bill begins phasing it out at that time, reducing the deduction 20 percentage points each year for four years and then sunsetting completely for the fifth year.

Stay tuned

Regardless of the final language, any tax bill that passes both houses of Congress is bound to represent the largest overhaul of the U.S. tax system in 30 years. We'll keep you up to date on how new tax legislation could affect you.

If you have specific questions, do not hesitate to contact your Meisel, Tuteur & Lewis advisor at (973) 228-4600.