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TAX WATCH

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On November 16, the U.S. House of Representatives passed the Tax Cuts and Jobs Act by a vote of 227 to 205. What are tax reform's next few steps? On November 17, the Senate Finance Committee approved its own tax reform bill, and the full Senate is expected to weigh in on the bill after the Thanksgiving holiday. If the Senate passes its bill, the House and Senate will work to reconcile their two bills into a final piece of legislation.

Here's an overview of some of the most significant provisions for individual taxpayers and businesses in the House bill. Most of the changes will go into effect in 2018 if they're included in reconciled legislation.

Individual taxes

Tax brackets. The bill consolidates the seven current individual income tax brackets of 10%, 15%, 25%, 28%, 33%, 35% and 39.6% into four brackets:

- 12% (on the first $45,000 of taxable income for individuals; first $90,000 for married couples filing jointly),
- 25% (begins at $45,000 for individuals; $90,000 for joint filers),
- 35% (begins at $200,000 for individuals; $260,000 for joint filers), and
- 39.6% (begins at $500,000 for individuals; $1 million for joint filers).

This change would shift some upper-income families who currently pay a top rate of 33% to the 35% bracket. And more taxpayers would be pushed into higher tax brackets over time because the bracket thresholds will be adjusted using the chained consumer price index (CPI), which is a slower-moving measure of inflation than the index currently used to determine inflation adjustments.

The bill also includes a 6% “bubble rate” on income over $1 million for single filers and $1.2 million for joint filers that would claw back the benefits of the 12% bracket for these taxpayers.

Personal exemptions. Under current law, taxpayers can claim a personal exemption of $4,050 each for themselves, their spouses and any dependents. The bill eliminates personal exemptions.

Standard deduction. The standard deduction for 2017 is $6,350 for single taxpayers and $12,700 for married couples filing jointly. The bill increases the base standard deduction amounts to $12,000 and $24,000, respectively ($12,200 and $24,400 for 2018 with inflation adjustments).

The combined effect of the personal exemption repeal and changes to the standard deduction could lead to higher taxes for some upper-middle-income families, especially those with three or more children.

Family tax credit. The bill includes a family tax credit that encompasses a larger child tax credit (increased from $1,000 for each qualifying child to $1,600), a $300 credit for each nonchild dependent (for example, an elderly parent or adult child with a disability) 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 child tax credit currently begins to phase out at $75,000 for singles and $110,000 for joint filers. The family tax credit would be available to more families because it wouldn’t start phasing out until $115,000 for single filers and $230,000 for joint filers.

However, the child tax credit wouldn’t be adjusted for inflation, reducing its value over time. Further, the nonchild dependent and family flexibility credits would end after 2022, creating an effective tax hike if not renewed before then.

Charitable contribution deduction. The charitable deduction remains intact, and the bill allows individuals to deduct up to 60% of their income, increased from the current 50%.

Mortgage interest deduction. The bill limits the deduction to interest on up to $500,000 of home mortgage debt for homes purchased after November 2, 2017 (compared with $1 million now). It limits the deduction to principal residences, and allows no deduction for home equity loans.

Property tax deduction. The bill limits the deduction to $10,000.

Principal residence gain exclusion. To claim the exclusion on gains from the sale of a principal residence of up to $250,000 for single filers and $500,000 for married couples, the bill requires taxpayers to own and use their home for five of the previous eight years (compared with two out of the previous five years now). Also, the bill allows taxpayers to use the exclusion only once every five years, instead of the current once every two years.

Other individual tax breaks. The bill repeals most itemized deductions other than those discussed above, as well as many above-the-line deductions. Eliminated deductions include those for state and local income or sales taxes, personal casualty losses, medical expenses, alimony payments, moving expenses (except for members of the Armed Forces on active duty and under relocation orders), tax preparation expenses, and student loan interest and other deductions related to education.

Unlike the original draft, the passed bill preserves the adoption tax credit in its current form. It does, however, repeal the credit for plug-in electric vehicles.

Alternative minimum tax (AMT) and estate tax. The bill repeals the AMT for individuals. It 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.

Affordable Care Act individual mandate. Although the current Senate version would repeal the individual mandate, the House bill doesn't.

Business tax breaks

Corporate tax rates. The bill reduces the current maximum corporate rate of 35% to 20%, the largest single drop ever for the business tax rate and a permanent reduction. The bill subjects personal service corporations (such as law, architecture and accounting firms) to a 25% rate.

An amendment to the original House bill reduces the 80% dividends received deduction to 65% and the 70% dividends received deduction to 50%.

The House bill also repeals the corporate AMT.

Pass-through entity tax rates. Under the existing tax regime, owners and shareholders of businesses organized as sole proprietorships, partnerships, limited liability companies and S corporations report net income on their individual tax returns at rates of up to 39.6%. Under the bill, 30% of net income distributed by a pass-through entity to an owner or shareholder generally can be treated as "business income" subject to a maximum rate of 25%. (The remaining balance would be considered compensation subject to ordinary individual income tax rates.)

In response to criticism of the initial bill from small businesses, the final bill adds 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. That rate begins to phase out as taxable income exceeds $150,000 and phases out entirely at $225,000. The 9% rate phases in over five years — 11% in 2018 and 2019, 10% in 2020 and 2021, and 9% in 2022.

Depreciation. In lieu of the bonus depreciation currently available, the bill allows 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 (with an additional year for certain property with a longer production period).

The bill also increases the cap on the Section 179 pass-through entity expensing deduction from the current base of $500,000 to $5 million, with the phaseout beginning at $20 million (up from $2 million). The limits would continue to be adjusted for inflation.

Deductions and credits. The House bill modifies the net operating loss deduction and caps the net interest deduction at 30% of earnings before interest, taxes, depreciation and amortization (EBITDA). Small businesses with average gross receipts of $25 million or less would be exempt from the limit.

The bill also repeals several business tax breaks, including the Section 199 domestic production activities deduction and the New Markets, Work Opportunity and rehabilitation credits. Unlike individuals, however, businesses can continue to deduct their business-related state and local taxes.

The research credit would continue. For tax years after 2023, though, businesses would be required to amortize certain research and experimentation expenses over five years (15 years for research conducted outside the United States).

Foreign income. The bill adopts a "territorial" taxation system for multinational companies, meaning U.S. taxes would generally be limited to income earned in the United States. All untaxed offshore earnings would be subject to a one-time tax at a 14% rate for liquid assets (for example, cash, stocks and bonds) and a 7% rate on illiquid assets such as factories. Companies would have eight years to pay these repatriation taxes.

The passed bill also contains several amendments related to the taxation of foreign affiliates of U.S. corporations, including an 80% foreign tax credit.

Deferred compensation. The original House draft would have dramatically changed the tax rules for nonqualified deferred compensation. The final version strikes those provisions.

In addition, it provides that employees who receive stock options or restricted stock units as compensation and later exercise them can elect to defer recognition of income for five years as long as the company's stock isn't publicly traded.

Up next: The Senate hashes out its bill

Now that the House has passed its version of the Tax Cuts and Jobs Act, it's the Senate's turn. Some Senators have expressed opposition to various provisions of the Senate bill, so it's not certain that the Senate bill will pass. If it does, negotiations between the two chambers of Congress also might be rocky, but Republicans are pushing to get a bill to President Trump before Christmas. We'll keep you up to date on further developments.

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