Tracking Tax Reform: The Tax Cuts and Jobs Act

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On November 2, the House Ways and Means Committee released the Tax Cuts and Jobs Act (the "Act"). The Act differs from the "Unified Framework for Fixing Our Broken Tax Code" (hereinafter referred to as the "Big Six Framework" or the "Framework") that was released by the "Big Six" (comprised of Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, and other top Republicans in the House and Senate) on September 27. The Big Six Framework was very high-level, and although the Act fills in some of the important details that were missing from the Big Six Framework, it also makes some important changes.

It is expected that the Act will undergo many modifications in the coming weeks as the House Ways and Means Committee works to get it through Congress. We will continue to provide updates when appropriate to help you keep track of the Act as it progresses. The changes discussed below would become effective as of January 1, 2018 if signed into law.

Individual Taxation

Rates.

- The Big Six Framework proposed three tax brackets – 12%, 25%, and 35%, but left the door open for an additional top rate to apply to the highest-income taxpayers. The Framework did not include the income levels that would apply to those rates. The Framework repealed the estate tax.
- The Act sets forth four tax brackets – 12%, 25%, 35%, and 39.6%. The brackets would apply to married taxpayers filing jointly as follows: households with income up to $24,000 would pay no income tax; the 12% bracket would apply to household income up to $90,000; the 25% bracket would apply to household income up to $260,000; the 35% bracket would apply to household income up to $1 million; and the 39.6% bracket would apply to households with income over $1 million. For unmarried taxpayers and married taxpayers filing separately, the bracket income thresholds would be half the thresholds for married taxpayers filing jointly, with the exception that the 35% bracket threshold for unmarried individuals would be $200,000. The Act phases out the estate tax over six years, increases the basic exemption amount from $5 million to $10 million (adjusted for inflation) during the transition period, and retains the gift tax and the basis step-up at death.

Deductions.

- The Big Six Framework nearly doubled the standard deduction to $12,000 for individual taxpayers and $24,000 for married taxpayers filing jointly, but eliminated the personal exemption. The Framework eliminated the federal tax deduction for state and local income tax. The mortgage interest and charitable contribution deductions were retained.
- The Act nearly doubles the standard deduction to $12,000 for individual taxpayers and $24,000 for married taxpayers filing jointly, but eliminates the personal exemption. The Act allows individuals to deduct the cost of state and local property taxes up to $10,000, but eliminates the deduction for state and local income taxes and sales taxes. The Act preserves the mortgage interest deduction for existing mortgages but sets the cap at $500,000 for mortgage debt for newly purchased homes, which is 50% lower than current law. The charitable contribution deduction is retained. However, because of the increase to the standard deduction, fewer taxpayers will have a tax incentive to make charitable contributions.

Elimination of the Alternative Minimum Tax.

- The Big Six Framework proposed the complete elimination of the Alternative Minimum Tax for individuals.
- The Act repeals the Alternative Minimum Tax for individuals and corporations.

Taxation of investment income.

- The Big Six Framework did not contain a proposal regarding the tax treatment of capital gains and dividends.
- The Act left the current capital gains and dividends tax rates unchanged. However, by setting new income tax rates, some investors could end up owing less tax on short-term capital gains and dividends because their ordinary income tax rate will fall (short-term capital gain tax rates are directly tied to ordinary income tax rates).

Business Entity Taxation

Rates.

- The Big Six Framework proposed a 20% corporate tax rate.
- The Act sets a permanent corporate tax rate of 20%.

Taxation of pass-through income to entity owners.

- The Big Six Framework proposed taxing income derived from pass-through entities to their owners at a rate of 25%, rather than the ordinary individual income tax rates, and left it up to Congress to classify whether income is wages or business profits.
- The Act reduces the tax rate for income derived from pass-through entities income to 25%. Under the Act, business owners can choose to either (i) categorize 70% of their income as wages, subject to ordinary rates, and 30% as business income, taxable at the new 25% rate, or (ii) set the ratio of their wage income to business income based on the level of their capital investment. Professional services firms (e.g. law, accounting, consulting) can only utilize the capital investment method.

Changes to depreciation and interest deductions.

- The Big Six Framework allowed businesses to immediately expense new investments in depreciable assets other than structures made after September 27, 2017 for at least five years. The Framework also called for the limitation of interest deductibility, but did not give details regarding the limitation. The Act reduces the tax rate for income derived from pass-through entities income to 25%. Under the Act, business owners can choose to either (i) categorize 70% of their income as wages, subject to ordinary rates, and 30% as business income, taxable at the new 25% rate, or (ii) set the ratio of their wage income to business income based on the level of their capital investment. Professional services firms (e.g. law, accounting, consulting) can only utilize the capital investment method.
- Under the Act, taxpayers would be able 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. The Act would cap interest deductions at 30% of a company's "adjusted taxable income" which is taxable income without regard to interest expense, interest income, NOLs, depreciation, amortization and depletion.

Business incentives.

- The Big Six Framework retained the R&D credit and the low-income housing credit, but encouraged Congress to eliminate other business credits.
- The Act retains the R&D credit and the low-income housing credit, but eliminates many other business credits, such as the new markets and rehabilitation tax credits, and limits, repeals, and modifies many credits affecting energy property. The domestic manufacturing deduction would be repealed.

Carried Interest.

- The Big Six Framework did not include any mention of a proposal regarding carried interests.
- The Act does not change or eliminate the carried interest tax break, despite previous insistence from the White House that the reform of carried interest tax treatment was a top priority. When asked specifically about carried interest, a House Ways and Means Committee member confirmed there was no change.

International Taxation.

Tax on future foreign earnings.

- The Big Six Framework proposed moving to a territorial tax system. The Framework also called for, but did not provide details regarding, a global minimum tax intended to protect the U.S. tax base and "level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies."
- The Act adopts a territorial tax system. Under the Act, U.S. companies would generally no longer pay taxes on active foreign income. However, the Act does create a new tax applied to 50% of "high foreign returns" of a foreign subsidiary. A high foreign return generally is net income in excess of 7% plus the Federal short-term rate multiplied by the subsidiary's depreciation basis in its tangible assets.

Tax on accumulated foreign earnings.

- The Big Six Framework proposed a one-time tax on previously accumulated foreign earnings. The Framework called for a higher tax rate on liquid foreign assets and a lower tax rate on illiquid foreign assets, but did not specify either rate.
- The Act provides for a one-time 12% tax on previously accumulated foreign earnings held as cash and cash equivalents, and a one-time 5% tax on previously accumulated foreign earnings on non-cash assets. This tax would be payable over up to 8 years, if the taxpayer so elects.

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