Tracking Tax Reform: The House and Senate Conference Committee's Conference Report on the Tax Cuts and Jobs Act

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On December 15, the House and Senate Conference Committee released the conference report on the Tax Cuts and Jobs Act (the "Conference Committee Report" or "Report"), containing the specific details on the tax plan they hope to pass. The Report comes after weeks of negotiations to reconcile the differences between the Senate Bill and the House Bill. This is the final step in the process and there will be no further amendments. A vote on the Conference Committee's bill in the House and Senate is likely to occur prior to Christmas, and if passed, will be signed by President Trump shortly thereafter.

Individual Taxation.

Rates.

- The House Bill set 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 $24,400 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 House Bill phases out the estate tax over six years, increases the lifetime exemption to $10 million during the transition period, and retains the gift tax and the basis step-up at death.
- The Senate Bill set forth seven tax brackets – 10%, 12%, 22%, 24%, 32%, 35%, and 38.5%. The brackets would apply to married taxpayers filing jointly as follows: the 10% bracket would apply to household income up to $19,050; the 12% bracket would apply to household income up to $77,400; the 22% bracket would apply to household income up to $140,000; the 24% bracket would apply to household income up to $320,000; the 32% bracket would apply to household income up to $400,000; the 35% bracket would apply to household income up to $1 million; and the 38.5% 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. The Senate Bill increased the estate tax lifetime exemption to $10 million until January 1, 2026, but does not repeal the estate tax. The Affordable Care Act's individual insurance mandate was also be repealed.
- The Conference Committee Report sets forth seven tax brackets – 10%, 12%, 22%, 24%, 32%, 35%, and 37%. The number of brackets in this plan seems inconsistent with the previously reiterated tax reform goal of simplifying tax reporting. The brackets would apply to married taxpayers filing jointly as follows: the 10% bracket would apply to household income up to $19,050; the 12% bracket would apply to household income up to $77,400; the 22% bracket would apply to household income up to $165,000; the 24% bracket would apply to household income up to $315,000; the 32% bracket would apply to household income up to $400,000; the 35% bracket would apply to household income up to $600,000; and the 37% bracket would apply to households with income over $600,000. 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% rate would apply to income up to $500,000 and the 37% bracket threshold for unmarried individuals would be $500,000. These tax rates expire January 1, 2026. The Report increases

the estate tax lifetime exemption to $10 million until January 1, 2026, but does not repeal the estate tax. The Affordable Care Act's individual insurance mandate would also be repealed.

Deductions.

- The House Bill increased the standard deduction to $12,200 for individual taxpayers and $24,400 for married taxpayers filing jointly, but eliminated the personal exemption. The House Bill allowed individuals to deduct the cost of state and local property taxes up to $10,000, but eliminated the deduction for state and local income taxes and sales taxes. The mortgage interest deduction for existing mortgages is preserved, but the cap was lowered to $500,000 for mortgage debt for newly purchased homes, a 50% reduction from the current law. The charitable contribution deduction was retained, and the adjusted gross income limitation on contributions is raised from 50% to 60%. However, because of the increase to the standard deduction, fewer taxpayers would have a tax incentive to make charitable contributions.
- The Senate Bill increased the standard deduction to $12,000 for individual taxpayers and $24,000 for married taxpayers filing jointly, but eliminated the personal exemption. The Senate Bill allowed individuals to deduct the cost of state and local property taxes up to $10,000, but eliminated the deduction for state and local income taxes and sales taxes. The Senate Bill retained the current mortgage interest deduction for new mortgages of up to $1 million. The charitable contribution deduction was retained, and similar to the House Bill, the adjusted gross income limitation on contributions was raised to 60%.
- The Conference Committee Report increases the standard deduction to $12,000 for individual taxpayers and $24,000 for married taxpayers filing jointly, but eliminates the personal exemption. The Report allows taxpayers to elect to deduct up to $10,000 of state and local sales, income, or property taxes. The mortgage interest deduction cap is lowered to $750,000 for mortgage debt incurred after December 15, 2017 for newly purchased homes, but reverts back to the current $1 million cap (regardless of when the debt was incurred) for tax years beginning after December 31, 2025. The Report suspends the deduction for interest on home equity indebtedness for taxable years beginning after December 31, 2017 and before January 1, 2026. The charitable contribution deduction is retained, and the adjusted gross income limitation on contributions was raised to 60% for contributions made in tax years beginning after 2017 and before 2026.

Elimination of the Alternative Minimum Tax.

- The House Bill repealed the Alternative Minimum Tax for individuals and corporations.
- The Senate Bill did not repeal the Alternative Minimum Tax for corporations. The Senate Bill increased the Alternative Minimum Tax exemption amounts for individuals.
- The Conference Committee Report repeals the corporate Alternative Minimum Tax. The Report increased the Alternative Minimum Tax exemption amounts for individuals to $109,400 for married couples filing jointly (and $70,300 for individual taxpayers) for tax years beginning after December 31, 2017 and before January 1, 2026. The phase-out of exemption amount thresholds is increased to $1 million for married couples filing jointly (and $500,000 for individual taxpayers).

Taxation of investment income.

- The House Bill 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).
- The Senate Bill placed the 15% capital gain rate threshold at $77,200 and the 20% capital gain rate threshold at $479,000 for married couples filing jointly for tax years beginning in 2018.
- The Conference Committee Report adopted the Senate Bill's approach to capital gain taxation, placing the 15% capital gain rate threshold at $77,200 and the 20% capital gain rate threshold at $479,000 for married couples filing jointly for tax years beginning in 2018.

Business Entity Taxation.

Rates.

- The House Bill set a permanent corporate tax rate of 20% after 2017.
- The Senate Bill set a permanent corporate tax rate of 20% after 2018.
- The Conference Committee Report sets a permanent corporate tax rate of 21% after 2017.

Taxation of pass-through income to entity owners.

- The House Bill reduced the tax rate for income derived from pass-through entities to 25%. Under the House Bill, business owners could 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) would not qualify for the reduced rate.

- The Senate Bill provided for a deduction for pass-through entities, instead of a tax rate reduction. Under the Senate Bill, taxpayers determine their "qualified business income" and then subtract 23% of that amount from their taxable income, thus in effect reducing their tax rate. Most professional services firms would not qualify for this deduction, but smaller professional services firms (where the taxpayer has individual income below $250,000 and married couples below $500,000) still benefit from this provision. The deduction would be limited to 50% of the W-2 wages of a taxpayer who has qualified business income from a pass-through entity. Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer, and does not include any amount allocated or distributed by a partnership to a partner who is acting other than in his or her capacity as a partner for services performed for the partnership or any amount that is a guaranteed payment for services actually rendered to or on behalf of a partnership to the extent that the payment is in the nature of remuneration for those services.
- The Conference Committee Report followed the Senate Bill's approach regarding taxation of pass-through income to entity owners, but the percentage of the deduction allowable under the provision is 20% instead of 23%. Smaller professional services firms where the taxpayer has individual income below $157,000 (or below $315,000 for married couples) are able to benefit from this provision. The wage limit to the deduction applicable to taxpayers with taxable income above $157,000 (or above $315,000 for married couples) is modified to be the greater of (a) 50% of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property (generally defined as tangible property subject to depreciation under Section 167 of the Code, held by a qualified trade or business, and used in the production of qualified business income).

Changes to depreciation and interest deductions.

- Under the House Bill, 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 House Bill 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, but provides an exception for businesses with average annual gross receipts of $25 million or less.
- The Senate Bill allowed taxpayers 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. For property acquired and placed in service after January 1, 2023, the expensing percentage drops 20% per year until 2027. The Senate Bill would cap interest deductions at 30% of a company's "adjusted taxable income," but the Senate Bill only provides an exception for businesses with average annual gross receipts of $15 million or less.
- The Conference Committee Report follows the depreciation schedule in the Senate Bill. The Report caps interest deductions at 30% of a company's "adjusted taxable income," providing an exception for businesses with average annual gross receipts of $25 million or less. In calculating "adjusted taxable income" for these purposes, for taxable years beginning after December 31, 2017 and before January 1, 2022, the Report provides that it is computed without regard to deductions allowable for depreciation, amortization, or depletion (EBITDA), and without regard to the Section 199 deduction, because the deduction is repealed. For taxable years beginning after December 31, 2021, "adjusted taxable income" is calculated by taking deductions allowable for depreciation, amortization, or depletion into account (EBIT).

Business incentives.

- The House Bill retained the R&D credit and the low-income housing credit, but eliminated 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 after 2017.
- The Senate Bill retained the R&D credit and the low-income housing credit, but imposed limitations on the rehabilitation tax credit and does not address the new markets tax credit. The domestic manufacturing deduction would be repealed after 2018. The Senate Bill limited, repealed, and modified a variety of other credits, but did not address many of the credits affecting energy property that the House Bill addressed.
- The Conference Committee Report retains the R&D credit, and does not address the low-income housing tax credit or the new markets tax credit. The Report also imposes limitations on the rehabilitation tax credit. The domestic manufacturing deduction is repealed after 2017. The Report does not include the repeals of many of the credits affecting energy property that the House Bill included.

Carried Interest.

- The House Bill provided that starting in 2018, a three-year holding period requirement would be imposed on partnership interests received in connection with the performance of certain investment management services (including rental real estate) in order to be eligible for long-term capital gain tax rates. This would triple the current length of time an asset needs to be held in order to qualify for the lower rate. Certain equity interests and interests held by corporations would be exempt.

- The Senate Bill imposed a three-year holding period requirement for qualification as long-term capital gain with respect to certain partnership interests received in connection with the performance of services.
- The Conference Committee Report provides for a three-year holding period requirement for tax years beginning after December 31, 2017 for long-term capital gain treatment with respect to certain partnership interests received in connection with the performance of services.

International Taxation.

Tax on future foreign earnings.

- The House Bill adopted a territorial tax system. Under the House Bill, U.S. companies would generally no longer pay taxes on active foreign income. However, the House Bill did 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.
- The Senate Bill also adopted a territorial tax system. The Senate Bill provided that U.S. corporate shareholders of CFCs would be subject to current U.S. taxation on 50% of "global intangible low-tax income", subject to a 37.5% deduction for foreign-derived intangible income.
- The Conference Committee Report adopts a territorial tax system and generally follows the "global intangible low-tax income" provisions from the Senate Bill.

Tax on accumulated foreign earnings.

- The House Bill provided for a one-time 14% tax on previously accumulated foreign earnings held as cash and cash equivalents, and a one-time 7% 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.
- The Senate Bill imposed a one-time 14.5% tax on accumulated foreign earnings held as cash and cash equivalents, and a one-time 7.5% tax on accumulated foreign earnings on non-cash assets. This tax would be payable over up to 8 years at the election of the taxpayer.
- The Conference Committee Report imposes a one-time 15.5% tax on accumulated foreign earnings held as cash and cash equivalents, and a one-time 8% tax on accumulated foreign earnings on non-cash assets. This tax would be payable over up to 8 years at the election of the taxpayer.

Base erosion provisions.

- The House Bill imposed a 20% excise tax on certain payments made by U.S. companies to related foreign corporations, with an exception for when the U.S. company elects to treat the payments as effectively connected income. A credit is permitted for 80% of the foreign taxes paid or accrued on such payments.
- The Senate Bill imposed a minimum tax on "base erosion payments" paid or accrued by a taxpayer to a foreign related person. Under this provision, certain large U.S. companies (companies with average annual gross receipts of at least $500 million over the prior three years) making a certain level of deductible, depreciable or amortizable payments to foreign related persons would have to pay a tax equal to the excess of 10% of its taxable income determined without reference to such deductible, depreciable or amortizable payments over its tax liability as determined under the normally applicable rules.
- The Conference Committee Report follows the Senate Bill's provisions regarding the minimum tax on "base erosion payments" paid or accrued by a taxpayer to a foreign related person.

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