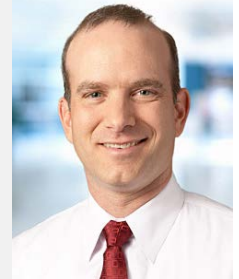


Highlights of the House Tax Cuts and Jobs Act

The House is the first to release a bill in what will be a contentious tax reform debate

This first tax reform proposal consolidates tax brackets, eliminates many deductions and cuts taxes on businesses, but will it pass?

Tim Steffen, CPA, CFP®, CPWA®
Director of Advanced Planning
Baird Wealth Solutions Group



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Over the last year there have been various outlines, frameworks and templates issued by President Trump to get the ball rolling on tax reform, but on November 2 the House issued the first formal bill that attempts to rewrite our country's tax code. This bill contained many of the provisions we've been expecting – consolidated tax brackets, limited deductions, significant business tax relief, etc. – but as always there are plenty of surprises waiting to be found in this very comprehensive plan.

This plan faces a challenging and uncertain future. First, it must pass the House, and with no Democrats publicly supporting the bill, Republicans can't afford many defections. Many Republicans have expressed concern over aspects of this proposal, making party unanimity uncertain. The same is true in the Senate, where Republicans hold an even slimmer majority. On top of that, the Senate plans to introduce their own version of a bill any day, meaning a conference committee could be necessary to reconcile the two. To make things more daunting, President Trump has said he'd like to have a reform bill passed by the end of 2017, leaving less than two months to complete the entire process.

Below are highlights of many of the proposals that would affect individuals and businesses. **Unless otherwise noted, all provisions described below would take effect beginning in 2018 and would be permanent changes to the tax code.**

UPDATE: After being debated in the House Ways & Means Committee, the original Tax Cuts and Jobs Act bill received a variety of amendments. Those amendments are highlighted below.

UPDATE: The House voted November 16 to pass their version of this bill. This version would need to be reconciled with the Senate plan, after which both groups would have to approve the bill again before it goes to President Trump for his signature.

CHANGES TO INDIVIDUAL TAX RATES & BRACKETS

This proposal would consolidate our current seven tax brackets down to just four, as shown in the table below. In general, income at all levels will be taxed at a lower rate under this bill.¹ This table compares the current 2017 tax

¹ It would appear at first glance that taxpayers in the lowest tax bracket would see an income tax increase, as income in the current 10% bracket would now be taxed at 12%. In order to offset this increase, both the standard deduction and the child tax credit would increase, and there would be a new family tax credit. All of these items are explained in more detail below.

Highlights of the House Tax Cut and Jobs Act, *continued*

brackets and rates to the amounts proposed under this bill. However, because these new rates wouldn't apply until 2018, all the income thresholds in this table would be adjusted for inflation before taking effect.

Married Filing Joint		Tax Rate		Single, Married Filing Separately		Tax Rates	
Taxable Income	Current	Proposed	Taxable Income	Current	Proposed	Taxable Income	Current
\$0 – 18,650	10%	12%	\$0 – 9,325	10%	12%	\$0 – 9,325	10%
\$18,650 – 75,900	15%		\$9,325 – 37,950	15%		\$37,950 – 45,000	25%
\$75,900 – 90,000	25%		\$45,000 – 91,900	28%		\$91,900 – 191,650	33%
\$90,000 – 153,100	28%	25%	\$191,650 – 200,000	33%	25%	\$200,000 – 416,700	35%
\$153,100 – 233,350	33%		\$416,700 – 418,400	35%		\$418,400 – 500,000	39.6%
\$233,350 – 260,000	35%	35%	\$500,000 +	39.6%	39.6%	\$500,000 +	39.6%
\$260,000 – 416,700	39.6%		\$1,000,000 +	39.6%		\$1,000,000 +	39.6%

Under today's tax system, all taxpayers receive the benefit of the lower tax brackets even though their marginal income may be taxed at a higher rate. For example, someone in the 39.6% bracket today still has some of their income taxed at 10%, some at 15%, etc. Under this new proposal, however, high-income taxpayers in the highest bracket would see a phaseout of the benefit of the new 12% bracket. Once married couples have Adjusted Gross Income over \$1.2 million (singles over \$1 million), the income that was taxed at 12% begins to be taxed at 39.6%. This phaseout does not apply to the 25% or 35% tax rates, however.

These changes to the ordinary brackets require a corresponding change to the 2018 brackets for the three different capital gain rates:

Capital Gain Tax Rate	Long Term Capital Gain/ Qualified Dividend Income	
	Married Filing Joint	Single
0%	\$0 – 77,200	\$0 – 38,600
15%	\$77,200 – 479,000	\$38,600 – 425,800
20%	\$479,000 +	\$425,800

CHANGES TO DEDUCTIONS

To help offset the cost of these lower tax rates, as well as to help simplify the tax filing process for many taxpayers, this proposal would dramatically change our current system of exemptions and deductions. For one, the personal exemption – the \$4,050 deduction allowed for each taxpayer and their dependents in 2017 – would be repealed. In addition, the standard deduction would be nearly doubled, as shown below:

Filing Status	Current Standard Deduction	Proposed Standard Deduction *
Married Filing Joint	\$12,700	\$24,000
Married Filing Separate	\$6,350	\$12,000
Single	\$6,350	\$12,000
Head of Household	\$9,350	\$18,000

* These amounts are expressed in 2017 dollars, and would be inflation adjusted for 2018.

In exchange for the increased standard deduction, the **following expenses would no longer be considered deductible**:

- State and local income and sales taxes.
- Medical expenses.
- Moving expenses.
 - **UPDATE:** The bill was revised to keep the current law that allows active duty members of the military to deduct moving expenses pursuant to a military order.
- Tax preparation expenses.
- Unreimbursed business expenses of an employee. These and the tax preparation expenses are among a group of expenses called “miscellaneous itemized deductions”, and are only deductible if they – in total – exceed 2% of AGI. Eliminating these two items will make it more difficult to exceed that floor.
- Personal casualty losses, other than those due to events covered under special disaster relief legislation.
- The charitable deduction for 80% of the amount paid to a college for the right to purchase athletic tickets.
- Contributions to Archer Medical Savings Accounts (MSAa). Employer contributions would now become taxable, as well. MSA balances could still be rolled over to a Health Savings Account (HSA) on a tax-free basis. MSAs have no advantages over HSAs, so when this change is combined with the loss of the deduction for medical expenses, an HSA becomes an even better planning tool for those who qualify.

In a surprise move, the **deduction for alimony** paid to an ex-spouse would also be disallowed, and the income would no longer be taxable to the recipient. This would only apply to divorces entered into after 2017, so existing agreements would not be impacted. This could have a significant effect on those going through divorce negotiations today, especially if alimony payments are determined using existing tax law but the agreement isn’t finalized until 2018.

Other expenses would remain deductible, although their benefit would be reduced:

- **Property taxes** on real estate would remain deductible, although the deduction would be capped at \$10,000. The deduction for personal property taxes would be repealed.
- The deduction for **mortgage interest** would be limited in the following ways:
 - For 2017, the interest paid on the first \$1 million of mortgage debt is deductible, along with the interest on up to another \$100,000 of home equity debt. The interest on existing loans would continue to be deductible under those rules, but for any loans entered into after November 2, 2017,

the debt cap would be lowered to \$500,000. Existing debt that is refinanced after this date would continue to qualify under the current rules.

- Interest on a home equity loan would no longer be deductible under this proposal.
- Currently taxpayers can deduct the interest on a primary residence and a second residence. Under this proposal, interest would only be deductible on a primary residence.
- Currently, **losses from gambling** can only be deducted to the extent of gambling winnings, while other expenses connected to gambling can be deducted in excess of winnings. This proposal would cap the deduction for both losses and other expenses to the amount of gambling winnings.

In 2017, high-income taxpayers are subject to the **Pease limitation**, which results in the phasing out of itemized deductions. This phaseout would be repealed under this proposal.

One area where deductions would be expanded is related to **charitable contributions**, albeit only slightly. Under this proposal, deductions that would have been subject to the 50% of AGI limitation (such as cash gifts to public charities) would now be deductible up to 60% of AGI. Excess gifts would still be carried forward for up to 5 years. Also, the per-mile deduction allowed for driving for a charitable organization would now be indexed for inflation.

ENHANCED CHILD CREDIT, NEW FAMILY CREDIT

In order to offset the proposed elimination of the personal exemption, the Child Tax Credit would be expanded in the following ways:

- The credit amount would increase from \$1,000 per child under the age of 17 to \$1,600 per child.
- A new \$300 family credit would be allowed for each taxpayer (including both spouses on a joint return) plus any other dependent that doesn't qualify for the \$1,600 child credit. This family credit would only apply for the five years from 2018 to 2022.
- Both credits would be subject to a phaseout, but the income level would be increased from current law levels:
 - For married couples, the credit would be reduced by 5% of AGI over \$230,000. Currently, their phaseout begins at \$110,000.
 - For all other taxpayers, the phaseout would begin at \$115,000 of AGI. Singles are currently phased out beginning at \$75,000, and married couples filing separately at \$55,000.

NEW TAX RATE ON PASS-THROUGH BUSINESS INCOME

This reform proposal contains a wide variety of changes to how businesses are taxed (discussed below), but it also makes a significant change to business income earned by individuals. This not only includes income from Sole Proprietorships, but also those considered "pass-throughs" such as S Corporations and Partnerships. Today, the net income from these businesses is taxed directly to the owners of those businesses, using the individual tax rates (not the corporate tax rates). Under this proposal, some portion of that income would be taxed at a maximum rate of 25%, although the amount varies based on the owner and the type of business:

- This lower rate would only apply to the portion of the income treated as "qualified business income". The balance of the income from the activity would be treated as compensation and would be taxed as it is today, at the individual's regular tax rate.
- For business owners considered passive investors, 100% of their share of the business income would be considered qualified and would be subject to the maximum 25% rate. This would include all business income from publicly traded partnerships.
- For those owners considered active investors, the rules are different:

- The default assumption for most businesses is that 30% of the business income will be considered qualified, with the remaining 70% of their income taxed at the standard individual tax rates.
- Service corporations, whose business is based primarily in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, will have a default of 0% qualified business income, making them ineligible for the lower tax rate.
- In all cases, active investors in a pass-through business will have the ability to claim a higher percentage of their income as qualified, using a formula that takes into account the activity's return on capital.
- **UPDATE:** A new lower tax rate would apply to the first \$75,000 of net business income for an active owner. The rate would be 11% for 2018 and 2019, 10% for 2020 and 2021, and 9% for 2022 and beyond. This lower rate would be phased out once that business income exceeds \$150,000, and would be fully lost at \$225,000 of income, at which point the original proposal of a 12% tax would apply to that first \$75,000. For single taxpayers, the lower rate would only apply to the first \$37,500 of income, and would begin phasing-out at \$75,000 of income.
- The 25% tax rate will also apply to some dividends from Real Estate Investment Trusts (REITs) and cooperatives.

SALE OF A PERSONAL RESIDENCE

Under current law, a married couple can exclude up to \$500,000 of gain on the sale of their home (\$250,000 for singles) as long as it was their primary residence for two of the last five years, and the exclusion can be claimed once every two years. This proposal would increase the time period to five out of eight years, and the exclusion could only be claimed once every 5 years.

In addition, the exclusion amount would be subject to a phaseout. The exclusion would be reduced by \$1 for every dollar a couple's AGI exceeds \$500,000 (singles over \$250,000). This means couples with income over \$1 million would no longer be able to exclude a gain on their home, as well as many other couples with income between \$500,000 and \$1 million.

IRA RECHARACTERIZATIONS

In the weeks leading up to the release of this proposal, there was speculation it would include a cap or even a complete elimination of the ability to make deductible contributions to retirement plans (sometimes referred to as "Rothification"). That concern turned out to be for naught, although the topic could be revisited in the Senate proposal. Instead, the proposal contained an unexpected change to Traditional and Roth IRAs.

This proposal would eliminate the ability to recharacterize a Roth conversion after it was completed. Currently taxpayers have until October 15 of the year after the year of conversion to essentially change their mind on doing the conversion. This technique allows taxpayers to undo conversions if the account has fallen in value, or even do large conversions up front and then reduce them later to an amount they're willing to pay tax on. Under this proposal, once a Roth conversion is completed, the conversion amount cannot be changed. In other words, taxpayers must be willing to fully commit to the conversion once it's completed.

This inability to recharacterize would also apply to contributions to either a Traditional or Roth IRA. However, the "backdoor Roth contribution" technique – where after-tax contributions are made to a Traditional IRA and then converted to a Roth IRA – was not addressed in this bill and would still be a viable strategy.

SIMPLIFICATION OF EDUCATION INCENTIVES

This proposal would consolidate a variety of education incentives, while eliminating some others:

- The deductions for interest paid on student loans and for qualified tuition and related expenses would be repealed.
- New contributions to Coverdell Education Savings Accounts would not be allowed after 2017, although these accounts could continue to be held and used for education expenses, or rolled over to section 529 accounts.

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Coverdell ESAs are currently the only tax-preferred way to fund K-12 expenses, so these expenses would become qualified expenses of a 529 account, but with an annual limit of \$10,000.

- **UPDATE:** Taxpayers would be allowed to rollover 529 account balances to an ABLE account, which is a tax-favored savings program for disabled individuals.
- An unborn child could be named beneficiary of a 529 plan, as long as the child is in utero.
- The Hope Scholarship Credit and the Lifetime Learning Credit would be repealed, leaving just the American Opportunity Tax Credit. The AOTC provides a 100% credit for the first \$2,000 of college expenses, and then 25% for the next \$2,000. The AOTC would be expanded to allow for a fifth year of college expenses, but at half the rate of the first four years.
- Interest on some US Government savings bonds is excluded from income today if they are used to pay for college expenses. That exclusion would be repealed.
- The tax exclusion for qualified tuition reduction programs would also be repealed, making these benefits taxable. These are programs where educational institutions provide reduced tuition or even cash payments to their employees and their spouses and dependents.
- The discharge of student loan debt that occurs upon the death or disability of the student would no longer be considered taxable income.

ESTATE, GIFT AND GST TAX CHANGES

This proposal greatly reduces the impact of the estate tax before ultimately repealing it:

- The estate exemption would be doubled beginning in 2018. The exemption is currently expected to be \$5.6 million, meaning it would become \$11.2 million per person, or \$22.4 million per couple.
- The gift tax would be lowered from 40% to 35%, although the same annual and lifetime exemption amounts would continue to apply
- In 2024, the estate and the generation skipping transfer taxes would be fully and permanently repealed. The rules adjusting the cost basis of assets to fair market value at death would continue to apply, however.
 - **UPDATE:** The repeal of the estate tax would be deferred until 2025.

ALTERNATIVE MINIMUM TAX REPEAL

This proposal would repeal the Alternative Minimum Tax that applies to individuals (and to corporations, as well). Taxpayers who have existing AMT credit carryovers would be able to use those carryovers as follows:

- Taxpayer could claim 50% of their otherwise unused AMT credit in 2019, 2020 and 2021.
- Any credit remaining after 2021 could be fully claimed in 2022.

In both cases above, the credit claimed would be fully refundable.

BUSINESS TAX CHANGES

Businesses structured as pass-through entities would see a new lower tax rate, as explained earlier, but those operating as C Corporations would also be subject to a new tax rate. These corporations, which pay their own tax rather than pass it through to their owners, would move from a tax rate of essentially 35% to a new flat rate of 20%. Personal service corporations (as defined earlier) would be taxed at 25%.

This bill contains many other provisions affecting business, some of which are highlighted below:

- Businesses could fully expense 100% of the cost of qualified property placed in service after September 27, 2017 and before 2023. Currently business can immediately deduct 50% of that cost (decreasing to 30% in 2019), and then depreciate the balance of the cost over the asset's useful life.
- Businesses can currently expense up to \$500,000 for the purchase of property considered "**section 179**" property, as long as their total assets placed in service for the year don't exceed \$2 million. This proposal would increase the expense amount to \$5 million and the phaseout amount to \$20 million, and index both for inflation. This provision would expire after 2022 and revert back to the current rule.
- **Like-kind exchanges** would only be allowed for real property (including rental properties), and not for personal property (such as vehicles or equipment).
- Businesses with gross receipts of less than \$25 million would be exempt from various **limitations on deducting interest expense**. On the other hand, larger companies would see new limits on their interest expense deduction.
- The carryback of **Net Operating Losses** would essentially be repealed, but those losses could instead be carried forward indefinitely (versus for just 20 years today). Only 90% of current income could be offset with an NOL carryforward, however.
- Businesses could no longer deduct the cost of entertainment or recreation activities, or membership dues relating to those activities, as well as on-premises gyms or other amenities for employees that are primarily personal in nature.
- The following **tax credits** would be repealed: employer-provided child care, historic building rehabilitation, and the Work Opportunity Tax Credit.

EMPLOYER-PROVIDED FRINGE BENEFITS

Employers are currently able to provide a variety of fringe benefits to their employees without the employee having to report them as taxable income. This proposal would change that treatment and make the following benefits taxable to employees:

- Employer-provided education assistance, of which up to \$5,250 is currently excluded from income.
- Employee achievement awards. These expenses would also no longer be deductible by the employer.
- Moving expense reimbursements.
- Adoption assistance programs
- The exclusion for housing provided for the convenience of the employer or for employees of educational institutions would be capped at \$50,000. This reduced limit would also be phased out by 50% of the employee's compensation that exceeds a threshold (\$120,000 in 2017, but adjusted for inflation).

In addition, contributions to **Dependent Care Flexible Spending Accounts** would no longer be allowed. Employees of companies that offer these programs can currently fund up to \$5,000, but it must be used by the end of the calendar year or it is forfeited.

MISCELLANEOUS PROVISIONS

A variety of other changes were included in this proposal, including the following:

- The interest on **private activity bonds** issued after 2017 would no longer be tax-exempt. Currently that interest is only taxable for AMT purposes. Interest paid on bonds issued to build or improve a professional sports stadium would become taxable as well.
- Several changes were proposed to **retirement plan rules**, including expanding in-service distribution options for state and local government employees in order to match private sector employees, allowing employers to loosen

the rules on hardship withdrawals from accounts, and increasing the time in which an employee can pay back a plan loan after the account was rolled to an IRA.

- Some forms of **nonqualified deferred compensation** would be taxed sooner, as the definition of “substantial risk of forfeiture” would be narrowed.
 - **UPDATE:** This provision was removed from the bill.
- A variety of **nonrefundable credits would be repealed**, including the adoption credit, the credit for plug-in electric drive motor vehicles, the credit available when states issue mortgage credit certificates and the credit for those over age 65 who have retired on disability.
 - **UPDATE:** The adoption credit would no longer be repealed.
- **Tax-exempt organizations** would be subject to a 20% tax on compensation over \$1 million paid to their five highest paid employees for the year.
- The excise tax on net investment income for **private foundations** would be a flat 1.4%, rather than a 1-2% tax.
- **Private colleges and universities** with at least 500 students would be subject to a 1.4% tax on their net investment income if their assets not directly used for educational purposes exceed a threshold.