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Highlights of the Senate Tax Cuts and Jobs Act

The Senate passed a bill with the same name as the House, but with plenty of other differences

The Senate version of a tax reform proposal lowers tax rates, eliminates some deductions, and reduces taxes on businesses, but takes a different approach than the House.

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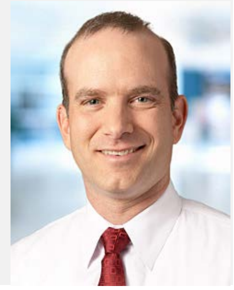

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Two weeks after the House of Representatives passed a tax reform proposal titled Tax Cuts and Jobs Act, the Senate responded by passing their own version. The Senate bill uses the same name and has many of the same recommendations, but there are plenty of differences between the two that are significant.

Much like the House version, this bill reduces tax rates on individuals, but takes a different approach by keeping generally the same income brackets as today but lowering the rate applied to each. They also provide a significant tax break to businesses, but do so by exempting income from tax, rather than lowering the applicable rate like the House did. The Senate chose to expand the exemptions to the AMT and estate tax, rather than following the House's lead and repealing them. The Senate did choose to follow the House elsewhere, replacing several itemized deductions with a larger standard deduction and child credit.

After their original proposal was released, the Senate then revised their version so that nearly all the provisions affecting individual taxpayers would expire after 2025. The expectation among Senators is that these provisions would eventually be extended rather than actually expire, but this expiration was needed in order to meet various budget rules. This same approach was used with the tax changes enacted in 2003 under President Bush. Those changes were set to expire after 2008 but in most cases were eventually made permanent.

The following is a summary of the key provisions of the Senate tax proposal. **Unless otherwise noted, all provisions described below would take effect beginning in 2018.**

The House and Senate will now convene a conference committee to hash out the differences between their two bills. Once a single, final bill is agreed upon, both houses of Congress will need to vote to approve the new agreement before it is sent to President Trump for his signature.

CHANGES TO INDIVIDUAL TAX RATES & BRACKETS

The Senate structured their tax reform for individuals around a combination of lower marginal tax rates and modified tax brackets, as shown in the following table. The proposed rates and brackets are compared to the rates and brackets that were previously announced for 2018.

<table>
<tr><th>Married Filing Joint</th><th colspan="2">2018 Tax Rate</th></tr>
<tr><th>2018 Taxable Income</th><th>Current</th><th>Proposed</th></tr>
<tr><td>$0 – 19,050</td><td>10%</td><td>10%</td></tr>
<tr><td>$19,050 – 77,400</td><td>15%</td><td>12%</td></tr>
<tr><td>$77,400 – 140,000*</td><td rowspan="2">25%</td><td>22%</td></tr>
<tr><td>$140,000 – 156,150*</td><td rowspan="3">24%</td></tr>
<tr><td>$156,150 – 237,950</td><td>28%</td></tr>
<tr><td>$237,950 – 320,000*</td><td rowspan="3">33%</td></tr>
<tr><td>$320,000 – 400,000*</td><td>32%</td></tr>
<tr><td>$400,000 – 424,950*</td><td rowspan="3">35%</td></tr>
<tr><td>$424,950 – 480,050</td><td>35%</td></tr>
<tr><td>$480,050 –1,000,000</td><td rowspan="2">39.6%</td></tr>
<tr><td>$1,000,000 +</td><td>38.5%</td></tr>
</table>

<table>
<tr><th>Single</th><th colspan="2">2018 Tax Rate</th></tr>
<tr><th>2018 Taxable Income</th><th>Current</th><th>Proposed</th></tr>
<tr><td>$0 – 9,525</td><td>10%</td><td>10%</td></tr>
<tr><td>$9,525 – 38,700</td><td>15%</td><td>12%</td></tr>
<tr><td>$38,700 – 70,000*</td><td rowspan="2">25%</td><td>22%</td></tr>
<tr><td>$70,000 – 93,700*</td><td rowspan="2">24%</td></tr>
<tr><td>$93,700 – 160,000*</td><td rowspan="2">28%</td></tr>
<tr><td>$160,000 – 195,450*</td><td rowspan="2">32%</td></tr>
<tr><td>$195,450 – 200,000</td><td rowspan="2">33%</td></tr>
<tr><td>$200,000 – 424,950</td><td rowspan="3">35%</td></tr>
<tr><td>$424,950 – 426,700</td><td>35%</td></tr>
<tr><td>$426,700 – 500,000</td><td rowspan="2">39.6%</td></tr>
<tr><td>$500,000 +</td><td>38.5%</td></tr>
</table>

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

<table>
<tr><th rowspan="2">Capital Gain Tax Rate</th><th colspan="2">Long Term Capital Gain/
Qualified Dividend Income</th></tr>
<tr><th>Married Filing Joint</th><th>Single</th></tr>
<tr><td>0%</td><td>$0 – 77,200</td><td>$0 – 38,600</td></tr>
<tr><td>15%</td><td>$77,200 – 479,000</td><td>$38,600 -425,800</td></tr>
<tr><td>20%</td><td>$479,000 +</td><td>$425,800</td></tr>
</table>

All of these changes to ordinary and capital gain tax brackets and rates would expire after 2025 and revert back to the laws in effect for 2017.

CHANGES TO DEDUCTIONS

This proposal would repeal the personal exemption, the $4,050 deduction allowed for each taxpayer and their dependents in 2017. The proposal would also increase the standard deduction, as shown in the table below:

Filing Status	2018 Standard Deduction, Current Law	2018 Standard Deduction, Proposed Law
Married Filing Joint	$13,000	$24,000
Married Filing Separate	$6,500	$12,000
Single	$6,500	$12,000
Head of Household	$9,550	$18,000

In exchange for a larger standard deduction, the proposal would eliminate the following itemized deductions beginning in 2018:

- State and local income and sales taxes.
- Interest paid on home equity loans. (The deduction for interest paid on a primary mortgage would not change.)
- The charitable deduction for 80% of the amount paid to a college for the right to purchase athletic tickets.
- Personal casualty losses, other than those due to events covered under special disaster relief legislation.
- Tax preparation fees.
- All other miscellaneous itemized deductions subject to the 2% of Adjusted Gross Income (AGI) floor, including investment-related expenses, trustee fees, safe deposit box rental, union dues, etc.
- Moving expenses, other than for members of the armed forces who move due to a military order.

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.

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.

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 in 2018 under this proposal, but would return after 2024 (this expiration is one year earlier than the expiration date for most other provisions).

Two areas where deductions would be expanded are related to **charitable contributions** and **medical expenses**.

- Medical expenses are currently only deductible to the extent they exceed 10% of a taxpayer's AGI. This threshold would be lowered to 7.5% for both 2017 and 2018. This is one of very few items in the bill that would impact 2017.
- In addition, charitable contributions 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.

All of the changes to deductions and exemptions would expire after 2025 and revert back to the laws in effect for 2017, other than the reinstatement of the Pease limitation on deductions.

MANDATE TO PURCHASE HEALTH INSURANCE

The revised proposal from the Senate includes a provision that would effectively eliminate the requirement that all individuals must be covered by a health plan that provides minimum essential coverage. Under the Affordable Care Act that was passed in 2010, individuals who don't purchase a policy meeting various requirements, and who aren't otherwise exempt from doing so, would pay a penalty equal to the greater of a specified dollar amount or a certain percentage of their income. Under this new proposal, the penalty for not purchasing insurance would be reduced to $0 in 2019, effectively ending the requirement. Insurance policies that are currently available through the various health care exchange programs would continue to be offered.

ENHANCED CHILD CREDIT

This proposal would expand the existing child tax credit in the following ways:

- The credit would be expanded from $1,000 per qualifying child to $2,000.
- Child under age 18 would be eligible for the credit, up from the current age 17 threshold.
- There would be a new $500 credit for any dependent not qualifying for the $1,650 child credit.
- These credits would be phased out once income exceeds $500,000 (for all taxpayers), up from the current $110,000 and $55,000 levels (for couples and singles, respectively).

All of the changes to the child credit would expire after 2025 and revert back to the laws in effect for 2017.

REDUCED TAXES ON PASS-THROUGH BUSINESS INCOME

One of the other major themes of both tax reform proposals has been a reduction in the taxes paid by businesses. The Senate has taken a very simplistic approach to their proposal by exempting 23% of all net business taxable income earned by a partnership (including a publicly traded partnership), S Corporation or sole proprietorship. The Senate proposal makes no distinction between passive and active owners of a business, meaning both appear to benefit from this provision.

In order to help prevent abuse of this proposed exclusion, there are a variety of limitations imposed as explained below:

- This exemption generally does not apply to specified service businesses, which include those in the fields of health, law, engineering, architecture, accounting, actuarial sciences, performing arts, consulting, financial services, brokerage services, or any other business where the primary asset is the reputation or skill of its employees.
    - There is an exception to this exception, however. A married couple with taxable income below $150,000 ($75,000 for all others) is eligible for the exemption, regardless of the type of business they have. This exception is phased out for couples with taxable income over $500,000, and is lost once their income exceeds $600,000 ($250,000 and $300,000 for all other taxpayers).
- The 23% exemption does apply to dividends from a real estate investment trust (REIT) or certain cooperatives.
- Losses realized by a business in one year must be treated as a loss in the following year for purposes of this exemption. In other words, a business can't generate a deductible loss in one year, but then have income the next year that benefits from the exemption. That income in year 2 must be offset by the loss in year 1 before calculating the 23% exemption.
- Any amount paid to an S Corporation owner that is treated as compensation (i.e., reported on a W-2) is not eligible for the exemption, nor are guaranteed payments paid to a partner in a partnership. Also, the 23% exemption on the business income is capped at 50% of the amount reported as wages to that individual and reported on a W-2. This W-2-related threshold would not apply to couples with taxable income below $500,000, and would only be phased in over their next $100,000 of income ($250,000 and $50,000 for all other taxpayers). Couples over $600,000 (and others over $300,000) would be fully subject to this W-2 limit.

All of the changes to the taxation of pass-through business income would expire after 2025. At that point, pass-through business income would be again be taxed using the standard individual tax rates and brackets.

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.

This expanded ownership and use requirement would expire after 2025 and revert back to the law in effect for 2017.

IRA RECHARACTERIZATIONS

The Senate 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.

This proposal did not change the tax treatment of contributions to retirement plans (so called "Rothification") or make any other changes to the rules for IRAs, Roth IRAs, etc.

CHANGES TO THE KIDDIE TAX

The current version of the kiddie tax requires any non-earned income over a threshold to be taxed as if it belonged to the child's parent. Under this proposal, that income would be taxed using the proposed trust tax rates. Those rates are shown below:

Ordinary Taxable Income	Ordinary Income Tax Rate
$0 – 2,550	10%
$2,550 – 9,150	25%
$9,150 – 12,500	35%
$12,500 +	38.5%

Capital Gain Income	Capital Gain Tax Rate
$0 – 2,600	0%
$2,600 – 12,700	15%
$12,700 +	20%

Any earned income for the child would be taxed using the single tax brackets and rates. There would be no change in the definition of children subject to this tax. Under this proposal, the tax assessed on the child would not be affected by the income of their parents or their siblings, unlike today's law.

These revised kiddie tax rules would expire after 2025 and revert back to the law in effect for 2017.

ENHANCEMENTS TO ABLE ACCOUNTS

ABLE accounts are a tax-preferred way for those with disabilities to save. Annual contributions are capped at the annual gift exclusion amount ($14,000 today) and are not deductible, but earnings in the account are tax-deferred, and can be tax-free if withdrawn for qualified disability expenses. The Senate amendment would allow ABLE beneficiaries to contribute their own funds to the account once the $14,000 limitation was reached after gifts from others, subject to other limitations. These contributions by the beneficiary would also qualify for the saver's tax credit.

In addition, a 529 account where a disabled individual is the beneficiary could be rolled into an ABLE account owned by that same individual. The rollover would count towards the annual contribution limit to the ABLE, however.

These changes would all expire after 2025 and revert back to the law in effect for 2017.

ESTATE TAX CHANGES

This proposal would double the estate exemption 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. There would be no other changes to the gift, estate or generation skipping transfer taxes.

This increased estate tax exemption would expire after 2025 and revert back to the law in effect for 2017 with inflation adjustments.

ALTERNATIVE MINIMUM TAX REPEAL

Rather than repealing the Alternative Minimum Tax as had originally been proposed, the Senate instead chose to increase the exemption amounts, thereby reducing the number of taxpayers subject to AMT. Under their proposal, the AMT exemption for couples would increase from $78,750 in 2017 to $109,400 in 2018 (and from $50,600 to $70,300 for singles).

The AGI level at which the exemption is phased out would also be increased, from $150,000 in 2017 to $208,400 in 2018 for couples (and from $112,500 to $156,300 for singles).

These increased exemptions and phaseout levels would expire after 2025 and would revert back to their 2017 levels, with inflation adjustments.

BUSINESS TAX CHANGES

While businesses structured as pass-through entities would be eligible for a new deduction of 23% of their income, those operating as C Corporations would instead 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%, but only for tax years beginning after 2018.

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. The 100% would be reduced to 80% for 2023, 60% for 2024, 40% for 2025 and 20% for 2026, and then would reach 0% for 2027 and beyond. Currently businesses can immediately deduct 50% of that cost (with the 50% gradually decreasing and then expiring in 2020), 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 permanently increase the expense amount to $1 million and the phaseout amount to $2.5 million, and index both for inflation. The proposal would also expand the definition of property eligible for the deduction.
- **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 $15 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, falling to 80% after 2023, with the remainder of the NOL continuing to carry forward.

- The cost of **nonresidential real property and residential rental property** could be deducted over a 25 year period. Currently, the depreciable lives for those two types of properties are 39 and 27.5 years, respectively.
- 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.

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 repeal the exclusions for employer-reimbursed moving expenses and bicycle commuting expenses.

MISCELLANEOUS PROVISIONS

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

- The cost basis of any security sold after December 31, 2017 must be determined on a **first-in, first-out basis**, unless an “average basis” method is allowed (such as with mutual funds). Investors could no longer specifically identify a tax lot to sell when multiple lots (with different cost basis and holding periods) of a position are owned. Mutual fund managers would be exempt from this requirement as well when selecting positions to sell within their funds.
- **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.
- **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.
- 529 college savings programs would be expanded to allow for up to $10,000 per year to be withdrawn for the cost of K-12 education. No changes would be made to Coverdell Education Savings Accounts, however.
- The discharge of **student loan debt** that occurs upon the death or disability of the student would no longer be considered taxable income (for discharges after 2017).
- The **deduction allowed for educators** who provide supplies and other materials for their classroom would permanently increase from $250 to $500.
- Beginning in 2019, **employers could claim a tax credit** equal to 12.5% of the wages paid to an employee on family and medical leave (FMLA), as long as they’re paid at least 50% of their normal wage. The credit rate would increase as the FMLA payment increased above 50% of normal wages.
- The new proposal would increase the time in which an employee can pay back a **loan from their 401(k) plan** after the account was rolled to an IRA.
- Certain **employees of privately held companies** who receive stock options or restricted stock units as compensation would be able to exercise those and then defer the recognition of income for up to five years.