Construction Industry
Round Table

Legislative News

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12/04/2017 – Tax Reform Moves Forward, Devils in the Details

After the Senate passed its tax reform bill in a dramatic early morning 51-49 vote (nearly entirely along party lines), the measure will now go to conference with the House version; keeping alive hope that a final bill will be presented to the President before the new year. Given the potential complexity of any tax bill, the House and Senate versions are remarkably similar on a number of issues. For example, they both: (1) set the corporate rate at 20 percent; (2) treat the state and local tax deduction identically, (including capping it for property taxes); (3) take similar approaches to expensing/interest deductions; and (4) institute a territorial international tax system and a one-time repatriated tax rate for funds brought back to the U.S. by C-corporations.

However, notwithstanding these similarities the devil is *still* in the details of the two versions, which have some remaining substantive provisions (often driven by the CBO scoring needs, that Republicans remain wedded to, even though they are notoriously inaccurate and aren't done dynamically) that will need to be addressed before a final version can move forward to an "up-or-down" vote in both chambers. Among the major differences, apart from the individual healthcare mandate, estate tax, and grad school issues, are:

- The Senate bill delays implementation of the 20% corporate tax rate until 2019 (which seems to be counter-productive, and politically insane – leaving the Republicans to face reelection in 2018 without any benefits from the "heavy lifting" of making the change!)

- The two versions are not aligned on how long the changes will remain – the House bill makes most permanent, whereas the Senate bill, however, lets almost all its individual changes expire, so the tax cuts don't cost money outside the 10-year "budget window." [Senate rules require that budget legislation passing by a simple majority of 50 votes cannot increase the deficit after the window is closed. Expect the Senate's expiration approach to make it into the combined bill; it's hard to see how Senate rules are satisfied otherwise. This may be less crucial since many point out, most tax code issues don't have much more than a 10-year shelf-life anyway].

- The House bill repeals both the individual and corporate alternative minimum taxes (AMTs), whereas the Senate version decided to retain both AMTs, to pay for other provisions the senators wanted. [Expect both AMTs to be fully repealed in the final legislation; Republicans have wanted to kill them for decades].

- The Senate has higher tax rates on pass-through income, in general, than the House bill: The House bill cuts the top rate down as low as 25 percent, whereas the lowest rate in the Senate bill is 29.6 percent. Beyond the rates, the two types of entities are treated differently, and even unequally. [Expect lots of negotiation over the precise approach to take toward pass-throughs; discontent by some senators (led by Sen. Ron Johnson) sympathetic to pass-through companies almost sank the Senate bill].

It is the pass-through or S-Corporation tax treatment, along with immediate implementation (2018 vs. 2019), that are the two biggest issues of importance to the business community, including CIRT members. Delaying the effective 20% tax rate implementation until 2019 makes absolutely no sense, and should be abandoned by the Senate negotiators. Likewise, the disparate treatment of C-Corp vs. S-Corp business entities MUST also be addressed with some effort to bring the two into some kind of equivalency. There simply is no good policy rationale for this amount of variance between "pass-through" businesses and C-Corps. To fix this, the S-Corp Association recommends the following:

- Trusts: Many family businesses will pay higher taxes under the Senate bill - and potentially the House bill - because it precludes trusts and estates from using the pass-through deduction. Solution: Allow trusts and estates to benefit from the pass-through deduction in the final version.

- Guardrails: The House bill offers a 25 percent top rate, but the guardrails preclude most businesses from getting that rate, or anything close to it. Businesses with active ownership would pay rates at least 10 percentage points higher. Solution: Rather than use the badly flawed 70/30 concept, conferees should look at a ratio that varies based on the payroll and other expenses incurred by the business - the higher these expenses are compared to revenues, the more profits the business can claim. This would be an excellent way to both prevent abuse and make sure that this tax relief actually gets to the bona fide ongoing businesses that are intended to benefit.

- SALT: Both bills would repeal the State and Local income tax deduction for pass-through businesses, but not for C-corporations. This has the effect of raising marginal rates of pass-through businesses by up to 5 percentage points, exacerbating the rate differential between S-Corps and C-corporations. Solution: Owners of pass-through businesses should be able to deduct state and local income taxes paid on their pass-through business income.

- Sunset: The Senate bill would now sunset the pass-through deduction after the year 2025, resulting in significant tax hike on pass-through businesses. This is a tax hike, not only relative to the Senate bill prior to 2026, *but also* relative to current law. The former obviously is due to the loss of the 23 percent pass-through deduction beginning in 2026. The latter is due, with one exception, to all the Senate base broadening provisions are made permanent and would have the effect of permanently increasing the taxable income of pass-through businesses. These revenue raisers include the new cap on interest deductions, repeal of the Section 199 manufacturing deduction, repeal of the IC-DISC, and numerous other provisions affecting both C-corporations and pass-through businesses. As currently constructed, the Senate bill is "corporate-only tax reform" with all the provisions affecting C-corporations made permanent, while only provisions ***benefiting*** individuals and pass-through businesses made temporary. Solution: Make the pass-through business deduction permanent, just as the reduction in the C-corporation rate to 20 percent is made permanent.

- International Tax Treatment: The Senate and House bills move business taxation from a world-wide system to a modified territorial system - but it is applied/reserved for C-corporations only. S-Corps and other pass-through entities are not included. This exclusion puts S-Corps with overseas operations at a distinct disadvantage. The Senate bill, in particular, would harm S-Corps with international operations. The bill applies the "GILTI" tax to S-Corps, but S-Corps are precluded from the deduction in Section 250. The net effect is that not only are S-Corps blocked from territorial treatment, they are required to pay tax on their foreign source income immediately at the highest marginal rates. Finally, the Senate bill limits the pass-through deduction to domestic income only. Foreign income earned by an S-Corps would be subject to the top 38.5 percent rate.

These are highly complex and vexing issues that must be sorted out during the House-Senate conference. The intent is to press the Senate negotiators to moderate their bill’s S-Corp treatment so that at least some of the disparages can be ameliorated creating some degree of a more level playing field.

To summarize the bills, their differences, and how they depart from the status quo, the **Tax Policy Center** has created a helpful chart which can be found on the next page:

Comparing Current Law and "Tax Cuts and Jobs Act," 2018

TPC

	Current Law	Tax Cuts and Jobs Act	
		As Passed by the House	As Passed by the Senate
Individual tax rates	10%, 15%, 25%, 28%, 33%, 35%, 39.6%; Top rate starts at $426,700 (single), $453,350 (head of household), $480,050 (joint)	12%, 25%, 35%, 39.6%; Top rate starts at $500,000 (single and head of household), $1,000,000 (joint)	10%, 12%, 22%, 24%, 32%, 35%, 38.5%; Top rate starts at $500,000 (single and head of household), $1,000,000 (joint); Sunsets after 2025[a]
Alternative minimum tax	Yes	Repealed for both individual income tax and corporate income tax	Retain the corporate AMT; Retain the individual AMT with higher exemption amounts and phaseout thresholds; Individual AMT changes sunset after 2025[a]
Standard deduction	$6,500 (single), $13,000 (joint), $9,550 (head of household); Indexed for inflation	$12,200 (single), $24,400 (joint),$18,300 (head of household); Indexed for inflation but not indexed for 2019	$12,000 (single), $24,000 (joint),$18,000 (head of household); Indexed for inflation; Sunsets after 2025[a]
Personal and dependent exemptions	$4,150; Indexed for inflation	Repealed	Repealed; Sunsets after 2025[a]
Child tax credit	Credit equal to $1,000 per qualifying child under 17; Phases out beginning at $75,000 (single), $110,000 (joint); Refundable portion equals 15% of earnings in excess of $3,000	Credit equal to $1,600 per qualifying child under 17; $300 for taxpayer, spouse, and other dependents ($300 credit expires after 2022); Phases out beginning at $115,000 (single), $230,000 (joint); Refundable portion equals 15% of earnings in excess of $3,000 up to $1,100 per qualifying child; Maximum refundable portion indexed for inflation; Requires Social Security number to claim credit	Credit equal to $2,000 per qualifying child under 18 (under 17 in 2025), $500 for other dependents; Phases out beginning at $500,000 for joint filers; Refundable portion equals 15% of earnings in excess of $2,500 up to $1,100 per qualifying child; Maximum refundable portion indexed for inflation; Requires Social Security number to claim refundable credit; Sunsets after 2025[a]
Higher education[b]	American Opportunity Tax Credit; Lifetime Learning Credit; Tuition and Fees Deduction (expired after 2016); Student Loan Interest Deduction	American Opportunity Tax Credit available for fifth year (at half value); Lifetime Learning credit repealed; Tuition and fees deduction repealed; Student loan interest deduction repealed	Unchanged
State and local tax itemized deduction	Real estate, personal property, and either income or sales taxes are deductible	Only real estate taxes up to $10,000 are deductible	Only real estate taxes up to $10,000 are deductible; Sunsets after 2025[a]
Mortgage interest itemized deduction	Interest payments on up to $1.1 million of debt are deductible; Applicable to principal and one other residence	Deduction for interest payments on debt accrued after 2017 limited to debt up to $500,000 and only for debt on a principal residence	Interest payments on up to $1 million of acquisition debt are deductible; Applicable to principal and one other residence; Sunsets after 2025[a]
Medical expense itemized deduction	Out-of-pocket medical expenses in excess of 10% of AGI are deductible	Repealed	Out-of-pocket medical expenses in excess of 7.5% of AGI are deductible in 2017 and 2018; Reverts to current law in 2019
Overall limit on itemized deductions	Itemized deduction phases out starting at AGI of $266,700 (single), $320,000 (joint); Amounts indexed for inflation	Repealed	Repealed; Sunsets after 2025[a]
Top capital gains tax rate	23.8% (20% plus 3.8% Net Investment Income Tax)	Unchanged	Unchanged
Inflation index	Consumer price index (CPI)	Chain-weighted consumer price index (C-CPI)	Chain-weighted consumer price index (C-CPI)
Top tax rate for pass-through businesses	39.6% rate (top rate for individual income tax)	25% rate for "passive" net business income; 35.22% rate for "active" net business income; 39.6% for personal service income	29.6% rate (38.5% top rate applied to qualifying business income after 23% deduction); 38.5% for personal service income; Deduction limited above $250,000 (single), $500,000 (joint) based on compensation paid; Sunsets after 2025[a]
Top corporate income tax rate	35%	20%	20%; Delayed until 2019
New investment purchases	2018: 40% "bonus" depreciation for qualified property; 2019: 30% "bonus" depreciation for qualified property; 2020: 20% "bonus" depreciation for qualified property Small business (Section 179) expensing up to $500,000	100% "bonus" depreciation (i.e., "expensing") for qualified property; Expires in 2023; Small business (Section 179) expensing up to $5,000,000	100% "bonus" depreciation (i.e., "expensing") for qualified property; Phases down from 100% by 20% per year starting in 2023; Small business (Section 179) expensing up to $1,000,000
Business interest deduction	Fully deductible (generally)	Disallowed for interest in excess of 30% of business income (including depreciation); Exemption for businesses with gross receipts of $25 million or less	Disallowed for interest in excess of 30% of business income (excluding depreciation); Exemption for businesses with gross receipts of $15 million or less
Taxation of US multinational companies	Worldwide system with deferral and foreign tax credit	Modified territorial system with base erosion provisions; Excise tax on certain payments to foreign corporations; One-time tax on unrepatriated foreign earnings at 7% (14% for cash)	Modified territorial system with base erosion provisions; "Anti-abuse" tax on certain payments to foreign corporations; One-time tax on unrepatriated foreign earnings at 7.5% (14.5% for cash)
Estate tax	Top rate of 40% on estates above $5.6 million; $11.2 million (couples); Amounts indexed for inflation	Top rate of 40% on estates above $11.2 million; $22.4 million (couples); Amounts indexed for inflation; Tax repealed after 2024	Top rate of 40% on estates above $11.2 million; $22.4 million (couples); Amounts indexed for inflation; Sunsets after 2025[a]
ACA individual mandate penalty[c]	Individuals without adequate health insurance coverage must pay a tax penalty or claim a coverage exemption.	Unchanged	Repealed

Source: Joint Committee on Taxation, Description of H.R. 1, the "Tax Cuts and Jobs Act" (JCX-50-17), November 3, 2017 and Tax Cuts and Jobs Act, S. H.R.1, 115th Cong. (2017). https://www.finance.senate.gov/imo/media/doc/12.1.17%20TAX%20SUBSTITUTE.pdf

(a) Provisions revert to current law in 2026. Inflation indexed tax parameters are computed using the chain-weighted consumer price index.
(b) For more information, see http://www.taxpolicycenter.org/briefing-book/what-tax-incentives-exist-help-families-pay-college
(c) For more information, see https://www.irs.gov/affordable-care-act/individuals-and-families/aca-individual-shared-responsibility-provision-calculating-the-payment