LOEB & LOEB LLP

Tax Law

NOVEMBER 2017

Highlights of House of Representatives Tax Bill

On November 2, 2017, Representative Kevin Brady introduced H.R. 1, the “Tax Cut and Jobs Act” in the United States House of Representatives. Below is a very brief summary of the provisions of the House Bill that we believe are of greatest interest to the readers of our newsletters.

We know from long experience that if any tax legislation is enacted this year, it likely will be significantly different from the November 2 House Bill. The Ways and Means Committee will make some changes, the Senate is expected to release its version of the legislation next week, and further discussions and negotiations will ensue. We will keep you apprised of further developments as warranted.

Estate, Gift and Generation-Skipping Transfer Taxes

Beginning in 2018, the lifetime exemption from the estate, gift and generation-skipping transfer taxes increases to $10 million, indexed for inflation. The House Bill repeals the estate tax and generation-skipping transfer tax for decedents dying after December 31, 2023. Indexed for inflation, the 2018 exemption would be $11.2 million per person, because the indexing still relates back to 2011.

The House Bill does not repeal the gift tax. As noted above, in 2018 the lifetime exemption increases to $10 million, indexed for inflation back to 2011 (again, $11.2 million per person in 2018). A new tax rate schedule becomes applicable for gifts made after December 31, 2023. On that date, the maximum gift tax rate decreases from 40 percent to 35 percent. The present interest annual exclusion for gifts up to $15,000 (as of 2018) remains, with further inflation indexing of the annual limitation.

For noncitizen nondomiciliaries of the U.S., the House Bill repeals the estate tax for decedents dying after December 31, 2023. Prior to that date, the applicable estate tax exemption remains $60,000 on assets located in the U.S. The gift tax for noncitizen nondomiciliaries of the U.S. remains in place for gifts of U.S.-based real and tangible property with no lifetime exemption (although the annual exclusion can be used).

Basis Increase at Death

The House Bill leaves intact Internal Revenue Code (“IRC”) Section 1014, which provides that the income tax basis of property received from a decedent is the fair market value of the property on the date of the decedent’s death (or on the alternate valuation date, generally six months later, if elected).

Maximum Tax Rate

The House Bill preserves the current highest marginal income tax rate of 39.6 percent; however, beginning in 2018, for taxpayers filing a joint return, this rate will not become applicable until their taxable income exceeds $1 million, compared to $470,700 in 2017. For separate returns and unmarried individuals, the 39.6 percent rate will become applicable when their taxable income exceeds $500,000 compared to $418,400 for unmarried individuals and $235,350 for married individuals filing separate returns in 2017. Estates and trusts will pay income tax at the highest rate on their taxable income in excess of $12,500. The maximum tax rate on long-term capital gain income will remain at 20 percent. The 3.8% Medicare tax is not repealed by the House Bill and this will be added to most capital gains.

Alternative Minimum Tax

The House Bill repeals the alternative minimum tax beginning in 2018.

Business Income Received by Individuals and From Pass-Through Entities

The House Bill adopts a 25 percent income tax rate on qualified business income of individuals, including income received through pass-through entities such as S corporations, partnerships and limited liability companies. The provision contains a number of rules to prevent the 25 percent rate from applying to income earned in any manner from the performance of services.

For businesses considered passive activities (excluding investment types of income), all income from the business is treated as qualified business income. For this purpose, passive activities are defined in the same manner as under current law, so it appears that rental income from real property will qualify for the 25 percent rate.

For active businesses, i.e., businesses in which the taxpayer materially participates, 30 percent of the income is presumed to come from capital and, therefore, is subject to the 25 percent maximum rate, while the other 70 percent is presumed to come from the services of the taxpayer and is subject to the maximum rate of 39.6 percent.

Treatment of Sales of Patents

Beginning in 2018, gain from the sales of self-created patents will be treated as ordinary income rather than capital gain.

Sales of Music Copyrights

Beginning in 2018, gain from the sales of self-created copyrights in music will be treated as ordinary income rather than capital gain.

Itemized Deductions

Charitable contributions. The limitation on the deduction of cash contributions to public charities and private operating foundations increases from 50 percent of the taxpayer’s adjusted gross income to 60 percent beginning in 2018.

State and local taxes. Beginning in 2018, state and local income taxes will no longer be deductible. The deduction for taxes on real property will be limited to $10,000; however, this limitation does not apply to real property taxes paid in connection with business or investment real property.

Home mortgage interest. The deduction of interest on existing home mortgages will continue to be subject to the current limitation of a $1 million loan amount. The deduction of interest on new home mortgages originated on or after November 2, 2017, will be limited to a $500,000 loan amount.

Medical expenses. Medical expenses will no longer be deductible beginning in 2018.

Alimony payments. The deduction for alimony payments is eliminated for divorce and separation agreements executed after 2017. Such alimony payments will be non-taxable to the recipient.

Casualty losses. Casualty losses will no longer be deductible beginning in 2018, except for casualties suffered for which special disaster relief legislation is enacted.

Employee expenses. Unreimbursed business expenses incurred by employees will no longer be deductible beginning in 2018.

Tax preparation fees. Fees incurred for the preparation of income tax returns by individuals will no longer be deductible beginning in 2018.

Student loan interest. Student loan interest will no longer be deductible beginning in 2018.

Overall limitation on itemized deductions. The phaseout of itemized deductions is repealed for tax years after 2017.

Like-Kind Exchanges

IRC Section 1031 would be amended to limit tax-deferred exchanges to those involving real property. Exchanges of like-kind personal property will be subject to taxation after 2017.

Business Tax Reform

Corporate tax rate. Beginning in 2018, the maximum income tax rate for C corporations will be reduced to 20 percent and personal service corporations will be taxed at a 25 percent rate.

Cost recovery. The House Bill provides for an immediate deduction for the cost of qualified property placed in service between September 27, 2017, and January 1, 2023. The property does not have to be new property. In general, qualified property is personal property with a depreciable life of 20 years or less. Property used in a real property business does not qualify, nor does property used by a business that is exempt from the limitation on the deduction of interest.

Increase in amount that can be expensed under IRC Section 179. The amount of depreciable property that can be expensed under IRC Section 179 increases from $500,000 to $5 million. The phaseout of the deduction will not begin until purchases exceed $20 million, compared with $2 million under current law.

Business interest expense. Beginning in 2018, the deduction of interest by a business would be limited to 30 percent of its adjusted taxable income, with certain exceptions made for businesses having average gross receipts of $25 million or less and real property trades or businesses.

Nonqualified deferred compensation. The ability to defer the taxation of deferred compensation will be significantly scaled back after 2017. Any deferred compensation will become taxable in the year in which it is no longer subject to a risk of substantial forfeiture, which is limited to the requirement that future substantial services must be performed. The fact that the compensation is not payable until a subsequent year will not prevent it from being taxable in the year in which it is no longer subject to a substantial risk of forfeiture.

Compensation deferred before 2018 will become taxable on the earlier of the 2025 tax year or the year in which it is no longer subject to a substantial risk of forfeiture.

Private Foundations

Our Nonprofits and Tax Exempt Organizations group will be sending further details on provisions related to these organizations. Some of the provisions of broad interest are described here.

<u>Excess business holdings.</u> Beginning in 2018, the House Bill repeals the provision that imposes an excise tax on private foundations that hold more than 20 percent of the interest in a business for holdings that meet the following requirements: i) the foundation must hold all of the voting stock of the business; ii) the business must not have been purchased by the foundation; iii) the business must distribute all of its net operating income to the foundation within 120 days of the close of its tax year; and iv) the directors and executive of the business are not "substantial contributors" to the foundation nor comprise a majority of the private foundation's board.

<u>Private foundation excise tax.</u> Under current law, private foundations pay a 2 percent excise tax on their net investment income, which can be reduced to 1 percent under certain circumstances. The 1 percent tax would be eliminated and the 2 percent tax would be lowered to 1.4 percent.

<u>New excise tax on compensation.</u> The House bill adds new IRC section 4960 which would impose a new excise tax (20%) on exempt organization executive compensation over $1,000,000. The tax is paid by the foundation, but in a state with active Attorney General oversight, the Attorney General may seek to surcharge the directors for such tax.