LOEB & LOEB LLP

Tax Law

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Highlights of Senate Tax Bill

The Senate Finance Committee has released a description of the chair's mark of the Tax Cut and Jobs Act that was prepared by the staff of the Joint Committee on Taxation. While the committee released the description November 9, the actual text of the Senate bill will not be released until it is marked up by the Finance Committee this week. The House Ways and Means Committee approved the House bill with some changes, and the full House is scheduled to vote on the bill this week. The Senate bill has some similarities to and some differences from the House bill. Below is a very brief summary of the key provisions of the Senate bill and a comparison to the House bill.

If both the House and Senate enact their respective bills, a conference committee will be appointed to reconcile the differences between the bills. Both chambers will vote again on the resulting conference bill.

Estate, Gift and Generation-Skipping Transfer Taxes

Like the House bill, the Senate bill will also double the exemption from estate, gift and generation-skipping transfer taxes beginning in 2018. The description mentions only estate and gift taxes, but we assume the exemption will also be increased for the generation-skipping transfer tax. The exemption is also indexed for inflation from 2011; for 2018 it is expected to be $11.2 million. In a major deviation from the House bill, the Senate bill does not repeal the estate and generation-skipping transfer taxes after 2023, and also leaves the tax rate at 40 percent.

Basis Increase at Death

The Senate bill and House bill both leave intact Internal Revenue Code 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 Senate bill lowers the maximum income tax rate to 38.5 percent beginning in 2018. As in the House bill, the maximum rate will become applicable when taxable income exceeds $1 million on a joint return and $500,000 on the return of a single individual or a married person filing separately. The House bill left the maximum rate at its current 39.6 percent. The maximum tax rate on long-term capital gain income will remain at 20 percent under both bills. Neither bill repealed the 3.8 percent Medicare tax.

Alternative Minimum Tax

The Senate bill, like the House bill, repeals the alternative minimum tax beginning in 2018.

Business Income Received by Individuals and From Pass-Through Entities

The Senate bill takes a different approach for the taxation of qualified business income of individuals, including income received through pass-through entities such as S corporations, partnerships and limited liability companies. The bill provides for a deduction from this income in the amount of 17.4 percent of the taxpayer's net qualified business income. Like the House bill, the provision does not apply to personal service income, except for taxpayers who earn limited amounts. The deduction results in a maximum marginal tax rate of 31.8 percent. The House bill provides for a tax rate of 25 percent on a portion of this business income.

The Senate bill provides that for income from S corporations and partnerships, this deduction is limited to 50 percent of the taxpayer's W-2 income from these entities. This will need to be clarified in the bill text, because partners of partnerships do not receive W-2s even if they receive a guaranteed salary.

The Ways and Means Committee amended the House bill to remove the provision that classified all the income not subject to the special 25 percent rate as net earnings from self-employment.

Carried Interests

A carried interest is generally an interest that a service provider receives in the future profits to be earned by a partnership or limited liability company. The interest is generally granted for the performance of services rather than the provision of capital to the business. Critics of the existing carried interest rule have suggested that it's not good tax policy to permit an employee to ultimately recognize capital gain income as compensation for services. The Senate bill has no provision on carried interests. The initial draft of the House bill did not have a provision either; the conference committee added a requirement to the House bill that such a partnership interest must be held for at least three years.

Treatment of Sales of Patents

The Senate bill leaves unchanged the current treatment of gains from the sales of self-created patents as capital gain, whereas the House bill would subject these gains to taxation as ordinary income.

Sales of Music Copyrights

The Senate bill also leaves intact the current provision that allows capital gain treatment for gains arising from the sales of self-created copyrights in music. The House Ways and Means Committee has also removed from the House bill the provision that would have treated such gains as ordinary income.

Itemized Deductions

Charitable contributions. The Senate bill follows the House bill in increasing the limitation on the deduction of cash contributions to public charities and private operating foundations from 50 percent of the taxpayer's adjusted gross income to 60 percent beginning in 2018.

State and local taxes. Beginning in 2018, the Senate bill will repeal all deductions for state and local taxes. The Senate bill does not allow the $10,000 deduction for taxes on real property that is provided in the House bill.

Home mortgage interest. The Senate bill leaves the deduction of interest on home mortgages unchanged, whereas the House bill limits the deduction for interest on new mortgages to a $500,000 loan amount. The Senate bill does repeal the deduction of interest on home equity loans beginning in 2018. Previously, interest could be deducted on home equity loans of up to $100,000.

Medical expenses. The Senate bill also leaves intact the deduction from medical expenses, which the House bill repeals.

Alimony payments. The Senate bill leaves unchanged the deduction for alimony payments; the House bill repeals this deduction.

Casualty losses. The Senate bill limits the deduction for casualty losses to losses sustained from events declared by the president to be disasters. The House bill limits the deduction to casualties suffered for which special disaster relief legislation is enacted.

Tax preparation fees. Fees incurred for the preparation of income tax returns by individuals will no longer be deductible beginning in 2018. This same provision is in the House bill.

Miscellaneous itemized deductions. Similar to the House bill, the Senate bill repeals all the miscellaneous itemized deductions that were subject to the floor of 2 percent of adjusted gross income, beginning in 2018.

Student loan interest. The Senate bill leaves intact the deduction for interest expense incurred on a student loan. This deduction is repealed by the House bill beginning in 2018.

Overall limitation on itemized deductions. The phaseout of itemized deductions is repealed for tax years after 2017, as in the House bill.

Like-Kind Exchanges

In the Senate bill, as in the House bill, IRC Section 1031 is 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. The Senate bill and House bill both lower the maximum income tax rate for C corporations to 20 percent, but the Senate bill will defer such rate reduction until 2019. The Senate bill does not contain the 25 percent rate for personal service corporations that is in the House bill.

Cost recovery. The Senate bill also provides for an immediate deduction for the cost of qualified property placed in service between September 27, 2017, and January 1, 2023. The Senate bill differs from the House bill in that it does require the property 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.

Cost recovery with respect to real property. The Senate bill reduces the recovery period for the cost of both residential and nonresidential real property from 39 years and 27.5 years, respectively, to 25 years for both types of property. The House bill does not contain this provision.

Increase in amount that can be expensed under IRC Section 179. The Senate bill is less generous than the House bill regarding the amount of depreciable property that can be expensed under IRC Section 179. The Senate bill increases the amount to $1 million, and the phaseout will begin at $2.5 million. Under the House bill, the deductible amount is increased to $5 million and the phaseout of the deduction will not begin until purchases exceed $20 million.

Business interest expense. Beginning in 2018, the deduction of interest by a business would be limited to 30 percent of its adjusted taxable income plus the amount of business interest income, with certain exceptions made for businesses having average gross receipts of $15 million or less (compared with $25 million in the House bill) and real property trades or businesses.

Limitation on deduction of business losses. The Senate bill imposes a limitation on the deduction of business losses for all taxpayers other than C corporations. A loss in excess of $500,000 cannot be deducted in the current year but will carry over as part of the taxpayer's net operating loss. Net operating losses can be deducted in an amount up to 90 percent of the taxable income of the taxpayer before taking into account the net operating loss deduction.

Compensation Provisions

Nonqualified deferred compensation taxed on vesting. Although the House bill was revised this week to remove the limitation on nonqualified deferred compensation, the Senate bill includes the repeal of old Section 409A and adoption of a new Section 409B that would include compensation in income when it is no longer subject to a "substantial risk of forfeiture" —effectively on vesting — even if not payable until a future year, unless paid by March 15 of the year after the year of vesting. As in the House bill, the Senate bill narrowly defines “substantial risk of forfeiture” as “conditioned on the future performance of substantial services” such that neither a performance condition nor a noncompete qualifies. This apparently means that contingent compensation will need to be valued based on some form of risk adjustment and included in income at the time services are complete, although neither bill includes any guidance on valuation or subsequent tax treatment of contingent amounts once taken into income.

Stock options and SARs are specifically included in the Senate bill’s definition of nonqualified deferred compensation. There is an exception in the Senate bill for statutory stock options (ISOs and qualified ESPP options) for which there is no disqualifying disposition.

The Senate bill’s restrictions apply to compensation for services performed after December 31, 2017. Existing deferred compensation amounts are grandfathered, but must be paid out before 2027 (one year later than under the original House bill).

<u>Limitations on executive compensation.</u> Section 162(m) currently imposes an annual limit of $1 million on the deductibility of compensation paid by a public company to each of its covered employees (the CEO and the three other highest-paid executive officers, other than the CFO). The Senate bill includes the same amendments to Section 162(m), repealing the prior exceptions for performance-based compensation including stock options and expanding the list of covered employees to include the CFO, and once employees are covered, they will continue to be included for as long as they receive compensation from the company (including after termination of employment). The amendment applies to taxable years beginning after December 31, 2017.