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TAX REFORM UPDATE

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By: **John W. Schmehl**, **Matthew I. Whitehorn** and **Stephanie L. Searles**

Congress has passed the largest structural overhaul of the U.S. tax system since 1986, the Tax Cuts and Job Act of 2017 (the "Act"), which is now awaiting the President's signature. One of the most significant (and controversial) proposed changes has to do with the taxation of income from pass-through business entities (partnerships, S corporations, sole proprietorships). Under the final version of the pass-through provisions (for which the Conference Committee generally adopted the Senate bill's approach), 20% of income from certain pass-through entities can be deducted by taxpayers. The remaining income is still subject to taxes at regular rates, up to the proposed top rate of 37% (which would be a 2.6% decrease from the current top rate of 39.6% in 2017). The 20% deduction can limit the tax rates to 29.6% (37% x 80%).

For an individual taxpayer with less than $157,500 in annual income (or $315,000 for a married couple), there is no limit on the 20% pass-through business income deduction, meaning that the full deduction is allowed. With respect to an individual taxpayer who makes more than $157,500 annually (or $315,000 for a married couple), the 20% pass-through business income deduction is limited, or phased out entirely, where the taxpayer is in a "specified service business" (which includes the medical, legal, financial services and consulting fields). Finally, for an individual taxpayer with more than $157,500 in annual income (or $315,000 for a married couple) in a business other than a specified service business, the deductible amount of pass-through business income is capped at the greater of: (i) 50% of the wages paid by the business, or (ii) 25% of wages plus 2.5% of the unadjusted basis immediately after acquisition of the business's "qualified property" (which is tangible, depreciable property (i.e., capital investment that a pass-through business uses to produce income).

This second limitation mentioned immediately above is what has drawn much criticism from Democrats because it would likely allow wealthy real-estate investors without significant payroll to benefit under the pass-through provision. Rep. Kevin Brady (R. Texas), chairman of the House Ways and Means Committee, said it was "important" to include this second threshold test because it would encourage capital investments by owners of pass-through entities. The Act also provides that trusts and estates are eligible for the 20% pass-through deduction.

The Act makes many other notable changes from the current tax regimen including, but not limited to:

– Lowers the corporate tax rate from 35% to 21% (beginning Jan. 1, 2018) – down from 35%, which today is the highest in the industrialized world – the largest reduction in the U.S. corporate tax rate in our nation's history.

- Limits net operating loss (NOL) deductions to 80% of taxable income for losses arising in tax years beginning after 2017. NOLs will be permitted to be carried forward, but not backward.
- Repeals the corporate alternative minimum tax (AMT). The individual AMT is retained, with increased phase-out thresholds.
- Lower individual tax rates to 0%, 10%, 12%, 22%, 24%, 32%, 35%, and 37% (the highest rate is currently 39.6%), but reduces the top bracket's threshold.
- Eliminates Obamacare's individual mandate penalty tax for uninsured taxpayers and dependents as of 2019, which is predicted to draw 13 million individuals off the health insurance rolls and save the government substantial money in subsidies.
- Significantly increases the standard deduction from $6,350 and $12,700 under current law to $12,000 and $24,000 for individuals and married couples, respectively, but eliminates personal exemptions.
- Limits the state and local tax deduction to $10,000.
- For all homeowners with existing mortgages that were taken out to buy a home, there will be no change to the current mortgage interest deduction. For homeowners with new mortgages on a first or second home, it makes the home mortgage interest deduction available on mortgages up to $750,000.
- Imposes a 21% excise tax on non-profit entities with respect to remuneration over $1 million in a year paid to certain employees.
- Provides for a mandatory foreign holdings repatriation toll tax of 15% for cash and 8% for illiquid assets for international business.
- Provides a 5-year period for immediate write-offs of certain business property.
- Limits certain business interest deductions.
- Increases the amount that can be passed tax-free from estates from $5.49 million to $11.9 million ($22.4 million per married couple).

Due to Senate parliamentary rules, the formal name of the Act was changed to: "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

If you have any questions with how these provisions may affect you or your business, contact **John W. Schmehl**, **Matthew I. Whitehorn**, or **Stephanie L. Searles**.