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Federal Tax Reform: The House Tax Bill—Summary and Where Do We Go From Here?

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House Republicans released their tax bill—the Tax Cuts and Jobs Act—last Thursday. Although its provisions are generally in line with the House Republican Blueprint for Tax Reform released in June 2016 by House Speaker Paul Ryan (R-WI), and House Ways and Means Committee Chair Kevin Brady (R-TX), and the tax plan released by President Trump on April 26, 2017, it contains several unexpected provisions that are already controversial.

The table below summarizes some of the key provisions of the House bill, and compares them with the proposals contained in the House Blueprint and the Trump Plan[1]. Below the table, we discuss the likelihood of, and the timetable for, passage.

PROPOSAL

Standard Deduction and Personal Exemption (Single Filers/ Joint Filers)

House Bill	House Blueprint	Trump Plan
$12,000/ $24,000 -No personal exemptions	$12,000/ $24,000 -No personal exemptions	$15,000/ $30,000 -No personal exemptions

Observations:

The House bill would nearly double the current standard deduction of $6,350 for single individuals and married individuals filing separately and $12,700 for married individuals filing a joint return. But the personal exemption (currently $4,050 each for the taxpayer, the taxpayer's spouse, and any dependents) would be eliminated. This likely will lead fewer individuals to choose to itemize deductions, since for many people the standard deduction would exceed itemized deductions (especially with the scaling back of the ability to take certain expenses as itemized deductions, outlined below).

PROPOSAL

Individual Marginal Tax Rates

House Bill	House Blueprint	Trump Plan
12%	12%	12%
25%	25%	25%[1]
35%	33%	35%
39.6%		

The retention of the 39.6% rate by the House bill is a surprise. Compared with existing tax brackets, however, the top rate of 39.6% appears to apply to higher income levels: single filers earning more than $500,000 and joint filers earning more than $1 million.

PROPOSAL

Individual Capital Gains Rates

House Bill	House Blueprint	Trump Plan
15%	6%	15%
20%	12.5%	20%
	16.5%	
-The 3.8% net investment income tax (NIIT) imposed under Affordable Care Act (ACA) retained	-The 3.8% NIIT of ACA repealed	-The 3.8% NIIT of ACA repealed

Observations:

The House bill preserves the existing capital gains tax rates, but again, the higher rate appears to apply to higher tax brackets as compared with existing tax brackets. In contrast to the House Blueprint and the Trump Plan, the 3.8% NIIT is not proposed to be repealed by the House bill (likely because it would increase the deficit too much).

PROPOSAL

Individual Deductions

House Bill	House Blueprint	Trump Plan
-State and local income or sales tax deductions: eliminated -Real property tax deduction: capped at $10,000 -Mortgage interest deduction: keeps the mortgage-interest deduction, but only for first $500,000 of loans for newly purchased homes (reduced from $1 million limit); deduction for second homes would be eliminated, as would deduction for interest paid on home-equity loans. -Extends holding period required for gain from sale of personal residence to qualify for exclusion, and phases out exclusion starting at certain adjusted gross income levels. -Medical expenses: eliminated	-All itemized deductions other than mortgage interest deduction and the charitable contribution deduction would be eliminated.	-Itemized deductions would be capped at $200,000 for married joint filers or $100,000 for single filers.

Observations:

The cap on the mortgage interest deduction, the elimination of the state and local tax deduction, and the cap on the real property tax deduction are among the most controversial proposals of the bill and have vocal critics, including many real estate industry groups. Blue-state Republicans such as

Representative Peter King (R-NY) have indicated a strong desire to keep the deduction, as it is important to their constituents. It remains to be seen whether this will affect their support for the bill.

PROPOSAL

Corporate Tax Rate

House Bill	House Blueprint	Trump Plan
20%	20%	15%

Observations:

There was considerable debate about whether this would be proposed as a permanent rate reduction or a temporary one leading up to the release of the House bill. The bill reflects this as a permanent reduction, with no phase-in. It is unclear if the bill to be released by the Senate can keep the corporate tax rate this low.

PROPOSAL
Interest Deductibility

House Bill	House Blueprint	Trump Plan
-Cap on business interest deductions equal to the sum of business interest income plus 30% of adjusted taxable income. -Any interest amounts disallowed for the taxable year would be carried forward to the next five taxable years. -Cap does not apply to some real property businesses, regulated public utilities, and small businesses with average gross receipts of $25 million or less.	-Business interest deductible only against interest income (and interest amounts could be carried forward indefinitely); otherwise interest expense eliminated.	-Business must elect whether to claim a net interest deduction or expense capital investment.

Observations:

Given how much many in the financial, private equity, real estate, and other industries have historically relied on—and currently rely on—the interest deduction in their business models and determinations of price for various purchases, this proposal will likely face significant pushback.

PROPOSAL
Immediate Expensing

House Bill	House Blueprint	Trump Plan
-Accelerated recovery of certain capital expenses, including full expensing for a five-year period.	-Immediate expensing/full deduction of business investments in tangible property and intangible assets.	-Firms engaged in manufacturing in the U.S. may elect to expense capital investment and lose the deductibility of corporate interest expense, or to deduct net corporate interest expense.

Observations:

The immediate-expensing proposal was highly touted by House Republicans. The phase-out after five years is new.

PROPOSAL
Pass-Through Business Income

House Bill	House Blueprint	Trump Plan
-Maximum tax on business income of owners and shareholders of pass-through businesses and sole proprietorships is 25%. -However, only passive owners/investors in such businesses are entitled to the 25% rate. -"Professional services" businesses could not automatically qualify for the rate.	-Maximum tax rate on business income of individuals from pass-through entities they own would be 25%. -Pass-through businesses will pay or be treated as having paid "reasonable compensation" to their owner-operators which would be taxed at regular rates, higher than 25%.	-Support for lower, 15% tax rate on pass-through entities' business income.

-Other business owners could choose from two options: 1. Default rule: 30% of income is considered attributable to the capital of the business (and subject to the 25% rate), and other 70% taxed at regular individual rates; 2. Establish a different ratio based on facts and circumstances. -For personal-service businesses (activity involving performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or investing, trading, or dealing in securities, partnership interests, or commodities) the default rule does not apply.			

Observations:

This proposal is also one of the more controversial areas of the bill. The complexity is aimed at preventing abuse of the 25% rate by high wage taxpayers using pass-through entities to get the tax cut. Critics say the proposal does not do enough to aid small businesses.

PROPOSAL

Carried Interest

House Bill	House Blueprint	Trump Plan
Silent	Silent	-Appeared to suggest that carried interest should be taxed as ordinary income. -However, 15% tax rate on pass-through entities' business income would have allowed hedge fund and private equity managers to retain substantial tax advantages compared to other workers.

Observations:

Some have observed that changing the existing favorable tax treatment of carried interest will be raised in the future. However, we note that since carried interests are in pass-through entities, even if their tax treatment is "called out" in the future, given the special 25% rate that would apply to pass-through business income, the increase in tax on carried interest may not be terribly significant.

PROPOSAL
Repatriation of Foreign Earnings

House Bill	House Blueprint	Trump Plan
-One-time transition tax on currently accumulated foreign earnings that would be deemed repatriated. Rate is 12% for earnings held in form of cash or cash equivalents, and 5% for other earnings. -Going forward, dividend exemption for 100% of foreign-source dividends from foreign subsidiaries.	-One-time transition tax on currently accumulated foreign earnings that would be deemed repatriated. Rate would be 8.75% to the extent held in cash or cash equivalents and 3.5% otherwise.	-One-time transition tax on deemed repatriation of corporate profits held offshore at 10%. However, note that the Unified Framework for Tax Reform that was released on September 27 by the "Big Six" appeared to suggest that a reduced tax rate would continue to apply to the foreign profits of U.S.

-However, despite the tax being called "territorial," there will be a 10% minimum tax imposed on certain foreign profits above a certain threshold from foreign subsidiaries of U.S. companies.		multinational corporations prior to the repatriation of earnings.

Observations:

The mandatory 12% tax on cash-backed foreign accumulated earnings has surprised most, as it is higher than expected and prior Republican proposals. In addition, given that the House Blueprint and the Unified Framework for Tax suggested that U.S. multinationals would be taxed on a territorial rather than worldwide basis, the House Bill's retention of a 10% worldwide income tax on U.S. multinationals' "foreign high-rate returns" is also a surprise. Under the new regime, U.S. multinationals will be subject to the 10% tax on a foreign subsidiary's aggregate net income in excess of a "routine return" (7% plus the federal short-term rate) on its depreciable tangible property, adjusted downward for interest expense, as well as other exclusions for income effectively connected to a U.S. trade or business, Subpart F income, certain insurance and financing income that meets the requirements for the active finance exemption (AFE) from Subpart F income, and certain related-party payments. The fact that the House Bill retains vestiges of the old worldwide tax regime by imposing a 10% tax on certain offshore profits earned by U.S. multinationals' foreign subsidiaries means that the House GOP plan is not, in fact, fully territorial.

PROPOSAL
Alternative Minimum Tax

House Bill	House Blueprint	Trump Plan
Eliminated for individuals and corporations.	Eliminated for individuals and corporations.	Eliminated for individuals and corporations.

Observations:

Generally in line with expectations

PROPOSAL
R&D Tax Credit, Low Income Housing Tax Credit (LIHTC) and Section 199 Deduction

House Bill	House Blueprint	Trump Plan
-R&D credit and LIHTC retained -Section 199 deduction eliminated	-R&D credit and LIHTC retained -Section 199 deduction eliminated	-Would have eliminated most corporate tax expenditures except for the R&D credit. -More details not

		provided

PROPOSAL
Pre-tax contributions to 401(k) Plans

House Bill	House Blueprint	Trump Plan
-Not included, but was in discussions leading up to release of bill	Silent	Silent

Observations:

It will be interesting to see if this arises again in amendments to the existing bill or in the Senate bill.

What Happens Now?

The tax-writing House Ways and Means Committee will begin considering the bill today. Representative Brady has released a Chairman's Mark already, which included "technical changes" and a change to conform the bill to the budget reconciliation instructions, and reduced the increase in deficit in the next 10-year period from almost $1.5 trillion to $1.41 trillion. He plans to offer another more substantive amendment at the start of the markup. Brady has said he expects the debate to conclude by Thursday. House Republicans' aim is to have the bill passed by Thanksgiving and moved on to the Senate. Brady has acknowledged that Republicans are looking to pass the tax bill quickly in order to notch a legislative victory before the 2018 midterm elections.

Is the House Bill Likely to Pass in the Senate?

All indications point to the Senate using the budget reconciliation process to pass tax reform because it requires only 50 votes instead of the 60 votes required to enact legislation outside the reconciliation mechanism. Because there are only 52 Republicans in the Senate, Democratic votes would needed to secure passage. As we understand, Republican leaders have not been trying to reach across the aisle for votes. This means that as currently enacted, the House bill cannot pass the Senate. To elaborate further: The budget was passed by the House and Senate on October 26, 2017, and the budget reconciliation instructions—which must be followed in order to change tax rules via the reconciliation process—allow for a tax bill to be passed that would increase the deficit by up to $1.5 trillion over the next 10-year period. The deficit cannot be increased by the tax legislation after the 10-year mark. The House bill is estimated to increase the deficit by approximately $1.5 trillion over the next 10-year period.

However, critically, there are not enough measures in the bill to stop the increase in deficit beyond a 10-year period. There are not tax cuts that expire in the eleventh year, or tax increases that go into effect in the eleventh year. In other words, the House bill does not provide for enough of the tax cuts to be temporary, or provide for additional tax increases after 10 years that would ensure that the deficit did not continue to increase after the 10-year period. Unless the bill is significantly amended prior to its passage in the House, it almost certainly will not pass in the Senate.

Meanwhile, the Senate has been working on its own bill, which may be released later this week. Since, as discussed above, the Senate most likely will use the reconciliation process, its bill will almost certainly have tax or revenue increases (as compared with the House bill), or a time limit on tax cuts.

Will Temporary Cuts Become Permanent?

Notably, the point has been made by commentators that even if the tax cuts are announced as temporary, once temporary tax cuts are in place, there is a likelihood that they will become permanent. For example, the Bush tax cuts were supposed to be in place for only 10 years. However, they were made permanent upon expiration. This is because once they expire, reverting back to the old rates is often viewed as a "tax increase." To counter that, there tends to be a large push at the time of expiration to make the cuts permanent. This may happen again.

Given that the House Republicans have a goal for completing tax reform by the end of the year, there is sure to be a great deal of activity and discussion of the bill in the coming weeks.

This is the latest in an ongoing series of Ballard Spahr advisories on the federal tax reform effort and its potential impact on organizations and people across the American economy. An alert on how the tax plan would affect employee benefits and compensation is available here. To read an alert on the provisions repealing the tax exemption for private activity bonds, and the repeal of advance refunding bonds, please click here.

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1. The Trump Plan refers to the plan released by the White House on April 26 as well as the tax plan then-candidate Trump described in speeches on August 8, September 13, and September 15, 2016, on his campaign's website and in other statements he made, including on Twitter.

2. These rates were proposed by President Trump on April 26, 2017. Earlier, as candidate, he had proposed 12%, 25%, and 33%.

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