Wealth Planning Insights

Tax Bill Negotiations: Key Focus Areas

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Highlights

- On November 2, the House Ways and Means Committee released the first detailed draft of tax cut legislation, the Tax Cuts and Jobs Act (referred to here as the House bill).
- The process is far from over. The House bill is likely to face significant pushback and modification. The Senate still has to produce its version, and differences between the two must be sorted out. The final version may bear little resemblance to this first draft.
- In this piece, we focus on potential implications for individuals; our investment team is also monitoring developments and will communicate on the potential impact of individual and corporate tax changes for markets and the economy as the legislative process unfolds.
- We will be watching several key areas throughout the negotiations. Based on our experience, these issues are likely to have a substantial impact on Bessemer clients: a reduced tax rate on flow-through business income, changes to itemized deductions, and repeal of the alternative minimum tax (AMT) and (eventually) the estate tax.
- Tax planning based on proposed legislative changes is challenging. However, we do have clarity on the tax rules currently in place. For 2017, we know the value of deductions claimed as well as the tax cost on recognized income. We can also plan for what may be the last year of alternative minimum tax (AMT). We identify a few planning steps that may be worth considering before year-end.

Tax Rates

Ordinary income. Although the promise of a reduced top tax rate on ordinary income was not delivered in the House bill, there may be a silver lining. The current top rate of 39.6% would apply at a higher taxable income threshold of $1 million, a significant jump from the current level of $470,000. As a result, more ordinary income would be taxed at the 35% rate instead of 39.6%. This widening of the tax brackets could have the effect of offsetting some lost deductions although a phase-out for higher-income taxpayers may erode much of this benefit. The phase-out could actually result in a 45.6% bracket for taxable income between $1.0 million and $1.207 million for single taxpayers and between $1.2 million and $1.614 million for married taxpayers.

Qualified dividends and long-term capital gains. The current top tax rate of 20% on qualified dividends and long-term capital gains was unchanged in the House bill. Further, the 3.8% tax on net investment income was not slated for repeal such that the top combined rate of 23.8% would remain in effect.

Reduced Tax Rate on Flow-Through Business Income

The House bill includes a new maximum tax rate of 25% on the business income earned by individuals through S corporations, partnerships, or LLCs. Under current law, this income is subject to a top tax rate of 39.6%. Anti-abuse rules were included to ensure that income that would otherwise be treated as compensation or wages would not be subject to this preferential rate. For example, business owners who actively participate in the business could elect a 70/30 income split such that 30% of their income would be subject to tax at the lower rate of 25% while 70% would be taxed as ordinary income. A facts-and-circumstances approach could also be employed to justify a more favorable allocation.

Passive investors would be eligible for the reduced tax rate on 100% of their share of business income.

Certain professional service businesses — such as in law, accounting, consulting, and financial services — would not be eligible for the reduced rate.

Most tax legislation creates winners and losers. High-income individuals with qualified flow-through business income are the clear winners in the House bill. This novel approach would seem to present a wide range of planning opportunities for individuals. Tax professionals will be sure to explore creative structuring to take advantage of the significantly lower tax rate while carefully navigating the anti-abuse rules.

Itemized Deductions

State and local taxes. The House bill repeals the deduction for state and local income and sales taxes (SALT) but retains the deduction for real estate taxes subject to a $10,000 yearly cap.

If enacted, this provision would have the greatest impact on high-income taxpayers in high-tax states. It will continue to be opposed vigorously by many House members from states such as New York, California, and New Jersey. While these are historically Democratic states, they do contain many Republican districts whose representatives may not support a measure fully disallowing this deduction.

Although opposition to this proposed change is likely, it is possible that some form of SALT remains in the ultimate bill. Without the significant revenue this creates, it would be difficult to offset the cost of lower tax rates in the House bill.

As a result, taxpayers should consider accelerating the payment of state income taxes that would otherwise be payable in 2018 as well as property taxes to the extent they exceed $10,000. For example, fourth-quarter state estimated tax payments due in January could be accelerated into December 2017. They can also be increased to cover any anticipated state balance due. This strategy would only be beneficial for taxpayers who will not be subject to AMT in 2017.

Charitable contributions. While most provisions governing the deductibility of charitable contributions were not changed in the House bill, there was one surprise. The income-based limit for deducting cash contributions to public charities was increased from 50% of adjusted gross income (AGI) to 60% of AGI.

This would be welcome news for taxpayers who are philanthropically inclined and who often run up against the limits for deductibility. It may also help those with charitable contribution carryforwards that might otherwise expire.

Mortgage interest. Although the deduction for mortgage interest was retained in the House bill, it was scaled back considerably for future home buyers. Going forward, the deduction would be limited to loan amounts of up to $500,000 and on one residence only. The deduction for interest on home equity loans would be repealed. The treatment of existing loans would be grandfathered.

In another jolt to homeowners, the exclusion of up to $500,000 of gain on the sale of a principal residence would be phased out for high-income taxpayers. It would be subject to a dollar-for-dollar phase-out based on adjusted gross income in excess of $500,000 for married taxpayers and $250,000 for single taxpayers. This would apply to sales and exchanges beginning in 2018.

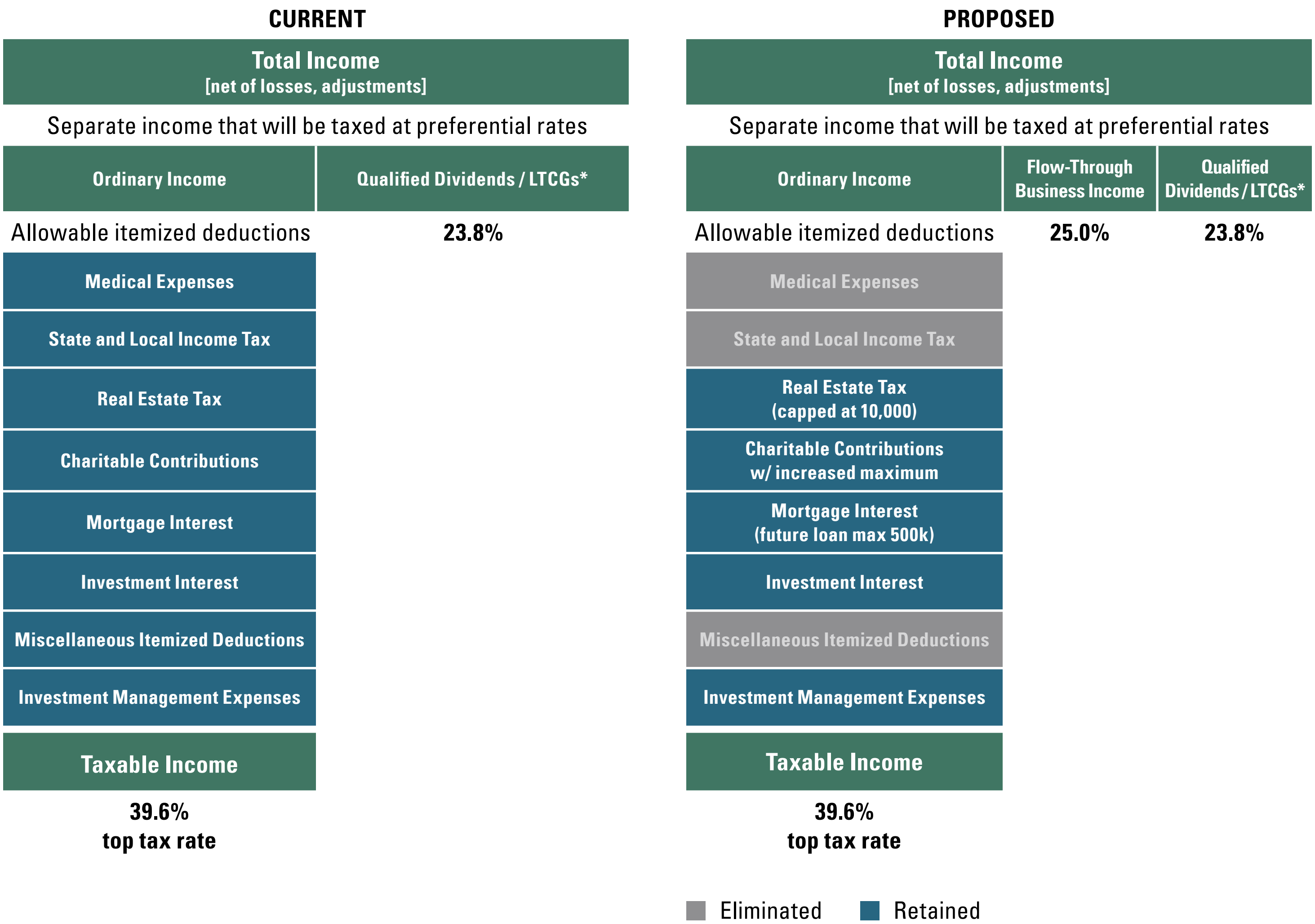
Medical expenses. The House bill fully repeals the deduction for medical expenses.

Alternative Minimum Tax

It is never good to be subject to AMT — by definition you are paying more tax than you would otherwise pay under the regular tax system. The House bill provision that would repeal AMT is sure to be cheered by many, but we also have some significant concerns.

Consider that AMT is a tax system where deductions are basically allowed only for mortgage interest and charitable giving and the top tax rate is 28%. The House bill calls for repealing AMT and replacing it with a very similar tax base where deductions are

Exhibit 1: Individual Tax Changes



* LTCGs are long-term capital gains.
Source: Bessemer Trust

basically allowed only for mortgage interest, charitable giving, and $10,000 in real estate taxes, and the top tax rate is a much higher 39.6%.

On its face, this would suggest that current high-income AMT taxpayers might face a significant tax increase. Taxpayers in this situation may want to defer charitable contributions into 2018 to offset income at higher rates.

There is another potential planning opportunity current AMT taxpayers should consider now that it may be slated for repeal. Although, as noted above, it is never a good thing to pay AMT, the marginal tax rate for AMT taxpayers is only 28%. This means that additional ordinary income can be recognized and taxed at this reduced rate. A Roth IRA conversion, for example, involves the current recognition of taxable income. In the future, this could be taxed at a top rate of 39.6%. If a tax bill passes with AMT repeal effective for 2018, the window for taking advantage of the 28% rate will close on December 31, 2017.

If Roth IRA conversions are considered, it is important to note the House bill would eliminate the ability to recharacterize, or undo, the conversions in the following tax year. This would not apply to 2017 Roth conversions, however.

Estate Tax

The House bill calls for a doubling of the estate tax exemption from $11.2 million for married couples to $22.4 million with full repeal scheduled for 2024, along with the generation-skipping tax. The gift tax would remain in place with this increased exemption amount but at a reduced top rate of 35%. Basis step-up would remain even after estate tax repeal.

The estate tax generates a relatively small amount of revenue since so few estates are large enough to incur this liability. Even fewer would be affected with the increased exemptions proposed in the House bill. It is much more of a political hot button than a revenue source. Several Republican senators have signaled they may be open to retaining the estate tax to keep the focus of the legislation on middle-class tax relief. Assuming the tax legislation eventually reaches conference committee (a committee used when the House and Senate have passed separate bills that have differences to be resolved), we will see whether estate tax repeal becomes a bargaining chip as the House and Senate seek to resolve differences in their respective bills.

Conclusion

It is always helpful to have the actual details of a tax bill to analyze, but even with the release of the House bill, we seem to have more questions than answers. The House mark-up process begins this week, and multiple changes to the current bill are to be expected. The Senate Finance Committee plans to release its version of the legislation later this month. The level of disparity with the House bill may provide some insight on how difficult it will be to reconcile both measures.

Nonetheless, we do expect tax legislation to pass as a result of this effort. It is sure to contain transition rules, effective dates, phase-ins, and possibly sunset requirements for certain provisions if the bill is not revenue neutral. As always, we will keep you informed of the changes and related planning opportunities.