HR 1 – "Tax Cuts and Jobs Act"
Preliminary Look --- Potential Federal Impact on California Residents
November 02, 2017

The following summary includes highlights of the personal income tax and business tax proposal addressed in HR 1 "Tax Cuts and Jobs Act" as published on November 2, 2017. This summary is not comprehensive and therefore does not include all of the bill's provisions. Unless otherwise noted the provisions would be effective for taxable years beginning after 2017.

Personal Income Taxes

Rates & Income Brackets

Reduces the number of federal personal income tax brackets from the current seven to four brackets of 12 percent, 25 percent, 35 percent and 39.6 percent, down from the 10, 15, 25, 28, 33, 35 and 39.6 percent under current law. The proposed brackets appear to be as follows:

Tax Rate	Proposed Taxable Income Brackets[a]			
	Single	MFJ[b]	HOH	MFS
12.0%	$0 to $45,000	$0 to $90,000	$0 to $67,500	$0 to $45,000
25.0%	$45,001 to $200,000	$90,001 to $260,000	$67,501 to $200,000	$45,001 to $130,000
35.0%	$200,001 to $500,000	$260,001 to $1,000,000	$200,001 to $500,000	$130,001 to $500,000
39.6%	Over $500,000	Over $1,000,000	Over $500,000	Over $500,000

a - These income brackets represent the tax rate applied to taxable income after the standard deduction (zero bracket amounts) are applied.

b - Includes the surviving spouse filing status

Standard Deductions

Nearly doubles the standard deduction increasing the deduction from $6,350 to $12,200 for single filers, $12,700 to $24,400 for joint filers and $9,350 to $18,300 for head of household filers and eliminates the additional standard deduction for the aged and the blind.

Itemized Deductions

Eliminates itemized deductions other than home mortgage interest, charitable deductions and property taxes up to $10,000.

Deductions for new mortgages would be capped by limiting the deduction to interest paid on acquisition indebtedness up to $500,000, down from $1 million for ***new*** mortgages that close after November 2017. Repeals the state and local tax deduction, but taxpayers can deduct the cost of state and local property taxes up to $10,000.

Retains the deduction for charitable contributions. Under the provision, the 50 percent AGI limitation for cash contributions to public charities and certain private foundations would be increased to 60 percent. The provision would retain the 5-year carryover period to the extent that the contribution amount exceeds 60 percent of the donor's AGI[1].

---

[1] In general, under current law cash contributed to public charities, private operating foundations, and certain non-operating private foundations may be deducted up to 50 percent of the donor's AGI. Contributions that do not qualify for the 50-percent limitation (*e.g.*, contributions to private foundations)

DRAFT

Itemized Deductions (Continued)

Repeals the overall limitation on itemized deductions commonly referred to as the "Pease limitation" under current law.

Personal Exemptions

Repeals personal exemptions. Under current law, a taxpayer may claim personal exemptions for the taxpayer, the taxpayer's spouse and any dependents. Taxpayers may deduct $4,050 for each taxpayer and qualifying dependent in the 2017 tax year.

Exclusions from Adjusted Gross Income (AGI)

Repeals the following exclusions from AGI. These exclusions are commonly referred to as "above the line deductions":

- Interest payments on qualified education loans, qualified tuition expenses, interest on savings bonds used to pay higher education expenses, qualified tuition reduction programs and employer-provided education assistance
- Employer-provided housing valued at more than $50,000 ($25,000 on a joint return), phased out for higher incomes
- Employee achievement awards
- Dependent care assistance provided by employers
- Qualified moving expense reimbursement
- Adoption assistance
- Expenses attributable to the trade or business of being an employee, except for reimbursed expenses and certain expenses of members of the reserve components of the military
- Contributions to Archer Medical Savings Accounts (due to a consolidation with Health Savings Accounts)
- Alimony payments would not be deductible by the payer or includable as income of the payee

Modifications to the Exclusion on Sale of Principal Residence

The exclusion on a gain from the sale of a principal residence would be phased out for high-earners (AGI higher than $250,000 for a single filer), the exclusion could be used only once every five years and the home must be used as a principal residence for five out of the previous eight years.

Enhanced Child Tax Credit & New Family Flexibility Credit

Increases the Child Tax Credit from $1,000 to $1,600 and provides a new "family flexibility" and non-child dependent credit of $300 for through the 2022 taxable year.

The phase out for the child credit, the non-child dependent credit and the credit for other taxpayers would be increased from $110,000 to $230,000 for joint filers and from $75,000 to $115,000 for all other filers.

may be deducted up to the lesser of (1) 30 percent of AGI, or (2) the excess of the 50-percent-of-AGI limitation for the tax year over the amount of charitable contributions subject to the 30-percent limitation.

HR 1 – "Tax Cuts and Jobs Act"
Preliminary Look --- Potential Federal Impact on California Residents
November 02, 2017

Earned Income Tax Credit (EITC)

The proposal does not appear to modify the credit amount, but would require a "work eligible" social security number for every dependent used to claim the refundable portion of EITC.

Higher Education

Under the provision, the three existing higher education tax credits the American Opportunity Tax Credit, Hope Scholarship Credit (HSC) or the Lifetime Learning Credit (LLC) would be consolidated into an enhanced American Opportunity. Tax Credit (AOTC). The new AOTC, like the current AOTC, would provide a 100 percent tax credit for the first $2,000 of certain higher education expenses and a 25 percent tax credit for the next $2,000 of such expenses.

Like the current AOTC, expenses covered under the credit include tuition, fees, and course materials.
The AOTC would also be available for a fifth year of post-secondary education at half the rate as the first four years, with up to $500 of such credit being refundable.

The HSC and LLC would be repealed.

Income resulting from the discharge of student debt due to death or disability of the student would be excluded from taxable income.

Other Credits

The following other credits would be repealed:

- Credit for taxpayers over 65 or who retire on disability
- Adoption Credit
- Mortgage Credit Certificate Credit
- Plug in electric drive motor vehicle credit

Retirement Plan Contribution Limits

etain contribution limits for retirement plans (i.e. 401(k) and presumably 457 plans).

Alternative Minimum Tax (AMT)

This proposal repeals federal AMT. Taxpayers with existing AMT credit carryovers would be able to claim a refund of 50 percent of the remaining credits from 2019 through 2021. Taxpayers would be able to claim a refund for all remaining credits beginning in the 2022 tax year.

Estate and Generation Skipping

The current estate value exclusion would be doubled from $5 million to $10 million beginning after 2017 and indexed for inflation. The estate and generation skipping taxes would be phased out beginning in 2024. The gift tax would be lowered to a top rate of 35 percent and would retain the basic exclusion amount of $10 million and the annual exclusion amount of $14,000 indexed for inflation.

DRAFT

Business taxes

Business Tax Rate

Lowers the corporate tax rate to 20 percent and lowers the rate for pass-through entities (often small businesses that report taxes as individuals) to 25 percent.

Pass-through (Partnerships, Sole proprietors, LLCs and S-Corps treated as Partnerships)

The bill would reduce the pass-through rate to 25 percent -- but limits the kind of income that would qualify. "Professional services" -- including doctors, lawyers, accountants and others -- wouldn't automatically qualify for the rate.

Other business owners could choose one of two options:

1. Categorize 70 percent of their income as wages -- and pay their individual tax rate on it -- and 30 percent as business income, taxable at the 25 percent rate or;

2. Set the ratio of their wage income to business income based on the level of their capital investment.

The simple approach allows businesses to classify 70 percent of income as wages and 30 percent as income. The second option may allow business owners to have more income classified as business income, rather than wages.

Interest

The deduction for business interest is limited to the sum of business interest income plus 30 percent of the adjusted taxable income of the taxpayer for the taxable year. The amount of any interest not allowed as a deduction for any taxable year may be carried forward for up to five years beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction on a first-in, first-out basis.

Corporations[2]

U.S. firms would generally only be taxed on active domestic income.

Overseas Earnings and Profits

U.S. multinationals would pay a 5 percent or 12 percent tax on "deemed repatriated" income from overseas earnings and profits; payment could be made over eight years. "Deemed repatriated" is calculated as the proportionate share of qualifying untaxed income from foreign subsidiaries[2].

Business Expensing

All qualified business property would be eligible for full and immediate expensing of 100 percent of the cost of qualified property acquired and placed in service after Sept. 27, 2017 and before Jan. 1, 2023 (with small exceptions)[3].

[2] The summary of the tax provisions is taken from the Federation of Tax Administrators draft summary dated November 2, 2017.

[3] Ibid

DRAFT

Business Expensing (Continued)

Property would be eligible if it is the taxpayer's first use of the property instead of the current requirement for original use of the property. Property used by regulated public utility companies or property used in a real property trade or business would not be qualified[3].

The small business expensing limitation under section 179 is increased from $500,000 of the cost of property to $5 million. The phase-out amount is increased from $2 million to $20 million. Energy-efficient heating and air-conditioning property is permanently qualified[3].

Other Provisions

There are a few changes to the interest earned on tax-exempt municipal bonds. The bill would repeal the interest exclusion for private-activity bonds and advance refunding bonds, prohibit the use of tax-exempt bonds to finance and build professional sports stadiums and repeal the use of tax credit bonds[3].

It would no longer be possible to re-characterize a contribution or a conversion of a traditional IRA as a contribution to a Roth IRA (or vice-versa)[3].

All defined benefit plans — including state and local government defined contribution plans — could make in-service distributions beginning at age 59-1/2. It would not be necessary to retire to begin to draw benefits[3].

There are important changes to accounting rules, including the cash method of accounting, accounting for inventories, capitalization of expenses in inventory costs and accounting for long-term contracts. We refer you to the section-by-section for an overview and to the bill language for details[3].

Deductions for businesses with $25 million or more in average gross receipts would not be allowed a net interest expense deduction in excess of 30 percent of the business's adjustable taxable income (as determined at the partnership level, not the partner level, in a partnership)[3].

There is a laundry list of similar changes to business accounting rules. The proposal also repeals the following credits:

- Credit for clinical testing expenses for certain drugs for rare diseases or conditions
- Credit for employer-provided child care
- Rehabilitation Credit
- Work opportunity tax credit
- New Markets Credit
- Credit for expenditure to provide access to disabled individuals
- Credit for portion of employer social security taxes paid with respect to employee tips

Other Provisions

Deduction for lobbying expenses that relate to legislation before local government bodies and repeal of a deduction for expenses relating to entertainment or recreation unless the item is "directly related to the active conduct of the

DRAFT

Other Provisions (Continued)

taxpayer's trade or business." These changes to business accounting rules are important and wide-ranging, but too detailed to list in this summary[4].

Extension and Phase-out of Residential Energy Efficient Property Credits

Under the provision, the credit for residential energy efficient property would be extended for all qualified property placed in service prior to 2022, subject to a reduced rate of 26 percent for property placed in service during 2020 and

22 percent for property placed in service during 2021. The provision would be effective for property placed in service after 2016[5].

Modification of Net Operating Loss Deduction

Under the provision, taxpayers would be able to deduct an NOL carryover or carryback only to the extent of 90 percent of the taxpayer's taxable income (determined without regard to the NOL deduction) – conforming to the current-law AMT rule.

The provision also would generally repeal all carrybacks but provide a special one-year carryback for small businesses and farms in the case of certain casualty and disaster losses.

The provision generally would be effective for losses arising in tax years beginning after 2017. In the case of any net operating loss, specified liability loss, excess interest loss or eligible loss, carrybacks would be permitted in a taxable year beginning in 2017, as long as the NOL is not attributable to the increased expensing (that would be allowed under section 3101).

Additionally, the provision would allow NOLs arising in tax years beginning after 2017 and that are carried forward to be increased by an interest factor to preserve its value.

Like Kind Exchange

Under the provision, the special rule allowing deferral of gain on like-kind exchanges would be modified to allow for like-kind exchanges only with respect to real property.

The provision would be effective for transfers after 2017. However, the provision would provide a transition rule to allow like-kind exchanges of personal property to be completed if the taxpayer has either disposed of the relinquished property or acquired the replacement property on or before December 31, 2017[5].

Examples

The following examples attempt to help illustrate the potential tax impact of H.R. 1 on Californians. The illustrations are based upon federal income taxes and do not account for "other taxes" such as employment taxes, additional taxes on IRAs and net investment taxes.

[4] Ibid
[5] Per the Committee on Ways and Mean "Tax Cuts and Jobs Act" H.R. 1 Summary published November 3, 2017.

DRAFT

Example 1 – Single taxpayer with wages of approximately $31,000

George is single with no children. He earns wages of $31,355 and claims the standard deduction. Under current law George's income tax liability is $2,700. Under the proposed law George's taxes would be $2,299, a decrease of $401 dollars. The savings from the increase in the standard deduction and decrease in the tax rate more than offset the loss of the personal exemption.

Single with Wages of approximately $31,000	
Name	George
Filing Status	single
Dependents	zero
W-2 Wages	$31,355
Deductions	standard
Federal AGI Current Law	$31,355
Tax Current Law	$ 2,700
Tax Proposed Law	$ 2,299
Difference (Decrease)	($401)

DRAFT

DRAFT

Example 2- Head of household taxpayer with wages of approximately $45,000

Elena is single with four dependents, two children under the age of 17 and her two elderly parents. Elena files as head of household, earns wages of $45,327, has other income of $289, and claims the standard deduction. Under current law Elena's income tax liability before credits is $1,799. Elena is entitled to a child tax credit of $2,000 and she uses $1,799 of the credit to reduce her tax to zero. Because Elena's child tax credit was $201 more than her tax liability, Elena received an additional child tax credit of $201, which is refundable under current law.

Under the proposed law Elena would have an income tax liability of $3,313 before credits, a child tax credit of $3,200 for her two children and a $600 "family credit" for her elderly parents who would qualify as non-child dependents. Elena could use her child and family credits totaling $3,800 to reduce her tax to zero. Because the family credits are non-refundable, and her child tax credits of $3,200 do not exceed her tax liability, she would not receive an additional refundable child tax credit.

Head of Household with Wages of approximately $45,000	
Name	Elena
Filing Status	single
Dependents	Four
W-2 Wages	$45,327
Deductions	Standard
Federal AGI Current Law	$45,616
Tax Current Law (after credits)	$0
Tax Proposed Law (after credits)	$0
Difference	$0
Refundable child credit (Current Law)	$201
Refundable child credit (Proposed Law)	$0
Difference (Decrease)	($201)

Example 3 – Married taxpayer with wages of approximately $60,000

Don is self-employed and his wife Celeste is a stay at home mom. Don earned $60,000 in wages, and received pass-through income from XYZ partnership of $139,871, other income of $1,408 and claimed total deductions from adjusted gross income of $11,040[6]. Don and Celeste filed a joint return and reported itemized deductions of $39,262 which included state and local taxes of $7,494, property tax of $5,805 and home mortgage interest of $20,000. The partnership income is passive and is not from a personal service corporation. Under current law Don and Celeste have an income tax liability of $25,332. Under the proposed law their income tax liability would be $27,918, an increase of almost $2,600. The net increase in their tax liability is attributable to the elimination of the state and local tax deduction, the elimination of personal exemptions offset by a decrease in the tax rate. The deductions from adjusted gross income are allowed under both the current and the proposed law.

The passive income from the partnership would qualify for the maximum tax rate of 25 percent available under proposed law. However, because this couple's tax rate was less than 25 percent, they did not benefit from this provision.

Also, because their house was purchased prior to November 2, 2017, they would not be subject to the interest limitation on mortgage acquisition debt over $500,000.

Married with waged of $60,000	
Name	Don & Celeste
Filing Status	married
Dependents	two
W-2 Wages	$60,000
Deductions	itemize
Other	flow through income
Federal AGI Current Law[7]	$190,239
Tax Current Law	$25,332
Tax Proposed Law	$27,918
Difference (Increase)	$2,586

[6] The reported deductions from AGI are allowed under current and proposed law.
[7] This is after deductions from AGI of $11,040. The deductions from AGI are allowed under both current and proposed law.

Example 4- Married taxpayer with wages of approximately $193,000

Jason and his wife Kate are married with two children and file a joint return. They reported wages of $192,394, passive pass-through income of $197,489 and other deductions from adjusted gross income of $9,114. Jason and Kate reported itemized deductions of $77,450, which includes state and local taxes of $ 45,118 and mortgage interest of $24,897. Jason and Kate purchased their house before November 2, 2017. They also paid alternative minimum tax (AMT) of $12,489. Jason and Kate did not claim any child tax credits because their dependents were over the age of 17, but they did claim a residential energy credit of $8,000. Under current law Jason and Kate's tax liability is $77,876. Under the proposed law, their tax liability is $66,863 decrease of approximately $11,040. The net decrease in their tax liability is attributable to the elimination of AMT and decrease in the tax rate offset by a decrease in itemized deductions. The deductions from adjusted gross income and the residential energy credit are allowed under both the current and the proposed law.

Because Jason and Kate purchased their home prior to November 2, 2017, they would not be subject to the interest limitation on mortgage debt over $500,000.

Married with wages of approximately $193,000	
Name	Jason & Kate
Filing Status	married
Dependents	two
W-2 Wages	$193,000
Deductions	Itemize
Other	flow through income
Federal AGI Current Law[8]	$380,799
Tax Current Law (after credits)	$77,876
AMT Current Law	$12,489
Tax Proposed Law [9] **(after credits)**	$66,683
AMT Proposed Law	$0
Difference (Decrease)	($11,014)

[8] This is after deductions from AGI of $9,114. The deductions from AGI are allowed under both current and proposed law.

[9] This after residential energy credits of $8,000. Under proposed law this credit is extended for all qualified placed in service prior to 2022, subject to reduced rate for property placed in service during 2020 and after.

Example 5 – Married taxpayer with wages of approximately $1 million

Sean and Zelda are married, file a joint return and have two children. They reported wages of just over $1 million, capital gains of $49,477 and other income of $20. Sean and Zelda purchased a house after November 2, 2017 and have itemized deductions in the amount of $147,913, which includes $99,177 of state and local taxes, $16,726 of real estate taxes and $54,483 in home mortgage interest. Under current law, Sean and Zelda's tax liability is $306,706. Under the proposed law, their tax liability would be about $323,784, an increase of almost $17,000. The net increase in tax liability is primarily attributable to the decrease in itemized deductions including the elimination of state and local taxes, and the cap on mortgage interest acquisition debt over $500,000 offset by the lower tax rate. This scenario assumes a full year of mortgage interest was paid.

Married with wages of approximately $1 million	
Name	Sean & Zelda
Filing Status	married
Dependents	two
W-2 Wages	$1,000,000
Deductions	itemize
Other	short term capital gain income
Federal AGI Current Law	$1,058,999
Tax Current Law	$306,706
Tax Proposed Law	$323,784
Difference (Increase)	$17,078

DRAFT