Tax Reform Update

As most people know, tax reform is a top priority for the Republicans. Back in June of 2016, the House Republican Tax Reform Task Force released its tax reform blueprint. The blueprint is commonly associated with Kevin Brady, Chairman of the Ways and Means Committee, and House Speaker Paul Ryan. They outlined an aggressive schedule for the House to pass a revenue neutral tax reform bill by August of 2017.

Major Provisions in the House Plan

- Individual income tax rates – The plan would reduce the number of individual income tax brackets from the current seven brackets to three – 12%, 25%, and 33%, thereby cutting the top 39.6% rate by 6.6 percentage points.
- Capital gains, dividends, and interest income – The plan would replace the current tax rates with 50% exclusion instead. This means the top rate on capital gains and dividends would be 16.5%. The top rate on interest income would also go down to 16.5%, a decrease of over 60%.
- Itemized deductions would be eliminated except the deductions for mortgage interest and charitable contributions.
- The individual AMT is repealed. A number of “special interest” tax provisions are also eliminated.
- Federal estate and generation skipping transfer taxes are eliminated under the House plan.

Business Taxes

- The top corporate tax rate would be reduced from 35% to 20%. Pass-through entities such as sole proprietorships, partnerships, and S corporations would have a top rate of 25%. There would be special rules for pass-through entities to require that they pay “reasonable compensation” so that the preferential 25% rate would not apply to all income of the pass-through owner.
- Pass-through businesses and corporations would be allowed to expense 100% (immediately deduct) of the cost of all purchases of horses, equipment, structures, and inventories, rather than having to capitalize the cost and depreciate these purchases over time as generally required under current law. Land could not be immediately expensed.
- Businesses would no longer be allowed to deduct net interest expense, but any unused net interest expense could be carried over indefinitely and could be deducted against interest income.
- The plan provides for a border adjustment tax (BAT) that would eliminate the US tax on products, services, and intangibles exported abroad (regardless of their production location). On the other hand, a US tax of 20% would be imposed on products, services, and intangibles imported into the US (regardless of their production location).
The House – Since the release of the plan in June of 2016, various portions of the plan have drawn criticism from a number of different sources, including Republicans on the Ways and Means committee. As a result of this, Ways and Means Chairman Brady has pledged to hold tax reform hearings in the near future, but he still intends to mark up and report a bill from the Committee this spring.

The BAT and elimination of the deduction of net interest are the two changes that have drawn the most criticism. Companies that import most of their products for retail sale, such as Wal-Mart, Target, Home Depot, companies that have to import large portions of their raw materials, and the National Retail Federation are strongly opposed to the BAT. The stakes over this proposal are huge since the Republicans are relying on the revenue it would raise - almost $1.2 trillion over a decade – to help finance their overall tax-reform plan. Some Republican members are talking about changing this proposal for small businesses.

Farmers and other small businesses are not happy with the proposed change not allowing them to deduct business interest in exchange for being able to immediately write off the entire cost of equipment purchases and expense other business purchases including horses. As current law stands now, small businesses can deduct (expense) under Sec.179 up to $500,000 of the cost of equipment and other business purchases, reduced by the amount all purchases exceed $2 million. Purchases that go over the limits are depreciated using current rules. House Republicans on the panel are reported to be seeking a change that would allow small businesses to deduct net interest expense and still retain some version of Sec.179 expensing for land and small businesses. Some members are pushing for a generous exemption that would go beyond Sec.179 for eligible companies and could be tailored to certain industries.

The Senate – Senate Republican leaders continue to express doubt about the feasibility of completing tax reform by the August target date set by the House. The Chairman of the Senate Finance Committee, Orin Hatch, has said his Committee will mark up its own bill. While he has not commented on the contents of a bill, he is exploring alternatives to the House BAT proposal because it has been criticized by a number Senators. The Chairman has said he is not ready to roll out anything yet and will wait for the House to act as technically the Senate is required to do.

The White House – The White House stated that it intends to “drive the train” on tax reform, and on April 26th released the principles and parameters of its tax reform plan. Treasury Secretary Steven Mnuchin declared that it would be “the biggest tax cut and the largest tax reform in the history of our country.” While the plan is short on details, its goals are to grow the economy and create jobs; simplify the tax code; provide tax relief to middle income families; and lower the business tax rate.

For businesses, the plan would:

- Cut the corporate tax rate to 15%, and extend that same rate to pass-through businesses, many of which are currently paying tax at the top individual rate.
- Help US businesses compete in the global market by moving to a territorial tax system, meaning businesses would be taxed only on their US income rather than on their worldwide income. Earnings currently held overseas by US multinational corporations could be repatriated to the US at a one-time lower tax rate.
- Eliminate tax breaks for special interests.

The plan does not include the controversial BAT proposal that is in the House blueprint. It is not clear whether the plan includes proposals related to the business interest deduction or expensing.
For individuals, the plan would:
- Reduce individual tax brackets from seven to three – 10%, 25%, and 35%.
- Increase the standard deduction.
- Provide tax relief for families with child care and dependent care expenses.
- Repeal the Alternative Minimum Tax.
- Repeal the estate tax.
- Repeal the 3.8% tax on investment income.
- Eliminate itemized deductions except for mortgage interest and charitable contributions. Secretary Mnuchin also said the plan would protect retirement savings.

Secretary Mnuchin suggested that the Administration’s tax reform plan would promote substantial economic growth to make offsets unnecessary, and also predicted that most individuals would be able to file their taxes on a one-page form.

Wrap-up – It is easy to conclude that a tax reform bill will not be enacted by August of 2017. There are just too many issues at this point that will have to be resolved, and it is clear at this time that the Senate has not bought into the House plan. Furthermore, the position of the Administration is still very much a work in progress, and Treasury Secretary Mnuchin has said that tax reform will happen by year’s end. Also, if Congress lives up to the Republican pledge to pass a revenue neutral bill, it will be very difficult to accomplish if the BAT proposal is not adopted. As noted previously, the retailers and others are going all out to keep the proposal from being adopted. Since it would raise almost $1.2 trillion over a decade, it would be a challenge to replace this income.

Horse Owners Perspective – Overall, the Republican plan looks to be positive for horse owners: Individual income taxes would go down to a top rate of 33%; 50% on capital gains, dividends, and interest income would be deductible, meaning a top rate of 16.5%; the individual AMT would be eliminated; Federal estate and generation skipping transfer taxes would be eliminated; the corporate tax rate would be reduced to 20%; the tax on proprietorships, partnerships, and other pass-through entities would have a top rate of 25%.

Pass-through businesses and corporations would be allowed to expense, immediately deduct, 100% of the cost of horses and other business property except for land in the year the property is placed in service. This treatment effectively does away with depreciation. (Currently, purchases of horses and other business property are limited to a total expensing of $500,000 per year and maybe less depending on the total cost of business property placed in service that year.)

Here is the bad news. Businesses would be allowed to deduct interest expense related to business purchases only to the extent it has interest income. A compromise retaining some version of Sec.179 currently in the code, as mentioned above, might solve that problem.

There are important issues for horse owners which are not addressed in the plan directly that may go away depending on provisions in the plan which are adopted. For example, 3-year depreciation for race horses, which expired at the end of 2016, is not relevant for horses which are expensed. This is already the case for horses that can currently be expensed under Sec.179. If the plan is adopted as is, all horses could be written off in the year placed in service making depreciation no longer an issue for horses (but interest expense would not be deductible). The holding period for horses to qualify for long-term capital gains treatment, now 24 months rather than 12 months like most other property, is not addressed at this point in the plan.
The White House plan just released is very short on details so it is difficult to say much about the overall impact on the horse owners other than it does have many provisions that are similar to the House plan and would reduce the tax rate to 15% on business income, more than the House plan. That said, there is quite a bit of skepticism about the 15% tax rate ever happening.

**Conclusion** – The discussion above is a short review of what is going on in Washington at this point in time, but things are fluid. Over the months ahead there will be a constant flow of information and issues about tax reform. Stay tuned!
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