Federal Tax Legislative Update

Will Tax Reform Finally Happen?

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A Prescient Comment on the U.S. Legislative Process

- "You can always count on Americans to do the right thing, **after they've tried everything else**." Winston Churchill (emphasis added)

THE CONTEXT

The Context

- Political
  - Republican control of White House, Senate and House of Representatives
  - Administration and Republicans anxious for legislative victory
- Process
  - Republicans have only 52 votes in the Senate, creating procedural issues
- Fiscal
  - CBO projects increasing annual deficits through 2027
    - Cumulative deficit - $9.5 tr.
    - Public debt - $25 tr. (88.9% of GDP)

What is Driving the Process

- Politics, Politics, Politics
- Multinational corporations
- High corporate tax rate
  - Effective tax rate is much lower
  - RATE v. ACT coalition
- Tax base erosion
  - IP transfers
  - Earnings stripping
  - Aggressive transfer pricing
- Inversions
  - CBO Report- 9/18/2017
- BEPS and state aid investigations

The Politics

- The Republicans want a legislative victory
  - The House has passed its version of H.R. 1, the Tax Cuts and Jobs Act.
  - The Senate Finance Committee version is on Senate floor
    - Subject to amendments designed to get to 50 votes
  - Not likely that any Democrats will vote for bill
    - Democrats will focus on distribution of tax cuts, ACA mandate repeal and overstated growth effects
  - Republicans can only lose 2 votes in the Senate
    - Six Republican Senators have expressed concerns
  - Time is running out

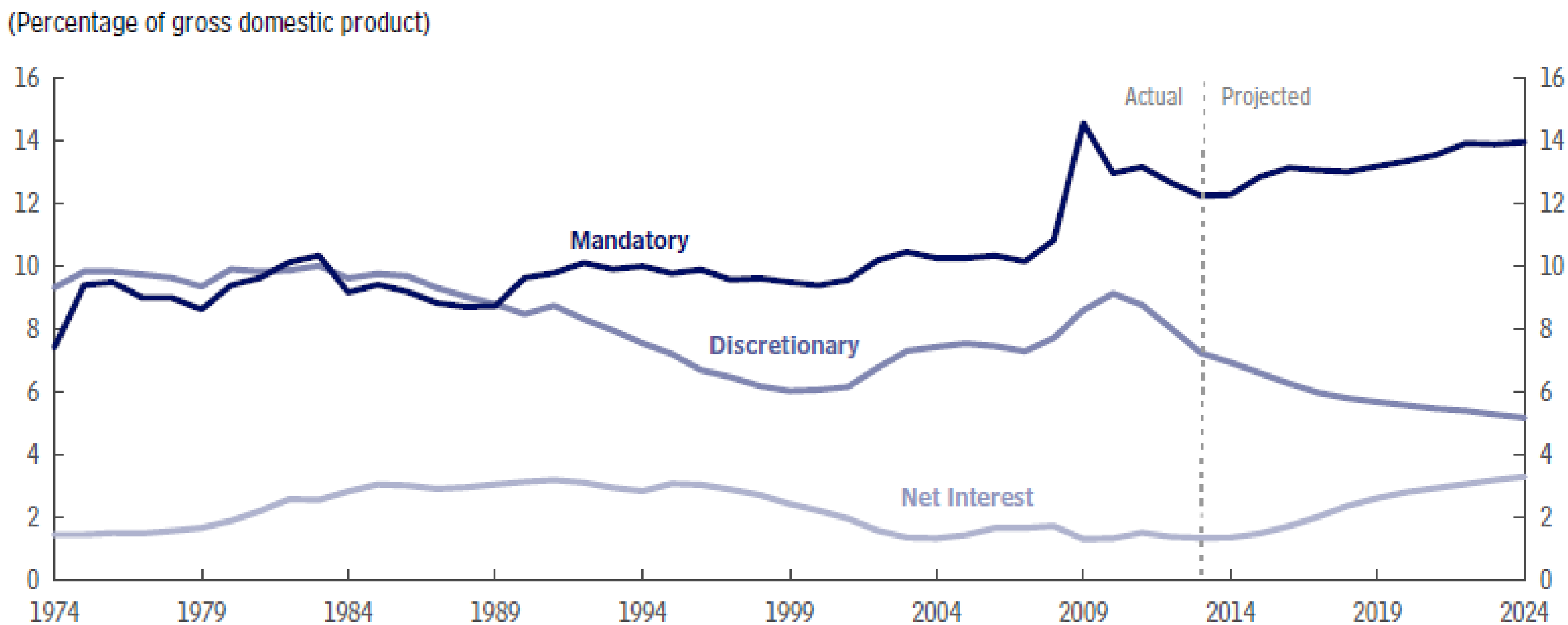
The process

- The "regular order" is not available because the Republicans lack 60 votes to overcome a filibuster in the Senate.
- The legislation will be considered in the Senate under the "reconciliation" process, which eliminates the filibuster obstacle, but has its own hurdles, each which would require 60 votes to overcome
  - The legislation cannot lose more than $1.5 trillion over the ten year budget window
    - Members have committed to use JCT "scoring" to determine these effects for reconciliation purposes
      - Note the "gimmicks" that are used
        - Phase-in, phase out and sun-set
        - Front and back load provisions
    - Some Senators have said they will not vote for legislation that increases the deficit even though the budget resolution authorizes a deficit increase
      - They may get comfortable using a "policy" baseline and factoring in economic growth projected by aggressive "dynamic" scoring models
      - Note the Administration claims for growth
  - No deficit effect outside the 10 year budget window
    - This is a serious problem
      - Original Senate bill lost increasing amounts of money every year through 2027
        - Projections that revenue losses would increase outside the 10 year window
    - Reported bill overcomes this obstacle by sun-setting most of Title I (the individual provisions) and repealing the individual mandate of the ACA .
      - Parliamentary inquiry re: whether reduced ACA spending can be counted as part of net tax cut
  - Non-revenue provisions are out of order

The Fiscal Situation

- **CBO projects increasing annual deficits through 2017**
  - Cumulative deficit - $9.5 tr.
  - Public debt - $25 tr. (88.9% of GDP)
- **Effect of increased deficit**
  - Spending on interest increases substantially
  - Because borrowing reduces total saving in the economy, the nation's capital stock would become smaller, and productivity and total wages would be lower
  - Less flexibility to use tax and spending policies to respond to unexpected challenges
  - Likelihood of a fiscal crisis increases.
    - Investors could demand higher interest rates to purchase government debt

Tax reform: Budget considerations – Federal expenditures



Source: Congressional Budget Office, The Budget and Economic Outlook:" Fiscal Years 2014-2024 (February 2014)

CBO Economic Assumptions

- **CBO's Economic Projections**
  - GDP—1.6 (2019-2020), 1.9 (2021-2027)
  - Inflation—3.5 (2019-2020), 4.0 (2021-2027)
  - Unemployment Rate—5.0 (2019-2020), 4.9 (2021-2027)
  - Three-month Treasury –2.0(2019-2020), 2.8 (2021-2027)
  - Ten-year Treasury– 3.0 (2019-20200, 3.6 (2021-2127)

The Proposals

How to think About tax changes

- Distribution- Who bears the burden?
  - A political decision-note tax increases in various lower income categories
    - House Bill—JCX-55-17
    - Senate Bill—JCX-60-17
    - CBO Cost Estimate-Reconciliation Recommendations of the Senate Committee on Finance, November 26, 2017
- Economic Effects
  - Macroeconomic effects
    - Economic growth, interest rates, inflation
  - Sectoral effects
    - Competitiveness of multinational businesses
    - Effects on various sectors of economy, e.g., real estate, financial, insurance, municipalities, tax exempts, pass-throughs, farms, etc.
- Substantive tax policy
  - Members don't know, reliance on staff
    - Enter the lobbyists!
  - Theory is not a driver of the process

Some Economic Forecasts Something For Everyone

- The President's Council of Economic Advisors (October, 2017)
  - Business side of Unified Framework would increase GDP by between 3 and 5 percent. Average household income would conservatively realize an increase in wages and salary income of $4000.
- Larry Summers, Washington Post, October 8,2017
  - "[T]he claims of Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn and Council of Economic Advisors Chair Kevin Hassett are some combination of ignorant, disingenuous and dishonest. Hassett, whose job is to stand up for rigorous apolitical economic analysis, had the temerity last week to accuse the Tax Policy Center—staffed by many of the most distinguished tax analysts in the country—of issuing 'scientifically indefensible' 'fictions.' He and his colleagues should look in the mirror."
- Tax Policy Center-House Bill (November 20, 2017)
  - Increase in GDP by .6% in 2018, .2% in 2037
  - Increase in output would offset 10 percent of revenue loss
  - Macro effect reduces the effect on debt by .7% of GDP in 2017, .9% in 2037
- Tax Foundation-Senate Bill (November 2017)
  - 3.7% increase in GDP over long term, 2.9%higher wages, 925,000 jobs
  - $1.26 tr. In new revenue on a dynamic basis—e.g., cuts pay for themselves
    - No negative impact from increased debt and high responsiveness of investment decisions to effective tax rates

Some Economic Forecasts Something for Everyone

- Penn Wharton Budget Model- Senate Bill (November 15, 2017)
  - Dynamic score-Revenue reduced in budget window by $1.3 (high initial return to capital) to $1.5 tr. (low initial return to capital
  - Debt rises by $1.4 to $1.6 tr. due to debt service
  - BY 2040 revenue falls between $1.1 to $2.1 tr., debt rises by $1.7 to 2.4 tr.
  - By 2027 GDP is between .3% to .8% larger than current policy
  - By 2040 GDP is between .2% to 1.2% larger than current policy due to debt accumulation
- Alan Viard (AEI) (November 21, 2017)
  - "The potential economic benefits of tax reform have been vigorously debated in recent months, with some supporters claiming that reform would raise the annual growth rate of the economy to 3%,…,4%[Grover Norquist], or even higher….[T]hose claims are misplaced and exaggerated…"
- Committee for a Responsible Federal Budget (October 4, 2017)
  - No theoretical basis to suggest tax cuts could be self-financing
  - Broad consensus among economic models that future tax cuts won't pay for themselves
  - Past tax cuts in 1981 and early 2000s led to widening budget deficits and lower revenue, not the revers as some claim
- Joint Committee on Taxation—no macro dynamic estimate as yet

Tax Plan Costs
Joint Committee on Taxation Estimates

House Bill
JCX-54-17

- 2017-2027
  - Individual Title –(963.7 b.)
  - Business Title-(754.2 b.)
  - International-278.4 b
  - Overall—(1,436.8 b.)
- "Out years"-increases deficit (not shown in JCX)
- No dynamic score

Senate
JCX-59-17

- 2017-2027
  - Individual Title-(886.4 b.)
  - Business Title- (682.4 b.)
  - International Title- 154.6 b
  - Overall-(1.414.2 b)
- "Out-years"—no increase in on-budget deficits by more than $5 b. in any of four consecutive 10-year periods beginning in 2028 (CBO Cost Estimate of Senate Bill, November 26, 2017)
- No dynamic score

High Level Comparison of Bills
General Business Tax Proposals

House Bill	Senate Bill
▪ Corporate Rate—20% effective 2018 ▪ Personal service corporation rate reduced to 25%	▪ Corporate Rate—20% effective 2019 ▪ Personal service corporation rate reduced to 20% ▪ Reduce 80% DRD to 65%, 70% DRD to 50%
▪ Repeal Corporate Minimum Tax	▪ Same as House
▪ Expensing for "qualified investments", sunsetting 12/31/22 ▪ Qualified property includes property the first use of which begins with the taxpayer ▪ Property used in a real estate trade or business is excluded	▪ Expensing for "qualified property" placed in service after 9/27/17 and before 2023 ▪ Not available for non-original use property ▪ Does not exclude property used in a real estate trade or business ▪ Shorten recovery period for real property to 25 years
▪ Increase section 179 expensing to $5 million with phaseout beginning at $20 million, sunsetting 12/31/2022	▪ Increase section 179 expensing to $1 million, phaseout beginning at $2.5 million, no sunset, additional property eligible

High Level Comparison of Bills
General Business Tax Proposals

House Bill

- Limit business interest deduction to 30% of "adjusted taxable income"
  - Adjusted taxable income is taxable income computed without regard to (1) items not allocable to the trade or business, (2) business interest or business interest income, (3) NOLs, and(4) depreciation, amortization and depletion
  - Non-business interest subject to investment interest expense limitations
  - Disallowed interest carried over for 5 years
  - Not applicable to businesses with average gross receipts of $25 million or less

Senate Bill

- Limit business interest deduction to 30% of business adjusted taxable income
  - "adjusted taxable income" is income computed without regard to (1) items not allocable to trade or business, (2) business interest or business interest income , (3) the 17.4% deduction for pass-through income, and (4) NOLs
  - Disallowed interest carried forward indefinitely
  - Not applicable to taxpayers with gross receipts of $15 million or less
    - Real property trade or business may elect out, but must use ADS to calculate cost recovery
  - Disallowance calculated at the entity level
  - Non-business interest subject to investment interest expense limitations
  - Coordinates with rules limiting the interest deductions of international reporting groups by disallowing interest deduction of whichever produces the higher amount

High Level Comparison of Bills
General Business Tax Proposals

House Bill	Senate Bill
▪ Limit NOL to 90% of taxable income, indefinite carryover of excess with interest ▪ Repeal NOL carrybacks ▪ Applies to all NOL carryovers after 12/31/2017	▪ Limit NOL to 90% of taxable income, 80% for years after 2022 ▪ Effective for NOLs arising after 12/31/17 ▪ 3 year capital loss carryback and unlimited carryforward ▪ 80 % limit reverts to 90% in 2026 if certain revenue targets are met ▪ Not clear whether interest would be paid
▪ No provision	▪ Zero percent dividends paid deduction ▪ Placeholder for partial integration?
▪ Repeal section 199	▪ Similar to House Bill
▪ Amortization of certain R&E expenses effective t/y/b/a 12/31/2022	▪ Similar to House Bill ▪ Provision repealed in 2026 if certain revenue targets are met
▪ Retain LIFO	▪ Identical to House Bill
▪ Repeal like-kind exchanges except for real property ▪ Effective for exchanges completed after 12/23/2017with transition rule for certain transactions partially completed on or before December 31, 2017	▪ Identical to House Bill

High Level Comparison of Bills General Business Tax Proposals

House Bill	Senate Bill

▪ Revise contribution to capital rules to limit non-taxable treatment to contributions in exchange for stock to the extent the fmv of money or property does not exceed the fmv of the stock received
  ▪ Provision intended to make non-shareholder contributions, e.g. state or local tax incentives, taxable
  ▪ This may have unanticipated consequences. Consider, e.g., the treatment of a parent contributing debt to subsidiary
	▪ No similar provision

▪ Repeal of numerous business tax credits ▪ Employer provided child care credit, rehab credit, WOTC, new markets credit, disabled individuals, orphan drugs, electric vehicles	▪ Modify low income housing credit, orphan drug credit, rehabilitation credit, employer credit for paid family and medical leave credit

High Level Comparison of Bills
General Business Tax Provisions

House Bill	Senate Bill
▪ Repeal or modify certain deductions ▪ Local lobbying activities, capitalize section 174 R&E expenditures, entertainment expenses,	▪ More limited modifications ▪ Deny deductions for settlements subject to non-disclosure agreements paid in connection with sexual harassment or abuse, expand non-deductibility of certain fines and penalties, repeal deduction for local lobbying activities
▪ Modify energy credits	▪ No similar provisions
▪ Executive compensation ▪ Preserve present law for nonqualified deferred compensation ▪ Increase scope of limit on excessive compensation	▪ Executive compensation ▪ Preserve present law for nonqualified deferred compensation ▪ Increase scope of limit on excessive compensation ▪ 20% excise tax on excess tax exempt executive compensation
▪ 8% surtax on life insurance company income	▪ No similar provision
▪ 3 year holding period for capital gain treatment of carried interests in investment service partnerships	▪ Similar to House Bill
▪ Small business accounting method reform and simplification for businesses with gross receipts of $25 million or less ▪ Increase threshold for use of cash method ▪ Create exemption from UNICAP	▪ Similar to House Bill, except gross receipts threshold is $15 million

High Level Comparison of Bills Taxation of Pass-Through Business Income

House Bill

- 25% rate on the net business income from passive business activities and "capital percentage" of net business income from active business activities of owners of pass-throughs
  - 9% for the first $75,000 in net business income of owners earning less than $175,00
    - Phased in over five years
    - Benefit of 9% rate phase d out as income increases to $225,000
  - Capital percentage is 30%
    - Election to apply 25% rate to a deemed return equal to the short term AFR plus 7% times the adjusted basis of section 1221 property used in the business
  - Does not apply to "service" businesses
    - Election to apply the alternative method above to capture return on capital assets

Senate Bill
SUNSETS 12/31/25

- Allow 17.4% deduction of certain non-service pass-through income of individuals, capped at 50% of the taxpayer's allocable share of the W-2 wages paid by the business.
  - W-2 wages is the sum of wages subject to wage withholding, elective deferrals, and deferred compensation paid during the taxable year
  - Not permitted with respect to income from "specified service trade or business"
  - Exceptions allow the deduction for service pass-through income for individuals below the taxable income threshold and provide the wage cap does not apply for individuals below the threshold level
    - Threshold level is taxable income below $500,000 for joint filers, $250,000 for others phased out over the next $100,000 or $50,000 respectively
- Disallow active pass-through losses in excess of $500,000 for joint filers, $250,000 for others

High Level Comparison of Bills International Tax Provisions

House Bill	Senate Bill
100% deduction of dividends attributable to foreign sourced income paid by 10% owned foreign sub	Foreign source portion of dividends paid to a U.S. parent owning at least 10% of the voting stock of a foreign corporation are 100% exempt from U.S. tax ▪ No "haircut" for administrative expenses
Determine source of income from sales of inventory on basis of production activities ▪ Eliminates "title passage "rule	Similar to House Bill
10 % minimum tax on "high return" foreign earnings ▪ High return amount is (in general) CFC net income minus (x) a routine return on the bases of depreciable property less (y) allocable interest income	Current year inclusion of "global intangible low taxed income" (GILTI) whether or not distributed ▪ GILTI is the excess of a shareholder's CFC income over a routine return of 10% on the pro-rata share of depreciable tangible property of the CFC

High Level Comparison of Bills International Tax Proposals

House Bill	Senate Bill

▪ Additional limitation on interest deductibility by domestic corporations that are members of an "international financial reporting group"
  ▪ Deduction limited to extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the U.S. corporation's share of the group's' EBITDA
    ▪ 5 year carryover of disallowed interest expense
  ▪ Applies only if greater than general interest disallowance rule
	▪ Similar to House Bill
	  ▪ Applies only to members of an "affiliated group" of corporations
	  ▪ Applies only if greater than general interest disallowance rule

High Level Comparison of Bills International Tax Provisions

House Bill

- 20% excise tax on most payments from domestic companies to foreign affiliates
  - Election for payment in hands of recipient o be treated as ECI
  - Effectively denies deduction for covered payments
- Deemed repatriation tax on currently deferred accumulated earnings payable over 8 years
  - 14% on cash or cash equivalents
  - 7% on illiquid assets
  - Deferred earnings subject to tax is the higher of the amount on November 2, 2017 or December 31, 2017

Senate Bill

- Creates a "base erosion minimum tax" (BEMT)
  - Targeted base erosion payments generally are amounts paid to foreign related parties for which a deduction is allowable
    - Payments treated as COGS do not appear to be within the scope
  - Tax liability computed through a multi-step formula
- Deemed repatriation tax on currently deferred accumulated earnings payable over 8 years
  - 10% on cash or cash equivalents
  - 5% on illiquid assets
  - Measuring date is November 9, 2017
  - Election to backload 8 year payments in five 5% installments, 15, 20 and 25 in following years without interest
  - S corps may maintain deferral

High Level Comparison of Bills International Tax Provisions

House Bill	Senate Bill
▪ No similar provision	▪ Terminate DISC
▪ No similar provision	▪ 37.5% deduction deduction for foreign-derived intangible income derived from trade or business in U.S for taxable years beginning after 12/31/17, reducing to 21.875 % for taxable years beginning after 12/31/25. ▪ Initial deduction provides a12.5% effective tax rate ▪ Subject to WTO challenge as illegal export subsidy
▪ No similar provision	▪ Allow CFC to transfer intangible property to U. S. shareholder without triggering income inclusion

High Level Comparison of Bills
Individual and Estate Tax Proposals

House Bill	Senate Bill Entire Title Sunsets 12/31/25*
Individual income tax rates of 12, 25, 35 and 39.6% ▪ Top rate for individuals with $500,000, married with $1 million of income ▪ Benefit of 12% rate phased out for high income taxpayers	Individual income tax rates of 10,12,22,24,32,35,and 38.5% ▪ Top rate for individuals with $500,00, married with $1million of income
New inflation adjustment measure	Same as House
Increase standard deduction to $24,000 for marrieds, $12,200 for single, $18,300 for HoH	Same as House
Repeal personal exemption	Repeal personal exemption, but retain additional standard deduction for elderly and blind as House
Increase child credit to $1600 ($1000 refundable) ▪ Create $300 credit for dependents other than children and $300 "family flexibility" credit—sunsetting 2022	Increase child credit to $2000 ($1000 refundable), $500 non-refundable credit for other qualifying dependents ▪ Require SSN to claim refundable portion
Repeal elderly and disabled credit	

*Inflation adjustment measure does not sunset

High Level Comparison of Bills Individual and Estate Tax

House Bill	Senate Bill
Simplify education incentives	No provision
Repeal AMT	Same as House
Repeal all itemized deductions (including alimony, casualty losses, moving expense, employee trade or business expenses and medical expenses) except for home mortgage interest, charitable contributions, investment interest, up to $10,000 in property taxes and certain miscellaneous expenses ▪ Mortgage interest deduction limited to $500,000 ▪ No deduction for mortgage on second home ▪ No deduction for home equity loans ▪ Effective for loans incurred after date of enactment	Repeal SALT, modify home mortgage interest deduction, limit casualty loss deduction to losses incurred in a federally-declared disaster, repeal deduction for tax return preparation, repeal miscellaneous itemized deductions subject to 2% floor, repeal qualified moving expense exclusion and deduction ▪ Repeal deduction for home equity loans with no grandfathering
Repeal of overall limitation on itemized deductions	Same as House
Modify exclusion of gain from sale of principal residence by increasing general period of ownership and use, limiting availability to once every five years and phasing out for high income individuals	Same as House except no phase out
Double existing estate, gift and generation-skipping tax exclusions through 2024 ▪ Repeal estate and generation-skipping tax in 2025, reduce gift tax rate to 35% ▪ Retain basis step-up	Same as House except NO REPEAL

High Level Comparison of Bills
Exempt Organizations

House Bill	Senate Bill
Deny deduction for college athletic seating rights	Same as House
1.4% excise tax on net investment income of certain private colleges and universities	Same as House
Permit 501(c)(3) organizations to make statements relating to political campaigns	No provision
	Name and logo royalties treated as UBIT
	Repeal of tax exempt status for professional sports leagues
	Separately compute UBIT for each trade or business
	Increase cash contribution limitation to 60%

What Happens Next

- Committee reports?
- Senate vote
- Conference

Presenter

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