

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
- **Procedural**
 - 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 completed its mark up of its version of H.R. 1.
 - NO legislative language
 - Will come to the floor in December
 - Not likely that any Democrats will vote for bill
 - Will focus on distribution of tax cuts and ACA mandate repeal
 - Republicans can only lose 2 votes in the Senate
 - Time is running out

THE PROCESS

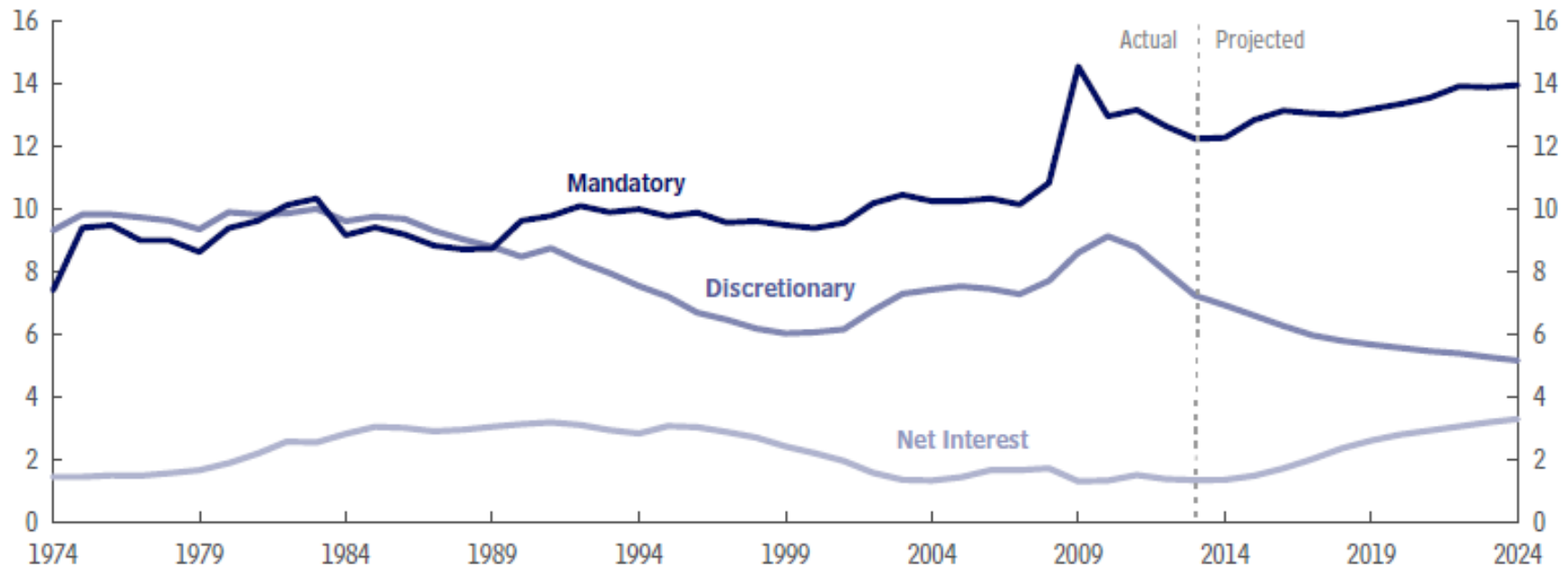
- The “regular order” is not available because the Republicans lack 60 votes to overcome a filibuster.
- The legislation will be considered in the Senate under the “reconciliation” process, which eliminates the filibuster obstacle, but has its own hurdles, each which would require 60 votes to overcome
 - 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 and phase out
 - 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
 - Manager’s Amendment overcomes this obstacle by sunsetting 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

(Percentage of gross domestic product)



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

HIGH LEVEL COMPARISON OF BILLS

GENERAL BUSINESS TAX PROPOSALS

House Bill

- Corporate Rate—20% **effective 2018**
- Repeal Corporate Minimum Tax
- 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
- Increase section 179 expensing to \$5 million with phaseout beginning at \$20 million, **sunsetting 12/31/2022**

Senate Bill

- Corporate Rate—20% **effective 2019**
 - Reduce 80% DRD to 65%, 70% DRD to 50%
- Same as House
- 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 \$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
 - Not applicable to businesses with average gross receipts of \$25 million or less

Senate Bill

- Similar to House
 - “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 passthrough income, and (4) NOLs
 - 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

- Limit NOL to 90% of taxable income, indefinite carryover of excess with interest
 - Repeal NOL carrybacks
- Repeal section 199
- Amortization of certain R&E expenses **effective t/y/b/a 12/31/2022**
- Retain LIFO
- Repeal like-kind exchanges except for real property
 - Effective for exchanges completed after 12/23/2017 with transition rule for certain transactions partially completed on or before December 31, 2017
- 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
- Repeal of numerous business tax credits
 - Employer provided child care credit, rehab credit, WOTC, new markets credit, disabled individuals, orphan drugs, electric vehicles

Senate Bill

- Similar to House Bill
 - Not clear whether interest would be paid
- Similar to House Bill
- Similar to House Bill
- Similar to House Bill
- Similar to House Bill
- No provision
- No similar provisions

HIGH LEVEL COMPARISON OF BILLS GENERAL BUSINESS TAX PROVISIONS

House Bill

- Repeal or modify certain deductions
 - Local lobbying activities, capitalize section 174 R&E expenditures, entertainment expenses and certain fringe benefits
- Modify energy credits
- Executive compensation
 - Preserve present law for nonqualified deferred compensation
 - Increase scope of limit on excessive compensation

- 8% surtax on life insurance company income
- 3 year holding period for capital gain treatment of carried interests in investment service partnerships
- 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

Senate Bill

- More limited modifications

- No similar provisions
- 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

- No similar provision
- Similar to House Bill

- Similar to House Bill

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 phased 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 passthrough 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
 - Exceptions allow the deduction for service passthrough 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

- Creation of territorial tax system with 100% deduction of dividends attributable to foreign-sourced income paid by 10% owned foreign subs
- Determine source of income from sales of inventory on basis of production activities
 - Eliminates “title passage” rule
- 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”
- 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 groups’ global EBITDA.
 - Five year carryover of disallowed interest expense

Senate Bill

- Similar to House Bill
- Similar to House Bill
- 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
- Similar to House Bill
 - Applies only to members of an “affiliated group” of corporations

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
- Similar to House Bill
 - 10% on cash or cash equivalents
 - 5% on illiquid assets
 - Measuring date is November 9, 2017

HIGH LEVEL COMPARISON OF BILLS INTERNATIONAL TAX PROVISIONS

House Bill

- No similar provision
- No similar provision

- No similar provision

Senate Bill

- Terminate DISC
- Deduction for foreign-derived intangible income derived from trade or business in U.S.
 - Provides a 12.5% effective tax rate
- 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

- 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
- New inflation adjustment measure
- Increase standard deduction to \$24,000 for marrieds, \$12,200 for single, \$18,300 for HoH
- Repeal personal exemption
- Increase child credit to \$1600 (\$1000 refundable)
 - Create \$300 credit for dependents other than children and \$300 “family flexibility” credit—sunsetting 2022
- Repeal elderly and disabled credit

Senate Bill

Entire Title Sunsets 12/31/25*

- Individual income tax rates of 10,12,22,24,32,35,and 38.5%
 - Top rate for individuals with \$500,00, married with \$1 million of income
- Same as House
- Same as House
- Repeal personal exemption, but retain additional standard deduction for elderly and blind as House
- Increase child credit to \$2000 (\$1000 refundable), \$500 non-refundable credit for other qualifying dependents
 - Require SSN to claim refundable portion

*Inflation adjustment measure does not sunset

HIGH LEVEL COMPARISON OF BILLS

INDIVIDUAL AND ESTATE TAX

House Bill

- Simplify education incentives
- Repeal AMT
- 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 of overall limitation on itemized deductions
- 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
- 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

Senate Bill

- No provision
- Same as House
- 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
- Same as House
- Same as House except no phase out

- Same as House except **NO REPEAL**

HIGH LEVEL COMPARISON OF BILLS EXEMPT ORGANIZATIONS

House Bill

- Deny deduction for college athletic seating rights
- 1.4% excise tax on net investment income of certain private colleges and universities
- Permit 501(c)(3) organizations to make statements relating to political campaigns

Senate Bill

- Same as House
- Same as House
- 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%

TAX PLAN COSTS

House Bill

- 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

Senate As of November 14, 2017

- 2017-2027
 - Individual Title-(885.9 b.)
 - Business Title- (683.4 b.)
 - International Title- 154.5 b
 - Overall-(1.414.8 b)
- “Out-years”—no increase in deficit

WHAT HAPPENS NEXT

- Release of legislative language in Senate
- Committee reports?
- Senate vote (after Thanksgiving)
- Conference

PRESENTER

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