Akin®

Top 10 Topics for Directors in 2018: Special Bonus on Tax Reform

Dec 18, 2017

Reading Time : **8 min**

By: G. Hunter Bates, Brian Arthur Pomper

With control of Congress and the White House, but a slim majority of 52 in the Senate, Republicans planned to use fast-track procedures available under the budget reconciliation process to advance tax reform legislation. However, efforts to repeal and replace the Affordable Care Act took precedence and delayed the start of tax reform by a number of months, ultimately resulting in a stalemate among Republicans over how to move forward on ACA, which remains unresolved.

Seeing the end of 2017 approaching, Republicans laid out an expedited timeline to quickly move tax reform through the House and Senate. Building on months of behind-the-scenes discussions among the so-called "Big Six" – House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), Senate Finance Committee Chairman Orrin Hatch (R-UT), House Ways & Means Committee Chairman Kevin Brady (R-TX), Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn – and their joint statement in July 2017 identifying common goals, Republican leaders aimed to move tax reform through the tax-writing committeesin November and send a bill to the President before Christmas.

To the surprise of many, this timeline has largely been met. The House approved their version of the Tax Cuts and Jobs Act (H.R. 1) on November 16 by a vote of 227-205. The same week, the Senate Finance Committee held a four day markup of their version of tax reform, ultimately sending the bill to the Senate floor under fast- track procedures that led to successful passage of the bill 51-49 during the early hours of Saturday morning, December 2. Despite a number of last minute concerns from Republican senators, retiring Senator Bob Corker (R-TN) was the lone Republican "no" vote. No Democrats voted for either the House or Senate bill. While President Trump made some public and private overtures to Democrats, the gulf between tax priorities for Democrats and Republicans was simply too large to bridge.

With significant areas of difference between the House and Senate bills, members of Congress are in the process of convening a conference committee to resolve these issues with the goal of final passage by December 22. As the conference committee gets underway, Republicans are largely united in their effort to get tax reform done this year, but a number of key differences on business, individual, and international tax reform stand between them and the finish line.

Corporate. The House and Senate approaches on corporate tax reform both highlight one of President Trump's top priorities: a 20% corporate rate. He originally called for a 15% rate, but agreed to 20% and has recently indicated a willingness to accept a 22% rate if necessary, which makes this slightly higher rate more likely since House and Senate conferees will need extra revenue to get to a final agreement.

During final negotiations on the Senate bill, a provision to repeal the corporate Alternative Minimum Tax (AMT) was removed from the bill, leaving the current 20% AMT rate intact. The House proposal includes full repeal. This will be a major area of discussion in conference given the weakening of business credits like R&D if the AMT rate is set at the same rate as the corporate rate since R&D and many other business credits cannot be taken against AMT.

In the House, the bill includes five years of immediate expensing for qualified property (including used property, newly acquired) placed in service after September 27, 2017, in an aim to provide a jumpstart to investment. The Senate bill originally included a similar provision, but was altered to gradually phase-out the provision after five years at the request of Senator Jeff Flake (R-AZ).

In exchange for a lower corporate rate and enhanced expensing, both bills limit or eliminate a number of business credits and other provisions including the rehabilitation credit for preservation of historic properties, New Markets Tax Credit, Orphan Drug Tax Credit, private activity bonds, and renewable energy tax provisions, although there are notable differences between the approach on each in the House and Senate.

Lastly, the House and Senate proposals both limit the deductibility of net interest expenses to 30% of pretax earnings. In the House, the limitation applies to 30% of earnings before interest, tax, depreciation and amortization (EBITDA). In the Senate, the limitation applies to earnings before interest and tax (EBIT). Both proposals include carve-outs for public utilities and certain real property businesses.

Pass-throughs. Reform for businesses organized as pass-throughs will be a major focus of the conference given the significant differences between the House and Senate approaches to providing relief. The House bill includes a 25% rate for 30% of business income with the remaining 70% treated as wage income at the owner or shareholder's regular individual rate, with a very low 9% rate for the first $75,000 of business income if earning less than $150,000. In the Senate, the bill instead provides a 23% deduction for domestic "qualified business income." An additional difference is that the pass-through provisions in the Senate approach are temporary (expire in 2026), while the House proposal is permanent, although many assume that popular tax changes would be extended before their expiration.

Despite beginning in different places, the House and Senate bills both include a three-year holding period for long- term capital gains treatment for carried interest.

International. The House and Senate bills propose fundamental changes to the taxation of businesses with international operations. Beginning in 2018, both bills would exempt from U.S. taxation (with important exceptions, the biggest of which are noted below) 100 percent of the foreign earnings repatriated to certain U.S. corporations. As a means of transitioning to this new "territorial" system of taxation, any U.S. corporation that owns at least 10 percent of a foreign corporation with previously untaxed (in the United States) post-1986 foreign earnings will have to pay a one-time mandatory tax of around 14 percent on its share of the cash portion of such earnings (or around 7 percent on its share of the remaining illiquid earnings), payable over eight years. The so-called "repatriation rates" were originally lower in both the House and Senate, but were raised to account for needed revenue.

Two significant new anti-base erosion measures are proposed as part of the move to territorial. The first is a sort of global minimum tax on foreign- source intangible-like income. While the House and Senate proposals differ in name (the House taxes foreign high returns, while the Senate taxes global intangible low-taxed income), they both tax essentially the same income at the same rate. They levy on certain U.S. corporations (whether they are part of a U.S.-parented multinational or a foreign-parented multinational) an effective 12.5 percent tax on all of the active, otherwise untaxed (in the U.S.) income earned by their foreign subsidiaries minus an amount of income designed to represent the return on tangible investments in the foreign jurisdictions (although the Senate provides a higher rate of return for this purpose—10 percent as opposed to 8 percent). The primary difference between the two is that the Senate adds a special patent box-like deduction (of 37.5 percent, to effect a rate of 12.5 percent) available to U.S. corporations (including those that are foreign controlled) on certain of their U.S.-source income that is foreign derived (and that would otherwise be taxed at 20 percent, beginning in 2019).

The second new anti-base erosion measure is effectively an import tax. Again, the House and Senate proposals differ in name (the House is described as an excise tax/effectively connected income election while the Senate is called the base erosion and anti-abuse tax or BEAT), but they both involve a tax on deductible payments made by a U.S. corporation (no matter if the parent is U.S. or foreign) to a related foreign corporation. That's where the similarities end. The House's version would impose a 20 percent tax on the payment made by the U.S. corporation (effectively negating the value of the deduction), unless the foreign corporation treats the amount received as effectively connected income, taxed in the United States at 20 percent with deductions allowed for deemed expenses and some foreign tax credits. The Senate's version is an alternative tax regime that applies if the U.S. corporation has made a lot of base eroding payments. If the BEAT applies, it adds back into taxable income the full amount of the payments and taxes the whole amount at 10 percent (as opposed to the corporation's regular tax liability, which taxes at 20 percent a smaller amount of income). While the House's version appears to sweep in payments for cost of goods sold, the Senate's version does not.

Individual. House Republicans stuck to their original goal of simplifying the individual rates by reducing the number of tax brackets and lowering the rates. The House ultimately went with four brackets, including a top bracket of 39.6% on income above $1 million. Seeing challenges in the House with making the distributional impact work under a smaller number of brackets, the Senate stuck with the current seven brackets, but still lowered the rates and adjusted the bracket breakpoints with the top bracket set at 38.5% on income over $500,000. Also, the House bill repeals individual AMT, while the Senate maintains it at a slightly higher exemption amount. The House bill would also repeal the estate tax effective in 2024, while the Senate would double the exemption amount from $5 million to $10 million.

The deduction for state and local taxes (SALT) was a major sticking point, particularly in the House where the deduction was limited to up to $10,000 for property taxes only. While not part of the Senate Finance proposal, the final bill included a concession to the House approach thanks to advocacy from Senator Susan Collins (R-ME).

On the mortgage interest deduction, the Senate bill would leave the current deduction of interest on up to $1 million, the House limited it to $500,000 and only on a primary residence.

Lastly, the Senate bill repealed the ACA's individual mandate, which requires individuals to purchase or obtain qualified health insurance coverage and certify that to the IRS, or else pay a penalty. This provision is likely to be maintained in the conference committee.

Next steps. Conferees will have a limited window to come to an agreement on a final version of tax reform. In most cases, the Senate version is expected to prevail since it is more challenging to pass a bill in the Senate with a slim majority margin of only two votes. The conference committee will also need to consider any final changes to issues like effective dates, provisions with a phase-in or phase-out, and transition rules. Reconciliation also comes with a complex set of rules and budgetary constraints, and conferees will need to closely examine all final provisions to ensure compliance with those rules. Otherwise, the bill would lose its privileged nature in the Senate, and with it, the ability to pass it with only a simple majority.

2018 and beyond. Even if tax reform makes it to President Trump by year-end, tax policy issues will not take a backseat in 2018. Due to the expedited timeline with limited ability to review the proposed changes in a methodical fashion, technical fixes will no doubt be necessary in 2018. Monitoring the implementation process at Treasury and the IRS will also be top of mind as many of the changes will require new regulations and guidance from the Administration. Lastly, Chairman Brady has indicated an interest in continuing to work on other tax reform issues in the new year, specifically mentioning topics such as the tax treatment of financial products and retirement savings incentives.

View the full report here.

Categories

Finance

Policy & Regulation

Compliance

Tax