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Tax reform proposal clears House; Finance bill headed to Senate floor

Congressional Republican efforts to rewrite the federal tax code took a significant step forward on November 16 as the House of Representatives approved its version of comprehensive tax reform legislation and the Senate Finance Committee reported out a competing measure.

House passage largely drama-free

House Republicans pushed through their proposal – the Tax Cuts and Jobs Act (H.R. 1) – by a largely party-line vote of 227-205.

The bill as approved would, among other things, lower the corporate tax rate to 20 percent and the rate for some income of passthrough entities to 25 percent; compress the individual rate brackets from seven to four (plus a bubble rate that some view as a fifth bracket); provide a more generous business expensing regime; boost the individual standard deduction and the child tax credit; repeal the estate tax and the corporate and individual alternative minimum tax; and shift to a territorial-style system for taxing foreign-source income of US multinationals. (For a detailed summary of the bill as introduced, see *Tax News & Views*, Vol. 18, No. 40, Nov. 3, 2017; for details on amendments that were incorporated during the Ways and Means Committee mark-up process, see *Tax News & Views*, Vol. 18, No. 41, Nov. 10, 2017.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171103_1.html
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171110_2.html

Republicans' success came with much less drama than many anticipated even a week ago, as all but 13 of their members fell in line behind leadership, signaling how critical a significant legislative win is for the party almost a year after they took control of both the legislative and executive branches. There had been fears of a greater number of defections in recent weeks as some House Republicans – primarily those representing constituents in jurisdictions subject to high state and local taxes – expressed reservations about a provision in H.R. 1 that would eliminate the deduction for state and local income taxes (and for sales taxes in those states that do not have an income tax) as well as limit the deduction for state and local property taxes.

As expected, no Democrats supported the bill.

Passage of tax reform legislation has been a top priority for House Speaker Paul Ryan, R-Wis., for many years and something he'd hoped to lead while he served as chairman of the House Ways and Means Committee in 2015. His plans were upended when turmoil in the Republican leadership led to his installation as speaker only 10 months after he took over the taxwriting panel, and current Ways and Means Chairman Kevin Brady, R-Texas, got to shepherd tax reform through the legislative process instead.

"This is nothing short of extraordinary," said Ryan, at a press conference immediately after the vote. "Getting 227 members to agree on something as complicated as [tax reform]. …The powers of the status quo in this town are so strong, and yet 227 men and women of this Congress broke through that today. That is powerful."

Finance passage follows contentious mark-up

Just hours after H.R. 1 won passage in the House, the Senate Finance Committee approved its own version of the Tax Cuts and Jobs Act on a strictly party-line vote of 14-12. Final passage came after a days-long mark-up that occasionally erupted into partisan rancor over a series of modifications that Chairman Orrin Hatch, R-Utah, unveiled late November 14 in an effort to ensure that the bill does not increase the federal deficit beyond the 10-year budget window – a requirement for legislation moving under fast-track budget reconciliation protections in the Senate. (Hatch made additional revisions in a separate "wrap up" amendment he offered in the final hours of the mark-up.)
URL: https://www.jct.gov/publications.html?func=startdown&id=5037
URL: https://www.finance.senate.gov/imo/media/doc/11-16-17-%20(25)%20Modified%20Hatch%20Modifications%20and%20clarifications%20final.pdf

The measure as introduced on November 9 broadly follows the contours of the House-passed legislation. Like the House bill, the Finance Committee proposal would reduce the corporate tax rate to 20 percent; however the Finance proposal would delay implementation of the rate cut until 2019, while the House provision would be effective beginning in 2018. It would reduce marginal tax rates for individuals but does not follow the House in reducing the number of rate brackets. The Finance bill provides significant relief from the estate tax but stops short of the full repeal included in the House package. It proposes no changes to the current-law deduction for mortgage interest on home purchases (which the House bill would cap at interest paid on loan amounts of up to $500,000); but it would fully repeal the deduction for state and local taxes – something the House bill would retain, although only for property taxes and even then subject to a cap. (For a summary of the proposal as introduced, see *Tax News & Views*, Vol. 18, No. 41, Nov. 10, 2017.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171110_1.html

Individual mandate repeal, sunsets for individual tax cuts: But the modifications to Hatch's chairman's mark include some significant new revenue offsets and proposals to pare back some of the tax relief provisions in the original measure, along with assorted proposals for new tax incentives.

As expected, the amendment would reduce to zero the penalty imposed on individuals who do not have adequate health insurance coverage (the "individual mandate" enacted in the Patient Protection and Affordable Care Act of 2010). This change – which is not part of the House-passed bill – is expected to raise $318 billion over 10 years, according to the Joint Committee on Taxation (JCT) staff, as the foregone penalty income would be more than offset on the spending side by an expected reduction in federal payouts for premium assistance credits. (The estimate assumes that some lower-income individuals who purchased insurance to avoid the penalty will decide to drop their coverage once the penalty is eliminated and therefore will no longer receive the federal subsidy payments.)

Among the other noteworthy proposals, the amendment also would:

- Sunset, after 2025, the changes to the individual side of the tax code in Hatch's original chairman's mark, including marginal rates, changes to credits and deductions, and the proposed doubling of the estate tax exemption. (The individual tax relief proposals in the House bill are all permanent.)
- Tweak some of the seven proposed individual rate brackets (ranging from 10 percent to 38.5 percent) and adjust the income thresholds at which those brackets would apply.
- Sunset the proposed new passthrough regime after 2025 and modify the 17.4 percent deduction for certain passthrough income – for example, by making it available to taxpayers with income from service partnerships whose taxable incomes are under $500,000 (for married-joint filers). (Again, the House proposes permanent passthrough tax relief.)
- Strike proposed changes to the rules affecting the tax treatment of nonqualified deferred compensation.
- Make numerous modifications to the complex international tax provisions in the underlying bill, including the deduction for global intangible low-taxed income, the deduction for foreign-derived intangible income, the base erosion anti-abuse tax, and the transition tax (deemed repatriation).
- Require certain research and experimentation (R&E) costs to be amortized over five years (15 if the research is performed outside the US) and clarify that specified R&E expenditures subject to capitalization and amortization include software development.
- Make several changes to the low income housing tax credit and to the excise tax rules for alcoholic beverages.

Highlights of the most significant modifications are available from Deloitte Tax LLP.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/171117_1_suppA.pdf

Partisan split: The JCT staff estimates that the Hatch's modified mark would increase the federal deficit by just over $1.4 trillion between 2018 and 2027 – down from its estimate of nearly $1.5 trillion over the same period for the proposal as originally introduced. (The recently approved unified budget resolution for fiscal year 2018 affords fast-track budget reconciliation protections to a tax bill that increases the federal deficit on net by up to $1.5 trillion over 10 years.)
URL: https://www.jct.gov/publications.html?func=startdown&id=5038
URL: https://www.jct.gov/publications.html?func=startdown&id=5033

But during the mark-up, Finance Committee Democrats appeared to be unmoved by the more favorable deficit numbers and contended that Hatch's modifications – particularly sunsetting tax relief for individuals while providing permanent tax breaks for corporations – only bolstered their position that the bill was skewed to large businesses and wealthy individuals rather than to the middle class.

That argument only intensified with the JCT's release November 16 of the projected distributional effects of the modified mark. Democrats argued that the tables show households with incomes under $30,000 would on average begin seeing an increase in their taxes beginning in 2021, and that households with incomes under $75,000 would see tax increases by 2027. They also noted that the tables project larger amounts of tax cuts accruing to households at the top of the income scale by the end of the 10-year budget window.
URL: https://www.jct.gov/publications.html?func=startdown&id=5040

Republicans countered that these numbers do not solely reflect direct tax increases but rather in some cases are the indirect result of reductions in federal spending brought about by certain changes in the chairman's mark. JCT Chief of Staff Tom Barthold, who was on hand during the mark-up to explain Hatch's original proposal and the modifications, confirmed that reduced outlays were a factor in some of these projections; but he also stated in response to questions from Ohio Republican Sen. Rob Portman that the increased tax burdens projected for 2027 were attributable to the proposed sunsetting of individual rate cuts and other benefits under the modified mark.

Democratic amendments rejected: Aside from Hatch's package of modifications to his original proposal, all the amendments offered during the mark-up were sponsored by Democrats and were rejected (mostly) along party lines. One amendment proposed by ranking Democrat Ron Wyden of Oregon to substitute the language of the House version of H.R. 1 for the measure under consideration in the Finance Committee received zero votes. Wyden offered the amendment as a way to gauge Senate support for the House measure. Hatch protested, arguing that the Senate was drafting its own version for a reason.

Next steps: The committee-approved bill is expected to come to the Senate floor the week of November 28, after lawmakers return from the Thanksgiving recess. Budget reconciliation rules will allow for passage by a simple majority rather than the three-fifths supermajority – that is, 60 votes – typically required to overcome Senate procedural hurdles. But Republicans hold only 52 seats in the chamber – which means they can afford to lose only 2 votes if they hope to secure a victory. (Vice President Mike Pence would step in to cast the deciding vote for Republicans in the event of a tie.)

Already Republicans have seen one public defection – Sen. Ron Johnson of Wisconsin, who has said he would not vote for the House or the Senate bill as currently drafted because of what he sees as their inequitable treatment of passthrough entities. Other GOP senators – such as Susan Collins of Maine and Lisa Murkowski of Alaska – have expressed reservations about the proposal to repeal the individual mandate, although neither so far has formally pledged to oppose the underlying bill. Other potential outliers include Tennessee Sen. Bob Corker, who has cited concerns about the bill's impact on the federal deficit and recently told reporters that he is undecided, and John McCain of Arizona, who has been critical of leaders for not moving the bill under regular order (a concern that contributed to his decision this summer to vote against legislation to repeal the Patient Protection and Affordable Care Act).

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State business tax issues raised by the House version of the Tax Cuts and Jobs Act

The comprehensive tax reform legislation approved in the House of Representatives November 16 represents a major step in the efforts of the Republican leadership in Congress and the Trump administration to enact sweeping changes to the Internal Revenue Code. But while the Tax Cuts and Jobs Act (TCJA, H.R. 1) would substantially revise and reform the federal Internal Revenue Code, many of its proposed changes will be of critical importance to state governments across the country. The Senate Finance Committee is currently marking up its own version of the TCJA (the Senate bill), which contains several similar provisions to the House version as well as certain provisions not found in the House version. (See separate coverage in this issue for details.) Given the developing nature of the Senate version of the TCJA, this analysis focuses solely on the House version of the TCJA (the House bill), and the initial release of the Senate bill.

Both versions of the TCJA contain certain proposed changes (such as the reduction in the corporate tax rate from 35 percent to 20 percent) that may encourage companies to make federal elections between now and the end of their tax year to capitalize on timing differences, for which the state tax consequences should be considered. In addition, many of these changes can be expected to affect the calculation of federal taxable income, which is used by numerous states as the starting point for calculating state taxable income. Finally, several of the provisions contained in the TCJA are designed to stimulate investment in the US economy, which can also have a significant impact on the states.

While the TCJA contains an extensive list of proposals, this summary focuses on those proposals that are likely to generate the most interest from a state and local tax perspective for businesses. (In general, state governments need to run balanced budgets and cannot borrow to fund current operating expenditures. Accordingly, we generally expect that each state will evaluate whether it can afford to conform to the federal changes or if conformity will be too "expensive" for its particular budget. Also, while several federal provisions are designed to raise additional federal revenue, influential local constituencies may be expected to lobby for the preservation of incentives at the state level. These forces combine to provide an environment where we expect the states to take varying approaches to how they will – or will not – conform to the changes proposed in the TCJA.)

While states have varying timetables for determining whether to conform to or decouple from certain TCJA provisions, on the day of enactment (Day One) certain states generally will automatically conform to many if not most of the TCJA's provisions based on each state's rolling conformity provisions. Accordingly, on Day One, companies will need to analyze and assess the financial implications of state conformity to these changes, based on each company's unique state tax filing footprint.

Reduction in federal corporate and passthrough rates

The House bill proposes several reduced tax rates, including:

- Corporate income tax rate: Flat rate of 20 percent and
- Noncompensatory business income of passthrough entities: 25 percent.

These provisions both would go into effect in 2018. The Senate bill also cuts the corporate income tax rate to 20 percent, but delays the implementation of this rate cut until 2019. The Senate bill also provides for a 17.4 percent deduction for owners of passthrough entities on certain qualified business income, and this provision would go into effect in 2018.

Based on these tax rate cuts, it is reasonable to expect companies to seek to accelerate deductions and defer income in order to capitalize on these declining rates. While these declining federal rates will not have a direct impact on applicable state rates, companies should evaluate how any such expense acceleration or deferral of income would impact any deferred state tax assets they may have. Also, companies should consider whether they have any state tax expense they could reasonably accelerate to the 2017 tax year (for example, entering into a voluntary disclosure agreement by which a payment of state taxes would be made in 2017) should the federal rate reduction be enacted. (Companies may have one more year to act if the Senate bill's delayed corporate rate cut is enacted.) Companies should also evaluate state consequences on Day One (including implications to attribute utilization plans) arising from federal acceleration/deferral elections the company may be considering and continue to monitor for additional considerations.

Limitation on interest expense deduction

Section 3301 of the House bill provides that companies (regardless of its legal entity form) will not be able to deduct their net interest expense to the extent it exceeds 30 percent of the taxpayer's adjusted gross income. Section 3203 of the House bill provides an exemption from this limitation for small businesses. The Senate bill contains a more modest limitation on the interest expense deduction: the deduction for business interest is limited to the sum of business interest income plus 30 percent of the taxpayer's adjusted taxable income for the year.

We generally expect that states will conform to any limitation on the interest expense deduction (some on Day One, others as they update their conformity provisions) as it will generally increase the income tax base and many states have already demonstrated a desire to limit taxpayers' ability to claim interest expense deductions (for example, requiring interest expense add-backs on state returns). While at the federal level it may be possible that this limitation on the interest expense deduction may reduce the need for federal limitations on the federal interest expense deduction (such as the section 385 regulations), we would generally expect states' scrutiny of interest expense deductions to continue.

Immediate expensing

House bill section 3101 provides that the current 50 percent bonus depreciation amount under IRC section 168(k)(1)(A) will increase to 100 percent for property placed in service after September 27, 2017 and before January 1, 2023. The Senate bill contains a similar proposal for investments made in the same time period. The state tax issues presented by these proposals include:

- **State conformity:** Given that the House bill's proposal is estimated to reduce federal revenues by $25 billion from 2018-2027 and would have a corresponding impact on state revenues, state governments will need to determine if they can afford to conform to this change. (The Senate has not provided a similar breakout of the federal revenue impact of its proposal, but it can be expected to be similar to the House bill's version.) Many states currently decouple from federal bonus depreciation, and this number may increase if full expensing is adopted. Decoupling could span a range of options at the state level, including a complete decoupling, retaining the current 50 percent limitation, or other state-specific modifications. Companies should evaluate state consequences as of Day One and then continue to monitor additional consequences as many states will either conform to or decouple from immediate expensing.
- **State credit and incentive opportunities:** These proposals are designed to encourage investment in capital assets across the United States. Many states offer statutory credits as well as negotiated incentives for this type of investment. Companies who may plan on making an investment to capitalize on the federal benefit from immediate expensing should consider whether any state and/or local incentives may be available prior to deciding where to make this investment. These incentives are not limited to income/franchise taxes, but may include: (1) sales and use taxes, (2) property taxes, (3) employment/payroll taxes, and (4) nontax incentives such as zoning and permitting assistance.

Expansion of section 179 deduction

House bill section 3201 provides for an expansion of the current IRC section 179 deduction from $500,000 to $5 million and an increase of the phase-out from $2 million to $20 million. The Senate bill contains a more modest increase to $1 million and $2.5 million, respectively. Many states already impose their own limit on taxpayers seeking to claim this deduction on their state tax returns, and we would expect that trend to continue.

Modification of net operating losses

House bill section 3302 provides for the general elimination of most net operating loss (NOL) carrybacks and limiting the NOL deduction prospectively to 90 percent of the taxpayer's pre-NOL taxable income. The Senate bill contains a similar provision. Just as with the IRC section 179 expansion, most states already impose their own specific NOL deduction rules and we would expect that practice to continue.

Various other base-broadening provisions

Both versions of the TCJA contains many other base-broadening provisions which are beyond the scope of this article. Companies will need to evaluate the state consequences of these provisions on Day One. While we would generally expect the states to conform to these federal changes as effective tax increases that the states do not have to directly enact, it is possible that local lobbying activity could seek to preserve some of these provisions at the state level. The TCJA's proposals include but are not limited to:

- Limitation on like-kind exchanges under IRC section 1031 (House bill section 3303);
- Contributions to capital may be taxable if the contributed asset benefited from state and/or local incentives (House bill section 3304);
- Repeal of the deduction for domestic production activities (House bill section 3306);
- Limitation on entertainment and similar expenses (House bill section 3307); and
- Reform of various federal business and energy credits, bond provisions, etc. (House bill sections 3401-3604).

Taxation of foreign operations

Some of the most far-reaching provisions contained in both versions of the TCJA pertain to the US taxation of foreign operations. These changes include, but are not limited to, the provisions listed below.

Participation exemption for foreign dividends: Currently, foreign income earned by a foreign subsidiary of a US corporation would not be subject to federal income tax until the income is distributed as a dividend to the US corporation. Section 4001 of the House bill proposes to exempt 100 percent of the foreign-sourced portion of dividends paid by a foreign corporation to a US corporate shareholder that owns 10 percent or more of the foreign corporation. Most of the states that include foreign dividends in the tax base have their own dividend received deduction. The Senate version contains a similar proposal.

Transition tax/deemed repatriation: Under section 4004 of the House bill, US shareholders owning at least 10 percent of a foreign subsidiary would include as subpart F income the shareholder's pro-rata share of the foreign subsidiary's net post-1986 historical earnings and profits (E&P), as determined as of November 2, 2017, or December 31, 2017, whichever is higher. This income would be reported as of the foreign subsidiary's last tax year beginning before 2018. This income would be taxed at one of two rates:

- 14 percent for E&P held as cash or cash equivalents; and
- 7 percent for all other E&P.

The Senate bill contains a similar proposal, but limits the tax rates to 10 percent for E&P held as cash or cash equivalents and 5 percent for all other E&P. In both versions, this deemed repatriation is subject to several complex adjustments (for example, netting E&P surpluses and deficits). However, the deemed repatriation raises a number of key state issues, including whether and how the respective states tax subpart F income. The idea behind the deemed repatriation is that once the federal tax is paid on the deemed repatriation, the actual repatriation of these amounts will be tax-free at the federal level. One key issue for companies to consider is this: to the extent a particular state has not taxed the deemed repatriation, will such a state attempt to tax the funds upon their actual repatriation? Another issue for companies to consider is whether the company has already paid state income tax on any of this E&P (for example, by filing a worldwide state income tax return) and, if so, whether this presents a basis to avoid state taxation of the deemed repatriation.

It is also anticipated by the proponents of the TCJA that a substantial portion of the E&P subject to the deemed repatriation will be repatriated to and reinvested in the American economy. This proposal works in conjunction with the proposal to allow for immediate expensing for five years discussed above. Accordingly, companies who anticipate repatriating and reinvesting a substantial amount of E&P following the deemed repatriation should consider state and local credits and incentives opportunities for such reinvestment, which often take lead time to negotiate.

Current taxation of foreign high returns: Section 4301 of the House bill proposes that a US corporation be subject to current taxation on 50 percent of the US corporation's "foreign high returns." These high returns will be the excess of the US corporation's foreign subsidiaries' aggregate net income over a benchmark rate of return (7 percent plus the federal short-term rate). The Senate bill contains a similar provision that would tax a US shareholder of a controlled foreign corporation (CFC) on its "global intangible low-taxed income," or "GILTI." Such GILTI for corporate shareholders would be subject to an effective tax rate of 12.5 percent. These provisions are intended to prevent against erosion of the US tax base. The states, particularly those that currently use a water's edge filing group, will need to determine whether conforming to such changes would result in a net benefit or a net cost to the state budget, keeping in mind such state-specific issues as formulary apportionment.

Excise tax on payments to related foreign corporations: Section 4303 of the House bill proposes to impose a 20 percent excise tax on payments (other than interest) by a US corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset. This tax would not apply if the related foreign corporation elects to treat the payments as income effectively connected to a US trade or business (ECI). Many states already limit taxpayers' ability to deduct certain payments associated with intangible assets. If foreign corporations elect to treat these payments as ECI, companies will need to evaluate where these foreign entities have nexus and how such payments will be apportioned. States may also consider whether this approach to related party transactions is more effective than the current efforts to limit deductions for related party transactions. Certain states may consider ECI to be included in the state tax base, thereby raising yet another Day One implication for companies.

The Senate bill does not include this excise tax provision, but instead proposes to impose a complex tax on a taxpayer's "base erosion minimum tax amount," or "BEMTA," for each taxable year. The Senate bill's proposal attempts to prevent deductions for "base erosion payments" made by domestic companies to foreign affiliates. Similar to the provisions of the House bill, a state considering whether to conform to this provision may need to consider whether this approach to related party transactions is more effective for the state's purposes than the state's current provisions for related party transactions.

The Senate bill also includes rules that appear to incentivize the "repatriation" of intellectual property currently held by CFCs to the United States. If the CFC at issue meets certain holding period requirements, the fair market value of the property on the date of the distribution to a US shareholder is treated as not exceeding its adjusted basis. Certain other favorable provisions also apply. States will need to consider whether they wish to conform to this federal change or if they would continue to treat such distributions as subject to state tax.

Consider state implications in tax planning

While this summary is not an exhaustive list of all state tax issues raised by each proposal in either version of the TCJA, it is intended to provide an overview of the range of state and local tax issues presented by the legislation. Each company may need to consider these state and local issues when evaluating the Day One impact of the TCJA on current and prospective tax planning.

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