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Tax reform conference language released

House Ways and Means Committee Chairman Kevin Brady, R-Texas, on December 15 released the official conference report for the Tax Cuts and Jobs Act (H.R. 1) after House and Senate conferees resolved the remaining differences in their competing versions of the legislation.

URL: http://docs.house.gov/billsthisweek/20171218/CRPT-115HRPT-466.pdf

The report combines legislative language, a summary of the agreement, and a "very preliminary" revenue score from the Joint Committee on Taxation staff in a single massive document numbering close to 1100 pages. (Legislative language begins on page 1, the summary begins on page 510, and the revenue estimate begins on page 1084.)

The Tax Cuts and Jobs Act would lower tax rates on corporations, passthrough entities, individuals, and estates and move the US toward a territorial-style system for taxing foreign-source income of domestic multinational corporations; but it would offset some of the cost of that tax relief by limiting or eliminating many current-law deductions, credits, and incentives for businesses and individuals (the balance – roughly $1.45 trillion – would be added to the deficit).

Key provisions in the conference agreement are highlighted briefly below.

Corporate taxation

Rate: The agreement would replace the current graduated corporate rate structure with a flat 21 percent rate, effective in 2018.

AMT: The corporate alternative minimum tax (AMT) is being fully repealed. (That was the House's position going into conference, but the Senate-passed bill maintained it.)

Expensing: Under the agreement, items that are amortized under current law could be fully expensed in the year placed in service through 2022, with a phase-out of that benefit thereafter. In addition, the agreement follows the House-passed bill's allowance of expensing for either new or used property.

Business interest: The agreement imposes new limits on the deduction for net business interest. Generally, it would be limited to 30 percent of a corporation's income, measured as EBITDA through 2021 and by EBIT after that. Unused deductions could generally be carried forward indefinitely under the agreement, though separate rules apply to partnership owners.

Also with respect to business interest, a separate provision intended as an additional limit on interest deductions by multinational companies, labeled as new code section 163(n), was dropped from the final agreement.

Section 199 deduction, local lobbying expenses, like-kind exchanges: Also, as in both bills, the section 199 manufacturing deduction is being repealed, as is the deduction for state and local lobbying expenses. Like-kind exchanges will be disallowed, other than for real property.

Net operating losses: The agreement also places new restrictions on the use of net operating losses (NOLs). Generally, under the agreement, NOLs arising in tax years beginning after 2017 may only be carried forward, not backward, and may only be used to offset up to 80 percent of taxable income.

Executive compensation: As in both bills, the conference agreement places new limits on deductions for executive compensation. Under current-law section 162(m), compensation above $1 million in a year to certain executives is only allowed if tied to meeting performance-based goals. The conference agreement would remove the performance-based exception, meaning income to these executives above $1 million would no longer be deductible by the corporation; however, it also provides a transition rule for agreements already in place.

FDIC premiums: The agreement contains language similar to provisions in both the House- and Senate-passed bills limiting the deductions available to larger financial institutions on their FDIC premiums.

Tax-exempt bonds: The agreement does not include a House-passed provision repealing the use of private activity bonds, but it retains a House-passed provision repealing the advance refunding of bonds. The agreement also does not include House-passed language denying tax benefits to bonds used to finance the construction of professional sports stadiums.

Alternative energy provisions: The agreement does not include House-passed language accelerating the phase-out of the tax benefits for renewable and alternative energy sources.

New Markets and Work Opportunity tax credits: The agreement does not include House-passed language phasing out the Work Opportunity Tax Credit and the New Markets Tax Credit (NMTC).

R&D amortization: Melding language in the House and Senate bills, the agreement requires amortization of certain research and development costs over five years (fifteen if the research is done outside the United States), beginning after 2021.

Life insurance: The agreement contains a number of provisions affecting the taxation of life insurance companies but does not include a House-passed provision imposing an 8 percent surtax on the income of those companies.

Settlements: The agreement retains Senate-passed language denying companies a deduction for settlement costs incurred for violations – or potential violations – of law. Further, settlements in cases involving sexual abuse or harassment will no longer be deductible if those payments are subject to a nondisclosure agreement.

Rare "orphan" drugs clinical testing tax credit: The agreement generally follows the Senate bill in reducing the value of the current-law orphan drug tax credit (though the allowable credit is slightly smaller under the agreement than in the Senate-passed bill).

Paid family and medical leave tax credit: The agreement generally follows the Senate bill in creating a temporary tax credit for employers who provide paid family and medical leave to employees.

Passthrough businesses

The conference agreement generally follows the Senate-passed provision allowing a deduction of up to 20 percent (down from the Senate's 23 percent) of passthrough income. It is available for specified service business owners with income under $157,500 (twice that for married filing jointly), but the definition of "specified service" no longer includes architecture or engineering. The provision was also modified to allow electing small business trusts (EBSTs) to qualify for the lower rate and to allow owners to calculate their maximum deduction based on either 50 percent of their share of W-2 wages paid or a combination of 25 percent of their share of W-2 wages paid plus 2.5 percent of the unadjusted basis of all qualified property.

Carried interests: As in both chambers' bills, carried interest income retains its treatment as a capital gain but will be subject to a longer holding period (three years v. one year in current law) in order to qualify.

Technical terminations of partnerships: The agreement retains a House-passed provision repealing technical terminations of partnerships.

International taxation

Like both the House and Senate-passed bills, the conference agreement would move the US from a worldwide tax system to a participation exemption system by giving corporations a 100 percent dividends received deduction for dividends distributed by a controlled foreign corporation (CFC).

To transition to that new system, the conference agreement generally follows rules passed by both chambers that would impose a one-time deemed repatriation tax on unremitted earnings and profits, albeit at higher rates than in either the House or the Senate bill. The conference agreement would tax those amounts at 8 percent for illiquid assets

and 15.5 percent for cash and cash equivalents. As in both bills, the conference agreement would give companies eight years to pay the resulting tax.

The conference agreement generally follows the Senate-passed structure in establishing new base erosion prevention provisions, with modifications. First, the so-called Base Erosion Anti-Abuse Tax (BEAT) is somewhat modified – the applicable rate is 5 percent in 2018 and then rises to 10 percent in 2019. In addition, the Senate-passed language allowing companies to bring offshore intellectual property back to the US without paying tax on the transfer was not included (though a modified version of the Senate's provision providing lower tax rates on foreign-derived intangible income was included in the agreement.). Negotiators had hoped to modify the BEAT to address the concerns of tax equity investors in renewable energy projects (especially wind and solar) but the changes made are different than was sought by the affected industries. The impact of the changes actually adopted is still being evaluated.

Language in both the House and Senate bills making permanent the CFC lookthrough rules (section 954(c)(6)) was not included in the agreement. Also not included was a new section 163(n) that would have placed a further limit on interest deductions of multinational corporations by measuring US interest expense and equity against the similar ratios for the worldwide group.

Individual taxation

As in the Senate-passed bill, all of the individual tax changes expire after 2025. This sunset is necessary to keep the bill compliant with the reconciliation instructions in the FY 2018 budget agreement, which provides procedural protections in the Senate for tax cuts that increase the deficit by up to $1.5 trillion over the next decade, and with the Byrd Rule, which prohibits budget reconciliation bills from increasing the deficit outside the 10-year budget window.

Rates and brackets: The conference agreement generally follows the Senate structure – and current law – by maintaining seven individual income tax brackets.

Under the agreement, the top individual income tax rate will be 37 percent (lower than in either the House or Senate bills). However, the 37 percent rate also comes with a significant "marriage penalty." It will apply to single filers with taxable incomes over $500,000 but kicks in for married couples whose taxable income exceeds $600,000. The rest of the bracket for single filers would be:

- 10 percent on taxable income up to $9,525;
- 12 percent on taxable income between $9,525 and $38,700;
- 22 percent on taxable income between $38,700 and $82,500;
- 24 percent on taxable income between $82,500 and $157,500;
- 32 percent on taxable income between $157,500 and $200,000;
- 35 percent on taxable income between $200,000 on $500,000; and
- 37 percent on taxable income over $500,000.

For married couples, the brackets would be:

- 10 percent on taxable income up to $19,050;
- 12 percent on taxable income between $19,050 and $77,400;
- 22 percent on taxable income between $77,400 and $165,000;
- 24 percent on taxable income between $165,000 and $315,000;
- 32 percent on taxable income between $315,000 and $400,000;
- 35 percent on taxable income between $400,000 and $600,000; and
- 37 percent on taxable income above $600,000.

Standard deduction, personal exemptions, Pease limitation: The agreement nearly doubles the standard deduction and repeals personal exemptions as well as the current Pease limitation on itemized deductions.

AMT: The conference agreement retains the individual AMT, albeit with higher exemption amounts.

Mortgage interest deduction: The agreement generally follows the House-passed measure's treatment of mortgage interest, but the amount of allowable indebtedness for new mortgages would be $750,000 (rather than $500,000 as in the House bill).

Capital gains on sale of primary residence: Deleted from the agreement was any portion of differing House and Senate provisions modifying the current-law capital gains exclusion on the sale of a primary residence.

Tax treatment of securities sales: A Senate provision proposing to tax securities sales on a first-in, first-out (FIFO) basis did not make it into the agreement.

Child tax credit: The refundability of the child tax credit was expanded relative to what passed the Senate. This change was demanded by Sen. Marco Rubio, R-Fla., who was threatening to vote against this package unless such changes were made.

Estate tax: The estate tax changes in the agreement generally follow the Senate-passed bill. The estate tax is not being repealed but exemption amounts are doubled.

SALT: The agreement would place substantial new limits on the ability of taxpayers to deduct state and local taxes (SALT). Specifically, it allows a deduction up to $10,000 for state and local income or sales or property taxes, an expansion from the language in the House and Senate bills limiting it to just property taxes. As in both bills, the $10,000 cap does not appear to be adjusted for inflation.

Individual mandate: The agreement follows the Senate-passed bill in reducing to zero the penalty under the Patient Protection and Affordable Care Act for individuals who do not maintain qualifying health insurance coverage. The provision is effective for months beginning after December 31, 2018.

Alimony payments: The agreement generally follows the House bill, and provides that alimony payments are not deductible by the payor and are not included in income of the recipient, though its effective date is delayed such that the provision is only applicable to divorce or separation agreements executed or modified after December 31, 2018.

Tuition waivers, student loan interest, unreimbursed medical expenses: The House receded to the Senate on some key revenue raising items. Notably, the conference report will not tax the value of tuition waivers provided to graduate students nor will it repeal the deduction for student loan interest or unreimbursed medical expenses.

In fact, the deduction for unreimbursed medical expenses is made more generous than current law, as the agreement follows the Senate-passed language reducing the floor on unreimbursed medical expenses necessary to claim the deduction to 7.5 percent of adjusted gross income for two years (2018 and 2019) rather than the current-law 10 percent.

Charitable giving changes: The agreement includes Senate-passed language increasing the percentage of taxable income that can be deducted when donated to public charities from 50 percent under current law to 60 percent. However, contributions made to a college or university to obtain the right to purchase seating at athletic events will not be tax deductible under the agreement. (Current law allows a deduction of up to 80 percent of those amounts.)

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