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Framework for tax reform: Implications for banking and capital markets

The White House, Republican leaders of the U.S. House and Senate, and the chairs of the House and Senate tax-writing committees on September 27, 2017, released a "unified framework" for tax reform.

While lacking many details, the framework offers some insight into the possible provisions of a tax reform bill, the timing of which is still uncertain. Read an initial report about the framework: ***TaxNewsFlash***

Below is a brief summary of key provisions and initial observations of the potential effects of the tax reform framework on banks and their customers.

Framework's proposal for corporate tax rate reduction to 20%

Reducing the corporate tax rate to 20% continues to be a priority of congressional Republicans, but the sources of revenue to offset the cost of a 20% rate remains an enigma. Regardless of the ultimate rate, the transition to a reduced rate (i.e., phase-in or effective on enactment) would be important as banks revalue their deferred taxes to reflect the new rate.

Potential implications

- Changes in the value of deferred taxes could affect banks' financial statements and could result in changes to banks' regulatory capital.
- A change in the corporate tax rate could also have broader implications for banking operations, as the new rates would be reflected in commercial loan demand, pricing models for municipal bonds, tax credit investments, and capital markets transactions.
- Although rate changes are expected to take effect as early as January 1, 2018, it is possible that the rate would be reduced in multiple steps over multiple years.

Framework's proposal for R&D credit and LIHTC

The framework would retain the research and development (R&D) tax credit and the low income housing tax credit (LIHTC). The framework defers to congressional tax-writers consideration of other business tax credits, such as new markets tax credits, historic rehabilitation tax credits, and energy credits. Banks investing in these credits may be affected if these tax credits are ultimately repealed.

Potential implications

The impact would depend on how the transition rules are written. In the meantime, uncertainty about a possible repeal may also be reflected in current deal volume. Additionally, banks that receive Community Reinvestment Act (CRA) credits through these investments would need to find alternate investments to satisfy their CRA requirement.

The framework is silent on tax-exempt interest from municipal bonds.

Framework's proposal for immediate expensing of qualified capital investments for at least five years

Consistent with previous tax reform proposals, the framework would allow businesses to expense immediately the cost of depreciable assets, other than structures, purchased after September 27, 2017, for at least five years. The framework appears to indicate that the immediate expensing provision would sunset after five years, but leaves the details to congressional tax-writers.

Potential implications

Allowing companies to expense the cost of capital assets is intended to stimulate capital expenditures, but may also have unintended consequences that could result in a greater divergence between federal and state taxable income.

- Immediate expensing would likely result in an increased deferred tax liability that may also affect banks' regulatory capital.
- Further, immediate expensing would likely affect assets that banks hold in leasing portfolios and may require additional examination of the lease structures that banks have in place.

Framework's proposal for partial limits on net interest expense deduction for C corporations

While the framework explicitly references a limitation for net interest expense deductions for C corporations, there is no specific guidance on how this limitation might apply to banks. To the extent the rules are applied on a consolidated group basis, the direct impact on banks may be limited, as they are unlikely to have net interest expense.

Potential implications

The details of this rule warrant close attention:

- Application on a non-consolidated basis would mean more significant implications for banking organizations.
- Taxpayers with significant interest income in an unconsolidated subsidiary (i.e., REIT) may be affected.

A net interest expense limitation could also have a significant effect on lending and leasing operations.

- There could be increased competition for lending by non-banks attempting to generate interest income to offset interest expense.
- There could be increased interest in raising capital or funding through means other than debt.
- The proposed limitation on interest expense may increase customers' preferences for leasing versus financing capital purchases and pricing.

Framework's proposal for a territorial tax system

The framework adopts a territorial tax regime in which income earned and taxed in foreign jurisdictions would be exempt from U.S. taxation when returned to the United States as a dividend, provided the U.S. corporation owns at least 10% of the foreign subsidiary. To transition to the new system, the framework would treat accumulated foreign earnings as repatriated. Cash and cash equivalents would be taxed at higher rates than illiquid assets, but the rates are not specified. Payment of the tax liability would be spread over multiple years. The framework does not propose a border adjusted tax as described in the House "blueprint."

Potential implications

- Taxpayers would need to understand E&P positions for financial statement reporting and for evaluating tax planning opportunities.
- In addition to the uncertainty around foreign tax credits, the shift to a territorial tax system could also raise issues with transfer pricing and APB 23 assertions.
- Banking operations could also be affected in a variety of ways including potential changes to cash management services that banks offer to their U.S. multinational clients, and a potential boon for bank deposits as cash is repatriated.

Framework's proposal for individual deductions for home mortgage interest and charitable contributions

The framework would eliminate most itemized deductions, including the deduction for state and local taxes paid, in favor of an increased standard deduction. While retaining the deductions for home mortgage interest and charitable contributions may be significant, the elimination of the other itemized deductions would likely result in fewer taxpayers choosing to itemize and therefore would effectively eliminate the benefit of retaining such deductions.

Potential implications

- For homeowners who are unable to benefit from the home mortgage interest deduction, there would be an increase in the after-tax cost of mortgages, which could lead to reduced demand for, or individual size of, new mortgages.

Framework's proposal to repeal estate and generation-skipping transfer taxes

The framework would repeal estate and generation-skipping taxes.

Potential implications

- The repeal of these taxes could affect high-net worth clients and provide new opportunities for banks' wealth management operations.

Framework's proposal for modernizing tax rules affecting specific industries

The framework states that industry specific tax regimes would be modernized to "better reflect economic reality" and "provide little opportunity for tax avoidance." While no specific tax regimes are named, this statement could suggest consideration of the mark-to-market rules for derivatives that were provided in the Modernization of Derivatives Act re-released by Senator Wyden last May.

Potential implications

- A change to the taxation of derivatives could affect the investment strategies of retail and institutional investors, driving a change in demand for different investment products.

Read the unified framework for tax reform [PDF 172 KB]

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