TaxNewsFlash

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Initial impressions: Tax reform bill released in House, November 2

Ways and Means Chairman Kevin Brady (R-TX) today unveiled legislative text of H.R. 1, the "Tax Cuts and Jobs Act," as well as a section-by-section summary of the proposed legislation.

Tomorrow, Chairman Brady is expected to release a "Chairman's mark" in preparation for a Ways and Means Committee markup of H.R. 1. That markup is scheduled to begin on Monday, November 6, and to continue throughout the week as necessary. The mark could include modifications to the bill. Chairman Brady also might make other modifications to his proposal before next week's markup begins.

KPMG will be providing preliminary analysis and observations regarding the Chairman's mark after it is released.

Documents

- Read **legislative text of H.R. 1** [PDF 988 KB] (429 pages)
- Read a **section-by-section summary** [PDF 643 KB] (82 pages) prepared by the Ways and Means Committee
- Read a related **Ways and Means press release**
- Read a revenue estimate prepared by the Joint Committee on Taxation: **JCX-46-17**

KPMG observation

The release of legislative text today represents the most significant step towards tax reform in over 30 years and begins the first official phase of the tax reform process.

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Importantly, the legislative text provides the first look at the details of many proposals that have been discussed at a high level for several months. It also reveals what other proposals the taxwriters are considering, including what revenue raisers are proposed to pay for some of the policy modifications.

Keep in mind, however, that today's developments are just the first step on the long road to potential tax reform. As explained below, there are numerous other steps that need to occur for tax reform to become law and many changes may be made to the bill unveiled today.

Highlights

Business provisions

In many ways, the centerpiece of the bill is the significant reduction in the corporate income tax rate from 35% to 20%. The 20% rate would be effective beginning in 2018. But the full list of proposed changes for businesses is extensive, including additional tax benefits and offsetting tax increases.

Notably, the bill would implement an "expensing" regime, allowing taxpayers to write off the costs of equipment acquisitions. This rule generally would apply to both new and used property (but not to property used in a real property trade or business or by a regulated public utility company).

The bill would also implement a new 25% maximum tax rate on business income earned by passthrough businesses such as partnerships, S corporations, and sole proprietorships. The bill proposes several rules to define what income is eligible for this lower rate and includes special rules for owners of certain personal services businesses.

To offset the costs of these tax benefits, the bill would repeal or modify a number of existing items in the tax law. For example, the bill generally proposes to:

- Repeal the section 199 domestic manufacturing deduction
- Impose a 30% limit on interest deductibility (based on an alternate version of taxable income and with an exception for interest incurred with respect to a real property trade or business)
- Limit the use of net operating losses
- Repeal tax credits including WOTC, New Markets Tax Credit, and several others
- Revise several rules governing the taxation of private activity, refunding, tax credit, and tax-exempt bonds
- Provide significant revenue-raising changes for taxation of the insurance industry

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The bill does not address the pending expiration of the moratorium with respect to the medical device excise tax.

Technical changes

The bill would retain the research credit and the low income housing tax credit. Extensive changes to provisions in the areas including real estate, tax-exempt entities, executive compensation, and excise taxes are also included in the bill as well as the repeal of dozens of special business credits and deductions.

Multinational entity taxation

The bill proposes significant changes to the taxation of business income earned outside the United States. It would move from the current system, which permits deferral of the U.S. tax on foreign active business earnings until those earnings are repatriated, to a “territorial” system.

U.S. corporate shareholders that own 10% or more of a foreign corporation would receive a 100% exemption on the foreign-sourced portion of dividends paid by the foreign corporation to the U.S. shareholder.

As a transition to this new system, the bill would deem a repatriation of previously deferred foreign earnings. This repatriation would impose a 12% tax rate on cash and cash equivalents and a 5% rate on illiquid assets. The resulting tax could be paid in installments over eight years.

As expected, the bill would also implement what is effectively a new 10% minimum tax on “high return” foreign earnings of multinational businesses.

One of the more novel proposals in today’s bill—and one that is certain to engender discussion and debate in the coming weeks—is a proposed 20% excise tax on certain payments made by a domestic company to a foreign affiliate. By imposing a 20% tax on these items, they become effectively non-deductible.

The bill also includes a number of other measures, including provisions to avoid erosion of the U.S. tax base through, for example, the excessive placement of debt in the United States relative to worldwide group debt.

Individual provisions

The bill would reduce the seven current tax brackets to four: 12%, 25%, 35% and 39.6%. The top rate would apply to single filers with income of $500,000 and married joint filers with income of $1,000,000—a substantial increase from the current income levels to which that rate applies. These income levels would be indexed for inflation using a chained Consumer Price Index (CPI) calculation.

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The standard deduction would be increased to $24,000 for joint filers and $12,000 for individual filers with these deductions indexed annually using a chained CPI. At the same time, the deduction for personal exemptions would be repealed while the child tax credit would be enhanced and a new family tax credit created.

The revenue cost of these changes would be offset by modifying or eliminating a number of tax preferences, many of them significant and long-standing. These include new limits on (and other changes to) deductions for home mortgage interest, state and local taxes, personal casualty losses, and certain medical expenses. The exclusion of gain from the sale of a principal residence would be phased out for taxpayers with adjusted gross income exceeding $500,000 ($250,000 for single filers) and modified. The "Pease" limitation would be repealed.

The individual AMT, like the corporate AMT, would be repealed. There are no changes to the capital gains and dividends tax rate. The bill also does not include repeal of the net investment income tax.

Changes would be made to a large number of other individual tax items including repeal of the adoption and plug-in electric drive motor vehicles credits; consolidation and modification of education savings benefits; and modifications to the treatment of discharge of student loan debt. A large number of other special credits and deductions would be repealed.

The estate tax exclusion would be doubled to $10 million (indexed for inflation). Beginning after 2023, the estate and generation-skipping taxes would be repealed while maintaining a beneficiary's stepped-up basis in estate property. The gift tax would be lowered to a top rate of 35%, retaining a basic exclusion of $10 million and annual exclusion of $14,000 (indexed for inflation)

Impact of reconciliation rules

When examining H.R.1 or any subsequent version of a tax reform bill in the current legislative effort, keep in mind that the legislation is at least partially being shaped by budget reconciliation requirements.

Budget reconciliation is a process by which some types of legislation (including certain tax measures) can be moved forward in the Senate with only a simple majority vote. The ability to use these rules was "unlocked" when the House and Senate agreed to a budget resolution for FY 2018. The budget resolution permits the tax bill produced pursuant to its instructions to increase the deficit by a maximum of $1.5 trillion over the 10-year budget window. Thus, the House bill presumably was structured with this revenue target in mind; the Joint Committee on Taxation has estimated that the bill would lose approximately $1.49 trillion over the 10-year period (not taking into account possible macroeconomic effects).

The budget reconciliation requirements can be expected to be particularly significant when the Senate considers tax reform legislation. To retain the protection from a

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Senate filibuster that the reconciliation rules provide, provisions in the tax legislation being considered under the budget resolution must meet a number of complex procedural requirements. Any senator could raise a point of order against any provision that does not meet these requirements.

For example, one of the budget reconciliation requirements is intended to prevent an increase in the long-term deficit of the United States. That is, even though a tax bill considered pursuant to the budget resolution could provide up to a $1.5 trillion net tax cut **within** the 10-year window, no title of the bill can result in a net tax cut in any year **beyond** the 10-year budget window.

As other examples, under the reconciliation rules, a point of order generally could be raised on the Senate floor if a provision does not produce a change in outlays or revenues, if its budgetary effects are "merely incidental" to the overall policy objective, or if it makes changes to the retirement and disability programs in Title II of the Social Security Act.

KPMG observation

Although these issues are primarily important in the Senate, it is likely that Chairman Brady considered the reconciliation requirements at least to some extent in putting together H.R. 1. This might explain, for example, why today's bill does not include provisions like technical corrections to prior legislation that do not have a revenue effect and thus could run afoul of reconciliation requirements in the Senate.

What is next?

As indicated, Chairman Brady is expected to release his "mark" tomorrow and may release further modifications before the committee begins markup next week. The modifications made in these documents could include technical improvements to the original proposal or could make policy changes designed to increase the likelihood of committee approval of the bill or the political prospects of the bill in the future. Additionally, it is possible that other amendments could be approved during the committee's markup of the bill.

If the Ways and Means Committee approves the bill and orders it to be reported, the bill would proceed to the House Rules Committee, and then would be debated and considered by the full House. In theory, the House could pass the bill by mid-November. However, this aggressive schedule depends on no major setbacks causing a delay in either the Ways and Means Committee or in the full House.

On the Senate side of the Capitol, Senate Finance Committee Chairman Orrin Hatch (R-UT) is also reportedly contemplating swift action on a tax bill. It is possible that Chairman Hatch could release his mark as early as the week of November 6th with Finance Committee action possibly taking place prior to the Thanksgiving recess. At this point, it is unclear to what extent a mark released by Chairman Hatch might differ from the mark released by Chairman Brady or from a bill that ultimately might be

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approved by the House. During the Finance Committee's markup, it is possible that additional amendments might be made.

After the Senate Finance Committee finishes its markup and approves a bill, it would order its bill to be reported. During consideration by the full Senate, it is likely that amendments would be adopted on the Senate floor. It is not yet certain when Senate floor action would commence or when a vote on final passage would take place. The Senate bill potentially could be very different from the House bill.

For tax reform to become law, the House and the Senate ultimately would have to pass identical legislation and send it to the president. Thus, a conference committee might be convened to work out the differences between the two bills. The more significant the differences between the two bills, the longer it can be expected to take to negotiate a conference agreement and reaching an agreement could be challenging. For tax reform to become law, the conference agreement would need to be approved by both the House and the Senate and signed by the president.

The often stated goal of Republican congressional leadership is to present President Trump with a bill that he could sign prior to the end of 2017. The aggressive schedule outlined by House and Senate leaders is aimed at meeting this deadline. If actions move forward and stay on track, it is possible that this deadline could be met—but any significant hiccups at any of the many junctures along the path to enactment could derail this tight timeline and push the process over into 2018 or lead to the demise of the bill.

KPMG observation

There were some surprises in today's release, but overall, the bill makes good on the promises made in the "unified framework" for tax reform.

It is important to remember that this bill is not a finished product. More changes, possibly significant ones, are coming in the following days. Recall, however, that any broadening of the tax benefits in the bill will need to be matched by tax increase elsewhere. Because changes are expected, it is too early to opine on the political viability of the bill.

There are scores of technical issues to highlight and observations to make regarding today's release. Those will be provided in KPMG's much larger report in the coming days. Meanwhile, a few initial observations can be made today:

- The expensing rule is broader than many had expected. In particular, applying the new rule to both new and used property moves the system a bit closer to the cash flow tax originally envisioned by the House Blueprint released in June 2016. One aspect of applying the rule to used property could be seen in M&A transactions as an expensing rule could, in some instances, make asset acquisitions more appealing than stock acquisitions.

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- The global minimum tax provision would impose tax on 50% of **all** income earned offshore in excess of a modest (AFR + 7%) return on investments in tangible depreciable property. This would represent far and away the lion's share of all offshore income earned by U.S. multinationals. It is worth noting, however, that the rate of return is computed on a global basis across all related controlled foreign corporations (CFCs) and that a credit for 80% of foreign taxes would be available to reduce the U.S. tax on these amounts. Thus, companies with a foreign effective tax rate (ETR) of at least 14% across all CFCs are not expected to be affected.

- The new 20% excise tax regime for payments to related foreign entities effectively imposes a destination-based tax on the income of a foreign- or domestic-parented multinational group that imports into the United States through a taxable presence. To some extent this can be viewed as in the spirit of the "BAT" (border adjustment tax) proposal that was abandoned earlier in the year. It does, however, differ significantly in that it applies only to transactions with related parties, and even then provides an option which allows for a formulaic deduction for costs incurred with unrelated parties.

- Finally, changes can be expected to the proposed transition rules from the current tax system to the new system as the process moves forward and lobbying continues. Transition rules could include grandfathering of existing arrangements or exemptions from regimes and accommodations for specific circumstances. While the bill has many such rules already, the need for transition relief can be fully understood by taxpayers and by tax-writers now that legislative text is available.

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