Tax Reform 2.0

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September 27, 2018

Agenda

The Past

- Tax Cuts and Jobs Act and Prior Tax Reform Efforts

The Present

- JCT Bluebook and Treasury Guidance

The Future

- Tax Reform 2.0

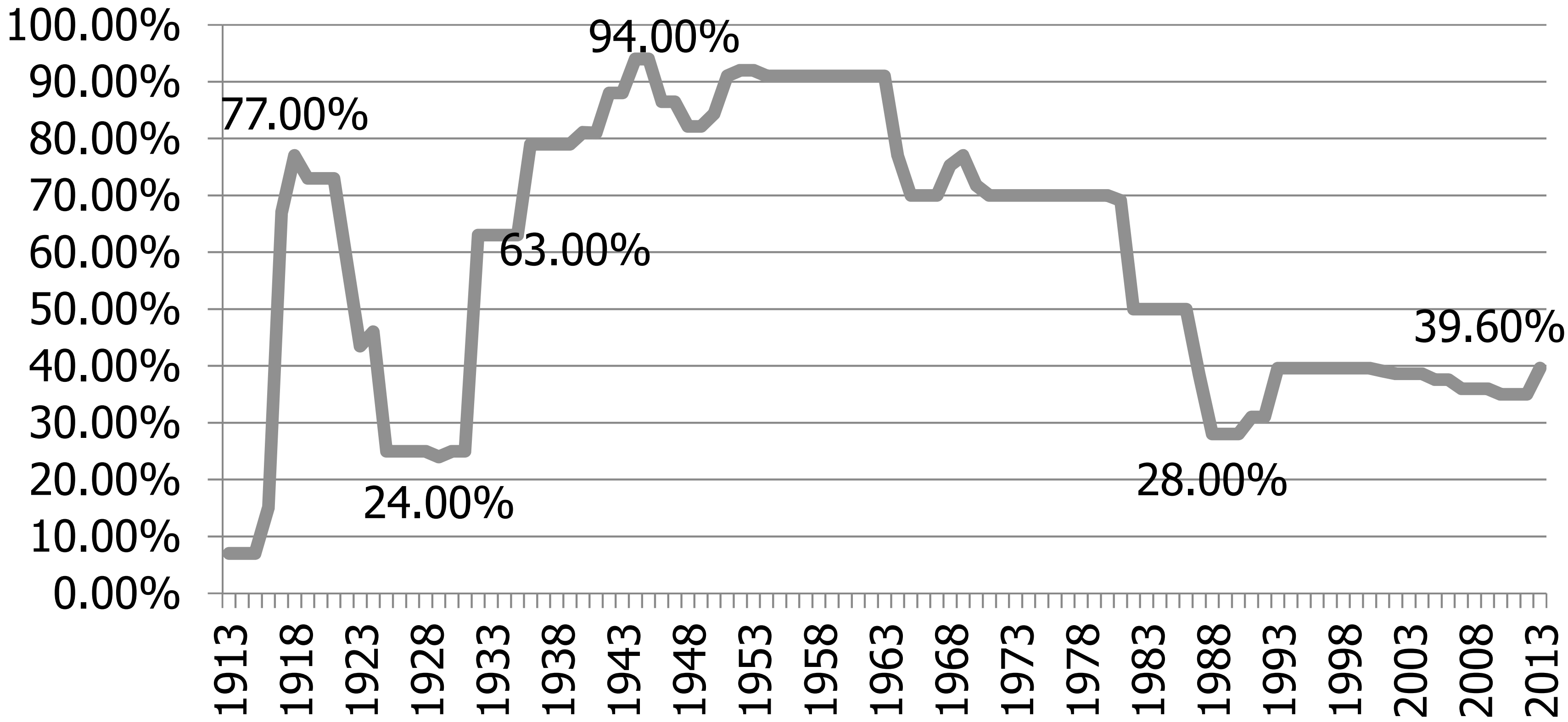
THE PAST:

“TAX CUTS AND JOBS ACT”

What is tax reform?

- Not all tax legislation is “tax reform”
- Tax reform is:
  - Revenue neutral (government share of revenue is the same as before)
  - Distributionally neutral (those with more pay more than those with less)
  - Horizontally neutral (similarly situated taxpayers pay the same)
  - Efficient (does not distort economic transactions)
  - Achieved by broadening tax base and lowering tax rates (eliminate “tax expenditures”)

US Top Marginal Tax Rates: 1913-2013



I would do anything for tax reform …

- 1986 Act:
  - Multi-year effort with sustained engagement from Treasury,
  - 100 base broadening measures,
  - lowered top individual income tax rate from 50% to 28%,
  - lowered corporate tax rate from 46% to 34%,
  - achieved parity of tax rate on capital and ordinary income
- Tax Reform Act of 2014 (Camp Draft)
  - Individual rates reduced from 39.6 to 35%, corporate rate to 25%, territorial system
- Tax Reform Blueprint of 2016
  - Destination based cash-flow tax with border adjustment (BAT)
  - Individual tax rates to 33%,
  - corporate tax rate to 20% with 25% passthrough rate

…(but I won't do BAT)

Joint Statement on Tax Reform (July 27, 2017)

"[W]e are now confident that, without transitioning to a new domestic consumption-based tax system, there is a viable approach for ensuring a level playing field between American and foreign companies and workers, while protecting American jobs and the U.S. tax base.

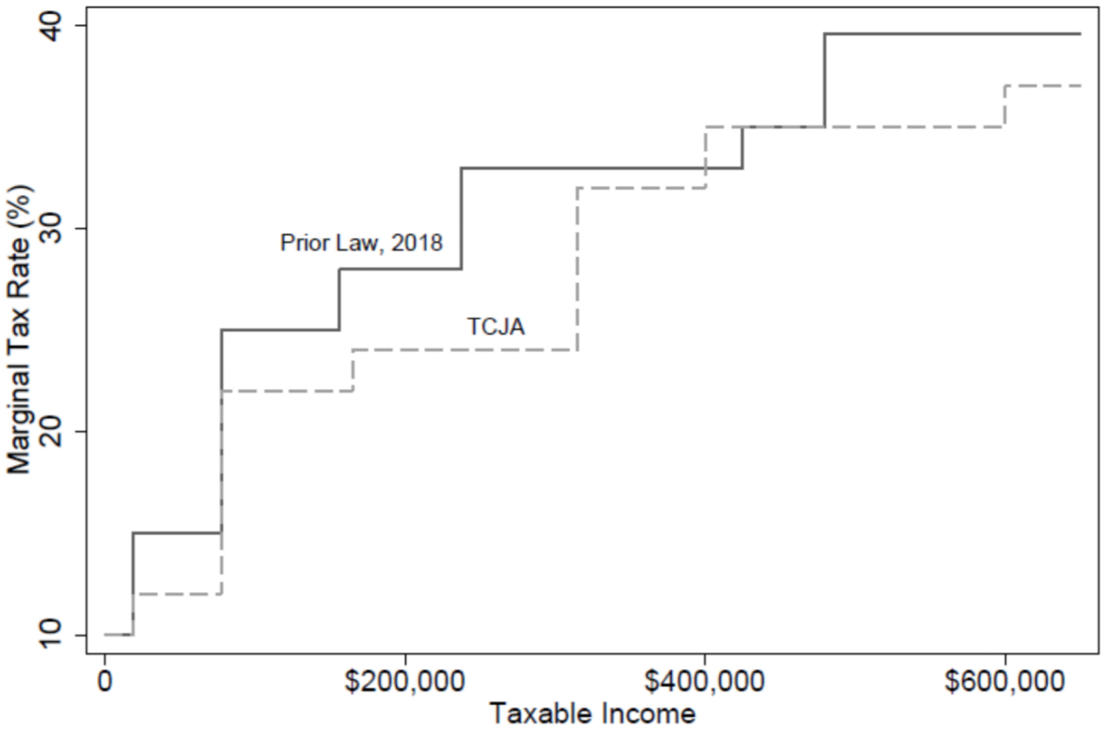
While we have debated the pro-growth benefits of border adjustability, we appreciate that there are many unknowns associated with it and have decided to set this policy aside in order to advance tax reform. …

Our expectation is for this legislation to move through the committees this fall, under regular order, followed by consideration on the House and Senate floors."

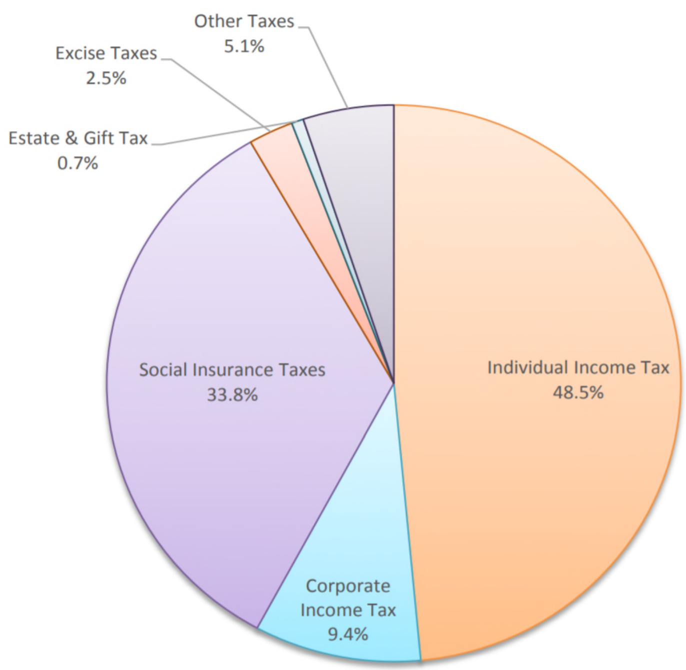
What was Public Law 115-97?

- It was not the “Tax Cuts and Jobs Act” because **reconciliation**
- More short-term **stimulus** than tax reform:
  - Reduces tax revenue by **$1.8 trillion** over 10 years, raises deficit by $2.3T
  - Cut max corporate income tax rate to **21 percent**
  - Redesigned international tax rules (**GILTI, BEAT, FDII, repatriation**)
  - New deduction for **pass-through income**
  - **Expensing** of equipment investment
  - Eliminates **corporate alternative minimum tax**, personal and dependent exemptions, tax on failure to obtain adequate health insurance coverage
  - Increases **standard deduction**, the estate tax exemption, and the individual alternative minimum tax exemption
- Corporate provisions **permanent**
- Individual and estate tax provisions **expire after 2025**

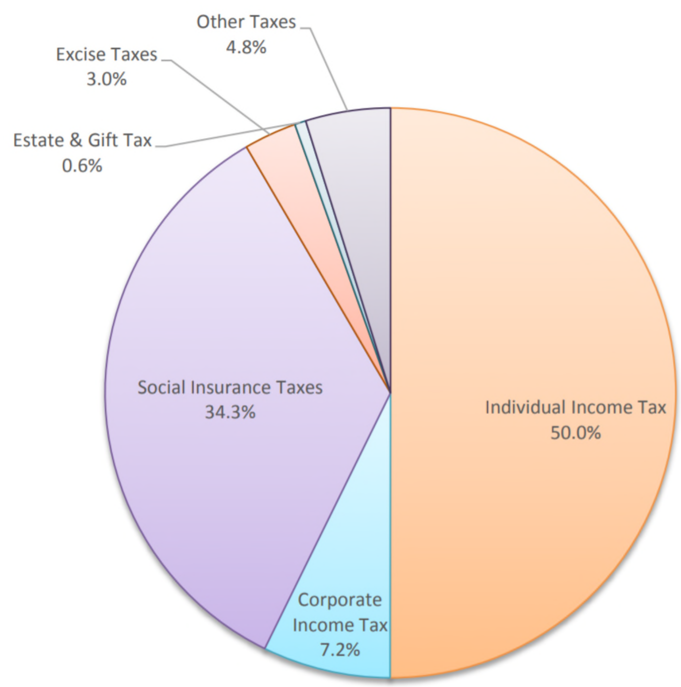
Effect of Tax Cuts and Jobs Act on individual tax rates



Sources of ~$3.3 trillion tax revenue: Shift of tax burden from corporations to individuals



2017



2018

See Joint Committee on Taxation, Overview of the Federal Tax System in Effect for 2017 and 2018, JCX-17-17 and JCX-3-18

Negative Consequences of Tax Cuts and Jobs Act

- SALT cap
  - Deduction for state and local taxes limited to $10,000
  - High tax states have democratic delegations (NY, CT, NJ, IL, WI, CA, MD)
  - 10th Amendment concerns
- BEAT
  - Base erosion anti-abuse tax establishes minimum tax on cross border related-party transactions involving payment of royalties, interest, rent, and high-margin service payments
- Limits on corporate interest deductions
  - Corporations cannot deduct more than 30% of taxable income computed without regard to interest and depreciation)
  - In 2022 depreciation add back goes away
  - Increased after-tax cost of leveraged structures

Negative Consequences of Tax Cuts and Jobs Act (cont'd)

- CFC attribution rules
  - US shareholders owning 10% of controlled foreign corporations must pay tax on Subpart F income
  - New upstream attribution rule significantly increases number of CFCs and changes international tax planning
- Mortgage Interest Deduction
  - Reduced maximum mortgage from $1.1 million to $750,000 and doubled standard deduction
  - 20.9 million taxpayers will be unable to claim a mortgage interest deduction
- Charitable Deduction
  - Charities are expected to lose $17.2 billion in donations in 2018 alone due to effect of doubled standard deduction and estate tax exemption
  - 21 million taxpayers will lose ability to claim a deduction, deduction limited to top 9%

Negative Consequences of Tax Cuts and Jobs Act (cont'd)

- GILTI
  - Significant uncertainty remains in global intangible low-taxed income (GILTI) rules
  - The special low tax rate of 10% creates incentives to plan **into** GILTI
  - GILTI applies to companies without intangible assets
  - Application of GILTI against depreciated basis of tangible assets creates distortions
- Deduction for passthrough income is difficult to apply and prone to abuse
- Error in bonus depreciation rule excluded "qualified improvement property"

Negative Consequences of Tax Cuts and Jobs Act (cont'd)

- NOLs
  - Net operating loss deduction limited to 80% of business's net income in a given year
  - Losses can be carried forward indefinitely, but **not backward** (no more 2 back and 20 forward) which makes income smoothing more difficult
  - Can't use net operating loss in one business to offset income from other sources
  - Effective dates are confused: law says NOL carrybacks eliminated effective for NOLs arising in tax years **ending** after 12/31/17 but conference report says it is effective for tax years **beginning** after 12/31/17. Fiscal year taxpayers with tax years beginning in 2017 and ending in 2018 can't carryback NOLs without a change.
- And many, many more…

THE PRESENT:

JCT BLUEBOOK
TREASURY GUIDANCE

JCT Bluebook

- The Joint Committee on Taxation hopes to publish a comprehensive technical explanation of the Tax Cuts and Jobs Act by year end (Bluebook)
- The explanation may clarify certain ambiguities in the text
- The Bluebook is nonbinding but instructive to Treasury when writing implementing regulations and is often cited in legal opinions
- Ambiguities that can’t be clarified through technical explanations may be added to the list of technical corrections for inclusion in future tax legislation
- Taxpayers with specific concerns about the legislation are strongly encouraged to come in to meet with staff

Treasury Guidance

- The IRS and Treasury have a task force committed to releasing guidance on the Tax Cuts and Jobs Act
- Taxpayers with specific concerns are strongly encouraged to write comments and/or meet with staff to discuss regulatory implementation of the legislation
- Information about the administrative burden of the legislation is particularly persuasive to staff
- Treasury generally cannot delay implementation of a statute through guidance, but it can relieve interest and penalties for good faith compliance

Initial Implementation of Tax Cuts and Jobs Act

1. Guidance on certain issues related to the business credit under §45S with respect to wages paid to qualifying employees during family and medical leave.
2. Guidance under §§101 and 1016 and new §6050Y regarding reportable policy sales of life insurance contracts. (Notice 2018-41)
3. Guidance under §162(m) regarding the application of the effective date provisions to the elimination of the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit.
4. Guidance under §162(f) and new §6050X (Notice 2018-23)
5. Computational, definitional, and other guidance under new §163(j) (Notice 2018-28)
6. Guidance on new §168(k).
7. Computational, definitional, and anti-avoidance guidance under new §199A.
8. Guidance adopting new small business accounting method changes under §§263A, 448, 460, and 471.
9. Definitional and other guidance under new §451(b) and (c) (Notice 2018-35)

Initial Implementation of Tax Cuts and Jobs Act (cont’d)

10. Guidance on computation of unrelated business taxable income for separate trades or businesses under new §512(a)(6) (Notice 2018-67)
11. Guidance implementing changes to §529
12. Guidance implementing new §965 and other international sections of the TCJA (Notice 2018-07, Notice 2018-13, Rev. Proc. 2018-17, Notice 2018-26)
13. Guidance implementing changes to §1361 regarding electing small business trusts.
14. Guidance regarding Opportunity Zones under §§ 1400Z–1 and 1400Z–2 (Rev. Proc. 2018-16, Notice 2018-48)
15. Guidance under new §1446(f) for dispositions of certain partnership interests (Notice 2018-08, Notice 2018-29)
16. Guidance on computation of estate and gift taxes to reflect changes in the basic exclusion amount.
17. Guidance regarding withholding under §§3402 and 3405 and optional flat rate withholding (Notice 2018-14)
18. Guidance on certain issues relating to the excise tax on excess remuneration paid by “applicable tax-exempt organizations” under §4960.

THE FUTURE:

TAX REFORM 2.0

Pre-Election Dynamics

- Tax Cuts and Jobs Act is the major legislative victory for Republicans
  - Republicans reluctant to criticize it publicly prior to the election
  - Yet "Tax Reform 2.0" suggests an iterative process, that the first cut was imperfect
  - Also Republicans in blue states like New Jersey and California have constituents adversely affected by SALT cap
- Legislation was passed without material Democratic support
  - Democrats publicly refusing to engage with Republicans about how to fix it
  - Those running for office, however, promise to eliminate the SALT cap

Pre-Election “Tax Reform 2.0”

- Current draft of Tax Reform 2.0 legislation
  - Makes expiring provisions permanent, including individual tax rate reductions, deduction for pass through income, child tax credit modification, estate tax exclusion, etc.
  - Additional incentive for cash gifts to charities
  - Retirement saving incentives for small businesses,
  - Incentives for new businesses to write off start up costs without limiting access to research and development (R&D) tax credit
  - Does not address technical corrections
  - Total cost of three bills: $657 billion
  - Not paid for with material revenue raisers
- Likely to pass House of Representatives
- Unlikely to pass Senate

Post Election Tax Reform 2.0

- Political incentives change dramatically after the election and before the next Congress begins in January 2019 (the "lame duck" session)
- Republicans would have a strong incentive to improve on Tax Cuts and Jobs Act and ameliorate its negative consequences
- Leadership desires new congress to start with a clean slate; legacy issues for retiring Speaker Paul Ryan
- Increasing the $10,000 SALT cap likely enjoys bipartisan support and may well get 10 Democrats to vote for it in the Senate
- With 60 votes in the Senate, Tax Reform 2.0 would not need to be paid for because Senate can waive the PAYGO rules
- For example, in 1994, Congress passed a major tax bill during lame duck session after the Democrats lost control in the election

All Signs Point to a Christmas Tree Bill

What should you do?

- Determine how the Tax Cuts and Jobs Act affects existing structures and business plans
- Don’t be surprised by phase outs, particularly the debt limits
- International tax planning is a whole new ball game
- Consider how regulatory implementation will impact you
- Meet with JCT staff and Members on tax writing committees about the Bluebook, technical corrections, and legislative improvements to Tax Cuts and Jobs Act
- Meet with Treasury and IRS staff about guidance
- Submit comments
- Call your tax advisor!

Biography

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Education

- New York University School of Law, 2002, LL.M.
- New York University School of Law, 2001, J.D.
- Yale University, 1997, B.A., With Distinction

Alexander L. Reid advises tax-exempt organizations in planning, structuring, and transactional matters. He also represents taxpayers under audit, and helps organizations improve their governance and enhance their tax compliance. Alexander counsels taxpayers seeking administrative guidance from the Internal Revenue Service (IRS) and US Department of the Treasury, as well as on legislative matters with the US Congress. His tax-exempt clients include charities, foundations, colleges and universities, museums, and other nonprofit organizations.

Before joining Morgan Lewis, Alexander served as legislation counsel for the Joint Committee on Taxation of the US Congress, where he advised members of Congress and staff regarding tax policy. He also drafted legislation, hearing publications, and technical explanations of tax legislation. Prior to his work with the government, he was a senior associate in the tax practice of an international law firm. He has also served as a tax policy fellow at the Treasury Department's Office of Tax Policy.

Morgan Lewis Tax Practice

Morgan Lewis represents clients in all stages of tax-related issues: planning, transactional-related tax work, and tax controversy and litigation matters. Our team includes lawyers with experience including high-level service in the US Department of the Treasury and the US Department of Justice, and we advise on international as well as US federal, state, and local tax exposures associated with pending transactions and ongoing business operations.

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- Band 1, Nationwide Tax Controversy, Washington, DC Tax, and Pennsylvania Tax (*Chambers*)
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https://www.morganlewis.com/topics/navigating-us-tax-reform

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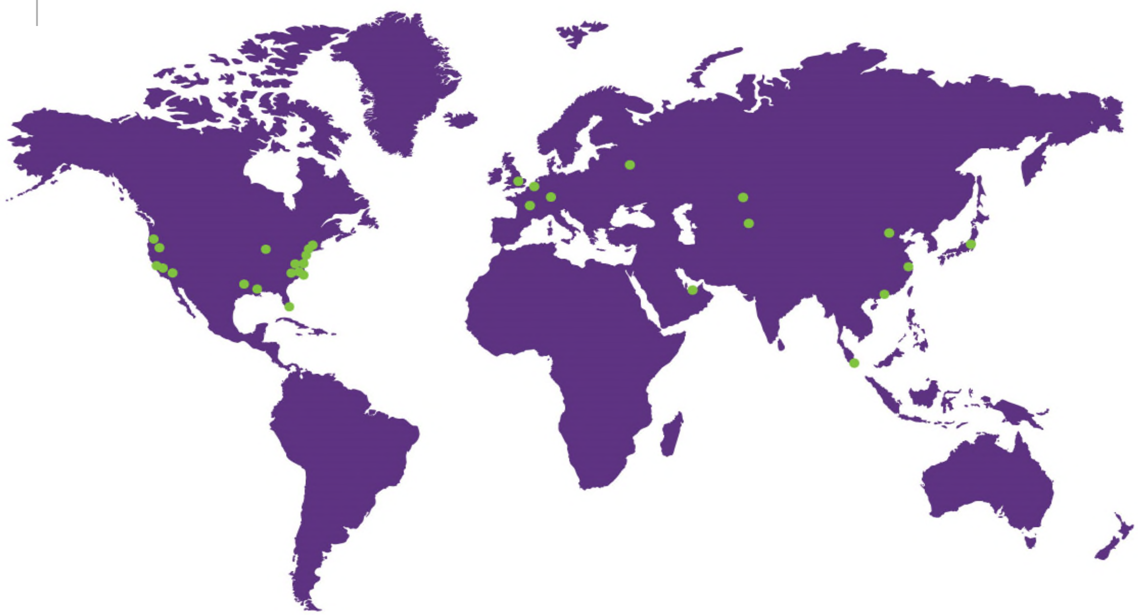

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