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Federal Tax Reform: The Senate Bill – Comparison to the House Bill, and Evaluating the Bigger Picture

by Saba Ashraf and Adam S. Wallwork | November 14, 2017

The Senate Finance Committee released a detailed description of the Senate's tax reform bill, titled the Tax Cuts and Jobs Act, on November 9. The Committee has not released the text of the bill, and likely will not do so until after it approves the bill. Earlier on the same day, the House Ways and Means Committee completed its four-day markup of the House bill, H.R. 1—which had been released on November 2, 2017—and approved the amended version.

Although it is important to focus on the details of the two plans, we also note the following broader points that could be helpful in evaluating the bills.

The table below summarizes the key provisions of the Senate bill and compares them to the original House bill and the amended House bill.

- Next steps. The full Senate and the full House will vote on their respective bills. The House is expected to vote on the House bill as early as this Thursday. The Senate is not expected to vote on its bill until closer to Thanksgiving. (Before the Senate bill goes to a floor vote, it must be approved by the Senate Finance Committee, which is in the middle of a multi-day markup of the bill). Once the two bills are approved—because they contain considerable differences—they must be merged in a conference committee. After this merged bill comes out of the conference committee, it must then be passed by the House and the Senate before it can become law. One commentator noted that the conference committee discussion/markup of the bill will "likely resemble the final scene in *Animal House* as leadership insists, 'Remain calm…all is well,' while bedlam ensues."

- To be enacted, the bill must increase revenue, decrease tax cuts, or make them temporary. Much like the House bill, the Senate bill does not meet the rules for it to pass via the budget reconciliation process. As we've earlier noted, in order for tax changes to be eligible to pass under the budget reconciliation process, and thus to be passable with the vote of only 50 senators rather than the 60 senators (i.e., have Democratic buy-in, which seems highly unlikely), the cost of the tax changes cannot exceed $1.5 billion past 10 years. In other words, the cost of the tax legislation has to be zero in 2027. Although both the House and the Senate bills will increase the deficit by nearly $1.5 trillion over the next 10 years, as written, they will continue to increase the deficit the next year as well. Critically, there are not enough measures in the bills to stop the increase in deficit beyond a 10-year period. There are not tax cuts that expire in the 11th year, or tax increases that will go into effect in the 11th year. In other words, the bills do not provide for enough of the tax cuts to be temporary, or provide for additional tax or revenue increases that would ensure that the deficit did not continue to increase after the 10-year period.

- Temporary tax cuts a possibility. It is quite possible that what eventually passes will be temporary tax cuts that are set to expire after 10 years. As we have noted earlier, even if the tax cuts are announced as temporary, once temporary tax cuts are in place, there is a likelihood that they will become permanent. For example, the Bush tax cuts were supposed to be in place for only 10 years. However, they were made permanent upon expiration. This is because once they expire, reverting back to the old rates is often viewed as a "tax increase," and it is hoped by the proponents of the tax cuts that their opponents will not have the political appetite to be viewed as responsible for "tax increases."

- Reductions in income from capital, versus from debt or labor. Income can be viewed as arising from three primary sources: labor/wages, capital-financed investment, and debt-financed investment. Both the Senate bill and the House bill contain several proposals decreasing taxes on income derived from capital. Critics note that the super-wealthy earn a disproportionate amount of their income from capital, as compared with those that earn it through wages.

- Past 2017. Republicans have repeatedly said they would like to enact new tax laws before the end of 2017. Although the political motivation for this is understandable, we note that even if no bill passes this year, we would not be at all surprised to see continued proposals and a push for tax reform well past 2017.

- Individual mandate repeal. Neither of the bills currently repeals the individual mandate (which requires individuals to have health insurance). However, President Trump suggested including the repeal, and several Republicans seem agreeable. Senator Toomey reportedly said it was a “terrific solution” to the dilemma that the tax bills add to the budget deficit outside the permissible 10-year window. The repeal of the individual mandate would increase revenue/decrease costs to the government because if individuals are not required to get health insurance, it would mean fewer individuals would be on Medicaid or enroll in plans on the Affordable Care Act’s marketplaces – both of which would reduce the cost to the government. While the repeal of the individual mandate may solve this problem, it would make the passage of the bills even more difficult.

Proposal	Senate Bill	Amendment to House Bill[1]	House Bill[2]
Individual Marginal Tax Rates	10% 12% 22.5% 25% 32.5% 35% 38.5%	-	12% 25% 35% 39.6%
Observations: The Senate bill would retain the seven existing brackets instead of consolidating them into four brackets as the House bill did. The effect on individuals of the rate changes is only meaningfully understood once the brackets to which they apply are examined. See footnote for tables summarizing brackets to which rates would apply under existing law, the House bill and the Senate bill.[3] Generally, there would be significantly fewer individuals in the highest brackets, as the higher brackets would shift to start to apply to higher levels of income. One important detail is that under the Senate bill and the House bill, the brackets will be adjusted annually according to the "chained CPI," rather than the normal or plain CPI, which is currently used. The effect of this is that gradually, more and more people would be pushed into higher tax brackets.			
Proposal	**Senate Bill**	**House Amended Bill**	**House Bill**
Standard Deduction and Personal Exemption **(Single Filers/ Joint Filers)**	$12,000/ $24,000 -No personal exemptions	-	$12,000/ $24,000 -No personal exemptions
Observations: Similarly to the House bill, the Senate bill nearly doubles the current standard			

deduction of $6,350 for single individuals and married individuals filing separately and $12,700 for married individuals filing a joint return. But, as under the House bill, the personal exemption (currently $4,050 each for the taxpayer, the taxpayer's spouse, and any dependents) would be eliminated. This will lead fewer individuals to choose to itemize deductions, since for many people the standard deduction would exceed itemized deductions.			
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Individual Capital Gains Rates	15% 20% -The 3.8% net investment income tax (NIIT) imposed under Affordable Care Act. (ACA) retained	-	15% 20% -The 3.8% NIIT imposed under the ACA retained.
Observations: The House and Senate bills both preserve the existing capital gains tax rates, but again, the higher rate appears to apply to higher tax brackets as compared with existing tax brackets. In contrast to the House Blueprint and the Trump Plan[4], the 3.8% NIIT is not proposed to be repealed by the House bill (likely because it would increase the deficit too much).			
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Individual Deductions	-Full elimination of state and local tax deduction (but state and local taxes paid or accrued in carrying on a trade or business may be deducted). -Maintains the interest	-	-State and local income or sales tax deductions eliminated -Real property tax deduction: capped at $10,000. -Mortgage interest

	deduction for up to $1 million of mortgage interest (but not for home-equity loans or second homes). -Preserves the charitable deduction, and expands it, allowing people to deduct up to 60% of their income in contributions (as compared, generally, with 50% under current law).		deduction: kept, but only for first $500,000 of loans for newly purchased homes (reduced from $1 million limit); deduction for second homes would be eliminated, as would deduction for interest paid on home-equity loans. -Extends holding period required for gain from sale of personal residence to qualify for exclusion, and phases out exclusion starting at certain adjusted gross income levels.

Observations: We expect the difference between the House and Senate proposals on the deductibility of state and local taxes to be a big point of contention. Commentators have noted that the difference on this point does not split along party lines, but rather on geographic lines, with those with constituents from high-tax states desiring to limit the deduction as little as possible. Chairman Brady (of the House Ways and Means Committee) has already stated that he would not accept a complete repeal of the state and local tax deduction in the final bill. Interestingly, there are no Senators from high-tax states up for reelection in 2018.

Proposal	**Senate Bill**	**Amended House Bill**	**House Bill**
Estate Tax	Does not repeal the estate tax; instead doubles the current	Repeal delayed until 2025.	Repeals estate tax effective 2024.

	exemption (currently approximately $5.5 million for single and $11 million for married individuals).	Until repeal, exemption doubled.	Until repeal, exemption doubled.
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Corporate Tax Rate	20% (phased in starting 2019)	-	20%

Observations: There was considerable debate about whether this would be proposed as a permanent rate reduction or a temporary one leading up to the release of the House bill. The House bill reflected this as a permanent reduction, with no phase-in, and the Senate bill delays it only by a year. There is a very strong desire on the part of the Republicans to have this tax cut be permanent. This may not be practical.

The Senate bill's delayed effective date reduces the bill's cost. The delayed effective date has also been noted by commentators as being helpful for tax planning (ex: plan to ensure deductions are taken in 2018, when rate is 35%, to result in maximum benefit). President Trump has noted he was hoping for a lower rate as his plan originally proposed a 15% corporate tax rate.

Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Interest Deductibility	-Cap placed on business interest deductions. However, limit on deductibility is stricter than House bill. While the House bill bases its 30% limitation on business interest income plus earnings before	-Provides a limited exclusion from the limit on deductibility for taxpayers that paid or accrued interest on "floor plan financing indebtedness" (debt used to finance motor vehicles acquired for retail sale and secured	-Cap placed on business interest deductions equal to the sum of business interest income plus 30% of adjusted taxable income. -Any interest amounts disallowed for the

	interest, taxes, depreciation, and amortization (EBITDA), the Senate bill limits to business interest income plus 30% of adjustable taxable income. -Disallowed interest can be carried forward indefinitely (as compared with 5 years under the House bill.) -Cap does not apply to some real property businesses, regulated public utilities, and small businesses with average gross receipts below $15 million (compared to $25 million under the House bill).	by that inventory.) This appears to benefit car dealerships which borrow money to buy inventory.	taxable year would be carried forward to the next five taxable years. -Cap does not apply to some real property businesses, regulated public utilities, and small businesses with average gross receipts of $25 million or less.

Observations: The existing tax deduction for interests lowers the effective cost of obtaining capital and has long been a part of our tax system. For years, U.S. taxpayers have been encouraged by existing tax rules to leverage their investments. If the proposals are enacted, this would change. If enacted, the interaction with and effect on various other tax rules would have to be carefully considered, including those distinguishing debt from equity, earnings-stripping, and inversion-related rules. Given how much many in the financial, private equity, real estate, and other industries have historically relied on—and currently rely on—the interest deduction in their business models and determinations of price for various purchases, we expect this proposal will likely face significant pushback, as its enactment would generally raise the cost of borrowing capital.

Proposal	Senate Bill	Amendment to House Bill	House Bill
Earlier taxation of Nonqualified Deferred Compensation	-Nonqualified deferred compensation is includible in income generally once no longer subject to a requirement to provide future service. Compensation taxable without regard to whether there are other conditions on the right to receive the compensation, such as conditions related to performance metrics. -Options and stock appreciation rights, other than incentive stock options, would also be subject to taxation once no longer subject to service-based vesting conditions.	-Preserved exception to general rule; current law retained	-Eliminate exceptions to the general rule requiring taxation of nonqualified deferred compensation as soon as there is no substantial risk of forfeiture.
Observations: There was somewhat of an uproar after the House bill originally revealed its proposals regarding the taxation of nonqualified deferred compensation plan. Ironically, the Senate bill includes significant changes to the taxation of nonqualified deferred compensation just hours after the House abandoned a similar plan.			

Proposal	Senate Bill	Amendment to House Bill	House Bill
Temporary Immediate Expensing **+ Section 179 Expensing**	-Immediate expensing/full deduction of new equipment placed in service – again available for 5 years, until the end of 2022 (with an extra year for certain property). -One important difference: under the Senate bill, bonus depreciation is limited to *original use* property, whereas the House bill would allow it for newly acquired property, including that for which the taxpayer was not the first to use the property. -Reduces the depreciation life for specified assets (ex. 39.5 years to 25 years for some real estate, 15 years to 10 years for qualified improvement property, and 7 years to 5 years for farming	-	-Accelerated recovery of certain capital expenses, including full, immediate expensing. -However, immediate expensing only available for 5 years. After that, back to the old rules. -For 5-year period, Section 179 immediate business expensing limit increased from $510,000 currently to $5 million.

	machinery). -Increases expensing limitation under Section 179 from $510,000 currently to $1 million.		
Observations: While both the House proposal and the Senate proposal would theoretically spur investment in certain business assets, are aimed at small businesses, and spur buyers to engage in M&A activity, both proposals are much milder versions of the much more expansive proposals in the House Blueprint and in the Trump Plan. That parts of the proposals would only be in effect for five years probably is reflective of the pressures to limit the cost of the tax bills.			
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Pass-Through Business Income	-Still lowers rate on certain pass-through income. However, the approach is different from that of the House bill. -The House bill simply has a lower tax rate on certain pass-through business income. The Senate bill lowers the rate by letting individual owners of sole proprietorships, S corporations and partnerships take a deduction of up to 17.4% of their	-The same as the House Bill, except that a lower 9% tax rate is introduced for some pass-through income. The 9% rate would apply to the "first $75,000" in net business taxable income of an active owner or shareholder earning less than $150,000 in taxable income through a pass-through business. The benefit of the 9% rate would phase out for income above $150,000 and would be fully phased	-Maximum tax on business income of owners and shareholders of pass-through businesses and sole proprietorships is 25%. -However, only passive owners/investors in such businesses are entitled to the 25% rate. -"Professional services" businesses could not automatically qualify

	"qualified business income" (generally net domestic business income – other than specified service income – see definition below). -The amount of the deduction is limited to 50% of the "W-2 wages" of the taxpayer allocable to the qualified business income. So, if an owner of a pass-through entity does not have any W-2 wages from a business, that owner will not get any deduction. -The deduction is disallowed for anyone in a service business *except* someone whose taxable income does not exceed $150,000 if married ($75,000 if single). -"Specified service businesses" involve the performance of services in the fields of health, law, engineering,	out at $225,000. The 9% would also be phased in over 5 years, so that it would not be fully in effect until 2022. -These changes were meant to win support of critics that said the bill did not do enough for small business.	for the rate. -Other business owners could choose from two options: 1. Default rule: 30% of income is considered attributable to the capital of the business (and subject to the 25% rate), and other 70% taxed at regular individual rates; 2. Establish a different ratio based on facts and circumstances. -For personal-service businesses (activity involving performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees, or investing, trading, or

	architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.		dealing in securities, partnership interests, or commodities) the default rule does not apply. They begin with the presumption that zero percent of their income should be subject to the 25% rate.

Observations: The approaches taken by the House and the Senate are considerably different. The House proposal is more clearly aimed at providing the rate cut to passive investors of capital in pass-through entities. The Senate proposal does not differentiate between passive and non-passive owners. Further, the Senate proposal ties the deduction to wages received by the taxpayer (and since partners are generally not W-2 employees, this presumably means guaranteed payments or payments for services in the case of a partner of a partnership). In addition, given the outcry from small business groups over their exclusion from the original House bill, the Senate bill and the amendment to the House bill provide a limited benefit to some small business owners of pass-through entities.

Both approaches are quite complex. They attempt to provide a benefit to intended targets, while at the same time prevent "abuse" (including the use of the rule by service partnerships). The result is likely to be tax legislation that includes "loopholes" that can be taken advantage of, given enough planning.

One wonders how many taxpayers would simply incorporate to take advantage of a simple, uniformly applicable low rate of 20% when all is said and done.

Proposal	Senate Bill	Amendment to House Bill	House Bill
Carried Interest	Silent	-Would impose a three-year holding period in order to be taxed at long term capital gains rates.	Silent

Observations: No new surprises here. We note that requiring a three-year holding period is likely not viewed as terribly burdensome by most holders of carried interests. It is unclear why the amendment to the House bill went to the trouble of adding this.

Proposal	Senate Bill	Amendment to House Bill	House Bill
Repatriation of Foreign Earnings	-One-time transition tax on currently accumulated foreign earnings that would be deemed repatriated. Rate is 10% for earnings held in form of cash assets, and 5% for other earnings. -Going forward, a dividend exemption for 100% of foreign-source dividends from foreign subsidiaries would apply to 10-percent U.S. shareholders, subject to a 731-day holding period (beginning 365	-The 12% rate is increased to 14%, and the 5% rate is increased to 7%. -This is estimated to raise $70.3 billion. -Amends the proposed excise tax (bill's international base erosion rules) on some payments from domestic corporations to related foreign corporations. Specifically, it eliminates the markup on deemed expenses, and it expands the foreign tax credit to	-One-time transition tax on currently accumulated foreign earnings that would be deemed repatriated. Rate is 12% for earnings held in form of cash or cash equivalents, and 5% for other earnings. -Going forward, dividend exemption for 100% of foreign-source dividends from foreign subsidiaries would apply to 10-percent U.S. shareholders, subject to a 361-day holding period (beginning 180

	days before the shares of the foreign corporation become ex-dividend). -However, despite the tax being called "territorial," U.S. shareholders of a controlled foreign corporation (CFC) will include in income its pro rata share of the CFC's global intangible low-taxed income, which is equal to (a) the shareholder's pro rata share of certain foreign profits of the CFC over (b) a deemed return of 10% of the shareholder's pro rata share of the CFC's average aggregate bases of tangible property used to produce such profits, as of the close of each quarter of the taxable year.	apply to 80% of foreign taxes and refines the measurement of foreign taxes paid.	days before the shares of the foreign corporation become ex-dividend). -However, despite the tax being called "territorial," there will be a 10% minimum tax imposed on certain foreign profits above a certain threshold from foreign subsidiaries of U.S. companies.

Observations: The mandatory 14% rate under the Amendment to the House Bill on cash-backed foreign accumulated earnings surprised many, as it is much higher than expected and prior Republican proposals. The Senate's 10% is more in line with earlier proposals – but still higher than that in the Republican Blueprint.

In addition, given that the House Blueprint and the Unified Framework for Tax Reform suggested that U.S. multinationals would be taxed on a territorial rather than worldwide basis, the House bill's retention of a 10% worldwide income tax on U.S. multinationals' "foreign high-rate returns" was a contradiction and a surprise. Under the original House bill, U.S. multinationals would be subject to the 10% tax on a foreign subsidiary's aggregate net income in excess of a "routine return" (7% plus the federal short-term rate) on its depreciable tangible property, adjusted downward for interest expense, as well as other exclusions for income effectively connected to a U.S. trade or business, Subpart F income, certain insurance and financing income that meets the requirements for the active finance exemption (AFE) from Subpart F income, and certain related-party payments. The fact that the House bill retains vestiges of the old worldwide tax regime by imposing a 10% tax on certain offshore profits earned by U.S. multinationals' foreign subsidiaries means that the House GOP plan is not, in fact, fully territorial.

Under the Senate bill, Subpart F's regime for taxing U.S. shareholders of "controlled foreign corporations" (CFCs) on a worldwide basis will be retained, at least in part, with respect to such shareholders' global intangible low-taxed income, which equals the excess (if any) of the shareholder's pro rata share of a CFC's gross income over an amount equal to 10% of the aggregate of the shareholder's pro rata share of the CFC's "qualified business asset investment" (defined as an average of the CFC's quarterly adjusted bases in business assets during the taxable year). It remains to be seen how exactly this complex rule will be implemented without creating new opportunities for international tax avoidance and deferral that are at the heart of most significant policy critiques of Subpart F.

So, like the House Ways and Means Committee, the Senate Finance Committee has proposed a hybrid international tax system, that, while more territorial than our current system, does not move as far away from worldwide income taxation of U.S. corporations as the border-adjusted cash-flow tax proposed as part of the House Tax Reform Blueprint (released by Republicans in the House on June, 2016) or other "territorial" international tax systems adopted by our closest trading partners (generally, in conjunction with a value-added tax or VAT).

Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Alternative Minimum Tax	Eliminated for individuals and corporations.	-	Eliminated for individuals and corporations.
Observations: Generally in line with expectations			

Proposal	Senate Bill	Amendment to House Bill	House Bill
R&D Tax Credit, Low Income Housing Tax Credit (LIHTC) and Section 199 Deduction	-R&D credit and LIHTC retained -Section 199 deduction would be eliminated – but effective in 2019.	-Section 199 deduction would be eliminated – but effective in 2019.	-R&D credit and LIHTC retained. -Section 199 deduction eliminated.
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Cash Method of Accounting	Increases thresholds for small businesses that can use cash method of accounting to $15 million (currently $5 million).	-	Increases thresholds for small business that can use cash method of accounting to $25 million (currently $5 million).
Proposal	**Senate Bill**	**Amendment to House Bill**	**House Bill**
Research or experimental expenditures	-	Requires certain research or experimental expenditures (including software expenditures) to be capitalized and amortized over a 5 year period (15 years where expenses are incurred outside the country). Thus the	-

		expensing allowed by Section 174 would be replaced with this. -Rule would be phased in after 2023.	
Observations: This is one of the more significant revenue raisers included in the House Bill.			

Ballard Spahr's Tax Group is closely monitoring developments as to the House and Senate bills. Please look for continued updates.

Ballard Spahr attorneys across practice areas are monitoring legislative developments and tracking the potential influence of the bill on your interests. Please visit our Tax Reform Alert Center for the latest details.

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[1] We refer to the 2 amendments from Chairman Brady released on November 6 and 9.
[2] This column refers to the original H.R. 1, without amendments.
[3]

Tax Brackets – Single Individual					
Existing Brackets		**House Bill**		**Senate Bill**	
10%	$0 to $9,325	12%	$0 to $45,000	10%	$0 to $9,525
15%	$9,326 to $37,950			12%	$9,526 to $38,700
25%	$37,951 to $91,900	25%	$45,001 to $200,000	22.5%	$38,701 to $60,000
28%	$91,901 to $191,650			25%	$60,001 to $170,000
33%	$191,651 to $416,700	35%	$200,001 to $500,000	32.5%	$170,001 to $200,000
35%	$416,701 to $418,400			35%	$200,000 to $500,000
39.6%	Over $418,400	39.6%	Over $500,000	38.5%	Over $500,000

Tax Brackets – Married Filing Jointly					
Existing Brackets		**House Bill**		**Senate Bill**	
10%	$0 to $18,650	12%	$0 to $90,000	10%	$0 to $19,050
15%	$18,651 to $75,900			12%	$19,051 to $77,400
25%	$75,901 to $153,100	25%	$90,000 to $260,000	22.5%	$77,401 to $120,000
28%	$153,101 to $233,350			25%	$120,001 to $290,000
33%	$233,351 to $416,700	35%	$260,000 to $1 million	32.5%	$290,001 to $390,000
35%	$416,701 to $470,700			35%	$390,001 to $1 million
39.6%	Over $470,700	39.6%	Over $1 million	38.5%	Over $1 million

[4] The Trump Plan refers to the plan released by the White House on April 26 as well as the tax plan then-candidate Trump described in speeches on August 8, September 13, and September 15, 2016, on his campaign's website and in other statements he made, including on Twitter.