Federal Tax Reform: The Current State of Play & The Big Picture (Updated 12/05)

by Saba Ashraf and Adam S. Wallwork | December 5, 2017

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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.

> *November 16 update: The House today voted, 227-205, to pass the House bill, generally in the same form as it was on November 9. Thirteen Republican members and all Democratic members opposed the bill. Nearly all the opposing Republicans are from states with high state taxes. The House approval of the House bill is generally in line with expectations.*
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> *In addition, late last night, the Senate Finance Committee voted along party lines, 14-12, to approve the Senate bill. The text of this bill still is not available, but is expected to be released shortly now that the bill has been approved. The description of the Senate bill was originally released on November 9, modified substantially by the Chairman's Mark of the description of the bill released by Committee Chair Orrin G. Hatch, (R-UT) on November 14, and further modified slightly by a manager's amendment issued by Senator Hatch on November 16 (the Senate Modified Mark).*
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> *The Senate bill now can be considered for a vote by the full Senate. The vote is expected to take place the week after Thanksgiving, even though Senate Republicans had previously hoped to vote before the holiday. Given that Republicans could lose a Senate seat in the Alabama special elections on December 12, the Senate vote will likely take place before that date. Three Republican Senators already have signaled their potential opposition to the Finance Committee's bill, which is more than Republicans can afford to lose.*
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> *December 5 update: The Senate voted 51-49 in the early hours of December 2 to pass its tax reform bill. Republicans provided all 51 votes in favor of the bill, including the votes of Senators Susan Collins (R-ME), Ron Johnson (R-WI), and Jeff Flake (R-AZ), each of whom had raised serious concerns about the bill previously. The approved bill is similar to the version passed on November 16, but contains some key changes, which we have described below.*

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.

> *December 5 update: The table below has been updated to reflect the key changes in the approved Senate bill and sets forth a side-by-side comparison of the two bills as passed by the House and Senate.*

- 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."

  November 16 update: The Senate bill as approved by the Senate Finance Committee now can go to the floor for a full Senate vote, which is now expected after Thanksgiving. Senators may find that obtaining the vote of the majority could be much more difficult than it was for their colleagues in the House. There also is a sense that if the Senate bill is approved by the required number of senators—and the Senate bill and House bill have to be reconciled—that the final bill will much more closely resemble the Senate bill than the House bill.

  December 5 update: While a handful of Republican Senators had earlier indicated opposition to portions of the bill they were considering, all but one of them eventually approved the Senate bill. The bill passed in a 51-49 vote, with Sen. Croker (R-TN) being the only Republican to vote against it out of concern over the bill's effect on the federal budget deficit. Sen. Collins, Sen. Flake, and Sens. Johnson and Daines (R-MT), however, did manage to have incorporated (in exchange for their support for the bill) some key changes.

  The House could have simply voted for the Senate Bill, but yesterday it opted to go to conference with the Senate. The differences between the two bills will now be ironed out in the conference committee and must then be voted on and passed by a majority of each of the House and the Senate. Here are the key points to note as to conference committee and process:

  - *Members nominated by each of the House and the Senate will serve as their negotiators to put together a merged bill. Their final product will be a "conference report," which must be passed by a majority of the members in the conference committee, and can then proceed to a full floor vote of the House and Senate. Each of the House and Senate must approve (by majority) the conference report wholly. No further amendments may be offered. Once approved, the legislation can be presented to the President for his signature.*

  - *Under House and Senate rules, the committee generally may not change a provision on which both houses agree (e.g., the state and local tax (SALT) deduction, which both bills render* *generally unavailable, except for $10,000 of state and local real estate taxes, after Sen. Collins's amendments conformed the Senate bill's exception to the repeal to the House bill's).*

- *In addition, conferees may not insert matters not committed to them by either of the bills already approved by the Senate and House. That being said, conference committees sometimes do introduce new matters. In this case, the rules of each house provide that a member may object through a point of order, although each house has procedures under which it can vote to waive the point of order.*

- *While there are important differences between the House bill and the Senate bill, we largely expect the House to fall in line with the Senate bill as to most of the differences (except with respect to the repeal of the corporate AMT discussed below). One reason for this is that while the Senate bill has enough temporary tax cuts in it to make it compliant with the budget reconciliation process, the House Bill does not and needs to raise more revenue or repeal more benefits to be able to be passed under reconciliation.*

- *Republicans are eager to have the conference report voted on by the House and Senate as soon as possible, and preferably prior to the election for the open Senate seat in Alabama on December 12, 2017, which may cause them to lose one Republican vote. Further, the longer the process takes, the more likely it may be for those opposed to the tax legislation to organize and influence the decision of some of the Senators.*

- <u>To be enacted, the bill must increase revenue, decrease tax cuts, or make them temporary</u>. 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.

  November 16 update: The Senate bill, as modified, did, in fact, make many of the tax cuts temporary. It also filled in needed revenue by repealing the individual mandate for health care, discussed below. The *temporary tax cuts are largely those aimed at individuals rather than corporations. The corporate rate cut is still permanent. See our updated table below for details.*

December 5 update: The Senate bill BARELY meets the rules to pass via the budget reconciliation process. That is, it increases the deficit by no more than $1.5 trillion during the next 10 years. The Senate bill also ensures that beginning in the 11th year after the bill is enacted (2026), the federal budget deficit will not be further increased. Thus, the sunsetting of certain individual tax rate decreases after December 31, 2025, are essential features of a bill that, among other provisions, increases tax revenues enough for the bill to satisfy the $1.5 trillion deficit limit for the entire bill and remain "deficit neutral" after the 10-year budget window required for reconciliation measures. The House bill, on the other hand, does not have a mechanism in place to ensure the increase in the budget deficit stops after year 10. This is partly why we believe that the merged bill that comes out of the conference committee will more closely resemble the Senate bill passed over the weekend than the House version passed on November 16.

- 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."

  November 16 update: As noted above, individual tax cuts are largely temporary now in the Senate Modified Mark.

  December 5 update: It is interesting to note that the White House is already defending the temporary nature of the individual tax cuts by pointing out that they may become permanent. Office of Management and Budget Director, Mick Mulvaney said, "the Bush tax cuts were the same way, and most of them didn't expire. We said before, we'll say again: If it's good policy, it will be permanent. If it's bad policy, it will be temporary."

- 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.

December 5 update: *An understanding of this point helps explain some of the provisions in the House and Senate bills, such as the limits on interest deductibility, the decrease in corporate tax, the temporary nature of any tax cuts on individuals, and the fact that the reduced pass-through rate generally has very limited application to income from services, as opposed to income from capital.*

- 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.

November 16 update: The Senate Modified Mark does, in fact, repeal the individual mandate. However, the House bill does not include the repeal. House Ways and Means Committee member Tom Reed (R-N.Y.) has indicated that if the Senate passes the Senate bill, he's confident the House would also pass a bill with the mandate repeal.

December 5 update: Sen. Collins has reportedly stated that before she votes for the final bill, she wants to see two ACA stabilization bills passed prior to the conference report coming out.

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.

> *November 16 update: Under the Senate Modified Mark, the rates and tax brackets of the Senate bill are adjusted. The tables in the footnote are modified to reflect the changes. The updated brackets reflect that the higher tax rates will apply to even fewer individuals. However, the individual tax cuts now expire after 2025. Notably, the use of the chained CPI will not expire, thus causing many that start out with tax cuts to be in higher brackets in a few years.*
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> *December 5 update: The combination of the tax cuts being temporary and the chained CPI being used instead of the plain CPI currently used will mean that most middle class families would pay higher taxes by 2026.*

Proposal	Senate 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.

> *November 16 update: Under the Senate Modified Mark, similarly to the individual tax cuts, these will also expire after 2025.*

Proposal	Senate 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	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 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). *November 16 update: The Senate Modified Mark makes these provisions temporary; they would expire after 2025.* *December 5 update: The Senate bill still completely repeals the state and local income tax deduction, but provides for a capped property tax deduction of up to $10,000. This was a last-minute addition to win the support of Sen. Collins. Another provision added by Sen. Collins allows individuals to deduct medical expenses in 2017 and 2018 if the expenses exceed 7.5% of adjusted gross income. This is actually more favorable than*	-State and local income or sales tax deductions eliminated -Real property tax deduction: capped at $10,000. -Mortgage interest 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.

	current law, which allows them to be deducted only if they exceed 10% of AGI. The medical expense deduction was proposed for repeal by the earlier version of the Senate bill as well as by the House bill.	

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**
ACA's Individual Healthcare Mandate Repeal	*Nov. 16 update: The Senate Modified Mark Repeals the penalty that is imposed under current law on individuals that fail to obtain minimum healthcare coverage (also known as the individual mandate). The repeal would be effective starting in 2019.* *December 5 update: This is not in the House bill, but several members of the House have indicated a willingness to adopt this.*		

November 16 update: ***Observations:*** *As noted above, the repeal of the individual mandate would increase revenue/decrease costs of the Senate bill 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 ACA's marketplaces—both of which would reduce the cost to the government, and make it more likely that the tax changes could pass under the budget reconciliation process. While the repeal of the individual mandate may solve this problem, it would make the passage of the Senate more difficult politically, as integral parts of the ACA are tied to the mandate being in place, and the repeal would mean an effective repeal of other parts of the ACA. The House bill does not include the repeal. However, Representative Reed has indicated that if the Senate passes its bill, he's confident the House would also pass a bill with the mandate repeal.*

Proposal	**Senate Bill**	**Amended House Bill**	**House Bill**
Estate Tax	Does not repeal the estate tax; instead doubles the current exemption (currently approximately $5.5 million for single and $11 million for married individuals). *November 16 update: The doubling of the exemption would expire after 2025.*	Repeal delayed until 2025. Until repeal, exemption doubled.	Repeals estate tax effective 2024. 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. *December 5 update: The tax rate would be significantly lower than the highest rate on ordinary individual income, and lower than the rate on pass-through qualified business income. This would change the conventional wisdom that in most cases, the choice of entity should be an LLC, LLP, or other entity taxed as a partnership. State corporate taxes are a significant factor to consider in addition to the federal rates.* *We also note that the value of tax credits, NOLs and depreciation, and other deductions generally would be reduced to corporations if their tax rate is reduced to 20% from 35%. This may impact purchase price in M&A transactions.* *Finally, we note that despite pushing for a 15% cut and being adamant that it not go above 20%, shortly after the approval of the Senate bill, President Trump oddly expressed support for a rate up to 22%. It is unclear what should be made of this.*		
Proposal	**Senate Bill**	**House Bill**
Corporate Alternative Minimum Tax (AMT)	Repealed *December 5 update: The approved Senate bill keeps the corporate AMT at its current rate of 20%, which is the same as the new regular corporate rate under the House and the Senate bill.*	Repealed
December 5 update: ***Observation:*** *The basic framework of the AMT is predicated on the AMT tax rate being lower than the regular tax rate. The retention of the corporate AMT at its current rate of 20% would mean that effectively, a taxpayer would lose wholly the benefit of any tax deduction that is taken into account in determining the regular tax liability, but not the AMT liability.* *There is expected to be immense pressure from business groups to repeal or scale back the corporate AMT. A top*		

House Republican has already called for the repeal of the corporate AMT.			
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 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	-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 by that inventory.) This appears to benefit car dealerships which borrow money to buy inventory.	-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 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.

	(compared to $25 million under the House bill).		

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.

December 5 update: Generally, the House version is more favorable than the Senate version.

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	-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.

	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. *November 16 update: Provisions relating to nonqualified deferred compensation are struck from Senate Modified Mark.*		

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).	-	-Accelerated recovery of certain capital expenses, including full, immediate expensing. -However, immediate expensing only available for 5 years. After that, back to the

	-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 machinery). *December 5 update: While the bill would initially allow full expensing for property placed in service between September 28, 2017, and December 31, 2022, it would begin to phase out the applicable percentage of business property that may be immediately expensed, generally (i) to*		old rules. -For 5-year period, Section 179 immediate business expensing limit increased from $510,000 currently to $5 million.

	80% for property placed in service in 2023, (ii) to 60% for property placed in service in 2024, (iii) to 40% for property placed in service in 2025 and (iv) to 20% for property placed in service in 2026. Since 50% of business property is currently allowed to be depreciated during its first year, it appears that the tax benefits received by businesses before 2025 will effectively be reversed thereafter. -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	-The same as the House Bill, except that a lower 9% tax rate is introduced for	-Maximum tax on business income of owners and shareholders of pass-

	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 "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	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 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.	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 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

	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, 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. *November 16 update: There are two key changes. First, the deduction is temporary and expires after 2025. Second, the group of individuals that may take*		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 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.

	the deduction is broadened. Specifically, (A) the W-2 wage limit described above does not apply in the case of a taxpayer with taxable income up to $500,000 (married, filing jointly) or $250,000 (all other individuals); and (B) the exception allowing the deduction in the case of individuals that have income from specified service businesses is broadened so that individuals with taxable income up to $500,000 (married filing jointly) or $250,000 (all other individuals) may take the deduction. The reduction in the tax rate on certain pass-through income is temporary and will expire in 8 years, unless extended of course. *December 5 update: The 17.4% deduction has been increased to 23%. This effectively means that if the deduction applies, then the highest marginal tax rate on income from the pass-through will become 29.5% rather than 38%. This change*		

	was added as a result of a push by Sens. Johnson and Daines to address their concern that small businesses by helped. Interestingly, while a number of small businesses are in fact pass-through entities, many large businesses will benefit considerably from this. *In a "manager's amendment" adopted just before the bill passed, Sen. Cornyn (R-TX) added a provision to allow publicly traded partnerships to claim the deduction – which of course no one would confuse for small businesses.*		

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.

November 16 update: The exceptions are broadened, which means considerably more individuals will be able to use it. However, it is temporary.

December 5 update: The House and Senate provisions relating to taxation of pass-through business income are quite different from each other in approach. The Senate version is friendlier to smaller businesses, and service businesses.

Proposal	Senate Bill	House Bill
Carried Interest	*November 17 update: The last released manager's amendment imposes a 3-year holding period similar to that in the amended bill in order to be taxed at long-term capital gains rates.*	-Would impose a three-year holding period in order to be taxed at long term capital gains rates.

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	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-	-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

	source dividends from foreign subsidiaries would apply to 10-percent U.S. shareholders, subject to a 731-day holding period (beginning 365 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. *November 16 update: The tax on GILTI is increased effective in 2026.* *December 5 update: The repatriation tax rate for offshore is increased for offshore income held as cash to 14.5% from 10%, and to 7.5% from 5% for other offshore earnings.*	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," there will be a 10% minimum tax imposed on certain foreign profits above a certain threshold from foreign subsidiaries of U.S. companies. *November 16 update: The 12% rate is increased to 14%, and the 5% rate is increased to 7%.* *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 apply to 80% of foreign taxes and refines the measurement of foreign taxes paid.*

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).

November 16 update: Under the Senate Modified Mark, the tax rate on U.S. shareholders' GILTI is increased from 10% to 12.5% for taxable years beginning in 2026 or later. GILTI derived from a U.S. shareholder's controlled foreign corporations would continue to be taxed at a 10% rate for tax years 2018 through 2025 under the Senate Modified Mark.

December 5 update: The repatriation tax rates in the Senate bill moved much closer to those proposed by the

House bill.		
Proposal	**Senate Bill**	**House Bill**
Alternative Minimum Tax	Eliminated for individuals and corporations. *December 5 update: As noted above, the corporate AMT repeal was deleted. The approved Senate bill repeals the individual AMT, with increased exemption amounts and phase-out thresholds for tax years 2018 to 2025, and then reverts to the current law's individual AMT beginning on January 1, 2026.*	Eliminated for individuals and corporations.
Observations: Generally in line with expectations *December 5 update:* ***Observations:*** *As noted above, the repeal of the corporate AMT was quite surprising and likely will be reinstated.*		
Proposal	**Senate 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**	**House Bill**
Research or experimental	*November 16 update: Has provision similar to the one in the amended*	Requires certain research or experimental expenditures (including

expenditures	*House bill.* *Would apply after 2025, provided, however, that it would not go into effect if overall federal revenues exceed a specified level by 2026*	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.

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.

[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]

<table>
<tr><th colspan="6">Tax Brackets – Single Individual</th></tr>
<tr><th colspan="2">Existing Brackets</th><th colspan="2">House Bill</th><th colspan="2">Senate Bill</th></tr>
<tr><td>10%</td><td>$0 to $9,325</td><td rowspan="2">12%</td><td rowspan="2">$0 to $45,000</td><td>10%</td><td>$0 to $9,525</td></tr>
<tr><td>15%</td><td>$9,326 to $37,950</td><td>12%</td><td>$9,526 to $38,700</td></tr>
<tr><td>25%</td><td>$37,951 to $91,900</td><td rowspan="2">25%</td><td rowspan="2">$45,001 to $200,000</td><td>22.5%</td><td>$38,701 to $60,000</td></tr>
<tr><td>28%</td><td>$91,901 to $191,650</td><td>25%</td><td>$60,001 to $170,000</td></tr>
<tr><td>33%</td><td>$191,651 to $416,700</td><td rowspan="2">35%</td><td rowspan="2">$200,001 to $500,000</td><td>32.5%</td><td>$170,001 to $200,000</td></tr>
<tr><td>35%</td><td>$416,701 to $418,400</td><td>35%</td><td>$200,000 to $500,000</td></tr>
<tr><td>39.6%</td><td>Over $418,400</td><td>39.6%</td><td>Over $500,000</td><td>38.5%</td><td>Over $500,000</td></tr>
</table>

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.