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Policy Perspectives

Ernst & Young LLP's rapid response to the House Ways and Means Committee's tax reform draft bill, "The Tax Cuts and Jobs Act"

2 November 2017

Building a better working world

Presenters

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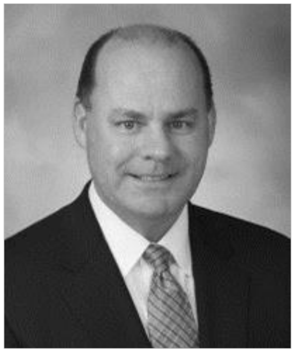

Ray Beeman

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Polling question

When do you think comprehensive US business tax reform is likely to happen?

A. 2017

B. 2018

C. 2019

D. US business tax reform is unlikely to occur anytime soon

E. Not applicable (EY professional, faculty, other)

Individuals

The “Tax Cuts and Jobs Act” - provisions affecting individuals

- Individual income tax rates: 12%, 25%, 35%, 39.6%; bracket thresholds modified
    - 25% rate - $90,000; 35% rate - $260,000; 39.6% rate - $1m (married filing jointly)
- Retains lower rates for capital gains and dividends
- Repeals deduction for personal exemptions (and the personal exemption phase-out)
- Roughly doubles the standard deduction; establishes a new “Family Credit” that includes an increased child tax credit and a new dependent credit
- Repeals the individual AMT
- Retains the deduction for state and local property taxes up to $10,000; deduction for state and local income or general sales taxes repealed

Individuals

Provisions affecting individuals (cont'd)

- Retains the mortgage interest deduction for existing mortgages, but caps it for new mortgages (incurred after Nov. 2, 2017) loans over $500,000
- Modifies rules governing exclusion of gain from sale of principal residence
  - Use as principal residence for 5 of 8 years preceding sale; use of exclusion limited to once every 5 years; phase-out for taxpayers with AGI over $500,000 (married, filing jointly)
- Increases the exemption for the estate tax to $10m; estate tax and generating-skipping transfer tax fully repealed beginning after 2023; gift tax lowered to top rate of 35%.
- Retains current retirement savings options
- Retains the deduction for charitable contributions, with some modifications; most other deductions eliminated or curtailed

Corporate/business

Provisions affecting businesses and corporations

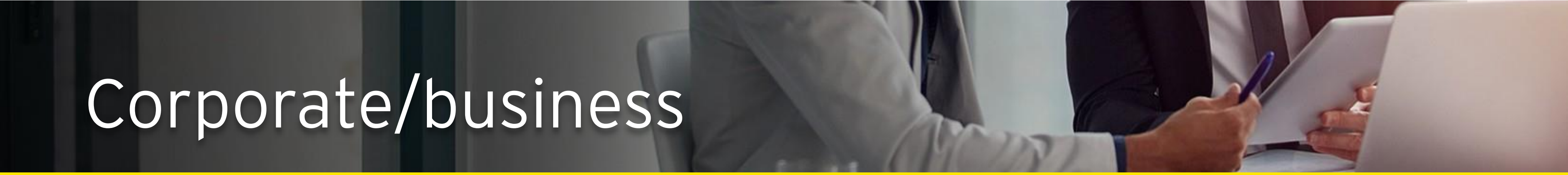
- Corporations
  - 20% rate, beginning 2018 (personal services corporations taxed at 25%)
- Small and family-owned businesses (flow-throughs)
  - Maximum 25% tax rate applied to "business income" of flow-through entities
  - "Capital percentage" formula applied for determining business income from active business activities
    - 30% capital percentage may generally be elected; otherwise "facts and circumstances"
    - 0% capital percentage for certain personal services businesses (e.g., law, accounting, financial services)
  - Special rule to prevent recharacterization of wages as business income

Corporate/business

Provisions affecting businesses and corporations (cont'd)

Expensing

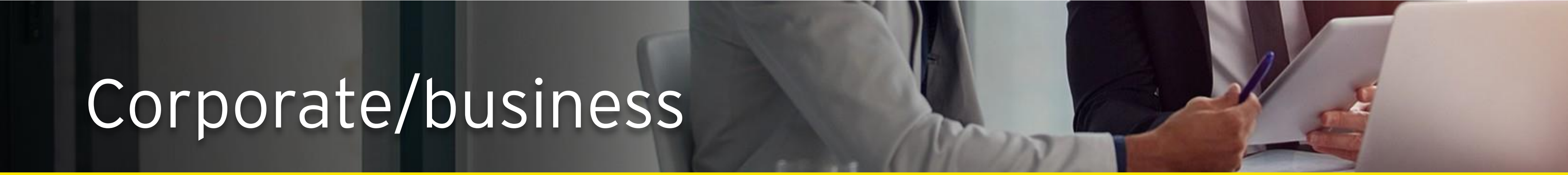
- Immediate write-off of qualified property placed in service after September 27, 2017, and before January 1, 2023 (plus an additional year for certain qualified property)
- Repeals requirement that original use begin with the taxpayer - property eligible if it is the taxpayer's first use
- Excludes property used by a regulated public utility or in a real property trade or business



Corporate/business

Provisions affecting businesses and corporations (cont'd)

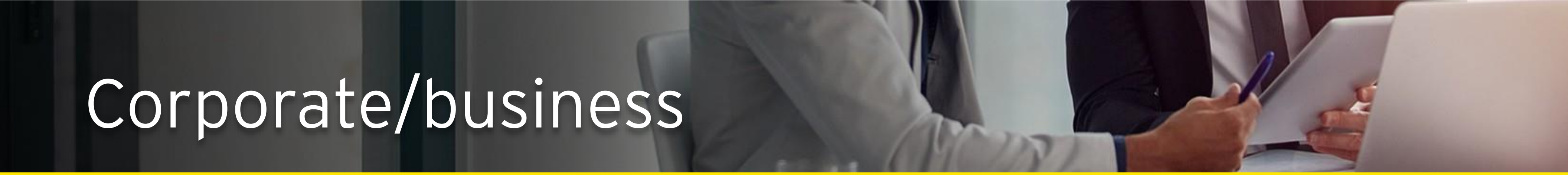
- Interest expense
  - Limits deduction of net interest expense to 30% of the business's adjusted taxable income (disallowed amounts may be carried forward five tax years)
  - Exemption for businesses with average gross receipts of $25m or less
  - Would not apply to certain regulated public utilities and real property trades or business (not eligible for full expensing)
  - Repeals Section 163(j)
- Modifies the net operating loss deduction (NOL)
  - Deduction limited to 90% of the taxpayer's taxable income (determined without regard to the NOL deduction)
  - Carrybacks generally repealed



Corporate/business

Provisions affecting businesses and corporations (cont'd)

- Repeals or restricts most business exclusions, deductions, and credits, including:
  - Section 199 (domestic production deduction)
  - Work Opportunity Tax Credit
  - New Markets Tax Credit
- Retains the R&D credit
- Limits the rules for like-kind exchanges to exchanges of real property
- Modifies many of the rules for tax-exempt organizations



Corporate/business

Provisions addressing compensation

- Existing nonqualified deferred compensation (NQDC) rules repealed; new rules tax employees on compensation as soon as there is no substantial risk of forfeiture (i.e., when it vests)
  - "Vesting" is limited to the requirement to perform future services; a covenant not to compete or a condition relating to a purpose of the compensation (other than the performance of future services) will not constitute a substantial risk of forfeiture
  - Effective for amounts attributable to services performed after 2017; current-law rules would apply to existing NQDC arrangements until the last tax year beginning before 2026 when such arrangements would become subject to the new provision
  - Provision generally would apply to stock options and stock appreciation rights as well as supplemental retirement plans paid from firms' general assets

Corporate/business

Provisions addressing compensation (cont'd)

- Repeals the exceptions to the $1m deduction limitation for commissions and performance-based compensation and revises definition of covered employee to include the CEO, CFO and three other highest paid employees
- Limits the ongoing deductibility of deferred compensation paid to individuals who previously held a covered employee position, even after they no longer hold that position.
  - Thus, once an individual is named as a covered employee, the $1 million deduction limitation would apply to compensation paid to that individual at any point in the future, including after the cessation of services. The provision would be effective for tax years beginning after December 31, 2017

Polling question

Which potential tax reform element would have the biggest impact on your business?

A. Lower business income tax rates

B. International tax changes

C. Base broadening provisions

D. Not applicable (EY professional, faculty, other)

International

- **Territorial System:** 100% deductions for foreign source dividends received from foreign subsidiaries by a 10% or greater US corporate shareholder
- **One-Time Transition Tax:** Accumulated foreign earnings subject to a transition tax at two rates (payable over 8 years):
  - 12% for earnings held in cash and cash-equivalents; and 5% for the balance
  - Mandatory inclusion equals the greater of foreign earnings accumulated in tax years beginning after December 31, 1986, determined as of
    - November 2, 2017, or
    - December 31, 2017
  - Mandatory inclusion for last year of a specified foreign corporation beginning before January 1, 2018
  - Foreign tax credit carryforwards fully available, foreign tax credits triggered by deemed repatriation partially available
  - No overall foreign loss (OFL)/foreign oil and gas loss (FOGL) recapture

qualified business asset investment

International

- Current Anti-Deferral rules retained other than foreign base company oil related income
- **New Anti-Deferral Provision:** A US shareholder must include in income 50% of any "foreign high-return amount" determined with respect to its CFCs
  - The foreign high-return amount equals the excess, if any:
    - Of the US shareholder's CFCs' "net tested income"; over
    - A return (7 percent plus short-term AFR) on the CFCs' qualified business asset investment "QBAI" reduced by interest expense
  - QBAI is the aggregate of the U.S. shareholder's pro rata shares of its CFCs' basis in certain tangible property
  - Tested income is all income other than specifically excluded amount
  - The US shareholder can claim a credit for 80% of the foreign taxes paid on that income

International

- **New Excise Tax:** Nondeductible excise tax at the highest rate under section 11 is imposed on specified amounts paid by domestic corporations after December 31, 2018, to foreign corporations that are members of the same international financial reporting group ("IFRG").
  - Excise tax equals the highest rate in section 11 in the year paid
- Specified amount includes an amount that is deductible, or includible as cost of goods sold, inventory, or the basis of depreciable or amortizable asset
  - Excludes interest, amounts paid or incurred to acquire certain commodities, any amount taxed under Section 881(a), and certain service fees
- Foreign corporation can make an irrevocable election to instead treat the specified amounts as ECI and be subject to net-basis taxation
  - A deemed expense amount is allowed to offset the deemed ECI
- Limited to IFRGs with average annual aggregate specified amounts in excess of $100 million over 3-year period

International

- Limitations on interest expense deduction
  - New 163(j) generally limits deduction for net business interest expense to 30 percent of adjusted taxable income for the year
  - New 163(n) limits deduction for net interest expense of a US corporation that is member of an IFRG to 110% of the corporation's share of the group's net interest expense. Members of a consolidated group treated as a single corporation for purposes of the provision
- A US corporation subject to both provisions must apply the one that disallows the greater amount of interest deduction
- Interest disallowed under either provision may be carried forward up to five years, exhausted on first-in, first-out basis
- Limited to groups with average annual gross receipts in excess of $100 million over 3-year period
- Applies to taxable years beginning after December 31, 2017

Revenue considerations

Top five revenue-raising provisions	
1. Simplification and reform of individual deductions	$ 1,274.50
2. Reform of business-related exclusions, deductions, etc.	$ 513.30
3. Prevention of base erosion	$ 265.80
4. Reform of business credits	$ 73.00
5. Simplification and reform of individual education incentives	$ 65.30
Top five revenue-reducing provisions	
1. Reform of business tax rates	$ (1,461.40)
2. Reform of individual rates, standard deduction, and exemptions	$ (843.90)
3. AMT repeal	$ (735.80)
4. Simplification and reform of family and individual tax credits	$ (612.90)
5. Estate and generation-skipping transfer taxes	$ (171.50)

Polling question

What effect would moving to a territorial system have on your business?

A. Positive
B. Neutral
C. Negative
D. No impact
E. Not applicable (EY professional, faculty, other)

Next steps in tax reform

Legislative process and potential timeline

November → November/December → December/early 2018

US House of Representatives

- Bill will start in the House
- House Ways and Means Committee markup
  - Full bill release
  - Joint Committee on Taxation (JCT) scores the bill
- Full House vote - need 218 votes to pass

US Senate

- Senate Finance Committee markup
- Full Senate votes
  - Reconciliation - pass by a simple majority rather than 60 votes
  - Limit debate time
  - Must follow certain budget rules

Office of the President of the United States

December/early 2018

- Congress sends President a unified bill after it has been passed by both chambers of Congress
- President signs bill into law
- Goal to complete in 2017
- May get pushed into 2018

Two chambers reconcile differences and pass a final bill

Next steps in tax reform

Final US tax reform legislation – what's anticipated

Lower rates	▸ **Final legislation is expected to reduce both the corporate and individual income tax rates. A new rate for flow-through entities may be included.**
Broader tax base	▸ To pay for the proposed lower rates, US tax reform proposals include a wide array of base-broadening provisions (e.g., limitations on deductions). The base-broadening proposals will likely extend to both business and individual taxation (and may come with a series of complex transition rules).
New international tax system	▸ A move to a territorial system of taxation is expected, and will likely include some type of "toll charge" on previously untaxed accumulated foreign earnings with the rate determined by whether the earnings are in cash or non-cash assets.
Timing	While the timing is subject to change, Republicans are targeting: ▸ **White House:** Republican framework released September 27 ▸ **House:** Legislative language – November 2; passage mid/late November ▸ **Senate:** Legislative language – November; passage November/December ▸ **Reconcile bills/signing:** December (though may push into early 2018)

Polling question

Now that tax reform details are emerging, what actions are you likely to take? Select all that apply.

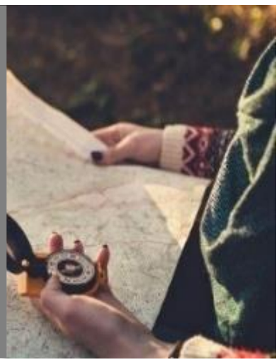
A. Explain the potential implications to my CFO and/or board
B. Model the effects of proposals on my operations
C. Engage with policymakers on aspects of the proposals
D. None of the above
E. Not applicable (EY professional, faculty, other)

Next steps in tax reform

Preparing for change

Preparing for US tax reform involves understanding the leading proposals and their potential effects, implementing strategies that account for these changes and educating policymakers on their real-world impact.

1



Model tax reform proposals:

See how proposals could affect your federal and state liabilities and business operations

2

Undertake scenario planning:

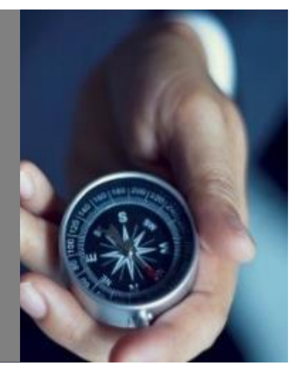
Use model output to run scenario planning

3

Plan:

Prepare for change and consider implementing planning strategies

4



Influence:

Engage lawmakers on provisions that could significantly affect your tax liability and business operations

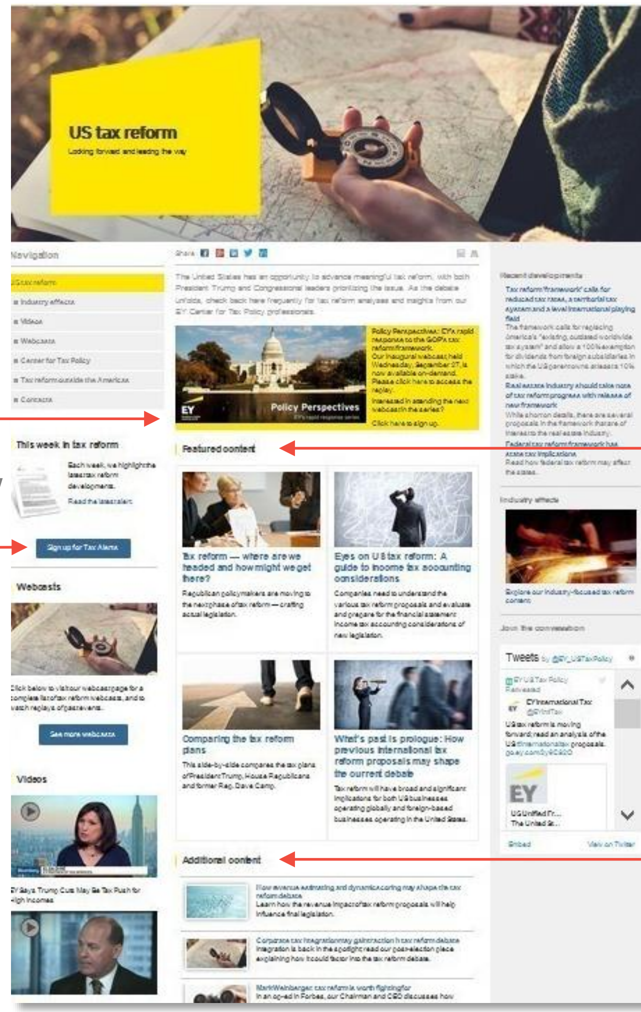
Stay up to date

The latest news and thought leadership is at ey.com/taxreform.

Policy Perspectives: Ernst & Young LLP's rapid response series sign-up link

WCEY's "This week in Tax Reform" and Tax Alert sign-up link

Tax reform webcasts and videos



Recent developments

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Industry content

EY Center for Tax Policy Twitter feed

Additional thought leadership

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Check out our tax video series: "Tax take 3" at ey.com/taxreform

Tune in for our Tax take 3 video series, where knowledgeable Ernst & Young LLP professionals highlight the top 3 takeaways on various tax issues. The first series focuses on tax reform.


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- Policy perspectives: Ernst & Young LLP’s rapid response to the House Ways & Means Committee's tax reform bill
- Thursday, November 2, 2017
- 6:30 p.m.–7:30 p.m. EST

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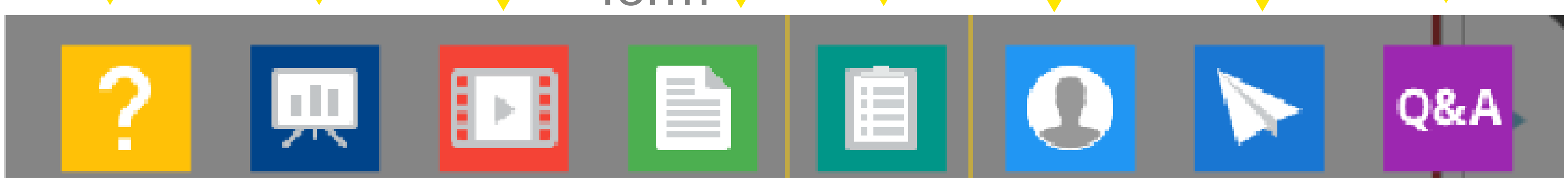

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