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Tax Policy Update

February 27, 2018

NUMBER OF THE WEEK: $666 Billion

A Snapshot of The Government's Financial Position & Condition	2017	2016*
Financial Measures (Dollars in Billions):		
Gross Costs	$ (4,609.3)	$ (4,515.7)
Less: Earned Revenue	$ 431.9	$ 383.9
Gain/(Loss) from Changes in Assumptions	$ (356.5)	$ (273.3)
Net Cost	$ (4,533.9)	$ (4,405.1)
Less: Total Tax and Other Revenues	$ 3,374.6	$ 3,345.3
Unmatched Transactions and Balances	$ 2.6	$ 8.1
Net Operating Cost	$ (1,156.7)	$ (1,051.7)
Budget Deficit	$ (665.7)	$ (587.4)
Assets:	$ 3,480.7	$ 3,534.8
Less: Liabilities, comprised of:		
Debt Held By the Public & Accrued Interest	$ (14,724.1)	$ (14,221.1)
Federal Employee & Veteran Benefits	$ (7,700.1)	$ (7,209.4)
Other	$ (1,472.7)	$ (1,401.1)
Total Liabilities	$ (23,896.9)	$ (22,831.6)
Net Position (Assets Less Liabilities)	$ (20,416.2)	$ (19,296.8)

Devil's in the Details. That's the U.S. budget deficit for fiscal year 2017 according to the *FY 2017 Financial Report of the United States Government*. The Department of the Treasury released the report on Feb. 15 to little fanfare — the annual report card on the nation's fiscal health was largely ignored by the media. Bill Bergman, the director of research at Truth in Accounting, puts it best: "The largest financial institution in world history issued its annual report yesterday, and nobody cares."

The $666 billion deficit reflects a 13.3 percent (or 78.3 billion) increase from FY 2016. The net federal debt for the previous fiscal year comes in at an eye-popping $20.4 trillion. Yikes!

LEGISLATIVE LANDSCAPE

Back to Work – Le Sigh. Congress has returned from its President's Day recess. The top two most urgent items on the to-do list are a fix for the Deferred Action for Childhood Arrivals (DACA) program and the FY 2018 omnibus spending bill. The DACA program is set to expire on March 5, and the next government-funding deadline is March 23.

The Senate's attempt at writing a bipartisan immigration bill to protect DACA recipients and strengthen border security went nowhere. The various proposals offered on the floor failed to garner the 60 votes needed for advancement, including the administration's own framework, which would put DACA recipients on a 12-year path to citizenship, provide $25 billion for border security, eliminate the visa diversity lottery program, and limit family sponsorships to spouses and minor children.

Since Senate floor action on immigration has flopped, Democrats are setting their sights on the FY 2018 omnibus spending bill — a must-pass legislation that would provide lawmakers one more chance to fix DACA.

With the March 23 government-funding deadline just around the corner, congressional appropriators are scrambling to put together and pass an omnibus bill to avoid doing another temporary funding patch. Appropriators were hoping to introduce an omnibus a week before the deadline. However, it looks like lawmakers will, once again, be cutting it close.

At this writing, appropriators still have yet to provide the sub-allocation numbers for committee members to begin drafting the omnibus legislation. Appropriators are trying to decide how best to divide up the funds under the *Bipartisan Budget Act*, which provides $10 billion for infrastructure, $3 billion for the opioid crisis, and $2 billion for veterans' healthcare.

Hey, It's a Fixer-Upper. A technical corrections bill is still all talks at this point. Congressional tax writers are unlikely to drop a bill until the Joint Committee on Taxation (JCT) issues its bluebook. Even if a package of corrections is introduced, it's hard to see Congress passing the measure this year — Democrats aren't exactly rushing to help the GOP fix its own mistakes.

That said, what might the package include? Our *Tax Policy Update* team has identified three key issues related to domestic businesses:

- Section 199A. The new deduction for pass-through businesses allows a benefit to agricultural cooperatives that is intended to mirror some of the benefits they received under the old Section 199 — the domestic productions activities deduction. Non-cooperatives are claiming they are placed at a market disadvantage as a result of the new deduction. This issue has garnered attention in both the House and the Senate. A group of House members submitted a letter to Speaker Paul Ryan (R-WI) and Majority Leader Mitch McConnell (R-KY) seeking a fix to this provision.

- Interaction of Net Interest Expensed Deductibility with Respect to Partnerships. The tax law limits the deductibility of net interest expense to 30 percent of earnings before interest and taxes (EBIT) until 2022 and limits it to EBITDA for years thereafter. The limitation is measured at the partnership level, and any excess business interest is allocated to its partners. If that partner has other business interest, then the limitation is applied at the partner level as well. Complex interaction between partnerships and the allocation of excess business interest has left many businesses wondering about its application. There are many technical issues that remain unclear in this space. Of note is whether interest (be it investment interest or business interest) retains its characterization when it passes through from a partnership to a partner that is a corporation. Furthermore, under certain partnership structures, there is no mechanism to carry back excess business interest or carry forward the excess taxable income (used in calculating the amount to be allocated). Technical corrections may not be needed here, as Treasury officials have suggested that it would be addressed through proposed regulations.

- Carried Interest. In an effort to curtail the perceived low tax rate on carried interest under prior law, the GOP tax bill enacted a 3-year minimum holding period requirement to qualify for capital gains treatment for such partnership interests. As written the new tax provision appears to exclude interests in corporations. It remains unclear whether it would also apply to S corporations, which are taxed as pass-through entities like partnerships. Many companies have already gone ahead and filed S corporations in Delaware in anticipation of the carried interest restriction not being applicable to S corporations. This issue has caught the attention of Secretary Mnuchin, who has signaled that this would apply to S corporations as it does to partnerships, but the path forward has not yet been determined.

In the coming months, the tax community will continue to identify problematic provisions in the tax code that either need outright corrections or just clarification from the tax writers. For example, the Base Erosion and Anti-Abuse Tax (BEAT) provision has caused a tizzy as companies and tax wonks continue to pour over the statute to understand what the term "base erosion payment" truly intends to capture.

Tax Extenders Gossip. Bipartisan talks continue behind closed doors over tax extenders. As a reminder, the *Bipartisan Budget Act of 2018* extended a series of provisions for one year. There's rumor that Congress might provide another one-year extension to those provisions in the forthcoming FY 2018 omnibus spending bill.

The House Ways and Means Committee is looking to schedule hearings the week of March 12 to discuss the future of tax extenders, specifically which ones should be eliminated and which should be made permanent.

More Hearings for Infrastructure. House and Senate committees have scheduled a slew of hearings this week on infrastructure, covering a variety of topics including energy infrastructure, aviation safety, the federal-state decision-making process, and cybersecurity. In addition, the Senate Environment and Public Works Committee has scheduled a Thursday hearing to examine the administration's $1.5 trillion infrastructure plan.

The House Transportation Committee is reportedly planning a hearing for March 7 to discuss funding options for the administration's proposals — the hearing will likely put the federal gas tax under the spotlight. President Trump recently signaled his support for increasing the gas tax by as much as 25 cents in a White House meeting with a group of bipartisan lawmakers. House Transportation Chairman Bill Shuster (R-PA), unlike many of his GOP colleagues, is also supportive of increasing the tax to help pay for infrastructure. The March hearing will provide a good opportunity to see whether other GOP lawmakers are receptive to the politically-sensitive proposal.

REGULATORY WORLD

A Very Washington Power Struggle. Implementation of the GOP tax law has kept officials and staff at the Treasury Department working overtime writing rules and guidances. As if there's not enough work and stress already, the Treasury is reportedly engaged in a power struggle with the Office of Management and Budget (OMB) over who should get the final say in writing tax regulations.

The new tax law has put a great deal of power in Treasury's hands to interpret various aspects of the statute. That kind of power tends to attract attention. The OMB wants to have the authority to review and approve regulations coming out of the Treasury and Internal Revenue Service (IRS).

Unlike other regulatory agencies, the Treasury is not used to ceding its rulemaking authority to the OMB. Tax regulations are exempt from review by the OMB's Office of Information and Regulatory Affairs because their scope and impact are limited; and they are not considered economically significant. The OMB questions whether those arguments are still valid.

House Ways and Means Chairman Kevin Brady (R-TX) has taken Treasury's side in this little fracas, acknowledging that Treasury is the "main driver" when it comes to finalizing tax regulations.

CPAs Request Tax Reform Guidance from Treasury. In a Feb. 22 letter, the American Institute of CPAs (AICPA) wrote a letter to Assistant Secretary for Tax Policy David Kautter and Principal Deputy Chief Counsel William Paul.

The AICPA letter asks for immediate guidance on various issues regarding the new Internal Revenue Code Sec.199A, the deduction for qualified business income (QBI) of pass-through entities. The letter notes that practitioners need clarity regarding QBI "in order to comply with their 2018 tax obligations and to make informed decisions regarding cash-flow, entity structure, and other tax planning issues."

Specifically, the letter urges the IRS and Treasury to provide guidance on the following issues:

1. Definition of section 199A Qualified Business Income
2. Aggregation method for calculation of QBI of pass-through businesses
3. Deductible amount of QBI for a pass-through entity with business in net loss

4. Qualification of wages paid by an employee leasing company
5. Application of section 199A to an owner of a fiscal year pass-through entity ending in 2018
6. Availability of deduction for Electing Small Business Trusts (ESBTs)

IRS and Treasury said earlier this month that the pass-through provisions were a priority but did not commit to a timeline for guidance.

The Aftermath of Extenders. The *Bipartisan Budget Act of 2018*, enacted on Feb. 9, retroactively renewed for tax year 2017 a number of tax extenders that expired at the end of 2016. In order for taxpayer to claim the benefits, the IRS has had to reprogram its processing systems.

On Feb. 22, the IRS announced that it is ready to process 2017 returns claiming the following:

- Exclusion from gross income of discharge of qualified principal residence indebtedness (often, foreclosure-related debt forgiveness).

- The mortgage insurance premiums treated as qualified residence interest.

- Deduction for qualified tuition and related expenses.

In the coming weeks, the IRS will work closely with tax professionals and the tax-preparation industry to ensure that software processes can accommodate the new provisions. The IRS emphasized that filing electronic returns is the best way to ensure that returns are processed accurately and refunds are properly issued.

The IRS will also continue to update its systems to handle returns claiming the other tax benefits extended by the *Bipartisan Budget Act*, though many of these benefits impact a smaller number of taxpayers. The IRS noted that taxpayers eligible for these benefits can file an amended return once systems are fully updated.

Pay Up! While the Trump Administration has not been enforcing many aspects of the *Affordable Care Act*, the IRS is fining companies for violating Obamacare's employer mandate. Several companies recent received notices from the IRS demanding millions of dollars in fines. Litigation is in the works as companies plan to sue the administration, forcing it to defend a statute that the president has repeatedly declared "dead." The enforcement actions cover potential violations in 2015, the first year the mandate was supposed to be applied.

IRS Releases Rules on Health Insurance Tax. On Feb. 22, the IRS issued final rules to define which entities are required to pay the health insurance providers fee under the *Affordable Care Act* (ACA), also known as the health insurance tax (HIT). The ACA imposed an annual fee on certain health insurance providers beginning in 2014. Congress temporarily suspended the HIT until 2020.

The final regulations (T.D. 9830) adopt the proposed version without any changes. The IRS initially published temporary and proposed regulations in Feb. 2015. The rules will continue to allow certain entities, such as nonprofits or employers with self-insured plans, to be exempt from the tax.

Critics of the HIT continue to advocate for its permanent repeal, noting that it increases premiums for consumers. Given that the tax faces bipartisan opposition, it may be a prime candidate for further postponement or repeal.

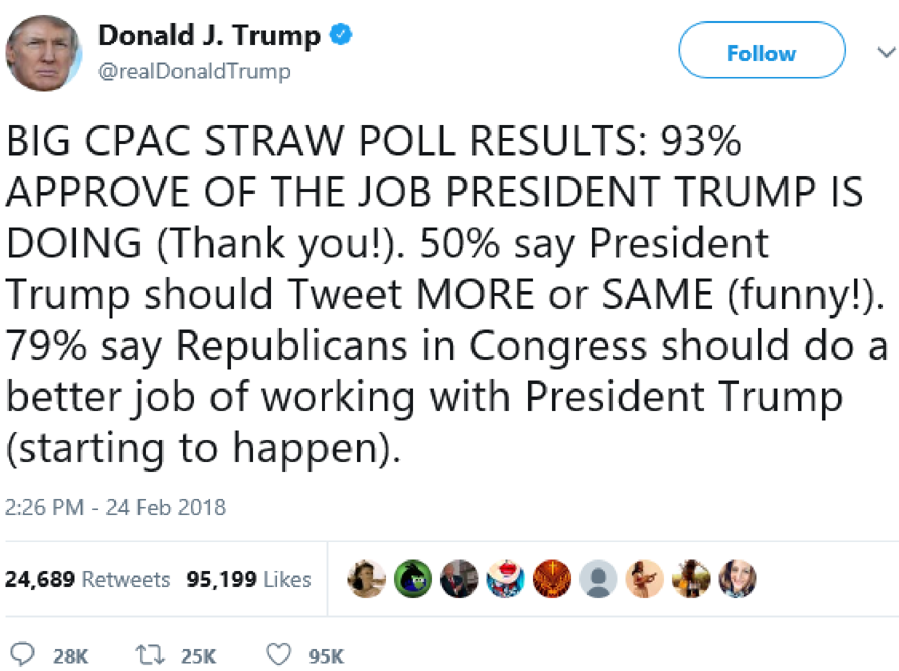
LINE ITEMS

1. The Department of the Treasury released its report on the Orderly Liquidation Authority and bankruptcy reform. The report recommends keeping the OLA as an emergency tool while calling for reforms to the resolution regime.

2. The Consumer Financial Protection Bureau (CFPB) issued a request for information to solicit public comments on the bureau's engagement with the public. This request is part of the CFPB's comprehensive review of its operations.

3. House congressional leaders have appointed members to the Joint Select Committee on Solvency of Multiemployer Pension Plans. At this writing, the Senate has yet to confirm its list of lawmakers for the panel. Read more here.

COMMANDER-IN-TWEET



IN THE QUEUE

Congressional Activity

Tuesday, 2/27

House Budget Committee
Hearing on “CBO Oversight: The Role of Behavioral Modeling in Scoring and Baseline Construction.”

House Ways and Means Committee
Meeting to adopt the Ways and Means Committee Views and Estimates on the FY 2019 Federal Budget.

House Financial Services Committee
Subcommittee hearing on “Oversight of the SEC’s Division of Enforcement.”

House Financial Services Committee
Subcommittee hearing on the “Foreign Investment Risk Review Modernization Act of 2017.”

House Small Business Committee
Hearing on “How Red Tape Affects Community Banks and Credit Unions: A GAO Report.”

House Financial Services Committee
Hearing with Fed Chair Jay Powell to receive his first semiannual Monetary Policy Report and discuss the state of the economy.

House Judiciary Committee
Subcommittee hearing on the proposed merger of CVS and Aetna.

Wednesday, 2/28

House Small Business Committee
Hearing on “How Red Tape Affects Community Banks and Credit Unions: A GAO Report.”

Joint Economic Committee
Hearing on “The Economic Report of the President” with Kevin Hassett, chairman of the Council of Economic Advisers.

Thursday, 3/1

Senate Banking Committee
Hearing with Fed Chair Jay Powell to receive his first semiannual Monetary Policy Report.

Senate EPW Committee
Hearing on "The Administration's Framework for Rebuilding Infrastructure in America."

Agency Activity

Tuesday, 2/27

FDIC
The FDIC and the Federal Reserve Board (FRB), in conjunction with the Financial Accounting Standards Board (FASB), the U.S. Securities and Exchange Commission (SEC), and the Conference of State Bank Supervisors (CSBS), will host a webinar to discuss how smaller, less complex community institutions can implement CECL.

Other Activity

Tuesday, 2/27

American Enterprise Institute
A discussion on eliminating Fannie Mae and Freddie Mac without legislation.

Brookings Institution
Event titled, "A Fed Duet: Janet Yellen in Conversation with Ben Bernanke."

U.S. Chamber of Commerce
The chamber holds the 2018 Invest in America Summit where investors and stakeholders will discuss the benefits and challenges of foreign investment in the United States.

Thursday, 3/1

American Enterprise Institute
Discussion on the impact of the new tax law with keynote remarks by Senate Finance Chairman Orrin Hatch.

McGuireWoods Tax Policy Group:

Russell Sullivan
Partner
rsullivan@mcguirewoods.com

Rosemary Becchi
Partner
rbecchi@mcguirewoods.com

Harold Hancock
Partner
hhancock@mcguirewoods.com

Charlie Iovino
Vice President
ciovino@mwcllc.com

Lai King Lam
Assistant Vice President
llam@mwcllc.com

Radha Mohan
Assistant Vice President
rmohan@mwcllc.com

Anne C. Starke
Research Associate
astarke@mwcllc.com

Daniel Chung
Associate
dchung@mcguirewoods.com