Tax reform on the horizon:
Opportunity amidst a changing industry environment

The Dbriefs Investment Management series

Ted Dougherty, Partner, Deloitte Tax LLP
Craig Gibian, Principal, Deloitte Tax LLP
James Calzaretta, Partner, Deloitte Tax LLP
Jeffrey Kummer, Managing Director, Deloitte Tax LLP

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Agenda

• Legislative update: General observations
• Pass-through entities
• Overview of tax reform frameworks
• Tax reform observations
• Mark-to-market treatment of derivatives
Polling question #1

Has your company had meaningful discussions about reform with its tax advisors?

• Yes – we have had high level/general discussions
• Yes – we have had detailed discussions and/or modeled out potential scenarios
• No
• Don’t know/Not applicable
Legislative update: general Observations
Tax reform debate is heating up

• House Republicans released a tax reform “blueprint” on June 24, 2016 indicating the direction they want to take the tax reform debate (“GOP tax plan”)

• Goal of reducing both corporate and individual tax rates as well as addressing pass-throughs

• Drafted with primary focus on enacting policies believed to speed economic growth

• Tax reform is one of a handful of issues where there is a consistent call for action from House and Senate Republicans as well as President Trump
White House tax reform fact sheet observations

1. The White House release is meant to demonstrate that the President is leading the narrative on tax reform – something that will be necessary for tax reform to ultimately be successful – although he will need Congressional Republicans in the House and Senate to provide heavy lifting.

2. Other than proposing – without elaboration – to “eliminate tax breaks for special interests,” there was little specificity on how to offset the cost of the proposed tax cuts in the fact sheet.

3. There is quite a bit in the fact sheet that is largely consistent with House Republican tax reform efforts, although no mention of a BAT or denial of deduction on net interest – and the revenue it might raise to help offset the cost of rate reductions – is significant.

4. The level of detail is going in the wrong direction. The fact sheet is about half as detailed as the September 2016 tax reform plan released by then-candidate Trump.
Polling question #2

Which of the following proposed tax reform changes do you believe would impact the investment management industry the most?

• Reducing the effective tax rate on capital gain and qualified dividend income
• Lower tax rate on pass-through income
• Repeal of the 3.8 percent Net Investment Income Tax as part of healthcare reform
• Changing the tax treatment of carried interest
• Mark-to-market treatment of derivatives
• Don’t know/Not applicable
Pass-through entities
Trump Administration and House GOP proposals impacting pass-throughs

Below is a brief summary of how the different tax reform plans may address issues relevant to pass-through entities.

“GOP tax plan” refers to the House GOP’s “A better way” tax reform blueprint dated June 24, 2016

“Trump tax plan” refers to the Trump Administration’s proposed tax reform plan

Summary of rates

• For individuals, both tax plans reduce the number of brackets (currently seven) to three, with tax rates for pass-through and sole proprietorships, the GOP tax plan taxes active business income at a maximum rate of 25%.

• The GOP tax plan notes that the top individual rate of 33% does not apply to active business income of pass-through and sole proprietorships.

Source: https://www.donaldjtrump.com/policies/tax-plan/?/positions/tax-reform
Summary of rates (cont.)

• Therefore, it appears that active business income flows through and is taxed at the owner’s rate, but no higher than 25% (The 25% rate does not appear to apply to professional services corporations under the GOP tax plan). Presumably a corporation with a 20% tax rate and an individual with a 12% tax rate would be taxed at those rates on active business income from a pass-through business. However, sole proprietorships and pass-through businesses pay or are treated as paying reasonable compensation to their owner-operators. This reasonable compensation is deductible by the business and is subject to tax at individual rates (from 12% to 33%).

• The Trump tax plan imposes a 15% tax rate on all businesses; note there is uncertainty as to whether this 15% rate applies to all pass-through businesses or whether there would also be a second level of tax on distributions to owners of some pass-through businesses.
Carried interest

• Both tax plans address carried interest in some form.

• As discussed above, the GOP tax plan imposes a maximum 25% tax rate on the active business income of pass-through businesses, but pass-through businesses are treated as paying reasonable compensation to their owner-operators for services, which is deductible by the business and subject to tax at individual rates (as high as 33%). Based on discussion with the Hill, this is not intended to tax carried interest as compensation.

• While the Trump tax plan is silent on carried interest, both President Trump and WH Chief of Staff Priebus have said it will be taxed as ordinary income.
Trump Administration and House GOP proposals impacting pass-throughs (cont.)

Elimination of deduction for net interest expense

• The GOP tax plan provides an immediate deduction for the cost of investments in tangible property (such as equipment and buildings) and intangible assets (such as intellectual property), but not land.

• Businesses are allowed to deduct interest expense against any interest income, but there is no current deduction for net interest expense. Any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years.

• The GOP tax plan states that the Committee on Ways and Means will work to develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models.

• The Trump tax plan provides that firms engaged in manufacturing in the U.S. may elect to expense capital investment and lose the deductibility of corporate interest expense. An election may be revoked within the first 3 years as long as returns are amended.
Differences in pass-through and corporate rates

The GOP tax plan taxes active business income at a maximum rate of 25% and corporations at a rate of 20%. This difference in rates may incentivize tax exemts to invest in corporate entities depending on whether the tax is ultimately an entity level or individual level tax.

Partnerships taxed as corporations

A previous version of the Trump tax plan indicated that distributions from pass-through businesses would be treated as dividends, subjecting them to double taxation. That statement has been removed from the Trump tax plan, and its status is uncertain.

Wind and solar tax credits

The Trump tax plan states that it eliminates most corporate tax expenditures except for the Research and Development credit. It may eliminate the Investment Tax Credit for solar, the Investment Tax Credit for wind energy, and the Production Tax Credit for wind energy. The GOP tax plan does not include a specific proposal for wind and solar tax credits but suggests that most credits, deductions, and preferences will be repealed.
Uncertain status of partnership rules

The GOP tax plan mentions that the immediate expensing proposal was inspired by the American Business Competitiveness Act (H.R. 4377), introduced by Rep. Devin Nunes of California. The American Business Competitiveness Act introduces a business cash flow tax, which would modify how businesses entities treat contributions of property, distributions of property, and property acquisitions. It is not known if other elements of the American Business Competitiveness Act will be included in the GOP tax plan. As a result of the cash flow tax, there is much uncertainty as to how the partnership rules will work.

Treatment of Property

For assets acquired by a business entity post-enactment, basis is largely irrelevant as acquisitions of tangible and intangible asset (including goodwill) other than land are immediately expensed.
Trump Administration and House GOP proposals impacting pass-throughs (cont.)

**Partnership property transactions**

There are very few details about the proposals. The GOP blueprint references the proposed American Business Competitiveness Act, which contains a few more detailed rules. It’s very uncertain how much these rules are being considered.

- Contributions are tax free.

- Partnership distributions (all business entity distributions) of assets are generally no longer tax free.
  - Distributions of assets (presumably excluding cash) are taxable receipts to the partnership, unless to a controlling business entity. Controlling business entity is an entity (and related persons) that directly or indirectly owns more than 50 percent of capital or profits. (Distributions to a controlling business entity are tax free and attributes carry over).
  - There is a limited previously contributed property (PCP) exception for individuals that treats the PCP’s fair market value as equal to basis plus any post contribution enhancements in value.
  - There is also an exception for spin-offs, split-offs, and split-ups of business entities. Presumably this would include partnership divisions.

- Partnership mergers are tax free.
Tax reform

Key questions for all pass-through entities

1. Will tax reform actually happen in near term?
2. Effective dates? 2017 or a portion thereof? 2018?
3. Transitional rules?
4. Will some provisions be phased in over years?
5. What items will be grandfathered?

There are many unanswered questions that will impact actions and planning.
Polling question #3

What do you think is the likelihood of meaningful tax reform passing?

• Very likely
• Likely
• Somewhat likely
• Not likely
• Don’t know/Not applicable
Overview of tax reform frameworks
## Comparing individual tax proposals

<table>
<thead>
<tr>
<th></th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top individual rate</strong></td>
<td>35%</td>
<td>33%</td>
<td>25% (plus 10% surtax on MAGI)</td>
</tr>
<tr>
<td><strong>Capital gains/dividends</strong></td>
<td>No change in rate;</td>
<td>Tax at ordinary rates</td>
<td>Tax at ordinary rates</td>
</tr>
<tr>
<td></td>
<td>repeal 3.8% net</td>
<td>with 50% exclusion</td>
<td>with 40% above-the-line</td>
</tr>
<tr>
<td></td>
<td>investment income</td>
<td>(i.e., effective top</td>
<td>deduction (i.e., effective top</td>
</tr>
<tr>
<td></td>
<td>tax (NII)</td>
<td>rate of 16.5%); NII</td>
<td>rate of 21%); retain</td>
</tr>
<tr>
<td></td>
<td></td>
<td>repeal part of</td>
<td>NII</td>
</tr>
<tr>
<td></td>
<td></td>
<td>healthcare reform</td>
<td></td>
</tr>
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<td></td>
<td></td>
<td>effort</td>
<td></td>
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<tr>
<td><strong>Carried interest</strong></td>
<td>No mention in</td>
<td>Unknown</td>
<td>Ordinary income for a</td>
</tr>
<tr>
<td></td>
<td>proposal (but</td>
<td></td>
<td>portion of carried</td>
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<tr>
<td></td>
<td>Trump and Priebus</td>
<td></td>
<td>interest of partners</td>
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<tr>
<td></td>
<td>stated it will be</td>
<td></td>
<td>providing services to</td>
</tr>
<tr>
<td></td>
<td>addressed)</td>
<td></td>
<td>certain partnerships</td>
</tr>
<tr>
<td>**Standard deduction/personal</td>
<td>Increase standard</td>
<td>Consolidate standard</td>
<td>Consolidate standard</td>
</tr>
<tr>
<td>exemption**</td>
<td>deduction to $12.6k/</td>
<td>deduction and personal</td>
<td>deduction and personal</td>
</tr>
<tr>
<td></td>
<td>$25.2k (single/joint);</td>
<td>exemption into larger</td>
<td>exemption into larger</td>
</tr>
<tr>
<td></td>
<td>personal exemptions</td>
<td>standard deduction</td>
<td>standard deduction into</td>
</tr>
<tr>
<td></td>
<td>not addressed</td>
<td>of $12k/$24k;</td>
<td>larger standard deduction</td>
</tr>
<tr>
<td></td>
<td></td>
<td>consolidate personal</td>
<td>of $11k/$22k; eliminate</td>
</tr>
<tr>
<td></td>
<td></td>
<td>exemption for</td>
<td>head of household; phase-</td>
</tr>
<tr>
<td></td>
<td></td>
<td>children and child</td>
<td>out for upper income</td>
</tr>
<tr>
<td></td>
<td></td>
<td>tax credit</td>
<td>taxpayers</td>
</tr>
</tbody>
</table>
Comparing individual tax proposals (cont.)

<table>
<thead>
<tr>
<th></th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
</table>
| **Itemized deductions** | Repeal most, with specified exceptions of mortgage interest, charitable deductions, and retirement savings | • Repeal state and local tax deduction  
• Review mortgage interest and charitable deductions to make more “effective and efficient” | • Repeal deductions for state and local tax, medical expenses, employee business expenses  
• Phased-in cap of $500k for mortgage interest (no home equity lines)  
• Dollar-for-dollar phase out of principal residence capital gain exclusion |
| **Estate tax**        | Repeal                                                                                | Repeal estate & generation-skipping-transfer taxes                                    | Retain                                                                                                    |
| **Individual AMT**    | Repeal                                                                                | Repeal                                                                               | Repeal                                                                                                    |
## Comparing business tax proposals

<table>
<thead>
<tr>
<th></th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate rate</strong></td>
<td>15%</td>
<td>20%</td>
<td>25% (phased in over 5 years)</td>
</tr>
<tr>
<td><strong>Pass-through rate</strong></td>
<td>15%, but unclear to which entities and income it applies/other restrictions</td>
<td>25%</td>
<td>Taxed at individual rate</td>
</tr>
<tr>
<td><strong>Expensing/depreciation</strong></td>
<td>Not addressed</td>
<td>Full expensing in year one of all assets, tangible and intangible, other than land</td>
<td>Phase in repeal of MACRS</td>
</tr>
</tbody>
</table>
| **Interest deduction** | Not addressed | No current deduction for net interest expense (disallowed deductions may be carried forward indefinitely) | • Modified section 163(j) and implements new thin cap rules  
• Section 163(j) interest deduction limit for adjusted taxable income reduced from 50% to 40% |
Comparing business tax proposals (cont.)

<table>
<thead>
<tr>
<th>Corporate AMT</th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No proposal</td>
<td>Repeal</td>
<td>Repeal with 50% refund of AMT credit carryforward for three years with full refundability in year four</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section 199 Deduction</th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Implicit repeal</td>
<td>Repeal</td>
<td>Repeal</td>
<td>Repeal (over 2 yrs)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Net Operating Losses</th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>No proposal</td>
<td>Eliminate NOL carryback&lt;br&gt;• Permit indefinite carryforward with amount “increased by an interest factor”&lt;br&gt;• Limit current deduction to 90% of taxable income</td>
<td>Eliminate NOL carryback&lt;br&gt;• Limit current deduction to 90% of taxable income</td>
<td>Repeal of LIFO and LCM&lt;br&gt;• Amortize section 174 expenditures over 5 yrs&lt;br&gt;• Amortize advertising expenditures over 10 yrs&lt;br&gt;• Extend section 197 intangibles amortization to 20 yrs&lt;br&gt;• Repeal entertainment expense deduction&lt;br&gt;• Repeal like-kind exchanges&lt;br&gt;• Repeal income exclusion for non-shareholder capital contributions</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Misc. Revenue Raisers</th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not addressed</td>
<td>Eliminate most business tax expenditures other than R&amp;D credit and LIFO</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## Comparing international tax proposals

<table>
<thead>
<tr>
<th></th>
<th>President’s tax plan</th>
<th>House GOP blueprint</th>
<th>H.R. 1 (2014 Camp plan)</th>
</tr>
</thead>
</table>
| **International regime**| Move to territorial | • Move to territorial (via 100% dividend exemption)  
                          |                      | • Eliminate most subpart F rules; retain foreign personal holding company rules  
                          |                      | • Provides US corp shareholders 95% dividends received deduction for foreign source dividends received from 10%+ owned foreign corporation  
                          |                      | • 15% minimum worldwide effective rate on foreign base company intangible income  
                          |                      | • 12.5% minimum worldwide effective rate on foreign base company sales income |
| **Deemed repatriation** | Rate not specified   | Differential rates for cash (8.75%) and noncash (3.5%) assets, payable over 8 years at taxpayer’s election  
                          |                      | Differential rates for cash (8.75%) and noncash (3.5%) assets, payable over 8 years (no interest charge; FTCs and NOLs may offset tax) |
| **Border-adjusted tax base** | Not addressed | Tax imposed on imports, but not exports (similar concept to other countries’ credit-invoice VATs)  
                          |                      | No proposal |
Tax reform observations
Tax reform: Opportunities and challenges

Opportunities

- There is general agreement by both political parties on the need to lower the corporate tax rate and reform international tax rules.
- The sense of urgency related to BEPS, increased foreign acquisitions of US-based companies, and EU state-aid actions is increasing.
- Significant tax reform work already done with discussion drafts released by Camp, Baucus and Wyden as well as the House GOP blueprint.
- Dynamic scoring may make it easier to achieve deficit-neutral tax reform.

Challenges

- Tax reform is always easier said than done. The actual task of paring back popular credits and deductions offers ample opportunities for well-organized opposition to arise.
- Who is “driving the train” on tax reform?
- President Trump and Speaker Ryan may have very different visions of how to move forward on taxes (“relief” v. “reform”).
- Does Treasury have the staff on the ground to actively support tax reform efforts?
- 2018 elections limit the window to achieve tax reform.
Tax reform through reconciliation—is it really an option?

**Arguments for using reconciliation**

• Cannot be filibustered, meaning it can pass the Senate with just 51 votes (or 50 plus the tie-breaking vote of the Vice President)

• Democrats may demand concessions on key issues (overall cost, estate tax, marginal rates, distribution of tax burden, etc.) that some Republicans may find unacceptable

**Arguments against using reconciliation**

• Procedural rules can have major substantive impacts by preventing inclusion of provisions that:
  − Have no budgetary or have budget effects that are “merely incidental”
  − Increase the deficit outside the budget window
A look ahead at the 115th Congress: Deadlines will dominate
Mark-to-market treatment of derivatives
Mark-to-market (MTM) proposals

• MTM treatment of derivatives has been included in a number of recent tax reform proposals

• In 2014, Representative Camp released a discussion draft of the Tax Reform Act of 2014 that included a MTM regime for derivatives

• The Obama Administration’s revenue proposals for FY 2014-2017 contained a MTM regime for derivatives referencing actively traded property

• In May 2016, Senator Wyden released a discussion draft of the Modernization of Derivatives Tax Act of 2016 that would require MTM treatment for derivative contracts

• Last week, Senator Wyden introduced a bill, the Modernization of Derivatives Tax Act of 2017 (“MODA”), which continues to include the MTM proposal and provides updates to the discussion draft released last year
Rationale for expanded MTM

• The current rules regarding the taxation of derivatives provide a patchwork of different regimes and anti-abuse rules
  − Accordingly, the timing, character and source of income or loss from derivatives depends on a number of factors
  − The starting place typically depends on the type of derivative in question, such as whether the derivative is a notional principal contract (swap), option, futures contract, forward contract, or some other type of derivative

• A summary of MODA released with the bill stated various reasons for the change, including preventing “sophisticated taxpayers from using derivatives to avoid taxes” and “radically simplifying” this complex area of the tax law

• The Joint Committee on Taxation (JCT) estimates MODA would generate more than $16 billion in revenue over ten years
MODA Overview

• Generally requires MTM and ordinary income tax treatment for derivative contracts

• Establishes new regime for “investment hedging units” (IHUs) that are MTM as ordinary gain or loss

• Carve out for hedging transactions under section 1221(b)

• Income, deduction, gain or loss on a derivative is sourced to the taxpayer’s country of residence (except as provided in section 871(m))

• Repeals nine current sections (sections 1233, 1234, 1234A, 1234B, 1236, 1256, 1258, 1259, and 1260)
  –Section 1092 straddle rules are not repealed, but revised to generally exclude derivatives otherwise subject to the provisions of MODA
Poll question #4

What impact would the Modernization of Derivatives Tax Act’s treatment of derivatives have on your business?

• No impact, we don’t use derivatives
• No impact, all of our derivatives are properly identified as hedges under section 1221
• A small impact, we generally mark our derivatives to market under section 475
• A small impact, we don’t use many derivatives
• A large impact, we hold many derivatives that are not currently MTM
• Don’t know/Not applicable
Treatment of derivatives under MODA

• Gains and losses on derivatives are taxed at ordinary rates upon termination or transfer

• Derivatives not terminated or transferred are MTM at the end of each taxable year as ordinary income or loss

• MODA defines a derivative as:

  Any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following:

  ➢ Any share of stock in a corporation
  ➢ Any partnership or beneficial ownership interest in a partnership or trust
  ➢ Any evidence of indebtedness
  ➢ Any real property (with an exception for physical settlement)
  ➢ Any commodity that is actively traded
  ➢ Any currency
  ➢ Any rate, price, amount, index, formula, or algorithm
  ➢ Any other item as the Secretary may prescribe
Investment hedging units

• An IHU may be established when taxpayers use derivatives to hedge capital assets

• An IHU consists of (i) one or more derivative contracts and (ii) an underlying investment with respect to the derivative(s), where the derivative has a “delta” in the range beginning with minus 0.7 and ending with minus 1.0
  – For this purpose, an “underlying investment” generally includes the same list of investments used to define the term “derivative”
  – For this purpose, “delta” is defined as the ratio of the expected change in the fair market value of the derivative to any change in the fair market value of the underlying investment

• The establishment of an IHU with respect to an underlying investment is a taxable event, requiring the recognition of built-in gain, but not built-in loss

• Components of IHUs are MTM and taxed as ordinary income over the applicable hedging period (i.e., the period the IHU is in existence)

• MODA provides detailed rules regarding the identification of, and testing for, IHUs and available elections
Question & Answer
Join us July 11th at 2 p.m. ET as our Investment Management series presents:

The new FASB revenue recognition standard: Charting an effective implementation
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