WASHINGTON TAX NEWS

Potomac Law Tax Newsletter— June 2017 | Susan Rogers

The agenda and legislative schedule facing Congress in the months ahead continues to present significant challenges with uncertainty as to whether any major legislation can be passed in the near future. Congressional leadership must deal with the issue of increasing the **debt limit ceiling** and **funding the government for FY 2018**, which starts on October 1st. None of the 12 **appropriations bills** are finished, so it seems to be a real possibility that a short-term spending bill will be necessary. **Health care reform legislation** has passed the House, but is moving more slowly in the Senate, which has opted to draft its own legislation rather than work with the House bill. Hearings on **tax reform** have started in the House and Senate, but the White House has yet to produce any details of their plan outlined in April, and it is unclear who will effectively be taking the lead on the advancement of tax reform.

With respect to a **timeline** in the Senate on tax reform, **Senate Majority Leader McConnell** has stated that his intention is to complete tax reform during the current Congress, which expires at the end of 2018. House Speaker Ryan and W&M Chairman Brady continue to express hope that tax reform can be completed in 2017, while they acknowledge the challenges to achieving that.

On May 23rd, the White House released its FY 2018 budget proposal, which includes $4.1 trillion of spending and a goal of balancing the budget over 10 years. The proposed budget does not include details on the President's tax reform plan, which was released on April 26th, but it does assume that any adopted tax reforms will be revenue neutral.

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There is divided opinion in Washington about whether the firing of FBI Director Comey and the related investigations of Russian contacts with Trump campaign personnel will make tax reform and health care reform more difficult. In any event, the legislative agenda facing Congress was already highly ambitious, and the political issues that are now added to the mix will only make legislative achievements more difficult.

Susan Rogers

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Tax Reform

There is growing concern in corporate America and on Wall Street that one of the President's key legislative initiatives to enact **comprehensive tax reform** is **facing increasing challenges this year**, and that the White House and Congress will be unable to deliver on their promises to cut corporate and individual tax rates in 2017. A crowded legislative calendar for the remainder of this legislative session presents procedural challenges to moving tax reform, while resistance to key revenue raisers in the House GOP blueprint including the border adjustment tax (BAT) present substantive challenges to moving a comprehensive package of tax cuts and base broadeners. GOP leadership continues to consider the option of a temporary tax cut to avoid issues with the long-term deficit rules of the budget reconciliation process with Secretary Mnuchin quoted as saying: "Permanent is better than temporary, and temporary is better than nothing."

The White House has nominated **David Kautter to be the Assistant Secretary of Treasury for Tax Policy**, which is a key position with respect to the advancement of tax reform in the Administration and requires Senate confirmation. The Administration budget for FY 2018 did not include new details about the tax reform plan released in April. In a recent interview, the President stated that he is willing to increase the deficit in the short term in order to get the longer-term economic growth and revenues that he believes will result from an improved tax system. He continues to support a reciprocal import tax on products made by manufacturers that have moved production outside of the US. He also expressed support for a Value Added Tax (VAT) but commented that he does not believe Americans would accept that type of system.

On May 18th, the W&M Committee held the first in a series of **hearings on tax reform** focusing on **economic growth and job creation**. On May 24th, the W&M Committee held a **hearing on the pros and cons of the border adjustment tax** (BAT) included in the House GOP tax reform blueprint with corporate executives and economic experts testifying. A detailed study of the BAT was issued by the Joint Committee on Taxation in conjunction with the hearing. The provision, which would tax all imports at 20 percent and exempt exports, is estimated to raise more than $1 trillion over 10 years and thereby is one of the key revenue offsets in the GOP blueprint. Testimony at the hearing demonstrated the lack of consensus on the effects of the proposal.

In recent public comments, **Treasury Secretary Mnuchin** has been careful not to completely reject the BAT, but he has taken issue with the contention that it would level the playing field for US companies. In a W&M Committee hearing on the Administration's FY 2018 budget, he stated that he does not support the BAT as currently drafted, and he is looking to work with the Congress on changes. In that hearing, the Secretary also commented that he believes the business deduction for net interest expense should be retained, but he is willing to consider this issue with other options. He also stated that tax rate parity between corporations and pass through entities must include anti-abuse measures that prevent the wealthy from using pass through entities to evade personal income taxes.

Senate Republicans to date have not drafted their own tax reform proposal or released a detailed outline of a plan but appear to have started working with the House and the White House on these issues. Comments from many Senators, however, indicate that they have positions and priorities that may be at odds with those of the other parties.

Senator Majority Leader McConnell (R-KY) stated recently that tax reform must be **revenue neutral**, which is in line with the House GOP blueprint but is not aligned with some recent comments by the White House (despite the Administration budget principles) or SFC Chairman Hatch (R-UT) who stated that he is not sure it is critical that tax reform be revenue neutral. **Senator McConnell** also stated recently that he does not believe the **BAT proposal** would pass the Senate, adding to the Administration's misgivings about this proposal. There also may be disagreement between the House and Senate on the issues of depreciation, expensing and the deduction for net interest expense.

Debt Ceiling Limit

Top economic aides from the White House are urging Congress to act **on raising the debt ceiling by the beginning of August** prior to the summer recess. In addition, Treasury Secretary Mnuchin is pushing for a "clean" debt ceiling bill (i.e., with no additional items). But Congressional leadership had hoped to include the debt ceiling issue in a broader spending package that will need to be approved prior to the beginning of FY 2018 on October 1st.

Congressional Republicans are divided over whether to combine spending cuts with the debt ceiling increase, and Senate Democrats are considering whether they should push for concessions on key issues as part of the package. Democratic support will be needed in the Senate where a 60-vote majority will be required, and if House conservatives do not support a clean debt limit bill, Democratic support may also be necessary in the House. In addition, Congressional leadership had hoped to devote the June/July work period to consideration of health care reform and tax reform rather than becoming embroiled in a fight over the debt limit.

On May 4, 2017, the House passed the American Health Care Act of 2017 (AHCA). While passage of the AHCA constitutes the first step in the Republican effort to repeal and replace the Patient Protection and Affordable Care Act (ACA), it appears an argument can be made that by itself it does neither. Consideration of the AHCA now moves to the Senate, where prospects for passage are challenging.

The non-partisan Congressional Budget Office (CBO) issued its cost estimate for the House-passed legislation to replace the ACA. CBO estimates that the bill would reduce the deficit by $119 billion over 10 years, as a result of $1.1 trillion in reduced spending and $992 billion in reduced revenues. The bill would reduce coverage for 23 million people by 2026 as compared to current law.

The AHCA is being advanced through the budget reconciliation process, which allows it to be approved by a simple majority vote in both the House and the Senate (where Republicans hold 52 seats.) The Senate has indicated that it intends to draft its own legislation rather than use the House-passed bill, and a working group has been meeting but no timetable has been set for Senate debate.

House of Representatives Finally Passes the American Health Care Act

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The AHCA would repeal several provisions that form the core of the ACA, including the effective elimination of the employer and individual health care mandates. Note that the AHCA does not technically eliminate these mandates but instead lowers the penalties associated with non-compliance to zero effective at the beginning of 2016. The AHCA would impose a 30% late-enrollment surcharge on individuals (generally beginning in 2019) who permit coverage to lapse for a period greater than 63 days. The bill would curtail the Medicaid expansion provisions under the AHCA. Federal funding to cover state costs for such expansion would be preserved through 2019 but after that states would be reimbursed at the higher ACA rates only for individuals enrolled prior to December 31, 2019.

The AHCA would repeal or modify many but not all of the taxes or fees included in the ACA. Except where specifically noted, these changes are effective as of January 1, 2017. The taxes or fees that would be repealed or modified include the following:

1. The 2.3% excise tax on the sale of certain medical devices would be repealed.
2. The additional 0.9 percent Medicare Hospital Insurance surtax would be repealed.
3. The 3.8% net investment tax imposed on certain investment income for individuals, trusts and estates would be repealed.
4. The $2500 annual limit imposed on contributions to health care flexible spending accounts (HCSAs) would be eliminated.
5. The rule prohibiting reimbursement for over-the-counter medication under HCSAs would be repealed.
6. The full business expense deduction available to employers for retiree prescription drug costs without reduction by the amount of any Medicare Part D subsidy elimination would be restored.

The AHCA would not eliminate the 40% excise tax imposed by the ACA on high-cost employer-sponsored health coverage (the “Cadillac tax”), which is scheduled to be effective in 2020 but would be delayed to 2026. Another change would restore the tax on distributions from health savings accounts (HSAs) that are not used for qualified medical expenses to 10% (the ACA had increased that tax to 20%). Beginning in 2017, the AHCA would repeal the rules imposed under the ACA that denied a deduction for compensation paid to employees for certain health insurance providers to the extent that compensation exceeds $500,000. The bill would lower the adjusted gross income threshold for the deduction of qualifying medical expenses to 5.8% if the taxpayer or spouse is aged 65 or older (effective January 1, 2017). The AHCA would increase the limit on annual HSA contributions to equal the sum of the annual deductible and out-of-pocket expenses permitted under a high-deductible health plan.

The GOP finally landed on a compromise that would allow states to submit a waiver application to the Department of Health and Human Services to (1) specify the state’s own essential health benefits beginning in 2020 and (2) charge higher premiums to those with pre-existing conditions who let their coverage lapse beginning in 2019. To obtain such a waiver, a state would be required to show how such waiver would affect coverage and premiums within the state. The ability to charge higher premiums for those with pre-existing conditions would be dependent on the establishment with the state of a risk mitigation program (or alternatively the state could elect to participate in a federal risk sharing program funded through the AHCA). Note that under the AHCA, states would only be allowed to consider pre-existing conditions when setting premiums with respect to individuals who let continuous coverage lapse.

Lastly, the AHCA replaces the individual subsidies to purchase health care coverage with a series of refundable tax credits. Eligible individuals include persons (1) who do not have access to coverage under employer-based coverage or a government health care program; (b) are citizens or qualified aliens; and (c) are not incarcerated. The tax credits are adjusted by age (with limited income related scale-backs.) The levels of these credits (which are lower than the ACA subsidies) likely will be hotly debated in the Senate.

Treasury and the IRS

The IRS issued two pieces of **guidance related to the issuance of rulings on two common spin transactions** – transactions implicating so-called "north/south" issues and transactions involving debt "issued in anticipation" of a leveraged spin. In 2013, the IRS had announced that it would no longer issue rulings with respect to these types of transactions as well as transactions that were recapitalizations into control in conjunction with spin-offs. In July 2016, the IRS removed the "no-rule" designation for recapitalizations into control and provided two limited safe-harbors where the IRS would not challenge an unwind of a high/low voting structure.

In May, the IRS issued Revenue Ruling 2017-9 offering guidance on the **north/south transactions** in which certain distributions of stock and securities of a controlled corporation are made to subsidiaries. The IRS noted that Revenue Procedure 2017-3 would be amended to allow the issuance of private letter rulings and determinations in this area with the caution that the IRS might decline to issue a letter ruling addressing the integration of steps when appropriate in the interest of sound tax administration or on other grounds when warranted by the facts or circumstances of a particular case.

The IRS also issued Revenue Procedure 2017-38, which states that the IRS will begin to issue new private letter rulings on **deals involving debt issued in anticipation of a spinoff**, although it continues to study matters concerning deals involving debt for a distribution. Specifically, the guidance states that the IRS will resume determinations on whether Code sections 355 or 361 apply to a distributing corporation's distribution of stock or securities of a controlled corporation in exchange for, and in retirement of, any putative debt of the distributing corporation if such distributing corporation debt is issued in anticipation of the distribution.

The President signed an **Executive Order** (EO) that directs government agencies with respect to activities involving **religious expression and liberties**, but does not appear to change current law. The EO instructs the Treasury Department not to pursue "adverse action" against persons, churches or religious organizations for speaking about political issues from a religious perspective. "Adverse action" is defined as "the imposition of any tax or tax penalty; the delay or denial of tax-exempt status; the disallowance of tax deductions for contributions made to entities exempted from taxation under section 501(c)(3) of title 26, United States Code; or any other action that makes unavailable or denies any tax deduction, exemption, credit or benefit." Because the IRS has almost never enforced this limitation, the EO should have little practical effect.

International Issues

The European Parliament voted to adopt proposed **amendments to the EU Anti-Tax Avoidance Directive** (EU Directive 2016/1164) that would expand the directive's current hybrid mismatch provisions, which generally apply to certain hybrid mismatches between two EU member states that are attributable to differences in the legal characterization of a financial instrument or entity.

The OECD released a discussion draft related to the implementation of the approach to **pricing transfers of hard-to-value intangibles** described in Chapter VI of its Transfer Pricing Guidelines. The final reports on Actions 8-10 of the BEPS project mandated the development of guidance in this area.

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