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Legal Alert: The Tax Cuts and Jobs Act, Take Two: A Methods-Based Comparison of the Senate and House's Tax Reform Plans

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On November 9, 2017, the Senate Finance Committee (SFC) released a summary of its initial draft tax proposal (the Senate proposal). While the Senate proposal is similar to the House Ways and Means Committee's proposal (the House proposal) (i.e., reduction in corporate tax rate, repeal of section 199 deduction, full expensing of certain business assets), many of the SFC's proposed changes regarding deductions and credits are more nuanced than those in the House proposal. Further, the Senate proposal also introduced a number of recommended changes that were not included in the House proposal. One distinction between the two bills is an SFC proposal that income must be taken into account for tax purposes no later than when it is recognized for financial accounting (book) purposes, which will impact many taxpayers.

This alert discusses the particular provisions that fall under the umbrella of income tax accounting and accounting methods. It also compares many of the House and Senate proposals for tax law changes that will impact corporate taxpayers.

<u>Corporate Tax Rate Reduction</u>

House proposal: Reduces the corporate tax rates to a flat rate of 20%, effective for tax years beginning after December 31, 2017

Senate proposal: Like the House proposal, the Senate proposal reduces the corporate tax rates to a flat rate of 20%, but it is effective for tax years beginning after December 31, 2018.

Eversheds Sutherland Perspective: Although a delay in the corporate rate reduction in the Senate proposal is unfortunate, it is not entirely disadvantageous. Deferring the effective date will provide companies additional time to plan for the corporate rate reduction that is expected to be part of any corporate reform ultimately enacted. Under the Senate proposal, taxpayers have an extra year to review income tax accounting treatment and accounting methods for various items to ensure that they take full advantage of expected changes that result from tax reform. Companies will have additional time to file amended returns—and even file for relief under section 9100—to take advantage of provisions that may be changed or repealed. And they will have additional time to make annual elections and take other actions in anticipation of the corporate tax rate reduction. This additional time is particularly beneficial for companies that need to file an accounting method change to effect more favorable treatment of an item. With respect to non-automatic accounting method changes, under the House proposal, such accounting method changes would have to be filed by December 31, 2017; under the Senate proposal, taxpayers have an additional year to fully

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review and evaluate whether and how to make such non-automatic accounting method changes. Importantly, this deferral will allow companies to take advantage of deductions and credits while the 35% corporate tax rate remains in place, which means deductions and credits taken in 2017 and 2018 would be more valuable than in a subsequent tax year when the corporate tax rate changes to a 20% rate.

<u>Limitation on Deduction for Interest</u>

House proposal: Limits the deduction for net interest expenses incurred by a business in excess of 30% of the business's adjusted taxable income. Effective for tax years beginning after December 31, 2017.

Senate proposal: Like the House proposal, the Senate proposal limits deductions for net interest expenses to 30% of the adjusted taxable income. This limitation applies at the taxpayer level (or at the consolidated tax return level for affiliated companies). Any disallowed interest expense may be carried forward indefinitely.

There are special rules for determining what is included in "business interest" and in "adjusted taxable income." For purposes of this provision, "business interest" incudes the amount of interest included in the taxpayer's gross income; it does not include investment interest. "Adjusted taxable income" refers to income computed without regard to: (1) any item of income, gain or loss that is not allocable to a trade or business; (2) any business interest or business interest income; (3) the 17.4% deduction for certain pass-through income; and (4) the amount of any net operating loss deduction.

Eversheds Sutherland Perspective: Under current law, businesses generally may deduct all interest in the taxable year in which it is paid or accrued, subject to certain specific limitations, e.g., earnings stripping rules. These rules limit the amount of interest that US corporations can deduct, and are intended to tax base erosion through earnings stripping by non-residents. Additionally, if a corporation's debt-to-equity ratio exceeds 1.5 to 1, then the earnings stripping rules limit the interest deduction to the extent the US corporation pays or accrues "disqualified interest," i.e., interest paid or accrued to a related person, if there is no US tax imposed on that interest, and the taxpayer has "excess interest expense," i.e., net interest expense in excess of 50% of adjusted taxable income.

Both the House and Senate proposals are concerning because such limitations apply to all interest, not just the aforementioned "disqualified interest." Furthermore, neither proposal provides a safe harbor debt-to-equity ratio as currently provided, i.e., the 1.5 to 1 ratio mentioned above. While there are certainly more nuanced changes to the treatment of interest expense, these two notable reforms alone force taxpayers that currently take advantage of this deduction to reevaluate their debt-equity practices to fully understand the impact these limitations will have on their businesses.

Expanded Bonus Depreciation and Other Cost Recovery Provisions

House proposal: Provides a five-year period for taxpayers to expense 100% of the cost of "qualified property" acquired and placed in service after September 27, 2017, and before January 1, 2023. The bill expands the definition of qualified property eligible for additional depreciation, allowing the provision to apply to both new and used property. Repeals taxpayer's election to use alternative minimum tax (AMT) credits in lieu of additional depreciation. Explicitly excludes from classifying as qualified property any property used by a regulated public utility company and any property used in a real property trade or business.

Senate proposal: Expanded bonus depreciation. Like the House proposal, the Senate proposal expands bonus depreciation to allow full expensing of the cost of "qualified property" acquired and placed in service after September 27, 2017, and before January 1, 2023. The Senate proposal makes fewer modifications to the existing definition of qualified property for bonus depreciation. Under section 168, qualified property includes (1) MACRS property with a recovery period of 20 years or less; (2) water utility property; (3) computer software; and (4) qualified improvement property. In addition, the original use of qualified property must begin with the taxpayer, and the property must be acquired and placed in service within certain parameters.

The Senate proposal extends additional first year depreciation through 2022 (2023 for longer production period property and aircraft). Like the House proposal, the 50% allowance is increased to 100%. The Senate proposal excludes certain public utility property from the scope of qualified property and makes a conforming amendment to the repeal of the AMT—repealing the election to accelerate AMT credits in lieu of additional depreciation.

Real property used in a trade or business. Unlike the House bill, which excludes real property used in a trade or business from the full expensing provisions, the Senate bill does not exclude such property. Rather, the Senate proposal shortens the recovery period from 39 years for nonresidential real property and 27.5 years for residential real property to 25 years for both nonresidential real property and residential rental property. The Senate proposal also eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, consolidating them under section 179(f) as "qualified improvement property." The Senate proposal provides a general recovery period of 10 years for this property and a special recovery period of 20 years for property that falls under the alternative depreciation system (ADS). There is also a proposed conforming amendment to section 467 changing the statutory recovery period for purposes of determining whether a rental agreement is a long-term agreement. The Senate proposal also requires a real property trade or business electing out of the limitation on interest deduction to use ADS for nonresidential real property, residential real property and qualified improvement property.

Depreciation limitation for luxury autos. While the House proposal is silent, the

Senate proposal modifies the section 280F depreciation limitations on luxury automobiles and personal use property. For passenger autos for which bonus depreciation is not taken, the amount of allowable depreciation is increased to $10,000 for the first year in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years. The Senate proposal also removes computer and peripheral equipment from the definition of listed property, thereby eliminating such property from the heightened substantiation requirements that apply to listed property for which a taxpayer seeks to take a deduction.

<u>Farm equipment recovery</u>. In addition to addressing luxury automobiles and personal use property, the Senate proposal specifically culls out certain farm property and shortens the recovery period from seven to five years for any machinery or equipment used in a farming business that the taxpayer places in service after December 31, 2017. The Senate proposal also repeals the required use of the 150% declining balance method for property used in a farming business.

Eversheds Sutherland Perspective: The Senate proposal strays from the House proposal in several interesting ways. The most significant distinction is that the Senate proposal retains the existing definition of qualified property provided in section 168(k). This means that the temporary full expensing provision will be limited to new property. The House proposal is more generous than the Senate proposal because it allows additional bonus depreciation for used property. Furthermore, the Senate proposal failed to exclude property used in a real property trade or business. Nonetheless, the Senate proposal shortens the recovery period to determine depreciation deductions from 39.5 to 25 years; reduces compliance complexities by eliminating the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property; and provides a general 10-year recovery period for qualified improvement property. In addition to this focus on real property, the Senate proposal provides more favorable treatment for luxury automobiles, personal use property, and certain farm property.

<u>Like-Kind Exchanges of Real Property</u>

House proposal: Limits deferral of gain on like-kind exchanges of real property occurring after December 31, 2017.

Senate proposal: Similarly, limits the non-recognition of gain in the case of like-kind exchanges of real property. Generally, this provision would apply to exchanges occurring after December 31, 2017, but does provide an exception for any exchange if either the property being exchanged or received is exchanged or received on or before December 31, 2017.

Eversheds Sutherland Perspective: Although both reforms maintain the taxpayer-favorable treatment of like-kind exchanges of real property, taxpayers seeking to apply the favorable provisions to exchanges of personal property are not without

options. Due to the transition rule provided in the Senate proposal, any taxpayer seeking to complete a like-kind exchange of personal property may still do so, and receive favorable treatment, provided the taxpayer has either disposed of the relinquished property or acquired the replacement property before December 31, 2017.

Expansion of Section 179 Expensing

House proposal: Increases the expensing limitation on the possible total amount written off to $5 million and limits the total amount of the equipment purchased to $20 million for small- and medium-sized businesses. Similar to the full expensing provision, the expansion of section 179 expensing would be available for the 2018-2022 tax years.

Senate proposal: The Senate proposal increases to $1 million the amount a taxpayer may deduct under section 179, with the phase-out amount raised to $2.5 million, effective for tax years beginning after December 31, 2017. Interestingly, the $1 million limitation is reduced, but not below zero, by the amount by which the cost of qualifying property placed in service during the taxable years exceeds $2,500,000.

Eversheds Sutherland Perspective: Although the Senate proposal increased the limitations with respect to section 179 deductions, they certainly were not increased to the extent of the House proposal. Despite the reduced increase in limitation amount, the Senate proposal provides a helpful provision for taxpayers willing to invest in new equipment and technology. This provision reduces the $1 million limitation dollar-for-dollar to the extent that the cost of such property placed in service during the year exceeds $2.5 million, i.e., if a taxpayer is motivated enough to invest in more than $3.5 million in qualifying property, there would be no limitation on the possible total amount written off by the taxpayer.

Repeal of the Domestic Production Manufacturing Deduction under Section 199

House proposal: Repeals the domestic production activities deduction provided for in section 199, effective for tax years beginning after December 31, 2017.

Senate proposal: The Senate proposal similarly repeals the domestic production activities deduction provided for in section 199, but this repeal is delayed until tax years beginning after December 31, 2018.

Eversheds Sutherland Perspective: If the Senate proposal is enacted, companies should consider how to maximize section 199 deductions prior to its repeal. Any benefit would be further enhanced if the corporate tax rate change is similarly deferred until 2019.

Reduction in Amount of NOLs and Repeal of Most NOL Carrybacks

House proposal: Reduces the potential amount of taxpayer's net operating loss (NOL) deductions to 90% of the taxpayer's taxable income. Eliminates all NOL *carrybacks except for a special one-year carryback for small business and farms in the case of certain casualty and disaster losses.*

Senate proposal: Similarly, the Senate proposal reduces the NOL deduction to 90% of the taxpayer's taxable income and eliminates most NOL carrybacks. This proposal, however, allows a two-year carryback for certain losses incurred in a farming business.

Eversheds Sutherland Perspective: But for the change from a special one- to two-year carryback in the case of certain losses incurred in the trade or business of farming, the Senate proposal should have the same impact on taxpayers as the House proposal in reducing the available amount of NOL deductions and eliminating all other carrybacks. *See* Eversheds Sutherland's perspective on the reform.

Special Rules for Tax Year of Income Inclusion

House proposal: Not addressed.

Senate proposal: The Senate proposal revises the rules associated with the recognition of income. It specifically requires taxpayers to recognize income no later than the tax year in which such income is taken into account for book purposes—the year in which income is recognized on an applicable financial statement. For example, under the proposal, any unbilled receivables for partially performed services would be recognized for tax purposes to the extent that they are recognized for financial accounting purposes. The Senate proposal further directs taxpayers to apply the revenue recognition rules under section 451 before applying the original issue discount (OID) rules under section 1272. Thus, to the extent amounts are included for book purposes when received—e.g., late-payment fees, cash-advance fees or interchange fees—such amounts are included in income under the general recognition principles under section 451.

It is important to note that the Senate proposal codifies the Deferral Method in Rev. Proc. 2004-34, 2004-22 I.R.B. 991. This administrative provision allows a taxpayer to defer the inclusion of advance payments for goods and services to the tax year following the year of receipt to the extent that such amounts are deferred for financial accounting purposes. The Senate proposal specifies that it is intended to override the income deferral provision included in Treas. Reg. § 1.451-5(c) for inventoriable goods. If enacted, it may also be used to narrow the application of Treas. Reg. § 1.451-4, which allows a reduction in current gross receipts with respect to the future costs of redeeming coupons.

Eversheds Sutherland Perspective: In the early 1970s, the Internal Revenue Service (IRS) issued three income deferral provisions that allow limited income deferrals from prepayments for goods and services. See Rev. Proc. 71-21, 1970-2 C.B. 501, superseded by Rev. Proc. 2004-34, 2004-22 I.R.B. 991, (allowing one-year for prepaid income for services); Treas. Reg. § 1.451-5 (providing up to a two-year deferral for advance payments attributable to the sale of goods); and Treas. Reg. § 1.451-4 (allowing a reduction in current gross receipts with respect to the future costs of redeeming coupons). Although these administrative provisions were issued in an effort to minimize disputes regarding the timing of revenue recognition, such disputes persist because the government continues to narrowly restrict the application of these provisions.

Thus, while it is certainly a welcome relief that the Senate proposal codifies an administrative provision that many companies use to defer income attributable to advance payments with respect to goods and services, it is disappointing that the proposal generally eliminates other deferral provisions. Most importantly, however, the Senate proposal suggests that the proper time for recognizing income for tax purposes should be matched with when it is recognized for financial accounting purposes. Because of the distinctive goals of financial accounting (conservatism) and income tax accounting (clear reflection of income), it seems erroneous to designate when a taxpayer must recognize income based on when that income is recognized for financial accounting purposes.

Changes to Many Business Credits

House proposal: Explicitly preserves the section 41 research and development (R&D) credit, as well as the section 42 low-income housing tax credit. Repeals the 50% credit for clinical testing expenses ("orphan drug credit") for certain drugs and rare diseases. Repeals the employer-provided child care credit, rehabilitation credit, work opportunity tax credit, and unused business credits.

Senate proposal: Similarly, the Senate preserves both the section 41 R&D and section 42 low-income housing tax credits. Unlike the House proposal, the Senate proposal limits the orphan drug credit to 50% of so much of qualified testing expenses for the taxable year as exceeds 50% of the average qualified clinical testing expenses for the three taxable years preceding the taxable year for which the credit is being determined. In the event that one of the three preceding years has no qualified clinical expenses, the credit is equal to 25% of the qualified expenses. Similar to the research credit under section 280C, the proposal allows taxpayers to elect a reduced credit in lieu of reducing otherwise allowable deductions. The proposal also limits qualified clinical testing expenses to the extent the testing giving rise to such expenses is related to the use of a drug which has previously been approved in the treatment of any other disease or condition, if all such diseases in the aggregate affect more than 200,000 persons in the United States. The Senate proposal did not address many of the credits that the House proposal repealed, including the employer-provided child care credit and work opportunity tax credit, but did repeal the deduction for certain unused business credits for tax years beginning after December 31, 2017, and modified the rehabilitation credit. Under the Senate proposal, the 10% rehabilitation credit for pre-1936 buildings would be repealed, as well as reducing the credit to 10% for qualified rehabilitation expenditures with respect to certain historic structures.

Eversheds Sutherland Perspective: Due to the current wide-ranging availability of business tax credits, and the negotiability of such limited taxpayer-favorable items, it is likely that as the Act continues to be debated and marked up, certain credits will be repealed or modified, and if not, left intact. To the extent credits play a significant part in a business's tax planning, it will be important to keep an eye out for applicable credits and take note of the ultimate position of the credits as tax reforms ends.

Please see our Tax Reform Law blog for more information, including the text of the House and Senate proposals and more in-depth analysis on other areas of reform.

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