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Five for 15 - KPMG report on five tax legislative issues to watch in 2015

January 9: What does 2015 hold in store in terms of federal tax legislation? Although it's impossible to know for sure, this report highlights five issues worth watching in the coming year and some practical "take aways" for tax executives and practitioners.*

*The list in this report focuses on five selected issues of general interest. It does not discuss other issues—for example, the Marketplace Fairness Act and FIRPTA reform—that may also be on the legislative radar screen.

Issue 1 - Fundamental tax reform

The last major overhaul of the Internal Revenue Code was in 1986. Pressure has been building in recent years to fundamentally reform the tax laws, and a lot of groundwork has been done—as illustrated by the comprehensive tax reform proposal introduced last Congress by the then-chair of the House Ways and Means Committee, Rep. Dave Camp, and the over 300-page report on tax reform prepared by the staff of the now-current chair of the Senate Finance Committee, Senator Orrin Hatch.

Nonetheless, like other major legislative initiatives, tax reform efforts in the previous Congress stalled—in no small part a result of divided government and mid-term election politics.

Optimistic view for tax reform

Could 2015 be the year that tax reform finally moves forward in the legislative process? Advancing such major legislation can be expected to remain an uphill battle. Nonetheless, several recent developments are promising, at least with respect to the prospects of *business* tax reform. These developments can be expected to keep tax reform on the radar screen this year—and, indeed, may make the likelihood of significant business tax reform being enacted greater than at any other time in recent years.

First, as a result of the mid-term elections, Republicans now control both the House and the Senate. Although the goal of reforming the Code has long been supported by many Republicans, Congress still may be wary of voting on a

specific tax reform bill without support from the president, given that such legislation is likely to contain unpopular base-broadening provisions (i.e., revenue raisers) as well as favorable rate reductions and other incentives. Note that, after speaking with the president, Senate Majority Leader Mitch McConnell indicated that tax reform may be one of the areas on which there could be agreement. Working with the Obama Administration on enacting some form of tax reform legislation also could show that a Republican-controlled Congress can get things done—a key goal of congressional Republican leadership.

Second, although President Obama has advocated revenue-neutral *corporate* tax reform as a general matter in the past, his administration has not released a detailed business tax reform proposal—notwithstanding statements by congressional Republicans that such a proposal is a necessary step in the legislative process. This could be about to change.

Treasury's Assistant Secretary for Tax Policy recently indicated that the Treasury Department would release a comprehensive business tax reform proposal if necessary to move the process forward. The president also has reiterated his view that business tax reform could be used to generate revenue for infrastructure. Thus, business tax reform may have become a more serious agenda item for the president—and could help show that he can work with a Republican Congress and, perhaps, further his legacy before the end of his final term.

Third, both incoming chairs of the tax-writing committees are interested in comprehensive tax reform and appear willing to be flexible with respect to the details—key ingredients in the political process of tax reform. For example:

- The new chair of the House Ways and Means Committee, Paul Ryan, has suggested that, while he prefers comprehensive tax reform (business and individual combined), he may be willing to entertain business-only reform that addresses passthrough businesses. Chairman Ryan also indicated that he might be willing to explore a scenario under which revenue from tax reform would be dedicated to infrastructure spending. Thus, while not making any commitments, Chairman Ryan at least has indicated an openness to considering the administration's objectives in pursuing tax reform.
- Further, Senate Finance Committee Chairman Hatch has said that tax reform is his "highest priority," while the lengthy report prepared by his staff reflects an open-minded approach. The report is mostly an even-handed review of a number of complex issues (taxation of multinationals, corporate tax integration, pass-through entity taxation, etc.) and sets forth several broad policy objectives. Chairman Hatch has also indicated that he is

preparing to release additional materials, possibly including specific proposals.

Fourth, the House has recently changed the "scoring rules" for major tax legislation, like tax reform, and it is possible that the Senate may follow suit. As is explained later below, this change requires macroeconomic changes (such as growth in gross national product) to be taken into account in the official estimates of major tax legislation. Changing the scoring conventions could reduce the amount of revenue raisers that are needed to offset the costs of rate cuts—and could make it easier for Congress to move forward tax reform legislation.

Pessimistic view for tax reform

Nonetheless, there are still significant obstacles to tax reform. For example, unlike their predecessors, neither Chairman Ryan nor Chairman Hatch has his own tax reform bill—and drafting a comprehensive proposal takes time and can be expected to involve difficult choices and compromises (even with macroeconomic scoring).

Further, there are a number of events that could derail cooperation between the White House and Congress, including, but by no means limited to, fall-out from the Supreme Court's decision on health care subsidies later this year, immigration issues, the Keystone pipeline, and increasing the debt ceiling.

As a final example, and perhaps most importantly, the 2016 presidential race will begin in earnest in the second half of 2015, and election politics could make compromise on major legislation extremely difficult. Thus, enacting tax reform before the election likely would require a fast and furious effort in the first half of 2015, with cooperation between the White House and the Congress that has not been seen in recent years—hurdles that could be too high to overcome.

Practical "take away"

Although significant obstacles to tax reform remain, and enactment before the next presidential election is still a long-shot, don't dismiss the possibility of fundamental reform being enacted off-hand, at least with respect to business tax reform. Note that Chairman Ryan has indicated that business reform should address passthrough entities, while Chairman Hatch historically has been a supporter of passthrough businesses. Watch to see if the administration releases a serious and detailed business tax reform proposal early in the year—this could be a critical signal that the White House and Congress may move from talking about tax reform to acting on it. Keep in mind that, although there are a lot of reasons tax reform might remain stalled, some of the politics necessary for tax

reform are better than in the past—and both the administration and key Republicans may have reasons to work together to get reform legislation enacted. And, if you are concerned about "base broadeners" and other revenue raisers that have been floated in the past (such as those that were included in Chairman Camp's reform proposal), stay vigilant. These could pop up again in reform proposals that emerge this year.

Issue 2 - Macroeconomic revenue scoring

Although the topic of revenue scoring may seem esoteric to many, Washington insiders know that how a tax bill is scored can affect its contents and ultimate fate—that is, the "money" can drive the policy and the politics. As mentioned above, the House recently changed its rules to require revenue estimates of "major" tax legislation to include macroeconomic effects on the economy. It is possible that this change could have an impact on the shape and substance of fundamental tax reform.

New rule

More specifically, the new House rules direct the Congressional Budget Office (CBO) and the Joint Committee on Taxation (JCT) to incorporate macroeconomic effects (e.g., changes in gross national product, employment, and capital stock) into revenue estimates of major tax legislation provided under the Congressional Budget Act of 1974.

Very generally, tax legislation is considered "major" if it would cause a gross budgetary effect (before considering macroeconomic effects) of at least 0.25% of the current projected U.S. gross domestic product (GDP) for the year, or if it is designated as major by certain key players in the House.

Possible impact on tax reform

In the past, JCT official estimates took into account behavioral changes associated with tax legislation, but held GNP fixed. A House rule adopted in 2003 directed JCT to prepare an analysis of the macroeconomic effects of tax legislation reported by the Ways and Means Committee, but that analysis was not part of the official revenue estimate.

When then-chair of the House Ways and Means Committee, Rep. Dave Camp, released his tax reform proposal last year, he requested an alternate, non-official estimate that considered the proposal's macroeconomic effects on revenues. The JCT analyzed the proposal using different models that employed different assumptions about the deficit, monetary and fiscal policies, sensitivities of

individual labor and savings choices and business decisions to changes in tax law, and other matters. Depending on the model and assumptions used, the JCT projected that the reform proposal would increase revenues relative to the conventional revenue estimate by as little as $50 billion to as much as $700 billion, over the 10-year budget period.

The new House rule goes one step further and requires the JCT to produce a "point" estimate of the revenue effect of major tax legislation that takes into account macroeconomic changes (as opposed to a range of possible results), and that estimate would be the official estimate of revenue. It is thought that, to the extent the macroeconomic model employed by JCT shows increased growth and, consequently, more revenue raised than under conventional scoring rules, the use of such an estimate could change the dynamic and substance of tax reform by permitting greater revenue-neutral reductions in tax rates or allowing preservation of tax preferences.

The Senate has not yet considered a complementary rule.

Practical "take away"

Watch to see how the Senate responds to the change in House rules. And then watch to see how JCT and the CBO interpret and apply the new rule. Be aware that the use of macroeconomic scoring perhaps could allow a tax reform bill to provide more rate reductions or to include fewer revenue offsets – but the size of the macroeconomic effect may vary depending on the details of the bill, as well as the assumptions, computations, and models used. And, keep in mind that the change in scoring rules only applies to "major" tax legislation. Thus, macroeconomic scoring would not necessarily apply to every tax bill the House considers.

Issue 3 - Expiring provisions

With the ringing in of the new year, over 50 tax incentive provisions expired for many taxpayers—including the research and experimentation (R&E) tax credit, the shortened recognition period for the section 1374 built-in gains tax, increased expensing under section 179, the exception under subpart F for active financing income, and look-through treatment of payments between related controlled foreign corporations under foreign personal holding company rules.

The demise of the extenders was particularly untimely. Only about two weeks earlier, the president had signed into law legislation that retroactively extended most (but not all) of the provisions that had expired at the end of 2013 (and some that had expired during 2014). However, most of the extensions applied only for

2014, making any celebration of their revival short lived.

As a result, taxpayers once again are left to deal with the uncertainties associated with the expiring provisions. For example, are any of the provisions completely and truly dead, as in forever dead, or will all be extended retroactively on a temporary basis yet again at some time in the future? What will happen with the production tax credit (which has been the subject of debate)? Will any provisions be restored to life on a permanent basis?

Interaction with tax reform considerations

It is likely that tax reform considerations will affect extenders legislation in at least a couple of ways. First, there may be a push (as there was last year) by some members of Congress to make some of the big ticket expiring provisions permanent before passing tax reform legislation. This could make the budgetary math of revenue-neutral tax reform easier to accomplish because these items then could be treated as present law when tax reform is done—thus, an incentive could be retained (permanently) in tax reform without losing revenue or could be repealed in tax reform to raise revenue.

As a result, both the House and Senate might try to pass legislation making some extenders permanent in the first part of the year, before they have tax reform proposals "scored." Looking to last year as a model, possible candidates for permanence include the R&E tax credit, bonus depreciation, section 179 expensing levels, certain charitable contribution provisions, and certain S corporation provisions.

It is important to note, however, that the president threatened to veto permanent extensions of some of the expiring provisions last year (both in the context of House-passed legislation and in the end-of-year negotiations between the House and the Senate on an extenders package), in part because the revenue costs of permanent extensions were not offset. Thus, even if the Republican-controlled House and Senate pass permanent extensions of some provisions, it is possible that the president might veto the legislation containing them (depending upon what other items they are packaged with). Although the Republicans control the Senate, they would need some Democratic votes to override a veto—possibly difficult votes to get.

Thus, it is not clear whether efforts to permanently extend some items before tax reform would succeed. If not, unless tax reform that addresses extenders moves forward on a super-fast track, all the expiring provisions might end up being addressed late in the year—consistent with Congress's typical practice of waiting until the last minute to address extenders.

Impact of permanence on the extenders "train"

What happens if some provisions do end up being extended permanently? This may be good news for those who benefit from those provisions, but not so good news for those who are more interested in other expired provisions.

Think of the extenders as a train (a common analogy). Some of the most popular items—like the R&E credit—are the engines for the train. They have broad support within Congress, and they are the provisions that drive forward extenders legislation.

By contrast, other provisions are more like cars on the train. They have constituencies that fight for them, but their support may not be as broad or deep. Thus, they benefit from being attached to legislation that includes the engines—in other words, the engines pull the other cars forward.

If the engines are removed from the extenders train (by being extended permanently), the other cars on the train may need to find new engines that are strong enough to pull the cars through the legislative process. For those interested in "non-engine" extenders, making the "engines" permanent may change the political dynamic and may introduce even more uncertainty as to whether expired provisions will be extended again.

Practical " take away"

Watch the House and the Senate for legislation to make some expiring provisions permanent and watch for the administration's response. If such legislation is not enacted (and if extenders are not otherwise addressed through tax reform legislation), watch for action on extenders late in the year. Be aware that, like last year, Congress may attempt to evaluate the merits of individual extenders (some of which, like the production tax credit, have been the subject of some debate). Keep in mind that some extenders may be in a weaker position if the most popular provisions are made permanent.

Issue 4 - Medical device excise tax

Repeal of the medical device excise tax is expected to be a Republican priority in the coming year—plus, it has the added benefit of enjoying some Democratic support. In the past Congress, the House voted to repeal the tax multiple times, but the Senate did not bring repeal legislation to an official vote.

This year, both chambers are expected to vote on repeal. Further, the president

has left open the possibility that he might be willing to sign stand-along medical device tax repeal legislation. And, even if the President were to exercise his veto authority, this is an issue that might garner enough Democratic support for a veto override.

Thus, repealing the medical device excise tax could happen in 2015. And, it's looking possible that the costs of repeal might not be offset. Recent repeal bills do not include revenue offsets and some key members of Congress, like Finance Committee Chairman Hatch, have suggested a preference for that approach.

Practical "take away"

Odds of the medical device excise tax being repealed are greater than they've been at any time since the tax was implemented. Watch to see whether repeal is paid for—although it appears that there could be a decent chance the cost of repeal would not be offset. And watch to see what the effective date is—could it be possible that refund opportunities may be available?

Issue 5 - Gas tax increase

The last time the federal gas tax was increased was over two decades ago—in 1993. With the highway trust fund chronically underfunded and gas prices dropping, some Republicans and Democrats have been hinting at the possibility of increasing the federal gas tax. Although it is not clear whether a gas tax increase could make it through both chambers of Congress and secure the president's signature, the fact that there is serious talk about increasing the tax could mean that an increase is on the horizon.

Practical "take away"

Money for highway projects may start to dry up by late spring, so look for the issue to come to a head by April. If Congress does move to increase the tax, prepare to count the pennies. It's not clear how large an increase would be; however, by way of illustration, one proposal from the last Congress called for a 12-cents per-gallon increase to the existing 18.4-cents per-gallon federal gas tax. (Different rates apply to diesel.)

should be determined through consultation with your tax adviser.

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