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The Council of Insurance Agents and Brokers (CIAB)—Tax Reform Issues Update

President Trump and congressional Republicans are striving to make significant process on tax reform legislation in the next few weeks and months. The House Ways & Means Committee is aiming to release draft legislative language the week of October 30, followed by a mark-up the week of November 6, and floor consideration the week of November 13. It is expected that the draft legislative language will be generally consistent with the "Unified Framework for Fixing Our Broken Tax Code" (the "Framework") released on September 27, 2017, by the "Big Six" administration and congressional leaders—Treasury Secretary Steven Mnuchin, National Economic Council Director Gary Cohn, House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), House Ways and Means Chair Kevin Brady (R-TX), and Senate Finance Committee Chair Orrin Hatch (R-UT). The Framework described, at a high level, the tax reform plan that the Big Six have been developing over the past several months.

An overview of the Framework proposals is attached in an appendix. This memo focuses on two issues of potential interest to CIAB—(1) the proposal to reduce the tax rate on passthrough income to a top rate of 25% and (2) the proposal to provide immediate expensing for "new investment" (other than structures).

Passthrough Tax Rate

The Framework proposes to reduce the tax rate on income earned through passthrough entities. Specifically, the Framework states:

> The framework limits the maximum tax rate applied to the business income of small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations to 25%. The framework contemplates that the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate.

The Framework also proposes to reduce the corporate tax rate to 20%.

The basic concept of the proposal is that income earned through partnerships, S corporations,[1] and sole proprietorships will be subject to a lower rate of tax than income earned

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[1] An S corporation is a corporation meeting certain requirements that elects to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. To qualify for S corporation status, a corporation must meet various requirements, including being a U.S. corporation, have only certain types of shareholders, have no more than 100 shareholders, have only one class of stock, and not be a certain type of ineligible corporation.

directly by an individual or income earned by a corporation. Partnerships, S corporations, and sale proprietorships are often referred to as "passthrough" or "flowthrough" entities because they do not themselves paid tax—rather, their income, losses, deductions, and credits "pass through" to their owners, who then report their share of the entity's income, losses, deductions, and credits on their personal tax returns. An owner's share of passthrough income is taxed at the owners' individual tax rates. The highest individual tax rate is currently 39.6% (and proposed to be reduced to 35% under the Framework). The highest corporate tax rate is currently 35% (and proposed to be reduced to 20% under the Framework). Thus, under current law, income earned through a pass-through entity can be subject to a higher rate of tax earned by a corporation. This differential is often cited as a justification for reducing the tax rate on pass-through income. However, while pass-through income is taxed only at the individual level, corporate profits are generally subject to two layers of tax—first at the corporate level and again in the hands of shareholders when distributed as a dividend. (The Framework states that the committees "may consider" methods to address the double taxation of corporate earnings, but the double tax on corporate earnings is not listed as a separate priority.)

The technical implementation of the proposed treatment of passthrough income is still under consideration by lawmakers and committee staff. White House economic advisors Gary Cohn has stated that the proposal raises the "toughest issues" being dealt with by Congress.[2] There are several design challenges. The Framework refers to reducing the tax rate on passthrough income that represents "business income of small and family-owned businesses" and contemplates some anti-abuse mechanisms to prevent individuals from converting personal income (such as wages or investment income) into passthrough business income to take advantage of the lower tax rate. Thus, it appears that some limitations on the types of income and/or types of entities eligible for the preferential treatment are contemplated, but none have been specifically identified. Potential limitations might include, for example, a limitation on the number of owners in an entity eligible for preferential passthough treatment or a mechanism for differentiating between salary-type income and business income.

Expensing of Intangibles

With respect to expensing, the Framework states:

> The framework allows businesses to immediately write off (or "expense") the cost of new investments in depreciable assets other than structures made after September 27, 2017, for at least five years. This policy represents an unprecedented level of expensing with respect to the duration and scope of eligible assets. The committees may continue to work to enhance unprecedented expensing for business investments, especially to provide relief for small businesses.

The Framework does not specifically address the types of assets that would be eligible for the immediate expensing.

[2] Naomi Jagoda, Trump economic adviser: 'pass-through' businesses one of the 'toughest issues' in tax reform,' The Hill (June 28, 2017).

Insurance brokers may have a particular interest in whether intangibles may be expensed, given that the primary value of agency businesses is intangibles (such as policy expiration date lists and agency goodwill). The Framework does not specifically address intangibles in the context of expensing. The reference to only "depreciable" assets might indicate that intangibles (which are typically said to be "amortized" for tax purposes, though the basic concepts are similar in that they refer to expensing over time) are not included. On the other hand, the reference to an "unprecedented level of expensing with respect to the duration *and scope of eligible assets*" may indicate that the Framework could go beyond traditional tangible depreciable assets.

Under current law, Internal Revenue Code section 197, which was enacted in 1993, generally requires the amortization of acquired intangibles over a 15-year period. Section 197 intangibles generally include goodwill, going concern value, workforce in place, information base such as business books and records, patents, copyrights, know-how, customer-based intangibles, supplier-based intangibles, licenses and permits, certain covenants not to compete, franchises, trademarks, tradenames, and contracts for the use of other section 197 intangibles. To be amortizable, the intangible must be held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. Section 197 generally only applies to direct acquisitions of section 197 intangibles, i.e., asset acquisitions, and not to the indirect acquisition of the intangibles through a stock acquisition. In general, section 197 does not apply to intangibles that are created (rather than acquired) by the taxpayer, unless they are created in connection with the acquisition of a trade or business.

One could make the case that expensing of intangibles should be re-examined in connection with tax reform. In an August 21, 2017, article published in the Bloomberg BNA Tax Management Memorandum, Professor Annette Nellen argued that:

> Proposals of recent years have included both lengthening and shortening the lives of acquired intangible assets. For economic growth and international competitiveness reasons, reducing the life of acquired intangibles makes more sense. Simplification is another commonly cited reason for tax reform. While some proposals would allow for expensing of most business assets including acquired intangibles, others have focused on increasing the §179 expensing limit for tangible assets. For simplification and economic growth reasons, why isn't the expensing rule of §179 [which allows a business to deduct the full purchase price of certain financed or leased equipment and off-the-shelf software, up to $500,000] expanded to include acquired intangibles? Today, businesses of all sizes acquire intangibles for operations including patents, customer lists, domain names, and social media assets.

Professor Nellen also recommended that: "If 100% expensing of tangible assets is part of tax reform, it should also extend to acquired intangible assets because both categories of assets are important to business growth."

There have been some recent proposals to permit immediate expensing for intangibles, but these proposals have generally been in the context of more a fundamental shift in our tax system, specifically a shift from an income tax to a consumption tax. In order to measure income over time, our current tax system contains rules that require certain business investments to be deducted over time rather than in the year they are acquired. In contrast, a consumption tax aims to tax consumption, not income, and generally exempts from tax savings associated with business investments. To exempt savings, assets are expensed upon acquisition. One example of a recent consumption tax-like proposal is the June 2016 House Republican Tax Reform Blueprint, which would have permitted immediate expensing of intangibles.

There has been at least one recent proposal to shorten the amortization period for businesses that acquire intangible property. Such a change would not be as favorable as immediate expensing but could provide an additional tax benefit for businesses that acquire intangibles. In May 2017, Senator Thune introduced the Investment in New Ventures and Economic Success Today (INVEST) Act of 2017 (S. 1144), which would allow businesses that acquire intangible property to recover that investment over 10 years, rather than the 15-year period under current law.

Appendix

Summary of "Unified Framework for Fixing Our Broken Tax Code"

Business Tax Provisions:

- Corporate rate: 20% (reduced from current 35%)
- Passthrough rate: business income limited to top rate of 25% (with measures to prevent wealthy individuals from converting personal income into business income)
- New investment (other than structures) after September 27, 2017 eligible for immediate expensing for at least five years
- R&D credit and low income housing tax credit (LIHTC) preserved
- Corporate AMT repealed
- International:
  - Move to territorial system with 100% exemption for dividends from foreign subsidiaries
  - Mandatory tax on previously untaxed foreign earnings at unspecified bifurcated rate; paid over several years
- Pay-fors:
  - Partial limitation on net interest expense for C corporations (tax writing committees to consider treatment for non-corporate taxpayers)
  - Section 199 domestic production deduction repealed
  - "Numerous other special exclusions and deductions" repealed or limited
  - Unspecified global minimum tax
  - Other base erosion measures and "rules to level the playing field between US-headquartered parent companies and foreign-headquartered parent companies"

Individual Tax Provisions:

- Reduces the current number of tax brackets from seven to three (12%, 25%, and 35%)
  - Top rate reduced to 35% (from current 39.6%); additional top rate possible
  - Lowest rate raised to 12% (from current 10%)
- Standard deduction doubled
- Enhanced child tax credit
- AMT, estate, and generation-skipping transfer taxes repealed
- Pay-fors
  - Most itemized deductions repealed but deductions for home mortgage interest and charitable contributions retained; other tax benefits that "encourage work, higher education and retirement security" also retained