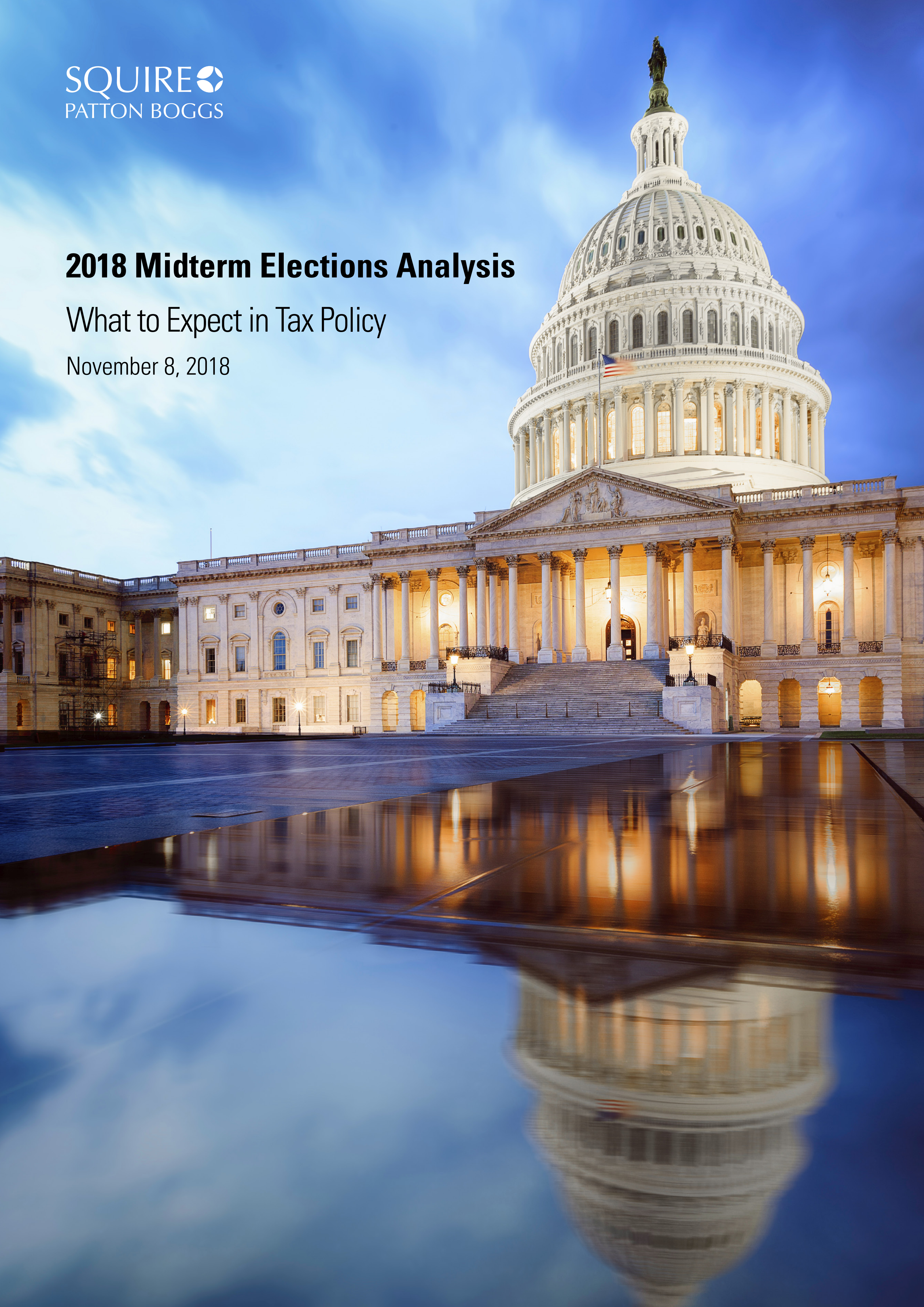
SQUIRE PATTON BOGGS

2018 Midterm Elections Analysis

What to Expect in Tax Policy

November 8, 2018



Introduction

On November 6, voters cast ballots in the most expensive midterm elections ever, with far-reaching consequences on every front of the policy landscape – especially tax policy.

In 2017, President Trump and congressional Republicans enacted the most comprehensive tax reform in over three decades. While lawmakers passed the Tax Cuts and Jobs Act (TCJA) on a partisan basis without any Democratic support, House Democrats will now have some opportunities to alter the tax policy environment and bring a greater focus on how the Trump Administration continues to implement the new law through regulations. The Democrats' opposition to several elements of the tax reform law will likely be priority areas for legislative action in the House, but – given the divided Congress – they are unlikely to succeed in undoing central elements of President Trump's main legislative achievement to date.

Looking ahead, we expect that three overarching factors will drive the tax policy agenda in the 116th Congress: (1) what happens in the lame-duck session, (2) changes in the composition of congressional leadership and tax-writing committees resulting from the election, and (3) whether President Trump and congressional Democrats are able to find ways to work together on legislative priorities. Below, we discuss those factors along with our expectations for relevant agencies and likely major tax policy developments.

Lame-Duck Session: Tax Extenders and Other Unfinished Tax Business

In the lame duck, Democrats likely will not relent in their opposition to funding President Trump's proposed border wall. A border wall funding fight could lead to at least a partial government shutdown during the lame-duck session, adding to the uncertainty of what will happen in the next two months. Below we outline our expectations for tax policy in the lame-duck session – though it is important to note that the struggle over funding the government will alter the substance and timing of each item.

Tax Extenders

While the elections are now over, the 115th Congress still has a number of tax issues that remain a priority to finish this year. The TCJA dealt with tax "extenders" (i.e., tax provisions that are regularly set to expire but lawmakers have extended on multiple occasions) retroactively for 2017, but these provisions have expired for 2018.

In particular, the Republican-controlled House has lamented the tax extenders process for some time and is likely to resist a renewal of all of the expired provisions. In March 2018, the Ways and Means Committee held a hearing to examine the role of these tax provisions in a post-tax reform world to demonstrate how tax reform had made many of these extenders duplicative or in some instances, not as generous. For example, of the 33 tax extenders that expired on December 31, 2017, there are seven cost recovery provisions in the tax reform law that provide similar or better treatment.

Lawmakers in both chambers will have to assess how to deal with those provisions and the other 26 tax extenders for 2018 – and possibly additional years. (Currently, neither chamber has a committee marked-up package ready to go.) It is also possible Congress could choose to defer any action on tax extenders to the early part of next year because, in either instance, these provisions would be reinstated retroactively to the start of 2018.

Technical Corrections

Even prior to enactment of tax reform, lawmakers and the Administration had been working on finalizing a set of technical tax corrections. Additional work is necessary to conform those technical corrections to modifications made to the Internal Revenue Code by TCJA. Lawmakers could seek to move these technical corrections on a bipartisan basis in the lame-duck session. What remains less clear is whether congressional Democrats will entertain additional technical corrections necessitated by errors in the tax reform law that Republicans passed without Democratic support. So far, there has not appeared to be many Democrats willing to bail out the Republicans for their "self-inflicted" wounds. If lawmakers choose to pass technical corrections to the TCJA, the most high-profile correction would be to clarify whether qualified improvement property (QIP) is eligible for a 100% bonus depreciation.

Tax Reform 2.0, RESA, and Tax Reform 3.0

In September, the House passed a trio of bills that comprised what outgoing Ways and Means Committee Chairman Kevin Brady (R-TX) called "Tax Reform 2.0." Collectively, these bills: (1) make permanent the tax relief for individuals and pass through entities enacted as part of the tax reform law, (2) promote and expand retirement savings options, including open multiple employer plans (MEPs) and the creation of a new universal savings account, and (3) encourage start-up businesses. Taken together, the Senate has not expressed much interest in taking up the Tax Reform 2.0 package to date, and that is unlikely to change after the elections, with the exception of finding common ground with the House on a retirement savings bill the Senate passed earlier this year.

In fact, the retirement legislation the Senate passed by unanimous consent earlier this year, the Retirement Enhancement and Savings Act (RESA), enjoys broad support. RESA shares many of the policy goals included in the retirement portion of the Tax Reform 2.0 package, including modifications to 401(k) plan safe harbor rules, and amendments to multiple employer plan rules to facilitate employers to join together to offer a shared retirement plan for their employees. The latter proposal on multiple employer plans has also been an area of interest for the Trump Administration. In particular, the Department of Labor issued a proposed rule to achieve a similar result on October 22, 2018. It is possible – despite the Department of Labor's proposed rule – that lawmakers will seek to enact RESA in a lame-duck session and possibly consider a newspaper pension relief bill that the Ways and Means Committee approved in July 2018. This could be one area where both parties would prefer to clear the decks before the 116th Congress begins.

Recently, President Trump surprised even the tax-writing committees in Congress when he announced that there would be an additional round of tax relief before the elections, specifically a resolution to provide a 10% tax cut for the middle class. Although Chairman Brady confirmed days later he was working with the President on the proposal, this potential "Tax Reform 3.0" certainly faces the longest odds of becoming law in the lame-duck session.

Anticipated Congressional Committee Developments

Looking behind the dais, the Senate Finance and House Ways and Means Committees will both have new chairmen next Congress. In the upper chamber, Senate Finance Committee Chairman Orrin Hatch (R-UT) is retiring at the end of 2018. With Republicans maintaining a majority in the Senate, the Finance Committee will have a new Republican at its helm. Senator Chuck Grassley (R-IA) is the next most senior member of the Finance Committee and is the most likely candidate to take the gavel. If Senator Grassley elects to stay Chairman of the Senate Judiciary Committee, Senator Mike Crapo (R-ID) could take the gavel instead. In either scenario, Senator Ron Wyden (D-OR) will most likely remain the ranking member.

At the Ways and Means Committee, a Democrat-controlled House will mean that Ranking Member Richard Neal (D-MA) will likely take the reins as the chairman of the powerful tax-writing committee. Meanwhile, outgoing Chairman Brady will likely become ranking member next year. Of course, the chairs and ranking members are not the only factors to consider. Given the new makeup of both chambers, both Finance and Ways and Means will likely have a new ratio of Republicans and Democrats, in addition to new membership.

Anticipated Agency Developments

TCJA Regulations

While a divided Congress will likely limit legislative action on Capitol Hill, Treasury officials plan to issue proposed regulations on several priority guidance projects by the end of 2018 and into next year, as well as welcome comments from industry and interested parties. Despite the political stalemate expected in the 116th Congress, Treasury and the Internal Revenue Service (IRS) are showing no signs of slowing down on tax reform implementation.

According to a regulatory plan released in October 2018, Treasury has identified 17 regulations implementing the TCJA at the top of its action list for FY 2019. Notably, the list includes high-profile rules on the new 20% deduction for pass-through businesses, interest deductibility, bonus depreciation, foreign tax credits, and the one-time tax on offshore earnings.

Outside of these top priorities, Treasury and the Office of Management and Budget (OMB) have marked 56 regulations as "significant," which increases the chances that a rule will be subject to an additional layer of review by OMB's Office of Information and Regulatory Affairs (OIRA). Looking ahead, while the impact of OIRA's involvement is uncertain for any given rule, it is another voice in the implementation process and is no doubt an area worth monitoring as Treasury and the IRS continue to issue proposed regulations.

International Developments

Many of Treasury's to-be-issued regulations will relate to the new international tax regime. In particular, we expect Treasury and the IRS to address the following issues in the next two months: (1) the foreign tax credit, (2) interest deductibility, (3) the base-erosion and anti-abuse tax (BEAT), (4) hybrid entities and transactions, (5) foreign-derived intangible income (FDII), and (6) distributions or other transactions by a controlled foreign corporation (CFC) involving earnings and profits (E&P) that have been included in the income of a US shareholder (i.e., previously taxed income, or PTI). It is important to emphasize that these proposed regulations will be proposals, meaning companies will have an opportunity to influence them before Treasury and the IRS make them final in 2019.

Looking further into the regulatory pipeline, we expect Treasury and the IRS to send proposed regulations on the foreign tax credit, BEAT, and hybrids to OIRA in the near-term, with the FDII and PTI rules to follow.

In the midst of this regulatory process in the US, many open questions linger abroad as to how other nations will respond to the TCJA's international tax framework. Specifically, it is unclear whether other countries with relatively high corporate tax rates will seek to mirror the TCJA's international provisions, such as FDII, BEAT, and the new minimum tax on global low-taxed intangible income (GILTI). Moreover, other nations may challenge the FDII provisions in particular as a violation of World Trade Organization (WTO) rules that prohibit tax subsidies for exports. As the implementation process marches forward in the US, it will be important to track how other nations respond to the TCJA, which could alter the scope and substance of the new US international tax framework.

Taxation of the Digital Economy

Staying on the international stage, tax authorities around the world – especially in the European Union (EU) – are grappling with novel and important issues about how to tax the digital economy. The tax policy choices that EU officials make will affect where multinational companies pay tax and how much tax they pay. Further, these choices will affect how multinationals interact with their customers, structure their supply chains, organize their businesses, and plan future transactions.

As EU officials consider the path forward, US technology companies, lawmakers, and administration officials alike are expressing concerns about proposed taxes on digital services. In a rare showing of bipartisanship on Capitol Hill, outgoing Senate Finance Committee Chairman Orrin Hatch (R-UT) and Ranking Member Ron Wyden (D-OR) sent a letter in October 2018 urging the European Commission to abandon a proposed tax on revenues stemming from digital commerce, arguing that it would create a significant trade issue between the US and the EU. The Trump Administration has echoed these concerns. Looking ahead, we expect this bipartisan agreement to continue into 2019 as US companies and officials ramp up their efforts to dissuade the European Commission from imposing a digital services tax.

Likely Major Policy Developments

Offensive Measures Against Trump Administration

Undoubtedly, progressive House Democrats will be calling for their newfound majority to conduct zealous oversight of the Trump Administration with investigations into dozens of corners of the Executive Branch. On the tax policy front, Democrats could begin their tenure with an investigation into a frequent topic of debate: President Trump's tax returns. This action could diminish President Trump's desire to work with House Democrats on legislative matters. Balancing these competing interests will be an early test for the typically more pragmatic approach of likely Chairman Neal.

Below, we further explore the policy dynamics of examining President Trump's tax returns and other offensive measures House Democrats may take against the Trump Administration.

Trump's Tax Returns

Assuming Representative Neal takes the gavel at Ways and Means, he will be asked to use his authority under Section 6103 of the Internal Revenue Code to inspect President Trump's tax returns and possibly take action in committee and the House to make some or all of the returns public. While releasing President Trump's tax returns has been an ongoing Democratic demand since before he entered the Oval Office, the issue picked up steam when *The New York Times* published an investigative article in October 2018 alleging President Trump of participation in "dubious tax schemes" decades ago. Although not every Democrat appears sold on publicly releasing Trump's returns, pressure from the party's base may be difficult to resist – and the issue may well draw the most headlines in the first few months of House Democratic control.

Non-profit Donor Disclosure Requirements

In addition to President Trump's tax returns, House Democrats appear poised to take aim at a Treasury policy change to 501(c)(4) donor disclosure requirements. In July 2018, Treasury announced that non-profits that spend money to influence elections – but are not required to disclose donors to the public – no longer need to share their donors' names or addresses in their tax filings. Democrats have warned the new rule would make it easier for foreign actors to funnel money into the US political system, creating another layer of transparency for "dark money" groups to influence US elections. It is uncertain how Democrats will address the rule, but we expect them to consider holding hearings on the issue and using their subpoena power to conduct investigations.

Johnson Amendment

On the legislative front, Democrats may push to protect the Johnson Amendment from Republican attempts to repeal it. The Johnson Amendment is a provision in the tax code that forbids non-profits, such as religious groups, from endorsing or opposing political candidates. President Trump has called for its repeal, though Senate Finance Committee Ranking Member Ron Wyden (D-OR) appears intent to ensure the IRS continues its enforcement of the law.

Stock Buyback Oversight

Democrats also might call attention to how the Securities and Exchange Commission (SEC) conducts oversight of stock buybacks. Democrats have frequently criticized stock buybacks since the TCJA became law, arguing that increased buybacks merely benefit large publicly traded companies. Further, Democrats have contended that corporate insiders may be exploiting buybacks to sell shares received as executive pay at inflated prices. Now in control of the House, Democrats may shine the spotlight on SEC rules that provide safe harbor protection from securities laws when repurchasing shares.

Deficit Result of the TCJA

In addition to stock buybacks, Democrats have criticized the TCJA for adding to the federal deficit. In fact, Treasury reported in October 2018 that the federal budget deficit increased by 17%, or US$113 billion, from FY 2017 to FY 2018. House Democrats will likely use their new position in power to highlight the increased deficit stemming from the TCJA.

Proactive Messaging Efforts

While House Democrats will likely spend much of their time holding hearings and conducting oversight of the Trump Administration, any legislative efforts to change tax policy will likely end up as messaging exercises that stand little chance of becoming law in a divided Congress. Specifically, and early on in the 116th Congress, Ways and Means will likely conduct a series of hearings, focusing on the efficacy of the newly constructed tax code and especially on middle class tax cuts. Below, we discuss other specific topics that will likely be the focus of the committee.

Reversing Elements of the TCJA

Although any legislation would likely die in the Senate, House Democrats may work to reverse key elements of the TCJA, such as (1) reinstating the top income tax rate of 39.6%, (2) increasing the corporate tax rate, and (3) restoring the estate tax exemption at US$11 million for couples. Democrats could then work to use that revenue to help pay for an infrastructure package or other priorities – though chances of such a proposal becoming law would almost certainly fizzle in the Republican-majority Senate.

Carried Interest

In addition to reversing elements of the TCJA, Democrats may also work to highlight the inequity they see in the so-called carried interest loophole, which stayed intact (although a three-year holding period was added) after tax reform and allows some investment managers to pay a lower tax rate than most individuals. Democrats have long criticized the preferential tax treatment as a "giveaway" to the wealthy, and could focus their attention on addressing carried interest through legislation.

BEAT/GILTI Rates

As previously discussed, the TCJA included a substantial overhaul of the international tax system, with provisions including a tax on global intangible low-taxed income (GILTI) and the base erosion and anti-abuse tax (BEAT). Some corporations have been critical of the new tax provisions, arguing that they may have unintended consequences that negatively affect US-based multinational companies. While Treasury and the IRS might solve some of the issues through regulatory interpretation, other issues may require new legislation. In so doing, Democrats could try to increase the tax rates included in the GILTI and BEAT provisions, to raise revenue for other legislative initiatives such as infrastructure.

SALT Reversal

Representatives from high-tax states may be especially motivated to undo the TCJA's State and Local Tax (SALT) deduction cap. The tax reform law capped the amount of state and local taxes an individual can write off at US$10,000. The SALT cap hit residents of high-tax states like New York, New Jersey, and California (all Democrat-leaning states) particularly hard, though undoing the limit may end up disproportionately benefit high-income earners.

Acts of Governing/Legislating Efforts

Although a divided Congress will likely bring a screeching halt to major legislating efforts, there are some areas where we expect at least a meaningful chance of bipartisan agreement. We discuss a few possible legislative efforts that could take shape over the course of 2019 below.

Tax Extenders

As part of the budget deal in February 2018, lawmakers agreed to renew about 30 tax preferences (commonly referred to as "extenders") that expired at the end of 2016, allowing taxpayers to claim them on the 2017 returns. The extenders include a wide variety of tax preferences relating to (among other things) renewable energy, motorsports, and racehorses. Generally, the Senate has expressed support for the extenders while House Republicans have vowed to do away with them. Given the bipartisan agreement on extenders in the 2018 budget deal, these tax preferences could find new life again next Congress, if not dealt with in the lame-duck session.

Infrastructure Package/Gas Tax Increase

While the Transportation and Infrastructure section of this analysis covers the dynamics of a possible infrastructure package more fully, tax policy could certainly intersect with a potential infrastructure spending deal. Although the federal tax on gas has remained unchanged for over two decades, House Democrats could try to increase the gas tax as a way to fund a major infrastructure deal and might find a willing partner in President Trump if it would mean enactment of one of his highest domestic priorities.

Middle Class Tax Package

Given President Trump's outspoken support of middle class tax cuts, House Democrats might be able to find some bipartisan agreement on this issue. One option would be to follow the lead of potential 2020 presidential candidate Senator Kamala Harris (D-CA), who recently proposed a new refundable tax credit for families making under US$100,000. Under her proposal, eligible families could receive up to US$6,000 from the tax credit, which would phase out as income increases. That said, House Democrats could certainly develop their own plan, and may find some willing participants across the aisle.

Tax Provisions in a Budget Deal

Another area of possible legislating that could affect tax policy is the budget deal in the new Congress. While the Bipartisan Budget Act of 2018 raised the statutory caps on discretionary spending by a total of US$296 billion, both sides of the aisle could use budget negotiations to strike deals on tax issues.

Debt Limit

Similarly, the debt limit may prove to be fertile ground for reaching a compromise. Since the 2018 budget deal suspended the debt limit through March 1, 2019, the 116th Congress will face a challenging test in its first year. Absent further congressional action when the suspension expires, Treasury will once again find itself up against the debt limit and implementing so-called "extraordinary measures" that prevent default for a limited time. Negotiations on the debt ceiling could include areas for agreement on certain tax policy issues.

Recession Stimulus

Though predicting the economic cycle always presents a difficult challenge, a downturn in the economy may lead to the development of a stimulus package. While it is too early to tell what such a package could look like, this is another area where legislating would have consequences for the tax policy community.

Other Expirations/Cliffs

In addition to tax extenders, several other provisions need a congressional stamp of approval to keep going. For example, the New Markets Tax Credit (NMTC), a federal tax credit that aims to help stimulate economic growth in distressed communities, will expire at the end of 2019, if Congress fails to act. Other provisions expiring at the end of 2019 without congressional renewal include: (1) the Work Opportunity Tax Credit (WOTC), (2) the final possible date to begin construction on wind renewable power facilities eligible for the electricity production or investment credits, (3) the look-through tax treatment of payments between related controlled foreign corporations (CFCs), (4) employer credit for paid family and medical leave, and (5) several provisions that lower alcohol tax rates. With certain members seeking to protect constituent interests, these expiring provisions could align lawmakers more by geography than party, creating an opportunity for bipartisan legislating.

Retirement Package

Expected Ways and Means Chairman Neal (D-MA) has been a longtime proponent (and sponsor) of measures to help Americans save more for retirement. In particular, he has previously introduced legislation to require employers that do not currently sponsor a retirement plan to offer their employees an opportunity to save for retirement. He has also offered proposals to provide troubled multiemployer pension plans with low interest rate loans to pay retirees' pensions. We expect Representative Neal to continue his work on retirement and savings proposals as chairman.

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