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The Tax Reform Back Story

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The ink is barely dry on **Tax Cuts and Jobs Act of 2017,** and it is likely to be months before we fully understand all of its provisions. The IRS has a huge challenge in trying to write the regulations and rules necessary to enforce the new law, and Congress will have to consider at least one "technical corrections" bill to fix the problems with the legislation that are certain to be discovered as it is implemented.

Numerous summaries of the bill's provisions have been written since its enactment, and we are not attempting to duplicate those efforts, although we provide a summary of some of the key business provisions at the end of this memo. Instead, we thought we would share with you some of the back story that was unreported as the bill moved through the legislative process.

NAW has been involved in the fight for tax reform for many years, and as reform finally became a real possibility, we had clear priorities critical to the distribution industry: leveling the uneven playing field in terms of *effective* tax rates for both corporations and pass-through companies and the preservation of Last-In, First-Out (LIFO) inventory accounting, which is widely used in our industry.

In the decades since the last major tax reform, the tax code had become filled with preferences that resulted in some industries, like wholesale distribution, paying effective tax rates at or close to the statutory 35 percent rate, while other industries paid rates in single digits – some even routinely enjoying negative tax rates. Several years ago NAW helped organize the Coalition for Fair Effective Tax Rates (http://faireffectivetaxrates.com/who-we-are/) to fight for reform that would level that playing field so that high-rate industries like wholesale distribution no longer paid a disproportionate share of the business tax burden. As NAW President Dirk Van Dongen told President Trump at an October White House meeting, "I represent an industry with very high effective tax rates; frankly, they're tired of paying the other guys' taxes." To see a video of the White House meeting, go to: https://www.youtube.com/watch?v=Dxv123ZOQtA&feature=youtu.be&t=7m1s

LIFO:

NAW has managed the LIFO Coalition (http://savelifo.org/about-lifo-coalition/) since repeal was first proposed in 2006 by a Republican senator and repeatedly sought by the Obama Administration and Republican tax writers since. We long believed that the threat of repeal was far greater in the context of comprehensive tax reform than it had ever been.

Our battle to preserve the use of LIFO was rewarded when neither the House nor the Senate included repeal in their tax reform legislation, even though we had been clearly told by Senate Finance Committee staff that repeal was likely to be included in their reform bill. As we have done multiple times over the last decade, NAW and our colleagues in the LIFO Coalition asked our member companies to contact the Senate Finance Committee members to urge them not to include repeal in their bill. NAW member companies rose to this challenge, and to good effect. The Finance Committee opted to leave LIFO alone, a clear and notable win for wholesale distribution and a case study in how businesses can impact public policy by actively engaging.

NAW will continue to manage the LIFO Coalition since repeal could come up again, but keeping LIFO out of the this tax reform bill was a huge success – thanks to each of you who helped us preserve LIFO.

Business Provisions in the Tax Reform Bills:

While Republican tax writers made significant changes to the individual tax code, and argued that their bill was a middle class tax reform initiative, the fundamental goal of both the House and Senate tax reform bills was significant reform of the corporate tax code. Both the original House and Senate bills provided for a corporate tax rate of 20 percent, reduced from 35 percent, along with significant "base broadening" provisions. The corporate tax reform proposals also included significant changes to international tax law, including moving to a territorial system and imposing a "deemed repatriation" tax on foreign-held assets.

With the House, Senate and White House fully and firmly committed to corporate reform that both dramatically reduced the corporate income tax rate and eliminated many of the preferences that had created inequities in effective rates, our mission to achieve a level playing field in corporate effective tax rates was close to becoming a reality from the outset of the debate. However, parity in effective rates for the pass-through industry was more elusive.

While reduction in the corporate tax rate was their priority, the "Blueprint" for tax reform released earlier in the year by the "Big Six" Republican tax leaders from the House, Senate and White House had also called for a maximum tax rate of 25 percent on pass-through businesses. However, it quickly became apparent that pass-through businesses wouldn't see anything close to the promised 25 percent top rate. There are about 30 million pass-through businesses, about 4.5 million of them S corps, and only 1.6 million C corps, so the disparate treatment of pass-throughs was very surprising. NAW members are approximately 65 percent pass-throughs, making this a major issue for us.

The House proposal: The House bill technically provided a 25 percent top pass-through rate, but in their effort to provide "guard rails" to ensure that the low rate didn't encourage tax avoidance, they effectively made the 25 percent meaningless. They provided for the reduced rate only on "qualified business income" to ensure that salaries and wages continued to be taxed at the individual tax rate. And they arbitrarily assigned a fixed ratio of 70/30 to a pass-through's income – 70 percent to be considered wages and only 30 percent eligible for the 25 percent tax rate.

The bill also provided a "prove-out" option for companies to prove that more than 30 percent of their income should qualify for the 25 percent rate. This alternative would "measure the capital percentage based on a rate of return (the Federal short-term rate plus 7 percent) multiplied by the capital investments of the business." Capital investments were narrowly defined as "depreciable assets."

The Senate proposal: Under the Senate bill, pass-through businesses would not be separately taxed as businesses but would continue to be taxed on the individual side of the code, with a new top tax rate of 38.5 percent. To compensate for the wide gap between their proposed 20 percent corporate rate and the 38.5 percent individual rate, they provided a broad 17.4 percent pass-through deduction from qualified business income, not to exceed 50 percent of the company's W-2 wages.

The Sausage-making: The treatment of pass-through entities in both reform proposals was widely rejected by the pass-through community because both proposals left pass-through businesses with effective tax rates well above 30 percent – significantly higher than the tax reform "blueprint" promise of 25 percent – and with a wider gap between C corps and pass-throughs than under current law.

NAW and our allies in the pass-through community lobbied for changes in the House formula, arguing both that the 70/30 ratio did not reflect the circumstances of most businesses, and that the "prove-out" formula was inadequate. We argued that capital investments in wholesale distribution are significantly higher in inventory and accounts receivable than in depreciable assets.

Disappointingly, the House tax writers acknowledged that our argument had merit, but admitted that their goal was to help capital intensive industries – specifically manufacturing – and that the revenue loss from including inventory as a capital investment was too high for them to consider.

Our bargaining position was stronger in the Senate – with only 52 GOP Senators and 50 needed for passage, every Senator had the opportunity to influence the legislation. We found allies in our battle for better treatment of pass-throughs in GOP Senators Ron Johnson (WI) and Steve Daines (MT), both of whom told the Senate Leadership that improvements in the pass-through provisions were necessary to ensure their votes for the bill.

Intense back-and-forth among the senators and determined lobbying followed. At one point an increase in the pass-through deduction to 20 percent from 17.4 percent was offered, but with a top marginal rate of 38.5 percent, that still left pass-throughs with an effective rate above 30 percent, a full ten points above the C corporation rate even before adding the 3.8 percent Net Investment Income Tax imposed in the individual tax code. We were told any additional increase in the deduction would "cost too much" in lost revenue.

There were numerous other disparities between the treatment of C corporations and pass-throughs in the Senate bill, among them: state and local income taxes remained deductible to C corporations but not to pass-throughs, and the C corporation rate cut was permanent while changes to the tax code related to pass-throughs were temporary and would expire in 2025.

While all of these issues were being debated, another critical problem in the Senate bill was brought to our attention: trust income would not be eligible for the deduction. While there are many different types of pass-through trusts, the language of the legislation did not make any distinctions but simply excluded trust income. A quick survey of some NAW S corp members made it clear that this was a huge problem – in some companies, all of the S corp income is trust income.

Given the gravity of the trust issue, the pass-through community began an intense lobbying effort to fix the problem. Again, we found allies in the Senate; in this case Senator Jim Inhofe (R-OK) took up the trust income cause joining forces with Senators Johnson and Daines.

After frantic days and nights of coordinated effort, Senate tax writers and Senators Johnson, Daines and Inhofe reached a compromise: Additional revenue would be made available to improve the pass-through proposals by increasing the tax rate on the "deemed repatriation" that multinational firms would pay; the pass-through deduction would be set at 20 percent and the top individual tax rate set at 37 percent rather than 38.5 percent thus reducing the effective pass-through rate to under 30 percent, and trust income would not be excluded. Additionally, rules for conversion to C corp statues by S corps were somewhat liberalized.

Next Steps:

Corporate effective tax rates: The final tax bill does address the inequities in effective tax rates that have disadvantaged our industry – a reduction to a 21 percent corporate income tax rate will clearly be hugely significant for industries like wholesale distribution which have for years paid a disproportionate share of the corporate income tax burden. Those industries which have benefitted from low or negative income tax rates will now more appropriately share the corporate tax burden, and the reduced corporate income tax rate and improved international provisions should help generate the economic growth and job creation that the tax writers argue they will.

The pass through battle continues: The final bill is a long way from the promise of effective rate parity for pass-through businesses, but it is also very much improved over the initial woefully inadequate proposals in both the original House and Senate bills. And the pass-through community is committed to continuing to fight for more equal treatment and to oppose the sun-setting of tax provisions in 2025.

(continued)

KEY BUSINESS PROVISIONS

- C corporation income tax rate reduced from 35 percent to 21 percent. Corporate AMT repealed. Both changes permanent.
- Pass through businesses provided a 20 percent deduction from business income, not to exceed 50 percent of W-2 wages, and pay 37 percent on the balance for a blended business rate of 29.6 percent, down from 39.6 percent. Provisions expire at the end of 2025.
- LIFO preserved.
- Bonus depreciation increased to 100 percent for 5 years, reduced by 20 percent per year thereafter; expiring at the end of 2027.
- Liberalized small business expensing.
- Death tax exclusion doubled to $22.4 million per couple, $11.23 million per individual. Stepped up basis retained. Provisions expire at the end of 2025.
- Transition rules eased for those converting to C corporation status.
- An international territorial tax regime is established along with a "deemed repatriation" tax.

This legislation is extremely complex. It is very important that you consult with your tax advisors to determine your tax planning strategy going forward.

Additional information on the new tax law can be found at:

Bill Summary:
https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/12/tnf-new-tax-law-dec22-2017.pdf and

Bill Text:
https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf

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