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Tax legislation this fall?

Congress returns from its August recess in early September, with a full agenda. This includes raising the debt ceiling by September 29th so that the government can keep paying its bills, addressing the budget for Fiscal Year 2018, which starts on October 1st and…tax reform, which has been complicated by Congress's inability to pass, just prior to the recess, "repeal and replace" legislation for the Affordable Care Act ("Obamacare"). In other words, the Obamacare taxes remain, such as the 3.8% tax on net investment income and the additional 0.90% Medicare tax on wage income over $200,000 (single taxpayers) and $250,000 (married joint filers) – meaning that if these taxes are to be repealed as part of reform, more revenue offsets must be found.

Although tax reform discussions have continued over this summer break, and Treasury Secretary Mnuchin (along with other top Republicans) remains optimistic about the prospects for reform this year, it is never an easy process, even under the best of circumstances: inevitably, someone's ox gets gored. Stated differently, each tax benefit typically has an army of defenders ready to spring into action if the provision's well-being is threatened. Although Republicans are highly motivated to accomplish tax reform, particularly after falling short on repeal and replace, a successful outcome is far from guaranteed.

Thus, if sweeping tax reform proves elusive between now and year end, what might happen instead? One possibility is a modest "extenders" bill. What does that mean?

"Extenders" refer to temporary tax provisions that Congress regularly renews. The last extenders bill was enacted on December 18, 2015, and was part of the "Consolidated Appropriations Act, 2016" (P.L. 114-113). Division Q of that Act was called "Protecting Americans from Tax Hikes Act of 2015"; it was scored at about $622 billion over 10 years, and dealt with over 50 temporary tax provisions. It made over 20 of those provisions permanent, including the following:

— Charitable IRA rollovers, which lets taxpayers who are at least 70 ½ give up to $100,000 annually from their IRA directly to a public charity such as the

taxpayer’s favorite museum or alma mater (donor advised funds, supporting organizations or private foundations are ineligible for the gift)
- The deduction for state and local general sales taxes (in lieu of the deduction for state and local income taxes)
- The $250 above-the-line deduction for certain expenses of elementary and secondary school teachers is now indexed for inflation
- The research and development credit for businesses (this had been extended numerous times over the years).

The Act extended four of the 50+ temporary provisions (including the new markets tax credit and bonus depreciation) for five years, through 2019. Finally, it extended for two years (through 2016) 25+ provisions that had already expired at the end of 2014. In other words, because the extension related back to the beginning of 2015, these 25+ provisions really only had an additional one-year “shelf life.” As of the start of this year, then, these provisions have expired; unless they get extended retroactively by the end of this year or by very early next year, it will be difficult to resuscitate them.

What are some of these expired provisions? Three fall under what the Act entitled “Tax Relief for Families and Individuals,” and address: 1) exempting the forgiveness of certain mortgage debt from income tax; 2) allowing mortgage insurance premiums to be treated as deductible mortgage interest; and 3) allowing an “above-the-line” deduction for qualified tuition and related expenses.

The other provisions that expired at the end of 2016 fall under what the Act entitled “Incentives for Energy Production and Conservation” and “Incentives for Growth, Jobs, Investment, and Innovation.” Many of the energy incentives provide various credits, including those for certain energy-efficient home improvements, 2-wheeled plug-in electric vehicles, biodiesel and renewable diesel, and second-generation biofuel plant property.

The investment and innovation provisions generally seem to target narrower constituencies, and include:

- Treating certain race horses as 3-year (instead of 7-year) property (this allows an owner to depreciate, and therefore recoup, the horse’s cost more quickly)
- Allowing a 7-year (instead of much longer) depreciation period for “motorsports entertainment complexes”
- Special expensing rules for certain film and TV productions, along with live performances
- Continuing the increased “cover over” (or payment) to Puerto Rico and the Virgin Islands for rum excise taxes

More targeted benefits such as these may be harder to pass unless they are part of an extenders bill that includes “must do – can’t let lapse” items. In the past, these have included the research and development credit for businesses and the provision protecting additional taxpayers from the alternative minimum tax (AMT) by indexing the AMT’s exemption for inflation. Yet the research and development credit is now permanent thanks to the 2015 Act (as noted above), and the AMT exemption provision is also now permanent, thereby permanently preventing the AMT from spreading beyond its current scope.

To explain, the AMT is a parallel tax system designed to ensure that taxpayers pay “enough” tax. If the AMT is higher than a taxpayer’s “regular” tax, that higher tax is paid. The first iteration of the AMT appeared in the late 1960’s in response to Congressional testimony by then-Treasury Secretary Barr that some 155 taxpayers had paid no income tax for a recent tax year, through judicious use of various items (e.g., credits, deductions and exemptions) that reduced their tax to zero. Outraged constituents made their voices heard, and the first minimum tax was born; it was seriously revamped in the 1986 Tax Reform Act, and is basically what we have now.

Under the AMT, then, many items that reduce a taxpayer's regular tax don't count against the AMT or are "add-backs" that become "income" in the AMT calculation. For example, a married couple with many children (and corresponding personal exemptions) will find that those personal exemptions can't be used against the AMT – thus that couple might be subject to the AMT, even though their income is relatively modest. Or taxpayers who live in high-tax states, such as New York, New Jersey, Connecticut or California, and have large itemized deductions for state and local income and real estate taxes will see those taxes added back to their alternative minimum taxable income. And so forth.

The point is that the AMT is a much-reviled tax, and is likely to be repealed if tax reform happens. Until then, however, it affects about 4+ million taxpayers – a number that could have swelled to some 24+ million taxpayers if Congress hadn't continually indexed the AMT exemption for inflation, so as to cap the tax's reach.

In other words, for a number of years, the provision to index the AMT exemption for inflation was an "extender"; it provided critical motivation for last-minute extenders bills. Yet once Congress finally made the AMT exemption provision permanent, as part of the "American Taxpayer Relief Act of 2012" (enacted on January 2, 2013 (P.L. 112-240)), some of the wind went of the sails for extenders legislation; Congress hoped that the 2015 extenders legislation (discussed above) would buy them enough time to come up with comprehensive tax reform to make future extenders legislation unnecessary.

And here we are. Will we, in fact, get comprehensive tax reform by the end of the year or early next year? Key Republicans certainly hope so. As noted above, however, tax reform is never easy…and in the meantime, there are those pesky provisions that expired at the end of 2016. Will they truly disappear, or be revived by a last-minute extenders bill?

What will happen is anyone's guess. But Congress's critical short-term "to do" list may put tax reform out of reach, at least for the moment, and make a "smaller" bill more realistic. In the meantime, we're all in a holding pattern.

September 7520 rate

The September 2017 7520 rate remains at 2.4%, where it was in August. The September mid-term applicable federal rates (AFRs) are down 0.01% (one basis point) from August: 1.94% (annual), 1.93% (semiannual and quarterly), and 1.92% (monthly). The August mid-term rates were: 1.95% (annual), 1.94% (semiannual and quarterly), and 1.93% (monthly).

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