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The Path to Tax Reform 2017: September Framework Sets Stage for Passage Before Year-End

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With the release today of a Republican budget framework (the Framework) reflecting the shared view of the White House and House and Senate leaders – and with GOP majorities in both chambers of Congress – there is a likelihood that Washington may pass comprehensive tax reform in 2017. The President has identified tax reform as a top priority, and many seem to agree that tax reform is a "must do" this calendar year, given the slow economy and the dreadful state of the tax system. While the Republicans' false starts this year on repealing and replacing the Affordable Care Act illustrate that advancing legislation is challenging and often unpredictable – notwithstanding Republican control – there seems to be growing consensus not only on the urgency for tax reform, but also on the likely components.

The Framework calls for, among other items:

- A top corporate tax rate of 20 percent.
- A territorial system of corporate taxation but with a minimum tax rate targeted at shifting profits to tax haven jurisdictions.
- A top individual tax rate of 35 percent (with the possibility of an unspecified higher rate).
- A top tax rate of 25 percent on pass-through profits (excluding compensation).
- Elimination of most itemized deductions (including state and local taxes) except for home mortgage interest and charitable contributions, a (nearly) doubling of the standard deduction, and consolidation of the current seven brackets to three for individuals.
- Repeal of the AMT for both individuals and corporations.
- Repeal of the estate tax and generation-skipping transfer tax.
- Allowance of current deductions for the cost of new investments in depreciable assets other than structures for at least five years.
- Limitation of deduction for net interest expense incurred by C corporations.
- A one-time repatriation tax on corporate earnings held overseas proposing different rates with respect to liquid and illiquid assets.

Today's Framework has been long anticipated since the White House on April 26 released a one-page overview (the President's April Overview) of its vision for tax reform, noting four goals: growing the economy and creating jobs, simplifying the code, providing tax relief to families, and lowering the business tax rate. With respect to business tax reform, President's April Overview suggested (i) a 15 percent tax rate for corporations and small businesses, (ii) a territorial system of taxation for American companies, (iii) elimination of "special interest" tax benefits and (iv) a one-time repatriation tax on corporate earnings held overseas. With respect to individual tax reform, the President's April Overview suggested preserving only the charitable gift and home mortgage tax deductions and eliminating targeted tax breaks that primarily benefit wealthy taxpayers (presumably including such items as deductions for state and local income taxes); repealing the alternative minimum tax, the death tax and the 3.8 percent tax on investment income; reducing the top individual tax bracket to 35 percent and reducing the current seven tax brackets to three (10 percent, 25 percent and 35 percent); doubling the standard deduction; and providing relief to families with children and dependent care expenses.

House Republicans in 2016 advanced their own proposals for tax reform, releasing their "A Better Way"

proposal (the House 2016 Blueprint). Paul Ryan on April 26 noted at the BakerHostetler federal policy seminar that he was open to making changes to the House 2016 Blueprint's border adjustment tax proposal, which subsequently was dropped from consideration and does not appear in the new Framework.

With release of the Framework, there seems to be broad agreement among the president and congressional Republicans that the foundation of tax reform will be lowering the individual and corporate tax rates, relying in part on the premise of a growing economy to cover some of the budgetary impact of sweeping tax cuts. Nevertheless, questions remain about a number of important details.

Hearings in the House Ways and Means Committee will continue in the near term, with legislative language of the House proposal expected to follow before markup and with passage expected to occur in the House by Thanksgiving. The Senate is likely to continue its efforts simultaneously but will take up legislation after the House.

Reduced corporate tax rate

The Framework would reduce the corporate tax rate to 20 percent. A number of deductions and credits would be eliminated to broaden the tax base. Importantly, the research and development credit would remain in place in order to incentivize U.S. development of intellectual property. Additionally, the Framework would preserve the low-income housing credit. Other benefits such as the domestic manufacturing deduction would be repealed in favor of a lower rate. The corporate alternative minimum tax would be repealed in an effort to simplify the tax law.

A territorial corporate tax system

A second key component of tax reform is moving to a territorial tax system. The territorial approach would exempt foreign active business income by providing a 100 percent exemption for dividends received from foreign subsidiaries (in which the U.S. parent owns at least 10%). The territorial proposal would allow for future offshore earnings to be repatriated to the United States without additional tax, which would have a positive impact on a company's ability to access its foreign cash. Nevertheless, the Framework proposes rules intended to protect the U.S. tax base by imposing a minimum tax on foreign earnings and to level the playing field between U.S.-headquartered and foreign-headquartered parent companies by implementing unspecified base erosion proposals.

The lower corporate tax rate combined with moving to a territorial system would align the U.S. tax system with the majority of the rest of tax systems throughout the world and is intended to eliminate both the competitive disadvantage created by our current worldwide system and the incentive for U.S. companies to invert. Congressional Republicans and the President have been aligned in their overall criticism of inversions, such as the 2015 proposed $160 billion merger between Pfizer and Allergan – the largest tax-inversion deal in history until it fell apart the following year as a result of Treasury regulations. The proposal to continue to tax U.S.-based companies on their worldwide income (albeit at a lower rate and with a stated purpose targeting tax haven activity) is problematic and could lead to continued pressure on U.S.-based companies not to be headquartered in this country. And even if they would like to stay headquartered here, they may become targets of foreign-based competitors who may use expected tax savings associated with moving that headquarters out of the U.S. to help defray the purchase price. On the other hand, these considerations must be balanced against the general base erosion and profit shifting concerns inherent in moving to a territorial system.

Tax on foreign earnings

Third, as part of a transition to a territorial system, the Framework imposes a deemed repatriation tax on foreign earnings that have accumulated abroad or have been reinvested, albeit at a lower rate than current law. The Framework proposes to tax the foreign accumulated earnings that are held in cash or cash equivalents at a higher rate than reinvested earnings held in illiquid assets (such as factories), although neither the rate nor the time period such liabilities will be payable is specified.

Increased deductions of certain capital expenses to stimulate growth

A fourth tenet of the Framework is an increased allowance of a current deduction for certain capital expenses as a means of stimulating economic growth. The Framework proposes to allow businesses an immediate deduction for the cost of new investments in certain depreciable assets (i.e., not structures or land)

purchased after September 27, 2017. The provision may be temporary, however, but is expected to last for at least five years.

Interest deductibility limitations

The Framework proposes to partially limit corporations' ability to deduct net interest expense. This can be contrasted to prior proposals such as the House 2016 Blueprint that would deny all net interest expense. The limitation appears to be tied in part to the benefit of the current deduction for capital expenses. Even absent that current deduction, however, there would likely be some limitation on interest expense. Under the proposed territorial system, certain foreign income would be exempt from taxation. Accordingly, the system cannot allow a deduction in the United States for debt that supports what is essentially zero-taxed income. Moreover, foreign companies and inverted companies benefit significantly from over-leveraging U.S. operations and reducing tax on U.S. income through the earnings stripping afforded by intercompany debt.

The details regarding proposed interest limitations are unclear, and the Framework reserves on the application of any interest deductibility limitations to pass-throughs. Companies depend on leverage for growth, and while deductions relating to offshore income not subject to tax in a territorial system should not be permitted, additional interest deductibility limitations could be problematic.

Timing and process

The Republicans are highly incentivized and motivated to move quickly on tax reform, particularly given the false starts in connection with repealing and replacing the Affordable Care Act. The window for achieving tax reform will not be open for very long.

2018 is a congressional election year, and there will be considerable pressure to complete tax reform before those campaigns advance very far. The markup process in the Ways and Means Committee will begin soon, and we expect the House may pass its tax reform bill before Thanksgiving with the Senate taking it up shortly thereafter. If Congress is successful in completing tax reform this year, we believe the most likely effective date for major changes will be Jan. 1, 2018. The bill would need only 51 votes in the Senate because Republicans likely will rely on the budget reconciliation process.

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House Speaker Paul Ryan (R-Wis.) at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

Rep. Peter Roskam (R-Ill.), chairman of the House Ways and Means Subcommittee on Tax Policy, talks tax reform at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

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