

## The Path to Tax Reform 2017: The Intersection of President Trump's Plan and the House Blueprint.

April 27, 2017

With a Republican President and 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 one of his top three priorities, and some would argue that tax reform is a “must do” given the slow economy and the dreadful state of the tax system. The Republicans’ false starts earlier this year on repealing and replacing the Affordable Care Act illustrate that advancing legislation is challenging and often unpredictable, notwithstanding Republican control.

On April 26, the White House released a one-page overview (the Overview) of its vision for tax reform, noting four goals: growing the economy and creating jobs, simplifying, providing tax relief to families, and lowering the business tax rate. With respect to business tax reform, the Overview suggests (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 Overview suggests 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,

which continues to be widely regarded as the guiding blueprint for a congressional rewrite of the Tax Code (the Blueprint). The President has been actively meeting with leaders in the House and Senate and his top economic advisers to discuss the various alternatives to tax reform under consideration. Paul Ryan on April 26 noted at the BakerHostetler federal policy seminar that he is open to making changes to the Blueprint’s border adjustment tax proposal (described below), stating, “We don’t want to have severe disruptions — if you’re an importer or a retailer heavily dependent on importers, we don’t want to shock the system so much that it puts them at a disruptive disadvantage.” Speaker Ryan did not elaborate on the components of such possible changes, including whether a revised border adjustment proposal might be phased in or might allow for some partial deduction as part of cost of goods sold for the cost of imported items.

There is 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. The Trump administration’s Overview does not include any reference to a cash flow tax, border adjustability or current expensing. Open questions remain about whether the legislation will be revenue-neutral and whether the tax cuts will be permanent.

For now, there are five key elements of corporate tax reform under active consideration which are expected to be part of the Ways and Means Committee’s legislative proposal. Hearings in the House Ways and Means Committee will begin in the near term, with legislative language of the House proposal expected to follow before markup later this year.

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## Reduce corporate tax rate

The Blueprint would reduce the corporate tax rate to 20 percent, and the President has suggested it go as low as 15 percent. A number of deductions and credits would be eliminated to broaden the tax base. Importantly, it appears that the research and development credit would remain in place in order to incentivize U.S. development of intellectual property. Other benefits such as the domestic manufacturing deduction would be repealed in favor of a lower rate. The corporate alternative minimum tax (AMT) would be repealed in an effort to simplify the tax law.

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## Move toward a territorial tax system

A second key component of tax reform that appears both in the Blueprint and in the President's Overview is moving to a territorial tax system. The territorial approach would exempt foreign active business income, likely by providing a 100 percent exemption for dividends received from foreign subsidiaries. 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.

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 the competitive disadvantage created by our current worldwide system and eliminate 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 new approach, however, would be different from the “stick” approach of the Treasury regulations, opting instead for a “carrot” approach by improving the U.S. tax system and removing the incentive to invert.

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## Change rules on foreign earnings brought home

Third, as part of a transition to a territorial system, Republicans will likely provide rules to allow foreign earnings that have accumulated overseas under the old system to be brought home at rates significantly lower than the current 35 percent rate, which would raise significant revenue from the estimated \$2.6 trillion in corporate profits that are trapped offshore under

the current system. The Blueprint has proposed taxing the foreign earnings at 8.75 percent for accumulated earnings that are held in cash or cash equivalents and at 3.5 percent for reinvested earnings held in illiquid assets, such as factories, payable over eight years. When discussing the Overview, Treasury Secretary Mnuchin did not propose any particular rate or rates.

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## Allow capital expense deduction to stimulate growth and interest deductibility

A fourth tenet of the Blueprint is an allowance of a current deduction for certain capital expenses as a means of stimulating economic growth. Paired with this proposal, however, is a denial of the deduction for net interest expense. This trade-off would cause the loss of a permanent benefit (interest deduction) in order to gain a timing benefit (a capital expense deduction that otherwise would have been recovered over time through depreciation or amortization). The President's Overview is silent on full expensing and denial of deductions for net interest expense. Regardless of the outcome with respect to currently deducting capital expenses, tax reform likely will include some limitation on corporate interest deductions, particularly if a territorial system is adopted. Under a territorial system, foreign income is exempt from taxation. Accordingly, the system cannot allow a deduction in the U.S. 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. Tax reform will address that issue.

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## Adopt destination-based border-adjustable tax

Perhaps the most controversial Blueprint proposal is the move toward a destination-based border-adjustable tax. A destination-based approach means that tax jurisdiction follows the location of consumption rather than the location of production. Under the Blueprint as originally drafted, revenue from exports would be exempt, and imports would be taxable, likely by denying a deduction for cost of goods sold. As a result, it would not matter where a company manufactures its products – U.S. sales would be taxable; non-U.S. sales would not. House Republicans believe this will raise significant revenue given our trade imbalance and will remove certain incentives for companies to locate production facilities offshore. They also believe that the revenue associated with this change is a necessary component

of achieving a corporate tax rate low enough to make reform meaningful. Although economists argue that the approach will strengthen the dollar sufficiently to make everyone whole, on its face it creates winners (such as large net exporters) and losers (such as big-box retailers) and, therefore, is being hotly debated. President Trump's Overview was silent on any border-adjustable tax, and as noted above, Speaker Ryan has stated that the House is willing to consider changes to this proposal to help avoid disruptions. The Blueprint itself is light on details, and it is unclear how it would impact income from services or intangibles. Many questions remain, such as whether it is compliant with our trade obligations – or whether that even matters – or our treaty obligations, to name a few.

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## Timing and process

The Republicans are highly incented and motivated to move quickly on tax reform in order to show progress on their legislative agenda, particularly given the earlier 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 health care reform legislation and tax reform before those campaigns advance very far. The hearings and the markup process in the Ways and Means Committee will begin soon, but we expect it will take Congress until fall to approve a tax overhaul bill, and if they are successful, the most common effective date for major changes is expected to 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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