LATHAM & WATKINS

Client Alert
News Flash

Latham & Watkins Transactional Tax Practice September 28, 2017 | Number 2217

Tax Reform Update: Administration and Congressional Officials Unveil Framework

The proposal would significantly change US taxation of businesses, setting the stage for legislative negotiations, but omits some key details.

On September 27, a group of Trump Administration and Congressional leaders known as the "Big Six" issued a Unified Framework for Fixing Our Broken Tax Code (the Framework) to serve as a starting point for negotiations leading to tax reform legislation.[1] Their objective is to enact the most sweeping reform of the US tax system since 1986. This *Client Alert* summarizes several key business tax issues the Framework addresses.

Rate Reductions

The Framework reflects the Trump Administration's and Congressional leaders' shared goal of reducing tax rates for businesses, both large and small. For corporations, the Framework calls for reducing the top marginal federal income tax rate to 20%, down from the current 35%. The 20% corporate tax rate proposal matches the rate proposed in the June 2016 House Ways and Means Committee Tax Reform Blueprint (the Blueprint), but exceeds the 15% rate proposed in the Trump Administration's high-level tax plan released in April 2017. The Framework contemplates eliminating the corporate alternative minimum tax. The Framework also states the Congressional tax-writing committees may consider ways to reduce the double taxation of corporate income when such income is distributed as dividends to shareholders — a reference to the "corporate integration" concept long championed by Senate Finance Committee chairman Orrin Hatch.

The Framework proposes taxing income earned via pass-through entities at a top rate of 25% rather than at the income rates otherwise applicable to the entity's owners. This 25% rate is consistent with the Blueprint, while the April 2017 Trump plan proposed a 15% rate for all businesses.

The Framework does not specify whether the pass-through rate will exclude service partnerships like law firms and accounting firms, as Treasury Secretary Steven Mnuchin has suggested. Further, the Framework's pass-through discussion focuses on small and family-owned businesses, leaving some question as to whether the 25% top rate would apply to larger pass-throughs.

The Framework calls on Congressional tax-writing committees to develop rules to prevent taxpayers from taking advantage of the special pass-through rate by reclassifying labor income as business income. No mention is made of differentiating investment income from business income.

Expensing of Capital Investments

In addition to reducing tax rates on businesses, the Framework calls for full and immediate expensing of new investments made after September 27, 2017 in depreciable assets other than structures, for a period of "at least five years." Allowing businesses to deduct the full cost of such investments in the year in which such costs are incurred, Administration and Congressional officials hope, will encourage business investment and thereby stimulate economic growth. By describing its proposal as representing an "unprecedented level of expensing with respect to the duration and scope of eligible assets," the Framework echoes language in the Big Six's July 2017 Joint Statement on tax reform principles, which called for "unprecedented capital expensing." Still, the five-year time frame appears to reflect a recognition of the potential budgetary impact that full expensing may entail.

Interest Deductibility

The Framework proposes limiting businesses' ability to deduct net interest expense from their taxable income, although details are sparse. As applied to C corporations, the deduction would be "partially limited," but the Framework does not specify the extent of this limit, nor does it address whether special rules will be needed with respect to businesses that rely heavily on debt, such as financial institutions and private equity firms and their portfolio companies. In addition, the Framework leaves it to Congressional tax-writing committees to "consider the appropriate treatment of interest paid by non-corporate taxpayers."

The committees might consider several approaches for limiting interest deductions, such as a percentage cap on deductible interest expense, or a limit based on the earnings of the corporate group, a concept used in some European countries. In addition to some form of general limitation on interest deductibility for all types of business taxpayers (including those that are domestic only), another question which may come up is whether the committees could consider enacting special rules for US-parented multinational groups that have interest expense allocable to foreign earnings which will be exempt or subject to a lower tax under the Framework's proposed new territorial tax regime, discussed below.

Territorial System

As expected, the Framework calls for a territorial system of international taxation to replace the United States' current worldwide system. The Framework states foreign profits would be exempt when they are repatriated to the United States, calling for a complete exemption applicable to dividends paid by non-US subsidiaries in which the US parent owns a 10% or greater stake.

As a transitional move toward a territorial system, the Framework proposes a mandatory one-time deemed repatriation tax on the existing, deferred overseas earnings accumulated by US multinationals, with the tax liability to be paid over several years. Significantly, the Framework states those deferred overseas earnings that have accumulated under the current system would ***be treated as repatriated*** — hence this would be a "deemed" repatriation tax and would differ from prior tax "holidays" that have imposed a reduced rate on earnings that businesses actually chose to repatriate to the United States. The deemed repatriation tax will apply to earnings measured as of a date to be determined. The applicable deemed repatriation tax rate, while unspecified in the Framework, would be lower for earnings held in illiquid assets than it would be for earnings held in cash or cash equivalents.[2]

Minimum Tax on Overseas Earnings

Recognizing the potential for erosion of the US tax base under this proposal and presumably the need to replace lost revenue from the corporate rate cut, the Framework also would tax — at an unspecified "reduced rate" and on a global basis — the non-US earnings of US multinationals. Thus, the Framework formally introduces into the current tax reform debate the concept of a minimum tax on future foreign earnings, an approach raised earlier this decade in former House Ways and Means Committee chairman Dave Camp's (R–Mich.) 2014 tax reform bill and in the Obama Administration's Fiscal Year 2016 budget.

The notion of enacting such a minimum tax poses a particularly thorny problem, as it puts the issue of US global competitiveness squarely in the cross-hairs if the tax will be applied only to US-parented multinationals. The United States' competitive disadvantage compared to other countries' corporate tax rates and systems for taxing (or exempting) overseas earnings was a major component of the debate over "inversions," whereby some US companies underwent transactions in which their tax domicile changed to a lower-tax jurisdiction that provides a favorable tax system (often in the form of full exemption) for overseas earnings.

The Framework's call for taxing global profits at a lower rate leaves open many questions. While the Framework does not address the treatment of purely passive income, presumably such income would continue to be taxed at the full rate. The Framework is also silent on whether any exceptions would apply for active business income.

In addition, the Framework does not reference the key question of whether a foreign tax credit will be allowed.

Other Provisions

Given the significant reduction in the tax rates applied to business income, the Framework proposes eliminating the domestic production deduction, as well as "numerous other special exclusions and deductions." However, the Framework calls for preserving business tax credits for research and development and low-income housing. The Framework does not provide details about the treatment of tax rules applicable to specific industries, although it does state that it "will modernize these rules to ensure that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance."

Looking Ahead

Over the coming weeks, increasing activity surrounding tax reform will likely generate details from the White House or Congressional leaders on certain key issues not addressed in the Framework, further hearings in the House and Senate, and specific legislative language from the key committees.

Latham will continue to carefully monitor tax reform developments and provide resources, including worthwhile third-party content materials, and insights through the Latham & Watkins US Tax Reform Resource Center.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Nicholas J. DeNovio
nicholas.denovio@lw.com
+1.202.637.1034
Washington, D.C.

Joseph M. Kronsnoble
joseph.kronsnoble@lw.com
+1.312.876.7657
Chicago

Jiyeon Lee-Lim
jiyeon.lee-lim@lw.com
+1.212.906.1298
New York

Laurence J. Stein
larry.stein@lw.com
+1.213.891.8322
Los Angeles

Patrick Allan Sharma
patrick.sharma@lw.com
+1.213.891.7934
Los Angeles

Thomas H. Halpern
Knowledge Management Counsel
thomas.halpern@lw.com
+1.213.891.8684
Los Angeles

You Might Also Be Interested In

Latham & Watkins US Tax Reform Resource Center

Tax Reform Update: 4 Issues to Watch as Congress Nears Summer Recess

US Tax Reform: Strategies for Executing Transactions in the Face of Uncertainty

US Tax Reform: Understanding the Proposals and Executing Transactions in the Face of Uncertainty (webcast)

Endnotes

1 The Framework was issued by Treasury Secretary Steven Mnuchin, Speaker of the House Paul Ryan, Senate Majority Leader Mitch McConnell, Senate Finance Committee Chairman Orrin Hatch, House Ways and Means Committee Chairman Kevin Brady, and National Economic Council Director Gary Cohn — the so-called "Big Six" individuals guiding the Administration's and Congress' tax reform efforts.

2 The Blueprint proposed a one-time tax on the existing, deferred foreign earnings of US multinationals at a rate of 8.75% for earnings held in cash and cash equivalents and 3.5% for other earnings, each payable over eight years.