ML Strategies Update

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MLS Update on Outlook for Tax Reform

The new congress and administration are eagerly working to advance their policy agendas, and comprehensive reform of the tax code is at the top of the list for Republicans. Despite having unified control of the executive and legislative branches and a general agreement on the need to reduce the corporate tax rate and make other reforms, Republicans have yet to coalesce around other specific provisions or a path forward in terms of process.

In June 2016, House Republicans unveiled their "blueprint" for tax reform, which would make significant changes in the tax code for business and individual taxpayers. Titled "A Better Way – Our Vision for a Confident America", the plan has to date served as the framework for discussion about tax reform in the 115th Congress. The blueprint would keep the mortgage interest deduction and charitable deductions, but less clear is the fate of provisions that are not specifically addressed by the blueprint, such as publicly traded partnerships, tax-exempt municipal bonds, regulated investment trusts, like-kind exchanges, and real estate investment trusts.

Little is known at this point about President Trump's plans for tax reform, and it is possible that he will not propose actual tax reform legislation, instead approaching the issue in the mode of President Reagan and simply laying out a set of principles like encouraging "Made in America", a significant cut in the corporate tax rate, and eliminating the estate tax. The President has said that he would maintain the research and development credit and the deduction for state and local taxes. The President is reported to be considering a new tax credit creating a scholarship program that would enable working class families to send their children to private and religious schools. We will probably know more when he delivers his first address to Congress on February 28th.

The House blueprint and President Trump's plans for tax reform are discussed in an earlier tax reform update from ML Strategies found **here**.

Speaker Ryan's Triangulation of Tax Reform

Increasingly, the debate over how any effort at comprehensive tax reform will unfold this year appears to hinge on where the President and the Senate come down on the House blueprint's proposed border adjustment tax (BAT), which would raise approximately $1.3 trillion in revenue.

What we are seeing at this point in the early stages of negotiation over tax reform is an effort by House Speaker Paul Ryan (R-WI) to triangulate – in the style of President Clinton in the 1990s – country-specific tariffs (i.e. for Mexico and China) proposed by President Trump vs. the BAT vs. serious opposition to the BAT in the Senate and the likelihood that the Senate will insist on producing its own tax reform measure. Opposition to the BAT in the Senate includes Republicans and Democrats, particularly Senator Tom Cotton (R-AR), whose state is home to Walmart, and Senator David Perdue (R-GA), a former executive for several retail companies. Retailers argue that consumers would incur higher prices under the BAT.

While the BAT is generally supported among the House GOP caucus, there is opposition, including some members of the Ways & Means Committee. On the other hand, Rep. Erik Paulsen (R-MN), a committee member, has expressed support for the BAT despite opposition from Minnesota retailers Best Buy and Target.

Further muddying the water is that the White House has not taken a clear position on the BAT. If President Trump endorses the BAT – or even just stays quiet on the issue – House Republicans are almost certain to approve a tax reform bill based on the GOP blueprint for tax reform. Alternatively, if the president were to come out against the BAT, one option might be for House Republicans to revive the tax reform proposal put forward several years ago by then-Rep. Dave Camp (R-MI) who was chairman of the Ways & Means Committee.

Issues to Consider in Tax Reform

Although the BAT is the focus of discussions right now, there are many other issues that will play a significant role in the fate of tax reform:

1) **Rates.** Chairman Brady and Speaker Ryan are trying to secure future leverage with the Senate in conference, by passing a House tax reform bill that lowers the corporate tax rate to 20 percent. This would put the Senate on the defensive unless they are also able to get the rate to that level. However, House leaders recognize that the position they're in is not binary – they're not forced to choose between preserving the 35% corporate tax rate and cutting it to 20%. In the end, they can cut the rate by whatever percent they want (provided they have the votes). Expect all parties to dial the rates up and down during negotiations to gain support. Each percentage reduction in the corporate tax rate would represent between $100 billion and $120 billion in reduced corporate tax revenues for the government, so the business sector will be watching closely on where the final corporate rate lands. The business sector will likely not accept a reduction of the rate to anything more than 20% if that comes with the elimination of current deductions. Under such a scenario, they might feel that they are better off with the existing 35% rate plus deductions.

2) **Interest expense deduction.** The right of a business to deduct interest payments from corporate profits before paying federal taxes is a long-standing and popular provision in the tax code. President Trump has proposed giving businesses the option of deducting the full cost of property in the year it is placed in service, in exchange for giving up the right to interest expense deduction. The House GOP blueprint would eliminate the deduction for interest expense, but provide instead a deduction for the cost of certain tangible and intangible assets. Elimination of the deductibility of interest expenses would help to pay for tax reform, but would surely meet with resistance from some business sectors.

3) **Revenue neutrality.** Republicans may base their estimates of tax reform's cost on dynamic scoring, which factors the revenue generated – both directly and indirectly – by tax cuts into its calculations. Congressional Republicans are almost surely going to want to see the tax reform bill be revenue neutral. It is less clear where President Trump is on that question.

4) **Like-kind exchanges.** Intended to encourage investment and reinvestment in U.S. assets, making it easier for taxpayers to exchange real property or personal property into a similar property that better meets their needs while deferring the tax, Section 1031 like-kind exchanges are not referenced in the House blueprint. However, the Camp proposal discussed above called for their elimination so there is some concern, particularly in the real estate industry, that elimination of Section 1031 could be included in tax reform.

5) **Infrastructure.** The President has called for a $1 trillion infrastructure program, and Senate Democrats have responded with a broad proposal of how to effectuate that plan. The looming question though is how to pay for a massive infrastructure program. The proposed repatriation of foreign earnings held abroad by U.S. companies is one option to raise revenue for infrastructure spending, but the GOP blueprint proposes that any repatriated dollars be used for lowering taxes. In short, a tax reform bill that provides for infrastructure funding could garner some Democratic votes, especially if it is paid for with repatriated earnings, but that approach could cause trouble with some Republicans who would see it as giving up a revenue source for tax reform which for some of them is a higher priority.

6) **Tax-Exempt Bonds.** The House blueprint does not specifically call for the elimination of the tax exempt treatment of municipal bonds, but it does call for eliminating special interest provisions and deductions and the general view is that this could include tax-exempt bonds (TEBs). President Trump met with a group of mayors in December and reportedly told them that he would favor keeping the exemption. An elimination or cap of the tax exempt municipal bond would have a dramatic impact on state and local governments, as well as non-profit hospitals and schools, which rely on the tax-exempt status as a means of encouraging investment in capital projects. With the House blueprint seeming to call for the elimination of TEBs, the municipal bond stakeholder community is actively lobbying congress to maintain the current tax treatment in the ultimate tax reform legislation, and the congressional Municipal Finance Caucus has mobilized its membership to urge the House Ways & Means Committee to protect TEBs in tax reform.

7) **Sweeteners.** Chairman Brady and Speaker Ryan are already trying to secure leverage for potential conference negotiations with the Senate by building broad support for their blueprint. They're trying to appeal to a wide range of stakeholders both with the provisions of the tax code they're proposing to change (e.g., expensing, the estate tax, pass-through taxes, etc.) and those they're trying to preserve.

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