STEP

SOUTHWEST FLORIDA CHAPTER

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U.S. Tax Reform
Where Are We?

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Prospects for Tax Reform
Recent Developments

- Until this past week, the major focus on tax reform has been the "A Better Way" proposal of Speaker Paul Ryan and Chairman Brady of the House Ways and Mean Committee (the House Blueprint).
- House Republicans indicated that:
  - tax reform would be enacted in 2017, with no specification of the effective date;
  - hearings would be held, but no mention of when; and
  - the Committee hoped to send tax reform legislation to the Congressional Joint Committee on Taxation for revenue estimates by the end of February.
- On the Senate side, Chairman Hatch of the Senate Finance Committee said the Senate would conduct its own tax reform process.

Prospects for Tax Reform
Recent Developments

- On January 17, President Trump called the House Blueprint's border adjustments "too complicated."
- On February 9, President Trump said he would announce a "phenomenal" tax reform proposal, dealing with business and individual tax reform, within the next few weeks.
- His Press Secretary also signaled the intent to use the process of Reconciliation under the forthcoming FY 2018 budget to advance tax reform, consistent with comments by Republican Congressional leaders.
  - Gary Cohn, Director of the National Economic Council (and former Goldman Sachs Group President), is leading the effort.
  - Mr. Cohn indicated that he has been meeting with Congressional members and working on two key goals: reducing corporate and individual tax rates; he further indicated that all corporate tax reform options are under consideration.

How Is Tax Legislation Enacted?

- Although most recommendations for new tax legislation come from the President, under the Constitution, all legislation concerning taxes must originate in the House of Representatives.
- The House usually must act on the legislation before the Senate can begin its consideration.

Tax Reform
Original Starting Points

- Trump Proposals
- House Republican Blueprint for Tax Reform (the House Blueprint)
- Senate Finance Committee

Trump Proposals
Individual

- New individual ordinary income rates:
  - 12%, 25%, 33%.
  - Dividends taxed @ existing rates
  - Capital gains taxed @ current rates (0%, 15%,20%).
- Alternative minimum tax repealed.
- Net investment income tax repealed.
- Carried interest taxed as ordinary income.
- Deductions capped at $100K for single filers and $200K for couples.
- Federal estate tax repealed, but capital gains over $10 million held at death taxed.

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Trump Proposals Individual

- Life insurance build-up included in income of high earners.
- Personal exemptions and Head of Household filing status eliminated.
- Standard deduction of $30K for married filing jointly and $15K for other individuals.
- Deduction for care expenses (up to four children, elderly dependents), capped at average cost of care for state of residence; income threshold $250K/year or less for individuals and $500K for couples.
- Earned income tax credit retained; plus spending rebates for childcare expenses of 7.65% of remaining eligible childcare expenses; subject to cap of half of payroll taxes paid by taxpayer; income threshold: $62,400 ($31,200 for single taxpayers) or less.

Trump Proposals
Corporate

- 15% corporate tax rate.
- 15% rate would apply to pass-through entities (partnerships) that retain profits within the business (unclear whether there would be another tax upon distribution).
- Allow firms engaged in manufacturing in the U.S. to elect to expense capital investment; manufacturers that expense could not deduct corporate interest expense.
- Most tax expenditures, other than R&D credit, eliminated.
- Corporate alternative minimum tax repealed.

Trump Proposals Corporate

- Deferral repealed; CFC profits currently taxed (at 15% rate) with foreign tax credits.
  - Unclear whether President Trump still supports this proposal.
- Accumulated offshore earnings repatriated at a one-time 10% rate.
- Tax incentives for infrastructure development projects (likely to benefit primarily utility companies and investors in construction industry).

House Blueprint Overview

- Starting point for tax reform in the House and originally for the larger tax reform.
- Proposal is highly conceptual.
- In general, House Blueprint proposes to reduce tax rates for businesses and for individuals and to move the U.S. tax system closer to a cash flow border adjusted consumption-based tax system through reforms of the income tax rules without providing a value added tax or national sales tax.
- Would continue to tax individuals, corporations, and pass through entities on non-business income.

House Blueprint
Individual

- Change the individual ordinary income rate structure to:
  - 12%
  - 25%
  - 33%
- Pass-through income: 25% rate for "active business income" from sole proprietorships and pass-through entities, except that an owner-operator's "reasonable compensation" for services subject to general ordinary rate structure.
- Dividends, interest and capital gains: 6%, 12.5%, 16.5% (50% deduction of ordinary rates on these categories of income).
- Net investment income tax repealed (possibly as part of separate health care reform legislation).
- Carried interest apparently retained for now.
- Estate and generation-skipping transfer taxes repealed.

House Blueprint Proposals Individual

- Deductions/Credits:
  - Standard deduction and personal exemptions consolidated ($24K for married filing jointly; $18K for singles w/child; $12K for other individuals).
  - State tax deduction eliminated.
  - Charitable deduction retained for now.
  - Mortgage interest deduction retained for now.
  - Earned income tax credit retained.
  - Not addressed: life insurance build-up, dependent care expenses.

House Blueprint Proposals Corporate

- 20% flat rate for all "C" corporations.
- 25% rate for pass-through entities that retain profits.
- Full expensing of cost of investments in tangible property (equipment and buildings) and intangible assets (intellectual property), excluding land.
- Allow businesses to deduct interest expense against interest income; net interest expense not deductible, but w/ indefinite carried forward against future net interest income.
- NOLs carried forward indefinitely, increased by an interest factor compensating for inflation and a real return on capital.
- NOLs not allowed to be carried back; deduction with respect to NOL carryforwards limited to 90% of the net taxable amount for the year determined without regard to carryforward.
- Eliminate domestic production activities deduction and all business credits other than R&D credit.

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House Blueprint Proposals Corporate

- Adopt destination-based cash flow tax (DBCFT). Taxing jurisdiction would be based on the location of consumption (*i.e.*, where goods are sold, services are performed and intangibles are used) rather than the location of production.
  - On February 14th, Chairman Brady indicated there would be a transition period to help companies adjust.
- Adopt a territorial system for foreign earnings that would provide a 100% exemption for dividends paid by foreign subsidiaries to domestic corporate parents.
- Repatriate accumulated, tax-deferred offshore earnings at a rate of 8.75% if held as cash or cash equivalents or 3.5% if held in another form.
- In sum, the new system would replace current system of taxing U.S. corporations on their worldwide income with a cash flow tax with ”border adjustments,” exempting exports and taxing imports, and a territorial tax system exempting corporate profits earned from production abroad, active earnings of U.S.-owned foreign subsidiaries and dividends from these foreign subsidiaries.

Cash Flow Tax

- Under this system, a taxpayer is taxed on the net cash flow received from its real business activities; in essence, a tax levied on the cash entering the business less the cash leaving the business.
- Cash flow is defined as revenues minus purchased inputs, to include capital outlays and wages.
- No distinction is made between capital and income in the calculation of a company's tax base.
- A cash flow tax does not require the measurement of economic income; *i.e.*, changes in the value of an asset in the market
- Expensing causes this tax to be imposed on "economic rent" and not on the normal return to capital.
- Economic rent means any payment to a factor of production in excess of the cost needed to bring that factor into production.
- Since interest expense is not deductible, debt finance is neutral with equity finance.
- Advocates of this type of tax have suggested that it is simpler to administer since there is no need to capitalize any expenditures or keep track of asset bases.

Consumption Tax

- A consumption tax is a tax on spending on goods and services.
- The tax base is the money spent on consumption.
- Consumption taxes are usually indirect, such as a value added tax or a sales tax.
- Commentators have written that since a pure cash-flow tax removes the tax disincentive to save for future consumption, a cash flow tax is viewed as a consumption rather than an income tax, *see Tax Analysts,* Doc. 2017-808.

Destination Based Tax

- A tax levied based on where goods, services or intangibles are consumed, rather than where produced, generated or created.

Border Tax Adjustment

- A system of taxation whereby exported goods are exempt from tax and imported goods sold domestically are subject to tax.
- It is a short name for a Destination-Based Cash Flow Tax.
- Typically, a border-adjusted tax arises in the context of a value-added tax (VAT).
  - A VAT is a type of consumption tax that applies to all provisions of goods and services. A VAT is collected incrementally, based on the value added, at each stage of production, and is usually implemented as a destination based tax, where tax rate is based on the location of the customer.
- A DBCFT is equivalent to a subtraction-method VAT with a deduction for wages.
  - In other words, same approach as a VAT but unlike a VAT, objective is to tax business profits but allow deduction for labor expense. That equates to a tax on consumption from sources other than wages and salaries.

How House Blueprint Transforms Current Income Tax into a DBCFT

- ❑ Blueprint proposal essentially repeals the current corporate income tax and replaces it with a DBCFT.
- ❑ The components of a DBCFT are:
  - ❑ Full expensing;
  - ❑ No interest deduction;
  - ❑ Border adjustability, whereby revenues from exports from goods, services and royalties are excluded from the tax base and imports are taxed through a denial of any deduction for imported goods, services or royalties.

House Blueprint Proposals Proposed Border Adjustments

- Actual operation of border adjustments not fully flushed out.
- The intended result is that products, services, and intangibles exported outside the U.S. would be exempt from U.S. income tax, while products, services, and intangibles imported into the U.S. would be subject to U.S. tax regardless of where they are produced.
- The DBCFT is intended to increase domestic growth by encouraging companies to maintain locations in the U.S. and to use domestically produced goods.
- As U.S. is a net importer, proposal could raise significant revenue.

Benefits of DBCFT

- Simplification:
  - Tax code.
  - Administration.
- Encourages U.S. HQ companies, U.S. activities, and U.S. consumption of U.S. produced goods.
- Investment choices: would not distort investment or financing choices since it eliminates taxes on the return to investment and treats debt and equity equally.
- International Issues -- eliminates or minimizes:
  - Ignores foreign activities.
  - Transfer Pricing profit-shifting issues.
  - Outsourcing to foreign locations through transfers of intangibles or otherwise to low-tax jurisdictions.
  - Inversions.
  - BEPS substance and other issues.
- Revenue raiser: $1 trillion over 10 years.

Downsides of DBCFT

- DBCFT has never been implemented.
- WTO and other international trade attacks.
  - Does border adjustment subsidize exports and discourage imports?
- Impact on U.S. bilateral income tax treaty network.
- FX uncertainties due to border adjustments.

FX Issues

- Differing views as to whether the DBCFT will increase the value of the dollar.
- Some believe that by exempting exports from U.S. taxes, the border adjustment would initially create higher demand for U.S. goods and the U.S. dollar while the taxation of imports would create lower demand for foreign goods and for foreign currencies. Together, these two effects would cause the value of the dollar to rise significantly.
- However, others believe that little clear relationship between trade deficits and currency strength because most buyers and sellers are interested in financial assets and not trade; trade flows are small in comparison to gross financial flows; hence, trade flows should not drive strength of dollar.

FX Issues

- Concern that increased dollar will make U.S. exports uncompetitive and more expensive for foreign consumers to purchase U.S. exported products.
- Concern that an increased dollar will cause imports to become more expensive, which would raise taxes of importers and increase the price to U.S. consumers.
- Counter argument that the increased U.S. dollar would permit U.S. exporters to sell goods for less and U.S. importers to purchase goods for less.

Other FX Consequences of DBCFT

- The border adjustment and resulting exchange rate appreciation will reduce the value of U.S. investments overseas.
- The border adjustment will increase the value of foreign investments in the U.S.
- A foreign issuer of dollar denominated debt will have sharply increased obligations and costs.
- A foreign holder of dollar denominated debt will gain as a result of the appreciation of the dollar.
- Economists have estimated that revenues from the DBCFT to the government will be negative in present value.

Senate Starting Point for Tax Reform

- The Senate Finance Committee has not produced a document similar to the House Blueprint.
- In view of fact that tax reform process likely would commence in the House, it was assumed that the most likely starting point for the Senate Finance Committee would be the bill passed by the House.
- However, in the past week or so, Senator Hatch stated that the Senate would undertake its own tax reform process.
- Senator Purdue, a Republican Senator from Georgia, has come out against the DBCFT on the grounds that it "is regressive, hammers consumers, and shuts down economic growth." Further, he notes that there would be a multi-trillion dollar reduction in the value of foreign investments held by U.S. investors.
- Other Senators have expressed concern over border adjustment effects.

Senate Starting Point for Tax Reform

- Also:
  - Senator Majority Leader McConnell said that any tax reform should be comprehensive.
  - Senate Democratic Leader Schumer supports international tax reform to fund infrastructure spending.
- Further, Chairman Hatch has been exploring the possibility of achieving business tax reform, in part through corporate integration.

Tax Reform Timing

- Timing will depend on when Trump Administration rolls out its proposals and Congressional reactions.

Tax Reform Process?

- Republicans have majority in House of Representatives and Senate 52/48, but do not have filibuster-proof 60 Senate votes.
- It is likely that Republican leaders may use a special legislative process called "Reconciliation" for their tax reform initiatives.
- Reconciliation enables a majority 51 vote in the Senate for spending, tax and debt limit bills, with certain limitations.
- Under Reconciliation, legislation generally cannot create a deficit outside of the 10 year budget process window. If it does, under the "Byrd Rule," Senators can block the legislation.
    - This could have practical effects on current tax reform initiatives.
- ***Through Reconciliation, tax reform could be enacted by majority Republican votes in the House and Senate.***

Tax Reform – A Sure Thing?

- Differing views as to how to implement tax reform, even among Republicans.
- Process is difficult and complex:
  - “winners and losers”,
  - economic repercussions, and
  - competitive landscape will be altered.
- The ability of Democrats to “filibuster” in the Senate could impact the success of tax reform, unless Reconciliation were used.

Thank You

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