# Federal Tax Legislative Update

## Here We Go Again!
## Will Tax Reform Finally Happen?

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# A Prescient Comment on the U.S. Legislative Process

- "You can always count on Americans to do the right thing, **after they've tried everything else**." Winston Churchill (emphasis added)

# Agenda

- The Context
- The Difficulties
- The Proposals
- The Sensible Alternative
- What Happens Next

# THE CONTEXT

# The Context

- Political
  - Republican control of White House, Senate and House of Representatives
  - Administration and Republicans anxious for legislative victory
- Procedural
  - Republicans have only 52 votes in the Senate, creating potential procedural issues
- Fiscal
  - CBO projects increasing annual deficits through 2027
    - Cumulative deficit - $9.5 tr.
    - Public debt - $25 tr. (88.9% of GDP)

# What is Driving the Process

- Politics
- Multinational corporations
- High corporate tax rate
  - Effective tax rate is much lower
  - RATE v ACT coalition
- Tax base erosion
  - IP transfers
  - Earnings stripping
  - Aggressive transfer pricing
- Inversions
  - CBO Report- 9/18/2017
- BEPS and state aid investigations

# What is Impeding the Process

- Little public support or understanding of the need for "tax reform"
- Congressional procedural rules
- No political agreement on revenue targets
- No agreement amongst the business interests
- Political and technical ineptitude of the Administration

# The Politics

- The Republicans want a legislative victory
  - No evidence at the moment that there is agreement on the elements that are impeding the process
  - Reconciling the rhetoric of the Freedom Caucus with other Republicans in the House is difficult
  - Not likely that any Democrats will vote for tax changes
  - Time is running out for action this session
    - Need for a Budget Resolution as a predicate to action

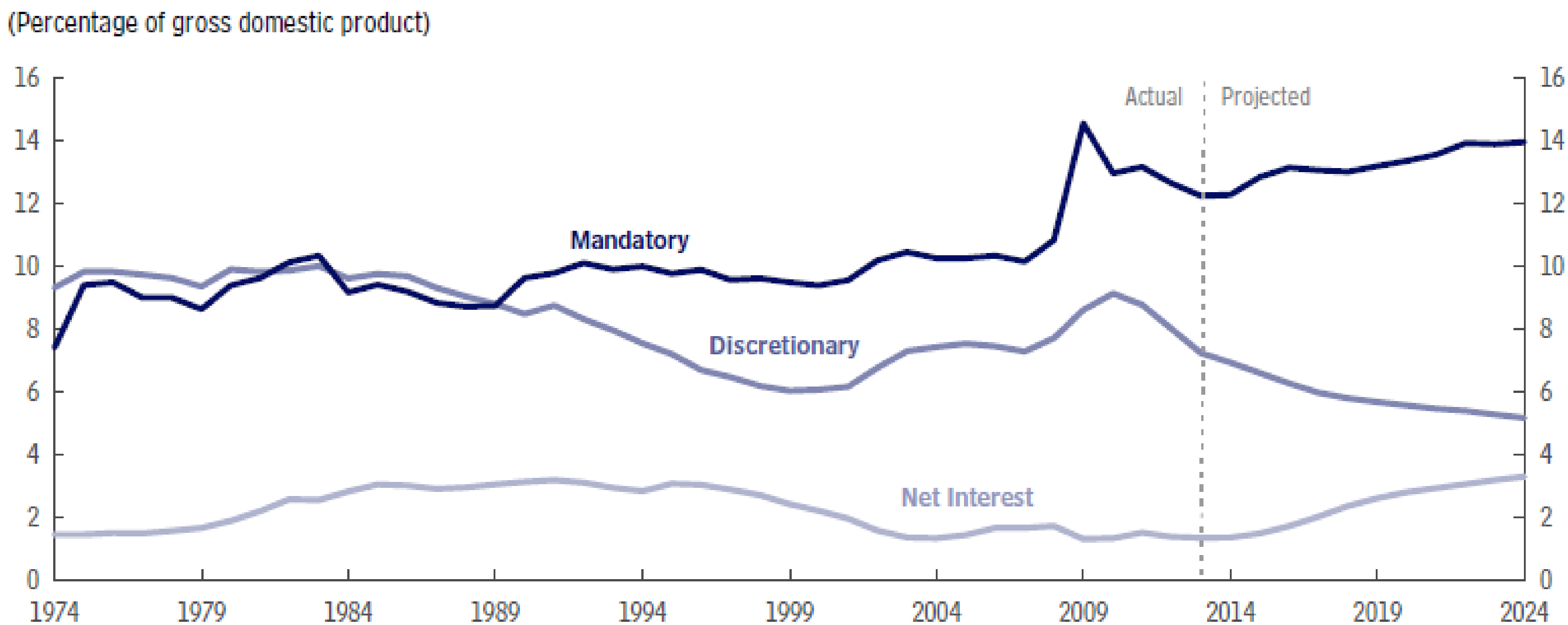
# The process

- The "regular order" is not available because the Republicans lack 60 votes to overcome a filibuster
- The "reconciliation" process, which eliminates the filibuster obstacle, is available but it has its own hurdles
  - A Budget Resolution is necessary to commence the process
  - No deficit effect outside the 10 year budget window
    - Budget gimmicks will be used to overcome this
      - "Dynamic" scoring
      - Policy as compared to a current law baseline
      - Phase-in and phase out
      - Front loaded timing provisions
  - Non-revenue provisions are out of order

# The Fiscal Situation

- **CBO projects increasing annual deficits through 2017**
  - Cumulative deficit - $9.5 tr.
  - Public debt - $25 tr. (88.9% of GDP)
- **Effect of increased deficit**
  - Spending on interest increases substantially
  - Because borrowing reduces total saving in the economy, the nation's capital stock would become smaller, and productivity and total wages would be lower
  - Less flexibility to use tax and spending policies to respond to unexpected challenges
  - Likelihood of a fiscal crisis increases.
    - Investors could demand higher interest rates to purchase government debt

# Tax reform: Budget considerations – Federal expenditures




*Source: Congressional Budget Office, The Budget and Economic Outlook:" Fiscal Years 2014-2024 (February 2014)*

# CBO Economic Assumptions

- **CBO's Economic Projections**
  - GDP—1.6 (2019-2020), 1.9 (2021-2027)
  - Inflation—3.5 (2019-2020), 4.0 (2021-2027)
  - Unemployment Rate—5.0 (2019-2020), 4.9 (2021-2027)
  - Three-month Treasury –2.0(2019-2020), 2.8 (2021-2027)
  - Ten-year Treasury– 3.0 (2019-20200, 3.6 (2021-2127)

# THE DIFFICULTIES

# The Difficulties

- On tax reform generally, see *Showdown at Gucci Gulch,* the story of the 1986 tax act.
- Revenue cost and the legislative process
  - Both the Republican Blueprint and Trump principles lose revenue during the ten-year budget window
    - Will fiscal conservatives buy in?
  - Procedural rules in the Senate will pose problems
    - Legislation "in the regular order" is subject to a filibuster
    - Budget reconciliation requires a budget resolution and is limited by the Byrd Rule
    - Corporate rate reductions generally trigger Byrd Rule
- Winners & losers
  - Elimination of tax expenditures to finance rate reduction creates winners and losers
  - Why would a multi-national with an effective tax rate below 15% agree to a domestic rate higher than that?
    - Speculation—they want repatriation relief

# The Difficulties

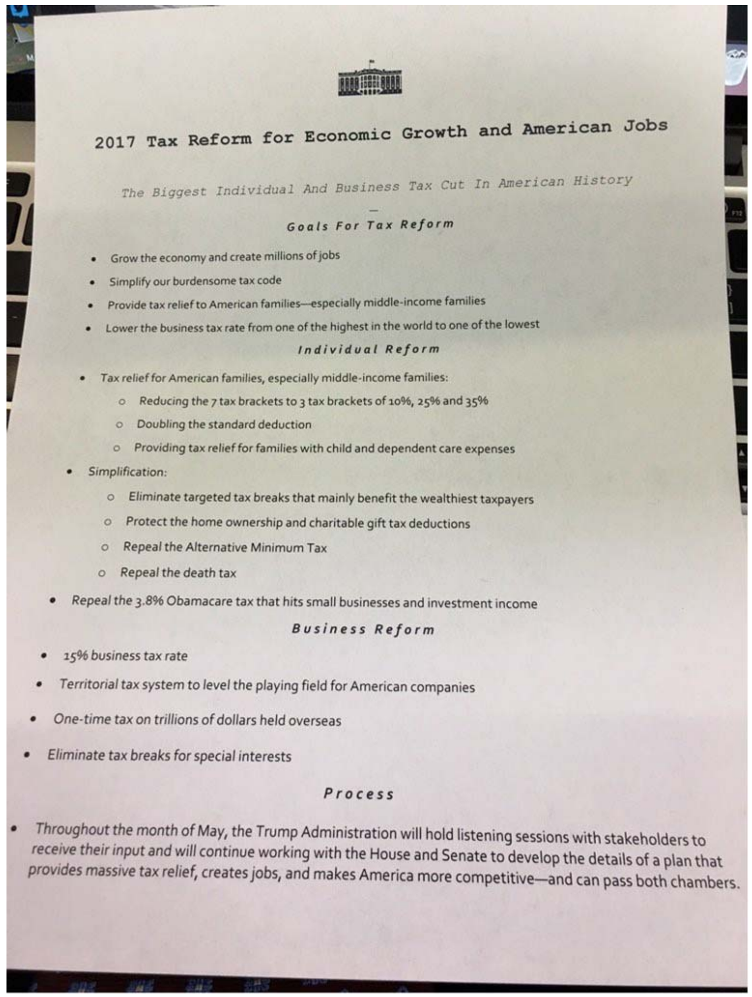
- The Substance
  - The Republican Blueprint and Trump principles have elements in common but appear to differ significantly on how to tax both domestic and foreign income
    - The original Republican Blueprint replaced the existing corporate tax with a "border adjustable" business cash flow tax (essentially a subtraction method VAT with a deduction for wages), and excludes foreign income through a territorial tax system with a full deduction for dividends from foreign corporations. The border adjustment feature has now been removed but the rest of the proposed structure remains. The Trump plan appears to retain the existing corporate tax structure with modifications to the base.
      - A myriad of technical issues are buried in the Republican proposal. For example,
        - What is the scope of expensing?
        - How does interest netting work?
        - What is the interaction with existing Subchapter C principles re: e.g., dividends., earnings and profits, mergers and acquisitions?
        - How to deal with pass-through abuse?
      - The scope of the territorial tax, including anti-abuse provisions, needs to be determined.
      - Will there be a tax on unrepatriated earnings and if so, what will it look like?
      - Will the provisions be temporary or permanent?
      - What will be the effective dates?
      - Transition rules will be critical.
  - The Hatch plan is a totally different approach and does not address individual taxation

# The Proposals

# The Major Proposals

- House Republican Blueprint, "A Better Way"
  - Once thought of as the starting point for the legislative process
- President Trump's "Principles"
  - "The biggest tax cut in history"
- Senator Hatch Integration Proposal
  - Not yet released, but broad outlines reported
- The 2014 Camp tax reform bill
  - Conventional repeal preferences/lower rates reform

# The President's Plan



## 2017 Tax Reform for Economic Growth and American Jobs

*The Biggest Individual And Business Tax Cut In American History*

**Goals For Tax Reform**

- Grow the economy and create millions of jobs
- Simplify our burdensome tax code
- Provide tax relief to American families—especially middle-income families
- Lower the business tax rate from one of the highest in the world to one of the lowest

**Individual Reform**

- Tax relief for American families, especially middle-income families:
  - Reducing the 7 tax brackets to 3 tax brackets of 10%, 25% and 35%
  - Doubling the standard deduction
  - Providing tax relief for families with child and dependent care expenses
- Simplification:
  - Eliminate targeted tax breaks that mainly benefit the wealthiest taxpayers
  - Protect the home ownership and charitable gift tax deductions
  - Repeal the Alternative Minimum Tax
  - Repeal the death tax
- Repeal the 3.8% Obamacare tax that hits small businesses and investment income

**Business Reform**

- 15% business tax rate
- Territorial tax system to level the playing field for American companies
- One-time tax on trillions of dollars held overseas
- Eliminate tax breaks for special interests

**Process**

- *Throughout the month of May, the Trump Administration will hold listening sessions with stakeholders to receive their input and will continue working with the House and Senate to develop the details of a plan that provides massive tax relief, creates jobs, and makes America more competitive—and can pass both chambers.*

# Republican Blueprint and Trump Outline– Individual and Estate Tax Proposals

## Republican Blueprint

- **Taxation of pass-through business income, after reduction for reasonable compensation, at 25%**
- Individual income tax rates of 12, 25 and 33%
- Deduction of 50% of capital gains, dividends and interest
- Increase standard deduction
- Repeal AMT
- Repeal all itemized deductions except for home mortgage interest and charitable contributions
- Retain retirement savings incentives
- Repeal estate and generation-skipping tax
  - Gift tax omitted

## Trump

- **Tax pass-through income at 15%**
- Individual income tax rates of 10, 25 and 35%
- Maximum 20 rate on capital gain
- 3.8% net investment tax repealed
- Double the standard deduction
- Repeal AMT
- [Cap itemized deductions at $100,000, $200,000 for marrieds]
- Repeal unspecified deductions but retain home mortgage and charitable contribution deductions
- New deductions, credits and other incentives for child and dependent care expenses care
- Carried interests taxed as ordinary income
- Repeal estate tax
  - No mention of gift and GST
  - [Tax capital gains on property held at death with an exemption of $5 million ($10 million for married couples)]

# Republican Blueprint and Trump Business Tax Proposals

| Republican Blueprint | Trump |
| --- | --- |
| Corporate Rate—20% | Corporate Rate—15% |
| Repeal Corporate Minimum Tax | [Repeal Corporate Minimum Tax |
| Replace corporate tax with a "Cash Flow" tax<br>▪ Full expensing of the costs of investments other than land<br>▪ No current deduction for net interest expense<br>▪ Border adjustment | Domestic manufacturers may elect full expensing of capital improvements with denial of net interest expense |
| Eliminate section 199 and other unspecified deduction and credits | Eliminate section 199 and other unspecified deductions and credits |
| Retain enhanced R&E credit | Retain R&E credit] |
| Indefinite carryover of 90% of NOL's with interest | No provision |
| Retain LIFO | No provision |

# Republican Blueprint and Trump Business Tax Proposals

## Republican Blueprint

- Creation of territorial tax system with 100% deduction of dividends from foreign subs
  - Repeal of Subpart F, except for PFIC rules
- Deemed repatriation tax on currently deferred accumulated earnings payable over 8 years
  - 8.75% on cash or cash equivalents
  - 3.5% on other earnings

## Trump

- Territorial tax
- Deemed repatriation tax on all currently deferred accumulated earnings
  - No repayment time specified
  - No rate specified

# Republican Blueprint and Trump Tax Plan Costs

| Republican Blueprint | Trump Proposals |
| --- | --- |
| ▪ Tax Foundation—($191 b.)<br><br>▪ Tax Policy Center—($3 tr.) | ▪ No official score because proposals are too vague.<br>  ▪ Tax Policy Center estimates a revenue loss of $6.2 tr. with added interest costs of $.8 tr. |

# Other solutions

## Integration of corporate and individual tax

- Senate Finance Committee hearings/study
- Dividends paid deduction
- Addresses base erosion, inversions, debt-equity issue
- Issues:  Complexity, taxation of tax exempts, taxation of foreign shareholders and treaties, equity sales

## Conventional reform (Camp bill)

- Eliminate tax preferences, reduce rates
- International
  - Territorial tax with minimum tax on foreign earnings
  - Bas erosion/earnings stripping measures
  - Repatriation of accumulated earnings at reduced rate

# The Sensible Answer

- Retention of the corporate tax, but at a rate of 15%
- Worldwide taxation of all income currently
  - Eliminates transfer pricing **as a US tax issue**
  - A territorial system would require either a minimum tax (of 15%) on foreign income or complex base erosion rules
- Assuming a cost of $2 trillion over ten years, a 4-5% VAT would make this revenue neutral. Administrative and transition costs would indicate a rate of at least 7%.
  - A higher rate could finance income tax changes. See, See, Progressive Consumption Tax of 2016, introduced by Sen. Ben Cardin

# A VAT

- "A tax imposed and collected on the 'value added' at every stage in the production and distribution process of a good or service. Joint Committee on Taxation, *Background on Cash-Flow and Consumption-Based Approaches to Taxation,* (JCX-14-16), March 18, 2016."
- Administered through a credit-invoice system.
  - Each seller in the supply chain charges VAT on a sale and gives the purchaser (other than a final consumer) an invoice that shows how much tax has been charged. A credit may subsequently be claimed for the amount of tax shown on the invoice.
- It is a **tax on transactions.**
- It is **not a tax on business**. Business acts as a collection agent.
- Is **"destination-based".** Exports are not subject to VAT, imports are.

# What Happens Next

- Extremely difficult to predict
- Things to watch for
  - Release of the "Gang of Six" proposals
  - Budget resolution relating to taxes
  - Republican "statement"
  - Congressional hearings
  - Reaction of the Senate

# Presenter

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