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CLIENT ALERT

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How the Election May Affect the Taxation of Business Income

A Trump Administration, combined with Republican control of both the Senate and the House of Representatives, makes legislation to reform the taxation of business income more likely. Despite the increased likelihood of legislative action, however, the specific content of reform legislation is more elusive than has been suggested by many, as is the path to enactment.

This Report

This report summarizes the following recent proposals: The House Republican Tax Reform Task Force Blueprint (the "Blueprint")[1]; the Trump Tax Plan (the "Trump Plan")[2] and the reported, but not yet released, Hatch Integration Plan (the "Hatch Plan"). It then discusses the legislative path to enactment.

The Blueprint and Trump Plan also address individual and transfer tax issues, but those aspects are not discussed here except insofar as they relate to the taxation of business income.

These proposals are simply a starting point in the process, are not fully articulated and could well be modified before formal legislative action commences. This is particularly true of the Trump Plan which was revised during the Presidential campaign and continues to lack specificity on critical points. The next iteration of the Trump Plan will most likely be a formal Administration Budget proposal that is not expected to be released until February at the earliest.

[1] http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf
[2] https:www.donaldtrumo.com/policies/tax-plan

Background

While there has been a broad consensus that our business income tax system needs to be reformed, there has been no consensus on what a reformed system should look like. There has been no groundswell of public support for business income tax reform and President Obama did not make it a legislative priority. Differing revenue objectives and substantive outcomes have separated Democrats and Republicans. As a practical matter, revenue constraints, combined with the procedural rules governing the consideration of tax legislation in the Congress, have posed an insurmountable obstacle to enacting a significant corporate rate reduction using the traditional model of financing through the elimination of business tax preferences. Moreover, the traditional reform model creates significant winners and losers in the business community and results in a politically untenable tax increase on the more than forty-four percent of business income earned in non-corporate form.

Lawmakers have been well aware of these problems but significant differences between Democratic and Republican solutions could not be reconciled. Now, with the Executive and two Legislative Branches about to be controlled by the Republicans who have consistently made tax reform a high rhetorical priority, and with both the Trump campaign and House Republican proposals somewhat aligned as to the need (if not the substance) of business tax reform, there is renewed hope that the legislative logjam can be broken. Reconciling the conflicting approaches of the Blueprint[3], the Trump Plan and the Hatch Plan and satisfying Congressional procedural rules, however, will not be easy.

The Major Proposals

The "Blueprint"

The Blueprint is the first proposal discussed because, as a practical matter, it is likely to be the starting point for Congressional consideration. The Blueprint proposes:

- A reduction in the corporate tax rate from 35 percent to 20 percent
- Repeal of the corporate alternative minimum tax
- Full expensing of the costs of investments other than land
- No current deduction for net interest expense (to eliminate interest subsidization of debt-financed investments)
- Indefinite carryforward of 90 percent of annual net operating losses with an interest factor to preserve the current value of the deferred amount
- Retention of LIFO
- Elimination of unspecified (apart from section 199) deductions and credits
- Retention of an enhanced R&D credit
- Creation of a territorial tax system with a 100 percent deduction of dividends from foreign subsidiaries, coupled with a destination-based tax system that imposes tax on the basis of where products are consumed rather than where they are produced
- Repeal of Subpart F, except for passive foreign investment company (PFIC) rules

[3] Other proposals, such as the 2014 Camp Discussion Draft and VAT proposals advanced by Congressman Renacci and Senator Cardin may become relevant as the process unfolds. If that occurs they will be addressed in subsequent reports.

- A deemed repatriation of currently deferred accumulated earnings at an 8.75 percent tax rate to the extent they are held in cash or cash equivalents, 3.5 percent for other earnings, with the tax liability payable over 8 years
- Taxation of pass-through business income, after a reduction for reasonable compensation, at 25 percent
- Three individual income tax rates: 12, 25 and 33 percent
- Deduction for 50 percent of net capital gain, dividends and interest

The Trump Plan

During his campaign, Trump proposed:

- Reducing the corporate tax rate from 35 to 15 percent
- Eliminating the corporate alternative minimum tax
- Allowing firms engaged in domestic manufacturing to choose between full expensing of capital investments and deducting interest paid
- Eliminating the domestic production activities deduction (section 199) and all other business credits, except for the research and development credit
- A deemed repatriation of currently deferred (cash and non-cash) earnings at a 10 percent tax rate
- Allowing owners of pass-through entities the option to be taxed at 15 percent rate rather than ordinary income rates, with special rules applicable to distributions from "large" pass-throughs, the owners of which elected the 15 percent rate.
- Three individual income tax rates: 12, 25 and 33 percent
- Maximum rate of 20 percent on capital gain
- Carried interests taxed as ordinary income

An early version of the Trump Plan proposed current taxation of worldwide income at 15 percent. That proposal was omitted from the last iteration of his Plan.

The Hatch Plan

The Hatch Plan, as reported, would allow a deduction for all dividends, limited by the amount that is subject to full taxation. The limitation denies a deduction for dividends paid out of preference income or foreign source income that has been sheltered by foreign tax credits. A withholding tax of 30 percent would be imposed on the deductible dividend. The withholding tax would be included in the income of a dividend recipient and would be a nonrefundable credit for U.S. taxpayers. The credit would not be refundable for foreign taxpayers and exempt organizations. Thus, it would be a final tax for those entities.

To equate the tax treatment of dividends and interest, a thirty-percent withholding tax would be imposed on interest payments. The interest withholding tax would be treated the same way as the dividend withholding tax, thus ensuring at least one level of tax on interest income.

The reports are silent on the treatment of foreign income. The specific question is whether taxes paid to a foreign government by a U.S. corporation would be treated the same as taxes paid to the U.S. government. If so, the foreign tax credit would effectively be transferred to U.S. shareholders and that income, if taxed at a rate equal to or greater than the U.S. rate would not be subject to U.S. tax.

Finance Committee Republican staff have said that the Hatch Plan will be released shortly and that it will contain legislative language, a technical explanation and both conventional and dynamic revenue estimates.

The Path Forward

The path forward involves two issues: achieving a consensus on the substance of the legislation and navigating the rules of the legislative process. Neither will be simple.

The Legislation

While sharing a number of common elements, such as a reduction of the corporate tax rate, repeal of the corporate AMT, repeal of section 199 and many business credits and the deemed repatriation of deferred foreign earnings, the Blueprint and the Trump Plan provide different views of the structure of the corporate tax with respect to the taxation of domestic and foreign source income. The Blueprint replaces the existing corporate tax with a business cash flow tax (essentially a subtraction method VAT or consumption tax), eliminates foreign source income from the U.S. tax base through "border adjustability", and provides a territorial tax system with a full deduction for dividends from foreign controlled corporations and the repeal of much of Subpart F. The Trump Plan retains the existing corporate tax structure with modifications to the base. The Hatch Plan, if it is unveiled as reported, represents a totally different approach to the issue of business income taxation and does not address individual taxation at all.

Only time will tell how these conflicts are resolved, or whether other approaches, such as the adoption of a credit-invoice VAT, as proposed by Congressman Renacci and Senator Cardin, to eliminate the corporate tax or finance a corporate rate reduction, could enter the discussion.

Navigating the Legislative Process

There is no official revenue estimate for the Blueprint. Chairman Brady has stated that revenue neutrality is a goal. The House Republican Tax Reform Task Force claims that the Blueprint is revenue neutral over the ten-year budget measuring period, but that claim is based on a questionable baseline from which to measure the revenue effect and an assumption that enactment will generate significant economic growth. Whether the official scorekeepers (the Joint Committee on Taxation) will agree is unknown. The Tax Foundation has estimated the Blueprint as losing $191 billion over the ten-window. The Tax Policy Center has estimated a loss of $3 trillion.

The Trump Plan has been estimated by the Tax Policy Center to reduce revenues by $6.2 trillion over the ten-year budget window. Including increased interest costs and macroeconomic effects, the federal deficit would rise by $7 trillion over the first decade. The Tax Foundation has estimated the Trump Plan would reduce revenue in a range of $4.4 to $5.9 trillion over the ten-year budget window. Including interest costs and macroeconomic effects results in a range of $2.6 to $3.9 trillion over the ten-year budget window.

Why does this matter? There are at least two reasons: one is political, the second is procedural.

On the political side, fiscal conservatives, particularly in the House, may resist any legislation that increases the deficit.

The procedural side is a bit more complicated. In simplified terms, under the Congressional Budget Act, when a bill is considered under the "regular order" legislation that loses revenue during certain measuring periods within and over the ten-year budget window is subject to a point of order. A point of order is an objection that can be made when a member of Congress believes that a rule has been broken. If the objection is sustained, the point of order can be waived in the House by a majority vote, but in the Senate it requires 60 votes. The Republicans will have 52. Thus, if tax reform legislation loses revenue during the budget window and if the Democrats remain united they can defeat the bill by raising a Budget Act point of order. Moreover, notwithstanding the Budget Act, if the bill is considered under the regular order in the Senate, it can be subject to a filibuster, which also requires 60 votes to overcome. The bottom line is that proceeding under the regular order is not likely to produce a bill in the Senate unless at least 8 Democrats support it. The current speculation is that the Republicans will try to reach an agreement with a sufficient number of Democrats in the Senate by including some of their priorities, such as infrastructure funding.

In Washington, there is almost always a way out. If the regular order is not available, there is an alternative. In this case it is the "reconciliation" process. Again in simplified terms, legislation that implements a budget resolution is afforded procedural protection in the Senate. Specifically, the reconciliation procedure specifies a time limit for debate (which precludes a filibuster) and, so long as the legislation complies with the instructions of the budget resolution, it is not generally subject to points of order.

The foregoing description masks a number of practical difficulties in utilizing the reconciliation process. First, a budget resolution is required. A budget resolution is the agreement of the House and Senate (the President is not involved) on the revenue and spending parameters for the fiscal year to which the resolution relates. Even when both chambers are controlled by the same party, it is sometimes difficult to pass a budget resolution. In the current context, fiscal conservatives in both the House and Senate as well as differing substantive legislative priorities could make passage contentious.

Second, while any legislation that implements the terms of the budget resolution is afforded the procedural protection of the reconciliation process, in the Senate there are special rules that have to be navigated. In particular, a reconciliation bill is subject to a 60-vote point of order (under the so-called Byrd rule) if it increases the deficit outside the ten-year budget window. Provisions that do not produce a change in revenue are also subject to a point of order. Thus, even if a budget resolution authorized a revenue loss for the ten-year budget window, a bill would be subject to a 60-vote point of order if it produced a loss outside the budget window. (Avoiding this rule is why the 2001 Bush tax cuts expired after ten years.) Accordingly, even if the potential 10-year revenue loss of tax reform legislation was authorized by a budget resolution, an "out-year" cost would subject the bill to a point of order that would require 60 votes to overcome. It is difficult to see how a politically acceptable ten-year sunset could be crafted to avoid this rule.

Finally, there is an unresolved issue as to whether there can be more than one tax reconciliation bill implementing a budget resolution in a single Session of Congress. Republicans have indicated that they want to use the reconciliation process to repeal the Affordable Care Act. If the ACA repeal is deemed a tax reconciliation bill (because it contains the repeal of the many tax provisions in the ACA), the reconciliation process might not be available for tax reform in the first Session unless it is combined with ACA repeal legislation. Achieving agreement on the terms of a combined bill would be difficult and time consuming.

Once again there is a potential solution and it is under active consideration. The Congress has not yet passed a budget resolution for the current fiscal year that ends on September 30. The thought is that the Republicans could in January pass a budget resolution for FY 2017 that would contain reconciliation instructions with respect to ACA repeal. Then, if they find that they cannot pass a tax reform bill under the regular order they could later pass a budget resolution for FY 2018 that would include tax reform instructions. The negotiations over the contents of that budget resolution could become complicated, particularly if the tax provisions lose revenue over the 10-year budget window.

As the foregoing illustrates, actual implementation of the reconciliation process to accomplish tax reform raises significant substantive and procedural challenges. Consequently, the Republicans would prefer to proceed under the regular order to avoid the limitations of the reconciliation process and the potential conflicts that could arise in the context of negotiations over the contents of a FY2018 budget resolution.

Conclusion

This report is intended to provide background for the forthcoming debate over substantive business income tax reform. Others will follow as the debate proceeds.

Hank Gutman is available to answer questions regarding both the substance and process of tax reform.

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