

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

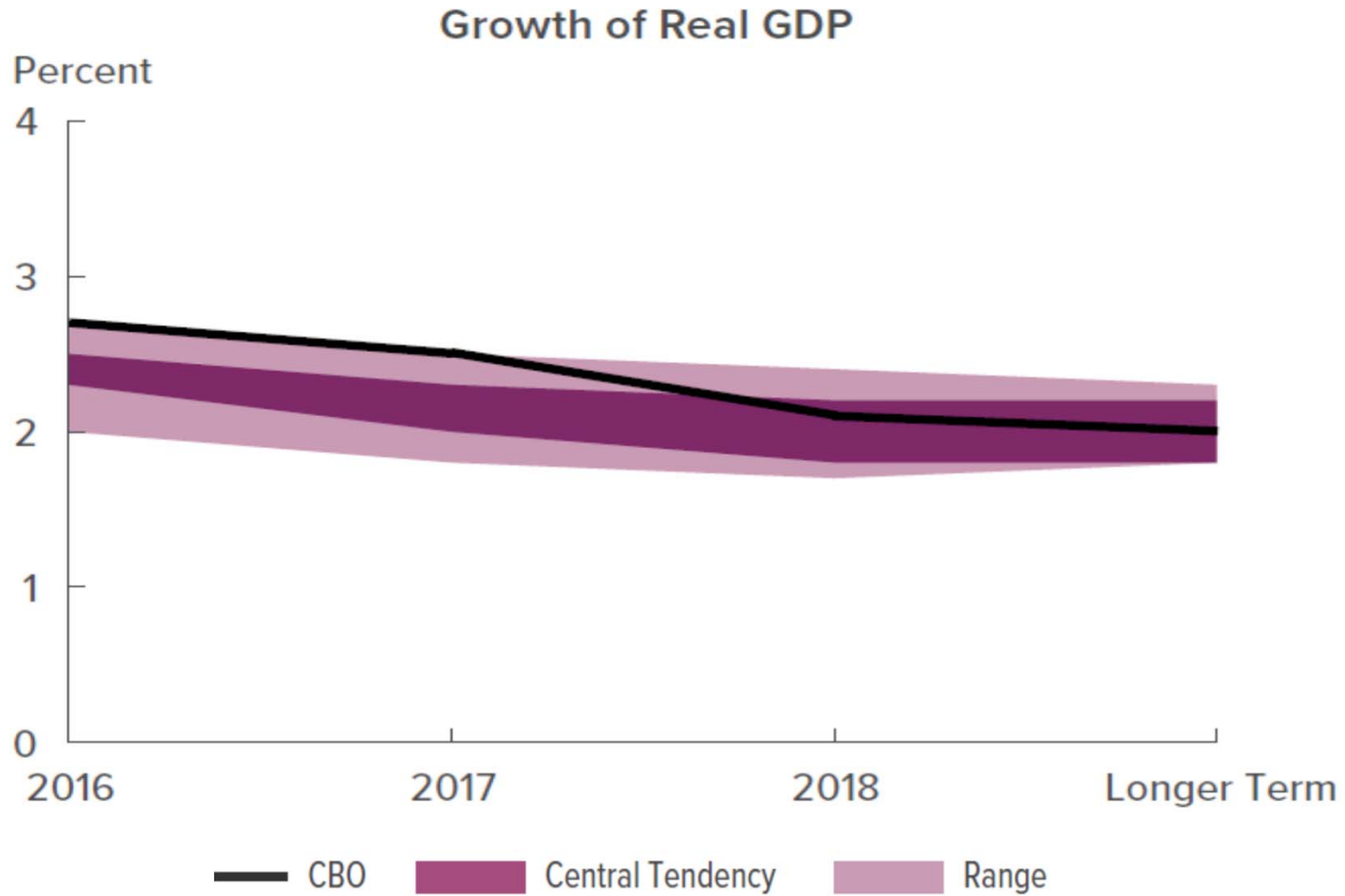
- The Context
- The Proposals
- The Difficulties
- The Sensible Alternative
- What Happens Next

THE CONTEXT

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- Republican control of White House, Senate and House of Representatives
 - Republicans have only 52 votes in Senate, creating potentially difficult procedural issues
- Professed desire to enact reform
- Fiscal constraints
 - CBO projects increasing annual deficits through 2017
 - Cumulative deficit - \$9.5 tr.
 - Public debt - \$25 tr. (88.9% of GDP)

GDP GROWTH PROJECTIONS



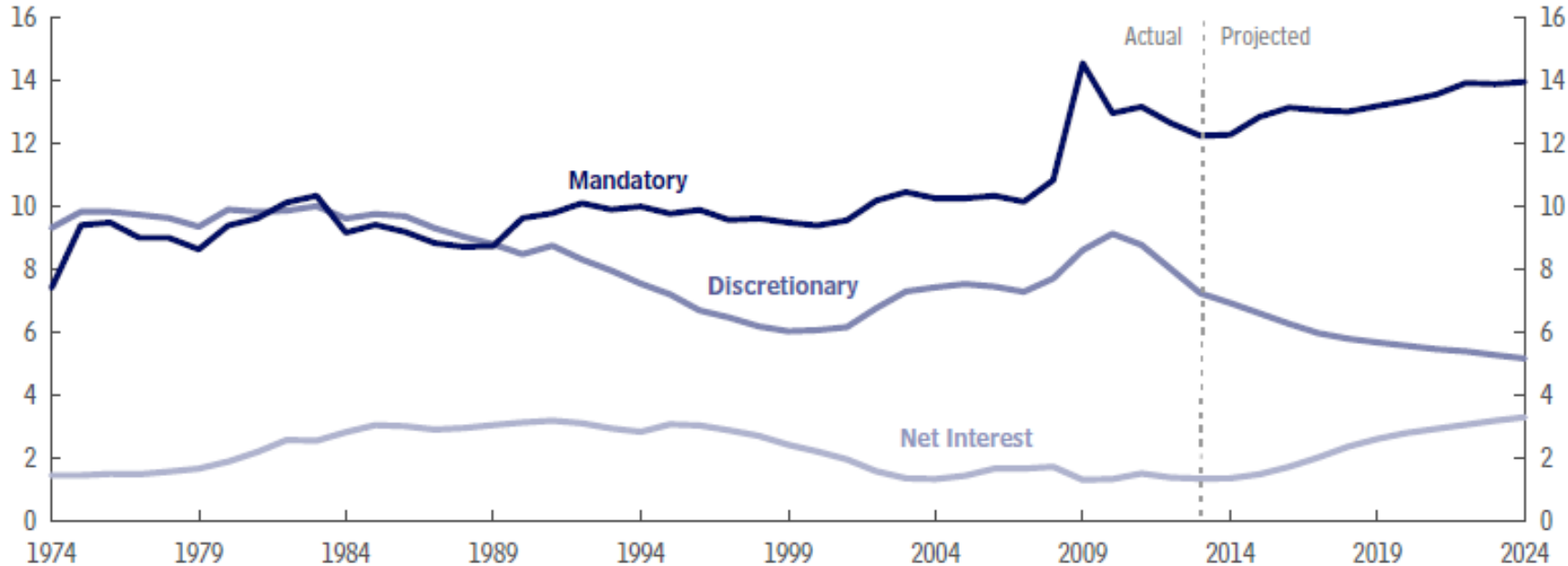
FEDERAL DEBT HELD BY THE PUBLIC, 1790-2047

■ Percentage of GDP



TAX REFORM: BUDGET CONSIDERATIONS – FEDERAL EXPENDITURES

(Percentage of gross domestic product)



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

WHAT IS DRIVING THE PROCESS

- High corporate tax rate
- Tax base erosion
 - IP transfers
 - Earnings stripping
 - Aggressive transfer pricing
- Inversions
- 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
- Staggering political and technical ineptitude of the Administration

WHAT REALLY MATTERS

- Congressional Process
- Fiscal Responsibility (or Not)
- Presidential Leadership

SOME RECENT COMMENTS—YOU TRY TO RECONCILE THEM

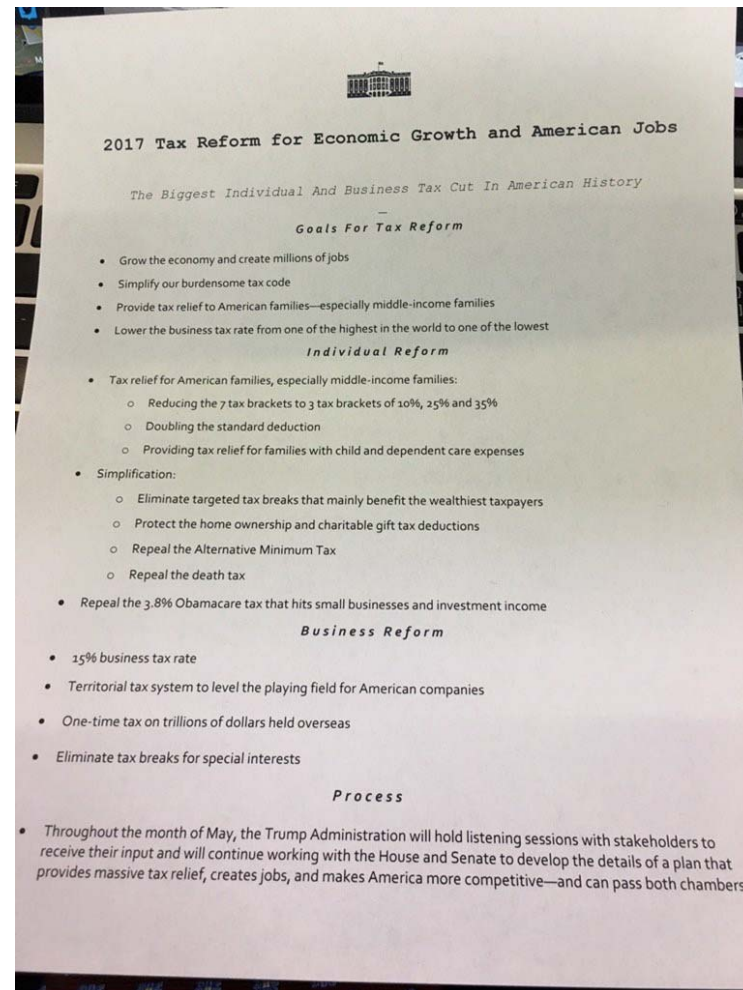
- **The DBCFT border adjustment is “economically equivalent and trade equivalent” to a VAT but it should not be labelled as one. Kevin Brady- 1/24/2017**
- **Timing**
 - House Speaker Paul Ryan (R-Wis.) has told colleagues he expects legislation to emerge in September after Republicans in the House, Senate and White House reach agreement. Politico- 6/2/17
 - We will have a very detailed, drafted tax plan to be delivered to Congress by when they get back from the August recess,” Cohn said today in a Fox Business Network interview. Politico- 6/2/17
 - Former House Speaker John Boehner said ... plans for massive tax reform initiated by President Trump and House Republicans are “just a bunch of happy talk.” Economic Policy Journal- 5/26/17
- **Revenue Neutrality**
 - The budget’s assumption on tax reform “is not an indication of what our preference is, as far as tax policy,” Office of Management and Budget Director Mick Mulvaney said in an interview with the *Washington Examiner*. “In fact, several folks in the White House have said that they are interested in pushing a larger tax bill that would add to the deficit,” he added. Tax Notes- 6/2/17
 - Senate Majority Leader Mitch McConnell said that any tax overhaul can’t add to the growing U.S. budget deficit, a position that places him at odds with President Donald Trump, who has called for a significant tax cut. Bloomberg Politics-5/16/17
 - House of Representatives Ways and Means Committee Chairman Kevin Brady has indicated that the US tax reform that he expects to propose early in 2017 will “break even,” on a dynamic scoring basis, which accounts for additional revenue from increased economic growth. TaxNews.com 11/17/16
- **On Border Adjustability**
 - In response to questioning by Rep. Lloyd Doggett (D-TX), Secretary Mnuchin affirmed that he has concerns with the proposal in its current form and said his understanding is that Chairman Kevin Brady (R-TX) is going to look at changes. EY Tax News Update 5/25/17
 - Despite concerns from other Republican Committee members, Tax Policy Subcommittee Chairman Peter Roskam (R-IL) continued to champion border adjustability as an anti-base erosion mechanism. Ibid.
 - Referring to one of these design issues in the House Blueprint, Hatch acknowledged that “at least a handful of senators” have reservations about the House Republicans’ border-adjustment proposal – also known as a destination-based cash flow tax (DBCFT). Deloitte Tax News and Views. 2/3/17

THE PROPOSALS

THE MAJOR PROPOSALS

- House Republican Blueprint, “A Better Way”
 - The current starting point for the 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



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

- Corporate Rate—20%
- Repeal Corporate Minimum Tax
- Replace corporate tax with a “Cash Flow” tax
 - Full expensing of the costs of investments other than land
 - No current deduction for net interest expense
 - Border adjustment
- Eliminate section 199 and other unspecified deduction and credits
- Retain enhanced R&E credit
- Indefinite carryover of 90% of NOL's with interest
- Retain LIFO

Trump

- Corporate Rate—15%
- [Repeal Corporate Minimum Tax
- Domestic manufacturers may elect full expensing of capital improvements with denial of net interest expense
- Eliminate section 199 and other unspecified deductions and credits
- Retain R&E credit]
- No provision
- 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

- Tax Foundation—(\$191 b.)
- Tax Policy Center—(\$3 tr.)

Trump Proposals

- No official score because proposals are too vague.
 - Tax Policy Center estimates a revenue loss of \$6.2 tr. with added interest costs of \$.8 tr.
 - Administration will argue cost is lower by aggressive use of “dynamic scoring” which purports to take into account the effect of the tax proposals on the macro-economy
 - Administration projects 3% growth
 - No intelligent adult believes this

ESTATE PLANNING ISSUES

- Repeal of Transfer Taxes
 - All or just estate and GST
 - Estate tax estimated receipts through 2026—approximately \$400 billion
- Gains at Death?
 - Exemption levels
 - Structure
 - Taxable unit
 - All gratuitous transfers?
 - Non-marketable assets
 - Losses
 - Charitable transfers
 - Life insurance
 - Property subject to a power of appointment
 - Non-charitable transfers in trust
 - Transfers to partnerships and corporations
 - De Minimis rules
 - Tangible personal property
 - Anti-abuse rules
 - Effective date
 - Grandfather existing assets
 - Apply to appreciation after effective date
 - Apply to gift or death after effective date
- Income taxation of pass-through entities
- Income taxation of capital income
- Treatment of life insurance
- Repeal of ACA investment income taxes

THE DIFFICULTIES

THE DIFFICULTIES

- On tax reform, see *Showdown at Gucci Gulch*, the story of the 1986 tax act.
- 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 Republican Blueprint replaces 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 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?
 - What to do about export companies in a permanent loss position?
 - How to deal with pass-through abuse/
 - “Border adjustability” may raise considerable revenue so long as the U.S. has a trade deficit
 - “Border adjustability” raises serious WTO compliance concerns
 - Importers are not happy
 - The scope of the territorial tax, including anti-abuse provisions, needs to be determined
 - Transition rules will be critical
 - A very select bibliography
 - **Volume 8 of the Columbia Journal of Tax Law (2017)**
 - Hariton, Planning for Border Adjustments: A Practical Analysis, Tax Notes, 2/28/17
 - Hariton, Financial Transactions and the Border-Adjusted Cash Flow Tax, Tax Notes, 1/9/17
 - Barnes and Rosenbloom, The Destination- Based Cash Flow Tax is a VAT?, Tax Notes, 3/13/17
 - Barnes and Rosenbloom, U. S. Corporate Tax Reform and Wallace Stevens, Tax Notes, 5/1/17
 - The Hatch plan is a totally different approach and does not address individual taxation

THE DIFFICULTIES

- 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
 - E.g. Blueprint: Importers vs. exporters
- Trade agreements (Blueprint)
- Politics of business-only tax reform

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

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.

A COMPARISON OF A BACFT AND A VAT

- How have countries typically financed corporate rate reduction?
- How many countries have a BACFT? A VAT?
- Are they both consumption taxes? Why?
- What is the economic incidence of a BACFT? A VAT?
- What is the price effect of introducing a BACFT? A VAT?
- What is the projected effect on inflation of a BACFT? A VAT?
- What is the projected effect on economic growth of a BACFT? A VAT?
- What is the effect on trade of a BACFT? A VAT?
- What are the WTO consequences of a BACFT? A VAT?
- What are the constitutional implications of a BACFT? A VAT?
- Does a BACFT affect existing bilateral tax treaties? A VAT?
- Which is more administrable/less likely to be abused?
- Which is more transparent—a BACFT or a VAT?
- Which raises more issues with respect to form of business organization (e.g., corporate v. non-corporate)?

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

WHAT HAPPENS NEXT

- Extremely difficult to predict
- Things to watch for
 - Progress on ACA repeal
 - Release of Republican draft
 - Release of details of Trump plan
 - Treasury personnel decisions and confirmation
 - Congressional hearings
 - Budget resolution relating to taxes
 - Reaction of the Senate

PRESENTER

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