Federal Tax Legislative Update

Here We Go Again!
Will Tax Reform Finally Happen?

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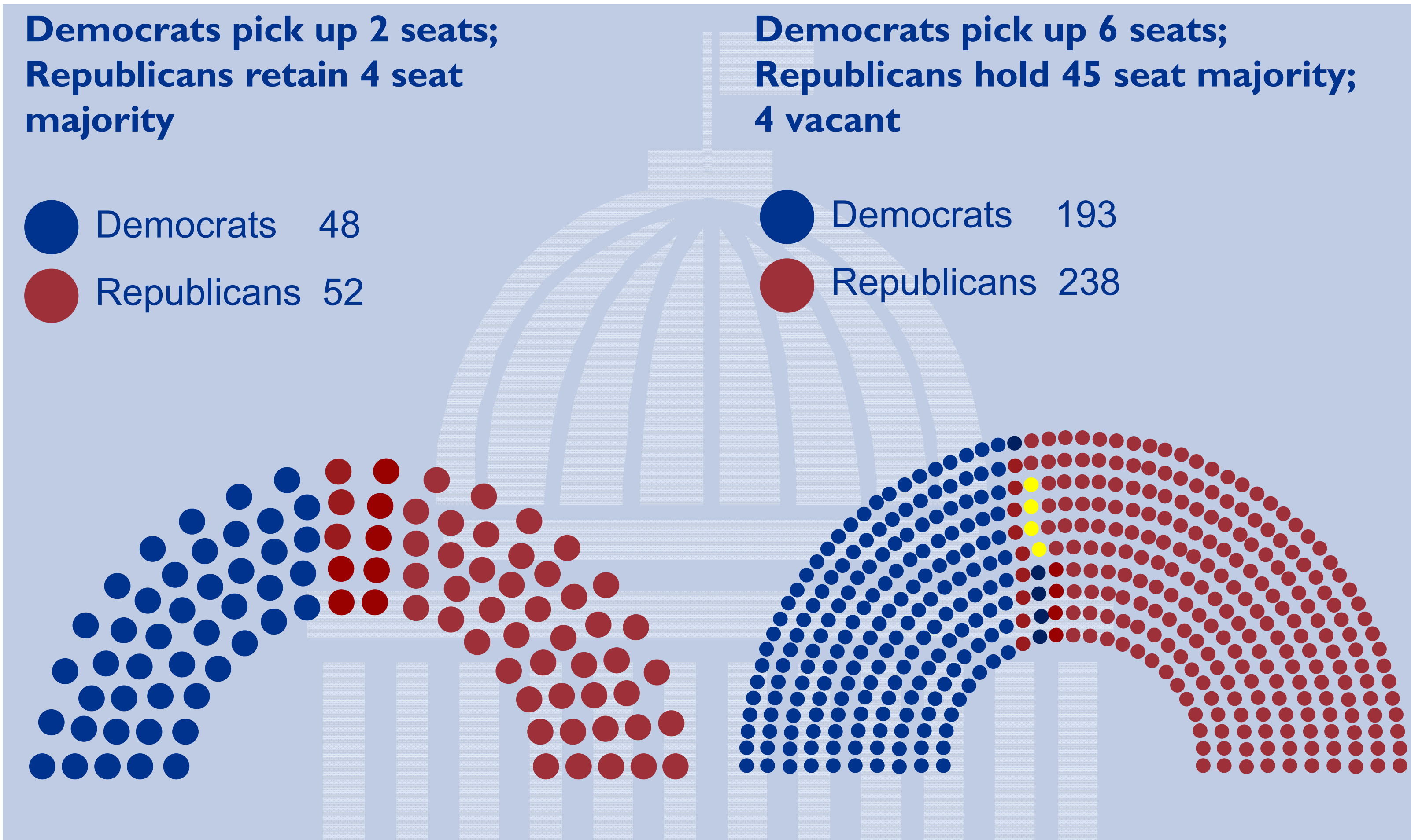
Agenda

- The Context
- The Proposals
- The Difficulties

THE CONTEXT

Congressional election results



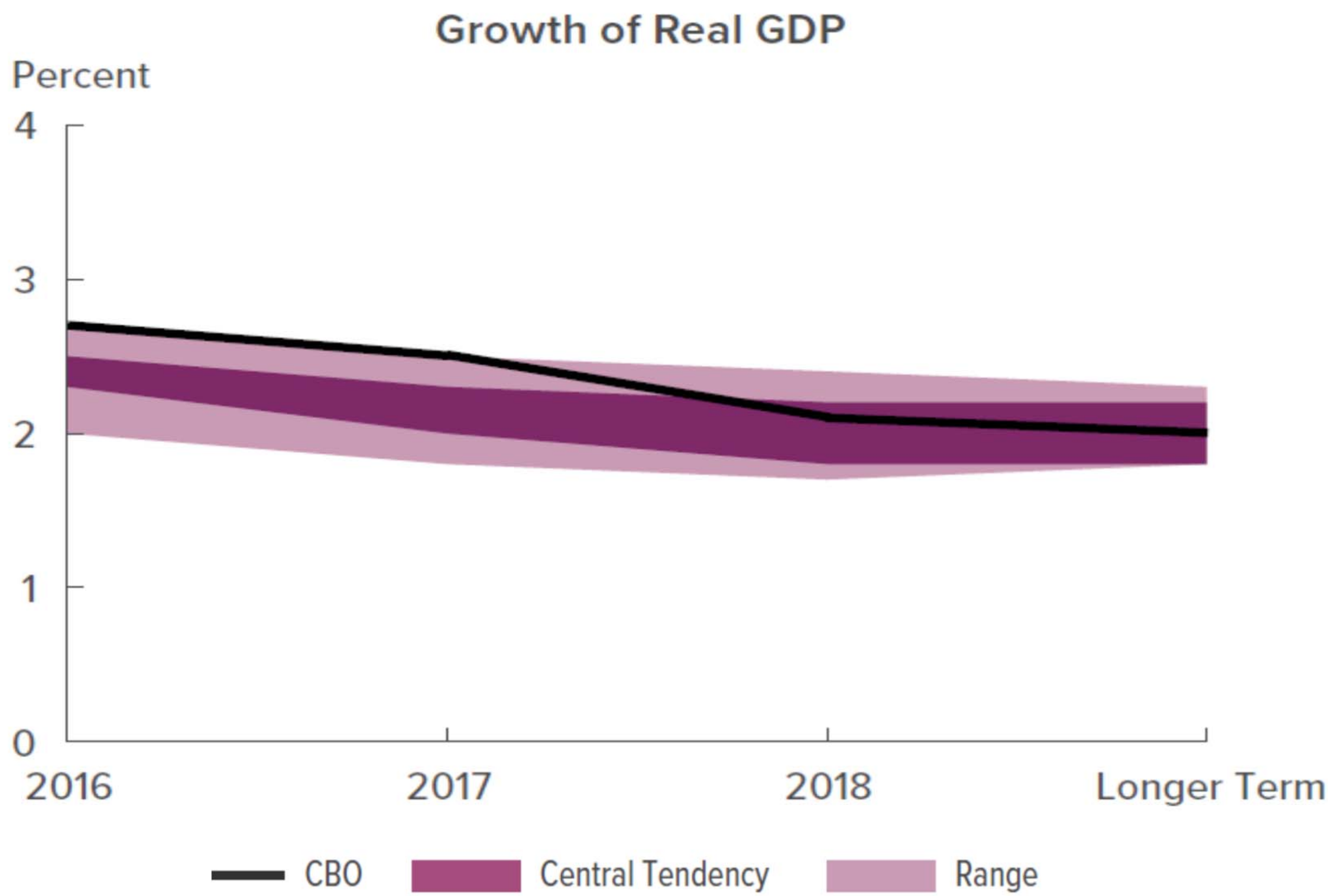
Budget reconciliation

- Budget Act of 1974
  - Budget resolution sets revenue and spending (except Social Security)
  - Limited debate in Senate for reconciliation bills – avoids filibuster
- Limitations: The Byrd Rule
  - Every provision of reconciliation bill must affect spending or revenue
  - No title of reconciliation bill can increase the deficit beyond the budget window
    - JCT estimates business tax rate cuts trip rule

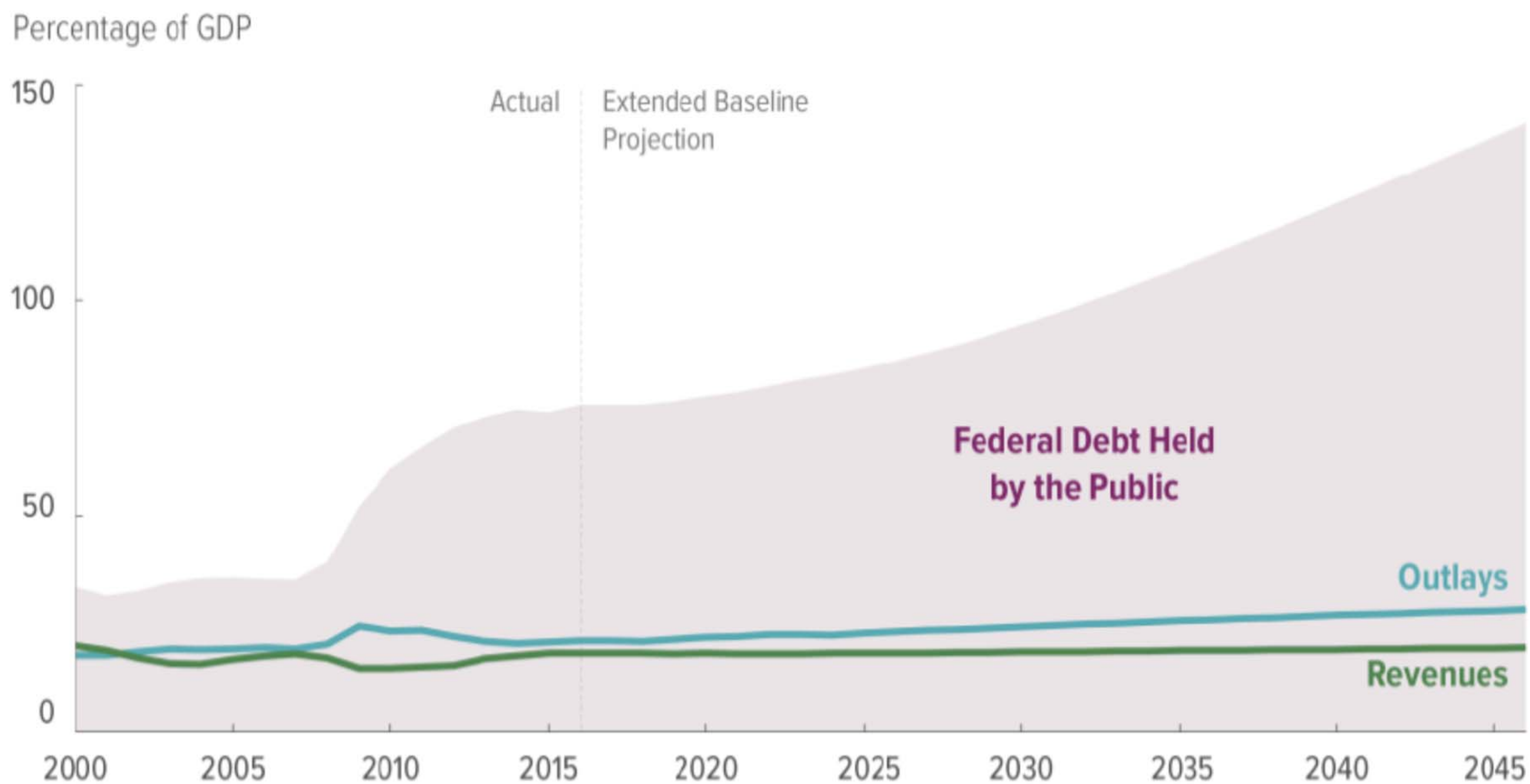
The economic challenges

1. Slow growth
2. Deficits and growing debt
3. Crumbling infrastructure

GDP Growth Projections

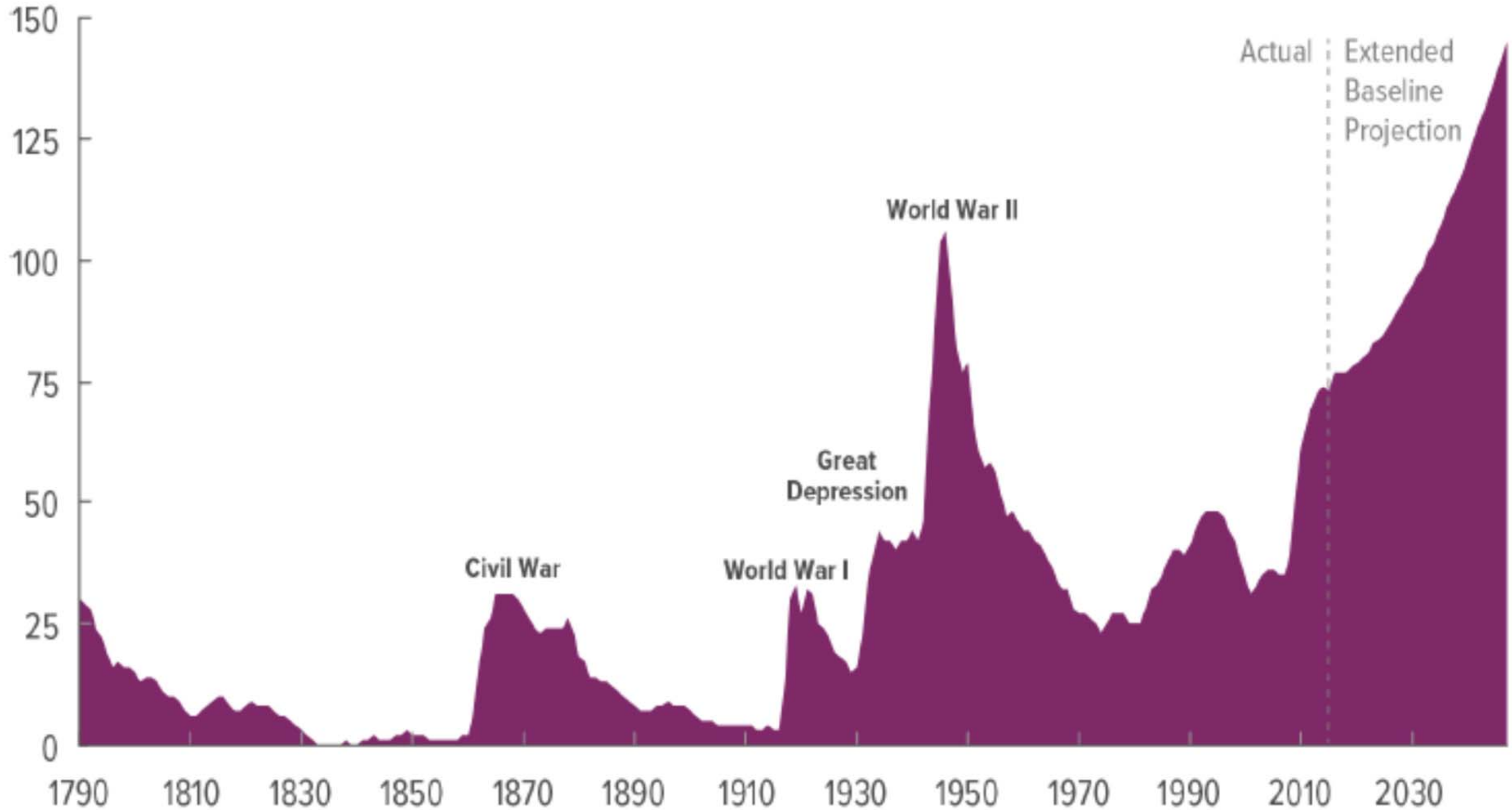


Federal debt, outlays, and revenues

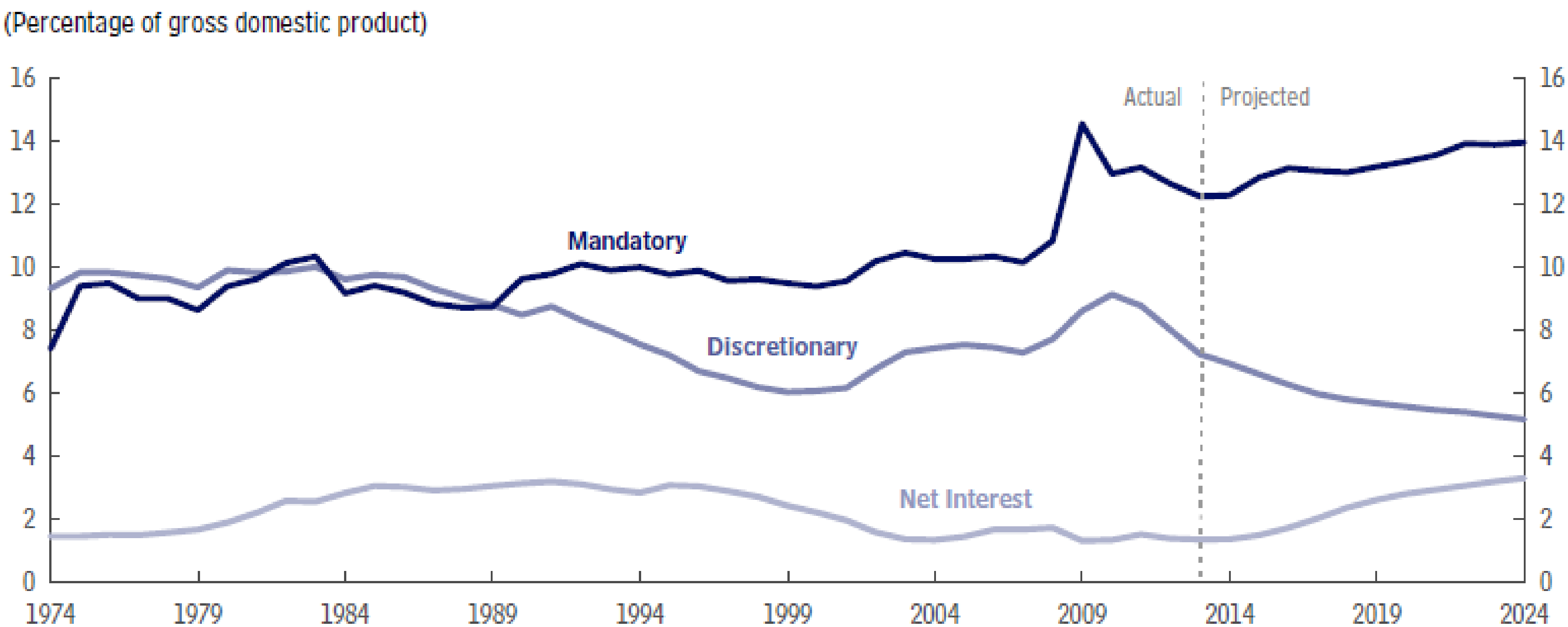


Federal debt held by the public, 1790-2047

- Percentage of GDP



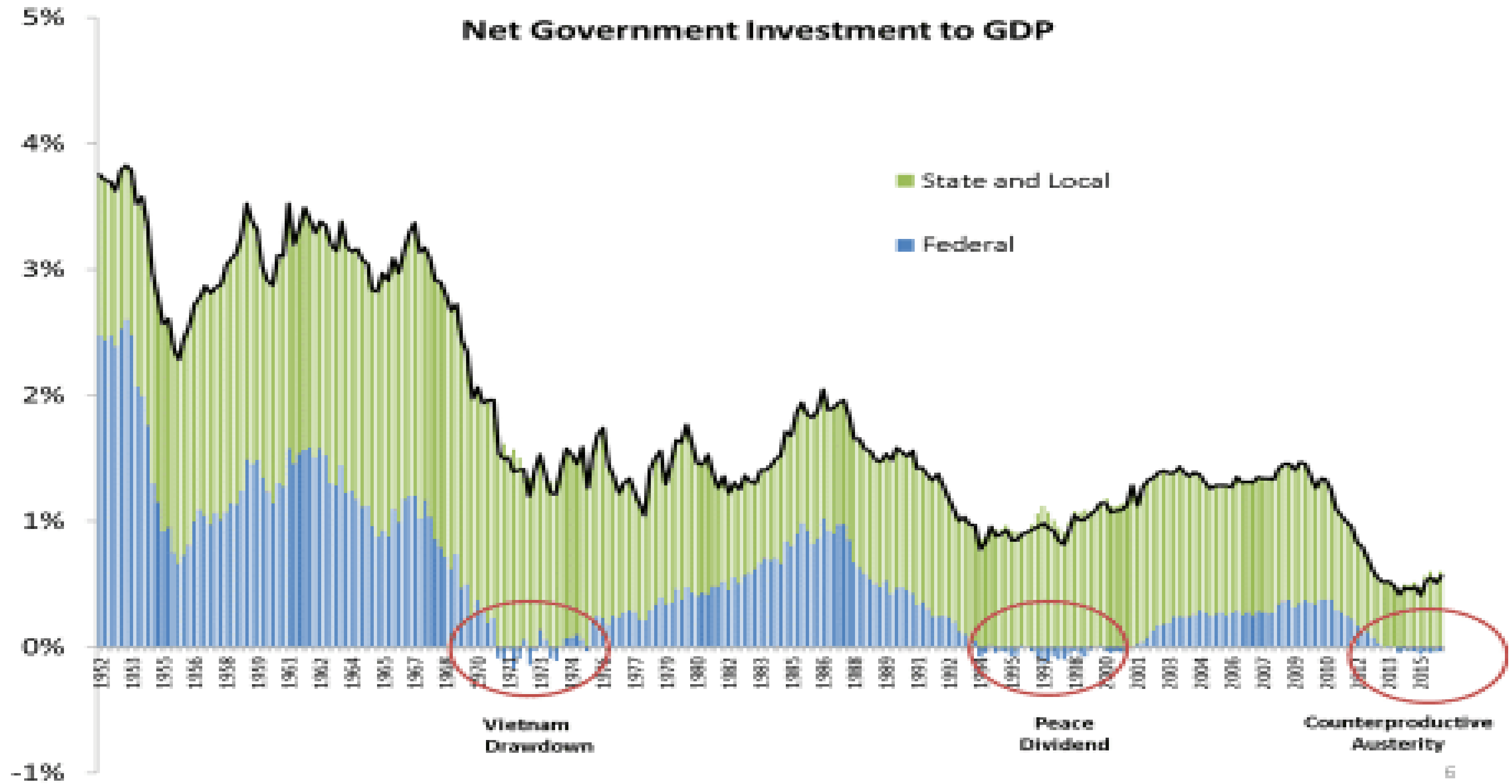
Tax reform: Budget considerations – Federal expenditures



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

Infrastructure: The one area of agreement

Net Federal Investment Negative



Source: Lawrence Summers, Brookings Institution Conference, "Strengthening the Safety Net to Mitigate the Effect of Future Recessions" (May 23, 2016)

Impetus for reform – International issues

Issues

- U.S./foreign rate differentials
- U.S. base erosion
- BEPS and state aid investigations
- Inversions

Possible solutions

- Reduce rates – Trump "principles"
- Tax income based on destination of sales – Blueprint, consumption tax
- Shift tax to equity owners - integration

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

Republican Blueprint and Trump Campaign 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

Trump

- Individual income tax rates of 10, 25 and 35%
- Maximum 20 rate on capital gain
- 3.8% net investment tax repealed
- Double standard deduction
- Repeal AMT
- Eliminate itemized deductions other than home mortgage interest and charitable contributions (not explicit)
- New deductions, credits or other incentives for child and dependent care expenses
- Repeal estate tax

Republican Blueprint and Trump Campaign Business Tax Proposals

Republican Blueprint	Trump

▪ Corporate Rate—20%
▪ Repeal Corporate Minimum Tax
▪ Replace corporate tax with a "Border-Adjusted 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
	▪ Corporate Rate—15%
	▪ Small business passthroughs rate – 15%
	▪ Repeal Corporate Minimum Tax (?)
	▪ Eliminate unspecified tax breaks for "special interests"

Republican Blueprint and Trump Business Tax Proposals

Republican Blueprint	Trump

▪ 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
	▪ Move to territorial tax system
	▪ Deemed repatriation tax on all accumulated deferred foreign earnings – rate to be determined

Republican Blueprint and Trump Tax Plan Costs

Republican Blueprint	Trump Campaign Proposals

▪ Tax Foundation—($191 b.)
 	
▪ Tax Policy Center—($3 tr.)
	▪ Tax Foundation
	  ▪ Conventional scoring –($4.4-$5.9 tr.)
	  ▪ “Dynamic” scoring—($2.6-$3.9 tr.)
	▪ Tax Policy Center
	  ▪ Conventional scoring—($6.2 tr.)
	  ▪ “Dynamic” scoring—($7 tr.)
	▪ “Dynamic” scoring takes into account increased Federal interest expense and macroeconomic effects

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 (although Trump principles lack crucial details)
    - 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.
      - "Border adjustability" raises considerable revenue
      - "Border adjustability raises serious WTO compliance concerns
      - Importers are not be happy
      - The scope of the territorial tax, including anti-abuse provisions, needs to be determined
      - Transition rules will be critical
  - 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

"The Five Biggest Obstacles to Trump's Plan to Overhaul the Tax Code"

By Kelsey Snell, The Washington Post, Dec. 23, 2016

- Cutting rates without ballooning the deficit [by $2.6-5.9 trillion].
- Selling a plan that will help the super-rich.
- Finding a way to tax international businesses.
- Getting Democrats on board.
- Persuading the business lobby

What Happens Next

- Extremely difficult to predict at the moment
- Things to watch for
  - Release of Republican draft
  - President's Principles
    - Details missing
    - Personnel decisions and confirmation
  - Effect of ACA failure
  - Congressional hearing announcements
    - Roskam House hearings
  - Budget resolution relating to taxes
  - Reaction of the Senate

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 & Obama budgets)

- 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; revenue used for infrastructure

Another Business Tax Alternative

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

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 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

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