A quick guide to US federal tax reform

Tax reform is a clear priority for both Congress and President Donald Trump, and Republican control of both houses of Congress and the White House makes the prospect of achieving significant tax reform much more likely within the next year. House Speaker Paul Ryan and Senate Majority Leader Mitch McConnell have both pledged to move tax reform legislation using the "budget reconciliation" rules. The use of the reconciliation rules would mean that only 50 senators would be necessary to approve legislation (with Vice President Mike Pence serving as the tie-breaking vote) rather than the usual 60-vote supermajority needed to move most legislation through the Senate. Thus, a tax reform measure could pass with only Republican support.

Reform ideas have been under development for some time — and continue to be shaped

A lot of the background work for tax reform stems from proposals and negotiations that have taken place over the last decade. Perhaps most significant are the 2005 Bush Advisory Panel on Federal Tax Reform report and the tax reform plan put forward by then-Chairman of the House Ways and Means Committee Dave Camp.[1]

In 2016, Trump briefly outlined a tax reform plan during his campaign – and he plans to release a detailed tax package soon. Also in 2016, the Republicans in the House of Representatives released the so-called Blueprint for tax reform,[2] the sixth and final plank of Ryan's "Better Way" campaign to provide Republican policy proposals on significant issues.

The Blueprint, a framework around which legislative language may take shape, proposes significant changes to the tax system, including:

- Lowering the statutory corporate tax rate to 20%
- Creating a new 25% tax rate for business income earned by pass-through entities
- Moving the US business tax regime toward a cash-flow destination-based tax through:
  - Immediate expensing of all capital expenditures (other than for land)
  - Eliminating deductibility of net interest expense
  - Implementing a border tax adjustment mechanism[3]
  - Eliminating most business preferences except the research and development tax credit and the last-in, first-out method of accounting
  - Imposing a territorial international tax system (with a one-time tax on accumulated foreign earnings as a transition mechanism)

[1] See "Five things businesses need to know about Chairman Camp's tax reform plan," http://www.ey.com/Publication/vwLUAssets/EY-five-things-businesses-need-to-know-about-chairman-camps-tax-reform-plan/$FILE/EY-five-things-businesses-need-to-know-about-chairman-camps-tax-reform-plan.pdf.
[2] See "Post-election focus: five things to know about the House GOP's tax reform Blueprint," http://www.ey.com/Publication/vwLUAssets/EY-post-election-focus-five-things-to-know-about-the-house-gops-tax-reform-blueprint/$FILE/EY-post-election-focus-five-things-to-know-about-the-house-gops-tax-reform-blueprint.pdf.
[3] See "US tax reform – what you need to know about border adjustments," https://www.taxnavigator.ca/Login/ViewEmailDocument.aspx?AlertID=35730.

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Along with the business tax changes, the Blueprint proposes to set individual income tax rates at 12%, 25% and 33%, with most itemized deductions eliminated other than the charitable contribution and mortgage interest deductions (which could each be modified). The Blueprint also proposes taxing investment income (dividends, interest and capital gains) at essentially one-half of the otherwise applicable rates and repealing the estate tax.

Trump's tax plan, announced during the campaign, differs from the Blueprint in several key ways. His plan would:

- Lower the corporate tax rate to 15%, with the same rate imposed on business income earned by pass-through entities
- Allow manufacturers to elect to expense capital investment; those manufacturers that make the expensing election would lose the ability to deduct corporate interest expense
- Lower the individual income tax rates to 12%, 25% and 33% (the same as in the Blueprint)
- Keep the current capital gains rates at existing levels (but repeal the 3.8% net investment tax)
- Cap itemized deductions at $100,000 for single filers and $200,000 for married filers

Regarding international tax reform, while the President has indicated support for a mandatory deemed repatriation of previously untaxed foreign earnings of US companies (an approach that is reflected in the Blueprint), taxed at a 10% rate, he has expressed reservations about the Blueprint's border adjustability proposal, calling it "too complicated." Moreover, the new Administration has not made clear whether it supports the Blueprint's proposed move to a territorial system or whether it supports a worldwide system with repeal of deferral going forward, which had been proposed by then-candidate Trump early in the presidential campaign.[4]

One other significant difference between the Blueprint and the Trump campaign plan is that the Blueprint, according to its authors, is largely revenue-neutral, using dynamic scoring. The Trump plan has been scored by various nongovernmental groups as costing trillions of dollars (although Trump's Treasury Secretary, Steven Mnuchin, has stated that his preference would be that tax reform be revenue-neutral).

Political landscape

Interestingly, while some of the elements of business tax reform proposed by Republicans could form the basis for discussions with Democrats, the two parties differ greatly over whether to reduce individual tax rates — a key component of both the Blueprint and the Trump campaign plan. The parties also do not agree on important revenue issues. These include whether reform should be revenue-neutral on a static, as opposed to a dynamic, basis (that is, should revenue from assumed economic growth be considered) and whether proposals that would raise revenue on a one-time basis (such as the deemed repatriation proposal) should be used to pay for a permanent tax rate reduction. Those differences become irrelevant, however, should the Republicans follow through with their plan to use the budget reconciliation process to advance tax reform, as under that process, Senate Democrats could have little power to change or block the legislation (and House Democrats would have no such power even under ordinary rules).

The Ways and Means Republican tax staff is in the process of receiving feedback and building out the Blueprint by drafting detailed statutory language. It is possible that the formal tax reform process could start in the House Ways and Means Committee in the April/May time frame.

Conclusion

Although many issues remain to be determined, tax reform is a top priority for both the Trump Administration and Congress. Businesses should closely monitor the debate and model the potential effects of the leading tax reform proposals. Companies that understand the concepts behind the Blueprint and other approaches to reform and that engage with policymakers now will be better positioned as the final product takes shape.

[4] See "EY compares Trump tax positions with House Republican Blueprint," https://www.taxnavigator.ca/Login/ViewEmailDocument.aspx?AlertID=35730.

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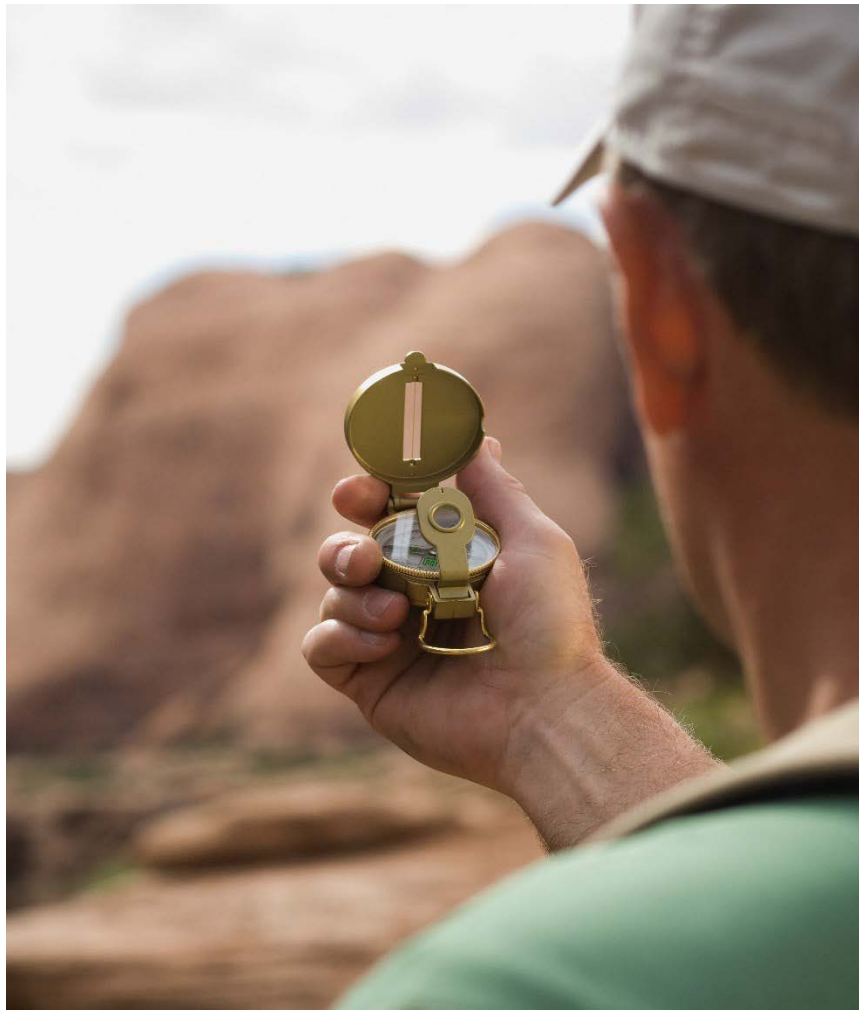

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