Executive summary

After the most tumultuous and unpredictable campaign in modern US history, Republican Donald Trump upset Democrat Hillary Clinton to win the Presidency on 8 November 2016, claiming at least 279 electoral votes (270 electoral votes to win) to Clinton’s 228, with results in Arizona, Michigan, and New Hampshire still outstanding, according to the Associated Press. The popular vote margin remains close, with Trump currently trailing by approximately 200,000 votes out of a total of almost 120 million votes that have been counted. Clinton’s blue wall of support was pierced by Trump with unexpected wins in Pennsylvania and Wisconsin. He also won the needed battleground states of Florida, Ohio, and North Carolina. With fewer losses than expected, Republicans will retain their majorities in the House and Senate.

Clinton, who called Trump in the early morning of 9 November to concede the race, said at her press conference, “I offered to work with him [Trump] on behalf of our country” and “our nation is more deeply divided than we thought,” but went on to say, “we stand together...and our best days are still ahead of us.”

In his remarks shortly before 3:00 AM on 9 November, President-elect Trump said, “It is time to bind the wounds of division. It is time for us to come together as one united America.” He went on to say that it was “not a campaign, but an incredible movement.” And, alluding to his policy agenda, Trump said we
Global Tax Alert

“would be working together to begin the task of rebuilding our nation and renewing the American dream.” Trump has touted an agenda of revitalizing the economy and promoting job growth by reforming the tax code, rebuilding America’s infrastructure, repealing and replacing “Obamacare,” and being “tough” on immigration and in renegotiating international trade agreements.

Maintaining the Senate majority will give Republicans the ability to set the agenda in the Senate. However, bipartisan cooperation still will be necessary to achieve meaningful policy accomplishments as Senate rules generally require a 60-vote threshold for movement on most issues.

This Alert summarizes the tax landscape, including the focus on comprehensive tax reform.

Detailed discussion

The surprising results of the election have teed up comprehensive tax reform as a clear priority for the new Republican President and the Republican Congress. A unified Republican Government makes the process of achieving significant tax reform much more manageable next year, in particular because House Speaker Ryan during the campaign pledged to move such a plan in the form of so-called budget reconciliation legislation, which would mean that only a simple majority of senators would be necessary to pass the plan, rather than the usual 60-vote majority. A lot of the groundwork has been laid through proposals and negotiations over the last three or four years on various key aspects of business tax reform, but Congressional Republican leaders and the new President will have to decide whether to push forward with legislation that embodies the House Republican Tax Reform Blueprint, or the outlines of a tax reform plan that President-elect Trump championed during the campaign. One significant difference is that the Blueprint, according to its authors, is largely revenue neutral using dynamic scoring, while the Trump plan was scored by various non-governmental groups as losing trillions of dollars.

House Speaker Ryan has said on multiple occasions that tax reform is his top priority. The Blueprint, the sixth and final plank of Ryan’s “Better Way” campaign to provide policy alternatives, proposed a 20% statutory corporate tax rate, a 25% business tax rate for pass-through entities, a move toward a cash-flow consumption tax through immediate expensing for all businesses and elimination of deductibility of net interest expense, a territorial international tax system, a border tax adjustment mechanism, and elimination of most business preferences except the research and development (R&D) tax credit and Last in first out (LIFO). Interestingly, all of these pieces of business tax reform may be fair game in discussions with Democrats, but the two parties differ greatly over whether to reduce individual tax rates – a key component of both the Blueprint and the Trump campaign agenda – and over important revenue issues, including whether reform should be revenue neutral on a static basis, and whether timing and one-time revenue raisers should be used to pay for permanent tax rate reduction. The use of budget reconciliation, however, could make many of these differences irrelevant as Senate Democrats could have little power to change or block the legislation on the Senate floor.

Along with the 20% statutory corporate tax rate, the Blueprint includes a 25% business tax rate for pass-through entities; and individual rates set at 12%, 25%, and 33%.

Ways and Means Republican tax staff is in the process of receiving feedback and building out the tax reform Blueprint by drafting detailed statutory language. The publicly expressed goal is to have that effort completed by the end of 2016. In remarks at the University of Wisconsin–Madison on 14 October, House Speaker Ryan said, “I really want to get tax reform running as quickly as possible...”

As 29 September whether there is opportunity for progress on big-ticket items in 2017, Senate Majority Leader McConnell said, “We need to do tax-reform – comprehensive tax-reform – not piecemeal.”

Trump’s tax plan differs from the Blueprint in that the corporate tax rate would be lower – 15% – with the same rate imposed on pass through entities. The latest statement from the Trump campaign suggests that small business owners who do not retain earnings may face double taxation.

Individual income tax rates would be 12%, 25%, and 33%, the same as the House Republican tax reform Blueprint.

Trump and his staff have supported a 10% tax rate on the deemed repatriation of previously untaxed foreign earnings of US companies, but the campaign never made clear whether they still support repeal of deferral in a new international tax system going forward.

Trump has pledged to work with House Republicans on tax issues and, in addition to adopting their proposed individual rates, brought his plan closer to theirs by announcing support for immediate expensing of new business investments for manufacturers. The House plan proposed expensing in conjunction with eliminating the deductibility of net interest expense. In the follow-up to a 15 September speech to the
Economic Club of New York, Trump clarified that he believes expensing should be limited to manufacturers and those who elect expensing will lose the deductibility of corporate interest expense.

The Trump campaign also clarified in September that they favored repeal of most corporate tax expenditures, except for the R&D Credit. Trump additionally proposed capping itemized deductions at $100,000 for single filers and $200,000 for married filers and highlighted the benefits of his proposals for working Americans and the middle class. “By lowering rates, streamlining deductions, and simplifying the process, we will add millions and millions of new jobs. In addition, because we have strongly capped deductions for the wealthy, and closed special interest loopholes, the tax relief will be concentrated on the working and middle class taxpayer...” he said. “This is a working and middle-class tax relief proposal.” A campaign fact sheet proclaims that Trump's economic proposals would add 25 million jobs over a decade, which equates to 200,000 new jobs per month.

The motivating factors for tax reform will remain the same as they were in the current Congress, but a unified government should make enacting tax reform much easier. The statutory corporate income tax rate is seen as too high and the international tax system compels profit shifting to low-tax jurisdictions and erodes the US tax base. That phenomenon escalated this year with the European Commission’s latest State aid decision, which was seen as demonstrating a tension between the US and Europe over who should tax the foreign income of US multinationals.

The passage of the European Union's (EU) harmful tax competition directive will lead to enactment in all EU countries of a variety of measures that could increase taxes on US companies operating in Europe, while implementation of innovation box regimes in many countries, following the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project outline, will make it more attractive for US companies to move intellectual property and exploit that intellectual property into those jurisdictions. The Obama Administration took significant steps this year to try to prevent further erosion of the US tax base through regulatory action to deter inversions and earnings stripping, but all involved said these were Band-Aid approaches that were no substitute for US tax reform.

**Design issues – international tax reform.** As has been the case for the last few years, there is broad agreement on the design elements of business tax reform, and more specifically, international tax reform, but the devil is in the details. For example, the House Republican Blueprint on tax reform calls for a 8.75% tax rate on previously untaxed accumulated foreign earnings held in cash or cash equivalents, and a 3.5% tax rate on all other accumulated earnings, with tax liability payable over an eight-year period. This is the same tax treatment of accumulated foreign earnings called for under former House Ways and Means Committee Chairman Dave Camp’s Tax Reform Act of 2014 (the Camp bill).

But in a departure from the Camp bill, the Blueprint also calls for a move to a destination-basis tax system, under which border adjustments exempt exports from tax while taxing imports, making the tax jurisdiction the location of consumption rather than production. Exempting exports from US tax and taxing imports regardless of where they are produced will eliminate incentives for US businesses to move or locate operations outside of the United States under a territorial tax system, according to the Blueprint. By relieving exports from US tax while imposing US tax on imports, the Blueprint would eliminate the need for any new exemption or territorial tax system to be accompanied by a minimum tax or any other more conventional anti-base erosion measure, thereby sidestepping one of the more intractable and divisive debates among the business community over the past several years of tax reform discussions.

Developing a workable border adjustability mechanism that is not actually a component of a value-added tax presents some significant policy and technical hurdles.

US companies that are net exporters could end up in a perpetual tax loss position, and handing out refunds to some of the largest US companies may not work from a political standpoint, particularly as the domestic income of US companies (including the suppliers for exporting companies) is subject to tax. How to apply the border adjustability concept to cross-border flows of capital, or whether to exempt financial transactions must also be considered.

While moving to a form of exemption system has some level of bipartisan support, more liberal Democrats will insist on a more pure worldwide system that includes repeal of deferral. Senate Finance Committee Ranking Member Wyden (intermittently) and Senator Warren (consistently) have both backed the latter approach, and Speaker Ryan noted the differing viewpoints in September given that Democrats increasingly call for a worldwide system and repeal of deferral.
“There is a big gulf between our two views... We believe that we should have a pure territorial system... And so I do believe that this issue is coming,” Ryan said. “I don’t think you can stand against a territorial system much longer.” Ryan also remarked that “the experience I had when I was Ways and Means chair with [Democrats] was not a pleasant one, and I don’t know if that’s going to change.”

In an 8 September New York Times op-ed, Senator Warren said foreign developments are increasing pressure on Congress to cut corporations “a new sweetheart deal” in tax reform, but lawmakers should instead take the opportunity to collect more revenue from corporations.

“Preferential tax treatment, either through special rates or deferred due dates, creates a huge financial incentive for American companies to build businesses and create jobs abroad rather than in the United States. Our tax code should favor jobs and businesses at home - period,” Warren said.

Along with these political and mechanical questions, there is the question of whether such a system, embedded in an income tax rather than a value added tax or other true consumption tax, is legal from an international trade perspective.

**Design issues – paying for rate reduction.** There may also be tension among House Republicans given that the Blueprint has not had a full airing among members - it was released soon before Congress left for its summer recess - and the drafting of legislative language may make apparent what is necessary to achieve the stated goals, particularly the reduced rates: a 20% statutory corporate tax rate; a 25% business tax rate for pass-through entities; and individual rates set at 12%, 25%, and 33%. Once the details are hashed out, the Blueprint could present just as many trade-offs as previous serious tax reform proposals. While the mix of winners and losers may be different than under other proposals, the ultimate fate of the Blueprint will still be determined by the same fundamental political dynamics that would face any tax reform proposal.

For example, the Blueprint would permit companies to fully and immediately deduct the cost of all tangible and intangible property, with the exception of land. However, the Blueprint also would correspondingly deny deductions for net interest expense. Companies must therefore weigh whether losing interest deductions is a cost they are willing to incur in exchange for full expensing (and a 20% corporate rate).

The purpose for denying deductions for net interest expense is to prevent a presumed double benefit from fully expensing leveraged purchases of property.

However, the exclusion of land from full expensing under the Blueprint would be particularly severe for debt-financed purchases of land because the land would not be eligible for full expensing (or apparently even depreciation as under current law), while deductions for interest expense on the debt would not be permitted.

Moreover, the persistent issues under current law involving the allocation of purchase price between non-deductible land and immediately deductible improvements on the land would be intensified under the Blueprint. Other aspects of paying for a reduced corporate rate will not come easier in the new Congress. The allure of reducing business tax rates did not draw members to support the bill presented to them by former Ways and Means Chairman Dave Camp.

**Corporate integration.** In the Senate, Finance Committee Chairman Hatch continues to go his own direction on tax reform, touting a corporate integration plan that could be a substitute for or be complementary to a rate reduction effort that includes international tax reform. Hatch says he is still aiming to release a corporate integration discussion draft. Chairman Hatch has said the proposal could accomplish the international tax reform that is widely seen as necessary, and the reception to the draft could dictate how strongly he tries to advance the proposal next year. The draft is expected to pair a dividends-paid deduction with a mandatory 35% withholding tax for dividends and interest. Other senators and third parties have raised concerns about a corporate integration plan, including:

- That the proposed 35% withholding tax expected would penalize tax-exempt entities like retirement plans and deter foreign investment in the United States.
- That a dividends paid deduction would, by reducing corporate tax liability, diminish the effectiveness of current tax incentives like the R&D credit and accelerated depreciation, and disadvantage startup companies more likely to retain their earnings rather than pay dividends.

**Extenders.** The fate of tax extenders (and certain other tax issues) will likely depend on both what can be accomplished during the 2016 lame-duck session and the success of the likely focus on tax reform in early 2017.
There is a push to include the provisions that expire at the end of 2016 in year-end legislation, though if that is unsuccessful the issue will certainly return in 2017, either through inclusion in a tax reform measure or separately if those efforts have played out.

The 2015 tax legislation made some extender provisions permanent and extended others for five years, meaning the two-year extensions that expire at the end of 2016 will be the focus of the next effort.

There will certainly be attention paid to these provisions during any discussion of tax extenders in 2017.

**Tax treaties.** Action on the eight Senate Foreign Relations Committee-approved tax treaties that Senator Rand Paul wants renegotiated over information sharing concerns is seen as overdue. The treaties include: new protocols amending US tax treaties with Switzerland, Luxembourg, Spain and Japan; new tax treaties with Hungary, Chile and Poland; and a multilateral convention on tax administration. There have been no plans announced for trying to move the treaties during the lame-duck session, though such an effort is possible.

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