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New Republican Proposal May Be Key To Unlocking Tax Reform

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On June 24, 2016, House Republicans, led by Speaker Paul Ryan and Ways & Means Committee Chairman Kevin Brady, released an outline of an aggressive tax reform proposal. This proposal has many similarities to a proposal put forward by the Bush administration in 2005, but one aspect of the new proposal — its treatment of pass-through business — may hold the key to unlocking tax reform in 2017.

Overview

The corporate and international tax components of the proposal are very similar to the Growth and Investment Tax Plan included in the President's Advisory Panel on Federal Tax Reform report released in November 2005 (sometimes referred to as the "Breaux-Mack Report"). From an economic perspective, both proposals broadly attempt to achieve the same economic outcomes and incentives that are associated with a consumption tax while maintaining the structure of an income tax. A number of the recommendations in the proposal are presented at a high level, and therefore the full impact of some of the recommendations are unclear pending the development of those details. In addition, the proposal notes that transition rules, which are not specified in the proposal, will need to be developed.

Business Tax: The proposal lowers the corporate tax rate to one flat rate of 20 percent and repeals the corporate alternative minimum tax (AMT). It provides for full expensing for both tangible and intangible property in the year in which the investment takes place.

To offset the revenue lost from lowering the tax rate, the proposal eliminates the deduction for interest expense. Interest expense would be deductible only against interest income. This applies to interest payments made both domestically and internationally to related and unrelated parties.

International Tax: With regard to international tax reform, the proposal shifts the United States to a territorial system by providing a deduction equal to 100 percent of qualifying foreign-source income. In addition, the proposal borrows a policy typically incorporated in value-added taxes (VATs) by applying border adjustments to both imports and exports. The proposal repeals most of the existing Subpart F regime, leaving in place only the foreign personal holding company rules. The proposal applies a one-time transition tax, or mandatory repatriation, on earnings currently held offshore. The tax on these earnings would be applied at a rate of 8.75 percent on cash and liquid assets and a rate of 3.5 percent on reinvested earnings. This transition tax would be payable ratably over eight years.

Pass-Through Tax: The proposal's new approach to the taxation of pass-through entities may be its most significant contribution to the tax reform debate. The proposal creates a new business-entity tax under which active business income earned by pass-throughs is taxed at a maximum rate of 25 percent. Nonqualifying income is taxed at the individual rates, and qualifying income is eligible for the lower individual rates if it does not exceed the income bracket associated with the lower rates. Thus, the proposal breaks the current link between the top individual tax rates and pass-through income.

Individual Tax: The proposal collapses the existing rate structure into three brackets of 12, 25 and 33 percent. Individual AMT is repealed. Income from capital gains, dividends and interest receives a 50 percent exclusion (effectively taxing that income at one-half of the individual rates). It repeals the estate tax. It greatly expands the size of the standard deduction and child tax credit. Retirement, mortgage interest deduction and charitable deduction are maintained although potentially in different forms.

Analysis

The reduction in the corporate rate to 20 percent represents a significant reduction in marginal tax rates, and for many sectors, a reduction in effective rates as well. The nonpartisan Joint Committee on Taxation has previously estimated that a 1 percentage point reduction in the U.S. corporate rate results in between $100 billion and $140 billion in lost revenue per year.

The repeal of the corporate AMT provides some marginal simplicity for taxpayers but, more importantly, taxpayers would receive a credit on AMT paid that can be carried forward as part of the repeal of AMT.

The proposal reduces the ability of taxpayers to use net operation losses (NOLs) to reduce tax liability in two ways. First, it caps the extent to which NOLs can eliminate tax liability to a maximum of 90 percent of the total liability. Second, it eliminates NOL carrybacks.

The shift to full expensing creates strong incentives for companies to increase capital investments. The elimination of interest deductions creates an incentive for taxpayers to rely on equity financing for their investments. This could pose a significant barrier to investing for taxpayers who do not have access to equity markets or otherwise do not have access to significant amounts of liquid capital. It could also have a significant negative impact on the real estate sector. The Tax Foundation, a tax policy think tank, has previously estimated that elimination of the interest deduction could raise approximately $150 billion per year in higher revenue. The proposal specifically notes that certain sectors, namely financial services, banking, insurance and leasing, will need additional rules or special consideration with regard to the elimination of interest deductions.

With respect to base-broadening provisions, in addition to repealing the interest deduction, the proposal implies that all other tax expenditures are repealed unless explicitly stated that they are retained. For example, Section 199 is repealed. The proposal states that the research and development tax credit will remain in some form. The proposal also notes that last-in-first-out (LIFO) accounting would be maintained. This may be an indication that LIFO would be maintained as a transition rule as full expensing presumably also applies to inventories. While the proposal seeks to move toward a consumption tax structure, unlike in traditional consumption taxes, wages and labor costs would remain deductible expenses.

Perhaps the most important contribution to the overall tax debate this proposal makes is its new structure for the taxation of pass-through entities. This new structure has potential to resolve one of the most significant partisan constraints to achieving tax reform. The proposal would subject active business

income earned by pass-through entities to a maximum tax rate of 25 percent. While the proposal maintains a disparity between the corporate rate of 20 percent pass-through, businesses would also benefit from lower individual tax rates at lower levels of income. Under the proposal, individual taxpayers currently subject to either the 10 or 15 percent rate would be taxed at 12 percent. Thus, pass-through income that would qualify for the 12 percent rate would still be taxed at 12 percent, and only income in excess of that threshold (currently a maximum of $75,300) would be subject to tax at the 25 percent rate. The proposal does not provide details on what income would qualify for the business rate versus the individual rate.

There are significant partisan differences among members of Congress over whether the top individual tax rates should be lowered as part of tax reform. Democrats in Congress have broadly opposed lowering the top individual tax rates because it would benefit high-income individuals. Republicans in Congress have broadly supported maintaining the link between pass-through business income and the top individual rates due to the belief that this link provides an anchor that limits how high the top individual rate can climb. Pass-through entities pay tax as individuals and therefore can be subject to the top individual tax rates. Groups representing pass-through entities have advocated for parity between the corporate tax rate and the rates paid by pass-through entities.

The current proposal provides a mechanism around the partisan differences on whether to lower the top individual tax rates by segregating active business income from individual income and subjecting the former to a lower tax rate than the rate applied to individual income.

Notwithstanding the lack of important technical details, the overall structure could provide a potential path around the partisan gridlock on individual rates and become a key to unlocking business tax reform in 2017.

With regard to international reform, the proposal comes close to a pure territorial regime by providing a 100 percent exemption for foreign-source income. It repeals all of the Subpart F income rules except for those related to personal holding company income.

The only other anti-base erosion rule in the proposal is one that would make the corporate income tax border adjustable. Income earned from export sales would be exempt from tax, and imports would be subject to tax. The proposal would apply the border adjustment to all goods, services and intangibles. While the proposal does not provide details on how the border adjustment would operate, given the similarities between the current proposal and the 2005 proposal, it may be useful to review how the 2005 proposal would implement border adjustments. The 2005 proposal recommended a "destination-based" approach. With regard to exports, a company would not be subject to tax on export income and would receive a rebate or credit in an amount equal to the cost of producing the export, including labor costs. With regard to imports, taxpayers would be denied the ability to take the costs of the import as an expense deduction when calculating taxable income. For example, assume a U.S. corporation imports a part that is incorporated into a finished manufactured product. Under the 2005 proposal, the cost of the imported part could not be included in the taxpayer's cost of goods sold (COGS) and subtracted from net income. As a result, the cost of the imported product would be added to the corporation's taxable income.

With respect to the border adjustability of intangibles, we can hypothesize on how this could work in practice. For example, assume that a corporation enters in a license agreement for the right to use patented technology where the patent holder is located in a foreign country. As part of the license agreement, the U.S. corporation pays a royalty to the patent owner but manufactures the product in the

United States. Presumably, based on the limited description available, the royalty paid to the foreign patent would not be a deductible expense, and the royalty costs would be added to the corporation's taxable income.

The current proposal notes that applying this border adjustment would level the playing field for U.S. companies versus their foreign competitors that benefit from the border adjustability of VAT taxes in those countries. However, the proposal would actually provide a significant competitive advantage for U.S. exporters versus foreign competitors. While foreign corporations can benefit from a rebate of VAT taxes on exports, export income is still subject to income tax in those countries. Under this proposal, export income earned by U.S. corporations would be completely exempt from federal tax.

The current proposal states that because the new corporate income tax structure mimics that of a consumption tax from an economic perspective, it is equivalent to an indirect tax under World Trade Organization rules. WTO rules permit the border adjustment of indirect taxes. Because the proposal lacks many of the details required to truly analyze the operation and effects of the border adjustment, it is not possible to make a conclusive determination as to whether the proposal is in fact consistent with U.S. WTO obligations.

The implementation of border adjustments would undoubtedly be a significant change for companies that have a global supply chain. The tax implications of the loss of expense deductions for imported products would be significant. In addition, border adjustability would presumably require substantial documentation requirements on the part of the taxpayer. These documentation requirements likely would also need to be contemporaneous as they directly impact the tax liability of the company in that tax year.

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