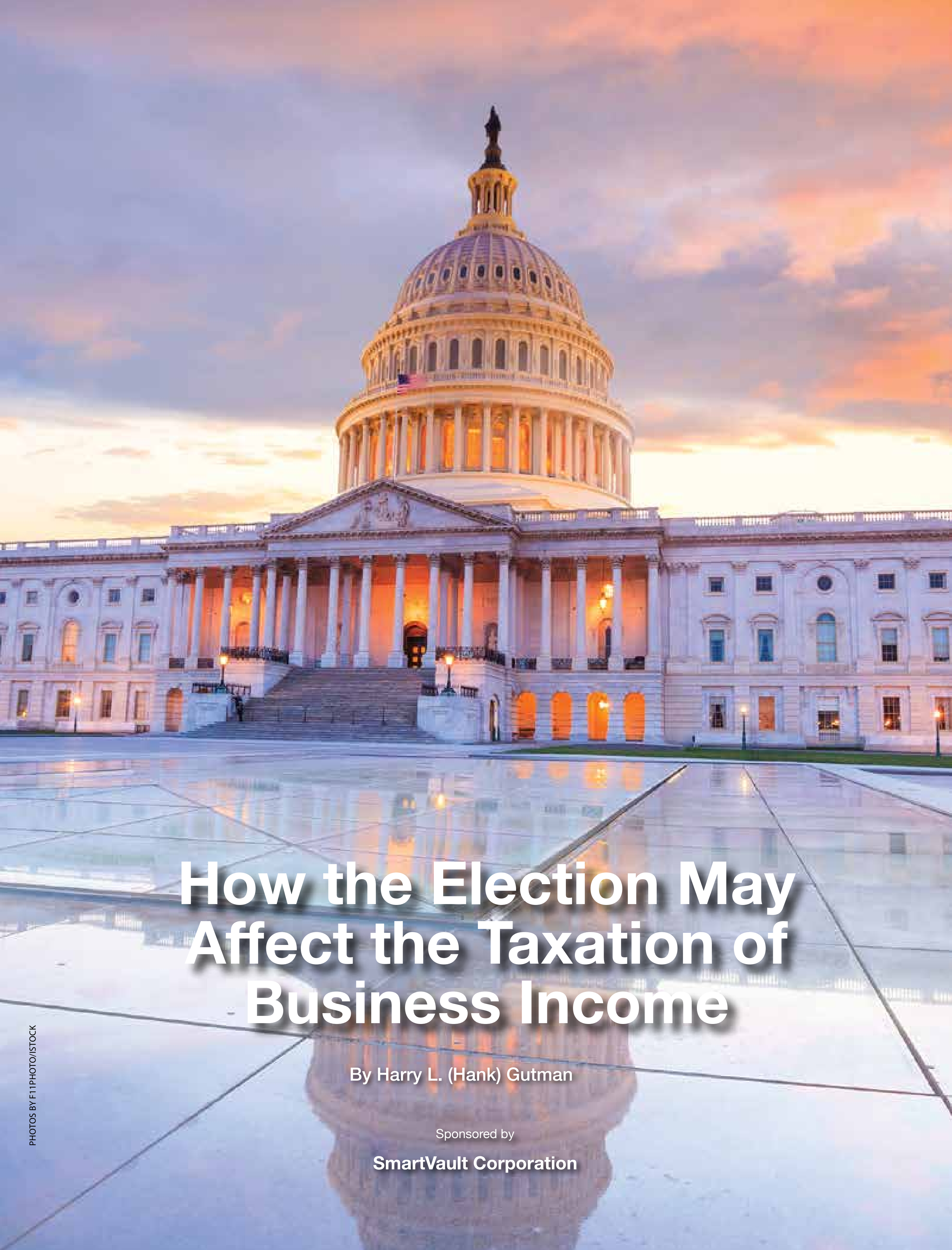

How the Election May Affect the Taxation of Business Income

By Harry L. (Hank) Gutman

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A Donald Trump administration, combined with Republican control of both the Senate and the House of Representatives, makes legislation to reform the taxation of business income more likely. Despite the increased likelihood of legislative action, however, the specific content of reform legislation is more elusive than has been suggested by many, as is the path to enactment.

This report summarizes the following recent proposals: The House Republican Tax Reform Task Force Blueprint (the Blueprint, available at tinyurl.com/z5dzfgu), the Trump Tax Plan (the Trump Plan, available at tinyurl.com/goxquwr), and Sen. Orrin Hatch's reported, but not yet released, Hatch Integration Plan (the Hatch Plan). It then discusses the legislative path to enactment.

The Blueprint and the Trump Plan also address individual taxation and transfer-tax issues, but those aspects are not discussed here except insofar as they relate to the taxation of business income.

These proposals are simply a starting point in the process, are not fully articulated, and could well be modified before formal legislative action commences. This is particularly true of the Trump Plan, which was revised during the presidential campaign and continues to lack specificity on critical points. The next iteration of the Trump Plan will most likely be a formal administration budget proposal that is not expected to be released until February at the earliest.

BACKGROUND

While there has been a broad consensus that the U.S. business income tax system needs to be reformed, there has been no consensus on what a reformed system should look like, and President Barack Obama did not make it a legislative priority. Differing revenue objectives and substantive outcomes have separated Democrats and Republicans. As a practical matter, revenue constraints, combined with the procedural rules governing the consideration of tax legislation in Congress, have posed an insurmountable obstacle to enacting a significant corporate rate reduction using the traditional model of financing through the elimination of business tax preferences. Moreover, the traditional reform model creates significant winners and losers in the business community and results in a politically untenable tax increase on the more than 44% of business income earned in noncorporate form.

Lawmakers have been well aware of these problems, but significant differences between Democratic and Republican solutions could not be reconciled. Now, with the executive branch and both houses of the legislative branch about to be controlled by Republicans, who have consistently made tax reform a priority, and with both the Trump campaign and House Republican proposals somewhat aligned as to the need (if not the substance) of business tax reform, there is renewed hope that the legislative logjam can be broken. Reconciling the conflicting approaches of the Blueprint, the Trump Plan, and the Hatch Plan and satisfying congressional procedural rules may not be easy. (Other proposals, such as the 2014 discussion draft by former Rep. Dave Camp, R-Mich., and value-added tax proposals advanced by Rep. Jim Renacci, R-Ohio, and Sen. Ben Cardin, D-Md., may become relevant as the process unfolds.)

THE MAJOR PROPOSALS

The Blueprint

The Blueprint is the first proposal discussed because, as a practical matter, it is likely to be the starting point for congressional consideration. The Blueprint proposes:

- A reduction in the corporate tax rate from 35% to 20%;
- Repeal of the corporate alternative minimum tax (AMT);

- Full expensing of the costs of investments other than land;
- No current deduction for net interest expense (to eliminate interest subsidization of debt-financed investments);
- Indefinite carryforward of 90% of annual net operating losses with an interest factor to preserve the current value of the deferred amount;
- Retention of LIFO;
- Elimination of unspecified (apart from Sec. 199) deductions and credits;
- Retention of an enhanced research and development (R&D) credit;
- Creation of a territorial tax system with a 100% deduction of dividends from foreign subsidiaries, coupled with a destination-based tax system that imposes tax on the basis of where products are consumed rather than where they are produced;
- Repeal of Subpart F, except for passive foreign investment company (PFIC) rules;
- A repatriation tax on currently deferred accumulated earnings at an 8.75% tax rate to the extent they are held in cash or cash equivalents, and 3.5% for other earnings, with the tax liability payable over eight years;
- Taxation of passthrough business income, after a reduction for reasonable compensation, at 25%;
- Three individual income tax rate brackets: 12%, 25%, and 33%; and
- Deduction for 50% of net capital gains, dividends, and interest.

The Trump Plan

During his campaign, Trump proposed:

- Reducing the corporate tax rate from 35% to 15%;
- Eliminating the corporate AMT;
- Allowing firms engaged in domestic manufacturing to choose between full expensing of capital investments and deducting interest paid;
- Eliminating the domestic production activities deduction (Sec. 199) and all other business credits, except for the R&D credit;
- A repatriation tax on currently deferred (cash and noncash) earnings at a 10% tax rate;
- Allowing owners of passthrough entities the option to be taxed at a 15% rate rather than ordinary income rates, with special rules applicable to distributions from “large” passthroughs, the owners of which elected the 15% rate;
- Three individual income tax rate brackets: 12%, 25%, and 33%;
- Maximum rate of 20% on capital gains; and
- Carried interests taxed as ordinary income.

An early version of the Trump Plan proposed current taxation of worldwide income at 15%. That proposal was omitted from the last iteration of his plan.

The Hatch Plan

The Hatch Plan, as reported, would allow a deduction for all dividends, limited by the amount that is subject to full taxation. The limitation denies a deduction for dividends paid out of preference income or foreign-source income that has been sheltered by foreign tax credits. A withholding tax of 30% would be imposed on the deductible dividend. The withholding tax would be included in the income of a dividend recipient and would be a nonrefundable credit for U.S. taxpayers. The credit would not be refundable for foreign taxpayers and exempt organizations. Thus, it would be a final tax for those entities.

To equate the tax treatment of dividends and interest, a 30% withholding tax would be imposed on interest payments. The interest withholding tax would be treated the same way as the dividend withholding tax, thus ensuring at least one level of tax on interest income.

The reports are silent on the treatment of foreign income. The specific question is whether taxes paid to a foreign government by a U.S. corporation would be treated the same as taxes paid to the U.S. government. If so, the foreign tax credit would effectively be transferred to U.S. shareholders, and that income, if taxed at a rate equal to or greater than the U.S. rate, would not be subject to U.S. tax.

Republican staff on the Senate Finance Committee have said that the Hatch Plan will be released shortly and that it will contain legislative language, a technical explanation, and both conventional and dynamic revenue estimates.

THE PATH FORWARD

The path forward involves two issues: achieving a consensus on the substance of the legislation and navigating the rules of the legislative process. Neither will be simple.

The legislation

While sharing a number of common elements, such as a reduction of the corporate tax rate, repeal of the corporate AMT, repeal of Sec. 199 and many business credits, and a repatriation tax on deferred foreign earnings, the Blueprint and the Trump Plan provide different views of the structure of the corporate tax with respect

to the taxation of domestic and foreign-source income. The Blueprint replaces the existing corporate tax with a business cash flow tax (essentially a subtraction method value-added tax (VAT) or consumption tax), eliminates foreign-source income from the U.S. tax base through "border adjustability," and provides a territorial tax system with a full deduction for dividends from foreign corporations combined with the repeal of much of Subpart F. The Trump Plan retains the existing corporate tax structure with modifications to the base. The Hatch Plan, if it is unveiled as reported, represents a totally different approach to the issue of business income taxation and does not address individual taxation at all.

Only time will tell how these conflicts are resolved, or whether other approaches, such as the adoption of a credit-invoice VAT, as proposed by Rep. Renacci and Sen. Cardin, to eliminate the corporate tax or finance a corporate rate reduction, could enter the discussion.

Navigating the legislative process

There is no official revenue estimate for the Blueprint. House Ways and Means Chairman Kevin Brady, R-Texas, has stated that revenue neutrality is a goal. The House Republican Tax Reform Task Force claims that the Blueprint is revenue-neutral over the 10-year budget measuring period, but that claim is based on a questionable baseline from which to measure the revenue effect and an assumption that enactment will generate significant economic growth. Whether the official scorekeepers (the Joint Committee on Taxation) will agree is unknown. The Tax Foundation has estimated the Blueprint would reduce revenues by $191 billion over the 10-year window. The Tax Policy Center has estimated a loss of $3 trillion.

The Tax Policy Center has estimated the Trump Plan would reduce revenues by $6.2 trillion over the 10-year budget window. Including increased interest costs and macroeconomic effects, the federal deficit would rise by $7 trillion over the first decade. The Tax Foundation has estimated the Trump Plan would reduce revenue between $4.4 trillion and $5.9 trillion over the 10-year budget window. Including interest costs and macroeconomic effects would result in a reduction of $2.6 trillion to $3.9 trillion over the 10-year budget window.

Why does this matter? There are at least two reasons: One is political, and the second is procedural.

On the political side, fiscal conservatives, particularly in the House, may resist legislation that increases the deficit.

The procedural side is a bit more complicated. In simplified terms, under the Congressional Budget Act, when a bill that loses revenue during certain measuring periods within and over the 10-year budget window is considered under the "regular order" legislative process, it is subject to a point of order. A point of order is an objection that can be made when a member of Congress believes that a rule has been broken. If the objection is sustained, the point of order can be waived in the House by a majority vote, but in the Senate it requires 60 votes. Republicans will have 52 votes in the Senate. Thus, if tax reform legislation loses revenue during the budget window, and if Democrats remain united, they can defeat the bill by raising a Budget Act point of order.

Moreover, notwithstanding the Budget Act, if the bill is considered under the regular order in the Senate, it can be subject to a filibuster, which also requires 60 votes to overcome. The bottom line is that proceeding under the regular order is not likely to produce a bill in the Senate unless at least eight Democrats support it. The current speculation is that Republicans will try to reach an agreement with a sufficient number of Democrats in the Senate by including some of their priorities, such as infrastructure funding, but the outcome is uncertain.

In Washington, there is almost always a way out. If the regular order is not available, there is an alternative. In this case, it is the "reconciliation" process. Again, in simplified terms, legislation that implements a budget resolution is afforded procedural protection in the Senate. Specifically, the reconciliation procedure specifies a time limit for debate (which precludes a filibuster) and, so long as the legislation complies with the instructions of the budget resolution, it is not generally subject to points of order.

The foregoing description masks a number of practical difficulties in using the reconciliation process. First, a budget resolution is required. A budget resolution is the agreement of the House and Senate (the president is not technically involved) on the revenue and spending parameters for the fiscal year to which the resolution relates. Even when both chambers are controlled by the same party, it is sometimes difficult to pass a budget resolution. In the current context, objections by fiscal conservatives in both the House and Senate, as well as differing substantive legislative priorities among members of Congress, could make passage contentious.

Second, while any legislation that implements the terms of the budget resolution is afforded the procedural protection of the reconciliation process, in the Senate special rules have to be navigated. In particular, a reconciliation bill is subject to a 60-vote point of order (under the so-called Byrd rule) if it increases the deficit ▶

outside the 10-year budget window. Provisions that do not produce a change in revenue are also subject to a point of order. Thus, even if a budget resolution authorized a revenue loss for the 10-year budget window, a bill would be subject to a 60-vote point of order if it produced a loss outside the budget window. (Avoiding this rule is why the 2001 Bush tax cuts expired after 10 years.) Accordingly, even if the potential 10-year revenue loss of tax reform legislation was authorized by a budget resolution, an "out-year" cost would subject the bill to a point of order that would require 60 votes to overcome. It is difficult to see how a politically acceptable 10-year sunset could be crafted to avoid this rule.

Finally, there is an unresolved issue as to whether there can be more than one tax reconciliation bill implementing a budget resolution in a single session of Congress. Republicans have indicated that they want to use the reconciliation process to repeal the Patient Protection and Affordable Care Act (PPACA). If PPACA repeal is deemed a tax reconciliation bill (because it contains the repeal of the many tax provisions in PPACA), the reconciliation process might not be available for tax reform in the first session unless it is combined with PPACA repeal legislation. Achieving agreement on the terms of a combined bill would be difficult and time-consuming.

Once again there is a potential solution, and it is under active consideration. Congress has not yet passed a budget resolution for the current fiscal year that ends on Sept. 30. The thought is that the Republicans could in January pass a budget resolution for FY 2017 that would contain reconciliation instructions with respect to PPACA repeal. Then, if they find that they cannot pass a tax reform bill under the regular order, they could later pass a budget resolution for FY 2018 that would include tax reform instructions. The negotiations over the contents of that budget resolution could become complicated, particularly if the tax provisions lose revenue over the 10-year budget window.

As the foregoing illustrates, actual implementation of the reconciliation process to accomplish tax reform raises significant substantive and procedural challenges. Consequently, Republicans would prefer to proceed under the regular order to avoid the limitations of the reconciliation process and the potential conflicts that could arise in the context of negotiations over the contents of an FY 2018 budget resolution. However, as noted earlier, they will need eight Democratic senators to agree—an uncertain outcome at the moment.

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