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The Five Key Components of Corporate Tax Reform

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The election of Donald Trump and the GOP's majorities in both chambers of Congress dramatically increases the likelihood that Washington will achieve comprehensive tax reform as early as this year. The President has identified tax reform as one of his top three priorities, and some would argue that tax reform is a "must do" given the Republican control of the administration and Congress.

Thus far, the House Republicans have taken the lead on advancing proposals for tax reform, releasing their "A Better Way" proposal, which is widely regarded as the guiding blueprint for a congressional rewrite of the Tax Code (the "Blueprint"). The President has been actively meeting with leaders in the House and Senate to discuss the various alternatives to tax reform under consideration and has promised his own proposal for meaningful reform will be released within the next several weeks.

There is broad agreement among the President and congressional Republicans that the foundation of tax reform will be lowering the individual and corporate tax rates, relying in part on the premise of a growing economy to cover the budgetary impact of sweeping tax cuts.

There are five key elements of corporate tax reform under active consideration which are expected to be part of the Ways and Means Committee legislative proposal. That proposal also is expected to be released in the coming weeks.

Reduce corporate tax rate

The Blueprint would reduce the corporate tax rate to 20 percent, and the President has suggested it go as low as 15 percent. A number of deductions and credits would be eliminated to broaden the tax base. Importantly, it appears that the research and development credit would remain in place in order to incentivize U.S. development of intellectual property. Other benefits such as the domestic manufacturing deduction would be repealed in favor of a lower rate. The corporate alternative minimum tax (AMT) would be repealed in an effort to simplify the tax law.

Move toward a territorial tax system

A second key component of tax reform is moving to a territorial tax system. The territorial approach would exempt foreign active business income, likely by providing a 100 percent exemption for dividends received from foreign subsidiaries. The territorial proposal would allow for future offshore earnings to be repatriated to the United States without additional tax, which would have a positive impact on a company's ability to access its foreign cash.

The lower corporate tax rate combined with moving to a territorial system would align the U.S. tax system with the majority of the rest of the world and is intended to eliminate the competitive disadvantage created by our current worldwide system and eliminate the incentive for U.S. companies to invert. Congressional Republicans and the President have been aligned in their overall criticism of inversions, such as the 2015 proposed $160 billion merger between Pfizer and Allergan – the largest tax-inversion deal in history until it fell apart the following year as a result of Treasury regulations. The new approach, however, would be different from the "stick" approach of the Treasury regulations, opting instead for a "carrot" approach by improving the U.S. tax system and removing the incentive to invert.

Although the President has not yet released his new tax reform plan, it is worth observing that in the plan set out during his campaign, he proposed a 15-percent corporate rate on worldwide income (ending deferral). While this is a low, competitive rate that would remove barriers to repatriation, it may not be sufficiently low to eliminate incentives for inversions. Moreover, congressional Republicans may view this as a significant broadening of the base which could lead to massive tax increases if the rate was ever increased if the Democrats regained control of the Congress.

Change rules on foreign earnings brought home

Third, as part of a transition to a territorial system, Republicans will likely provide rules to allow foreign earnings that have accumulated overseas under the old system to be brought home at rates significantly lower than the current 35-percent rate, which would raise significant revenue from the estimated $2.6 trillion in corporate profits that are trapped offshore under the current system. The Blueprint has proposed taxing the foreign earnings at 8.75 percent for accumulated earnings that are held in cash or cash equivalents and at 3.5 percent for reinvested earnings held in illiquid assets, such as factories, payable over eight years. During the campaign, the President offered similar proposals at 10 percent for liquid earnings and 4 percent for illiquid earnings.

Allow capital expense deduction to stimulate growth and interest deductibility

A fourth tenet of the Blueprint is an allowance of a current deduction for capital expenses as a means of stimulating economic growth. Paired with this proposal, however, is a denial of the deduction for net interest expense. This trade-off would cause the loss of a permanent benefit (interest deduction) in order to gain a timing benefit (a capital expense deduction that otherwise would have been recovered over time through depreciation or amortization). Regardless of the outcome with respect to currently deducting capital expenses, tax reform likely will include some limitation on corporate interest deductions, particularly if a territorial system is adopted. Under a territorial system, foreign income is exempt from taxation. Accordingly, the system cannot allow a deduction in the U.S. for debt that supports what is essentially zero-taxed income. Moreover, foreign companies and inverted companies benefit significantly from over-leveraging U.S. operations and reducing tax on U.S. income through the earnings stripping afforded by intercompany debt. Tax reform will address that issue.

Adopt destination-based border-adjustable tax

Perhaps the most controversial Blueprint proposal is the move toward a destination-based border-adjustable tax. A destination-based approach means that tax jurisdiction follows the location of consumption rather than the location of production. Revenue from exports would be exempt, and imports would be taxable, likely by denying a deduction for costs of goods sold. As a result, it would not matter where a company manufactures its products – U.S. sales would be taxable; non-U.S. sales would not. House Republicans believe this will raise significant revenue given our trade imbalance and will remove the incentive for companies to locate operations offshore. They believe that it is a necessary component of achieving a corporate tax rate low enough to make reform meaningful. Although economists argue that the approach will strengthen the dollar sufficiently to make everyone whole, on its face it creates winners (such as large net exporters) and losers (such as big-box retailers) and, therefore, is being hotly debated. President Trump is still evaluating the approach. The proposal thus far has been light on details, and it is unclear how it would impact income from services or intangibles. Many other questions, such as whether it is compliant with our trade obligations – or whether that even matters – or our treaty obligations, to name a few, remain.

Timing and process

In terms of timing, revamping the Tax Code likely will come second to reforming the Affordable Care Act. That said, the Republicans are highly incented and motived to move very quickly. The markup process in the Ways and Means Committee will start this spring, but it may take Congress until fall to approve a tax overhaul bill, with a potential effective date as early as Jan. 1, 2018. The bill would need 60 votes in the Senate unless the budget reconciliation process is relied on, in which case it will need only 51. It is unlikely the Republican plan would garner 60 votes in the Senate; accordingly, we expect them to rely on the reconciliation process.

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