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House GOP tax reform blueprint proposes across-the-board rate cuts, move to territorial tax system

House Republicans on June 24 released their highly anticipated tax reform blueprint that calls for cutting tax rates for corporations, passthrough businesses, and most individuals; adopting a territorial system for taxing foreign-source income of US multinationals; and moving the US toward a cash-flow tax system without adopting an explicit consumption levy such as a national sales tax or value-added tax.
URL: http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf

The tax plan was the sixth and final piece of the "Better Way" agenda introduced by House Speaker Paul Ryan, R-Wis., over the past month. The blueprint leaves many critical questions unanswered and leaves a number of details to be filled in by the Ways and Means Committee at a later date and was therefore not released as legislative language. Additionally, it was not accompanied by estimates from the nonpartisan Joint Committee on Taxation describing its impact on federal revenues or the distribution of the tax burdens on business and individual taxpayers.

The GOP's agenda – which Ryan calls a "vision for a Confident America" – is intended to provide congressional Republicans a policy platform for this year's election season and to lay the groundwork for legislation the party hopes to see enacted if there is a Republican in the White House in 2017. Other planks introduced earlier in June included a plan to replace the Patient Protection and Affordable Care Act (PPACA) and blueprints addressing poverty, national security, executive branch authority, and regulatory policy.

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At a June 24 press event to officially unveil the tax reform blueprint, Ryan pointed to the political and economic turmoil resulting from this week's vote by the United Kingdom to pull out of the European Union as "all the more reason for America to lead."

House Ways and Means Committee Chairman Kevin Brady, R-Texas, and House Majority Whip Steve Scalise, R-La., joined Ryan at the podium for the rollout. Brady chaired the tax reform task force that was launched in January and charged with soliciting policy ideas from Republican members both on and off the taxwriting committee. In addition to an individual tax system simple enough to "fit on a postcard," Brady also touted proposed business and international tax rules that he says will allow employers to "compete and win." He noted also that the design elements of the plan, which differ in many ways from the tax reform bill put forward by then-House Ways and Means Committee Chairman Dave Camp, R-Mich., were driven by the desire of the members to devise the most pro-growth tax plan possible.

This edition of *Tax News & Views* provides highlights of the blueprint's proposed changes to the business, international, and individual tax rules.

A table comparing provisions in the blueprint to current law and to the proposals in former Ways and Means Chairman Camp's 2014 comprehensive tax reform bill is available from Deloitte Tax LLP.
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/160624_1suppA.pdf

Business reforms

The blueprint calls for reducing the top statutory corporate income tax rate from 35 percent to a flat rate of 20 percent.

Passthrough business income (e.g., business income earned through sole proprietorships, partnerships, limited liability companies, subchapter S corporations, etc.) would face a maximum rate of 25 percent – greater than the proposed top rate for corporations, but less than the proposed 33 percent top income tax rate for individuals. (See discussion of the proposed new personal income tax brackets below.)

The blueprint notes that reasonable compensation paid to employee-owners of passthrough entities would remain deductible to the business and would be taxed to the employee-owner at his or her marginal rate.

Other notable proposals in the blueprint would:

- Move toward a cash-flow business tax model by allowing 100 percent first-year expensing of investments in tangible personal property, real property other than land, and intangible property.
- Disallow deductions for net business interest expense (i.e., interest expense would be deductible only to the extent of interest income), with an indefinite carryforward period for disallowed net interest expense deductions. The blueprint notes that the Ways and Means Committee intends to develop special rules for industries such as banking, insurance, and leasing, for which interest expense is integral to their business model.
- Repeal carrybacks of net operating losses (NOLs), but allow NOLs to be carried forward indefinitely with a dollar adjustment designed to compensate for inflation. The blueprint proposes to limit NOL deductions in any one year to 90 percent of taxable income (similar to the current-law NOL limit under the alternative minimum tax).
- Repeal the corporate AMT.
- Repeal most business tax preferences, which according to the blueprint would reduce complexity, encourage economic growth through a more efficient allocation of capital, and raise revenue to help finance lower business tax rates. The blueprint is generally vague on details in this regard, but specifically mentions the section 199 deduction for domestic production activities income as a business tax preference that should be repealed.
- Retain the research and experimentation tax credit and the last-in-first-out (LIFO) method of inventory accounting. The blueprint notes that these two preferences could undergo changes upon further evaluation by the Ways and Means Committee.

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International reforms

The blueprint proposes to overhaul the international tax rules by moving toward a territorial system with a 100 percent tax exemption on dividends received from foreign subsidiaries. This regime would replace the current international tax system which generally taxes US firms on their worldwide income – subject to deferral and an allowance for foreign tax credits.

Deferred foreign earnings generated prior to enactment would be subject to a mandatory "deemed" repatriation tax at a rate of 8.75 percent if held as cash or cash equivalents, or 3.5 percent if held in another form. At their election, firms could pay this deemed repatriation tax over a period of eight years. (The provision is similar to one included in Camp's 2014 comprehensive tax reform proposal.)

Border adjustments: The blueprint provides for "border adjustments" within the context of the reformed business tax system that would serve to eliminate US tax on products, services, and intangibles exported abroad (regardless of their production location). Meanwhile, US tax would be imposed on products, services, and intangibles imported into the US (regardless of their production location). The mechanism for these border adjustments is not specified in the blueprint, however.

In describing this approach, the blueprint notes that the US is currently at a competitive disadvantage relative to its major trading partners, all of which raise considerable revenue through border-adjusted value-added taxes. Under World Trade Organization rules, border adjustments are only permissible in the context of consumption taxes.

Noting that the base of tax under the reformed business system would more closely resemble consumption rather than income (e.g., due mainly to full expensing, which would effectively lower taxes on returns to saving), the blueprint contends that the US system could be border-adjusted, putting US goods and services "on a more equal footing in both the US market and the global market."

Many base erosion protections repealed: The blueprint indicates that by providing a border adjustable mechanism, the revised corporate tax will obviate the need for many current-law base erosion safeguards and therefore calls for repealing most current-law rules under subpart F, although it would retain the current-law "foreign personal holding company income" rules, possibly in modified form, in order to limit deferral on certain types of passive income. No other protections against base erosion are discussed in the blueprint.

Individual reforms

On the individual side, the blueprint calls for the current seven individual income tax brackets (with a top rate of 39.6 percent) to be consolidated into three, with rates of 12 percent, 25 percent, and 33 percent; however, the blueprint does not specify income thresholds for these proposed new rate brackets.

Net capital gain, dividend, and interest income would be taxed as ordinary income, but would be subject to a 50 percent exclusion resulting in effective rates on such income of 6 percent, 12.5 percent, and 16.5 percent, depending upon the taxpayer's marginal rate.

The individual AMT would be repealed, as would the estate and generation-skipping transfer taxes.

Certain taxes on high-income individuals enacted under the Patient Protection and Affordable Care Act also would be repealed as part of separate blueprint released by the health care reform task force earlier this week. The health care blueprint also proposed limiting the exclusion for employer-provided health benefits – a move that could increase the base of income subject to the newly proposed brackets for certain taxpayers. The tax reform blueprint states the intent of drafters that the health care-related tax changes would be enacted in conjunction with the business and individual tax proposals from the blueprint. (See separate discussion below for details on these proposals.)

Standard deduction, itemized deductions, exemptions: The blueprint calls for consolidating the standard deduction (in 2016, $12,600 for joint filers and $6,300 for singles) and personal exemptions for a taxpayer and spouse (in 2016, $4,050 per person) into an enhanced standard deduction of $24,000 for joint filers and $12,000 for singles, adjusted for inflation, as well as consolidating the child tax credit and personal exemptions for dependents into an enhanced "child and dependent tax credit."

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The blueprint would repeal most itemized deductions (including the deduction for state and local income and sales taxes) but would retain the deductions for mortgage interest and charitable giving. According to the blueprint, the surviving itemized deductions will be reviewed by the Ways and Means Committee with an eye toward making them more effective and efficient at achieving their policy goals.

The enhancements to the standard deduction coupled with the reforms to itemized deductions would reduce the share of taxpayers who itemize their deductions from roughly one-third to only 5 percent, the blueprint notes.

Retirement savings and higher education incentives: The blueprint would retain current tax incentives to encourage saving for retirement and to help finance higher education, but it notes that the Ways and Means Committee intends to look at ways to consolidate and reform each set of benefits to make the system simpler and more efficient.

Other tax preferences: The blueprint calls for repealing other, unspecified tax preferences for individuals except for the Earned Income Tax Credit, which will be reviewed and reformed by the Ways and Means Committee.

Health care blueprint calls for repeal of PPACA and related taxes

In a separate blueprint released June 22, the House GOP task force on health care reform – which includes Ways and Means Chairman Brady along with other chairs of committees with jurisdiction over the issue – laid out its vision of a revamped health care system that calls for repealing the PPACA and replacing it with a series of reforms intended to reduce the cost of coverage and allow individuals to carry coverage with them while they move from job to job, while also preserving the current system of employer-provided health insurance.
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/160624_1suppB.pdf

On the tax side, that would mean scrapping current-law provisions such as the individual and employer mandates, the 0.9 percent Medicare Hospital Insurance Tax and the 3.8 percent net investment income tax imposed on certain upper-income taxpayers, the so-called "Cadillac" excise tax on certain high-cost employer-provided insurance plans, the 2.3 percent excise tax on medical device manufacturers and importers, the excise tax on drug manufacturers and importers, and the increased floor (10 percent of adjusted gross income) for claiming the medical expense deduction.

The health care blueprint's core tax provisions include a cap on the exclusion for employer-provided health insurance, a tax credit for individuals to purchase health insurance, and expanded access to tax-preferred savings vehicles such as health savings accounts (HSAs).

Exclusion for employer-provided insurance: The blueprint contends that the current-law exclusion from employee gross income for the cost of employer-provided health insurance is regressive, suppresses wages "as workers substitute tax-free benefits for taxable income," and raises health insurance premiums by encouraging employers to offer – and workers to select – more expensive health care coverage than they otherwise might need. Capping the amount of the exclusion, according to the blueprint, would encourage employers to redesign their health care plans to avoid the cap "by shifting compensation away from health care and toward take-home pay."

The threshold for capping the exclusion is not provided. The blueprint states only that the cap would be set "at a level that would ensure job-based coverage continues unchanged for the vast majority of health insurance plans" and that the amount of the cap would be adjustable to account for regional differences in the cost of health care. The latter feature, according to the blueprint, is a key distinction between the GOP proposal and the current-law Cadillac tax, which imposes excise tax of 40 percent of the cost of applicable employer-provided health care coverage that exceeds a threshold amount, but does not adjust the threshold for high cost-of-living areas. (The Obama administration proposed to recalibrate the Cadillac tax threshold to address this issue in its fiscal year 2017 budget proposal. For prior coverage, see *Tax News & Views*, Vol. 17, No. 8, Feb. 12, 2016. The Cadillac tax is currently scheduled to take effect in 2020.)
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/160212_1.html

Expanding HSAs: To encourage "consumer-directed health care," the blueprint calls for expanding access to HSAs – tax-preferred savings accounts which, when used in conjunction with a high-deductible health insurance plan, allow individuals to pay for qualifying out-of-pocket health care expenses "using tax-free dollars." Specific reforms cited in the blueprint would:

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- Allow spouses to make catch-up contributions to the same HSA account;
- Allow qualified medical expenses incurred before HSA-qualified coverage begins to be reimbursed from an HSA account as long as the account is established within 60 days;
- Set the maximum contribution to an HSA at the maximum combined and allowed annual deductible and out-of-pocket expense limits; and
- Expand accessibility for HSAs to certain groups, like those who get services through the Indian Health Service and TRICARE.

Several of these proposals were addressed in three measures – H.R. 5445, H.R. 5452, and H.R. 5458 – that were approved by the Ways and Means Committee on June 14. (For prior coverage, see *Tax News & Views*, Vol. 17, No. 22, June 17, 2016.) H.R. 5452, which would make access to HSAs available to individuals who use the Indian Health Service, was approved by the full House on June 21.
URL: http://newsletters.usdbriefs.com/2016/Tax/TNV/160617_2.html

The blueprint also calls for expanding so-called health reimbursement arrangements (HRAs), an employer-funded benefit under which employees are reimbursed tax-free for qualified medical expenses up to a maximum dollar amount for a coverage period.

Health care tax credit: For individuals and families without access to employer-sponsored health insurance, the blueprint proposes the creation of a "universal advanceable, refundable tax credit" that could be used to purchase insurance coverage in the open market. The blueprint does not specify the credit amount, but indicates that it "would be adjusted for age, ensuring older Americans receive more support, and would grow over time."

Because the credit be refundable, an individual who purchases insurance coverage that costs less than the credit amount would be able to have the difference deposited into "an HSA-like account" to pay for other health care expenses such as over-the-counter medicines or dental and vision care.

Revenue-neutral tax reform?

The tax reform task force notes in its blueprint that "it envisions tax reform that is revenue neutral" – though in a way that is unlikely to sit well with congressional Democrats, many of whom believe tax reform (at least on individual side of the tax code) should, on net, result in higher federal revenue levels.

First, the blueprint notes that revenue-neutrality should be measured against a budget baseline that assumes all remaining temporary tax provisions are made permanent. Moving to such a "current policy" baseline would reduce tax reform's revenue target by about $400 billion, according to the blueprint.

Second, the blueprint states that the feedback effects on revenue levels from economic growth – so-called "dynamic" effects – should be factored in to any budgetary assessment of the overall plan.

Finally, the blueprint makes explicit that House Republicans do not intend to offset with other revenue the tax cuts included in their health care policy blueprint. The tax reform task force notes that it expects the revenue loss from the repeal of the PPACA tax provisions would be offset by the repeal of the various PPACA entitlements.

Democratic reaction

Not surprisingly, Democratic reaction to the blueprint was critical. Ways and Means ranking Democrat Sander Levin of Michigan said in a June 24 news release that the proposal would "significantly decrease the tax burden on the wealthiest households, with no relief for hardworking American families." He also questioned the plan's reliance on dynamic scoring to achieve revenue neutrality, noting that "dynamic scoring has proven to be extremely unreliable and is used by Republicans to cover up their fiscal irresponsibility."

Levin also criticized the plan for not including any measures to prevent erosion of the corporate tax base in conjunction with the shift to a territorial system.

Senate Finance Committee ranking Democrat Ron Wyden of Oregon struck a similar tone.

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"There is no question it's long past time that we reform our badly broken and overly complicated tax code. Few would disagree that we need a fresh set of simple rules that creates good jobs at home, helps our country compete and win internationally, and is fiscally responsible," Wyden said in a June 24 news release. "Any serious, bipartisan reform effort must help all hard working Americans get ahead. The House GOP's framework goes in the opposite direction, allowing the privileged few to push what they rightfully owe onto the backs of middle class families."

Next steps

With the blueprint's release, committee members and House tax staff will now turn to the task of fleshing out the many details needed and converting the outline into legislative language. While no timeline has been set, it is thought unlikely that legislation will be released this year.

Ways and Means Chairman Brady said members will be asking their constituents for feedback on the proposal.

"Here's the challenge going forward," he said. "Tax reform only happens once a generation, and it can too easily be hijacked by Washington and special interests. ...Let your voice be heard."

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