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GOP tax reform framework long on rate cuts, short on pay-fors

The "Big Six" negotiating team of congressional Republican leaders and White House officials released a long-awaited tax reform framework on September 27 that calls for ambitious cuts to tax rates for corporations, passthrough entities, and individuals; a more generous – albeit temporary – expensing regime; significant increases to the individual standard deduction and the child tax credit; and repeal of the estate tax and the individual alternative minimum tax.
URL: https://waysandmeansforms.house.gov/uploadedfiles/tax_framework.pdf

But even though the plan contemplates that tax reform will result in the modification, scaling back, or outright repeal of many current-law business and individual tax incentives, it provides relatively few specifics on the policy tradeoffs that will be necessary to enact reform within the confines of budget rules that prohibit legislation moved under fast-track reconciliation protections from increasing the federal deficit outside the 10-year budget window.

Members of the Big Six include House Ways and Means Committee Chairman Kevin Brady, R-Texas, Senate Finance Committee Chairman Orrin Hatch, R-Utah, House Speaker Paul Ryan, R-Wis., Senate Majority Leader Mitch McConnell, R-Ky., Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn.

Business provisions

In general, the framework calls for restructuring the business tax rules to create a more competitive environment for large and small businesses alike.

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Corporate rate reductions: The framework calls for reducing the US statutory corporate rate from 35 percent down to 20 percent, which would place the US below the OECD average of 22.5 percent. President Trump had pushed for a rate of 15 percent, however most members of the Big Six indicated in public comments in recent weeks that a 15 percent corporate rate would be unrealistic given the large revenue loss associated with that level of rate reduction.

Integration in the mix?: The framework also leaves the door open for a corporate integration proposal – an approach favored by Finance Committee Chairman Hatch – noting that the congressional taxwriting committees "may consider methods to reduce the double taxation of corporate earnings." (Hatch has been an outspoken advocate of corporate integration and has spent considerable time over the past few years developing a plan that would couple a dividends-paid deduction with a withholding tax on both interest and dividend payments, although he has not released a formal proposal. Senate taxwriter John Thune, R-S.D., recently told reporters that a Finance Committee tax reform bill could include a "partial corporate integration" plan that likely would not have a withholding component.)

Corporate AMT: Under the framework, the corporate alternative minimum tax would be repealed, though no mechanism is specified for dealing with existing AMT credits.

Passthroughs: The framework calls for a top rate of 25 percent on "small businesses" – defined as a business organized as a sole proprietorship, partnership, or S corporation – which are currently taxed on the individual side of the code. To address concerns that a special passthrough rate will lead to gaming, the framework also says that the taxwriting committees will be tasked with drafting rules to prevent recharacterization of wage income as partnership income. The framework does not, however, provide guidelines for what those anti-abuse rules should look like, though in the past, Secretary Mnuchin has commented that the lower rate will not be available for professional services income.

Treatment of capital expenditures, net interest expenses: The framework would allow businesses to immediately write off 100 percent of the cost of new capital investments – other than structures – for "at least five years," effective for investments after September 27, 2017.

The ability of C corporations to deduct net interest expenses would be "partially limited"; however, the framework leaves it to the taxwriting committees to determine how any limitations will operate.

Changes to business incentives: According to the framework, the substantial reduction in marginal business tax rates will eliminate the need for additional business incentives so many will be pared back or repealed.

Although it generally does not elaborate on the fate of specific current-law business tax incentives, the framework explicitly identifies the section 199 deduction for domestic manufacturing activity as a target for repeal. It also specifically calls for retaining current-law credits for research and development and for low income-housing.

Credits for specific industries: The framework states without further elaboration that the taxwriting committees will look to "modernize" rules governing the tax treatment of "certain industries and sectors" to ensure "that the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance."

International taxation

For US multinationals, the framework proposes switching from a worldwide system, where all profits are subject to the US statutory rate upon repatriation regardless of where they were earned, to a territorial system that provides for a 100 percent exemption for dividends paid by a foreign subsidiary to a US parent with at least 10 percent ownership.

Deemed repatriation: To transition to the new system, accumulated overseas earnings would be deemed repatriated and taxed over an unspecified period at one of two rates (one for earnings held in illiquid assets and one for cash or cash equivalents). The framework does not specify the rates, but presumably, as in prior proposals, the rate for cash and cash equivalents will be higher.

Minimum tax: The framework calls for "rules to protect the US tax base by taxing at a reduced rate on a global basis the foreign profits of US multinational corporations," but leaves the specifics of those rules – including the applicable rate – to the taxwriting committees.

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Individual provisions

On the individual side, the drafters of the framework indicate that their primary focus is on reducing tax burdens on the middle class and "creating a healthier economy [to] give American families greater confidence and help them get ahead."

Income tax brackets and rates: The framework calls for compressing the current seven income tax rate brackets into three: 12 percent, 25 percent, and 35 percent.

However, the framework leaves the option open for Congress to create an additional new top bracket for "the highest-income taxpayers" – at an unspecified rate – to ensure the tax code is "at least as progressive as the current tax code."

Increased standard deduction: The framework essentially would double the current-law standard deduction to $12,000 for single filers and $24,000 for married filers. The personal exemption would be repealed as would, presumably, the "head of household" filing status.

The framework states that the increased standard deduction is meant to create more taxpayers within the "zero bracket" as well as address some concerns over raising the lowest tax rate from 10 percent to 12 percent.

Capital gains rates: The framework does not mention changes to tax rates on capital gains, although it notes that the taxwriting committees will be tasked with examining "additional measures to meaningfully reduce the tax burden on the middle class."

Carried interests: The framework does not discuss the tax treatment of income from carried interests.

Estate tax, AMT: The estate tax and the individual alternative minimum tax would be repealed.

Individual incentives: To replace the personal exemptions for dependents, the framework would increase the child tax credit as well as the income threshold at which the credit begins to phase out. (Neither amount is given in the framework, but it specifies the first $1,000 of the credit will remain refundable.) There is an additional nonrefundable credit of $500 for nonchild dependents.

Itemized deductions: The framework proposes – largely without elaboration – to eliminate the vast majority of current-law itemized deductions other than those for charitable contributions and mortgage interest payments. In their recent public comments, however, members of the Big Six have specifically identified the deduction for taxes paid to state and local governments as a current-law incentive that would be eliminated under tax reform. This has already been flagged as an issue by congressional lawmakers in both parties who represent higher-tax states.

Work, education and retirement savings: The framework generally calls for retaining current-law incentives that promote work, education, and retirement savings, but tasks the taxwriting committees with streamlining them to increase their efficiency.

Ambitions of the framework meet reality of budget rules

A critical aspect of tax reform missing from the framework is its overall net impact on the federal budget. Taken together, it is likely that the revenue-losing policies enumerated in the plan – including the reduced rates on individual, corporate, and passthrough business income, enhanced expensing, the territorial system, plus the repeal of the corporate and individual AMT and the estate tax – would cost several trillion dollars over the next decade.

But under the special legislative process Republicans are eyeing to move a tax bill through the Senate on a simple-majority basis – *i.e.*, "budget reconciliation" – legislation generally cannot increase the deficit in any year beyond the budget window (which is typically 10 years), lest it be subject to procedural hurdles under the "Byrd Rule" that require 60 votes to waive. (Because Republicans currently control 52 of 100 Senate seats and more-than-token Democratic support for a tax reform bill that follows these general contours is not anticipated, Byrd Rule waivers presently seem very unlikely.)

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In practical terms, this means Republicans eventually also must identify several trillion dollars' worth of revenue-*raising* provisions (in addition to the few alluded to in the framework such as partially limiting interest deductibility for C corporations, repealing the section 199 domestic manufacturing deduction, and repealing the itemized deduction for state and local taxes) if they want to enact the framework's tax cuts on a permanent basis – or, absent that, scale back their tax-cutting ambitions to something they are, in fact, able to fully finance over the long-run.

These difficult trade-offs are exemplified in a recent analysis by the nonpartisan Tax Policy Center which concludes that, even if Congress were to eliminate *all* business tax expenditures – including the research credit, which the framework says should be maintained in some form – the lowest top corporate rate achievable on a long-run revenue-neutral basis is 26 percent.
URL: http://www.taxpolicycenter.org/taxvox/experiment-how-low-could-tax-rates-go-if-congress-eliminated-all-tax-expenditures

Another possibility, which has been alluded to by Republican leaders including Speaker Ryan, would be to sunset certain revenue-losing provisions such that they no longer score as deficit-increasing over the long run, perhaps with the hope that a future Congress and president would act to extend them further, or even make them permanent – similar to what ultimately occurred with respect to a large share of the individual tax cuts originally passed under budget reconciliation in 2001 and 2003.

Senate budget process to kick-off next week: Before any tax bill can be moved under reconciliation, however, the House and Senate GOP first must adopt a budget resolution for fiscal year 2018 that includes reconciliation instructions to the taxwriting committees in both chambers. Senate Majority Leader Mitch McConnell, for his part, signaled this week that a budget mark-up would occur in the Senate Budget Committee during the week of October 2.

Based on reports recent reports, the Senate budget resolution – the text of which may be made public as early as September 30 – could differ significantly from the budget resolution that cleared the House Budget Committee on July 19. (For prior coverage, see *Tax News & Views*, Vol. 18, No. 32, September 22, 2017.)
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/170922_1.html

Specific to tax reform, the Senate budget is expected to incorporate a handshake deal struck by Budget Committee Republicans Bob Corker of Tennessee and Pat Toomey of Pennsylvania on September 19 that would instruct the Senate Finance Committee to report legislation that reduces revenues by as much as $1.5 trillion over the next decade. According to comments made by Sen. Corker, this would give taxwriters some political flexibility to pursue tax legislation on a filibuster-proof basis that is not fully-financed. (Note, however, that the "Byrd Rule" mentioned above would continue to constrain the GOP's ability to enact a fully *permanent* tax bill that increases the deficit beyond the budget window.)

House budget developments: Meanwhile, the budget plan advanced by the House Budget Committee earlier this summer includes a broad set of reconciliation instructions to 11 committees aimed at expediting both revenue-neutral tax reform and significant cuts to entitlement programs. (For details, see *Tax News & Views*, Vol. 18, No. 26, July 21, 2017.) But a vote by the full House had been held up by members of the conservative House Freedom Caucus who demanded details of the tax reform proposal first. (Because no Democrats are expected to support the budget resolution, Republican leaders can afford to lose only about two dozen votes, and the House Freedom Caucus has about three dozen members.) The Freedom Caucus officially endorsed the new framework on September 27, clearing the path for a possible floor vote as soon as the week of October 2.
URL: http://newsletters.usdbriefs.com/2017/Tax/TNV/170721_1.html

Challenges for the taxwriting committees

With the release of the framework, it now falls to the congressional taxwriting committees to turn the high-level guidance into legislative language – filling in the gaps in a way that ensures the bill meets budgetary requirements and crafting the complex but crucial transition rules – something Senate Majority Leader Mitch McConnell has labeled a "daunting task."

Ways and Means likely up first: The Ways and Means Committee is expected to act first, meeting the requirement that all revenue measures must originate in the House. While Chairman Brady has not set an official timeline, he reportedly has said he hopes to release a legislative product sometime in October and complete a mark-up and vote in the committee before Thanksgiving.

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“Now it’s time for the Ways and Means Committee to build on this momentum and deliver legislation that President Trump can ultimately sign into law,” said Brady in a September 27 press release. “We are closer than ever to finishing what we have started for the American people – and 2017 is our year to make it happen.”

But Brady has noted that release of draft legislation won’t take place until the House completes its work on the fiscal year 2018 budget resolution, which will carry reconciliation instructions and revenue targets for the tax reform process.

One potential challenge to a GOP tax reform plan in the House is likely to come from a group of 52 Republicans representing districts where taxpayers disproportionately use the current state and local tax deduction slated for repeal under the new framework. Rep. Peter King of New York, who calls the incentive “absolutely essential to my district,” says he’ll vote against any package that includes repeal – and he believes he has the support of enough colleagues to force the issue.

“I intend to fight it with everything I know how,” said Rep. Tom MacArthur of New Jersey.

The elimination of the deduction is estimated to raise a significant amount of revenue that will help offset lower rates and other beneficial changes (last year, the Joint Committee on Taxation estimated the deduction’s cost at more than $368 billion through 2020), so removing the provision from the bill would make the math even harder for taxwriters.

Similar political battles are likely to be waged over the many still-to-be-unveiled revenue raising provisions that will be necessary to offset the cost of the large proposed rate reductions.

Whither the Senate?: The Senate poses an additional challenge for tax reform. With Republicans holding only 52 seats and with few Democrats currently expected to support a GOP tax reform package, the margin for error is extremely small and – as leadership has experienced with health care legislation this year – it can be challenging to draft a bill that satisfies the diverse interests of senators even within a single party.

Moreover, while the Big Six framework means the House and Senate are starting from the same point, Finance Committee Chairman Hatch recently made it clear that his panel will not necessarily reach the same conclusions as its House counterpart.

“Any forthcoming documents may be viewed as guidance or potential signposts for drafting legislation, but at the end of the day, my goal is to produce a bill that can get through this committee.” he said during a September 14 hearing on the individual side of the tax code. “Anyone with any experience with the Senate Finance Committee knows that we are not anyone’s rubber stamp,” he added.

Emphasizing the challenge ahead to reporters today, Sen. Bob Corker of Tennessee said that “tax reform is going to make health care look like a piece of cake.”

No bipartisan kumbaya expected: While both Hatch and Brady have said they welcome input from their Democratic colleagues and would like bipartisan support for tax reform legislation – and President Trump continues to try and woo several Senate Democrats from deep red states – the framework is an entirely Republican-crafted product unlikely to get any support from the other side of the aisle.

“If this framework is all about the middle class, then Trump Tower is middle-class housing,” said Sen. Ron Wyden of Oregon, the Finance Committee’s senior Democrat, in a September 27 press release. “It violates Trump’s tax pledge that the rich would not gain at all under his plan by offering sweetheart deals for powerful CEOs, giveaways for campaign coffers and a new way to cheat taxes for Mar-a-Lago’s loyal members. This continued lack of detail for the middle class guarantees that average Americans will be the ones hit with shrinking paychecks and higher tax bills,” Wyden said.

Finance Chairman Hatch offered his own take on bipartisanship in the tax reform process during a September 27 interview on Fox Business.

“I hope we don’t need Democratic votes, but I hope we get them…I think we can hold together the Republicans on this matter.”

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