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Tax Reform – An Update Based on Recent Statements from the Trump Administration

The Trump plan released this week proposes a significant reduction of tax rates applicable to business income (including income earned through pass-through entities) and a territorial system (with a one-time tax on accumulated overseas earnings) as in Congress' blueprint, but is silent on border-adjusted tax and deductibility of interest expense or capital expenditure.

Introduction

On April 26, 2017, Secretary of the Treasury Steven Mnuchin and Director of the National Economic Council Gary Cohn held a White House Press Briefing (the Briefing) addressing a high-level plan distributed at the Briefing entitled "2017 Tax Reform for Economic Growth and American Jobs" (the Trump Plan) that provides an outline of the goals and principles upon which the Trump Administration will focus in the context of tax reform. The following summarizes the fundamental changes proposed in the Briefing and the Trump Plan, and includes a comparison to certain key elements of the House Ways & Means Committee blueprint[1] (the Blueprint).

Summary of the Trump Plan

The Trump Plan calls for the following major changes in the taxation of businesses and individuals:

For businesses:

- The top corporate tax rate would be reduced from 35% to 15%.
- Business owners would be taxed at a rate of 15% on income earned through pass-through entities, rather than at ordinary income rates.
- The US would move towards a territorial system in which the foreign earnings of US multinationals are generally exempt from taxation.
- A one-time tax, at an unspecified rate, on the overseas profits of US businesses would be imposed.

For individuals:

- The number of tax brackets would be reduced from seven to three, with rates of 10%, 25% and 35%, thus bringing the top marginal rate down from 39.6% to 35%.

- The standard deduction would be increased to US$12,700 for individuals and US$25,400 for married couples filing joint returns.
- All itemized deductions other than with respect to mortgage interest and charitable contributions would apparently be eliminated.
- The 3.8% tax on net investment income, the estate tax and the Alternative Minimum Tax (AMT) would be eliminated.

Notably, the Trump Plan is silent on the deductibility of interest expense and capital investment, and is also silent on the issue of a border-adjusted tax.

Comparison to Certain Key Elements of the Blueprint

The below chart provides an overview of the similarities and differences between the Blueprint and the Trump Plan on five key issues of concern to businesses, which may be instructive as business leaders and in-house counsel analyze how tax reform may ultimately impact the taxation of their businesses and potential transactions.

Blueprint	**Trump Plan Released April 26**
1. Lower Corporate / Investment / Pass-Through Income Tax Rates	
Corporate tax rate of 20% and elimination of corporate AMT.	Corporate tax rate of 15% and possible elimination of corporate AMT.
Investment income (including interest) generally taxed at 16.5% and elimination of 3.8% net investment income tax for individuals.	Maximum rate of 20% on capital gains and dividend income for individuals. Elimination of 3.8% net investment income tax for individuals. Effect on taxation of investment interest income unclear.
Special 25% rate on distributive share of business income allocable to partners/members in pass-through entities.	15% rate on business income allocable to partners/members in pass-through entities.
2. Interest and Other Deductions	
Investments in tangible and intangible assets (other than land) can be fully expensed in the year incurred.	No indications of changes to current law.

Blueprint	Trump Plan Released April 26
No net interest deduction, for related or unrelated party debt, with net interest expense instead being carried forward indefinitely to offset interest income.	No indications of changes to current law.
Certain “Special interests” deductions are eliminated, but the R&D credit remains in place.	No indications of changes to current law.
3. Territorial System	
Going forward, foreign earnings of US multinationals are generally exempt from US tax regardless of whether those earnings are held offshore or repatriated.	Going forward, foreign earnings of US multinationals are generally exempt from US tax regardless of whether those earnings are held offshore or repatriated.
4. One-Time Tax on Certain Foreign Earnings	
The existing, deferred foreign earnings of US multinationals are subject to a one-time tax of 8.75% (for earnings held in cash and cash equivalents) and 3.5% (for other earnings), each payable over eight years.	The existing, deferred foreign earnings of US multinationals are subject to a one-time tax, with rate and timing of payment to be determined.
5. Border Adjustment Tax	
Businesses are taxed on cash flow rather than income. Border adjustments are imposed that are intended to subject imports to full tax while exempting exports. Net effect is a business tax that is akin to a tax on US consumption.	No indications of changes to current law.

Observations

The Trump Plan proposes two fundamental changes to the Blueprint and current law that are of particular note as the debate over comprehensive tax reform continues:

1. The Blueprint provides for: 1) the immediate expensing for all business investments; 2) the elimination of the deduction for interest expense; and 3) the imposition of a border-adjusted tax; thus largely adopting the framework of a cash-flow tax system for business income. The Trump Plan, on the other hand, maintains the framework of an income tax system with significant rate cuts and an overhaul of certain tax regimes within such system.

2. The Trump Plan, even more than the Blueprint, would reduce the tax on business income of "pass-through entities" — those entities that are not subject to an entity-level income tax — to a maximum of 15% at the owner level from 39.6% under current law. Such a dramatic rate reduction would likely have a significant effect on business formation and planning.

Conclusion

While significant questions remain, the principles set forth in the Blueprint and the Trump Plan identify the initial fundamental tax reform points for consideration and discussion in the coming months, including as the Trump Administration engages with Congress and members of the business community in the coming weeks. Latham's recently published tax *Client Alert* focused on strategies for executing transactions in the face of the uncertainty presented by the Blueprint, outlining the impact of the proposed changes on M&A, finance and the overall global business platform. Latham will continue to carefully monitor tax reform developments and provide resources — including worthwhile third-party content materials — and insights through the Latham & Watkins US Tax Reform Resource Center.

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Endnotes

1 House Ways & Means Committee, "A Better Way – Our Vision for a Confident America," June 2016.