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The Path to Tax Reform 2017: Long-Awaited Tax Cuts and Jobs Act Released by House Ways & Means Committee for Potential Passage This Year

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With the release yesterday by the House Ways and Means Committee of draft statutory text of the Tax Cuts and Jobs Act ("Chairman's Mark"), and with GOP majorities in both chambers of Congress proceeding under budget reconciliation rules, there is a possibility that Washington will pass before year-end the most comprehensive tax reform since 1986. The president has identified tax reform as a top priority, and many agree that tax reform is a "must do" given the dreadful state of the tax system. While the Republicans' false starts this year on repealing and replacing the Affordable Care Act illustrate that advancing legislation is challenging and often unpredictable – notwithstanding Republican control – there seems to be growing consensus on the urgency for tax reform, but there are many surprises in the draft legislation and the details are almost certain to give rise to some level of controversy.

For businesses, the Chairman's Mark calls for, among other items:

- A corporate tax rate of 20 percent.
- A territorial system of corporate taxation but with current taxation of 50 percent of "foreign high returns."
- Allowance of current deductions for the cost of new investments in qualified depreciable assets for five years.
- Limitations on interest deductions for large businesses except those related to public utilities and real estate.
- A 20 percent excise tax on certain deductible or capitalizable payments by very large corporations to related foreign corporations.
- A one-time repatriation tax on corporate earnings held overseas, applying different rates to liquid assets (12 percent) and illiquid assets (5 percent), and payable in equal installments over eight years.
- A top tax rate of 25 percent on pass-through profits attributable to capital, but not labor (i.e., compensation), applying certain presumption rules.
- Repeal of the corporate alternative minimum tax (AMT).

For individuals, the Chairman's Mark calls for, among other items:

- A reduction of the current seven brackets to four: 12 percent, 25 percent, 35 percent, and a top individual tax rate of 39.6 percent for couples with taxable income of $1 million or more and individuals with taxable income of $500,000 or more.
- Elimination of most itemized deductions (including state and local income and sales tax deductions) other than charitable deductions, home mortgage interest deductions (with a lower cap), and state and local property tax deductions (capped at $10,000).
- A (nearly) doubling of the standard deduction.
- Repeal of the individual AMT.
- A doubling of the estate tax exemption thresholds followed by proposed repeal in 2024.

There seems to be 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 some of the budgetary impact of sweeping tax cuts. Markup in the House Ways and Means Committee is scheduled for Nov. 6, with passage intended in the House before Thanksgiving. The Senate will continue its efforts simultaneously, with markup in the Senate Finance Committee set for the week of Nov. 13.

Reduced corporate tax rate

The Chairman's Mark would reduce the corporate tax rate to 20 percent. A number of deductions and credits would be eliminated to broaden the tax base. Net operating losses (NOLs) would be allowed only to the extent of 90 percent of taxable income, and new NOLs could only be carried forward, but would be increased by an interest factor. Importantly, the research and development credit would remain in place to incentivize U.S. development of intellectual property. Additionally, the Chairman's Mark would preserve the low-income housing credit (though no additional new markets credits would be allocated after 2017). Other benefits such as the domestic manufacturing deduction would be repealed in favor of a lower rate. The corporate AMT would be repealed in an effort to simplify the tax law.

A territorial corporate tax system

Another key component of tax reform is moving to a territorial tax system. The territorial approach would exempt foreign active business income by providing a 100 percent deduction to U.S. corporations for dividends received from foreign subsidiaries (in which the U.S. corporations own at least 10 percent). The territorial proposal would allow for future offshore earnings to be repatriated to the U.S. without additional tax, which would have a positive impact on a company's ability to access its foreign cash. The Chairman's Mark also proposes a number of base-erosion prevention proposals. The current "subpart F" rules applicable to passive and readily movable foreign income generally would remain in place (subject to some modifications, such as the repeal of the foreign base company oil-related income rules and making permanent the look-through rules for certain dividends, interest, royalties and rents). The rules causing a foreign corporation's investment in U.S. property to be deemed a subpart F inclusion (i.e., Section 956) would be repealed for U.S. corporations.

Deemed-paid foreign tax credits would be allowed only with respect to subpart F inclusions (not dividends eligible for the territorial regime). Also, income from inventory produced in the U.S. and sold abroad would no longer be eligible for split sourcing, but rather would be fully U.S.-sourced.

The lower corporate tax rate combined with moving to a territorial system would align the U.S. tax system with the majority of tax systems throughout the developed world. The proposed changes are intended to eliminate both the competitive disadvantage created by our current worldwide system and the incentive for U.S. companies to invert. The measures to help prevent base-erosion may be prudent from the perspective of protecting the U.S. tax base but could lead to continued pressure on multinational groups not to be headquartered in this country.

Tax on foreign earnings

As part of a transition to a territorial system, the Chairman's Mark imposes a deemed repatriation tax on foreign earnings that have accumulated abroad or have been reinvested, albeit at a lower rate than current law. The Chairman's Mark proposes to tax the foreign accumulated earnings that are held in cash or cash equivalents at 12 percent and reinvested earnings held in illiquid assets at 5 percent. The deemed inclusion would apply to the greater of earnings and profits as of Nov. 2, 2017, or Dec. 31, 2017. The mechanics involve a deemed inclusion at the relevant year-end (irrespective of whether cash is actually repatriated), with a dividends-received deduction to reduce the taxable income sufficient to result in the 12 percent or 5 percent rate, as the case may be. A proportionate foreign tax credit would be allowed for foreign taxes paid or deemed paid on the deemed repatriated earnings. The Chairman's Mark allows the repatriation tax to be paid in equal installments over an eight-year period.

Increased deductions of certain capital expenses to stimulate growth

The Chairman's Mark also provides for an increased allowance of current deductions for certain capital expenses. It proposes to allow businesses an immediate deduction for the cost of new investments in certain depreciable assets (i.e., not structures or land) acquired and placed in service after Sept. 27, 2017, and before Jan. 1, 2023. However, rules that would allow tax-free like-kind exchanges of property would be repealed except for real property exchanges.

Interest deductibility limitations

The Chairman's Mark would limit a large business's deduction for net interest expense to 30 percent of the business's adjusted taxable income (roughly, EBITDA) and would repeal the existing Section 163(j) anti-earnings-stripping rules.

Prevention of Base Erosion

Disallowance of deductions for disproportionate U.S. leverage

The Chairman's Mark would impose an additional limit on the ability of a very large (i.e., groupwide global gross receipts of more than $100 million) U.S.-corporate member of a multinational group to deduct net interest expense. This additional limitation would apply to the extent the U.S. corporation bore a disproportionate amount of the group's global net interest expense. The U.S. corporation's share of the group's global net interest expense could not exceed 110 percent of its share of the group's global EBITDA. The excess portion would not be deductible. A corporation subject to this rule would be disallowed the greater of the amounts disallowed under this rule or the 30 percent of adjusted taxable income rule described above.

Current U.S. taxation of foreign high returns

The Chairman's Mark would subject a U.S. corporation to current taxation on half of its foreign high returns. The foreign high returns would be based on the U.S. corporation's foreign subsidiaries' earnings over a routine return, as determined by a formula. A limited deemed paid foreign tax credit would be allowed to reduce the U.S. tax on the inclusion. "Foreign high returns" generally would mean the amount in excess of a return (the applicable federal rate plus 7 percent) applied to the adjusted basis of tangible depreciable property, adjusted downward for interest expense, determined across the foreign subsidiaries on an aggregate basis. Fifty percent of the income from such foreign high returns would be subject to current taxation in the U.S. (at the new 20 percent rate, essentially providing a 10 percent tax). Foreign tax credits would be separately basketed on the foreign high returns and would be limited to 80 percent of the foreign taxes paid, and any excess foreign taxes could not be carried back or forward.

Twenty percent excise tax on certain payments to related foreign corporations

The Chairman's Mark would subject certain deductible or capitalizable payments (other than interest) made by a very large U.S. corporation to a related foreign corporation to a 20 percent excise tax. The excise tax would not apply, however, if the recipient of the payments elected to be taxed in the U.S. on the net income attributable to the payments. The attributable net income would be based on the profit margins reported in the group's financial statements. The provision would apply only to groups with average annual payments from U.S. corporations to their foreign affiliates totaling at least $100 million.

Limitation on reduced U.S. withholding tax under treaties

The Chairman's Mark would limit the availability of reduced U.S. withholding tax on a deductible payment (e.g., interest or royalties) by a U.S. subsidiary of a foreign-parented group to a foreign member of the group. The reduced U.S. withholding tax would apply only if the foreign parent would have been eligible for reduced U.S. withholding if the payment had been made directly to it.

Timing and process

The Republicans are highly incentivized and motivated to move quickly on tax reform, particularly given the false starts on repealing and replacing the Affordable Care Act. The window for achieving tax reform will not be open for very long.

2018 is a congressional election year, and there will be considerable pressure to complete tax reform before those campaigns advance very far. The markup process in the Ways and Means Committee should be complete by the end of next week, and the House may pass its tax reform bill before Thanksgiving. If that agenda is successful, the Senate could be in a position to act on the legislation before year-end. The bill requires only 51 votes in the Senate because this legislation is proceeding under the budget reconciliation process.

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House Speaker Paul Ryan (R-Wis.) at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

Rep. Peter Roskam (R-Ill.), chairman of the House Ways and Means Subcommittee on Tax Policy, talks tax reform at BakerHostetler's 28th Annual Legislative Seminar on April 26, 2017.

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