Client Alert News Flash

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Tax Reform Update: 4 Issues to Watch as Congress Nears Summer Recess

Administration and Congressional tax negotiators abandon border adjustment tax, but leave unanswered questions regarding rates, revenues, and taxation of US multinationals.

As Congress heads toward its late summer 2017 recess, the shape of potential tax reform is beginning to come into focus. On July 27, the Trump Administration and Congressional leaders issued a joint statement (the <u>Joint Statement</u>) providing a basic outline of the goals of tax reform.¹ In the wake of the Joint Statement's release, this *Client Alert* summarizes several key issues to watch as the business tax reform process moves forward.

Issues to Watch

1. Rate Reductions

As discussed in a previous Latham & Watkins <u>*Client Alert*</u>, the Trump Administration's high-level tax plan released on April 26, 2017, proposed reducing the top corporate tax rate from 35% to 15% and taxing income earned via pass-through entities at 15% rather than at ordinary income rates. The June 2016 House Ways & Means Committee Tax Reform Blueprint (the <u>Blueprint</u>) called for a 20% corporate rate and a special 25% rate applicable to pass-throughs' active business income.

The Joint Statement reflects the Trump Administration's and Congressional leaders' shared goal of reducing tax rates for businesses, both large and small, but includes no specific proposed rates. Many observers have regarded the goal of rates in the teens as aspirational, and it appears such rate reductions may be a challenge, especially given the Joint Statement's elimination of a border-adjusted tax (BAT), whose proponents expected it to provide the key revenue offset to rate reductions as part of a revenue-neutral reform process.

2. Territorial System

As expected, the Joint Statement suggests significant changes in the taxation of the foreign earnings of US multinationals. Indeed, the business community is unlikely to refer to any legislative proposal as real "reform" if such legislation does not include significant changes in this area. Specifically, the Joint Statement calls for a tax "system that encourages American companies to bring back jobs and profits trapped overseas" and that ensures "a level playing field between American and foreign companies and workers." Again, as expected, this language suggests (i) a mandatory one-time (deemed repatriation) tax on the estimated US\$2.5 trillion of existing deferred overseas earnings accumulated by US

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multinationals,² and (ii) a move toward a territorial system whereby future foreign earnings would be exempt, or at least subjected to significantly lower US tax rates, on a current or deferred basis.³

3. Expensing of Capital Investments

The Joint Statement also calls for "unprecedented capital expensing." Even if this language does not mean full and immediate deductibility of capital investment, the Joint Statement appears to signal a move to greater expensing than allowed under current law.

4. Revenue Offsets to Rate Reduction Given Removal of BAT

- Interest Expense? A revenue offset that may still be on the table is the elimination of, or limitations on, the deductibility of interest expense. Some observers had expected limitations on interest deductibility to offset the revenue anticipated to be lost if full and immediate expensing of capital investment were adopted. The Joint Statement, however, is silent on the deductibility of interest expense.
- **Minimum Tax on Foreign Earnings?** One important question is whether the loss of the BAT revenue offset, combined with concerns over possible erosion of the US tax base, in part resulting from a shift to a territorial system, could raise the prospect of a mandatory minimum tax on future foreign earnings, which would be a new component in the recent tax reform debate. The Joint Statement does not discuss a minimum tax, nor have other releases from policymakers discussed such a tax, but the idea might become a topic of discussion. Ironically, it was the Obama Administration that proposed such a concept in its Fiscal Year 2016 budget.

Observation

As the Labor Day holiday approaches and passes, observers should see a lot more activity surrounding tax reform, including details from the White House on certain key issues not addressed in the Joint Statement, further hearings in Congress, and specific legislative language from the key committees.

Latham previously published a <u>*Client Alert*</u> focused on strategies for executing transactions in the face of the uncertainty surrounding the tax reform debate and the potential impact that reform could have on M&A, finance, and the overall global business platform, as well as another <u>*Client Alert*</u> focused on the Trump Administration's announced plan. Latham will continue to carefully monitor tax reform developments and provide resources, including worthwhile third-party content materials, and insights through the <u>Latham & Watkins US Tax Reform Resource Center</u>.

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Endnotes

¹ The Joint Statement was issued by Treasury Secretary Steven T. Mnuchin, Speaker of the House Paul Ryan, Senate Majority Leader Mitch McConnell, Senate Finance Committee Chairman Orrin Hatch, House Ways and Means Committee Chairman Kevin Brady, and National Economic Council Director Gary Cohn — the so-called "Big 6" individuals guiding the administration's and Congress' tax reform efforts.

² The Blueprint proposed a one-time tax on the existing, deferred foreign earnings of US multinationals at a rate of 8.75% for earnings held in cash and cash equivalents and 3.5% for other earnings, each payable over eight years.

³ The Blueprint called for a territorial system in which, going forward, foreign earnings of US multinationals generally would be exempt from US tax regardless of whether those earnings are held offshore or repatriated.