Tax Legislative Update

Breaking news from Capitol Hill
From Grant Thornton's Washington National Tax Office

2017-09
Sept. 27, 2017

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Republicans coalesce around unified framework for tax reform

Republican leaders released a unified framework for tax reform on Sept. 27 that would make sweeping changes to both individual and business taxation with deep corporate rate cuts and less dramatic reductions for individuals and pass-throughs.

The framework represents a general agreement between the Trump Administration and House and Senate Republican leadership on the major pillars of tax reform. It leaves many details for the tax writing committees to resolve, but still provides the most comprehensive template for reform since the House Republican Blueprint released last year. Key aspects of the framework include:

- Creating three individual tax brackets of 12%, 25% and 35% with the potential for a fourth bracket on high-income taxpayers at an unspecified rate
- Repealing most itemized deductions, while retaining those for charitable gifts and mortgage interest
- Repealing the estate tax
- Cutting the corporate rate to 20%
- Creating a separate 25% rate on business income from pass-throughs with rules to ensure certain income remains taxed as compensation
- Providing full business expensing for depreciable assets other than structures for at least five years while limiting the interest deduction for C corporations
- Shifting to a territorial tax system with a 100% dividends received deduction for foreign subsidiaries owned at least 10% by a U.S. parent

The framework is somewhat similar to the House Republican blueprint but without the border adjustability proposal and with a clear shift toward higher individual tax rates favored by President Donald Trump. The Trump Administration has been vocal about avoiding any tax cut for high-income taxpayers, and the framework gives tax writers the ability to add a fourth tax bracket on the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers.

Many similar details, such as the income levels for the tax brackets, were omitted deliberately to allow the Congress to adjust for revenue and distribution needs. This raises the question as to just how binding the framework is. House Republican leadership was under pressure to show members details of the tax plan before they vote for a budget resolution that has been touted as a vehicle for tax reform. On the other hand, the tax writing committees expected to write tax legislation under regular order. Senate Finance Committee Chair Orrin Hatch, R-Utah, has already said his committee would not be "bound" by the agreement. As the framework was more House-driven, it more closely represents the intentions of House leaders rather than Senate leaders.

Hatch still favors allowing corporations to partially deduct dividends paid to shareholders. Senate staff have discussed pairing a 25% corporate rate with a 40% deduction so that distributed earnings would be taxed at just 15%, Trump's original target. The framework does not include any deduction for dividends, but gives committees the option to consider methods to reduce the double tax of corporate earnings.

Revenue remains a major hurdle. Administration officials said economic growth would ultimately pay for the tax cuts, but they admitted that Congress' official scorekeepers would view the plan as a revenue loser. This could complicate the reconciliation process. Republicans plan to use reconciliation to avoid 60-vote procedural blocks in the Senate, but it comes with restrictions. Reconciliation instructions can only be made in a budget resolution, and they will need to provide for a large revenue loss.

The framework does not outline a specific revenue goal, but the Senate Budget Committee is planning to mark up a budget next week that would allow for a $1.5 trillion tax cut within the budget window. Earlier drafts of the House budget resolution would not provide for tax cuts. Ultimately, the two chambers will have to go to agree on a single budget resolution for reconciliation instructions to be effective, and House Ways and Means Chair Kevin Brady, R-Texas, said he will not release or make up a tax reform bill until he receives final revenue instructions from the budget resolution.

More importantly, the reconciliation process only allows revenue losses inside the budget window, currently 10 years. A reconciliation bill cannot lose revenue outside this window. The framework does not specify how the plan could comply with this limitation, but Senate staff are reportedly considering expiring the individual tax cuts after 10 years, while making the rest of the bill permanent. Lawmakers have also discussed extending the budget window beyond 10 years, but the Senate Budget Committee does not appear to be pursuing this option.

Despite the unresolved issues, the framework is a big step toward reform. The broad agreement on the major issues should provide a potential path forward. Tax reform now appears to be the top GOP priority. With health care reform floundering, it may be Republicans' last chance at a signature legislative achievement before the 2018 elections. The following provides more details on the proposals in the framework, and includes a table comparing the framework to the House Republican blueprint.

Individual taxes

The plan calls for replacing the seven individual tax brackets that currently range from 10% to 39.6% with three tax brackets of 12%, 25% and 35%. This is higher than the House GOP blueprint's top rate of 33%, but the framework also gives tax writers the flexibility to insert a fourth bracket at an even higher rate if needed to maintain the current progressivity in the tax code. The framework does not provide income levels for the tax brackets, but does contemplate a "more accurate measure of inflation" for purposes of indexing. The alternative minimum tax would be repealed.

The framework includes no information on investment income. The House GOP blueprint had provided a 50% exclusion for interest, dividends and capital gains, resulting in effective rates of 6%, 12.5% and 16.5% depending on the taxpayer's bracket. Capital gains and dividends can be taxed at a rate as high as 23.8% under current law, and interest taxed as high as 43.4%.

The standard deduction would be increased to $24,000 for joint filers, $12,000 for single filers and $18,000 for single filers with a dependent. Personal exemptions would be eliminated, but the child credit would be increased by a "substantial amount" with a new, nonrefundable $500 credit for dependents.

The framework proposes to repeal all itemized deductions except those for mortgage interest and charitable giving, and officials confirmed that the deduction for state and local taxes would be repealed. The framework also calls for the tax writing committees to retain incentives for higher education, retirement, and work, but to "to simplify these benefits to improve their efficiency and effectiveness."

Administration officials said they are not considering proposals to convert all traditional retirement accounts into "Roth" versions, and the framework says any change to retirement plans "will aim to maintain or raise retirement plan participation of workers and the resources available for retirement." Administration officials confirmed that the earned income tax credit would be retained but said they favored changes to make the program work better.

The framework promises to repeal the estate and generation-skipping transfer tax, but makes no explicit mention of the gift tax. It includes no information on whether the step-up in basis of inherited assets would be retained or repealed.

Business taxes

The plan would create a single 20% corporate rate, down significantly from the current top rate of 35%. In addition, it would provide a top rate of 25% for business income from a pass-through entity. Pass-through businesses would be required to pay or be treated as paying reasonable compensation to their owners at ordinary income rates.

The plan provides no technical details about how to distinguish this income, only that "the committees will adopt measures to prevent the recharacterization of personal income into business income to prevent wealthy individuals from avoiding the top personal tax rate." House staff favors a bright line test that automatically designates 70% of all pass-through income as compensation and 30% as qualified business income. Administration officials have also discussed excluding all professional service business income from the lower rate.

The plan calls for full business expensing on all depreciable assets other than structures for "at least" five years. This presumably would not allow expensing on buildings, land or intangibles. It is less generous than the House GOP Blueprint, which provided permanent expensing for everything except land. The framework does provide that the committees can work to enhance the "unprecedented" expensing. The changes are proposed to be effective for property placed in service after Sept. 27, 2017, to avoid any slowdown of business investment in anticipation of more generous cost recovery.

The price of full expensing is typically the loss of interest deduction, and the framework includes a "partial" limit on the deductibility of interest expense for C corporations. Tax writers are instructed to "consider the appropriate treatment of interest paid by non-corporate taxpayers," but no further detail is provided. The House GOP Blueprint fully disallowed any deduction for interest expense in excess of interest income with an exception for certain financial institutions.

The corporate AMT would be repealed with no mention of the House GOP Blueprint's plan to retain the rule that would only allow net operating losses to offset 90% of taxable income. The framework also gives the committees the option to "consider methods to reduce the double tax of corporate earnings."

The framework instructs the committees to repeal most business incentives, but specifically pledges to retain the research credit and low-income housing tax credit. Administration officials also pledge to retain tax-exempt bonds, and allows committees "to retain some other business credits to the extent budget limitations allow." Only the Section 199 deduction for domestic production was specifically identified for repeal by the framework, though administration officials said the deduction for state and local taxes would also be repealed.

International taxes

The plan calls for a shift from a worldwide tax system to a territorial system in which offshore earnings could be repatriated tax-free with a 100% dividends-received deduction. The framework also pledges an anti-base erosion measure that would impose a minimum tax on earnings for U.S. multinationals. This proposal breaks from the preferences of many committee members, who favor base erosion measures that provided a reduced rate on earnings for intellectual property held in the United States to combat base erosion.

To transition to the system and raise revenue, current unrepatriated earnings would be subject to a one-time tax at two different rates, a higher rate for cash and cash equivalents and a lower rate for other earnings. The framework allows tax writers to set these rates based on revenue and policy goals. The House GOP Blueprint had used 8.75% for cash and cash equivalents and 3.5% for illiquid assets. The framework did not provide a measurement date or detail on how the accumulated earnings would be calculated.

The following side-by-side comparison of the House Blueprint and the unified framework incorporates information from both the written framework and statements for officials.

Comparison of proposals in House Blueprint and new unified framework for tax reform		
Provision	**House Blueprint**	**Unified framework**
Individual rate	• Creates three brackets: 12%, 25%, 33%	• Creates three brackets: 12%, 25%, 35%, with a potential fourth bracket at a higher rate to avoid providing a tax cut for high-income earners
Individual benefits	• Repeals itemized deductions (including state and local taxes) except those for charitable giving and home interest • Increases standard deduction but repeals personal exemptions • Increases child tax credit to $1,500 and creates $500 dependent tax credit • Retains the earned income tax credit (EITC)	• Repeals itemized deductions (including state and local taxes) except those for charitable giving and home interest • Increases standard deduction but repeals personal exemptions • Increases child tax credit by unspecified amount and creates $500 dependent tax credit • Pledges to retain incentives for retirement, higher education, and work (work incentives refers to EITC)
Investment income	• Interest, dividends and long-term capital gains taxed at effective rates of 6%, 12.5%, and 16.5%	• No information
Estate tax	• Repeals but does not specify whether it would retain step-up in basis of inherited assets	• Repeals estate and generation skipping transfer tax, but provides no information on gift tax or step-up in basis
Corporate rate	• 20% flat rate	• Same
Pass-through tax rate	• 25% rate on active business income from a pass-through with rules to ensure income is characterized as compensation	• Same
Business benefits	• Generally repeals tax benefits but specifically retains an R&D credit and a last-in, first-out method of accounting • NOL can be carried forward indefinitely but cannot reduce taxable income below 90% or be carried back	• Generally repeals tax benefits but specifically retains an R&D credit, low-income housing tax credit and exclusion for tax exempt bonds • State and local tax deduction and Section 199 specifically repealed
Depreciation	• 100% expensing for everything except land, including intangibles and buildings	• 100% expensing for "at least five years" on "depreciable" assets placed in service after Sept. 27, 2017 (other than structures)
Interest deduction	• Disallows deduction for interest expense in excess of interest income with special rules to retain deduction for banks and other financial companies	• "Partial" disallowance of net interest deduction for C corporations with tax writers responsible for determining treatment of non-corporate interest
Border adjustment	• No deduction for imports while gross receipts from exports are excluded	• No provision
International	• 100% exemption for repatriated dividends	• 100% exemption for repatriated dividends • Base erosion provisions will include minimum tax on global income
Transition	• One-time tax on unrepatriated earnings at 8.75% for cash and 3.5% for reinvested earnings	• One-time tax on unrepatriated earnings, with separate unspecified rates for cash and illiquid earnings

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