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"You're in the Big Leagues Now"
Prospects for Comprehensive Tax Reform in 2017

The excitement for comprehensive tax reform has ebbed and flowed over the past few years in Washington, DC. In 2014, former House Ways and Means Chairman Dave Camp introduced the *Tax Reform Act of 2014*, a 979-page bill to simplify and overhaul the U.S. tax code. Thereafter, the Senate Finance Committee and the House Ways and Means Committee held numerous hearings to examine the challenges and principles of tax reform. Congressional working groups were convened to tackle various components of reform and were asked to set forth policy recommendations for the tax-writing committees' consideration. Despite this flurry of activities, tax policy experts and Capitol Hill watchers have grown pessimistic about Congress actually passing tax reform legislation, especially in view of an administration that has not been aggressively pushing for a comprehensive overhaul. No doubt policymakers and lawmakers have learned firsthand that comprehensive tax reform is an immensely difficult undertaking, both in terms of the policies and the politics — that's why the tax code has not seen a meaningful makeover since the reforms of 1986.

Almost overnight, the conversation on tax reform shifted dramatically. Since the 2016 presidential election, Washington has whipped itself into a frenzy for comprehensive tax reform. Republicans pulled off an electoral hat trick on the night of Nov. 8, defending their majorities in both the House and Senate and capturing the White House. The unexpected victory of Donald J. Trump and the Republican Party in the 2016 electoral season has congressional tax writers, policy wonks, and industry stakeholders talking about tax reform with renewed alacrity. Suddenly, the House GOP's tax reform blueprint is no longer just a collection of talking points for the campaign trail: the blueprint will be the basis for any comprehensive tax reform legislation next year. With a unified Republican government on the horizon, many believe that Reagan-era style reforms are a real possibility. At a tax reform discussion on Nov. 16, Stephen Moore, Trump's senior economic advisor, said unequivocally that tax reform will be a top and immediate priority for the Trump Administration. Sensing the big battle ahead, House Ways and Means Ranking Member Sandy Levin told outside progressive groups to circle up their wagons and prepare for a fight over revamping the tax code: "It's different now — and tax reform and tax issues are real […] We need to take seriously where this is going."

In this special McGuireWoods' tax policy alert, we offer a high-level look at the timing, approach, and challenges to comprehensive tax reform in 2017. Also included at the end of this alert is a quick reference chart comparing the Trump tax plan to the House GOP's tax reform blueprint.

Timing of and Approaches to Comprehensive Tax Reform

There is no question that the Trump Administration and congressional Republicans will want to move quickly and get tax reform legislation across the finish line in 2017. Although there is consensus in Washington that an overhaul of the tax code is long overdue, significant disagreements remain over what reform should ultimately look like.

According to Trump's senior economic adviser Stephen Moore, the incoming administration is considering doing tax reform in two stages: first, revamp the business side of the code and then, tackle the individual side. Moore believes that business tax reform will be the easier of the two to tackle and thus, should be dealt with first. The Trump Administration is looking to pitch the business tax reform bill as a jobs creation bill to the American people. In Moore's views, tax cuts for businesses will mean higher wages for workers down the line. For those worried that passthrough entities will be left out in the first phase of tax reform, Moore assured that the business tax reform bill will address the treatment of passthroughs as well.

Under the best case scenario, reform would be done in a bipartisan matter. Moore hopes Democrats will get behind tax reform next year, as bipartisanship is critical to ensuring that any changes to the tax code will have "durability." There is early indication that the Trump Administration is open to the idea of tying tax reform to infrastructure investment. Putting any revenues generated through tax reform towards infrastructure spending may attract Democratic support, but GOP tax writers are optimistic that they can move tax reform legislation even without their support. Despite the absence of a supermajority in the House and Senate next year, Republicans can still get a lot done via the budget reconciliation process. Moving legislation via reconciliation requires only a simple majority in both chambers — so long as the provisions adhere to a certain set of parliamentarian rules. Already, Republican are seriously considering the use of reconciliation procedures to repeal Obamacare and pass tax reform.

Challenges to Comprehensive Tax Reform

International tax reform may be the issue that can bring Republicans and Democrats together at the table. For starters, both parties have been largely united in objecting to recent European state-aid investigations. Both parties have noted that American companies have been unfairly scrutinized by EU officials. While Republicans and Democrats agree that business tax reform is urgently needed to help American companies remain competitive globally, both parties differ on the particulars. Of note are their varying positions on repatriation, the corporate and individual tax rates, and the interest expense deduction.

- **Repatriation.** It is estimated that $2.6 trillion in corporate earnings are currently held overseas. Lawmakers on both sides of the aisle agree that the earnings should be brought back to the United States. The subject of repatriation raises two important questions:

    (1) At what rate should repatriated earnings be taxed?
    (2) How should the revenue generated through repatriation be used?

Trump's economic team is considering imposing a 10 percent repatriation tax. The House GOP blueprint calls for an 8.75 percent tax. The Obama Administration would like the repatriation tax rate to be even higher at 14 percent. Republicans have previously indicated that revenue from repatriation could be used to help pay for a reduction in the U.S. corporate tax rate. Democrats, on the other hand, believe that the windfall from repatriation should be put towards infrastructure spending — a proposal that conservatives have long cringed at. Though the House GOP blueprint does not explicitly endorse the idea of using the funds for infrastructure, there are promising signs that congressional Republicans may be willing to come around to the idea, especially if it brings Democrats on board for tax reform. Tying tax reform to infrastructure is an approach that the Trump Administration will likely push for: after all, job creation through infrastructure investment was often the centerpiece of Trump's stump speech on the campaign trail.

- **Corporate and Individual Tax Rates.** Republicans are in favor of lowering the corporate tax rate — currently at 35 percent. But Trump and House Republicans disagree on how much to reduce the rate. The president-elect would like to see a 15 percent rate for <u>all</u> businesses. The House GOP blueprint calls for a flat 20 percent rate for C-corporations and a 25 percent rate for pass-throughs. Those who have worked on tax reform over the past few years will admit that the treatment of pass-through entities poses a significant political hurdle for policymakers. Small businesses have long been vocal in their demands for rate parity with big corporations, and their support is critical to the success of any tax reform legislation.

  On the other side of the aisle, Democrats have not been able to reach a consensus within the party for lowering the corporate tax rate. More progressive elements of the party, like Sen. Elizabeth Warren have opposed a rate cut for large corporations, preferring to focus on small business tax relief. On the individual front, both parties differ significantly on rate cuts. Republicans prefer to slash the rate across the board, while Democrats want to focus tax breaks on the middle and lower income families.

- **Interest Expense Deduction.** There are a number of Republican tax proposals that allow businesses to immediately expense capital investments. Immediate expensing enables businesses to deduct the full cost of investments in tangible and intangible assets as soon as they are purchased. The House GOP tax blueprint, unlike Rep. Devin Nunes's *American Business Competitiveness Act* which forms the basis for this provision, does not apply full expensing to land. In order to pay for this provision, the House GOP proposal allows businesses to deduct interest expenses against any interest income but repeals the current deduction allowed for net interest expenses. The Trump plan, on the other hand, phases in a "reasonable" cap on the deductibility of business interest expenses, without specifying the actual amount. All three proposals for expensing must contend with the serious implications that this provision will have for various groups, including the financial services and real estate industries.

Trump Tax Plan vs. House GOP's *A Better Way* Tax Blueprint

Although many open policy questions remain for tax reform in 2017, there is no doubt that the House GOP's tax reform blueprint will be the starting point for many policy debates. Thus, one would not be completely off the mark to suspect that any final tax reform legislation will have a strong resemblance to the blueprint. Below is a quick reference chart outlining the differences and similarities between President-elect Donald Trump's tax proposals and the House GOP blueprint. Keep this high-level comparison chart handy as tax reform shifts into high gear next year.

Issue	Trump Tax Plan	A Better Way —Tax Blueprint
Individual Tax		
Rates on Ordinary Income	Establishes three tax brackets, with rates of 12%, 25% and 33%. All those earning greater than $225,000 would be in the top tax bracket.	Establishes three tax brackets, with rates of 12%, 25%, and 33%.
Itemized Deductions	Increases the standard deduction for joint filers to $30,000, from $12,600, and the standard deduction for single filers to $15,000. Personal exemptions will be eliminated, along with head-of-household filing status. Caps itemized deductions at $200,000 for married-joint filers or $100,000 for single filers. Phases out all other itemized deductions except for the charitable deduction and the mortgage interest deduction. He has specifically targeted Wall Street, noting that he will eliminate the "carried interest deduction" and other "special interest loopholes" that have been good for the industry, but unfair to American workers. Trump was likely referring to the preferential treatment that carried interest receives. Allows working-class parents to deduct child care expenses for up to four children and elderly dependents to help them cope with the rising costs of child care. The Trump campaign defines "working class" with an income cap of $250,000 for individuals and $500,000 for couples.	Eliminates all deductions except for the charitable deduction and the mortgage interest deduction. Retains the Earned Income Tax Credit (EITC), while consolidating the five basic family tax deductions and credits of the tax code into two simpler benefits: (1) a larger standard deduction adjusted annually for inflation and (2) an enhanced child and dependent tax credit.

Issue	Trump Tax Plan	A Better Way —Tax Blueprint
Tax Credits	Helps low-income families with the cost of child care with rebates through the existing EITC.	No specific proposals.
Alternative Minimum Tax	Eliminates the alternative minimum tax.	Eliminates the alternative minimum tax and limits net operating loss carryforwards to 90% of income, similar to current restrictions on a corporation's AMT NOL deduction. NOLs could also no longer be carried back, but could be carried forward indefinitely.
Rates on Capital Gains and Dividends	Taxes long-term capital gains and qualified dividends at a top marginal rate of 20%, with a 0% rate for individuals earning up to $25,000 and couples earning up to $50,000. Eliminates the 3.8% net investment income tax.	Provides a 50% deduction for net capital gains, dividends, and interest income, making the rates 6%, 12.5%, and 16.5%.
Gift and Estate Tax	Eliminates the gift and estate tax.	Eliminates the gift and estate tax.
Miscellaneous	Trump's child care plan would create a Dependent Care Savings Account that would allow tax deductible contributions and tax free appreciation year-to-year. The government would also match half of the first $1,000 deposited per year.	No specific proposals.
Corporate Tax		
Tax Rate	Lowers the top corporate rate to 15% and eliminates the corporate alternative minimum tax. Trump's plan also eliminates "corporate loopholes," which he claims will be unnecessary due to the new lower tax rate.	Creates a flat 20% rate for c-corporations.
Tax Rate for Pass-Through Business Income	Taxes pass-through business income at 15%.	Taxes pass-through business income at 25%. The difference between the pass-through rate and the top rate for individuals may create an opportunity for tax arbitrage.

Issue	Trump Tax Plan	A Better Way —Tax Blueprint
Small Businesses and Start-Ups	While Trump has not unveiled a formal plan to help small businesses, in his speeches he has noted that no business of any size should have to pay more than 15% of their business income in taxes. While Trump's corporate income tax rate cut is not geared solely towards small businesses, they would also stand to benefit from a lower rate.	No specific proposals.
Capital Investment	Calls for full expensing of capital investment. Phases in a "reasonable" cap on the deductibility of business interest expenses, though he is yet to specify the actual amount.	Allows businesses to fully and immediately writing off the cost of investments in tangible and intangible assets. However, unlike the *American Business Competitiveness Act* which forms the basis for this provision, full expensing does not apply to land. Allows businesses to deduct interest expenses against any interest income, but no current deduction would be allowed for net interest expenses. Any interest expense can be carried forward indefinitely and allowed as a deduction against net interest income in future years.
Miscellaneous Business Credits	No specific proposal.	Keeps the R&D tax credit.
International Taxation	Proposes ending the deferral of corporate earnings held overseas, while preserving the foreign tax credit. Proposes a one-time deemed repatriation of corporate cash earnings held overseas at a 10% rate.	Liquid accumulated foreign earnings subject to 8.75% rate. Illiquid earnings subject to tax at 3.5%. Companies will be able to pay the resulting tax liability over an 8-year period. Eliminates the export penalty and import subsidy by moving to a destination basis tax system, where tax is applied based on the location of consumption rather than the location of production.
Carried Interest	Proposes taxing carried interest at the same rate as ordinary income.	No specific proposals.
Retirement	No specific proposal.	The GOP is looking closely at Universal Savings Accounts, where individuals could contribute cash and would be able to control all investment decisions. Account holders could withdraw both contributions and earnings at any time, and for any reason, without penalty.

Issue	Trump Tax Plan	A Better Way —Tax Blueprint
Education	Proposes to look at a university endowment tax to force universities to ensure that colleges make "good faith" efforts to curtail student debt.	The GOP hopes to provide a more effective package of higher education tax benefits to cover both college and vocational training programs, including a savings incentive, such as 529 plans, and tax relief targeted at helping low-income and middle-income families save for costs of higher education, such as the American Opportunity Tax Credit.
Miscellaneous	No specific proposals.	Outlines a plan to rebuild the IRS through the creation of three major units: (1) families and individuals; (2) businesses; and (3) an independent "small claims court." The new IRS will be headed by a presidentially-appointed administrator who will manage the agency and administer the new tax code in a fair and non-political manner.

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