

Tax Reform Update

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Agenda

1 2017 priorities – Administration & Congress

2 ACA repeal – Status update

3 Tax Reform – Issues and status update



Trump/Republican priorities for 2017

ACA repeal



- ▶ House GOP released Affordable Care Act (ACA) “repeal/replace” plan along with reconciliation instructions for Senate passage; bill pulled before House vote
- ▶ Trump signed ACA executive order January 20, 2017

Tax reform



- ▶ Trump campaign, House GOP have similar tax rate proposals
- ▶ Different approaches to international taxation
- ▶ Controversy over House GOP’s border adjustments

Infrastructure



- ▶ Trump wants public-private partnerships, private investments
- ▶ Focus shifting away from repatriation as a funding source?
- ▶ Senate Democrats unveiled their own infrastructure proposal

Regulatory reform



- ▶ Trump signed executive order – one-in, two-out/enforcement
- ▶ “Regulatory Freeze Pending Review” memo issued
- ▶ House GOP Better Way effort also targeted regulatory reform

Immigration



- ▶ Trump signed executive orders - immigration/border security
- ▶ Budget bills could include funds for border enforcement
- ▶ Trump: “work out something” for immigrant children

Trade



- ▶ Instructing Treasury to label China a currency manipulator
- ▶ Removed US from Trans-Pacific Partnership
- ▶ Renegotiating existing US trade deals

Lookback - first major pieces of legislation enacted after recent presidents took office

Barack Obama Took office January 20, 2009	American Recovery and Reinvestment Act of 2009 Enacted February 17, 2009 <ul style="list-style-type: none">▶ Stimulus legislation, included bonus depreciation
George W. Bush Took office January 20, 2001	Economic Growth and Tax Relief Reconciliation Act of 2001 Enacted June 7, 2001 <ul style="list-style-type: none">▶ The “Bush tax cuts” reduced individual rates, estate tax
Bill Clinton Took office January 20, 1993	Omnibus Budget Reconciliation Act of 1993 Enacted August 10, 1993 <ul style="list-style-type: none">▶ Increased individual, corporate taxes
George H. W. Bush Took office January 20, 1989	Omnibus Budget Reconciliation Act of 1990 Enacted November 5, 1990 <ul style="list-style-type: none">▶ Increased individual taxes despite “no new tax” pledge
Ronald Reagan Took office January 20, 1981	Economic Recovery Tax Act of 1981 Enacted August 13, 1981 <ul style="list-style-type: none">▶ Sharply reduced individual, corporate taxes

Path to changes: budget reconciliation

- ▶ Republicans don't have filibuster-proof 60 Senate votes
- ▶ Reconciliation allows simple majority vote (51) for spending, tax, debt limit bills (or combination), under two-step process:
 1. House and Senate need to pass a concurrent budget resolution with reconciliation instructions
 - ▶ Includes directions to committees to change spending or revenue numbers
 2. Also must pass reconciliation bills that adhere to the instructions
- ▶ Plan is for two sets of reconciliation instructions in 2017:
 1. Senate approved FY 2017 budget resolution January 12, House approved January 13
 2. FY 2018 budget likely to include second set of instructions, possibly addressing issues like tax reform
- ▶ 2018 Senate elections may influence voting outcomes

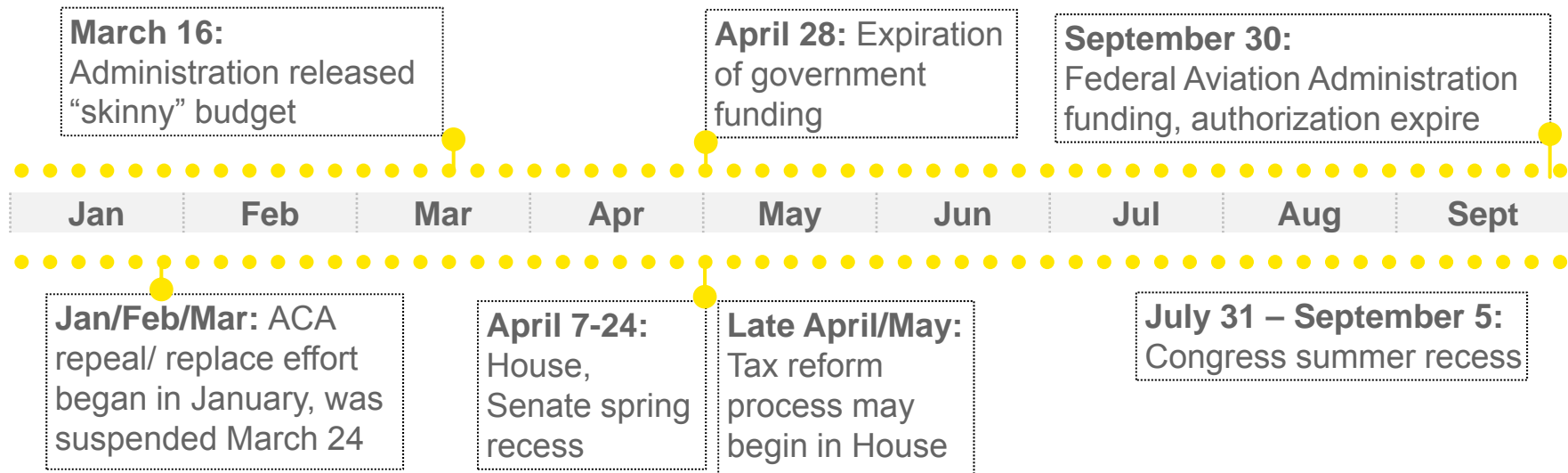
2018 Senate elections

Seats up for re-election: 23 Democratic plus 2 Independents, 8 Republican

Democrats		Republicans
Tammy Baldwin (D-WI) T	Amy Klobuchar (D-MN)	John Barasso (R-WY)
Sherrod Brown (D-OH) T	Joe Manchin (D-WV) T	Bob Corker (R-TN)
Maria Cantwell (D-WA)	Claire McCaskill (D-MO) T	Ted Cruz (R-TX)
Ben Cardin (D-MD)	Robert Menendez (D-NJ)	Deb Fischer (R-NE)
Tom Carper (D-DE)	Chris Murphy (D-CT)	Jeff Flake (R-AZ)
Bob Casey (D-PA) T	Bill Nelson (D-FL) T	Orrin Hatch (R-UT)
Joe Donnelly (D-IN) T	Debbie Stabenow (D-MI) T	Dean Heller (R-NV)
Dianne Feinstein (D-CA)	Jon Tester (D-MT) T	Roger Wicker (R-MS)
Kirsten Gillibrand (D-NY)	Elizabeth Warren (D-MA)	
Martin Heinrich (D-NM)	Sheldon Whitehouse (D-RI)	
Heidi Heitkamp (D-ND) T	+2 Independents that caucus with Democrats:	
Mazie Hirono (D-HI)	Angus King (I-ME)	
Tim Kaine (D-VA)	Bernie Sanders (I-VT)	

T = Running in state Donald Trump won in 2016

2017 Congressional timeline



“Must-do” items for 2017

- ▶ Government funding beyond April 28, for remainder of FY 2017
- ▶ Government funding for FY 2018
- ▶ Federal debt limit: current suspension ended March 15, 2017
- ▶ Supreme Court nomination and other Administration appointments
- ▶ Federal Aviation Administration (FAA) reauthorization
- ▶ Children’s Health Insurance Program – expires 30 September 2017

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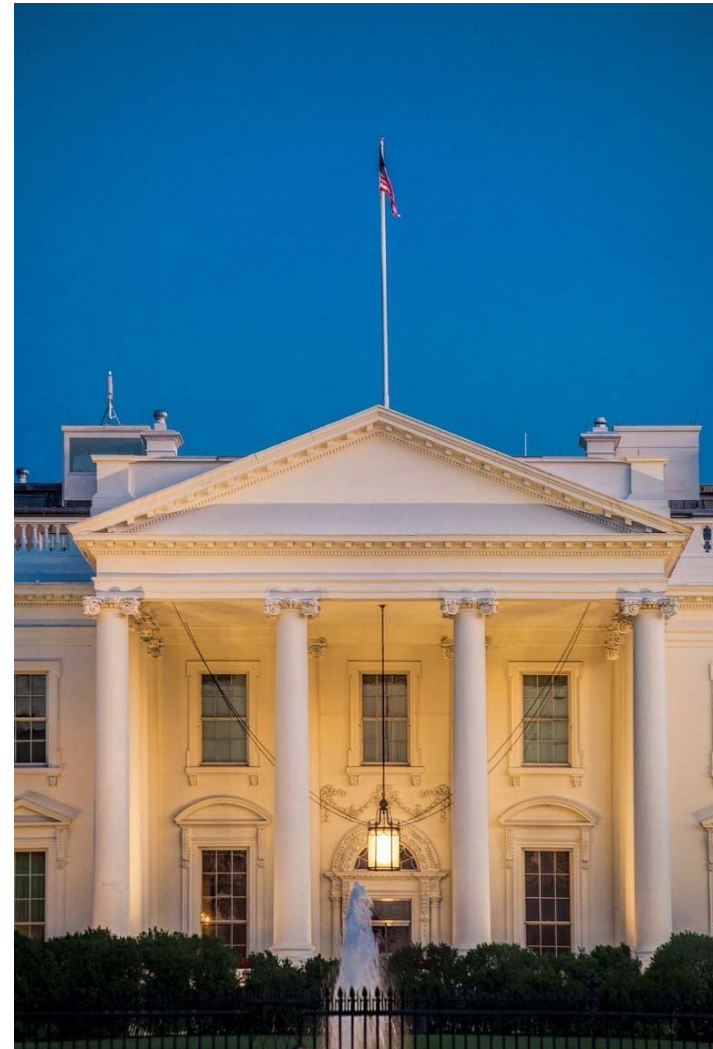
ACA update

- ▶ The Administration announced March 24, 2017 that it would shift from health care reform to other priorities after the House failed to obtain enough votes to pass the American Health Care Act (H.R. 1628)
 - ▶ The AHCA would have ended most ACA tax provisions effective in 2017 and further delayed the Cadillac tax
 - ▶ The ACA, including the individual and employer mandates, continues to be the “law of the land”
 - ▶ President Trump signed an executive order January 20, 2017 directing the Departments of Health and Human Services (HHS) and Treasury to minimize the ACA burden and cost
 - ▶ HHS has issued proposed regulations and may issue further administrative guidance to stabilize the insurance marketplaces and provide states with greater flexibility related to health care coverage offerings
 - ▶ Meanwhile, employers still are required to comply with the 2016 ACA information reporting requirements
-

ACA repeal: President Trump's ACA executive order – remains in place

Key elements

- ▶ Signed on January 20, 2017, “Minimizing the Economic Burden of the Patient Protection and Affordable Care Act Pending Appeal”
- ▶ While ACA repeal is contemplated, act to:
 - ▶ Ensure that the ACA is being efficiently implemented
 - ▶ Take all actions consistent with law to minimize the unwarranted economic and regulatory burdens of the ACA



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Tax reform: improved political environment for comprehensive tax reform

- ▶ Trump, Republican congressional leaders have said tax reform is a priority and have turned attention to that goal
- ▶ Trump's tax reform proposals as outlined in the campaign and GOP tax reform plans are not identical but do overlap
 - ▶ Similar interest in lower rates for individuals and corporations, including pass-through entities
 - ▶ House GOP plan moves toward cash flow consumption tax, border adjustability
- ▶ Trump plans to release a comprehensive tax reform plan and has signaled an intent to use reconciliation instructions, but a failure to pass health care reform could complicate the process
 - ▶ The AHCA would have repealed most ACA taxes in 2017; with that bill's failure to pass, a number of political and economic issues remain that may be folded into tax reform

Tax reform: focus on economic growth

- ▶ For GOP lawmakers, growth is a key goal of reform
 - ▶ Must include provisions that will increase demand for goods and services and increase the return to capital investment
- ▶ Growth will be “scored”
 - ▶ Joint Committee on Taxation (JCT) now uses dynamic revenue models; producing positive revenue scores depends on tax reform design
 - ▶ House rules now require dynamic revenue estimating
- ▶ Pro-growth proposals:
 - ▶ Reducing individual and corporate tax rates
 - ▶ Allowing 100% expensing of investments in tangible, intangible assets

Tax reform: input from key players

Executive branch

- ▶ **Trump (campaign plan)**
 - ▶ 15% business income rate, 15% pass-through rate
 - ▶ Elective expensing for manufacturers with loss of interest expense deduction
 - ▶ Most business provisions eliminated, except for R&D Credit
 - ▶ 10% mandatory tax on accumulated foreign earnings
 - ▶ Individual: 12%, 25%, and 33% rates; deductions capped at \$100,000/\$200,000

House

- ▶ **Republican Blueprint for tax reform**
 - ▶ 20% corporate income tax rate/25% rate for business income of pass-throughs
 - ▶ Immediate expensing of capital expenditures with no interest expense deduction
 - ▶ Mandatory tax on accumulated foreign earnings
 - ▶ Territorial system of taxing future foreign earnings
 - ▶ Destination-basis border adjustment tax system exempts exports while taxing imports
 - ▶ Reduced individual tax rates: 12%, 25%, and 33%

Senate

- ▶ **Senate Finance Committee**
 - ▶ Chairman Hatch: Senate will conduct its own tax reform process
 - ▶ Senators have concerns with border adjustability, including who will ultimately pay and whether it is consistent with our international trade obligations
 - ▶ Chairman Hatch reportedly still developing corporate tax integration proposal

Tax reform: Trump campaign tax plan vs. House GOP Blueprint

	Proposal	Trump campaign plan	House GOP Blueprint
Business	Top corporate tax rate (now 35%)	15%, corporate AMT eliminated	20%, corporate AMT eliminated
	Top pass-through tax rate (now 39.6%)	15% rate for pass-through entities that retain profits within the business	25% top rate for active business income passed-through to individuals
	Taxation of future foreign earnings	In 2015, proposed worldwide system, repeal of deferral; currently unclear; also unclear if Trump will support border adjustments	Territorial tax system with 100% exemption for dividends from foreign subsidiaries; border adjustments (exempts exports, taxes imports)
	Mandatory tax on previously untaxed accumulated foreign earnings	10%	8.75% for cash/cash equivalents, 3.5% otherwise, payable over 8 years
	Cost recovery	Expensing for manufacturers	100% expensing: tangible, intangible assets (does not apply to land)
	Interest expense	Manufacturers electing to expense capital investment lose the deductibility of corporate interest expense	No current deduction will be allowed for net interest expense
	Other business tax provisions	Calls for them to generally be eliminated, except for R&E credit	Calls for them to generally be eliminated, except for R&E credit and LIFO
Individual	Individual tax rates (now 10%, 15%, 25%, 28%, 33%, 35%, 39.6%)	12%, 25%, 33%	12%, 25%, 33%
	Capital gains and dividends	Current law (maximum rate of 20%), 3.8% Net Investment Income Tax (NIIT) repealed	50% deduction for capital gains, dividends and interest, leading to basic rates of 6%, 12.5% and 16.5%
	Carried interest	Ordinary income	(Not addressed)
	Estate tax (now 40% rate, \$5.45 million exemption)	Repealed, capital gains held until death taxable, first \$10 million tax-free	Repealed
	State tax deduction		Eliminated
	Charitable contribution deduction	Cap itemized deductions at \$100,000 for single filers and \$200,000 for couples	Retained, but could be modified
	Mortgage interest deduction		Retained, but could be modified
	Personal exemption phase-out (PEP), Pease deduction limitation	Unspecified "steepening the curve" of PEP and Pease	(Not addressed)
	Life insurance buildup	Included in income for high earners	(Not addressed)

Tax reform: House GOP Blueprint and interest deductibility

- ▶ Allows immediate expensing of business investment in tangible property (such as equipment and buildings, but not land) and intangible assets
- ▶ Repeals net interest expense deductibility for most non-financial businesses:
 - ▶ Interest expense can be deducted against any interest income, but no current deduction allowed for net interest expense, and any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years
 - ▶ Proposal modeled on H.R. 4377, introduced in January 2016 by House Ways and Means Committee member Devin Nunes (R-CA)
 - ▶ Financial services companies may be exempted
- ▶ Transition rules important:
 - ▶ How will existing undepreciated basis be treated?
 - ▶ Does the change in treatment of interest expenses apply prospectively or to current and future debt arrangements?
 - ▶ What is the impact on the Section 385 debt-equity regulations?

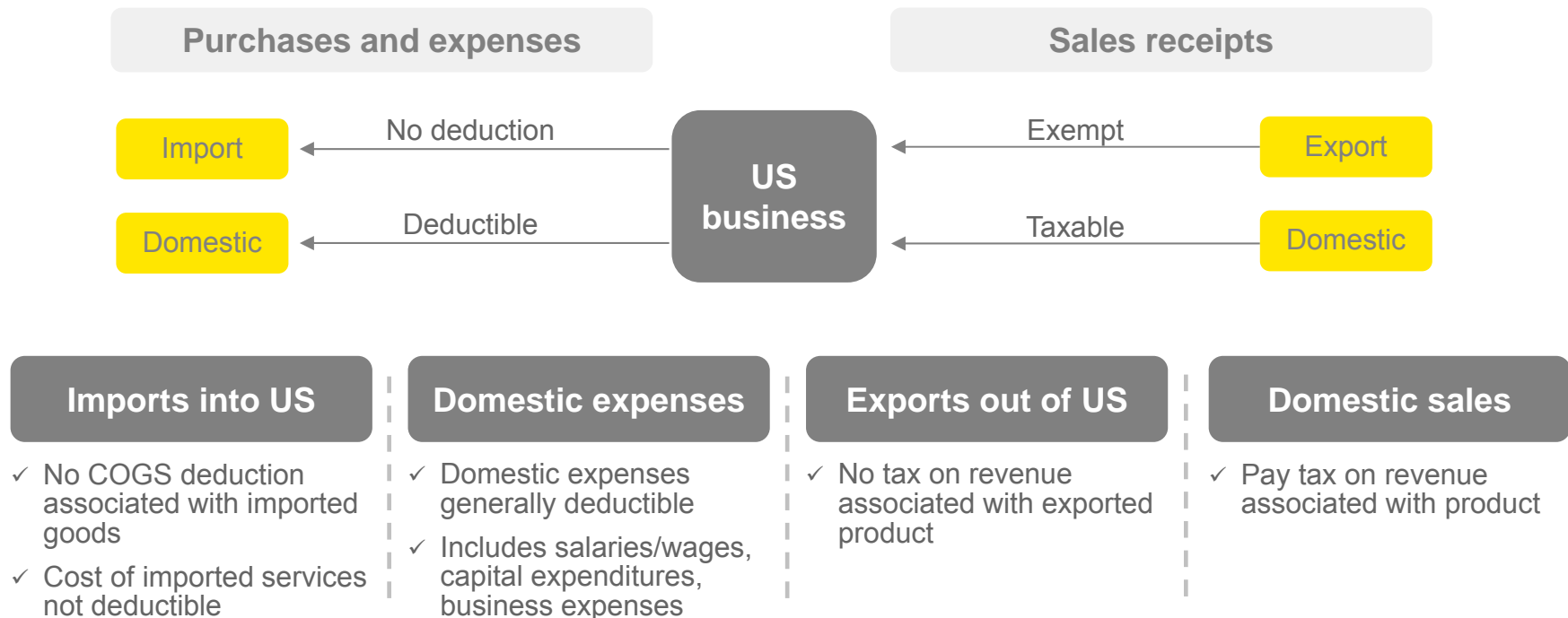
Tax reform: House GOP Blueprint - international provisions

- ▶ Future foreign earnings – territorial system, 100% exemption for dividends paid from foreign subsidiaries
- ▶ Accumulated foreign earnings
 - ▶ 8.75% tax rate on previously untaxed accumulated foreign earnings held in cash or cash equivalents
 - ▶ 3.5% tax rate on all other accumulated earnings
 - ▶ Tax liability payable over an eight-year period
- ▶ Destination-based tax system – border adjustments tax imports but exempt exports from tax
 - ▶ Cash-flow approach is basis for allowing United States to counter border adjustments that other nations apply in their value-added taxes (VATs)
 - ▶ Question as to viability under World Trade Organization (WTO) rules
 - ▶ Possible trade issues

Tax reform: mechanics of BACFT border adjustability

Border adjustments are a way to tax imports and refund (or credit) taxes paid on business purchases used in the production of exports. Under the BACFT, revenue from US export sales are not taxable, and the cost of imported goods and services are not deductible (or taxed separately).

Note: The arrows below are cash-flow directional.



Tax reform: impact on state taxes

- ▶ Will state conform to any federal tax law changes?
 - ▶ It depends ...
 - ▶ States use the Internal Revenue Code as the starting point for determining state taxable income
 - ▶ If the Code changes (e.g., base expansion, elimination of deductions, modifications of credits), the state tax base may change as well
 - ▶ Conformity dates
 - ▶ Static (e.g., California, Texas, New Hampshire) = not automatic
 - ▶ Rolling (e.g., Florida, Illinois, New York) = automatic
 - ▶ States generally don't conform to rate reductions
 - ▶ All states except Vermont must have a balanced budget and must address the cost of conforming to the federal changes
 - ▶ If federal tax reform transforms federal taxation in a way that is adverse to state revenues, they could resort to newer forms of business taxation already employed in other states
 - ▶ Gross receipts (Ohio, Washington and Nevada) or taxable margin (Texas)

Tax reform: outstanding questions

- ▶ Will it be bipartisan?
 - ▶ If not, budget reconciliation will likely be used
 - ▶ When will it happen?
 - ▶ Late 2017? Early 2018?
 - ▶ Will it include infrastructure proposals?
 - ▶ Part of tax reform or outside the package?
 - ▶ What type of international system will be proposed?
 - ▶ Worldwide or territorial?
 - ▶ What will be the revenue impact?
 - ▶ Revenue-losing or revenue-neutral?
 - ▶ Will tax reductions be permanent or temporary?
 - ▶ Will it include a dramatic shift towards a consumption tax, as proposed in the House Blueprint?
-

Issues that could determine success of tax reform

Border adjustability



- ▶ Exports exempt from tax with cost of goods sold deductible; all imports non-deductible, including costs of goods sold
- ▶ House proposal faces opposition from Trump, retailers, oil and gas, high tech, others who rely on imports
- ▶ Even using budget reconciliation, GOP can lose only 2 Senate votes

Interest deductibility



- ▶ Trump, during campaign, proposed immediate expensing of new business investments for manufacturers, who would lose deductibility of corporate interest expense
- ▶ House GOP plan: expensing, eliminate deductibility of net interest expense
 - ▶ Prevent a double benefit from fully expensing leveraged purchases
- ▶ Companies must decide if expensing is worth losing interest deductions

Pass-through vs. corporate



- ▶ Trump proposed 15% pass-through rate, 15% corporate rate during campaign
- ▶ House Republicans propose 25% pass-through rate, 20% corporate rate
- ▶ Issue may not erupt because both plans call for cuts in top individual rate
- ▶ Still, how elimination of current benefits to pay for rate cuts affects pass-through entities vs. corporations could create tension

Individual tax issues



- ▶ Trump (campaign) and House Republicans propose top individual rate of 33%
- ▶ Cuts to key individual tax benefits may jeopardize comprehensive reform
- ▶ Conservatives warn of political fallout from cutting popular provisions
 - ▶ Mortgage interest deduction costs \$950 billion over 10 years
 - ▶ Deductibility of state and local tax costs \$700 billion over 10 years

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