Holland & Knight

17th Street N.W., Suite 1100 | Washington, DC 20006 | T 202.955.3000 | F 202.955.5564
Holland & Knight LLP | www.hklaw.com

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To: **Interested Clients**

From: **Holland & Knight Taxation Team**

Re: **Tax Reform Outlook**

Comprehensive tax reform has eluded the U.S. Congress since 1986. While myriad challenges have obstructed an overhaul, a confluence of factors now portend a unique opportunity to pursue reform. Below, Holland & Knight's Taxation Team briefly discusses the current environment and procedural paths ahead of us.

Background

With Republicans in control of the U.S. Senate, the U.S. House of Representatives and the White House in 2017, the federal government is now well-positioned to move forward on comprehensive tax reform, with anticipated legislation that restructures both the individual and business income tax provisions of the Internal Revenue Code. It is expected that upcoming tax reform efforts will build on the principles set forth in the House Republicans' "A Better Way" plan, released by House Speaker Paul Ryan (R-Wis.) in June 2016, as well as the tax plans advanced by President-Elect Donald Trump during the course of his campaign. The President-Elect's original tax plan was proposed in September 2015, and his revised tax plan was proposed in September 2016.

The President-Elect's tax plan and the House GOP plan are generally aligned with one another. According to staff of the House tax-writing committee, the Committee on Ways and Means, staff is hard at work converting the House GOP plan into legislative text. The House GOP plan would set three tax rates (instead of the current seven) for individuals: 12 percent, 25 percent and 33 percent. The corporate rate would be 20 percent (instead of the current 35 percent), with a new 25 percent rate for owners of pass-through entities who currently pay individual rates on their profits. However, while the House GOP and the President-Elect seem to agree on individual rates, they differ on other issues, and the President-Elect has given mixed signals on how he is likely to proceed and whether he will insist on some of his signature elements. As discussed below, a major political point of contention will be how the House GOP addresses the President-Elect's potential demand to include infrastructure. If the President-Elect is successful, tax reform may end up being piecemeal instead of a comprehensive overhaul of the Internal Revenue Code.

By contrast, the Senate tax-writing committee, the Senate Committee on Finance led by Chairman Orrin Hatch (R-Utah), has been rather tight lipped on tax reform, and has yet to reveal even a general approach. In 2016, Hatch announced that he was working on a "corporate integration" proposal aimed at eliminating the double taxation on corporate income and "further moderniz[ing] the tax code, including simplification of the system and an end to some of the gamesmanship." However, after the election, statements by Hatch indicated that he was considering holding off on releasing his proposal while the Senate Finance Committee worked with the House Ways and Means Committee. Senior Democrats and Senate Finance

Committee staff have been critical of the House GOP plan but have not released any of their own proposals.

While there is fairly good insight on the direction Republican leadership would like to take – specifically the President-Elect and the House GOP – more remains uncertain than certain, including timing and the procedural path any tax reform will take. Also unknown is whether Senate Republicans are on board with the House GOP plan and to what extent Democratic members will be swayed on any tax reform legislative proposals. In addition, once legislative text is produced, stakeholders (and their lobbyists) who wish to take aim at the legislation can be expected to mobilize. If Rep. Kevin Brady (R-Texas), the current Chairman of the House Ways and Means Committee, and Ryan are successful in moving legislation through the House by the end of spring, the focus would shift to the Senate, where consensus for a package would rely extensively on whether a bill could pass by simple majority under reconciliation rules or by the supermajority 60-vote threshold.

Plan Details

As noted above, there are currently separate tax plans from the House GOP and the President-Elect. Neither plan, however, is particularly detailed. For example, with the exception of a few targeted items, neither plan proposes the kind of tax revenue raisers or loophole closers that will be necessary to achieve anything close to revenue neutrality. Notwithstanding this lack of specifics, certain observations can be made with respect to business or corporate tax reform, particularly where the plans generally align:

- reduced tax rates for pass-through entities and sole proprietors*
- reduced corporate tax rates*
- repeal of the corporate alternative minimum tax (AMT)
- allowing immediate write-offs for business investments*
- limitations on deducting business interest*
- changes to the deduction of net operating losses (some liberalizing and some restricting)*
- elimination of many special interest deductions and credits (except research and development)*

* Denotes items with at least some disagreement in approaches between the President-Elect's plan and the House GOP plan

The President-Elect's plan is largely silent on international tax reform with the exception of repatriation, as noted below. Meanwhile, the House GOP has a three-pronged approach to international tax reform:

1. **Movement From Worldwide Taxation to a Territorial System**
    - companies would only pay tax to the U.S. government on U.S. source active income
    - territorial systems are used in the vast majority of countries (the U.S. is the only G7 country that imposes a worldwide system)
2. **Repatriation Tax on Accumulated Foreign Earning**
    - House GOP plan calls for a tax of 8.75 percent for cash and 3.5 percent for everything else payable over eight years
    - President-Elect's plan calls for a tax of 10 percent payable over 10 years
3. **Border Tax Adjustments**
    - revenues from imported goods, services and tangibles would be subject to a tax, but revenues from exports would be exempt
    - implementation of this adjustment is currently extremely unclear

Legislative Options

To the extent that bipartisan, comprehensive tax reform for individuals and business is abandoned, there are two general directions reform of the tax code could take, which are not mutually exclusive.

1. Action Through Budget Reconciliation

Although the Senate remains in Republican control, Republicans do not have a filibuster-proof majority (i.e., they only have 52 of the 60 seats needed to end a debate). Accordingly, Republican leadership could pursue a budget reconciliation process, which allows for expedited consideration of spending, revenue or debt limit legislation to be passed by a simple majority, without being subject to a filibuster. This process has existed since the 1970s and was intended to help lawmakers quickly make tax and mandatory spending changes.

The first step in this process is for Congress to pass a budget resolution. The budget resolution must contain "reconciliation instructions" that set forth targets for cost or savings and identify the committee(s) that are tasked with the reconciliation. The committee(s) then work to identify policies to meet these targets and produce a reconciliation bill that must then be approved and signed by the President.

Use of this procedural process is limited in two significant ways. First, under current law, a rule known as the Byrd Rule strikes "extraneous" matters from reconciliation bills. Importantly, the so-called extraneous provisions include those that don't change, or are incidental to, spending or revenue or any provisions that increase the federal deficit for a fiscal year outside of the "budget window." The budget window is the year covered by the budget resolution (i.e., the period to which the reconciliation instructions apply). Although changes to the tax code, which are usually permanent, could run afoul of the Byrd Rule by increasing the federal deficit outside of the budget window, it should be noted that there is a historically utilized workaround. Notably, lawmakers who enacted the tax cuts under former President George W. Bush used the reconciliation process and navigated around the Byrd Rule by including sunset provisions, thus limiting tax cuts to a specific time frame.

The other limitation of this procedural process is how often it can be used. For every budget resolution, there can be only one set of reconciliation instructions. It is expected that the reconciliation process related to the 2017 budget will be used to repeal parts of the Affordable Care Act. This means that the 2018 budget resolution will need to be passed before Republicans can get a second bite at the reconciliation process. Senate Majority Leader Mitch McConnell (R-Ky.) has stated a preference to move tax reform through a second budget resolution, suggesting two separate reconciliation vehicles: one for Affordable Care Act changes and the other for comprehensive tax reform. This approach gives time not only to Senate leadership, but to the House Ways and Means Committee, so it can work its legislation first, providing it with more political room to test issues and flag political challenges. Accordingly, it is predicted that a second reconciliation will not come until later in 2017.

In addition to the limitations posed by reconciliation, there are also political costs associated with the process. It is expected that some Republicans, particularly Hatch, will oppose reconciliation, instead preferring a more bipartisan approach. Additionally, Senate Republicans have not endorsed the House GOP plan, particularly the controversial border adjustment tax.

2. Move Bipartisan Legislation on Limited Issues

If lawmakers are committed to moving legislation on a bipartisan basis, piecemeal tax reform might be pursued. There are two key areas that have received considerable attention and generally have broad support among rank-and-file lawmakers: a change in the corporate tax rules and rates, and the repatriation of overseas earnings while reducing or eliminating incentives for corporations to move overseas. Focusing on these lofty objectives could split tax reform into two paths: pursuing corporate and international tax reform first, while putting tax reform for small businesses and individuals on the back burner. While such an approach would be expedient and potentially more palatable, it has political downsides. Most importantly, such a bifurcated approach would leave lawmakers open to criticism that they are focused on Wall Street instead of Main Street. One option that the President-Elect could support that has garnered some attention is funding an infrastructure plan through a repatriation tax on foreign earnings being held overseas. The pushback from this position could be that the revenues from the repatriation tax should be used to fund the promised reduction in tax rates, not to fund infrastructure and more government spending.

Conclusion

There is universal agreement that the tax code needs revamping and the list of complaints is long: it is too complicated, tax rates are too high, there are too many benefits for special interests and it is not driving the economic growth we need to succeed in the global economy. While these criticisms are well-founded, the 74,000-page Internal Revenue Code did not grow overnight or by happenstance. While no one knows what is coming or the exact timing of what is to come, it is clear that tax reform will be difficult and hard fought by our elected representatives.