Hogan Lovells

U.S. Tax reform effort moves forward

28 September 2017

"Unified Framework for Fixing Our Broken Tax Code" released in the U.S.

Yesterday, significant progress was made in moving U.S. tax reform forward. This was in the form of the “Unified Framework for Fixing Our Broken Tax Code”, an outline of the U.S. tax reform proposal that Republicans plan to move through the legislative process starting as early as late October.

The Framework is a joint piece from the U.S. Senate, U.S. House of Representatives and the Trump Administration and this consensus is significant on the path to tax reform.

While lacking detail in many respects, it sets out critical top-level detail of a business tax reform plan that will have significant consequences for any business with operations in the U.S.

Key Highlights

- U.S. Corporate tax rate of 20%
- Eliminates the Corporate Alternative Minimum Tax (AMT)
- Full expensing for “at least 5 years” for investments in depreciable assets (other than buildings).
- “Partial” limit on deductibility of “net” interest expense incurred by C-corporations. “The Committees will consider the appropriate treatment of interest paid by non-corporate taxpayers.”
- One-time tax on accumulated earnings and profits of controlled foreign subsidiaries of U.S. corporations, with a higher rate on cash or cash equivalents and a lower rate on illiquid assets
- Territorial system going forward, with 100% exemption for dividends from foreign subsidiaries to U.S. parent
- “Base erosion rules” that tax on a global basis, at a reduced rate, certain profits of U.S.-based multinational corporations
- “Modernize” special tax regimes governing specific industries to ensure the tax code better reflects economic reality and that such rules provide little opportunity for tax avoidance
- Maximum tax rate of 25% for income of small and family-owned pass-through business entities
- “Numerous” special exclusions and deductions, and business tax credits, (including section 199 domestic production deduction) will be repealed.
- Preserves R&D credit and possibly some other business credits

Hogan Lovells comments

- *The U.S. corporate rate in the final tax bill is very unlikely to be lower than 20%, and could be higher*

- *The proposal to limit deductibility of interest expense, depending on its scope when details are released, is likely to be very controversial in the business community, and will likely split* *lobbying alliances even in the same industries, depending on capital structures of individual businesses and the specific rules*

- *The specific details of how the one-time tax is determined under the legislation will be very important to determining tax liability under this provision*

- *The details of the base erosion provisions are critically important and will determine in many cases winners and losers in tax reform among U.S.-based multinational corporations*

- *The provision for a lower pass-through business income tax rate is likely to be very difficult to draft and could create significant potential for tax structuring*

- *It's not clear what the drafters mean by "modernize" special tax regimes for specific industries, but many industries, such as the insurance industry, are on the lookout for changes that could negatively affect their tax treatment*

Timing and Process

Republicans plan to move the tax reform bill through the House and Senate via the Budget Reconciliation process, which requires only a majority vote in both houses for passage. In other words, Republicans can pass this bill without a single Democrat voting for it. Going forward, the likelihood is that Republicans will use the reconciliation process and not count on the support of any Democrats. If they did not use the Budget Reconciliation process, Republicans would need the votes of at least 8 Democrats to pass the bill in the Senate, which would require significant changes to the proposal.

The Budget Reconciliation process involves significant procedural hurdles, most notably that the tax bill must not be assessed by budget scorekeepers (the congressional joint committee on taxation) as resulting in an increase in the budget deficit of the U.S. government in the years beyond the "budget window" (generally 10 years) covered by the budget resolution. Melding of the significantly differing House and Senate budget resolutions will be a significant early hurdle to moving forward on the reconciliation tax bill.

Republicans have indicated plans to pass budget resolutions (required for the Budget Reconciliation process) in the House and Senate in early October, and to resolve differences between these two bills and pass a conferenced budget resolution by late October.

The Ways and Means Chairman, Representative Kevin Brady, has indicated his intention to release a detailed draft tax legislative proposal after passage of the budget resolution, and to commence the process of marking-up this bill shortly thereafter. Senate Finance Committee Chairman Hatch has also indicated plans to release his own tax reform legislative proposal, but has noted that this will almost certainly be different from the Ways and Means version, even if both are consistent with the Framework. All Republican leaders maintain they are hoping to get a tax reform bill to the President's desk by the end of 2017.

The process will almost certainly slow down once more details are released. In order to satisfy budgetary needs, hard choices will have to be made, which are certain to be controversial. It is much more likely that the process will spill into 2018.

What it means for you

As the legislation and process matures over the coming weeks, U.S. lawmakers will have to make difficult decisions that will undoubtedly create winners and losers in U.S. tax reform.

There will be transition rules to provide relief to those negatively impacted and special exceptions to mitigate harm to certain industries or sectors.

These elements will become well-defined down the road but they are being shaped today.

We would advise businesses to engage now to ensure that their interests are protected and that they are U.S. tax reform winners.

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