ALSTON & BIRD

WWW.ALSTON.COM

Tax Policy & Regulation ADVISORY ▪

OCTOBER 3, 2017

The Republican Tax Reform Framework: What It Says and What It Doesn't

by Carolyn Smith and Scott Harty

Republican leaders provided some additional details on the framework for tax reform in a September 27 document from the Big Six – House Speaker Paul Ryan (R-WI), Ways and Means Committee Chairman Kevin Brady (R-TX), Senate Majority Leader Mitch McConnell (R-KY), Finance Committee Chairman Orrin Hatch (R-UT), Treasury Secretary Steven Mnuchin, and National Economic Council Director Gary Cohn. The Unified Framework for Fixing Our Broken Tax Code has some helpful information but also leaves many open questions, including the scope of revenue raisers to be added, the specifics of a partial denial of the net interest deduction, the definition of business income subject to a 25% tax rate for certain pass-through entities, details of a minimum tax to prevent base erosion under the proposed territorial tax system, effective dates, and transition rules. The answers to these questions can have a significant impact on the tax liabilities and tax planning opportunities for specific industries and businesses.

Corporate Tax Rate

What the Framework says

The Framework sets the **corporate tax rate at 20%** and aims to eliminate the corporate alternative minimum tax (AMT). The tax committees also may consider methods to reduce the double taxation of corporate earnings.

What it doesn't say

The reference to reducing double taxation of corporate earnings is a nod to the considerable work that has been done by Chairman Hatch and his staff on corporate integration. One possibility is partial integration. A partial dividends paid deduction, for example, could be set at a rate that effectively reduces the 20% corporate rate to 15% (the President's preferred rate) for some corporations. Shareholder taxes could increase, however. The Framework does not address the rate individuals would pay on dividends, which could be impacted by any integration proposal.

Tax Rate for Pass-Through Entities

What the Framework says

The Framework includes a **maximum 25% rate** on the business income of "small and family-owned" businesses conducted as sole proprietorships, partnerships, and S corporations. The Framework contemplates that the tax-writing 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.

What it doesn't say

The scope of the businesses that will be able to take advantage of the 25% maximum rate is not clear and will depend on the definitions of "small" and "family-owned." For example, small could be defined based on the number of shareholders/partners or the income/receipts of the business. Even the definition of what family members are included in determining ownership could make a significant difference in what entities receive the benefit of this lower rate. A variety of current law rules provide some possible models for these definitions.

The Framework acknowledges that anti-abuse rules or "guardrails" will be needed to prevent taxpayers from trying to recharacterize "personal" income as "business" income to take advantage of the 10-percentage-point difference between the proposed highest individual tax rate of 35% and the rate on business income of pass-through entities. This difference could be even greater because the Framework contemplates that an additional top rate could be added to ensure that the tax code remains at least as progressive as it is now. Congressional staff have commented that crafting appropriate rules to prevent avoidance of the highest individual tax rate on nonbusiness income is one of the most technically complicated issues under tax reform.

Expensing

What the Framework says

The first announcement from the Big Six on July 27, 2017, promised "unprecedented" capital expensing. The Framework follows up on this by allowing businesses to **immediately expense the cost of new investments** in depreciable assets other than structures. The provision would be effective for investments made after September 27, 2017 (the day of release of the Framework) and would be available for at least five years. The tax-writing committees may continue to work to enhance expensing for business investments, especially to provide relief for small business.

What it doesn't say

The reference to a possibly temporary provision reflects budgetary and process realities.

International

What the Framework says

Significant changes are called for in the international arena:

- Move to a territorial system of taxation with a **100% exemption for dividends from foreign subsidiaries** in which the U.S. parent owns at least a 10% interest.
- "**Deemed repatriation**" of foreign earnings that have accumulated overseas, i.e., a one-time tax on such earnings as part of the transition to a territorial system. Although no specific rate is mentioned, the Framework calls for a bifurcated rate, with a lower rate on earnings held in illiquid assets and a higher rate on cash or cash equivalents. Payment of this tax liability would be spread out over several years.
- Some type of **minimum tax** on worldwide earnings to prevent base erosion. In the words of the Framework, "taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations." The tax-writing committees are to develop rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.

What it doesn't say

The shift to a territorial tax system would be a fundamental change that would require the U.S. to more vigorously protect its tax base. Some anti-base erosion proposals contained in prior legislation include denying the deduction of net interest expense for excessive domestic indebtedness (which would complement current proposals) and addressing the problem of highly mobile income, particularly with the transfer of intangible property. For example, these proposals could treat foreign earned income as Subpart F income where the effective rate of tax is below a threshold (e.g., 10%) or they may create a new category of Subpart F income for worldwide income derived by controlled foreign corporations from intangibles. As for the rates on deemed repatriated assets, among the possibilities is the House Republican Blueprint rate of 8.75% on cash and cash equivalents and 3.5% on other assets (with the tax liability spread over eight years). President Trump has previously mentioned a 10% rate (which could be adjusted based on the type of asset). Definitions of the relevant asset categories remain to be worked out later.

Revenue Raisers and Budget Impact

What the Framework says

The Framework calls for "fiscally responsible" tax reform by broadening the tax base (which means cutting back on or eliminating current deductions, credits, and exclusions), closing loopholes (more revenue raising), and growing the economy (meaning dynamic scoring will be used). As for specifics:

Two current deductions are being **targeted**:

- The deduction for **net interest expense** incurred by C corporations will be **partially limited**. The tax-writing committees will consider the appropriate treatment of interest paid by some noncorporate taxpayers.
- The **Section 199 manufacturing deduction** would be eliminated.

Credits in two specific areas would be **retained** based on their proven effectiveness:

- **Research and development**
- **Low-income housing**

There is also a general statement that some industry and sector-specific rules will be modernized to ensure that the tax laws reflect economic reality and provide little opportunity for tax avoidance.

What it doesn't say

Other than these few provisions, the Framework leaves the tough task of revenue raising to the tax-writing committees. The tax rates and other provisions called for in the proposal mean that there will need to be some significant revenue raisers, even if dynamic scoring is used and the changes are not fully paid for.

Conclusion

In the Framework, Republican leaders have set out a bold agenda for comprehensive tax reform and tax cuts. They are also looking at an ambitious time frame to get something passed by year-end. There is much work still to be done, however, and a number of things may slow the process, including getting agreement on a budget, concerns over increasing the deficit, debates over revenue raisers, working out the many important missing pieces and details, and plain old politics.

Even if comprehensive tax reform proves elusive, some kind of tax cut seems likely. Timing on enactment could shift into the beginning of 2018, although we should see more details emerging and the process moving significantly forward this year.

In the meantime, businesses can continue to review what impact these reforms could have if enacted, determine whether to step up advocacy efforts on particular issues now that we have the outline, and prepare for the impact that these reforms could have if enacted. It's important for businesses to consider specific issues, such as conducting a study of foreign earnings and profits in anticipation of deemed repatriation or review the impact that disallowance of interest expense may have on their tax liabilities going forward. It's also important to consider the package as a whole as there are interactions between numerous provisions that impact who will be winners and losers.

Click **here** for Alston & Bird's Tax Blog.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Tax Policy & Regulation Group

Carolyn Smith
Co-Chair
202.239.3566
carolyn.smith@alston.com

Hon. Earl Pomeroy
Co-Chair
202.239.3835
earl.pomeroy@alston.com

George Abney
404.881.7980
george.abney@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

Shannon Campagna
202.239.3680
shannon.campagna@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Dominic DeMatties
202.239.3011
dominic.dematties@alston.com

Scott Harty
404.881.7867
scott.harty@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

Kendall L Houghton
202.239.3673
kendall.houghton@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Stefanie E. Kavanagh
202.239.3914
stefanie.kavanagh@alston.com

Sam K. Kaywood, Jr.
404.881.7481
sam.kaywood@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Michael T. Petrik
404.881.7479
mike.petrik@alston.com

Mark H. Rayder
202.239.3562
mark.rayder@alston.com

Danny Reach
704.444.1272
danny.reach@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Michael Senger
404.881.4988
michael.senger@alston.com

Edward Tanenbaum
212.210.9425
edward.tanenbaum@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN ▪ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ▪ Suite 2100 ▪ San Francisco, California, USA, 94105-0912 ▪ 415.243.1000 ▪ Fax: 415.243.1001
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333