SQUIRE PATTON BOGGS

US Tax Reform Update

The annual two-week congressional spring recess now underway provides an opportunity to take stock of the status of the Republican pledge to enact comprehensive structural reforms to the US federal income tax system this year.

As we discuss in this update, the feelings of "certainty" and "optimism" seemingly held by many when Republicans formally took control of both the legislative and executive branches of government in January have given way to an atmosphere now described as "fluid." Key provisions of the Blueprint for tax reform published by the House Republican leadership have encountered strong headwinds; in some quarters, there has been talk of alternatives to the type of comprehensive tax reform envisioned by the Blueprint, including perhaps a mere tax rate cut accompanied by a 10-year sunset similar to the 2003 Bush tax rate cuts; the Trump Administration has announced that it will table its own tax reform plan, which may or may not differ significantly from the campaign proposals of "Candidate" Trump and the key provisions of the Blueprint; and the consensus is that any action on tax reform will be completed well after the August target date envisioned by Treasury Secretary Mnuchin. As we look ahead, we think it makes more sense to focus on the week before Christmas as the week when Congress will complete action on tax reform legislation if it can find common ground, given the challenges we describe below.

The Story So Far

In January, the Trump Administration and Congressional Republicans, particularly House Republicans, seemed poised to deliver a one-two punch of repeal of the Affordable Care Act (the ACA), followed in short order by a comprehensive tax reform package, perhaps completing action on tax reform by August and with only Republican votes. At that point and as of today, the only fully developed tax reform package outstanding is the so-called tax reform "Blueprint" issued by the House Republican leadership in June 2016. With the expectation that the tax reform legislative process would begin sooner rather than later, the Blueprint received heightened attention in the private sector, the media and elsewhere. At the same time, House staff members continued their efforts to convert the Blueprint narrative into statutory language so that formal action could indeed begin in the aftermath of ACA repeal (including repeal of the nearly $1 trillion in taxes and fees embodied in the ACA when it was originally enacted in 2010). ACA repeal was, thus, presumed to provide for nearly $1 trillion of tax reductions itself, in effect resetting the revenue baseline for purposes of the tax reform initiative.

Proponents of comprehensive tax reform took comfort in the fact that many of the Blueprint's high-level points, such as lower tax rates and simplification, appeared compatible with the tax proposals advanced by "Candidate" Trump in 2016, but, as discussed below, there may in fact now be key differences between the Blueprint and the positions of the Trump Administration. The key provisions of the Blueprint include (1) reducing the corporate tax rate from 35 to 20%, (2) eliminating the worldwide application of tax so that US-based corporations would no longer be taxed on the earnings of their subsidiaries from active business operations from outside the US (i.e., going to a "territorial tax system"); (3) converting the tax from an income tax to a cash flow tax by allowing immediate deductions for most capital expenditures and disallowing deductions for net interest expense; and (4) making the tax border adjustable so that export receipts would be exempt from tax, but business importers would not be allowed to deduct the cost of those imports (including imports used as raw materials or components of goods produced in the US for US consumption), effectively equating to a 20% tax on imports.

The increased attention given to the Blueprint's corporate tax proposals resulted in the development of sharp divisions in the private sector related to such key features as border adjustability and the disallowance of deductions for net interest expense. As a result, business representatives and others began to look to the Trump Administration for announcements laying out the tax reform proposals of President Trump. Readers of the proposals tabled by "Candidate" Trump in 2016 noted several key differences between those proposals and the Blueprint. The campaign proposals (1) suggested a 15% corporate income tax rate was achievable; (2) did not provide for eliminating the worldwide application of the corporate income tax; (3) did provide that corporations could elect immediate write offs for capital expenditures, but electing corporations would forfeit deductions for net interest expense; and (4) while "Candidate" Trump did propose tariffs on some imports, he did not propose anything resembling the comprehensive border adjustable tax embodied in the Blueprint. In addition, the Blueprint and "Candidate" Trump provided differing proposals to address the fact that in recent years, a growing portion of active business income is earned through partnerships and LLCs and, thus, is taxed currently at the rates applicable to individuals.

While the Trump Administration announced it was at work on crafting its tax reform positions, no substantive announcements were issued. Additionally, some had a sense earlier this year that the Administration might rely, at least initially, on House and Senate Republicans to develop and pass their own respective tax reform bills similar to the approach taken with ACA repeal, which could then be molded into a single package in a House-Senate conference and adopted on a party-line vote using the so-called budget reconciliation rules. In the meantime, the effort to repeal the ACA gathered momentum and captured most of the headlines.

The situation changed dramatically on March 24 when the House Republican leadership and the Trump Administration announced they were abandoning the efforts then underway to secure passage of its legislation to repeal and replace the ACA rather than, as they concluded was otherwise certain, have it collapse for want of sufficient support among House Republicans. The failure of the ACA repeal-and-replace effort, at least for the time being, had immediate consequences for the pace and scope of the tax reform initiative. First, both the Trump Administration and the House Republican leadership announced an immediate "pivot" to tax reform, a strategy that seemingly was abandoned, at least temporarily, when a second, but unsuccessful, effort was made to devise a new Affordable Healthcare Act compromise for approval before the spring recess. Second, the President's press secretary announced that the Administration would "drive the bus" on tax reform and not, as in the Affordable Care Act defeat, defer more or less entirely to Congressional Republicans on content. This latter announcement produced a more or less immediate response from Ways and Means Committee Chair Brady (R-TX) urging the Administration not to table a comprehensive alternative to the Blueprint, which was in turn followed by suggestions from Administration spokespersons that the Administration may merely propose principles. As discussed below, however, the Trump Administration has more recently announced that it was working on its own proposal. Third, the President announced that, given the intransigence of some House Republicans on the ACA repeal-and-replace initiative, he was prepared to reach out to Congressional Democrats on tax reform, and this was accompanied by indications that the Administration was prepared to combine tax reform with a large infrastructure initiative in a single legislative package.

Thus, as Congress entered its recess period the evening of April 7, that state of play on both ACA repeal and tax reform could not reasonably be described as other than "fluid." While House Republicans continued to talk of reviving their healthcare initiative, notwithstanding their failure to achieve consensus on a second effort just before the spring recess, when Congress returns, it will have to turn its near-term attention to legislation to fund the government and avoid a shut down by April 28. It now appears, however, that negotiations are underway to reach a bipartisan compromise on funding that would avoid such a shutdown.

The Bumpy Road Ahead for Tax Reform

It is an understatement to say that the border adjustability feature of the Blueprint has encountered "strong headwinds," and not merely in the private sector. For example, border adjustability has gained little traction and increasing opposition in the Senate, and there is a sense that a number of House Republicans are becoming lukewarm with respect to the proposal. As a result, on the eve of the spring recess, Ways and Means Committee Chair Brady adopted a seemingly more flexible posture on substantive modifications to the border adjustability proposal and it now appears that hearings may be held on this and other key features of the Blueprint.

If border adjustability is completely abandoned as the legislative process unfolds in the spring and summer, the loss of the some $1.2 trillion the proposal would raise over 10 years would have a dramatic and adverse impact on Congress' ability to enact comprehensive tax reform on anything approaching a revenue neutral basis. If the reconciliation process is used in an effort to enact tax reform with only Republican votes, there would be, under established congressional rules, a requirement that the legislation not increase the projected budget deficit beyond a 10-year budget horizon. Whether this required revenue neutrality could be achieved in a comprehensive structural tax reform measure without the border adjustability proposal or a comparable revenue raiser appears problematic and, if it cannot, serious structural reform could be at risk. A sunset of tax rate reductions, as occurred with the 2003 Bush tax rate cuts, is one thing; a sunset of structural reforms that would have companies fundamentally changing the way they do business is quite another. In this connection, there may not be another politically acceptable substitute for the revenues that would be produced by border adjustability, as is illustrated by the fact that the Trump Administration was forced to issue an almost immediate denial that it was considering the use of either a carbon tax or traditional value added tax to bridge the revenue gap that would be created if the border adjustability proposal did indeed fail.

For these reasons, as Congress prepared to recess on April 7, some had begun to discuss possible alternatives such as a smaller tax reform package that could more easily be structured as revenue neutral. Still others had countered with a suggestion that the basic reforms are so important that they should be adopted, notwithstanding the increase in the deficit and even if the reforms are only temporary under the 10-year sunset budget reconciliation bill. Moreover, there had been exploratory discussions about crafting a legislative package that would attract sufficient support from Democrats to permit use of the regular legislative process rather than the budget reconciliation process. To this end, and perhaps in response to the failure to date of the Republican-only approach on ACA repeal, the Trump Administration floated the idea of combining tax reform with an infrastructure initiative, a priority for Democrats and Republicans alike; although, the parties currently differ on whether infrastructure spending should be accomplished by direct spending or tax credits.

Whether tax reform ultimately moves forward on a Republican-only or a bipartisan basis (and it is hard to imagine how either the President or the Congressional Republicans could completely abandon such a key component of their election campaigns), it seems fair to assume that, even if a less comprehensive package than envisioned by the Blueprint is adopted, it will contain some form of tax relief for individuals, as there is a growing realization that enacting corporate tax relief on a standalone basis may not politically practical. On the other hand, it is possible that the individual taxes imposed in 2010 under the ACA may remain in place unless and until the repeal-and-replace effort succeeds.

A Final Word or Two

We expect "fluid" will continue to be the most apt description of the tax reform process for an additional time following the spring recess. When Congress returns, its first priority will, and must, be developing some form of spending legislation that will attract sufficient support to avoid the government shutdown that otherwise will occur on April 28. Given the urgency of completing work on ACA repeal and replace legislation, Speaker Ryan is reportedly thinking about bringing the House back into session before the end of the scheduled recess. Beyond keeping the government open beyond April 28, the House and Senate also must begin work on a budget resolution for fiscal year 2018. For reasons that are understandable only by aficionados of the congressional budget rules, some have expressed the view that either action on the legislation to repeal and replace the Affordable Care Act must be completed first or a new set of budget reconciliation instructions targeted to tax reform adopted before tax reform legislation can be adopted by Republicans without support from Democrats.

It is axiomatic that the success of any effort to enact comprehensive reforms will, as was the case of the landmark Tax Reform Act of 1986, require the active and personal engagement of the President to adopt and carry forward the strong leadership posture necessary to achieve congressional consensus, at least among Republicans. Recent statements by Administration representatives that the Trump Administration will table its own tax plan (which may supersede the proposals made in 2016 by "Candidate" Trump) suggest that this necessary level of increased engagement is now underway; although, congressional action now may be on hold until the Administration proposal is unveiled. As noted, the President may attempt a degree of outreach to Democrats in an effort to build bipartisan support for a single tax reform package, perhaps by combining tax reform with an infrastructure initiative, but it remains to be seen whether this will in fact occur and, if so, be successful as recent statements by Senate Republican leader McConnell (R-KY) suggest that Congressional Republicans are still focused on a Republican-only scenario. Nevertheless, given the increased engagement of the President, we believe the enactment of significant and reasonably comprehensive tax reform legislation remains a real possibility.

Contacts

Donald Moorehead
Partner, Washington DC
T +1 202 457 5212
E donald.moorehead@squirepb.com

Mitch Thompson
Partner, Cleveland
T +1 216 479 8794
E mitch.thompson@squirepb.com

Linda Pfatteicher
Partner, San Francisco
T +1 415 954 0347
E linda.pfatteicher@squirepb.com

Matthew Cutts
Partner, Washington DC
T +1 202 457 6079
E matthew.cutts@squirepb.com

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