A Better Way or a Conversation Starter: The GOP Tax Reform "Blueprint"

On June 24, 2016, House Ways and Means Committee Chairman Kevin Brady (R-TX) released the House Republicans' long-awaited tax reform "Blueprint." In this alert, we discuss the politics of the Blueprint, the background on its development, and provide details of what it contains.

Political Overview

The Blueprint is the "sixth and final plank" of House Speaker Paul Ryan's (R-WI) "A Better Way" plan, which represents the GOP's policy vision for 2017. In releasing the Blueprint (the details of which are discussed below), Republicans themselves acknowledge that their proposal is only "the beginning of our conversation about how to fix our broken tax Code." In fact, while Republicans point out that their proposals would be revenue neutral, the lack of a score – which is necessary to understand the true economic and political consequences of the Blueprint – serves to underscore the preliminary nature of this renewed effort to reform the nation's tax laws.

What's more, as we have seen from the tax reform debate during the 113th and 114th Congresses, clearly differences remain between the parties. Democrats have spent much of their efforts continuing to hammer home the need to take legislative action to directly address the issue of corporate tax inversions. Indeed, following a slew of proposals from both Chambers over the course of this year, Senate Finance Committee Democrats are presently working to finalize their months-long work on a package of anti-inversion proposals. Importantly, however, Senator Ron Wyden (D-OR) – who may well be the next Chairman of the Senate Finance Committee – has confirmed during our recent conversations that he plans to broaden this package beyond inversion issues alone; in other words, the Senate Democrats plan to take on tax reform more broadly and will set out their own vision no later than the beginning of next year. Note too, even within the Republican Party, while not technically inconsistent with the House proposal, Senate Finance Committee Chairman Orrin Hatch (R-UT) has remained focused on "corporate integration" and is expected to release his own proposal soon.

In spite of the differences that exist between these approaches, lawmakers' continued work on tax reform suggests that both parties understand the pressing need to overhaul the nation's tax Code. With US-based multinational corporations, in particular, already feeling the pain of an uncompetitive tax Code, worldwide implementation of the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Project will further undermine the ability of US companies to compete with their foreign counterparts. As countries around the world work to update their tax laws, US lawmakers should feel growing pressure to work together and do the same. The question remains: will they?

With 30 years having passed since the last major reforms to the US tax Code, the stage is now set for tax reform in 2017.

With increased pressure on Congress by US taxpayers to reform the nation's tax Code, Members are clearly taking notice, as tax reform remains a priority for both parties. For the GOP, the Blueprint represents not only their vision for tax reform, but also puts Democrats on notice of where tax reform negotiations will begin with their Republican counterparts. From all indications, both Republican lawmakers and their staff believe the Blueprint represents a serious, workable proposal and thus, anticipate undertaking significant work over the coming months to push their vision forward.

In addition to growing public pressure and the work being done by Congress, there is one remaining question that our crystal ball is not yet willing to predict: who will be the next President of the United States and will he or she take on tax reform? With the US presidential election just over four months away, it is important to remember that both Hillary Clinton and Donald Trump have already released their own tax reform proposals. Therefore, if either candidate, once elected, decides to undertake the herculean effort that is tax reform, their competing proposals will need to be reconciled.

Background on the Tax Reform Task Force and the Blueprint

Speaker Ryan originally announced six committee-led task forces – including the Tax Reform Task Force – in February 2016. Shortly thereafter, the Tax Reform Task Force held the first in what would be a series of six "idea forums," during which Republican lawmakers discussed how to "fix our broken tax Code." As part of its work, the Task Force also met with various economic leaders and held a series of hearings on tax reform, which Republicans say helped inform their work on the Blueprint.

In releasing the Blueprint, the Task Force underscored its commitment to growing the economy without increasing the deficit. Specifically, Republicans outlined three goals they believe the Blueprint will achieve: (1) fuel job creation and deliver opportunity for all Americans; (2) simplify the tax Code and make it more fair and less burdensome; and (3) reform the Internal Revenue Service (IRS) so that it is more focused on customer service.

After much speculation, the 35-page Blueprint offers some detail about the Republicans' plan to reform the tax Code. Though there is no legislative text (that is expected to be ready for debate in 2017), the proposal does include many specifics – including rates, which deductions and credits will be kept in place, etc. Nevertheless – and as the Blueprint recognizes – these proposals represent only the first step in the next phase of tax reform efforts.

To help provide a snapshot of where these efforts will begin, below we provide an overview of the Blueprint and its main proposals.

Details of the Blueprint

The Republican Blueprint "represents a dramatic reform of the current income tax system." Specifically (and as discussed in greater detail below), the proposal addresses various issues, including: (1) individual taxation; (2) corporate taxation; (3) international taxation; and (4) the need to reform the IRS. Moreover, in releasing its Blueprint, the Tax Reform Task Force notes that the "Blueprint does not include a value-added tax (VAT), a sales tax, or any other tax as an addition to the fundamental reforms of the current income tax system…but instead seeks to simplify, flatten, and lower tax rates… [and] deliver a 21st century tax code that is built for growth and that puts America first."

1. Individuals

Overall, the individual portion of the Blueprint focuses on simplifying the tax Code and reducing rates, while at the same time imposing a progressive, but reduced tax on capital gains, dividends and interest income. In addition to eliminating the alternative minimum tax (AMT) for individuals, the proposal seeks to make tax filings "simple enough to fit on a postcard for most Americans."

The section of the Blueprint dealing with individual tax issues focuses on: (a) tax rates; (b) sole proprietorships and pass-throughs; (c) investment and savings; and (d) deductions, credits, and other tax benefits.

a. Tax Rates

The Blueprint will continue taxing individuals based on compensation received, providing exceptions for "two pressing national priorities – quality health care and retirement security." The proposal also shifts from seven tax brackets to three brackets. The brackets will be indexed for inflation going forward, with the top individual income tax rate lowered to 33%.

Current Law	Blueprint
10%	0%/12%*
15%	
25%	25%
28%	
33%	33%
35%	
39.6%	

*The new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0% bracket. As a result, taxpayers who are currently in the 10% bracket *always will pay lower taxes than under current law.*

b. Sole Proprietorships and Pass-Throughs

With 95% of businesses operating as sole proprietorships or pass-through entities – together generating more than 50% of all business income in the US – determining how to tax these businesses is a key issue that will need to be addressed in any tax reform package. Building on concepts developed by Representative Vern Buchanan (R-FL) in H.R. 5076, *Main Street Fairness Act*, the Blueprint seeks to achieve tax parity between small businesses and C corporations by limiting the tax rate that applies to active business income of sole proprietorships and pass-throughs to the 25% bracket – the lowest top tax rate on pass-through income since before World War II.
Moreover, these small businesses will pay or be treated as having paid reasonable compensation to their owner-operators, which will be deductible by the business and subject to tax at the graduated rates for individuals.

c. Investment and Savings

Republicans are proposing to reduce the tax on investment income, allowing individuals to deduct 50% of their net capital gains, dividends, and interest income, effectively resulting in rates of 6, 12.5%, and 16.5% on such investment income, depending on the individual's tax bracket.

Current Law	Blueprint	
10%	0%/12%*	6%
15%		
25%	25%	12.5%
28%		
33%	33%	16.5%
35%		
39.6%		

*The new standard deduction is larger than the current-law standard deduction and personal exemptions combined. This, in effect, creates a larger 0% bracket. As a result, taxpayers who are currently in the 10% bracket *always will pay lower taxes than under current law.*

Additionally, the Blueprint would continue the current tax incentives for savings. Moreover, in an effort to provide "effective and efficient" incentives for savings and investment, the Ways and Means Committee plans to consolidate and reform the various retirement savings provisions in the current tax Code. Specifically, the Committee will explore more general savings vehicles – including Universal Savings Accounts, as most recently proposed by Representative Dave Brat (R-VA) in H.R. 4094 – as a way to eliminate the double taxation of savings and investment for families.

The Blueprint would also repeal the estate and generation-skipping transfer taxes.

d. Deductions, Credits, and Other Tax Benefits

Under current law, there are five basic family tax deductions and credits, each with its own rules, eligibility criteria, and calculations: (1) basic standard deduction; (2) additional standard deduction; (3) personal exemption for taxpayer and spouse; (4) personal exemptions for children and dependents; and (5) child tax credit. To simplify and streamline these tax benefits, the Blueprint would consolidate these five benefits into two simpler benefits: (1) a larger standard deduction; and (2) an "enhanced" child and dependent tax credit.

Specifically, the Blueprint proposes consolidating the basic standard deduction, the additional standard deduction, and the personal exemptions for families and individuals into a larger standard deduction that would be: (1) $24,000 for married individuals filing jointly; (2) $18,000 for single individuals with a child in the household; and (3) $12,000 for other individuals. These amounts would be adjusted annually for inflation. In addition, the Blueprint would consolidate the child credit and personal exemptions for dependents into an increased child credit of $1,500 – the first $1,000 would continue to be refundable, with a non-refundable $500 credit for non-child dependents.

Additionally, as part of Republicans' plan to simplify the tax filing process, the Blueprint would eliminate all itemized deductions *except* for the mortgage interest deduction and the charitable contribution deduction.

Note, too, the Blueprint indicates that the Committee will work to simplify and consolidate what are currently more than a dozen tax benefits relating to education into a package of higher education tax benefits that will cover both college and vocational training programs. The package is expected to include a savings incentive, such as 529 plans, and tax relief targeting low- and middle-income families, such as the American Opportunity Tax Credit.

2. Corporations

The Blueprint proposes "the largest corporate tax rate cut in US history" and represents a shift toward taxation based on business cash flow. By implementing what is effectively a consumption-based approach to taxation, the Task Force suggests that the US will be able to end the current penalty on exports and subsidy on imports. Note too, as with individuals, the Blueprint eliminates the AMT for corporations.

The section of the Blueprint dealing with corporate tax issues focuses on: (a) tax rates; (b) expensing and accounting; and (c) deductions, credits, and other tax benefits.

a. Tax Rates

Under the current tax Code, corporate income of C corporations is taxed at a rate of 35% – the statutory rate for nearly 30 years. The Blueprint highlights that when lawmakers last overhauled the tax Code in 1986, the average corporate tax rate in the other OECD countries was 47.2; today the average rate in those same countries is just under 25%. As such, in an effort to make the US a more competitive place to do business, the Blueprint would lower the corporate tax rate to a flat rate of 20%.

Additionally, as discussed above, the Blueprint addresses the issue of "double taxation" on corporations at the shareholder level through its proposal to tax dividends and capital gains at half the regular individual tax rate.

b. Expensing and Accounting

In an effort to address the complex rules governing cost recovery for businesses' investments in assets needed to maintain and grow their operations, the Blueprint would allow businesses to fully and immediately write off the cost of such investments (i.e., expensing). It appears that H.R. 4377, *American Business Competitiveness Act*, which was introduced by Representative Devin Nunes (R-CA) and would introduce a business cash-flow tax, will inform the Committee's work in this area. Note, the proposed cost recovery rules would apply to both investments in tangible property (e.g., equipment and buildings) and intangible assets (e.g., intellectual property); it would not apply to land.

With respect to inventory, the Blueprint preserves the last-in-first-out (LIFO) method of accounting; though, the Committee will continue to evaluate options for making the treatment of inventory more effective and efficient under the newly proposed tax regime.

c. Deductions, Credits, and Other Tax Benefits

As a general matter, the Blueprint would eliminate "special-interest deductions and credits in favor of providing lower tax rates for all businesses and eliminating taxes on business investment." Though the Committee highlights the section 199 domestic production deduction as an example of a deduction that would no longer be necessary, most deductions and credits presently available to businesses will likely be discontinued as part of Republicans' tax reform efforts.

Additionally, the Blueprint allows businesses to deduct interest expense against any interest income, but would not allow a deduction for net interest expense. Instead, businesses would be permitted to carry forward any net interest expense indefinitely and use it as a deduction against future net interest income. The Blueprint suggests that eliminating the deduction for net interest will help equalize the tax treatment of different types of financing and reduce "tax-induced distortions" in investment financing decisions. The Committee will, however, work to develop special rules governing interest expense for financial services companies, which will take into account the role of interest income and interest expense in their business models.

The proposals would also allow businesses to carry forward net operating losses indefinitely, increasing such losses by an interest factor that takes into consideration inflation and a "real" return on capital; the deduction in any year would be limited to 90% of the net taxable amount for such year determined without regard to the carryforward. The Blueprint, however, would not permit carrybacks of net operating losses.

Notably, despite an earlier push, Representative Charles Boustany's (R-LA) "Innovation Box" proposal was not included in the Blueprint. Instead, Republicans are opting to continue the Research and Development (R&D) credit in similar form; though, the Committee will evaluate options for improving the credit.

3. International

In terms of the international impact, the new tax system would end the taxation on the worldwide income of US-based multinational corporations, instead shifting to a territorial system of taxation aimed at simplifying these companies' tax compliance burden and reducing the potential for controversy. Additionally, as mentioned above, the proposal eliminates the existing export penalty and import subsidy by moving to a destination-basis tax system. According to Republicans, "[t]hese two fundamental structural changes in turn allow other important aspects of the international tax rules to be simplified and streamlined significantly."

The section of the Blueprint dealing with international tax issues focuses on: (a) territorial system of taxation; and (b) exports and imports.

a. Territorial System of Taxation

As has been discussed for quite some time by both parties, the Blueprint would replace the existing worldwide system of taxation with a territorial system of taxation that provides a 100% exemption for dividends from foreign subsidiaries. Republicans believe this approach would both make US-based multinationals more competitive with their foreign counterparts and help eliminate the "lock-out effect" by allowing US companies to repatriate their foreign earnings and reinvest the money domestically. Specifically, accumulated foreign earnings would be taxed at a rate of 8.75% to the extent held in cash or cash equivalents, and would otherwise be taxed at a rate of 3.5%. Companies would be permitted to pay the resulting tax liability over an eight year period.

As a result of the proposed changes, the Blueprint would eliminate the majority of current subpart F rules, as there will no longer be tax incentives to locate outside the US. In other words, Republicans believe that because "[b]usinesses will be able to make location decisions based on the economic opportunities, not the tax consequences…[o]nly the so-called foreign personal holding company rules, which counter the potential for truly passive income to be shifted to low-tax jurisdictions, will continue to play a role in addressing potential abuse and will be retained under this Blueprint."

b. Imports and Exports.

The Blueprint would replace the current US income-based tax system with a cash-flow tax system. Because this represents a consumption-based approach, the GOP believes that the US would be permitted by the rules of the World Trade Organization (WTO) to apply border adjustments (i.e., value tax (VAT) is rebated when a product is exported to a foreign country and is imposed when a product is imported from a foreign country). As such, products, services, and intangibles that are exported outside the US will not be subject to US tax regardless of where they are produced; however, when imported, they would be subject to US tax. According to the proposal, such an approach will help eliminate the incentives created by the current tax system to relocate outside the US and help make US businesses more competitive.

4. IRS

Continuing to take issue with current operations at the IRS, the Republican Blueprint would "rebuild" the agency into a "modern and efficient 21st century administrator of the nation's tax system." The IRS would be divided into three major units: (1) families and individuals unit; (2) businesses unit; and (3) an independent "small claims court" unit. Additionally, the proposal would replace the current head of the IRS with an appointed Administrator "whose sole objective will be to manage the agency and administer the new tax Code in an impartial, non-political manner for the benefit of American taxpayers." The President, with advice and consent of the Senate, would appoint the Administrator for a three-year term, and would only be permitted to reappoint the Administrator once.

Next Steps

The Ways and Means Committee will now turn its attention to drafting the tax reform legislation that reflects the principles contained in the Blueprint, with the goal of readying the legislation for action in 2017. However, as lawmakers move forward with this process, the Committee is seeking "robust comments" from the public that will "affect our final legislation and determine the final product." Moreover, as part of its efforts, the Committee will work to create rules to help ensure a smooth transition to the system proposed under the Blueprint. Still, one thing is for sure: we are in the eye of the tax reform storm, and lawmakers on both sides may well all need a blueprint to successfully navigate the obstacles that lie ahead.

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