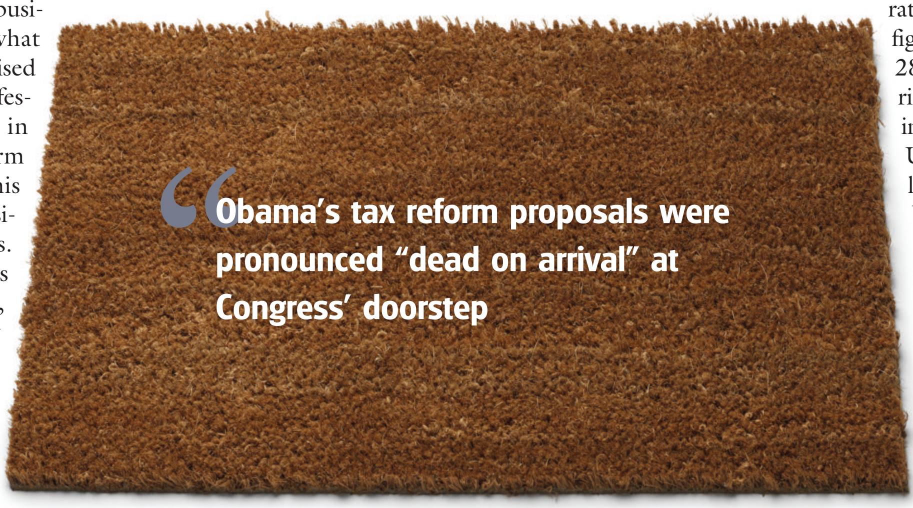
Reform of the US tax system: Searching for the magic key

Donald Moorehead, partner at Squire Patton Boggs in Washington, DC, assesses the prospects for action towards US tax reform in 2015, explaining that it's no surprise many are looking back at 1986 - the last time reform was achieved - for keys to unlock the process, but significant challenges remain.

Comprehensive tax reform (that is, reform of *both* the business and individual federal income tax) is once again on the domestic agenda, just as it was in the preceding Congress, when no proposals reached the point of being subjected to a vote. With new leadership at both of the Congressional tax committees, Republican majorities in both the House of Representatives and the Senate, and a president who can focus on his legacy rather than re-election, can comprehensive tax reform become a reality in this Congress? Let's take stock of where we are as Congress gets down to work.

That the new Congress opened with the Republican Congressional leadership professing a commitment to comprehensive tax reform and a willingness to work with the President was widely expected. What did make the headlines was the President's decision to table specific and far-reaching tax reform proposals for both individuals and businesses *in lieu* of what some have characterised as the generalised professions of interest in "corporate" tax reform that characterised his Administration's position in previous years. Both sets of proposals not only made "news", but were immediately pronounced "dead on arrival" at Congress' doorstep. And yet, the question remains: were those proposals opening bids or final positions? If the former, then the prospects for comprehensive tax reform in the current Congress are still very long, but alive. If the latter, then the conventional wisdom that comprehensive tax reform will follow rather than precede the 2016 presidential election will likely prove to be true.



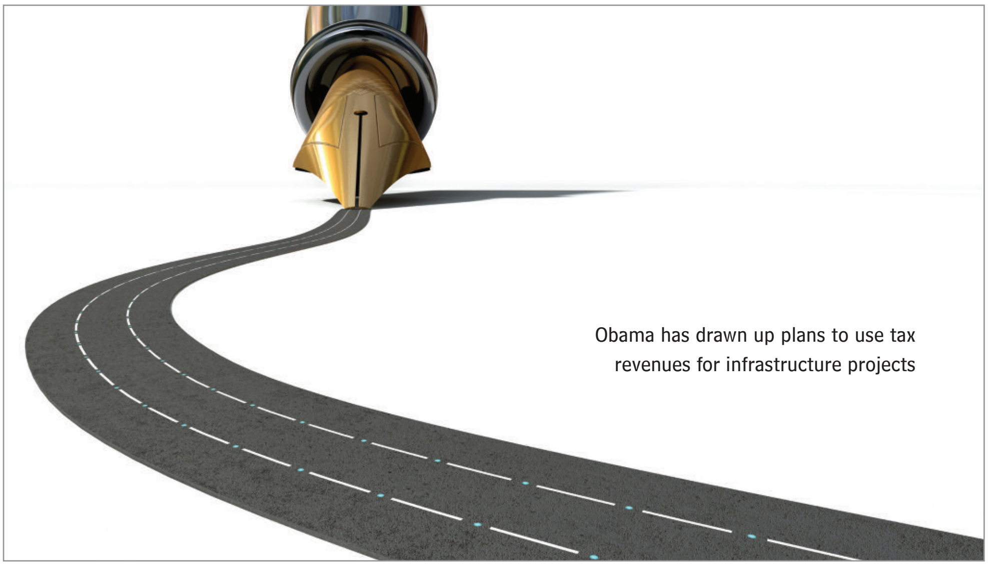
Challenges remain

As of now, enactment of comprehensive tax reform by the current Congress is thought by many to be unlikely because there is little or no consensus between Republicans and Democrats on many key policy issues that will arise in any effort to reform the individual income tax, including such fundamental questions as whether to raise taxes on the "wealthy" to address issues of income equality or to fund new social programmes. If this assessment proves to be correct, the operative question may be whether this president and this Congress can reach a consensus on a business tax reform package and do so in a manner that is sensible from a policy standpoint, and politically acceptable, even if the system for taxing individuals is left in an unreformed state. While the adage "never say 'never'" is obviously applicable, the task will be daunting.

It is acknowledged that the US federal income tax rate for corporations (generally 35%) is higher than that of most of the country's trading partners and the application of that tax to a US corporation's worldwide income is likewise out of step with international norms, even though the credit for foreign taxes is intended to ameliorate the risk of double taxation. Indeed, the current system is viewed by many Republicans as responsible for the wave of inversion transactions. Whether or not that is in fact true, the existing system has certainly contributed significantly to the actions of many US-based multinationals in declining to repatriate the earnings of their non-US subsidiaries. As a result of these and other real or perceived consequences of the current system of corporate taxation, many have come to equate business tax reform with lowering the corporate federal income tax to a figure in the area of 25% to 28% and adopting a territorial system under which income earned outside the US would be wholly or at least partially exempt from US tax. The mere statement of such a view of reform, however, highlights three of the major roadblocks to a corporation-only approach to tax reform.

First, reducing the corporate income tax rate will be expensive. By some estimates, each percentage point by which the rate is lowered will reduce federal revenues by somewhat more than $100 billion over the 10-year budget estimating period. As a practical matter, it will be very difficult to raise sufficient offsetting revenues by broadening the base of the corporate income tax even if all the revenues resulting from base broadening are dedicated to rate reductions. Each base broadening proposal necessarily involves repealing, or limiting, a deduction, credit or special tax status and will therefore attract vocal opponents from those who now benefit from those provisions. In short, rate reductions offset by base broadening changes will produce losers as well as winners. It is also quite possible – indeed, Obama referenced as much in his Budget 2016 announcements – that some revenues resulting from corporate base broadening measures will be dedicated to new spending programmes such as replenishing the Highway Trust Fund so that funding will be available for a new round of infrastructure projects.

Second, moving to anything approaching what is commonly characterised as a territorial system for corporate income will be



Obama has drawn up plans to use tax revenues for infrastructure projects

quite difficult even if one can surmount the desire of some in Congress to retain the existing system and expand it even by limiting the deferral of US tax on income earned through foreign subsidiaries. Moreover, a not insignificant number of those who may be prepared, in principle, to move toward some form of a territorial system nevertheless fear that such a system will in practice necessarily create incentives for "runaway" plants and other schemes to move economic activity outside the US. In his most recent Budget, President Obama has tried to steer a middle ground by proposing a "hybrid" system for taxing corporate income from international operations that includes a 14% tax on previously earned but unrepatriated foreign earnings and a 19% per country minimum tax on non-US income earned in the future. The 14% tax on prior years' unrepatriated foreign earnings would raise billions of dollars that the President's Budget would devote, not to rate reduction or other tax reforms, but to the Highway Trust Fund to finance new spending for infrastructure.

The 14% and 19% rates apparently were sufficient, particularly when combined with the complexity of the President's anti-abuse proposals, to earn his proposal the sobriquet of "dead on arrival" from Congressional Republicans. Nevertheless, there is considerable speculation that the proposal may provide a framework that could be used by Republicans and Democrats alike to fashion a new system for taxing corporate income that would feature a lower corporate tax rate; a reduced rate on future foreign income; anti-abuse rules to prevent artificial shifting of operations and/or income abroad; and a tax on previously unrepatriated foreign earnings that, together with base broadening measures, could help finance the move to the new system. Indeed, such a framework would parallel in several important respects the model suggested by former Republican Ways and Means Committee chairman Dave Camp in the previous Congress. Whether such an approach will in fact gain traction in the coming months remains to be seen.

Third, reforming the corporate income tax, and only the corporate income tax, would ignore the fact that in the United States a significant portion of business income is taxed on individual income tax returns as distributions from partnerships, limited liability companies that elect partnership status, so-called S corporations and the like, which are not themselves subject to entity-level income taxes as "corporations" are. This produces both policy and political issues.

Policy perspectives and lessons from '86

From a policy standpoint, and assuming that the new corporation tax rate is substantially less than the top individual income tax rate, income from identical business activities might be taxed at different rates depending on the type of entity through which the business is conducted. Perhaps because income conducted through partnerships and other tax transparent entities is subject only to a single level of tax while corporate earnings are taxed twice (once at the entity level and again when distributed to shareholders), Congress and the President might simply ignore the disparate treatment, but that could be somewhat difficult for some to accept in policy terms. This could be particularly true in the case of income from international business operations if that income is subject to a modest income tax when received by a corporation while being subject to taxes at higher than the current corporate rates if earned through a non-corporate business entity.

A corporation-only approach to tax reform could be equally challenging politically and indeed the President seems willing to consider including tax relief for "small business" in a corporate reform package. That, however, fails to address the broader political implications that individuals could wake up one morning to find that their taxes remain taxed at "too high" levels while the big corporations have received a major tax cut. President Obama may not need to stand for re-election in 2016 but all members of the House of Representatives and one-third of the Senate will be required to do so and the failure to reduce individual tax rates while cutting the corporate tax rate could well create yet another issue of the "Main Street vs. Wall Street" variety.

These three issues, which by no means comprise a complete catalogue of barriers to a corporation-only approach to tax reform, illustrate the point that, in both policy and political terms, separating corporate tax reform from individual tax reform may be easier said than done. And yet, comprehensive reform of both the corporate and individual income tax system will no doubt prove to be incredibly difficult as well.

Such a comprehensive approach was last achieved in 1986, nearly 30 years ago, by a Republican President, a Democratic House and Republican Senate. The process that produced that legislation was captured in a book entitled 'Showdown at Gucci Gulch'. While one can, and many still do, debate the merits of the Tax Reform Act of 1986, the process did produce legislation that made it all the way to the White House where it obtained the president's signature. It should therefore come as no surprise that on February 10 2015, the Senate Finance Committee held a hearing seeking to identify the "secrets" to the success of that effort.