House Republicans outline plan for comprehensive tax reform

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In brief

House Republicans today released a 35-page report on tax reform that proposes to lower corporate and pass-through business tax rates, reduce individual tax rates, provide full expensing for business costs (with no deduction for net business interest expense), and move the United States from a worldwide international tax system to a ‘territorial’ dividend-exemption system.

The report was prepared by a House Republican task force on tax reform, led by Ways and Means Committee Chairman Kevin Brady (R-TX). House Speaker Paul Ryan (R-WI) in January announced the creation of six task forces to develop policy recommendations to address poverty, national security, regulatory reforms, the US Constitution, health care, and tax reform.

Under the House Republican plan, the top US corporate income tax rate will be reduced from 35 percent to 20 percent. A new pass-through business income tax system with a top rate of 25 percent is proposed for non-C corporation business entities, including S corporations, limited liability companies, partnerships, and sole proprietorships.

The report envisions a 14-line “postcard” size tax return for most individuals, but the report leaves to the House Ways and Means Committee the task of simplifying the tax code sufficiently to achieve that goal. The current top individual tax rate will be reduced from 39.6 percent to 33 percent. In general, the current seven individual tax brackets will be replaced with three rates set at 12 percent, 25 percent, and 33 percent.

Qualified individual capital gain, dividend, and interest income will be subject to a 50-percent exclusion, with the remainder taxed at ordinary income tax rates. This exclusion system will replace current tax rules for investment income that include a top rate of 20 percent for qualified capital gain and dividend income.

The report states that the House Republican plan “envisions tax reform that is revenue neutral.” It states that House Republicans measure revenue neutrality by referring to a “current policy baseline” under which temporary tax provisions are assumed to be extended and by including the positive revenue effects from economic growth. No revenue estimates of specific provisions are included in the report. The report states that the House Ways and Means Committee will draft statutory language in the future.
In detail

Business tax reform

Under the House Republican plan, the top US corporate income tax rate will be reduced from 35 percent to 20 percent.

The report states that the “double-taxation of corporate income will be reduced through the reduction in the tax on dividends and capital gains of individual shareholders.” See below for a description of the plan’s investment income tax proposals.

The corporate alternative minimum tax (AMT) will be repealed.

A new pass-through business income tax system with a top rate of 25 percent is proposed for the active business income of non-C corporation business entities, including S corporations, limited liability companies, partnerships, and sole proprietorships.

Note: The report states that “sole proprietorships and pass-through businesses will pay or be treated as having paid reasonable compensation to their owner-operators. Such compensation will be deductible by the business and will be subject to tax at the graduated rates for families and individuals.” The report does not define “reasonable compensation.”

Full expensing

The proposed full expensing for business costs (in lieu of depreciation and amortization) will apply for investments in both tangible property (such as equipment and buildings) and intangible assets (such as intellectual property). It will not apply to land.

The report states that the proposed new tax system will “focus on investment in America and investment for America. The focus on business cash flow, which is a move toward a consumption-based approach to taxation will allow the United States to adopt ... the same destination-based approach to taxation that has long been used by [US] trading partners.”

Interest

As part of the move to full expensing for business investment, the plan eliminates the current deduction for net business interest expense associated with debt incurred to finance such investment.

Businesses will be allowed to deduct interest expenses only against any interest income. “Any net interest expenses may be carried forward indefinitely and allowed as a deduction against net interest income in future years.”

The report states that the Ways and Means Committee “will develop special rules with respect to interest expense for financial services companies, such as banks, insurance, and leasing, that will take into account the role of interest income and interest expense in their business models.”

Border adjustable

The plan provides for border adjustments exempting exports and taxing imports within the context of the new proposed business tax system. The report states that a “cash-flow based approach will replace our current income-based approach for taxing both corporate and non-corporate businesses” and that this “consumption-based” tax system will be “applied on a destination basis.”

The report states that the proposed border adjustments will be “consistent with [World Trade Organization] rules regarding indirect taxes.”

Observation: Previous US income tax provisions seeking to benefit exports (e.g., foreign sales corporations and extraterritorial income provisions) have been successfully challenged by other countries as being in violation of US trade agreements. The World Trade Organization generally has ruled that border-adjustable indirect taxes (e.g., value-added taxes or VATs) are permitted, while border-adjustable income taxes are not permitted.

Business tax deductions and credits

The report identifies the current tax system as delivering “special-interest” business subsidies and “crony capitalism.” Under the House Republican plan, numerous business tax deductions and credits would be eliminated. The report states, “for example, the domestic production (Section 199) deduction would no longer be necessary.”

The report states that the plan “will provide a business credit to encourage research and development (R&D).” The report notes the recent action by Congress to make permanent the current research credit, and states that the Ways and Means Committee “will evaluate options for making the R&D credit more effective and efficient.”

Note: The report does not include any proposals for special tax incentives related to ‘patent box’ or ‘innovation box’ income.

Net-operating losses (NOLs) will be allowed to be carried forward indefinitely, and will be increased “by an interest factor that compensates for inflation and a real return on capital.” The deduction allowed with respect to an NOL carryforward in any year “will be limited to 90 percent of the net taxable income for such year determined without regard to the carryforward.” NOL carrybacks would not be permitted under the plan.
The report states that the last-in, first-out (LIFO) method of inventory accounting will be retained. At the same time, the Ways and Means Committee will continue to evaluate options for a “more effective and efficient” treatment of inventory.

Note: Retention of inventory accounting would represent a deviation from a pure cash-flow tax system.

International tax reform
Under the House Republican plan, the foreign earnings of US businesses will receive a 100-percent exemption for dividends from foreign subsidiaries.

The plan calls for a mandatory ‘deemed’ repatriation tax on previously unrepatriated foreign earnings and profits. “Accumulated foreign earnings will be subject to tax at 8.75 percent to the extent held in cash or cash equivalents and otherwise will be subject to tax at 3.5 percent (with companies able to pay the resulting tax liability over an eight-year period).”

Note: These are the same rates proposed in the mandatory repatriation provision of the Tax Reform Act of 2014 (H.R. 1), introduced by then-House Ways and Means Chairman Dave Camp (R-MI).

The report states that the move to a dividend exemption system will “eliminate the ‘lock-out effect’ of current law” and “will free up more than $2 trillion in foreign earnings” that have been “stranded” overseas.

The report states that the proposed reforms overall will address fully the issue of corporate ‘inversions.’ “Taken together, a 20 percent corporate rate, a switch to a territorial system, and border adjustments will cause the recent wave of inversions to come to a halt.”

The report states that the “destination-based, territorial approach for international taxation” reflected in the plan will allow Subpart F rules “to be significantly streamlined and simplified.” The report states, for example, that foreign base company sales rules will no longer be needed due to the plan’s proposals for destination-based, border-adjustable approach to business taxation.

Foreign personal holding company rules may be retained in some manner to address the shifting of “truly passive income” to low-tax jurisdictions.

The report also states that the Ways and Means Committee will consider the appropriate tax treatment of individuals living and working abroad.

Individual tax reform
The current seven individual tax brackets will be replaced with three rates set at 12 percent, 25 percent, and 33 percent.

The individual AMT will be repealed.

The estate tax and the generation-skipping transfer tax will be repealed.

The report states that the present-law basic standard deduction, additional standard deduction, and personal exemption for taxpayer and spouse will be consolidated into a new larger standard deduction. Under the plan, the new standard deduction will be $24,000 for married individuals filing jointly, $18,000 for single individuals with a child in the household, and $12,000 for other individuals. These amounts will be adjusted annually for inflation.

The present-law personal exemption for children and dependents and the child tax credit will be consolidated into a new enhanced child and dependent care tax credit. The new child tax credit will be $1,500. The first $1,000 will be refundable as under current law. A non-refundable credit of $500 also will be allowed for non-child dependents.

Note: The new proposed child credit will begin to phase-out for married couples earning more than $150,000.

The report states that the Ways and Means Committee will continue to work to “simplify and consolidate” current-law education tax benefits.

The plan “will preserve a mortgage interest deduction.” The report states that the Ways and Means Committee will “evaluate options for making the current-law mortgage interest provision a more effective and efficient incentive for helping families achieve the dream of homeownership.” The report states that any such changes will not affect “existing mortgages or refinancings of existing mortgages.”

The report does not include any proposals affecting current-law deductions for charitable contributions. Instead, the report states that the Ways and Means Committee will “develop options” to continue encouraging donations, while “simplifying compliance and record-keeping.”

The report states that all itemized deductions other than the mortgage interest deduction and the charitable contribution deduction will be eliminated. In addition, “numerous other exemptions, deductions, and credits for individuals riddle the tax code,” and that these unspecified “special-interest provisions” will be repealed.

According to the report, the Ways and Means Committee will continue to examine existing tax incentives for retirement savings, including employer-based 401(k) retirement plans, defined benefit pension plans, and individual retirement savings.
accounts. In addition, the report notes the Ways and Means Committee will explore more general expanded savings vehicles under which withdrawals could be taken at any time without penalty.

The report states that the Earned Income Tax Credit will be retained, but work will continue to “reduce fraud and erroneous overpayments.” In addition, the Ways and Means Committee “will develop options for providing a more effective and efficient incentive to work.”

The report notes that health-related provisions in the tax code, such as the exclusion for employer-provided health insurance, health savings accounts, and flexible spending arrangements are being addressed by a separate House Republican task force on health care.

**Investment income**

Qualified individual capital gain, dividend, and interest income will be eligible for a 50-percent exclusion, with the remainder taxed at ordinary income tax rates.

**Note:** With a proposed top rate of 33 percent for ordinary income, the plan provides a top effective rate of 16.5 percent for qualified investment income.

This exclusion system will replace current tax rules for investment income that include a top rate of 20 percent for qualified capital gain and dividend income.

The plan assumes that the current 3.8-percent net investment tax and other tax provisions enacted as part of the Affordable Care Act will be repealed as part of future separate health care reform legislation.

**Internal Revenue Service**

The report proposes to restructure the IRS, to be headed by a newly appointed Administrator. The report calls for “streamlined” IRS service units, a new dispute resolution mechanism independent of the IRS, and better workforce and information systems.

**Other recent House tax reform efforts**

The House Republican tax reform report issued today differs in certain aspects from the comprehensive tax reform bill introduced in 2014 by then-Ways and Means Committee Chairman Camp. Building on three years of hearings, bipartisan working groups, and various discussion drafts, Chairman Camp initially released a 979-page statutory tax reform draft in early 2014, which he later introduced as H.R. 1, the Tax Reform Act of 2014. Joint Committee on Taxation (JCT) staff also released a multi-volume technical explanation of H.R. 1.

Chairman Camp’s Tax Reform Act of 2014 would have lowered the top corporate tax rate to 25 percent, with a 95-percent dividend exemption system for foreign earnings and anti-base erosion provisions. The bill proposed a top individual tax rate of 35 percent. The bill also proposed various reforms to tax rules affecting pass-through businesses, investment income, financial services and products, retirement savings, and other tax provisions.

Base broadening provisions in H.R. 1 included an extension of certain cost recovery periods and other specified offsets. Business interest costs would have continued to be deductible, although the bill proposed certain limitations on worldwide interest expenses.

JCT staff estimated that Chairman Camp’s bill was revenue neutral using traditional ‘static’ scoring methods. A macroeconomic analysis stated that economic growth associated with the proposals could increase federal revenues by as much as $700 billion over 10 years.

For an overview of the Camp tax reform plan, see our February 28, 2014 Tax Insight.

**Next steps**

The House Republican report on tax reform states that the Ways and Means Committee will have an “ongoing dialogue with stakeholders” as the committee drafts the plan’s proposals into tax legislation in the future. The Ways and Means Committee also is expected to address transition issues identified by stakeholders.

Key Senate leaders also are working this year to develop tax reform proposals that may provide a basis for future legislation.

Senate Finance Committee Chairman Orrin Hatch (R-UT) and his staff have been working on a detailed corporate integration proposal that could be considered as part of reform efforts.

Finance Committee Ranking Member Ron Wyden (D-OR) in recent weeks has released detailed statutory tax reform discussion drafts addressing cost recovery rules and the tax treatment of derivatives. Senator Wyden also is working on legislation to address corporate ‘inversions’ that may be released in coming weeks.

Finance Chairman Hatch and Ranking Member Wyden both have said that they are offering tax reform discussion drafts this year so that interested parties can comment in advance of possible action on tax reform legislation in 2017. For more on recent tax reform efforts in the Senate Finance Committee, see our April 26 Tax Insight.

The Senate Finance Committee in July 2015 released bipartisan tax reform
working group reports on international tax, business income, individual tax, savings and investment, and community development and infrastructure. The international tax reform working group, led by Senators Rob Portman (R-OH) and Charles Schumer (D-NY), called for adopting a dividend exemption system "with robust and appropriate base erosion rules." For a summary of the Finance tax reform working group reports, see our July 8, 2015 Tax Insight.

Presumptive Republican presidential nominee Donald Trump has proposed a tax reform plan with a 15-percent top rate for business income and a 25-percent top rate for individual income. Presumptive Democratic presidential nominee Hillary Clinton has proposed a number of targeted tax increase proposals for certain businesses and for upper-income individuals, with some targeted tax relief for manufacturing and domestic investments.

The takeaway
The release of the House Republican plan for comprehensive tax reform provides an opportunity for the business community to have a voice in the ongoing development of tax reform proposals. The direction of future tax reform efforts ultimately will be influenced by the results of the 2016 elections for control of the White House and Congress.

Click here for information on the House Republican report, “A Better Way: A Pro-Growth Tax Code for All Americans.”

Let’s talk
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