TRUMP AND THE REPUBLICAN-LED CONGRESS SEEK OVERHAUL OF INTERNATIONAL TAX RULES

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January 3, 2017 marked the first meeting of the 115th U.S. Congress, which – due to the unforeseen outcome of the 2016 election – is comprised of a majority of Republicans in both the House of Representatives and the Senate. On January 20, Donald Trump took office as president. Both the newly-minted president and the Congressional Republicans have said that the U.S. tax code is in for a dramatic change, and that change may come quickly given the Republican election sweep.

President Trump's tax plan has undergone revisions since the days of his candidacy and has come to more closely resemble the House Republican Tax Reform Blueprint (the "House Blueprint") – a plan released in June 2016 by the G.O.P.-led House Ways and Means Committee, shortly before the Republican National Convention. The chairman of the House Ways and Means Committee, Kevin Brady (R-T.X.), has said that he expects to have the legislative language for the House Blueprint ready for President Trump's first 100 days in office. By some estimates, the new tax law is expected to be ready by the second half of 2017. The following is a discussion of some of the key points of each plan, with an emphasis on the proposals that would impact cross-border business activities, and how businesses might prepare for the upcoming changes.

PROPOSED PLANS FOR INDIVIDUALS

Tax Rates and Brackets

Both the Trump plan and the House Blueprint would condense the existing seven individual income tax brackets to three: 12%, 25%, and 33%. The top 33% rate would apply to married joint filers with income over $225,000 and single filers with income over $112,500.

Deductions

Another item the Trump plan and the House Blueprint have in common is an increase in the standard deduction. Under current law, the standard deduction is only $12,600 for joint filers and $6,300 for single filers. The Trump plan would increase the standard deductions for joint filers to $30,000 and single filers to $15,000. Further, the Trump plan would eliminate personal exemptions and the head-of-household filing status. The House Blueprint would increase the standard deductions to $24,000 for joint filers, $18,000 for single parents, and $12,000 for other singles.

Under the Trump plan, itemized deductions would be capped at $200,000 for joint filers and $100,000 for single filers. The House Blueprint would eliminate all itemized deductions, except for the mortgage interest deduction and the charitable contributions deduction. That the latter two tax benefits would stay in effect was recently confirmed by House Majority Leader Kevin McCarthy (R-C.A.).

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Capital Gains Taxation

The Trump plan would retain the current system for taxing capital gains with a maximum rate of 20% but would tax carried interest (*i.e.*, the profits interest earned by the investment manager of a hedge fund or private equity fund) as ordinary income. Under current law, carried interest is taxed at the preferential 20% capital gains tax rate. Thus, this Trump proposal would result in a significant tax increase for investment managers. This is in line with various initiatives that have been proposed throughout the past years but have not managed to gain traction in Congress. The House Blueprint would reduce the capital gains tax rates to 6%, 12.5%, and 16.5%. The House Blueprint does not address carried interest.

Net Investment Income Tax

The 3.8% tax on net investment income, which was enacted as part of the Affordable Care Act (*i.e.*, "Obamacare"), would be repealed under the Trump plan and presumably under the House Blueprint, along with Obamacare itself. According to latest statements by President Trump, Obamacare would be replaced by a new health care plan. No details have been released so far. The Senate's budget-resolution,[1] which serves as a vehicle to dismantle Obamacare, was a first indication that G.O.P. lawmakers are determined to follow suit.

Estate, Generation Skipping, and Gift Taxes

Both the Trump plan and the House Blueprint would repeal the Federal estate tax and generation skipping transfer tax. However, the Trump plan calls for imposition of a tax on capital gains held until death and valued over $10 million, including gains on assets passing to family-controlled private charitable foundations. It appears that under both plans the Federal gift tax would remain in effect. The gift tax is viewed as a backstop to the income tax: it discourages individuals from shifting income-producing assets to a taxpayer in a lower tax bracket.

PROPOSED PLANS FOR BUSINESSES

Tax Rate

Under the Trump plan, the business tax rate for all businesses would drop from the current rate of 35% to 15%, whereas under the House Blueprint, the corporate income tax rate would drop to 20%. The corporate alternative minimum tax ("A.M.T.") would be eliminated under both plans. Further, under the House Blueprint, active business income from sole proprietorships and pass-through entities would be taxed at no higher than 25%, unless the income represents reasonable compensation for services, in which case it would be taxed at the usual rates for individuals (*i.e.*, up to 33%).

Tax Expenditures

Under the Trump plan, most corporate tax expenditures would be eliminated, except for the research and development credit. Manufacturers would be allowed to expense capital investments, but in so doing, they would lose the deduction for the corporate interest expense.

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[1] S. Con. Res. 3., January 12, 2017; passed by the House the following day.

Under the House Blueprint, the current system for depreciating certain investments in tangible and intangible property would be replaced with the ability to fully and immediately expense such investments. In general, "special-interest deductions" and "credits" (terms not specifically defined in the House Blueprint) would be eliminated under the House Blueprint.

Deductibility of Interest

The House Blueprint would eliminate the net interest expense but would allow the deduction of interest payments against interest income; interest payment amounts in excess of interest income would be carried forward indefinitely as a deduction against future interest income. The elimination of the net interest expense would overlap, to some extent, with the recently adopted Code §385 regulations.[2] However, unlike the primary focus of the Code §385 regulations on intra-group debt, the House Blueprint proposal is broader and would deny a deduction for net interest expense arising from interest payments to third parties. In addition, the House Blueprint would disallow the net interest expense regardless of whether the standards of the regulations are satisfied. Nonetheless, the House Blueprint proposal is narrower than the Code §385 regulations in that it would not apply to recharacterize debt as equity for all Federal income tax purposes. Moreover, the House Blueprint proposes to deny an interest deduction only for net interest expense. It is unclear to what degree the House Blueprint proposal would be coordinated with existing rules in the Code (*e.g.*, anti-earnings stripping rules).[3]

Net Operating Losses

In addition, under the House Blueprint, net operating losses ("N.O.L.'s") could be carried forward indefinitely and increased by an interest factor that compensates for inflation and a real return on capital. However, the N.O.L. deduction would be limited to 90% of the net taxable amount for the year without regard to the carryforward, and it could not be carried back.

PROPOSED PLANS FOR CROSS-BORDER ACTIVITIES

The most dramatic changes proposed by both the Trump plan and the House Blueprint would affect the tax rules governing cross-border activities.

One-Time Repatriation Tax

For starters, under both the Trump plan and the House Blueprint, corporate profits held offshore would be subject to a one-time deemed repatriation tax. Under the Trump plan, the tax rate on the deemed repatriated income would be 10%. Under the House Blueprint, the deemed repatriated income would be subject to tax a rate of 8.75% to the extent held in cash or cash equivalents, and otherwise 3.5%, with companies able to pay the resulting tax liability over an eight-year period.

U.S. multinational corporations such as Apple Inc. and Microsoft Corp. are estimated

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[2] See in detail Philip Hirschfeld and Stanley Ruchelman, "The Resurrection of Code §385: Treasury Department Revises Regulations on Related-Party Debt," *Insights* 11 (2016).

[3] Code §163(j).

to be holding a total of $2.6 trillion in foreign profits overseas. President Trump and the Congressional Republicans have said that the proposed tax holiday would encourage such companies to repatriate their foreign earnings and invest them into creating new jobs in the U.S. However, there is also the possibility that such companies would instead choose to use the repatriated income for stock buybacks, executive bonuses, and dividends.[4] Further, companies that had no intention of bringing foreign profits back to the U.S. would be hit with a large tax bill.

Destination-Based Tax System

The House Blueprint would move the U.S. from the current worldwide tax system, which generally taxes U.S. corporations on income earned anywhere in the world but permits deferral of U.S. Federal income tax on foreign active business earnings until those earnings are repatriated, to a destination-based tax system. Under a destination-based tax system, corporations would not be taxed based on where they are incorporated, like under a worldwide tax system, nor where their profits are located, like under a territorial tax system. Tax jurisdiction would follow the location of consumption (*i.e.*, where goods are sold and services are performed) rather than the location of production. According to the House Blueprint, this would be achieved in two ways: (i) by moving to a (not in a strict sense) "territorial" tax system and (ii) through border adjustments.

A destination-based system starts in the same place as a territorial tax system. Overseas profits earned by U.S. multinationals that are repatriated as dividends would be exempt from additional U.S. Federal income tax. However, unlike a territorial system, it would not encourage overseas production by U.S. multinationals because all production for U.S. consumption would be taxable, no matter where the production occurred. The House Blueprint notes that this system would eliminate the incentive to expatriate and the foreign profit "lock-out" effect under current law (*i.e.*, a disincentive to repatriate earnings due to residual U.S. taxation). Consequently, other than the one-time deemed repatriation tax, the House Blueprint would exempt foreign active business income by providing a 100% exemption for dividends received from foreign subsidiaries – similar to the participation exemption found under the E.U. Parent Subsidiary Directive and domestic tax law in many European countries. The 100% exemption rate is more generous than some prior proposals for an exemption system, which proposed a small (approximately 5%) "haircut" as a proxy for not disallowing domestically incurred expenses attributable to the exempt foreign income as, for example, is found under the German participation exemption.

According to the House Blueprint, the switch to a destination-based, territorial tax system would allow the streamlining and simplification of the Subpart F rules (*i.e.*, a complex set of rules governing the taxation of foreign income earned by U.S. corporations through foreign subsidiaries). The rules for passive foreign investment companies ("P.F.I.C.'s") would likely stay in place since they are designed to counter

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[4] A report by the nonpartisan Congressional Research Service cited studies on the repatriation provisions of the 2004 American Jobs Creation Act that found the tax holiday to be an ineffective means of increasing economic growth and some empirical evidence that repatriations were used to return money to shareholders through stock repurchase programs. See *Tax Cuts on Repatriation Earnings as Economic Stimulus: An Economic Analysis* (Congressional Research Service, 2011), p. 7.

the potential for truly passive income to be moved to low-tax jurisdictions.

A destination-based system adds one additional piece to the territorial system: "border adjustments." Through border adjustments, tax is rebated when a product is exported and imposed when a product is imported, such that sales to U.S. customers would be taxed but sales to foreign customers would be exempt. Regardless of whether the taxpayer was a foreign or U.S. corporation, costs of imported inputs would no longer be deductible from taxable income, but at the same time, export sales revenue would not be taxed. This is intended to compensate for the impact of value-added tax ("V.A.T.") rebates for exported goods in foreign tax jurisdictions using a V.A.T. system.

"Companies with significant foreign tax credits should identify ways to accelerate their use."

The House Blueprint states that border adjustments would not require the addition of a new tax but a transformed business tax system in which exports are exempt from tax and imports are taxed, within the context of a territorial tax system. Proponents of border adjustments further state that the value of the U.S. dollar will rise about 20% to 25% to cover the border adjustments. A counterargument is that an appreciated U.S. dollar could lower the demand for U.S. exports.

The House Blueprint addresses the obstacle posed by the World Trade Organization (the "W.T.O.") rules on border adjustments. Under the rules, border adjustments upon export are permitted with respect to consumption-based taxes, also known as indirect taxes. An example of a consumption-based tax is the V.A.T. system common to most European countries. However, under the rules, border adjustments upon export are not permitted with respect to income taxes, also known as direct taxes. Thus, under the current tax system, which imposes income tax on business transactions, the U.S. is not permitted to use border adjustments.

In an early version of his plan, President Trump had indicated that he would retain the worldwide system but end "deferral of taxes on corporate income earned abroad." This proposal was later dropped from the Trump plan. While it is currently unclear what Trump's exact position on the shift towards a destination-based tax system is, he did not favor the border adjustment in a recent statement. Even though, in a recent tweet, the president threatened to impose a "big border tax" on General Motors Co. for manufacturing some of its Chevrolet Cruz cars in Mexico.

THE DEMOCRATS' RESPONSE

The Democrats generally believe that the Trump plan and the House Blueprint are giveaways to businesses and wealthy individuals, and shift the tax burden to modest income earners. However, Senator Charles Schumer (D-N.Y.), has indicated a willingness to compromise on a plan that would cut corporate taxes, if proceeds from the estimated $2.6 trillion in U.S. companies' foreign profits held offshore were devoted to nationwide infrastructure improvements.

PLANNING CONSIDERATIONS FOR BUSINESSES

Use Foreign Tax Credits

Foreign tax credits for the income taxes paid to a foreign country would be less valuable if companies were able to repatriate foreign profits at a lower rate. Further, a shift to a territorial tax system may eliminate the need for foreign tax credits.

Companies with significant foreign tax credits should identify ways to accelerate their use.

Accelerate Deductions

Like foreign tax credits, deductions will generally be worth comparatively less if the corporate tax rate drops to 15% or 20%. Further, under both the Trump plan and the House Blueprint, most deductions would be eliminated. Companies would be required to revalue the deferred tax assets on their financial statements. They may also seek accounting method changes to accelerate deductions and defer income.

Installment Method

If the corporate tax rate is lowered, companies seeking to sell an asset now may choose the installment method to receive some of the payments when the lower rate is in effect.

Delay Capital Expenditures

Since the House Blueprint would allow for full and immediate expensing of machinery and equipment, companies might consider deferring capital expenditures – at least for machinery and equipment that is not immediately necessary.

Incur Debt

Though the House Blueprint would eliminate the interest expense deduction for businesses, it is expected that existing debt would be grandfathered so that taxpayers would still be able to deduct the interest expense on those loans. Accordingly, businesses should identify their near-future borrowing needs and consider incurring debt now to preserve the interest expense deduction.

Reconsider Inversion Plans

While the limitations on inversions introduced last year may not be revoked, a shift to a territorial tax system may mean that a company has less incentive to move to a lower tax jurisdiction. Companies should model the tax effects of a territorial tax system to determine the overall tax impact.

WHAT NEXT?

Although the Republicans have a slight majority in the Senate, it may not be a smooth path to pass the tax reform bills in the absence of a bipartisan agreement. Republicans may have to deal with the possibility of filibuster, an action to obstruct progress in the legislative process such as inordinately lengthy speeches, which can be overcome only by a 60-vote majority. However, a filibuster cannot block a budget reconciliation bill, and tax legislation could be included in such a bill and passed with a simple majority vote. The disadvantage of a reconciliation bill is that provisions in budget reconciliation must expire at the end of the budget window, usually a ten-year period.[5] Provisions that have no budgetary effect may not be

[5] As an example, the 2001 and 2003 Bush tax cuts were the result of reconciliation bills, and thus were expected to expire in 2010. As a result of political compromise, the tax cuts were extended for a two-year period during the presidency of Barack Obama, and most of the tax cuts were made permanent with

permitted in a reconciliation bill. Another obstacle in the Senate is the Byrd Rule, an instrument allowing senators to block a piece of legislation if it purports to significantly increase the Federal deficit beyond a ten-year period. To overcome it requires a 60-vote majority.[6]

Compared to previous legislative periods, the chance of a major tax overhaul passing both the House and the Senate is considerably higher. The president and Congress have already signaled their determination for immediate action. Thus far, the proposals are the starting points for a tax debate that leaves many open questions. Details remain to be seen once draft legislation is released.

the passage of the American Taxpayer Relief Act of 2012.

6 This is the reason the estate tax repeal enacted as part of the Bush tax cuts was subject to a ten-year sunset period.

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