Tax Plans Compared (December 2016)
Corporate Tax

December 16, 2016

It is widely expected that Congress will address tax reform early in its 2017 session. This alert summarizes President-Elect Trump's proposal and Speaker of the House Paul Ryan's proposal on key corporate tax provisions applicable to U.S. domestic and multinational corporations. Estate, gift and generation-skipping tax proposals (including possible changes to the treatment of basis at death), as well as income tax proposals relevant to high net worth individuals (including the treatment of income from pass-through entities) are addressed in separate Alerts.

Possible Repeal of the Estate Tax in 2017

Tax Plans Compared (December 2016) Individual Income Tax

While President-Elect Trump's plan is light on details, and Speaker of the House Paul Ryan's plan, "A Better Way," is more clearly defined, both plans address a number of specific areas of U.S. corporate tax law. This Alert provides a general high-level summary of certain aspects of each plan's approach to U.S. corporate tax reform.

Corporate Tax Rate. Both Trump's proposal and Ryan's proposal would redu`ce the corporate tax rate. The rate, currently 35%, would be reduced to 15% under Trump's plan and 20% under Ryan's plan.

Capital Investments. Under our current system, corporate investments/expenditures in tangible and intangible assets are generally depreciable or amortizable (i.e., their cost deducted) over a number of years, with the length of such period depending on the type of asset. Ryan's plan would allow corporations to take an immediate expense deduction for investments in tangible and intangible property, but not land. Trump's plan would allow corporations "engaged in manufacturing in the U.S." to elect to immediately expense their capital investments (but would require them to relinquish the ability to deduct net interest expense). We read Trump's plan as expensing only investments in assets related to a manufacturing business.

Net Interest Expense Deduction. Under the current system, corporations can generally deduct their net interest expense on indebtedness. The Ryan plan would eliminate this deduction (i.e., interest paid will only be allowed as a deduction against interest received, with an indefinite carryforward of any excess). The Trump plan would only eliminate this deduction for manufacturing businesses that elect to immediately expense their capital investments (See "Capital Investments" above).

Net Operating Loss (NOLs). Our current system allows a corporation to carry back NOLs to its two prior taxable years and carry forward NOLs to its twenty subsequent taxable years. Ryan's plan would disallow the NOL carryback, but would allow NOLs to be carried forward indefinitely. The amount of the carryforward usable in any year would be capped, however, at 90% of net taxable income for that year (as is currently the case under the

corporate AMT). Ryan's plan would also increase the amount of any NOL carryforward by an inflation adjusted amount. Trump's plan does not address the corporate NOL.

Deductions and Credits. Both plans would eliminate so-called "special interest" corporate deductions and credits. Neither plan specifies precisely which credits and deductions will be preserved, other than the Research and Development credit.

Alternative Minimum Tax (AMT). Both Trump's plan and Ryan's plan would eliminate the corporate AMT.

Earnings of Foreign Subsidiaries. The current system has a comprehensive system of rules (the "subpart F rules") for determining when earnings of a foreign subsidiary of a U.S. corporation are subject to current U.S. income tax and when such tax can be deferred. Both plans would amend these rules significantly.

Both plans would provide for an immediate, mandatory, deemed repatriation of existing foreign earnings held abroad, but would apply reduced rates of taxation to such earnings. Trump's plan would apply a 10% rate; Ryan's plan would apply an 8.75% rate to the deemed repatriation of cash or cash equivalents and a 3.5% rate to other assets. Companies would pay the resulting tax liability over an eight year period.

The plans do not currently address whether foreign tax credits will be allowed against the U.S. tax imposed on the deemed repatriation. To the extent such credits are allowed, we would expect that they would be subject to a haircut based on the reduced U.S. rate applicable to such deemed repatriation. In this regard, it is important to consider the fact that while the deemed repatriation proposed by the plans would not generally result in non-U.S. taxation, the actual repatriation of cash to the U.S. may give rise to foreign withholding taxes.

We note that the deemed repatriation will have collateral effects on the financial reporting of public companies. Most U.S. multinationals have not booked a deferred tax liability with respect to most earnings retained offshore and, thus, we would expect that the mandatory deemed repatriation, even at a reduced rate, will be a hit to earnings in the year the legislation is enacted even if the tax is payable over multiple years.

Going forward, Trump's plan would generally end deferral for earnings of foreign subsidiaries and retain the foreign tax credit. Ryan's plan, on the other hand, would replace our existing worldwide system of U.S. corporate taxation with a territorial system, and allow for a full exemption on dividends paid to the United States by foreign subsidiaries. The Ryan plan provides that it would do away with "the bulk of" the subpart F rules, but would retain the foreign personal holding company rules, which generally provide for current U.S. taxation of certain passive income earned abroad. We would expect that legislation will in fact tax all income of foreign subsidiaries on a current basis, but that active income will be subject to a preferential rate to avoid shifting such income to zero tax jurisdictions. We expect the PFIC rules to remain in place.

Finally, we note that some prior Republican tax proposals, including the House Republican Proposal in June 2016, gave some consideration to completely replacing our current income tax system with a "destination-based cash flow tax" (a "DBCFT"). While a detailed discussion of a DBCFT is outside the scope of this Alert, we note that

the DBCFT is a rather complex subtraction-method VAT that would have widely differing consequences to different industries and would likely have material macro-economic consequences. Moreover, transitioning from an income based system to a DBCFT would be a challenging endeavor.

Procedural Hurdles to Passage. There are two procedural rules that could stand in the way of tax reform. Both impact only the Senate consideration of a bill. Right now it takes 60 votes to stop a filibuster. In addition, the Senate might adhere to the "Byrd Rule," which requires a 60-vote majority to pass any bill that has a negative impact on revenue outside of the 10-year revenue window. However, both of these rules are procedural and could be changed in the next Congress.

Even with those rules in place, there are several potential paths to passage. First, a tax reform bill could have sufficient bipartisan support to garner a 60-vote majority. Second, the bill is likely to be in the form of a budget reconciliation act, which is not subject to filibuster. Consequently, we can envision several options leading to enactment of a comprehensive tax reform bill.

Effective Date Considerations. There are several possible effective dates for a tax reform bill. With respect to changes in the corporate tax rate, the tax code already includes a provision that automatically provides a "blended" income tax rate--a weighted average of the old rates and the new rates--for the year of transition when tax rates change mid year, although Congress could override that in legislation. More generally, a bill could be effective retroactively to January 1, 2017. Alternatively, a bill passed during the year could be made effective on January 1, 2018, but it seems unlikely that Congress would want a full year to pass without the benefit of the reforms they enact. That raises the possibility of a mid-year, "date of enactment" effective date.

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