Client Update
Tax Reform on the Horizon

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Republican leaders in Congress are eager for significant tax reform and believe the election results provide an opportunity for legislation. We expect that the starting point will be a policy paper (called the Blueprint) issued by House Republicans last June. The key takeaway is that the Blueprint upends many of the fundamental principles we have operated under for decades (*e.g.*, by **denying interest deductions to businesses, permitting all business investment to be expensed and exempting foreign earnings**). President-elect Trump also issued a high-level outline of his tax reform plan during his campaign. Many of Mr. Trump's plans are consistent with the Blueprint. Below are key elements of the Blueprint. The Blueprint and Mr. Trump's plans are both preliminary. Any tax reform bill that emerges from the legislative process undoubtedly will be different from the Blueprint in many respects and will likely include extensive transition rules.

INDIVIDUALS

- The top **individual** rate on ordinary income will be 33% instead of 39.6%. The individual alternative minimum tax will be repealed.
- The top individual rate on **capital gain**, **dividends** and **interest** will be **16.5%**. The 3.8% Medicare tax on passive income will be repealed. Carried interest is not mentioned in the Blueprint. However, Mr. Trump's plan calls for **carried interest to be taxed at ordinary rates** (*i.e.*, carry will not enjoy the reduced rate of 16.5%).

Comment: Interest is included in the category of income subject to the maximum 16.5% rate. This will reduce the tax benefit of holding municipal debt.

- All **itemized deductions** will be **eliminated** other than those for mortgage interest and charitable donations.

Comment: The elimination of the deduction for state and local income and property taxes will disproportionately affect taxpayers living in jurisdictions with high state and local tax rates (*e.g.*, New York and California). Taxpayers will effectively pay federal tax on state and local tax.

- The **estate tax** will be **eliminated**. The fate of the gift tax and the basis step up upon death is unclear. Mr. Trump's plan indicates that the gift tax will be repealed and that capital gains will be taxed upon death (with an exemption of $5 million ($10 million for married couples)).

BUSINESSES

- The **corporate** tax rate will be a flat **20%** (15% under Mr. Trump's plan). The corporate alternative minimum tax will be repealed.
- "**Small business**" income earned by proprietorships or through pass-through entities (partnerships, LLCs and S corporations) will be taxed at a maximum rate of **25%**. It is unclear what constitutes a small business. Proprietorships and pass-through entities will pay or will be treated as having paid **reasonable compensation** to their owner-operators. This compensation will be deductible by the small business and includible by its owner-operators.

Comment: The requirement to pay reasonable compensation to owner operators (even in the case of a proprietorship) will reduce the benefit of the 25% rate on small business income, if the owner-operators are taxed at the 33% rate.

- All **business investment** (including buildings, tangible and intangible personal property, but not including land) will be **expensed** (written off entirely in the year of acquisition).

Comment: The 13-point rate differential between the 33% individual and 20% corporate tax rates could encourage some large businesses held in pass-through form to incorporate. However, for corporations that distribute most of their profits, the effect of the 20% corporate rate and the 16.5% individual rate on dividends will bring the overall effective rate in both the pass-through and corporate scenarios close to the same figure (about 33%). Furthermore, the possibility of offering purchasers of unincorporated businesses an immediate write-off of the purchase price will encourage many large businesses to choose the pass-through form where possible. The same may be true for small businesses. (The Trump plan allows pass-through owners to elect to be taxed in a manner similar to corporate shareholders, eliminating the incentive to incorporate.)

- **Interest expense** will be **non-deductible**, except against interest income. Unspecified special rules will apply to financial services companies such as banks, insurance companies and leasing companies.

Comment: The disallowance of interest expense might encourage alternative forms of financing such as leasing, if rental expense is deductible. However, leased property cannot be expensed (in contrast to purchased property).

- **Net operating losses** will be carried forward indefinitely (but not carried back) and increased by an interest factor. A net operating loss carryforward may offset only 90% of taxable income determined before the carryforward.
- Tax **deductions and credits** applicable to "special interests" will be repealed, other than a credit for research and development conducted in the US.
- Existing **offshore earnings** held in cash and cash equivalents will be subject to an immediate **8.75%** tax, and earnings held in other forms will taxed at a **3.5%** rate (which can be paid over an 8-year term).

Comment: Presumably there will be rules denying the 3.5% rate and extension of the payment period in the case of the conversion of cash and cash equivalents into other property in anticipation of the change in law. The Blueprint estimates that US multinationals have over $2 trillion of offshore earnings. Even if all of the $2 trillion were taxed at only 3.5%, the one-time tax revenue from the proposal would be $70 billion.

- Prospectively, the US will apply a "**territorial system,**" meaning that distributions from foreign subsidiaries and income earned through foreign branches will be exempt from US tax and that foreign tax credits will be disallowed.

As part of the territorial system, the US will adopt a "**destination-based tax system**" under which products, services and intangibles that are exported outside of the US will not be subject to US tax, regardless of where they are produced. Under this approach, products, services and intangibles that are imported into the US will be subject to US tax regardless of where they are produced. The Blueprint is vague on the details of the export/import regime and its legality under WTO commitments.

Comment: Although the details of the destination-based tax system are unclear, its effect will be to encourage both domestic and foreign companies to locate business activity in the US so that goods and services do not have to be imported and output can be exported without US tax. Allowing a US business to derive tax-free profits from exports would be a major departure from existing tax rules and could incentivize trading partners to retaliate.

- The CFC anti-deferral rules will be streamlined to apply only to passive income.

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Please do not hesitate to contact us with any questions.