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US Business Tax Reform Proposals

Proposals for Major US Business Tax Reform

There has been a great deal of talk in recent months about potential legislation to "reform" the existing rules on the taxation of businesses (both corporate and non-corporate). Unfortunately, the proposals are not very far along in terms of specifics. The timing of any such legislation is also murky. At this writing, it seems unlikely that any legislation will be enacted before Fall 2017. More likely, any legislation will be pushed into 2018.

Two plans have received the most attention. President Trump (while he was a candidate) set forth a plan for business tax reform (the "Trump Plan"). This plan consists of a several page outline and does not contain much in the way of details. The other plan was issued by Paul Ryan, the Speaker of the U.S. House of Representatives. This plan is called "A Better Way: A Pro-growth Tax Code for All Americans" (the "Better Way Plan"). The Better Way Plan is more fleshed out than the Trump Plan, but does not include legislative language.

1. Tax Rate Reduction

Currently, corporate profits are taxed at a rate that can go as high as 35%. Under the Trump Plan the rate would be lowered to 15% and the rate would be lowered to 20% under the Better Way Plan.

Both the Trump and Better Way Plans propose to repeal the corporate alternative minimum tax (AMT). The AMT is an alternative tax regime with a higher tax base and a lower tax rate (20%).

Currently, individuals are taxed at normal tax rates on their business income. These rates can go as high as 39.6%. The Trump Plan appears to propose a regime by which noncorporate businesses may be able to avail themselves of the proposed lower corporate tax rate of 15%. However, this lower rate will only apply to profits that are retained in the business.

The Better Way Plan proposes to limit that tax rate to 25% for individuals on active business income. The plan proposes to reduce the tax rate on other income earned by individuals from 39.6% to 33%. The benefit of the lower 25% rate will be reduced if the business does not pay reasonable compensation to their owner-operators.

2. Deductions and Credits

The lower tax rates under both plans would be offset by the elimination of many favorable deductions and credits. Neither plan generally specifies which provisions will be retained and which will be repealed. However, the both plans state that the research and development (R&D) credit will be retained (but possibly revised to make it more effective and efficient).

Under the Trump Plan, firms engaged in manufacturing in the U.S. would be allowed to elect to deduct the costs of capital investments (e.g., a new machine). Taxpayers that make this election would not be allowed to deduct interest.

Under the Better Way Plan, businesses will able to deduct the costs of capital investments. This would include both tangible property (e.g., equipment and buildings) and intangible property (e.g., trademarks and patents), but not land.

Under the Better Way Plan, the deduction for interest would be limited to the amount of interest income. Any net interest expense could be carried forward indefinitely and deducted against future net interest income. Different rules may apply to financial services companies (e.g., banks and insurance companies).

Currently, net operating losses (NOLs) can be carried back two years for a refund or carried forward to offset taxable income for twenty years. The Better Way Plan will eliminate the ability to carryback an NOL. NOLs would be allowed to be carried forward indefinitely (and increased by an interest factor to compensate for the effect of inflation). However, the deduction for NOL carryforwards would be limited to 90% of taxable income (before NOLs). The Trump Plan makes no mention of proposed changes to the NOL rules.

3. Border Adjustment

The Better Way Plan includes a controversial “border adjustment” proposal. The Trump Plan is silent on this issue. Statements by President Trump (and his staff) since his inauguration have been equivocal and inconsistent as to whether he supports border adjustments.

The intent of the border adjustment rules is to make the corporate income tax similar to a value-added tax (VAT) used by many other countries. Under the proposed border adjustment rules, imports of goods or services are taxed at a 20% rate (as if income was received). Exports of goods and services will be exempt from tax (i.e., a deduction will be allowed for exports).

4. Foreign Profits

Currently, U.S. corporations are generally allowed to defer paying tax on foreign investments until the profits are brought back to the U.S. This deferral scheme has resulted in attempts by U.S. companies to make the deferral permanent by engaging in inversion transaction (by which the parent corporation is moved from the U.S. to a foreign country).

The Trump Plan proposes to charge a one-time 10% tax on all foreign deferred income. Although not totally clear, it appears that going forward the foreign income would be taxed currently at a 15% rate.

Under the Better Way Plan, dividends from foreign subsidiaries will be exempt from US income tax. Existing deferred foreign profits will be subject to a 3.5% tax (8.75% to the extent held in cash or cash equivalents). Corporations will be able to pay this liability over eight years).

WTS Observations

Both proposals represent major changes in how businesses are taxed in the U.S. There is a great deal of uncertainty as to whether either proposal will become law.

Both proposals will create winners and losers compared to current law. In that regard, the Better View Plan will pit importers against exporters. Retailers will be especially hard hit as they will be taxed on their profits as well as their imported goods. On the other hand, manufacturers that export substantially all of their goods will greatly benefit from the plan, as they will no longer have a significant U.S. federal income tax liability.

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