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Tax Reform Update

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Not much has been accomplished this year on tax reform. Congressional Republicans and the Administration have yet to agree on basic tax reform parameters: whether the legislation must be revenue-neutral or can be a net tax cut, which revenue offsets should be included, and whether tax reform must be permanent. House and Senate Republicans and the Administration are currently in negotiations they hope will result legislation to be released in September. On corporate tax rates, Administration officials have recently said they no longer believe a 15% rate is achievable; instead they are aiming at the low end of the 20-25% range.

Congressional Republicans and the Administration used the August recess to try to sell their vision of tax reform. Their desire to release legislation in September is optimistic as there are other critical and contentious measures that must be enacted, including appropriations for FY 2018 (that begins October 1), an increase in the federal debt limit (before mid-October), and Hurricane Harvey disaster relief. Congressional Republicans also remain divided on a proposed budget resolution, with conservatives seeking additional non-defense spending cuts and moderates objecting. Without an agreed budget resolution, Congress cannot use the budget reconciliation procedures it needs for moving tax reform through the Senate.

House Republican Blueprint

It has been more than a year since House Republicans released their “Better Way” tax reform blueprint, but there is still no legislative draft. The blueprint did not receive much scrutiny upon its release because few thought it might be enacted: Democrats were expected to regain a majority in the Senate and Hillary Clinton was expected to be President. The blueprint was not particularly detailed and avoided meaningful discussion of the potentially controversial tax-increase proposals that would be necessary to keep the legislation revenue-neutral.

The tax blueprint said it “will continue tax incentives for retirement savings,” but does not promise to leave them unchanged. The blueprint assumes the elimination of all itemized deductions for individuals except the home mortgage interest and charitable contributions deductions (both of which would be modified in unspecified ways). The blueprint “will continue the current tax incentives for savings” but “other exemptions, deductions, and credits for individuals,” characterized in the blueprint as “special-interest provisions,” would be eliminated. The blueprint does not explicitly address the tax treatment of life insurance or nonqualified deferred compensation. For large businesses (C corporations), the blueprint would lower the corporate tax rate to 20%. In general, business interest expense would only be deductible against interest income; although there would be special rules for financial services companies that take into account the role of interest expense and interest income in their business models.

Following the Republican sweep in November, the business community began to consider the blueprint seriously. An immediate focus was the border adjustable tax that would have imposed a tax on imports. But after overwhelming opposition, negotiators on July 27 said the idea would be dropped. A second blueprint proposal that has attracted significant opposition is disallowance of the business interest expense deduction. House leaders have suggested they would grandfather existing debt and exempt utilities, small businesses, and real estate. It is understood that House/ Senate/Administration tax reform negotiators have been discussing the idea of cutting back on interest deductions;

although it remains to be seen whether such an idea would be politically viable. A third controversial blueprint proposal is the elimination of the individual deduction for state and local income and property taxes. Republicans have traditionally viewed the deduction as subsidizing high-tax, primarily Democratic states and have therefore been relatively comfortable in proposing to eliminate it.

Senate Finance Committee

Senate Finance Committee Chairman Orrin Hatch (R-UT) has not advanced any tax reform proposals this year. Finance Committee staff have been watching activity in the House and studying all past tax reform proposals, including the tax reform proposal former House Ways and Means Committee Chairman Dave Camp (R-MI) released in 2014. The Camp tax reform draft has been seen by many as a model of the type of tradeoffs that may be necessary if Congress declines to adopt the major tax increases (interest deduction, already-abandoned BAT) in the House Republican blueprint but still wishes to keep tax reform revenue-neutral. For example, the Camp draft included prospective expansion of the pro-rata interest disallowance for business-owned life insurance, rules taxing nonqualified deferred compensation upon vesting, and rules limiting pre-tax contributions to IRAs and qualified retirement plans (negotiators have recently been discussing this idea). However, the Camp proposal enjoyed little support when it was released, and it is unclear that things would be different now.

Timing of Tax Reform

Republican leaders continue to suggest that tax reform is imminent. But it would not be surprising if it slips into next year since there is no apparent consensus on key issues. When Congress returns in September it will be occupied with other matters, leaving just a short time for tax reform consideration before the end of the year. However, seemingly impossible tax bills have come together quickly in the past, and one should not bet completely against Congress pushing through tax reform late this year (possibly in December).

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