Congress to consider tax reform with significant impact on inbound companies

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In brief

The Trump Administration and Congressional Republican leaders released on September 27 a nine-page "unified framework for fixing our broken tax code" (the Framework) that includes specific goals for lower business and individual tax rates. The Framework statement is the latest product of tax reform discussions by a working group known as the "Big 6" – consisting of Treasury Secretary Steven Mnuchin, White House National Economic Council Director Gary Cohn, House Speaker Paul Ryan (R-WI), Senate Majority Leader Mitch McConnell (R-KY), House Ways and Means Committee Chairman Kevin Brady (R-TX), and Senate Finance Committee Chairman Orrin Hatch (R-UT) – and builds off an earlier July 27th joint statement (the joint statement).

The Framework calls for a 20-percent corporate tax rate, a new 25-percent rate for certain passthrough business income, and international reforms that include a territorial tax system and a one-time mandatory repatriation tax. The Framework proposes 100-percent full expensing for five years, effective after September 27, 2017, while partially limiting the deduction for net business interest expense. The plan "aims to eliminate" the corporate alternative minimum tax (AMT). It would repeal the Section 199 domestic manufacturing deduction and "numerous other special exclusions and deductions" but retains the research credit and the low income housing tax credit. Proposals in the Framework primarily affecting individuals are not covered in this Insight.

The Framework calls for the House and Senate tax committees to provide specific details of tax reform legislation and resolve many open issues, including effective dates for the proposals. Administration officials and Republican Congressional leaders say their goal is to enact tax reform in 2017. US inbound companies should be prepared to take steps as tax reform legislation moves through the US legislative process.

In detail

The Framework does not mention a "border adjusted tax" (BAT) – this was expected because the joint statement specifically announced the BAT had been dropped from further consideration. The BAT would have exempted from tax export income while denying a deduction for import costs, and likely would have imposed a disproportionate burden on US inbound companies.

The Framework also states that the deduction for net interest expense for C corporations will be "partially limited" and that the tax-writing committees "will consider the appropriate treatment of interest paid by non-corporate taxpayers" as well.

Observation: Separately from tax reform, the US Treasury Department is considering whether to modify or rescind final and temporary regulations under Section 385, which address whether certain instruments between related parties are treated as debt or equity. In July, Treasury announced a one-year delay in the implementation of the documentation requirements under the Section 385 regulations. Elimination or modification of the Section 385 regulations would help reduce the cost of doing business in the United States for US inbound companies.

The Framework would allow businesses to completely expense the cost of depreciable assets, other than structures, made after September 27 and for at least five years. It calls this "an unprecedented level of expensing" and further states that the tax-writing committees "may continue to work to enhance unprecedented expensing for business investments," especially for small businesses.

In addressing corporate tax reform, the Framework states that small businesses deserve a "significant tax cut" and sets a 25% rate on business income of "small and family-owned businesses conducted as sole proprietorships, partnerships and S corporations."

Observation: The use of this language raises the possibility that certain large passthrough businesses may be excluded from this rate. Treasury Secretary Mnuchin recently suggested that certain kinds of firms should not be eligible to benefit from this provision. US inbound companies utilizing passthrough entities should follow this issue during the legislative process and plan accordingly if any new legislation excludes them from this tax rate.

The Framework reduces the corporate rate to 20% and "aims to eliminate" the corporate AMT. A 20-percent federal corporate income tax rate combined with current average state income tax rates would be 24.8 percent, just above the 23.75-percent average rate for all other OECD countries in 2017. The language on corporate AMT repeal is noticeably less forward leaning than that which is used in other places, a possible indication that this is a place where revenue constraints may limit what can be achieved.

Observation: The Framework states that the tax-writing committees "may consider methods to reduce the double taxation of corporate earnings." Senate Finance Chairman Hatch and his staff have been exploring options to reduce the double taxation of corporate dividends by providing a partial corporate dividends paid deduction.

The Framework states that due to lower rates, the domestic production deduction under Section 199 will not be necessary and that "numerous other special exclusions and deductions will be repealed or replaced." The research and development credit and low-income housing credit are specifically mentioned as "promoting policy goals important in the American economy" and will be preserved.

Observation: While some US inbound companies might utilize certain credits that may disappear under tax reform legislation, these companies still may experience benefit due to the lower tax rates.

The Framework acknowledges that special tax rules exist for certain industries and sectors. The Framework states that these rules should be modernized to reflect "economic reality" and "provide little opportunity for tax avoidance."

The Framework states that it "puts America on a level international playing field and puts an end to the incentives for shipping jobs overseas." To accomplish this, the Framework calls for the elimination of America's current world-wide taxation system and for the creation of a territorial system through a 100-percent exemption for dividends from foreign subsidiaries, provided those subsidiaries are at least 10-percent owned by a US parent.

In addition, the Framework calls for a one-time repatriation tax by treating all currently accumulated foreign earnings as repatriated. While no tax rate is given, the Framework states that "foreign earnings held in illiquid assets will be subject to a lower tax rate than foreign earnings held in cash or cash equivalents."

Observation: This approach may be relevant to certain US inbound companies that operate through a US group that has underlying foreign operations (i.e., US "sandwich structure").

To prevent corporations from shifting profits overseas, the Framework calls for "rules to protect the U.S. tax base by taxing at a reduced rate and on a global basis the foreign profits of U.S. multinational corporations." Further, the tax-writing committees are to "incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies."

House and Senate Republican leaders have stated that tax reform legislation is likely to be considered under "budget reconciliation" procedures that allow the Senate to approve a bill with a simple majority, instead of the 60 votes generally required in the Senate. However, budget reconciliation cannot be used to enact a measure that increases long-run deficits, potentially forcing legislation to "sunset" some of the proposed tax relief. While tax reform that is temporary and not permanent is not ideal, US inbound companies may benefit from reduced rates and other reform provisions in the short term.

Observation: Any US tax reform enacted by Congress may not also be adopted by states in which US inbound companies do business. While most states conform to the US federal tax code as of a certain date (with certain exclusions and additions), some states may desire to keep their current income tax system if they believe the federal reform model does not raise sufficient state revenue.

The takeaway

The Framework reaffirms that pro-growth tax reform remains a top priority for President Trump and Republican Congressional leaders. Despite this commitment to tax reform, there are many difficult policy and technical issues to resolve if Congress is to enact comprehensive tax reform. As Congress proceeds with consideration of tax reform legislation this fall, US inbound companies should analyze the potential impacts on them of the legislation as it develops.

Additional information

PwC's Tax Insight from Washington National Tax - Trump Administration, Republican Congressional leaders release new tax reform framework

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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