United States: release of framework for tax reform

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On 27 September 2017, the Trump Administration and Congressional Republican leaders released a nine-page "Unified Framework for Fixing Our Broken Tax Code" (the "Framework"). The Framework statement is the latest product of tax reform discussions and calls for a 20% corporate tax rate, a new 25% rate for certain pass-through business income, and international reforms that include a territorial tax system and a one-time mandatory repatriation tax.

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.

Border-Adjusted Tax and limitation on interest deductions

As expected, the Framework does not mention a Border-Adjusted Tax ("BAT"). 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 some 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. Separately from the 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.

Lower tax rates, elimination of deductions

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." The use of this language raises the possibility that certain large pass-through businesses may be excluded from this rate.

The Framework reduces the corporate rate to 20% and "aims to eliminate" the corporate Alternative Minimum Tax ("AMT"). A 20% federal corporate income tax rate combined with current average state income tax rates would be 24.8%, just above the 23.75% 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.

The Framework states that due to lower rates, several deductions and special exclusions will be repealed or replaced.

Let's talk

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

Stefan Schmid
Partner, Corporate Tax Switzerland
stefan.schmid@ch.pwc.com
+41 58 792 44 82

Monica Cohen-Dumani
Partner, Corporate Tax Switzerland
monica.cohen.dumani@ch.pwc.com
+41 58 792 97 18

Michael Ruckstuhl
Director, Corporate Tax Switzerland
michael.ruckstuhl@ch.pwc.com
+41 58 792 14 94

Territorial system

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% 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."

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

Budget reconciliation

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.

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, companies should analyze the potential impacts on them of the legislation as it develops.

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