Potential roadmap to US tax reform: key points in the Hatch Report

Tax Reform Alert

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As the work of the new Congress gets under way , there is general agreement that business tax reform is one of a handful of issues that may be achievable in the closing two years of the Obama Administration, and, in fact, business tax reform is likely to be a priority this year.

The focus on business reform is a departure from intensive efforts in Congress over the past four years to enact comprehensive reform, and is driven by a deepening concern among tax policy makers in Congress and within the Administration that unless the United States acts soon to reduce its corporate rate − now the highest among OECD nations − and discards the outdated US system of worldwide taxation, the erosion of the corporate tax base will accelerate.

Over the past year, a number of major American companies have undertaken dramatic tax planning initiatives to reduce their US tax burdens, most notably through so-called inversions, in which they shift their domiciles overseas, and many others have threatened to do so unless Congress and the President agree to reforms this year.

While Republicans generally would prefer to pursue comprehensive reform, there are indications from the Administration that while the President is flexible on the business side he is reluctant to agree to reduce the highest individual rates. Absent the threat of an eroding business tax base, many Republicans lawmakers would prefer to roll the dice and defer tax reform altogether to 2017 with the hope that the next elections will bring to office a Republican President. But, as Ron Wyden (D-OR), now the ranking Democratic member of the Senate Finance Committee, has indicated, if the business side is not addressed soon "there may not be any US-domiciled Fortune 500 companies left" by the next presidential election.

Starting last fall as the inversions issue became a topic of major public concern and debate, senior Administration officials, among them Treasury Secretary Jack Lew, expressed their eagerness to work with Congress to achieve business tax reform in 2015. The Administration has also indicated that it will issue a far more detailed set of tax reform proposals than it has previously in the budget that will be released on February 2. In his prior business reform proposals, the President indicated his support for a lower domestic corporate tax rate and some form of minimum global tax rate that is in some respects consistent with the "base erosion" approach that tax reformers in Congress, most notably former Ways and Means Committee Chairman Dave Camp (R-MI), have proposed.

There have been indications as well that some leading Congressional Republican tax writers may be willing to compromise. The new Chairman of the Ways and Means Committee, Paul Ryan (R-WI) has promoted the concept of enacting tax reform in phases, with business reform prior to 2017 as the first phase. In response to the concern that corporate reform alone could create economic distortions given that most American businesses are taxed on the individual side, the Ways and Means Committee staff are considering ways to provide tax relief to non-incorporated businesses through, among others, the enactment of greater depreciation allowances. Last week Representative Devin Nunes (R-CA), a senior Ways and Means Committee Member, circulated his draft American Business Competitiveness Act, which would reduce over a ten-year period the tax rate on all business income (including unincorporated businesses) to 25 percent while shifting the US to a territorial tax system. The Nunes bill does not otherwise touch the individual tax system.

In anticipation of his elevation to Chairman of the Senate Finance Committee, Senator Orrin Hatch (R-UT) on December 11 released a 340-page document entitled "Comprehensive Tax Reform for 2015 and Beyond," which outlines in detail the history and intent behind key aspects of the current tax code and makes the case, perhaps more forcefully and in greater detail than in documents issued by any of his recent predecessors, that the current US tax code is in dire need of reform.

As the Hatch Report, an outline of which appears below, points out, the last substantive reform of the tax code took place almost 30 years ago, in 1986, and was not designed to address the seismic US and global changes that have occurred since then (e.g., significant growth of the US and foreign economies, world population, capital mobility, percentage of foreign profits as a percentage of total US multinational profit, and use of pass-through structures and alternative financial instruments, such as derivatives).

The Report points out that besides the high corporate rate and outdated worldwide system of taxation, the current tax code is hampered by having more than 100 temporary provisions, up from 42 such provisions in 1998, and the current ability of corporations to establish US tax deferral structures creates an incentive to form new corporations and hire people outside the US and creates a disincentive for repatriating profits, resulting in the so-called lock-out effect.

Chairman Hatch announced that he will organize five bipartisan working groups within his committee to make policy recommendations for reform (business, individual, international, savings and investment, and infrastructure and community development) as a way of consensus building for a reform effort that is expected to intensify in the spring.

The key elements of the Hatch Report, which is the starting point for the Finance Committee's tax reform efforts, are as follows:

FOUNDATIONAL PRINCIPLES FOR REFORM

In addition to laying out the case for tax reform, the Hatch Report also recommends seven foundational principles on which to build the reform agenda: (1) efficiency and economic growth, (2) fairness, (3) simplicity, (4) revenue neutrality, (5) permanence, (6) competitiveness and (7) incentives for savings and investment.

Importantly, the Hatch Report reiterates that “reform is not an excuse to raise taxes on Americans or U.S. businesses.”

POTENTIAL ROADMAP TO A CORPORATE TAX REFORM AGENDA

While the Hatch Report is not prescriptive, it presents a roadmap for crafting a corporate tax reform agenda. Key provisions are summarized briefly below.

- **Classical system versus integrated system**
  - Corporate profits are subject to two levels of taxation (known as the “classical system”). The Hatch Report discusses four detrimental effects of the classical system that indicate it would be beneficial to migrate to a tax system that integrates individual and business tax rules (known as the “integrated system”):
    - Disincentive to invest in corporations due to the two levels of taxation
    - Incentive to finance with debt rather than equity because interest is deductible and dividends are not
    - Incentive to retain corporate earnings based on the relationship between the corporation, the shareholder and the capital gains tax rate
    - Incentive to distribute earnings to avoid second level of tax, such as payments that give rise to deductions
- **Other potential reform solutions supported by the Hatch Report include:**
  - Implementation of an overall lower corporate tax rate
  - Migration from the existing worldwide tax regime (with deferral) to a territorial system which would tax only US profits of US companies
    - The Report notes that this will address the lock-out effect and put US companies on par with foreign counterparts
    - Further, the Report contends that the transition should ensure that there is no continued lock-out incentive, and there should be no windfall for either US corporations or for the US government; one possible proposal put forth is that pre-enactment earnings should be taxed at a reduced rate
  - Continued favorable treatment for certain expenses, such as the research credit
  - Following the lead of numerous OECD countries, implementation of a patent box
  - Implementation of a full or partial dividend participation exemption
  - Harmonization of the tax treatment of certain pass-through entities
    - Reduction of the current incentives for corporate inversions by limiting earnings stripping of foreign corporations

In addition to expressing a positive viewpoint with respect to numerous proposals, the Report identifies certain proposals as inadvisable. These include:

- **Implementation of a worldwide tax system with no deferral**
  - Only Brazil has a worldwide tax system with no deferral
  - The report contends that this would be “bad tax policy” as income earned abroad by a US company should not be taxed in the US in the absence of repatriating those profits
- **Implementation of value added tax (VAT)**
  - Although over 150 countries have a VAT, the Hatch Report explains that implementing VAT is a “bad idea” for the US because it would be an effective tax hike on every American, including those who currently pay no income tax

Tax reform will likely include the consideration of changes that may be beneficial to clients as well as changes that will prove challenging. The Tax and Government Relations groups at DLA Piper have been following tax reform very closely and are well prepared to analyze the impact of proposed reforms, guide you through the legislative process, and help you make your views and concerns known to policymakers both on Capitol Hill and in the Administration.

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