Chief Executive

What you Need to Know about Tax Reform

By Gordon Schonfeld

July 9, 2017

On April 26, the Trump administration handed U.S. CEOs a generous gift in the form of a new tax reform plan. Designed to simplify the tax code and foster economic growth, it is a blueprint for how the administration intends to put more money in the hands of businesses and individuals alike. The plan's business measures include reducing the business tax rate to a flat 15%; taxing profits on a "territorial" basis (i.e., earned only in the United States and not overseas); encouraging the repatriation of cash held overseas by levying a one-time tax if the cash is brought home; and eliminating tax breaks for special interests.

For individuals, there are proposals to consolidate the current seven tax brackets into three (i.e., 10%, 25%, and 35%); double the marital standard deduction to $24,000; provide relief for families with child- and dependent-care expenses; get rid of "targeted tax breaks that mainly benefit the wealthiest taxpayers"; preserve deductions for home ownership and charitable gifts; repeal the Alternative Minimum Tax; repeal the estate tax; and repeal the tax on small businesses and investment income that helps fund the Affordable Care Act.

REALITY GETS IN THE WAY

There's just a slight problem: It's improbable that the plan will find its way into law in the near future. Here's why:

Few Specifics. The plan—which consists of a few bullet points on a single piece of paper—lacks crucial details, such as the rate at which it would tax repatriated cash, the income levels to which the proposed individual rates apply and which tax breaks it would eliminate.

Congress has Other Ideas. Congressional Republicans have been working on their own tax agenda for years and want to cover much more ground. Their reaction to the Trump plan was telling: a polite press release that praised it for providing "critical guideposts" for the real work to be done.

Reconciliation. Final legislation will be achieved through a complicated congressional process called reconciliation, which depends on the passage of a federal budget resolution that itself is the subject of lengthy and intense negotiations. Passage of the law will require a minimum of either 51 or 60 votes in the Senate, depending on whether the included tax cuts are intended to be permanent. There are 52 Senate Republicans, so Democratic votes will be required—hardly a slam-dunk in today's hyper-partisan environment.

How to Pay for It? The administration expects the plan to pay for itself by stimulating economic growth that would flood the Treasury in tax receipts. But most economists think the growth rates needed to fund the plan are unrealistically high.

Exploding the National Deficit and Debt. The Tax Policy Center estimates that by 2026, the tax measures proposed by the Trump campaign in 2016 (the closest detailed equivalent to the new plan) would cut federal revenues by $6.2 trillion and raise the national debt by at least $7 trillion. These are staggering numbers, especially for the majority of Republicans who espouse balanced budgets and shrinking the debt.

The Pass-Through Problem. The plan's 15% business tax rate would presumably apply not only to larger corporations, but also to the various pass-through entities (e.g., partnerships, S corporations, LLCs) that are the tax

structures for most middle-market and small businesses. Since pass-throughs are typically taxed at the much higher individual tax rate of their owner(s), this would be a huge boon for the owners. It would thus be an open invitation to all individuals to reclassify themselves as pass-throughs for tax purposes—a mass gaming of the system resulting from a plan whose avowed goal of simplifying the system would seem to discourage such gaming.

Corporate Tax Rates are Already Low. The rationale for reducing corporate tax rates is that the U.S. corporate rate—currently 35%—is much higher than in most of the rest of the world, which puts U.S companies at a major competitive disadvantage. But reality doesn't support this conclusion: J.P. Morgan calculates that most U.S. corporations pay an effective rate of closer to 20%.

The Clock is Ticking. Congress must pass new laws for healthcare and infrastructure spending, hammer out the next federal budget and address the nation's debt limit before it can deal with tax reform. At the time this article was published, Congress had only about six working weeks to do all of this.

Don't Forget the Fed. Even without tax reform, the Federal Reserve is committed to raising interest rates to prevent inflation. Fed rate hikes would almost surely offset whatever gains in economic growth the plan might generate.

WHAT CAN CEOs DO?

Considering the Trump plan's vagueness and the likelihood that any legislation will be significantly different, preparing for it will be challenging for CEOs. But according to Joseph J. Perry, partner-in-charge of Tax & Business Services at accounting and advisory firm Marcum, the plan at least offers important things to think about now.

Most notably:

Possible Major Implications for the Individual Owners of Pass-Throughs

and Their Shareholders. Individual tax rates will come into play here. CEOs might have to decide whether to take home their cash windfall as income or reinvest it in the business.

Compensation and Benefits Plans Might Need Reconfiguring. Again, this will depend on the level of individual tax rates. If rates fall enough, the attractiveness of compensation and benefits tax advantages will decline as well.

Managing the Business's Cash Flows Could Become Harder. This is likely if the tax treatment of capital expenditures (which is on Congress's agenda but not included in the Trump plan) changes. Potential shifts in the timing of capex investments would directly affect the size and availability of cash flows.

Take the Time to Process and Plan. On a positive note, business leaders should have plenty of time to consider the possibilities that a new tax law will present and plan ahead. By consulting with their tax advisors and playing out multiple scenarios, they can position themselves and their companies for the range of outcomes.