Time to Really Get Ready for Federal Tax Reform

by Annette Nellen

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In this article, Nellen outlines the issues that states should consider regarding federal tax reform, which she says is likely to happen in 2017 with Republicans winning both the presidency and Congress.

Goodbye 2016, which continued activities from previous years that may continue through 2017. These activities include challenging the *Quill* physical presence test, resolving apportionment in states in the Multistate Tax Compact, litigation on how much online travel companies owe in transient occupancy taxes, and the fate of federal legislation involving mobile workforce and marketplace fairness.

Hello 2017, a year likely to revisit the longstanding federal debate over tax reform and a year when reform could easily happen. The November election put Republicans in control of Congress and the White House, and both the U.S. House and U.S. Senate have been working on it for the past few years. In June House Republicans released a tax reform blueprint, and President-elect Donald Trump included elements of it in his campaign's tax plan.[1]

The Senate has had several working groups and has numerous plans and analyses on tax reform. U.S. Sen. Orrin G. Hatch, R-Utah, is expected to release a plan to move toward an integrated corporate tax (one layer of tax).

Action on tax reform is likely, because it is reasonable to assume Republicans learned a lesson eight years ago — when President Obama and the Democrat-controlled Congress ended up with only a two-year window to move without a need for bipartisan support.

This article offers suggestions for states regarding federal tax reform.

I. Federal Tax Reform Themes

A review of recent federal tax reform proposals reveals a few themes for what a reformed federal income tax would reflect. By the same token, there are issues for states to consider to both take advantage of reform and prepare for changes that could either adversely affect them or present opportunities.

A. Lower the Corporate Tax Rate

Lowering the 35 percent top corporate tax rate has been the significant theme and justification for federal tax reform for the past several years. In his State of the Union address in January 2011, Obama called for a bipartisan effort to lower the corporate tax rate in a revenue-neutral manner.[2] One of his five proposals for business tax reform was to lower the rate to 28 percent.[3]

In launching the first in a series of tax reform hearings in January 2011, then-U.S. Rep. Dave Camp, chair of the House Ways and Means Committee, observed that the U.S. had the highest corporate tax rate.[4] He released the Tax Reform Act of 2014, which included a flat 25 percent rate for corporations.[5] The House Republican tax blueprint released in June 2016 calls for a 20 percent flat corporate rate.[6]

A lower federal corporate income tax rate does not require that states also lower their rates — and conformity generally does not apply to state tax rates. The rationale for lowering the federal corporate income tax rate is that it is high relative to other countries. A lower rate, particularly if revenue neutral and done with base broadening, supports at least the following state discussion topics:

- How does the state corporate tax rate compare with other states' rates? Is it a competitive disadvantage if higher than other states?
- What changes would accompany a lower federal corporate rate to achieve revenue neutrality? How would

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[1] Donald J. Trump, "An America First Economic Plan: Winning the Global Competition," Aug. 8, 2016, speech to the Detroit Economic Club, *available at* https://www.donaldjtrump.com/press-releases/an-america-first- economic-plan-winning-the-global-competition.

[2] President Obama, State of the Union address, Jan. 25, 2011, *available at* https://www.whitehouse.gov/the-press-office/2011/01/25/remarks-president-state-union-address.

[3] The White House and Treasury Department, the President's Framework for Business Tax Reform (Feb. 2012; rev. Apr. 2016), at 1.

[4] U.S. House Ways and Means Committee, "Hearing Advisory: Chairman Camp Announces First in a Series of Hearings on Fundamental Tax Reform," Jan. 19, 2011, *available at* https://waysandmeans.house.gov/event/chairman-camp-announces-first-in-a-series-of-hearings-on-fundamental-tax-reform/?replace=news.

[5] H.R. 1 (113th Congress), sec. 3001.

[6] "A Better Way — Our Vision for a Confident America — Tax Reform" (June 2016), at 25, *available at* http://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf.

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those changes affect the state's revenue base? Would a rate reduction be warranted for revenue neutrality at the state level?

- States' deductions and credits do not match federal tax preferences. Federal tax reform is an opportunity to review special corporate tax preferences at the state level. Should these be eliminated or cut to support a rate reduction and take advantage of federal reform?
- Federal reforms call for a flat corporate rate. Is a graduated rate structure warranted at the state level, particularly if one already exists?

B. Treat Business Types Similarly

Lowering the corporate tax in a revenue-neutral manner is a concern for other types of business entities. The deductions, exclusions, and credits that would be eliminated or reduced would increase taxes for partnerships, S corporations, and sole proprietors. To address this, reform proposals have explored ways to reduce rates for other entities. For example, the House blueprint provides that "active business income" of sole proprietors and passthrough entities would be taxed at no more than 25 percent. For this to work, however, the owners must be reasonably compensated (taxed at the individual tax rates and subject to employment taxes), with the remaining entity income taxed at 25 percent (still higher than the 20 percent corporate rate).[7]

This federal tax reform would likely be sought by businesses at the state level as well. Questions for states to address include:

- How would base changes in the federal business tax affect state revenues? If a rate reduction possible and warranted?
- Should states that impose an entity-level tax on passthrough entities continue to do so?
- Reasonable compensation, particularly of S corporation owners, has been a longstanding issue for both state and federal employment tax purposes. If the federal government plans to define it or codify any existing case law guidance on the subject, states may want to provide assistance.

C. Expense Assets

The House blueprint and other federal proposals call for expensing business assets. The rationale is that the blueprint aims to "move toward a consumption-based approach to taxation."[8] Other federal plans make similar suggestions generally either because of a move toward a consumption tax or a desire to stimulate economic growth. For example, U.S. Rep. Devin Nunes, R-Calif., has proposed a reform plan that "would encourage businesses to invest and expand, make it much easier for Americans to open their own business, and kickstart growth through the entire U.S. economy."[9]

Expensing of assets, generally offered for its expected economic stimulus effect, also simplifies compliance by eliminating the need for depreciation calculations and records. Generally, states have not followed existing federal expensing provisions, such as higher amounts under section 179 and bonus depreciation. If federal tax reform includes expensing of assets, questions for states to address include:

- If asset expensing becomes a permanent part of the federal income tax, businesses will most likely want the same at the state level to avoid depreciation records all together. What is the cost to the state? What is the likely economic effect to the state of expensing?
- What transitional rules are used at the federal level for depreciable assets in existence at enactment date? How would similar rules affect state revenues?

D. Territorial System and Repatriation

Several federal proposals — including Camp's and the House blueprint — call for moving from a worldwide business tax base to a territorial system. The House blueprint observes that "virtually all of our major trading partners have adopted territorial tax systems, under which these governments generally do not tax the active business income earned overseas by companies headquartered in their countries."[10] This is viewed as a reason many U.S. corporations want to invert or merge with foreign corporations and become foreign corporations. According to the House blueprint, the number of the world's largest companies headquartered in the United States dropped from 17 in 1960 to six in 2015.[11]

The move to a territorial system is tied to what to do with earnings of the subsidiaries of U.S. parent corporations reluctant to repatriate earnings because of the 35 percent tax on them. Keeping the earnings offshore helps with foreign expansion and can encourage inversion. The House blueprint proposes to end this activity with a shift to a territorial system and a repatriation holiday:

> Accumulated foreign earnings will be subject to tax at 8.75 percent to the extent held in cash or cash equivalents and otherwise will be subject to tax at 3.5 percent (with companies able to pay the resulting tax liability over an eight-year period). This will free up the more than $2 trillion in foreign earnings that have been locked out of the United States by the current tax rules. And no such buildup will occur under the international tax rules provided in this Blueprint, as

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[7] *Id.* at 23.

[8] *Id.* at 15. The authors of the blueprint seek a border-adjustable tax that can be imposed on imports but not on exports.

[9] H.R. 4377 (114th Congress), the American Business Competitiveness (ABC) Act. *See also* Nunes's website; http://nunes.house.gov/legislation/tax-reform.htm.

[10] House blueprint, *supra*, at 10.

[11] *Id.*

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businesses will be free to bring home their foreign earnings to be invested to create American jobs and grow their U.S. operations.[12]

Tax reform questions for states to address regarding a territorial tax system and repatriation holiday include:

- If the state does not already use a territorial system, should it move to one regarding income earned outside the United States? What is the effect on water's-edge election schemes? Without federal reporting of foreign branch income, is it feasible to tax that income at the state level (if done today)?
- What might a state do to encourage companies to spend or invest their repatriated earnings in that state?

E. Lower Individual Rates and Broaden the Base

Tax reform proposals have also included base broadening, lower rates for individuals, and simplification. For example, the House blueprint would change the individual rate structure from its current seven rates — ranging from 10 percent to 39.6 percent — to a three-rate structure of 12, 25, and 33 percent. Investment income would be subject to the same rate structure as ordinary income, but half would be excluded. The plan would consolidate the basic and additional standard deductions, personal exemptions, and child tax credit into a larger standard deduction and an "enhanced child and dependent tax credit." An individual could claim either the standard deduction or mortgage interest expense and charitable contributions. The alternative minimum tax would be repealed.

Camp's reform plan also called for consolidation of provisions such as personal exemptions and the standard deduction. He also proposed repeal of the dependent care credit (and most individual credits other than the earned income tax credit) and repeal of the head-of-household filing status (for simplification purposes).[13]

Possible federal reforms to the individual income tax raise these questions for states:

- What is the effect of conformity on state tax revenues? Would the changes (if adopted by the state) warrant a rate reduction? Are other reforms warranted, such as using the revenue generated from base broadening to make the system more progressive?
- What is the desired progressivity of the state income tax system? Federal reforms for base broadening to support rate reduction offer an opportunity to review the progressivity of the state income tax — including the effect of rates, bracket cutoffs, the standard deduction, personal exemptions, the EITC (if any), and similar tax reduction measures.
- What might be the state budget impact of federal repeal of tax benefits directly or indirectly affecting the state such as the EITC, low-income housing credit, dependent care credit, adoption credit, health insurance preferences, and charitable contributions? Note that while federal proposals generally do not call for repeal of the charitable contribution deduction, a larger standard deduction results in fewer itemizers and fewer individuals factoring tax breaks into the making of charitable donations.[14] Might some of the revenue generated from base broadening and repeal of tax credits be needed for state programs rather than solely for rate reductions?
- Repeal of the federal AMT (for both individuals and corporations) would likely lead taxpayers to strongly oppose its continuance in the state income tax. What is the effect of AMT repeal at the state level? How does that affect decisions to keep, cut back, or repeal various tax preferences of the regular tax system?
- How can the system be further simplified? Base broadening means there are fewer deductions, exclusions, and credits. Have enough been eliminated to justify calculating state income tax as a percentage of the federal income tax liability?

F. IRS Reform

The House blueprint includes restructuring the IRS. Per the plan:

> An integral element of this Blueprint will be to rebuild the IRS into a modern and efficient 21st century administrator of the nation's tax system. The new IRS will have a streamlined structure aligned with the simpler and fairer tax system for families and individuals and businesses of all sizes. . . . With a dramatically simpler tax code, the Blueprint will create a new streamlined IRS dedicated to delivering world-class customer service. The new IRS will be centered on three major units: families and individuals, businesses, and an independent "small claims court" unit.[15]

The House Republican platform includes the following plank: "We also support making the federal tax code so simple and easy to understand that the IRS becomes obsolete and can be abolished."[16]

Few details exist on how the IRS might be reformed to improve both administration and enforcement. Also, would

[12] *Id*. at 28-29.

[13] U.S. Rep. Dave Camp, "Tax Reform Act of 2014 Discussion Draft Section-by-Section Summary, " *available at* https://waysandmeans.house.gov/UploadedFiles/Ways_and_Means_Section_ by_Section_Summary_FINAL_022614.pdf.

[14] The drafters of the House blueprint estimate that the proposed change would reduce the number of individuals itemizing deductions from about 33 percent today to 5 percent; House blueprint, *supra*, at 19.

[15] House blueprint, *supra*, at 29.

[16] Republican Platform 2016, at 27, *available at* https://prod-static-ngop-pbl.s3.amazonaws.com/media/documents/DRAFT_12_FINAL[1]-ben_1468872234.pdf.

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tax reform focus on improved compliance to reduce the tax gap? For example, would information reporting be expanded?

Questions for states to consider regarding potential reforms to the IRS include:

- Today, only about 1 percent of individual returns are audited. States rely on this work in finding state income tax adjustments. Despite a simplified system as part of tax reform, compliance concerns would still exist, particularly regarding nonfilers. Could states encourage Congress and the president to include measures to increase enforcement? If not, what funding is needed to enable states to increase their enforcement efforts?
- States benefit from increased information reporting. For example, the threshold for many of the Forms 1099-K issued in our sharing economy is more than $20,000 of receipts and more than 200 transactions.[17] Thus, even a home rented every weekend generating over $50,000 annually does not result in issuance of a Form 1099-K. What can states do to encourage Congress to incorporate tax gap reduction measures into tax reform that would also help reduce state tax gaps?
- What IRS reforms do the states want? Can reform include better ways for the IRS and state tax agencies to coordinate tax administration?

II. Additional State Considerations in Tax Reform

Major federal tax reform doesn't occur often. The Tax Reform Act of 1986 was signed into law on October 22, 1986. Thus, it is important for states to closely monitor reform efforts likely to resume in the 115th Congress so that they can provide input and determine the effect on their tax systems, budgets, and economy. The House blueprint is a starting point, and legislative staffers are already drafting the legislative language.[18] Proposals such as Camp's and others should also be reviewed.[19]

Also, studies and reports on tax reform (including over 50 hearings since January 2011) should be reviewed to identify issues to consider and reforms that states support and oppose. States should let Congress know that they want to weigh in on tax reform.

And as noted, there are numerous questions states should be asking to understand the effect of tax reform on their budgets and economies. Where might these reforms also present opportunities to make the state system simpler, more transparent, more equitable, and more neutral?

States also have their own unique tax topics to address, including dealing with state competitiveness, tax rules for marijuana businesses, supporting new business activity and jobs, and use of new technology for improved tax administration and compliance.

III. Looking to the Future

Most likely, federal tax reform will really happen in 2017. States have a stake in it, as federal reform affects their tax systems, budgets, economies, and residents. States should be ready to participate in the congressional activities. Federal reform presents an opportunity and need for state tax reform. So hello to a busy tax agenda for states in 2017. ■

[17] *See* section 6050W and PLR 201604003 (Jan. 22, 2016).

[18] Dylan F. Moroses, Stephen K. Cooper, and Jonathan Curry, "Trump Win Opens GOP Path for Tax Reform, ACA Repeal," *Tax Notes*, Nov. 10, 2016, p. 904.

[19] Other proposals include H.R. 1 (113th Congress); H.R. 4377 (114th Congress), *supra*; and S. 3005 (113th Congress), the Progressive Consumption Tax Act. U.S. Rep. James B. Renacci, R-Ohio, has a plan called Simplifying America's Tax System to replace the corporate income tax with a credit invoice method value added tax and simplify the individual income tax. *See also* Molly F. Sherlock and Mark P. Keightley, "Tax Reform in the 114th Congress: An Overview of Proposals," Congressional Research Service (Mar. 18, 2016).

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