State of Play on Tax Reform

With the Senate’s failure to pass Affordable Care Act repeal and replace legislation, tax reform efforts became more urgent for the Trump Administration and Republican leadership as they seek a major legislative victory before the 2018 midterm elections. To avoid a similar fate as health care reform, however, the level of ambition may need to shrink for tax reform, as the margin for error is small. For example, last month, the Gang of Six\(^1\) put out a set of principles for tax reform (discussed below) that finally pulled the plug on the House Republican Blueprint’s proposed border tax adjustments (BAT) because “there are many unknowns associated with it” (i.e., the proposal lacked the votes for passage in the Senate and possibly the House as well). Many members of the Gang of Six took to the road in August to promote tax reform, setting up possible action this fall.

**Likely Timing of Tax Reform.** The Gang of Six may release an outline or framework for tax reform (a 3 to 5 page document) in early to mid-September, but action on proposed tax reform legislation will likely have to wait the completion of other legislation.

First, several must-pass pieces of legislation await Congress when they return from August recess that must be addressed before the end of September,\(^2\) including:

- Extension of the Federal debt limit;
- Appropriation bills or a continuing resolution to keep the government running;
- Extension and potential reform of FAA funding;
- Flood insurance reform; and
- Extension of the children’s health insurance program (CHIP).

Second, Republican leaders have said they intend “to go it alone” on tax reform without Democratic support. To do this, they will need to pass a FY 2018 budget resolution providing reconciliation instructions for tax reform.\(^3\) This will provide process protections in the Senate, limiting time for debate and allowing them to pass tax reform with a simple majority vote in the Senate. Passage of a FY 2018 resolution will not be easy and is likely to take some time because of various intraparty conflicts that are likely to arise among House and Senate Republicans. The House Budget Committee has favorably reported a budget that should be on the House floor the second week of September. Majority Leader McConnell has said he wants the Senate to take up the budget in September; many are skeptical this can happen.

Third, Republican leaders may determine it is advantageous to complete the tax bill next year to claim credit for a major accomplishment (and provide certain benefits to taxpayers) right before the election.

Fourth, it is important to note that, while the BAT has been the most controversial issue to date, other proposed features of tax reform (e.g., limiting interest deductibility or eliminating the state

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\(^1\) The Gang of Six is comprised of: Treasury Secretary Mnuchin, National Economic Council Director Cohn, House Speaker Ryan, Ways & Means Committee Chairman Brady, Senate Majority Leader McConnell, and Finance Committee Chairman Hatch.

\(^2\) There are only 12 legislative days in September.

\(^3\) Procedurally, mark up tax reform legislation can be marked up without a budget reconciliation instruction. Any favorably reported legislation would then have to be modified to meet the targets in the instruction.
and local tax deduction) could raise controversy and slow the process down. Controversial revenue offsets are difficult because the margin for error in both the House and Senate under a “go it alone” reconciliation approach is small.

Finally, the Republican plan to “go it alone” may require that they complete (or give up) work on health care reform before turning to tax reform. Passage of a new budget resolution for tax reform likely would turn off the previous budget resolution under which health care reform is being processed. It is not yet clear that House Republicans or the Trump Administration are willing to move on and abandon health care reform efforts.

As of today, the anticipated scenario is a mark-up in the House Ways and Means Committee in October, with the hope of Senate action in November. Many believe Senate action will be much later, perhaps into 2018.

**Gang of Six “Unity” Approach.** The Gang of Six has been meeting regularly to develop a “unity bill” in an effort to avoid the problems they encountered with health care reform. Last month, they put out a joint statement that sets forth a few principles for tax reform, but otherwise offers little detail. The principles are:

- Lower tax rate for small businesses (so they can compete with larger ones);
- Lower tax rate for U.S. businesses (so they can compete with foreign ones);
- Allow “unprecedented” capital expensing;
- Lower tax rates as much as possible;
- Create a system that encourages U.S. companies to bring jobs and profits back from overseas; and
- Not to include a BAT.

They also said they would like to proceed through regular order (presumably, mark-ups in the tax-writing committees, opportunities for amendments, a conference committee, etc.).

While no framework or outline has been released yet, we believe the Gang of Six is likely to adopt an approach similar to former Chairman Camp’s tax reform bill that will reduce rates, provide partial (e.g., 50%) expensing for capital investment, broaden the tax base, and adopt a territorial system with some form of deemed repatriation toll charge and a minimum tax to prevent base erosion. Because of Chairman Hatch’s interest in corporate integration, the proposal may also include a partial dividends-paid deduction.

Because they intend to rely on dynamic scoring and use of a current policy baseline, they have greater “headroom” than former Chairman Camp did in crafting a “deficit-neutral” tax reform package. However, they will still need significant offsets and are searching for alternatives to replace the significant revenue raised from the BAT. This means almost anything could be in play, including various items from former Chairman Camp’s discussion draft (e.g., deferral of advertising or R&E expense), and revising retirement and fringe benefit rules.

Also, based on recent conversations, we understand they are considering a percentage haircut on interest deductibility and/or a thin capitalization rule that would limit the deductibility of interest exceeding certain thresholds (e.g., 30% of EBITDA). Whether they will provide grandfather relief for existing debt or a phase-in of the haircut is still uncertain. However, because they are only considering a partial haircut rather than a complete disallowance of interest as under the House
Republican Blueprint, some policymakers are arguing that grandfather relief is less needed. Also, the decision to provide grandfather relief will necessarily depend on revenue considerations.

There also is no agreement yet as to whether the tax reform bill will be fully offset. While the principles released by the Gang of Six last month say they have placed a priority on permanence, Treasury Secretary Mnuchin has said that the Administration will be happy with a temporary bill if that is all that is achievable politically. The budget reconciliation rules require that a bill cannot add to the deficit in the out years. This determination is made on a title-by-title basis. Thus, some provisions could be made permanent (if offset), while others would have to be sunset.