Setting the Stage for Comprehensive Tax Reform

December 2, 2016

Tax reform will be one of the top priorities for the 115th Congress. Hopes for pursuing tax reform to a successful conclusion are high, given one-party control of the government (and exuberant campaign promises). However, a number of obstacles, political and substantive, must be overcome to get a major tax bill enacted, even without a divided government. Details matter, and President-elect Trump’s tax proposals, so far, include very few. In June, House Republicans released a high level tax reform proposal known as the Blueprint and are reportedly working on turning it into legislative language. However, many details remain to be fleshed out, including how differences with the President-elect’s plan will be resolved. At this pre-inaugural stage, it is too soon to predict the content or timing of tax legislation for the next Congress, but it is a good time to set out the background and context in which tax reform measures will be considered. Here’s what to watch:

To Watch: Key Trump Appointments

Treasury
President-elect Trump has recently announced that Steven Mnuchin, a hedge fund manager and former Goldman Sachs executive, is his choice for Secretary of the Treasury. (The nomination is subject to Senate confirmation.) Does selection of a political moderate with financial industry experience, but no government or public policy experience, suggest that the Trump administration is more likely to leave details of tax reform to Congress, and focus the efforts of Treasury on Dodd Frank and other regulatory reform? Perhaps, but in confirming his nomination, Mnuchin said that the Trump administration’s plan will be to cut the corporate tax rate to 15% and that tax reform, including a large tax cut for middle-income taxpayers, would be achieved within 90 days of the inauguration.

OMB
The President-elect has dispatched a transition team to OMB but has not announced his pick for the top spot at OMB, also a Cabinet-level position. The OMB director, like the Secretary of the Treasury, is typically involved in development of the Administration’s budget and tax proposals.

NEC
The top spot at the National Economic Council also remains to be filled. The NEC (which consists of a number of other advisors, including the Treasury Secretary and (at times) the OMB Director) deals with economic policy development, coordinates policy-making for domestic and international economic issues, and ensures that economic policy decisions and programs are consistent with the President’s stated goals.

To Watch: Key Congressional Players

The lame-duck session of Congress commenced November 15, with House Republicans holding elections for leadership positions. As expected, Paul Ryan (R-WI) will serve a second term as Speaker. Ryan is considered one of the top tax experts in Congress, and is an advocate of comprehensive individual and business tax reform. He was also a key player in persuading the House to adopt dynamic scoring rules, which take into account likely economic effects of legislation. The House Majority Leader is Kevin McCarthy (R-CA). McCarthy has recently stated that tax reform will be taken up early in the 115th Congress and will be pursued through the budget reconciliation process. More on that below.
Congressman Kevin Brady (R-TX) is expected to retain his post as Chairman of the House Ways and Means Committee, the House committee responsible for drafting tax legislation. The committee’s staffers are already reportedly working on translating some combination of the Blueprint and Trump proposals into legislative language. Jim Renacci (R-OH) is another Congressman to watch. Although he is a relatively junior member of the Ways and Means Committee, he released an independent proposal for tax reform in July 2016 that would eliminate corporate-level tax and replace it with a VAT-like “Business Activities Tax”. Devin Nunes (R-CA), an 11-year veteran of the Ways and Means Committee, introduced legislation in January 2016 that would enact business tax reform. His proposals may be an indication of the more incremental reform that could result if fundamental tax reform proves too politically (and financially) difficult to achieve.

On November 30, House Democrats reelected Representative Nancy Pelosi as House Minority Leader. Pelosi has supported the Progressive Caucus on tax positions.

In the Senate, Mitch McConnell (R-KY) is the Senate Majority Leader. Senator Chuck Schumer (D-NY) will become the Senate Minority Leader. Schumer has said that his top priorities for 2017 include a corporate tax cut and some kind of international tax reform to fund infrastructure. Schumer has long been working with Senator Rob Portman (R-OH) on a bipartisan approach to international tax reform based on a hybrid model that combines some elements of territoriality with a low annual tax on offshore earnings.

Orrin Hatch (R-UT) is expected to stay on as Chairman of the Senate Committee on Finance. In the past, Hatch has been an ardent supporter of “corporate integration” (i.e., eliminating double taxation on corporate earnings). In 2016 Hatch announced that he was working on a proposal that would allow corporations to deduct dividends paid to shareholders. The Senate Committee on Finance held hearings on the idea in May 2016, but no written proposal has been released. Senator Hatch, who is 82, previously said that he would retire in 2018, but recent reports indicate that he may stand for reelection.

**To Watch: The Administration’s FY 2018 Budget Proposals**

Soon after the inauguration, the Trump administration is supposed to propose a budget, which may include, at a very general level, elements of Trump’s campaign promises relating to tax reform, and/or other tax reform proposals. Will the Trump administration’s budget include a detailed tax reform proposal, or will it leave the details to Congress? Traditionally the Administration’s budget proposal for the coming fiscal year is due on the first Monday in February – that’s February 6 in 2017. The Trump administration is unlikely to meet that deadline (most new presidents do not), but an outline of the Administration’s FY 2018 budget proposal may appear sometime in February, followed by a more detailed version of the budget later in the year. If the Administration’s FY 2018 budget proposal includes tax reform, Treasury Department staff would typically publish a “General Explanation” (sometimes called the “Green Book”) detailing those proposals.

**To Watch: The Debt Limit/Budget Battles**

Lame-Duck Session

Actions in the current lame-duck session will affect budget discussions in the next Congress. The continuing resolution for the current federal fiscal year is scheduled to run out on December 9. In the remaining days of the session, Congress could kick the can down the road and pass another continuing resolution at current funding levels to take the government though spring 2017. Republicans prefer this approach, but it is more easily accomplished in the House than the Senate, given the lack of a 60-vote majority in the Senate. Alternatively, Congress can pass an “omnibus” spending package on a bipartisan basis that could include new spending and policy riders designed to attract support from lawmakers on both sides of the aisle and ensure President Obama’s signature. A compromise might look like last year’s December omnibus bill that funded the government for the remainder of FY 2016, included some extenders, and addressed other policy matters.
The 115th Congress

Assuming that the lame-duck session produces a continuing resolution that keeps the government funded for another four or five months, major decisions about federal spending as well as the federal debt limit will have to be addressed in the early days of the Trump administration and the 115th Congress.

The two-year budget agreement reached by Paul Ryan and Senate Budget Committee Chairwoman Patty Murray (D-WA) in 2015 provided temporary relief from the sequestration process that expires in 2017. Ryan is a budget hawk who is expected to renew efforts to restore regular order to the budget. This may set the stage for a battle between the Administration and Congress. Democrats will push for ending sequestration cuts on domestic spending, and may use the debt limit as leverage to extract concessions on Democratic spending priorities.

To Watch: Budget Resolutions and the “Fast-Track” Reconciliation Process

Republicans are currently developing strategies for pushing through tax reform legislation and legislation to repeal and replace the Affordable Care Act (“ACA”). One possibility is that the budget reconciliation process could be used, and it is conceivable that there could be two budget resolutions with reconciliation instructions – one passed in early 2017 for FY 2017 and a later resolution for FY 2018, giving Republicans two opportunities to pass legislation without threat of filibuster in the Senate. (Senate debate over budget bills produced in the reconciliation process is limited to 20 hours, so Republicans will not need a 60-vote supermajority to end a filibuster and bring the bill to a vote.) House Majority Leader Kevin McCarthy’s recent statements are consistent with the notion that House Republicans will seek to use an early 2017 budget resolution to invoke the reconciliation process for budget items, potentially including tax reform, the debt limit and parts of the ACA “repeal and replace” agenda.

To Watch: The Opening Bid on Tax Reform

Introduction of a Tax Bill in the House

The game is likely to begin in earnest in mid-2017. Since the 2010 election restored a Republican majority in the House, House Republicans, including former Ways and Means Committee Chairman Dave Camp, have been laying the groundwork for tax reform, but have not reached a consensus on a reform proposal within the House or with Senate Republicans who have been pursuing different tax reform agendas.

Action in the House is likely to start with the introduction of legislation based on the Blueprint, which was developed by Ways and Means Committee Chairman Kevin Brady (R-TX) with some input from the broader House Republican caucus. As noted above, the Blueprint document is not a legislative draft that can be acted on by the House, but Brady is reportedly working on legislative language in anticipation of introducing a bill in 2017. When the bill is introduced, it will be referred to the Ways and Means Committee for consideration, which will typically include hearings and a markup by the committee. No decisions regarding the timing for hearings or committee markup have been announced. In addition to the Ways and Means Committee, other House committees may want to hold hearings on how tax reform will affect areas within their jurisdictions. Watch for members to find ways to demonstrate their involvement in the process on behalf of their constituents.

What’s Going to Be in the Bill?

Two Tax Bills?

It has been suggested that the Trump administration might try to persuade Congress to pursue tax reform in two stages, with business tax reform separated from individual tax reform. That strategy has been tried before. Last year, Ryan attempted to find common ground with the Obama administration with a corporate-only tax reform measure, and when that failed he floated a more narrow international reform proposal with Senator Schumer, which also failed to gain traction. As noted above, the legislation...
introduced by Congressman Nunes in January 2016 may be an indication of the more incremental business-only tax reform that could be pursued as a compromise measure.

**A Consumption Tax?**
At a high level, the Blueprint proposal would reduce marginal tax rates on new investment capital and modestly lower the average marginal tax rate on labor. Most of the individual income tax reforms are intended to approach revenue neutral at the end of the budget window and beyond, but the business tax reforms would reduce revenues relative to current law using standard revenue estimating methodology, even after taking into account the one-time transition tax on offshore earnings. Dynamic scoring makes only a modest difference.

As a vehicle to begin the tax reform dialogue, the Blueprint is particularly provocative in proposing a consumption tax. The Blueprint proposes converting the corporate tax into a destination-based, border-adjusted cash flow tax, under which U.S. exports would be tax exempt. (It is not called a VAT, but it is very similar to a subtraction method VAT.) While details of the proposal are still developing, it is already attracting criticism from companies that are significant importers of goods. Other consumption-tax-based proposals have been floated in the House, including the proposal discussed above from Congressman Renacci, which is based on a credit invoice VAT system, a more traditional way to implement a VAT.

The significance of including VAT and VAT-like consumption taxes in the discussion is that it opens the door to “pay-fors” that do not rely on base broadeners from within the income tax. Many academics have noted that to reduce rates to an internationally competitive level in a revenue neutral way, Congress will likely need to find an alternative revenue source; base broadeners from within the income tax tend to bog down legislation by attracting opposition from the forces that protect the targeted tax expenditures.

**To Watch: Action in the Senate**
While the Blueprint may be the starting point for tax reform, it is not clear that Senate Republicans are on board with every aspect of the proposal. In particular, Orrin Hatch, Chairman of the Senate Committee on Finance, is reportedly not enamored of the destination-based cash flow tax and may push corporate integration as an alternative. After a House-passed bill is sent to the Senate, watch for the Senate Committee on Finance to hold hearings followed by a markup that is likely to produce a bill very different from the House-passed version.

**To Watch: Wildcards**

**Midterm Elections**
Notably, a number of Senate Committee on Finance members, most of them Democrats, are up for reelection in 2018, and 10 Senate Democrats from states carried by Trump are up for reelection. Watch for Senators facing midterm elections to be especially interested in participating in and progressing tax reform in advance of the midterm elections.

**Social Media/General Media Environment**
Social media will love tax reform, and constant scrutiny may make horse-trading compromises more difficult. Tax reform in the mid-1980s took three years (if counted from the Treasury Department’s publication of its proposal for comprehensive tax reform), and that was in the pre-Twitter world.
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