Tax Reform

Corporate Tax Reform – Immediate Asset Expensing at a Cost of Losing Interest Deductions

A key component of an overall tax reform package is the portion impacting both small and large businesses. While change in this area appears to be desired by all, the process of finalizing a package that will be acceptable to all is difficult.

While we are still waiting for more details on President Trump's tax proposals, in June 2016, the Republican Party issued a white paper called *"A Better Way – Our Vision for a Confident America"*. This vision is the foundational "Blueprint" for the GOP's tax reform proposals. As noted in its Blueprint, the GOP believes that reform is needed in order to improve competitiveness and growth for all job creators.

> "For businesses both small and large, the focus of the new tax system will be on the growth and competitiveness of all job creators. It represents the largest corporate tax rate cut in U.S. history. It also will bring the lowest tax rate since before World War II to small businesses operated as sole proprietorships or pass-through entities such as partnerships or "S" corporations. **And for the first time ever, all businesses will have the benefit of a full and immediate write-off of their investments in tangible and intangible assets"** (emphasis added).

The GOP plan calls for a full and immediate expense deduction, available to all businesses, for investment in both tangible and intangible property; it would apply to investments in real property (but not land), equipment, and intellectual property such as patents and trademarks. The Blueprint states that this "represents a 0 percent marginal tax rate on new investment".

Ancillary benefits to taxpayers of this proposal could include reduced compliance costs of maintaining multiple federal tax depreciation schedules (Regular Tax, Alternative Minimum Tax and Earnings and Profits Depreciation), reduced tax audit costs related to tangible and intangible assets, and an increased present value of the overall deduction since inflation will not reduce the value of future depreciation deductions not available for up to 40 years later.

The Tax Foundation estimates that enacting full expensing could increase long-run Gross Domestic Production by as much as 5%. However, the Tax Foundation also estimates the revenue impact to the Treasury of this provision will cost $2.2 trillion over 10 years.

Not surprisingly though, in the tax environment the U.S. is currently in, some industries see potential problems with the expensing provision. The like-kind exchange industry (or the §1031 industry) for instance is concerned that §1031, which provides for tax deferral on like-kind exchange transactions (particularly real property exchanges), would be a casualty in any substantial tax reform package. The industry's position is that §1031 is still needed "because property owners cannot expense land." Also, most or all of the real estate gain is in the land and not the improvements. For example, farmers allocate approximately 90% of the value of their real estate investment in the land."

To offset some of the tax revenue lost, other tax law changes are proposed that would be less beneficial than under current law. One important deduction for many businesses is the deduction for interest expense incurred on business activities. The GOP Blueprint proposes to eliminate an overall interest deduction by modifying rules on how interest expense would be deducted. It is estimated that this change would raise more than $1 trillion in revenue that would partially offset the $2.2 trillion revenue cost of immediate expensing.

Under the Blueprint, job creators will be allowed to deduct interest expense against any interest income, but no current deduction will be allowed for a business with an overall net interest expense. Any net interest expense may be carried forward indefinitely and allowed as a deduction against net interest income in future years. The Blueprint anticipates that special rules will be developed with respect to interest expense for financial services companies (banks and insurance companies for example) that take into account the role of interest income and expense in their business models.

As noted in the Blueprint, the House Republicans believe:

> "The benefit of immediate expensing of business investment operates as a more beneficial and more neutral substitute for the deduction of interest expense associated with debt incurred to finance such investment. Allowing investments to be immediately written off provides a greater incentive to invest than is provided through interest deductions under current law; allowing both together would be distortive as it would result in a tax subsidy for debt-financed investment."

This net interest expense deduction provision is also controversial. More than 30 agricultural groups have expressed their concern over interest expense elimination. "As Congress works to enact comprehensive tax legislation, the positive reforms made should not be undermined by negative, unintended consequences as a result of eliminating the business interest deduction for agricultural entities," the groups wrote in a letter earlier this month to House Ways and Means Committee Chairman Kevin Brady (R-Texas) and ranking member Richard Neal (D-Mass.). The agriculture groups said in their letter that most family-owned farms rely heavily on credit, and that agricultural producers use debt financing to purchase land and equipment. "Eliminating the interest deduction will place further financial stress on an already debt-burdened industry, and prevent producers from staying profitable in challenging economic times". They went on to state that, "As older producers exit the workforce, financing will be critically important for new and beginning farmers and ranchers looking to establish businesses. Eliminating interest deductions creates a significant barrier for the next generation."

Further still, Treasury Secretary Steven Mnuchin has said that he wants to keep the deduction for businesses’ interest costs.   "On the business tax, my preference is to maintain interest deductibility, which is important for small- and medium-sized businesses," he said during a House Ways and Means Committee hearing. Mnuchin added, however, that the administration is looking at the deduction "like everything else that's on the table."

There is still a lot of work to be done, and overall tax reform is no sure bet, as special interests jockey for position to help their industries come out a winner under any outcome. Looking through the lens of your own business, have you considered whether an immediate write-off for investments in your business be more or less beneficial to you than the impact of losing a deduction for net interest expense? At a minimum though, businesses need to be considering how all the various provisions that are being proffered will work together and determine the overall impact on their net cash federal tax as compared under tax reform compared to their net cash federal tax under the status-quo of existing law. They may then be in a position to conclude whether overall tax reform will be good for them.