



Tax Reform – Can It Be Ignored?

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Top Ten Federal Tax Expenditures 2008 - JCT

- Capital gains, dividends rates (\$128 billion)
- Income exclusion for employer health care contributions (\$117 billion)
- Net income exclusion for employer retirement plan contributions (\$114 billion)
- Mortgage interest deduction (\$80 billion)
- Exclusion of capital gains at death (\$54 billion)
- Earned Income Credit (\$47 billion)
- Credit for children under 17 (\$45 billion)
- Exclusion of benefits provided under cafeteria plans (\$34 billion)
- Deduction for charitable contributions other than education, health care (\$34 billion)
- Exclusion of capital gains on sales of principal residence (\$29 billion)



Expiration of “Bush tax cuts”

- Expiration of tax cuts in 2010
 - Maintain individual tax rate reductions \$1.05 trillion
 - Maintain 15% dividend rate \$216.5 billion
 - Maintain 15% capital gains rate \$101.5 billion
 - Permanent estate tax repeal \$670 billion
 - Other items
 - Marriage Penalty Relief \$81 billion
 - Child Tax Credit \$261 billion
 - Miscellaneous \$70 billion
 - **10-year cost of making 2001 and 2003 tax cuts permanent \$2.4 trillion**



Social Security and Medicare

- Spending on Social Security in 2007 was \$581 billion; it is projected to increase to \$1.092 trillion in 2018
- Spending on Medicare in 2007 was \$436 billion; it is projected to increase to \$879 billion in 2018
- Spending on Medicaid in 2007 was \$191 billion; it is projected to increase to \$445 billion in 2018
- Social Security spending will rise from its current level of 4.3 percent of GDP in 2007 to approximately 6 percent in 25 years
- Spending on Medicare and Medicaid is projected to rise from 4.6 percent of GDP in 2007 to approximately 12 percent by 2050



Obama's Corporate Tax Plan

- Intent to “end tax breaks for companies that send jobs overseas” - “limit the ability of multinational corporations to use tax havens to hide income overseas” - codify the economic substance doctrine – would reform deferral
- “The Stop Tax Haven Abuse Act (S. 681) co-sponsored by Sen. Obama and ‘Tax Evasion Watch List’
 - Establishes a rebuttable presumption of operating in “offshore secrecy jurisdiction”
 - Includes Hong Kong, Singapore, Cayman, Luxemburg, Switzerland
 - Penalizes companies reporting income in those locations – 6 year statute; \$1 million penalty for failure to disclose
 - Codification ‘economic substance’ – 40% underpayment penalty
- Intends to use money gain from taxing offshore earnings to lower taxes for companies that expand operations in the United States - \$3,000 tax credit for each new hire
- Permanent R&D credit
- Capital gains
 - 20% tax rate AGI over \$250,000; 15% for others
 - Eliminate capital gains for investments in ‘small business start ups’
 - ‘Carried interest’ tax at ordinary income rates



Rangel's Tax Bill (H.R. 3970)

- Reduce corporate tax from 35% to 30.5%
- Repeal production deduction
- No deduction for expenses allocable to deferred offshore income
- Repeal worldwide allocation of interest expense
- Limit treaty benefit for certain deductible payments
- Repeal LIFO
- Repeal 'lower of cost or market' inventory method
- Permanent extension small business expensing
- Increase Sec. 197 amortization period to 20 years
- Codify 'economic substance'
- Reduce dividends received deduction
- Clarify gain recognition spin off transactions
- One year extension R&D tax credit



McCain's Corporate Tax Plan

- Reduce tax rate to 25% - 30% 2010; 28% 2012; 26% 2014; 25% 2015
- Repeal production deduction
- Repeal LIFO
- Immediate expensing of three and five year equipment but disallow purchase price interest expense (2009 - 2013)
- Permanent R&D credit equal to 10% of R&D wages
- Capital gains
 - 7.5% tax for 2009 and 2010
 - Increase stock loss deduction to \$15,000 for 2008 and 2009



USA Tax (H.R. 4159)

- Export income not taxed
- Operating income from domestic activity is taxed
- Imported items “bear a fair and proportionate share of the tax burden”
- Intended to be revenue neutral
- Immediate deduction is allowed for plant and equipment
- Credit for payroll taxes paid by employer



Treasury Paper (Dec. 2007)

- Three possible alternatives
 - Business Activity Tax (BAT)
 - Reduce corporate tax rate to 28% and broaden the tax base or allow full expensing of new business investment
 - Target specific areas for reform, such as multiple taxation of corporate earnings; taxation of international income; capital gains; address bias in favor of debt financing; treatment of losses



President's Advisory Panel – Tax Reform

- Simplified Income Tax Plan
 - Reduce corporate rate to 31.5%
 - Repeal corporate AMT
 - 100% dividend exemption for U.S. taxed income
 - 75% exclusion sale of U.S. company stock
 - Territorial tax system
 - Eliminates R&D credit; state/local deduction; Sec. 199
 - Expense allocation
 - Worldwide interest apportionment
 - R&D not allocated because intercompany royalties taxed
 - Royalties taxed if deductible offshore
- Growth and Investment Plan
 - Cash flow taxed at 30%
 - Immediate expensing capital (including land) expenditures
 - No tax on interest and dividend income
 - Border adjusted: export revenue not taxed: import purchases not deductible



Tax Reform – Back and Forth

- Was an idealist – BTT (e.g., *USA Tax* for corporations)
 - Simpler, transparent - Border adjust
 - Would encourage U.S. investment - Dump the current system
- Idealism evolved into practical perspective/realist
 - BTT would be big change – companies not ready to analyze BTT
 - Companies know and want to protect what they have – deferral to reduce ETR
 - Became a convert to the practical approach - offshore business restructuring resulting in improved tax rate
- Anti-deferral rhetoric/proposals and Rangel's 'Mother' tax bill (and Obama's views) increases the focus that the old ways of reducing corporate tax rate are at risk
 - Rangel's bill heightens focus and attention to resurrecting bigger ideas (like BTT) to reforming the corporate tax system



Company Perspective-Tax Reform Possibilities

- Three possible directions for corporate tax reform
 - ~22% or lower statutory tax rate
 - End foreign income deferral
 - End production deduction
 - End R&D tax credit
 - ~27% or lower statutory tax rate
 - Retain foreign income deferral
 - Repeal deemed income inclusion intercompany transactions
 - End production deduction
 - End R&D tax credit
 - Business Activity Tax (BAT)
 - Replace current income tax with 12-15% tax rate
 - Capital expensing
 - Border adjustment – exports and foreign income not taxed
 - No deduction salaries and wages or credit for OASDI



Territorial Tax System

- Currently, we have a de facto territorial tax system with deferral – HIA holidays
- Territorial proposals that disallow U.S. expense (e.g., R&E) will encourage offshore IP and R&E migration
 - Unnecessary if the intent is to establish foreign tax credit limitation on royalty income because in most cases, withholding taxes are NIL



Territorial Continued - Observations

- Global tax rate management becomes more difficult with territorial system
 - If foreign audits properly managed, foreign adjustment should not impact global tax rate – corresponding adjustment or foreign tax credit
 - Under 'territorial', IRS probably has less incentive to argue in company's favor in competent authority
- Complicated and fluid §482 transfer pricing rules would continue – the amount of IRS and Treasury resources put into defining offshore profit attribution is tremendous



Is 'Business Transaction Tax' (BTT) or 'Business Activity Tax' (BAT) A Better Approach

- A tax person in the trenches experiences
 - Quick financial statement close process – even minor tax accounting adjustments (e.g., reclasses) can be a big issue for tax departments these days
 - Attest firm 1 ½ months to complete their work; tax department numbers expected 1 ½ weeks – chances of finding some adjustment is high
 - Mgt and BOD with very little understanding of the complexity → both good and bad surprises are bad – not like the old tax planning days
- Reasons for BTT – simplicity, transparency, resources, stimulative
- BTT as a tax reform alternative bogs down because
 - Border adjustability/WTO; winners and losers; transition



Why BTT Type Reform – Taxpayer Perspective

- Simplification
 - Eliminates complexity
 - Taxation of foreign income rules, including elimination of foreign tax credit; §482 transfer pricing complication; and subpart F deemed dividend rules
 - §199 production deduction
 - Tax credits, such as R&D tax credit
 - Addresses Subchapter C double taxation of corporate earnings
 - No gain to corporations internal restructuring
 - Eliminates most of real or perceived corporate tax shelters
- With credit for employment taxes, wage and capital intensive companies are (in large part) equalized
- Is border adjusted – encouraging U.S. investment and exports
- Is more transparent than the current income tax



BTT Policy Advantages

- Border adjustment and accelerated deduction for capital and inventory expenditures encourages U.S. investment
- Border adjustment reduces current IRC complexity - e.g., taxation of foreign operations and transfer pricing
- No deduction for imported articles, or taxation at import, addresses political 'runaway plant' concerns
- No deduction for salary and wages
 - Can be used in 'wage gap' political debate – No deduction executive income
 - No tax impact from hiring or laying off employees
 - Credit for employment taxes equalizes wage and capital intensive U.S. companies
 - Had this been in place, ill-advised GAAP stock option expensing rules might have been avoided – stock options are not an economic expense to corporations and EPS impact already built into fully diluted EPS
- Simpler system reduces IRS resource requirements
- Congress time spent on complex tax issues is reduced

Territorial/BTT Complexity Comparison

	BTT – Payroll Credit	Territorial Tax
Mergers and acquisitions	++	-
Foreign income taxation	++	+
Foreign tax credit	++	+
Expense allocation to foreign income	+/-	-
Dividend, interest, capital gain taxation	++	-
Cross border income allocation/transfer pricing	+	-
Deterrent to offshore IP migration	++	-
Deterrent to proscribed 'listed'/corporate tax shelter transactions	++	-
Reduces consolidated return/investment stock basis complexity	++	-
Elimination of tax credits	++	-
Increases after tax cost of executive compensation related deductions	+	-
FAS 123r tax accounting related issues	++	-
Reduced SOX complexity	++	-
Reduced Fin 48 complexity	++	-
Reduced FAS 109 complexity	++	-
Financial statement transparency	++	-
Transition	-/+	-/+
Tax treaties	-/+	+



Territorial vs. BTT – Some Foreign Points

- Offshore operating income
 - Both exempt offshore operating income
 - Satisfies the HIA2 proponents; also satisfies domestic producers/exporters
- BTT exempts export profit
 - Unlike 'territorial', incentive for U.S. investment
- Expense disallowance
 - 'Territorial' proposals inconsistent – any expense disallowance increases ETR
 - BTT – export profit exempt – therefore expenses attributable to foreign sales should be disallowed



Key Elements (one version of) BTT Proposal

•Export income not taxed	Yes
•Inventory purchases fully expensed	Yes
•Capital purchases fully expensed or depreciated	Yes
•Wages & salaries not deducted - credit for payroll taxes	Yes
•Passive income & capital gains not taxed	Yes
•Deduction for royalties-U.S. Sales	Yes
•Deduction for royalties-Foreign Sales	No
•Royalty income taxed – U.S. Sales	Yes
•Royalty income taxed – Foreign Sales	No

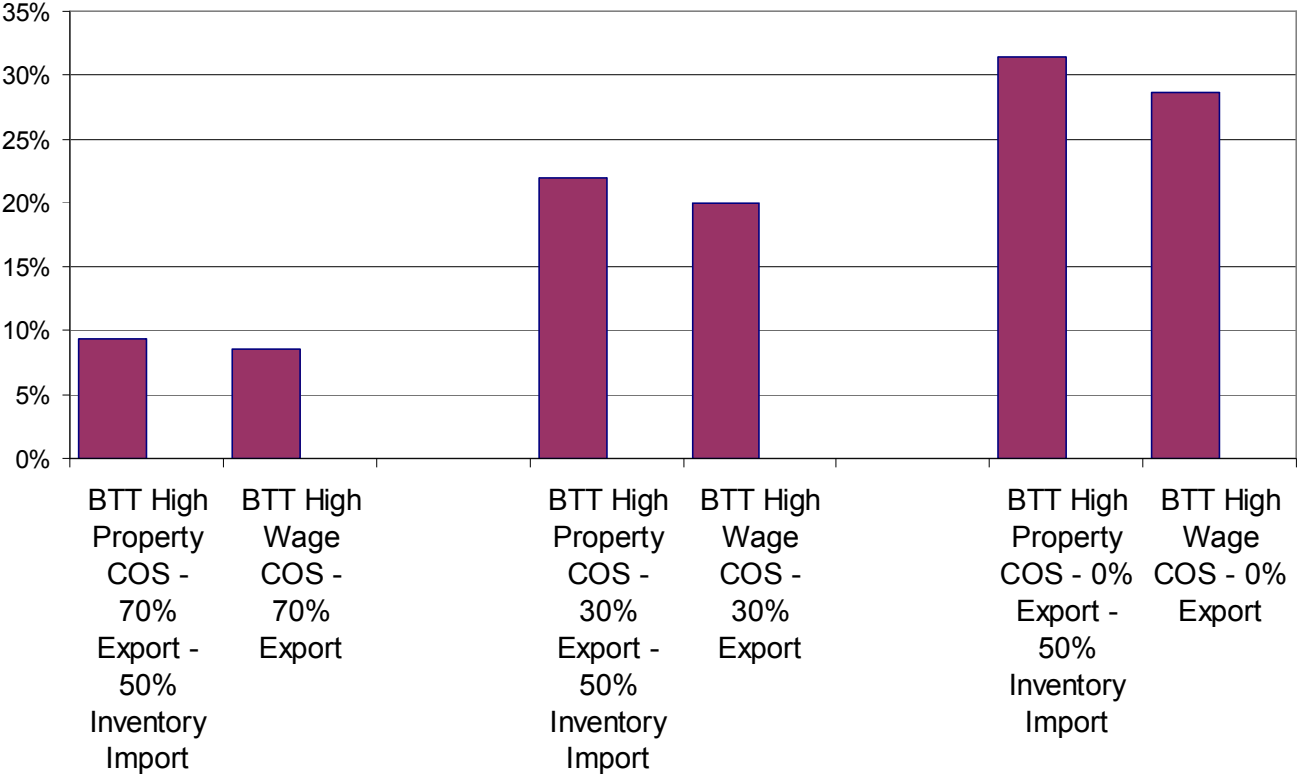


How To Combat 'Winners & Losers' Under BTT

- Compared to Current Tax Law - Findings from modeling
 - Both high property COS companies and high wage **exporters** have reduced tax rate – **Non exporters** tax rate approximately the same
 - Non export/low margin trading companies would bear highest effective tax rate
- Important BTT design elements revealed from modeling
 - Employer paid OASDHI credit attributable to domestic sales equalizes wage and capital intensive companies
 - BTT cap at 50% (before OASDHI credit) of domestic book income – necessary for low profit/low wage companies
 - OASDHI credit scaled back to % of BTT book income cap
 - Low profit import/trading companies – tax rate could go up

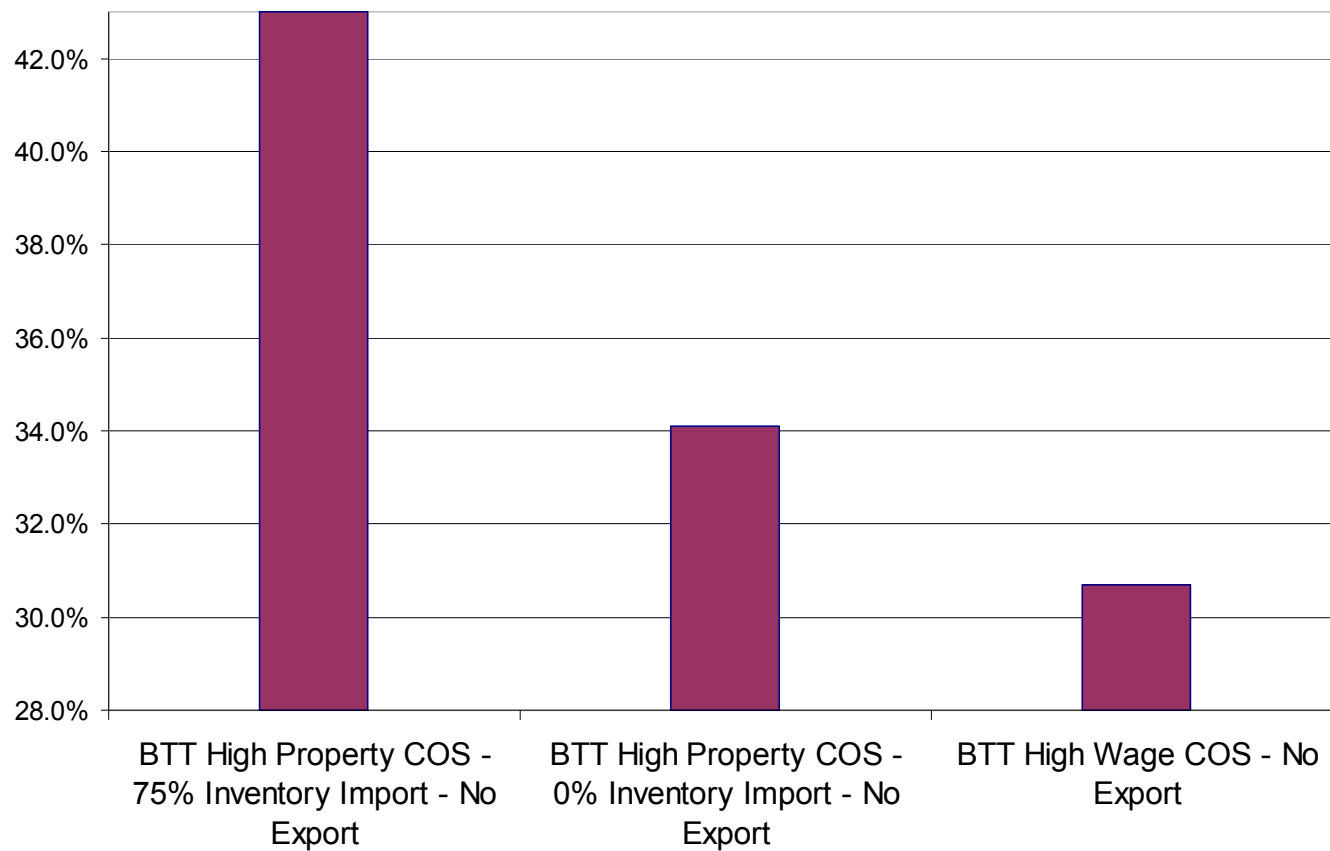
BTT Winner's and Loser's Comparison

Tax Rate Comparison - High Property vs. High Wage Cost of Sales Company - 50% Import Assumption



BTT Winner's and Loser's Comparison

Non Exporter - Domestic Only/Low Margin Company





Can Corporate Income Tax Be Border Adjusted?

- 3 part test under WTO/GATT
 - 1 “Subsidy” – Articles 1 & 2 1979 Agreement on Subsidies and Countervailing Measures (ASCM)
 - Whether there is a financial contribution in the form of government revenue otherwise due
 - FSC/ETI was an exception to the general rule of corporate taxation (§61)
 - 2 “Export Contingent” – Article 3.1 ASCM
 - ASCM Annex – Illustrative List of Export Subsidies Item (e)
 - 3 Discrimination against imported products – GATT Article III:4
 - E.g., U.S. manufacturing content requirement



Would 'Border Adjustment' Survive WTO Scrutiny?

- From WTO cases, problems with FSC/ETI:
 - A 'subsidy' existed (ASCM Articles 1 & 2)
 - The 'subsidy' was export contingent (ASCM Article 3.1(a))
 - And, imported goods received less favourable tax treatment than U.S. manufactured goods (GATT Article III:4)
- As I understand, 'Border Adjustment' is okay, if
 - It is a consumption based/indirect tax (Illustrative list Items (g) & (h))
 - Income tax, if general corporate rule excludes export income – a 'subsidy'/exception would not exist – export contingency becomes irrelevant
 - FSC/ETI provisions were an exception to general rule (§61)
 - Export income on exported items must be exempted from U.S. tax (GATT)
- Note: Both Italian IRAP and Japan Consumption Tax (both are BTTs) have not been challenged under WTO



Is BTT Constitutionally Sound?

- Some commentators believe tax reform proposals not meeting definition of income tax must be apportioned based on population (origins in *Pollack* decision (1895))
 - However, 16th Amendment reads: “The Congress shall have power to lay and collect taxes on incomes, *from whatever source derived*, without apportionment”
 - U.S. Constitution Article I, section 8 reads: “The Congress shall have power to lay and collect *excises*, ; but *excises* shall be uniform [i.e., single rate] throughout the United States.”
 - A single rate of tax under a BTT type system for corporations should not be hindered by Constitutional concerns
 - Either the 16th Amendment, if it is a new income tax with redefined tax base, or
 - Article I, section 8, if it is not an income tax – i.e., an excise tax
 - *Flint* (1911) decision – tax can be labeled an *excise* on doing business in corporate form
 - Or, *Pollack* decision could be overturned by Supreme Court



Transition Observations

- Short term reserves – ‘prepaid’ tax should have full transition benefit at 35% rate
- Long term timing
 - Depreciation – 2 alternatives
 - Either: (1) Existing tax asset or liability amortized over 3 years; (2) No deduction for remaining basis
 - Or: Simply continue to amortize remaining basis over remaining life of assets
- Deferred taxes offshore income/Deferred tax liability
 - Would have been deferred indefinitely anyway – no U.S. tax
- NOLs – adjust NOL to BTT tax base – e.g., reduce NOL for salaries and wages
- Tax credit carryforwards
 - Foreign tax credit – full transition benefit – consistent with tax treaties
 - R&D credit – 3 year transition – is consistent with GAAP tax asset recognition rules – aligns with public policy



Application of FAS 109

- FAS 109 applies to 'income' tax – can it apply to an economic 'consumption' tax?
 - FASB staff conclude that both Michigan business tax and Texas margin tax possess sufficient 'income' tax characteristics
- 'Legislative intent' and 'economic incidence' tests for 'income' vs. 'consumption' tax distinction
 - 'Legislative intent' – burden of BTT is on corporation
 - 'Economic incidence' – may be no universal view on this



BTT – Tax Treaty Observations

- Many treaty articles may become obsolete
 - Double taxation
 - PE - There would be no need for ECI and double tax treaty articles for U.S. business income – all sales in U.S. would be subject to BTT, regardless of where the sale was negotiated
- U.S. would have limited incentive for bi-lateral Competent Authority negotiations – open season for foreign tax adjustments?
- Sourced based withholding tax treaty provisions – Corporate context becomes obsolete



Summary Thoughts

- Current tax system is challenging and can be professionally satisfying
 - However, not enough IRS and tax professional resources
 - And, management often has limited appreciation for the planning and worth of tax function
- Biggest source of complexity and strain relates to foreign operations and transactions
 - Rangel's approach perpetuates the problem, increases the corporate tax rate, and would not encourage investment
 - 'Territorial tax' a small step forward but is really an extension of the existing model (deferral) and would not create U.S. investment incentive
 - If possible, 'border adjusted' income tax would be the most significant 'reform' to the existing system
- BTT is the only real alternative for less complexity and economic stimulus
 - Hopefully, this presentation confronts and addresses anti-BTT 'red herring' arguments
 - In particular, 'winners and losers' and WTO compatibility



Some Backup Examples

High Export /High Property Cost of Sales/50% Inventory Import

Assumptions			Current Tax Law	BTT		
Cost of Sales As % of Product Sales	50%	Product Sales	5,000,000	1,500,000		
Cost of Sales Labor/Burden %	20%	Cost of Sales - U.S. Inventory	(2,000,000)	(600,000)		
Percent Export Sales	70%	U.S. Labor/Burden	(500,000)			
Operating Income %	30%	Gross Margin	2,500,000	900,000		
Current Effective Tax Rate - U.S. Tax Return	30%	Salaries & Wages	600,000			
BTT Rate	15%	Supplies	200,000	60,000		
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	200,000	60,000		
OASDHI %	1.9%	Total expenses	1,000,000	120,000		
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	1,500,000	780,000		
Cost of Sales Import %	50.0%	Tax Expense Import Value		(45,000)		
		Tax Expense	30%	(450,000)	(117,000)	
		Less: OASDHI Credit			20,915	
		OASDHI Cap			0	
		Adjustment - Not to exceed regular BTT			0	
		Net Tax Expense	30%	(450,000)	(141,085)	9.4%
		Pre-Tax Income		1,500,000	1,500,000	
		Net Income	21%	1,050,000	1,358,915	27%

High Export /High Labor Cost of Sales

Assumptions			Current Tax Law	BTT		
Cost of Sales As % of Product Sales	50%	Product Sales	5,000,000	1,500,000		
Cost of Sales Labor/Burden %	70%	Cost of Sales - U.S. Inventory	(750,000)	(225,000)		
Percent Export Sales	70%	U.S. Labor/Burden	(1,750,000)			
Operating Income %	30%	Gross Margin	2,500,000	1,275,000		
Current Effective Tax Rate - U.S. Tax Return	30%	Salaries & Wages	600,000			
BTT Rate	15%	Supplies	200,000	60,000		
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	200,000	60,000		
OASDHI %	1.9%	Total expenses	1,000,000	120,000		
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	1,500,000	1,155,000	30%	
Cost of Sales Import %	0.0%	Tax Expense Import Value		0		
		Tax Expense	30%	(450,000)	(173,250)	
		Less: OASDHI Credit			44,683	
		OASDHI Cap			0	
		Adjustment - Not to exceed regular BTT			0	
		Net Tax Expense	30%	(450,000)	(128,567)	8.6%
		Pre-Tax Income		1,500,000	1,500,000	
		Net Income	21%	1,050,000	1,371,433	27%

No Export /High Property Cost of Sales/50% Inventory Import

Assumptions			Current Tax Law	BTT		
Cost of Sales As % of Product Sales	50%	Product Sales	5,000,000	5,000,000		
Cost of Sales Labor/Burden %	20%	Cost of Sales - U.S. Inventory	(2,000,000)	(2,000,000)		
Percent Export Sales	0%	U.S. Labor/Burden	(500,000)			
Operating Income %	30%	Gross Margin	2,500,000	3,000,000		
Current Effective Tax Rate - U.S. Tax Return	30%	Salaries & Wages	600,000			
BTT Rate	15%	Supplies	200,000	200,000		
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	200,000	200,000		
OASDHI %	6.3%	Total expenses	1,000,000	400,000		
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	1,500,000	2,600,000		
Cost of Sales Import %	50.0%	Tax Expense Import Value		(150,000)		
		Tax Expense	30%	(450,000)	(390,000)	
		Less: OASDHI Credit			69,718	
		OASDHI Cap			0	
		Adjustment - Not to exceed regular BTT			0	
		Net Tax Expense	30%	(450,000)	(470,282)	31.4%
		Pre-Tax Income		1,500,000	1,500,000	
		Net Income	21%	1,050,000	1,029,718	21%

No Export /High Labor Cost of Sales

Assumptions			Current Tax Law	BTT	
Cost of Sales As % of Product Sales	70%	Product Sales	5,000,000	5,000,000	
Cost of Sales Labor/Burden %	70%	Cost of Sales - U.S. Inventory	(1,050,000)	(1,050,000)	
Percent Export Sales	0%	U.S. Labor/Burden	(2,450,000)		
Operating Income %	10%	Gross Margin	1,500,000	3,950,000	
Current Effective Tax Rate - U.S. Tax Return	30%	Salaries & Wages	600,000		
BTT Rate	15%	Supplies	200,000	200,000	
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	200,000	200,000	
OASDHI %	6.3%	Total expenses	1,000,000	400,000	
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	500,000	3,550,000	10%
Cost of Sales Import %	0.0%	Tax Expense Import Value		0	
		Tax Expense	(150,000)	(250,000)	30%
		Less: OASDHI Credit		193,309	
		OASDHI Cap		(96,655)	
		Adjustment - Not to exceed regular BTT		0	
		Net Tax Expense	(150,000)	(153,346)	30.7%
		Pre-Tax Income	500,000	500,000	
		Net Income	350,000	346,655	7%

No Export /High Property Cost of Sales/75% Import

Assumptions			Current Tax Law	BTT	
Cost of Sales As % of Product Sales	50%	Product Sales	5,000,000	5,000,000	
Cost of Sales Labor/Burden %	20%	Cost of Sales - U.S. Inventory	(2,000,000)	(2,000,000)	
Percent Export Sales	0%	U.S. Labor/Burden	(500,000)		
Operating Income %	10%	Gross Margin	2,500,000	3,000,000	
Current Effective Tax Rate - U.S. Tax Return	35%	Salaries & Wages	600,000		
BTT Rate	15%	Supplies	200,000	200,000	
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	1,200,000	1,200,000	
OASDHI %	6.3%	Total expenses	2,000,000	1,400,000	
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	10% 500,000	1,600,000	
Cost of Sales Import %	75.0%	Tax Expense Import Value		(225,000)	
		Tax Expense	35% (175,000)	(25,000)	
		Less: OASDHI Credit		69,718	
		OASDHI Cap		(34,859)	
		Adjustment - Not to exceed regular BTT		0	
		Net Tax Expense	35% (175,000)	(215,141)	43.0%
		Pre-Tax Income	500,000	500,000	
		Net Income	7% 325,000	284,859	6%

No Export /High Property Cost of Sales/0% Import

Assumptions			Current Tax Law	BTT	
Cost of Sales As % of Product Sales	50%	Product Sales	5,000,000	5,000,000	
Cost of Sales Labor/Burden %	20%	Cost of Sales - U.S. Inventory	(2,000,000)	(2,000,000)	
Percent Export Sales	0%	U.S. Labor/Burden	(500,000)		
Operating Income %	10%	Gross Margin	2,500,000	3,000,000	
Current Effective Tax Rate - U.S. Tax Return	35%	Salaries & Wages	600,000		
BTT Rate	15%	Supplies	200,000	200,000	
Other Compensation As % of Sales	12%	Depreciation/Capital Expense	1,200,000	1,200,000	
OASDHI %	6.3%	Total expenses	2,000,000	1,400,000	
BTT Cap (Pre OASDHI) as % of Book Income	50.0%	Taxable Income	500,000	1,600,000	10%
Cost of Sales Import %	0.0%	Tax Expense Import Value		0	
		Tax Expense	(175,000)	(240,000)	35%
		Less: OASDHI Credit		69,718	
		OASDHI Cap		0	
		Adjustment - Not to exceed regular BTT		0	
		Net Tax Expense	(175,000)	(170,282)	34.1%
		Pre-Tax Income	500,000	500,000	
		Net Income	325,000	329,718	7%