Federal tax reform outlook and the states

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Building a better working world

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Setting the stage

Background to federal tax reform

- American Tax Relief Act, January 2, 2013
- Sequestration
- Ten-year deficit projections and deficit targets
- Growing economy, but slow improvement
- Government funding for FY14 and debt limit debates
- Tax-writing committee chairman future plans and Committees' actions
- OECD Base-erosion and profit shifting

Fiscal cliff bill — *American Taxpayer Relief Act (ATRA)*
Key tax provisions

- **Income tax rates:** This made permanent the 10%, 15%, 25%, 28%, 33% and 35% rates for families with $450,000 or less and individuals with $400,000 or less of taxable income. Taxpayers earning more are taxed at 39.6%, up from 35%.
- **Investment tax rates:** Top capital gains and dividend rates remain at 15% for those below the $450,000/$400,000 income thresholds, and are increased to 20% for those with incomes above those amounts.
  - *Note: The 3.8% tax on investment income under the Patient Protection and Affordable Care Act (ACA) (2010) is applied to capital gains, and dividends rates on AGI greater than $200,000 (single) and $250,000 (couple).*
- **Estate tax:** The $5m per-person estate tax exemption is made permanent and indexed for inflation; the tax rate is increased to 40% from 35%.
- **Alternative minimum tax (AMT):** The individual AMT is patched permanently and indexed for inflation.

Fiscal cliff bill — ATRA
Key tax provisions (cont.)

- **Personal exemption phaseout (PEP) and Pease:** The PEP and overall limit on itemized deductions (Pease) is reinstated for families with incomes over $300,000 and individuals with incomes over $250,000.
- **Roth retirement account conversions:** Conversions from 401(k)s to Roth accounts prior to retirement are permitted, subject to ordinary income tax treatment.
- **Other credits:** The American Opportunity Tax Credit, the Enhanced Child Tax Credit and the enhanced Earned Income Tax Credit are extended for five years.
- **Extenders:** Business and other tax extenders are extended through 2013. These provisions include the R&D tax credit, the active financing exception under Subpart F, the controlled foreign corporation (CFC) look-through rule, the IRA charitable rollover that allows for donations to be made from an IRA tax-free, and state and local sales tax deduction. The 50% bonus depreciation provision is also extended for one year.

Budget Control Act (BCA) sequester: how did we end up here?

2011 debt limit debate

The standoff over increasing the debt limit in the summer of 2011 produced the BCA, which includes spending caps and a select committee, with sequestration as a backstop to each.

Supercommittee

The Joint Select Committee on Deficit Reduction was tasked with producing at least $1.2t in spending cuts for FY2013–2022, lest that level of savings be achieved through sequestration — a draconian mechanism meant to force a deal.

Failure to replace sequester

The expectation that the sequestration cuts would be replaced with less onerous savings never materialized, in part because of a standoff over tax increases. The sequester was delayed for two months by the fiscal cliff bill, however.

The BCA was structured so at least $2.1t in deficit reduction is achieved over 10 years:

Over 10 years, $917b saved through a combination of statutory caps on discretionary spending for FY2012–2021.

At least another $1.2t in savings achieved through the “Supercommittee” or sequestration achieve that level of savings FY2013–FY2021.

BCA sequester: what does it really mean?

$85b	in spending cuts for fiscal year 2013, split between defense and non-defense spending

- 7.8% reduction defense discretionary funding
  - Military programs, research, family housing
- 5.0% reduction in nondefense discretionary funding
  - Includes funding for Congress, White House salaries and expenses
  - Agency budgets, including treasury department, labor department
    - e.g., IRS enforcement, business systems modernization
- 2.0% reduction to Medicare
- 5.1% reduction to other nondefense mandatory programs, such as:
  - Section 1603 grants for specified energy property in lieu of tax credits
  - Build America bond payments
  - Payments to issuers of new clean renewable energy bonds

$1.2t	in total spending cuts FY2013–2021

Ten-year deficit reduction target: $14t

Status report	
$1.2t	Reduced spending from sequestration
$ 917b	Savings from caps on discretionary spending
$ 750b	Tax increases and interest savings from ATRA
$2.867t	Total deficit reduction
$1.133t	**Additional reduction needed to reach $4t goal set by president**

Congressional Budget Office (CBO) budget and economic outlook: fiscal years 2013 to 2023

- Deficits shrinking and debt stabilizing over the next few years, but swelling again toward the end of the decade — "high and rising debt"
  - Increase attributable to: aging population, rising health care costs, an expansion of federal subsidies for health insurance = higher outlays
- Deficit: 3.9% of GDP in FY2013; 2.1% 2015; 3.3% 2023; 5.8% 2033
- Debt held by the public: 73% of GDP in 2013, 71% 2023; 89% 2023
- Revenues: 17% of GDP in 2013; 18.5% 2015 and 2023; 19.3% 2033
- Outlays: 20.8% of GDP in 2013; 21.8% 2023; 25.1% by 2033
    - Source: CBO Long-Term Budget Outlook, Sept. 2013

House and Senate budget resolutions

	House GOP FY2014 budget	Senate Democrats' FY2014 budget
Deficit reduction	► Aims to balance budget over 10 years — $4.6t in deficit reduction ► Calls for bringing outlays down to 19.1% of GDP by 2023 to match projected revenue of 19.1% of GDP in that year ► Would reduce debt held by the public to 55% in 2023	► Calls for $1.85t in deficit reduction: $975b from spending cuts, $975b in tax increases ► Calls for outlays of 21.9% of GDP in 2023, compared to revenue of 19.8% of GDP ► Would reduce debt held by the public to 70% in 2023
Tax	Calls for tax reform to: ► Lower the top statutory income tax rates to 25% for individuals and corporations ► Provide a more competitive system of international taxation	► Provides reconciliation instructions for increasing revenues by $975b/10 years; tax reform could move under reconciliation or separately ► Suggests revenue could come from limiting deductions, closing loopholes for wealthy and corporations; mentions offshore tax abuse, carried interest, corporate jets
Health care	► Calls for repealing the coverage expansion under the ACA, converting Medicaid to a block grant program and converting Medicare to a premium support system for beneficiaries ages 55 and older	► Calls for building upon provisions of the ACA to achieve $275b in savings through health care delivery system reforms and cutting waste and fraud

Federal tax reform - general

Three main buckets of tax reform

Corporate

- General consensus is that many tax expenditures should be eliminated in favor of lower rate.
- Republicans target 25%.
- Democrats aim for 28%.

International

- Republicans pushing for territorial system.
- Democrats skeptical of territorial over base erosion concerns.
- Republicans also favor anti-base erosion provisions — making international tax reform revenue neutral.

Individual

- Republicans propose lowering top individual rate to 25%; only one other bracket of 10%.
- Rescinding individual tax expenditures among most politically risky elements of tax reform.
- Likely source of deficit reduction revenue

Issues:

- Impact on pass-through entities if expenditures eliminated, only corporate rate lowered?
- Will large pass-through entities be taxed as corporations?
- Can corporate rate be lowered enough to make losing tax expenditures worth it?
- Will deductibility of interest be limited?

House W&M Committee Chairman Camp's tax reform discussion drafts

International

Released 29 October 2011

- Participation exemption for foreign income received from CFCs by domestic corporations that are 10% US shareholders
- Options for base erosion:
  - a) The administration's excess returns proposal
  - b) Income earned not taxed above a certain threshold (e.g., 10%) treated as low-taxed cross-border income
  - c) New category of subpart F income derived by CFCs from intangibles

Financial products

Released 24 January 2013

- Requires derivatives to be marked to market unless they qualify as hedges for tax purposes
- Expands range of transactions to which the mark-to-market requirements could apply:
  - Agreements to buy or sell any stock in a corporation or an interest in a partnership
  - Employee stock options and other forms of executive compensation
  - Possibly real estate, including leases and sale transactions involving multiple properties

Small business

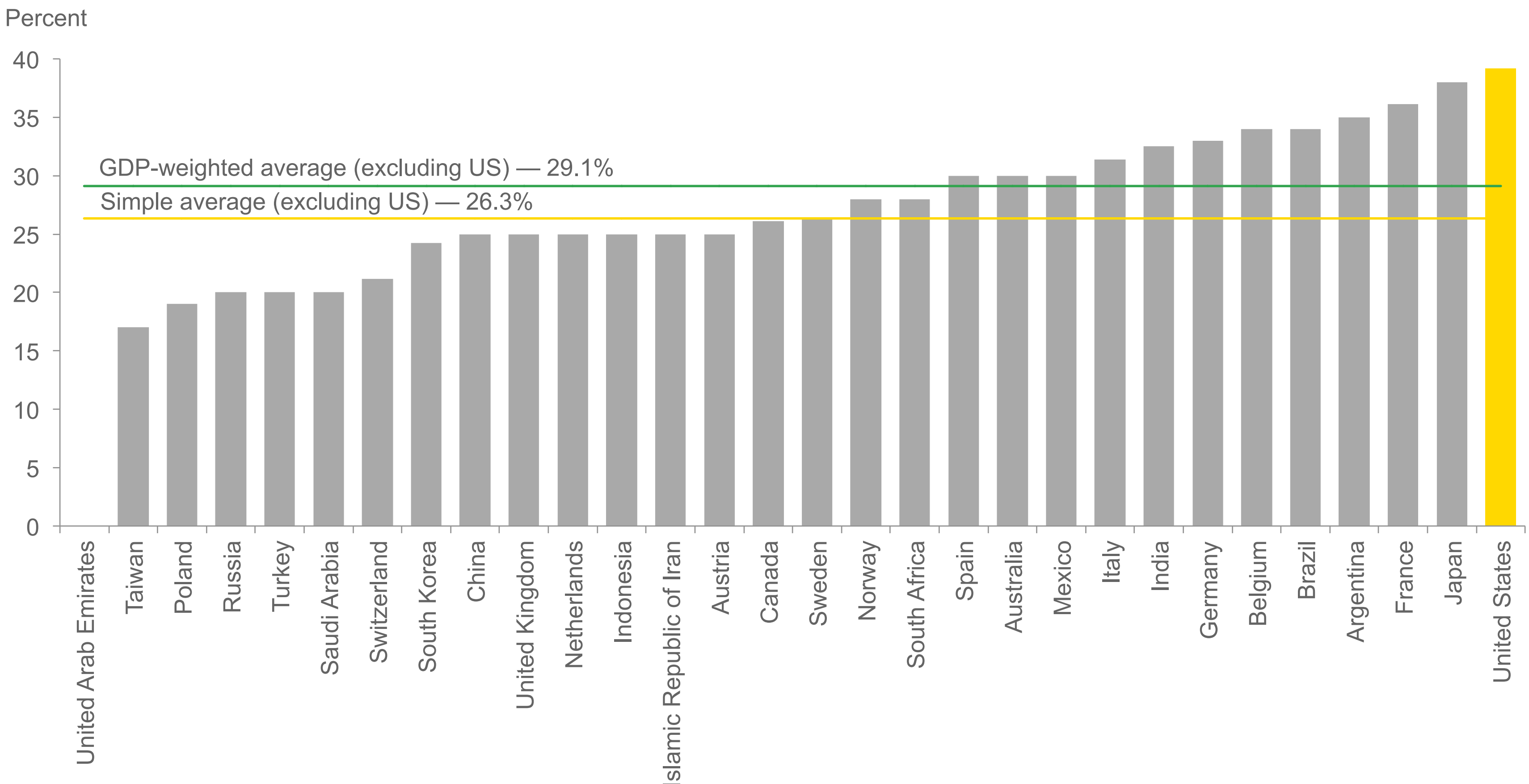
Released 12 March 2013

- Make permanent Section 179 small business expensing levels at $250,000, phased out over $800,000
- Allow businesses with gross receipts of $10m or less to use the cash method of accounting
- Two options for reforming the rules for businesses organized as S corporations and partnerships:
  - Incremental changes to the current system

  Or

  - Repeal Subchapters K and S and provide a new set of rules for non-publicly traded businesses

Corporate tax rates in the top 30 economies, 2013



Note: includes both national and sub-national statutory corporate tax rates
Source: Ernst & Young LLP, OECD, IMF.

Challenges of corporate tax base broadening

1 **Cutting tax expenditures to lower the rate**

- Roughly, a 1%-point reduction in the US corporate tax rate costs \$110b–\$120b/10 years
- Thus, reducing the statutory corporate rate from 35% to 25% requires “base broadening” of up to \$1.2t/10 years

JCT memo on reducing corporate rate 2

- October 2011 memo to Rep. Levin: reduction in corporate tax rate to 28% is estimated to cost \$717b/10 years
- \$634b derived from repealing expenditures for manufacturers: accelerated depreciation and domestic production deduction

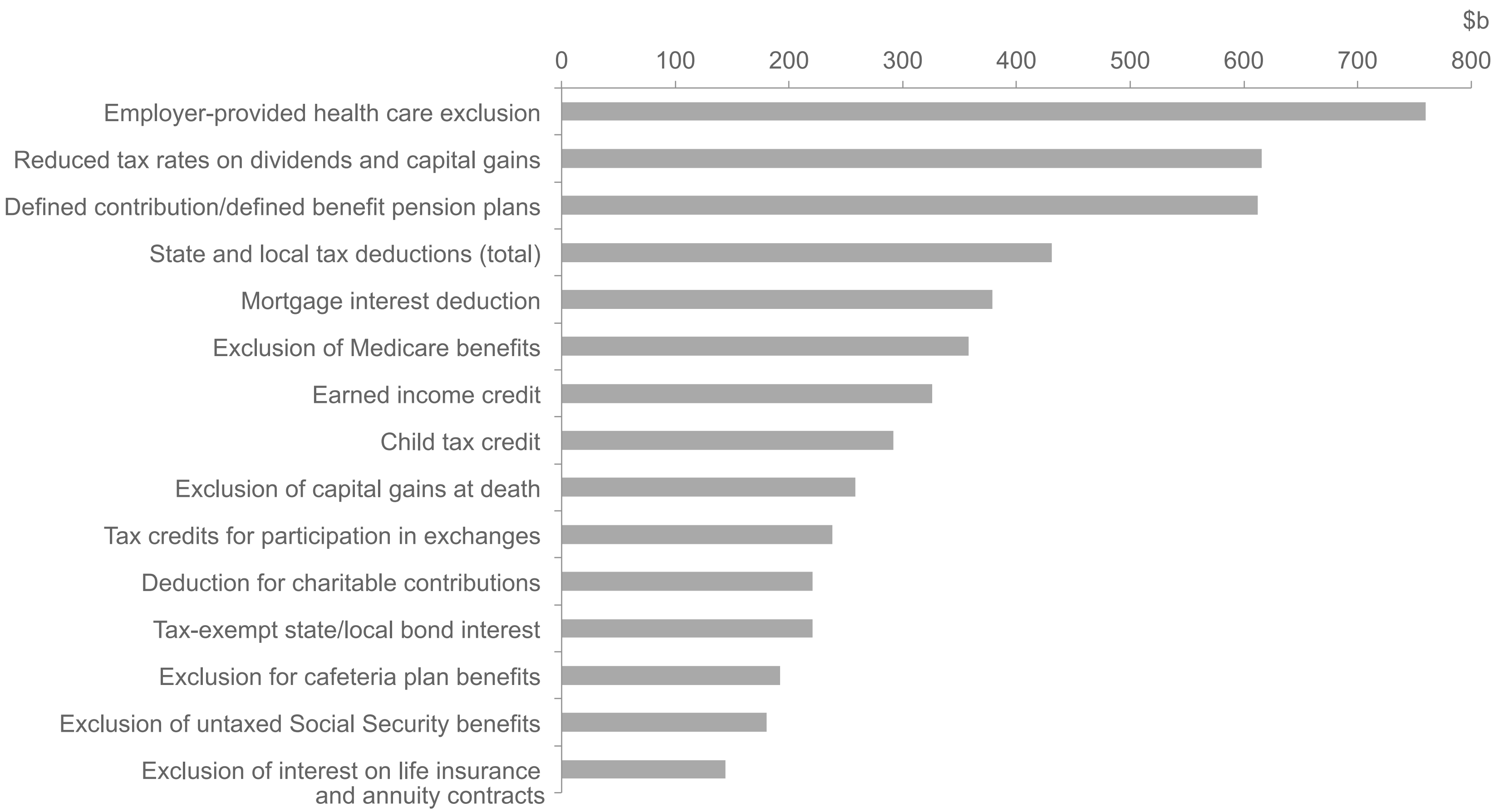
Top individual expenditures

1. Exclusion for employer-provided health care
2. Capital gains and dividend rates
3. Pension plans
4. State and local tax deduction
5. Mortgage interest deduction

Top corporate expenditures

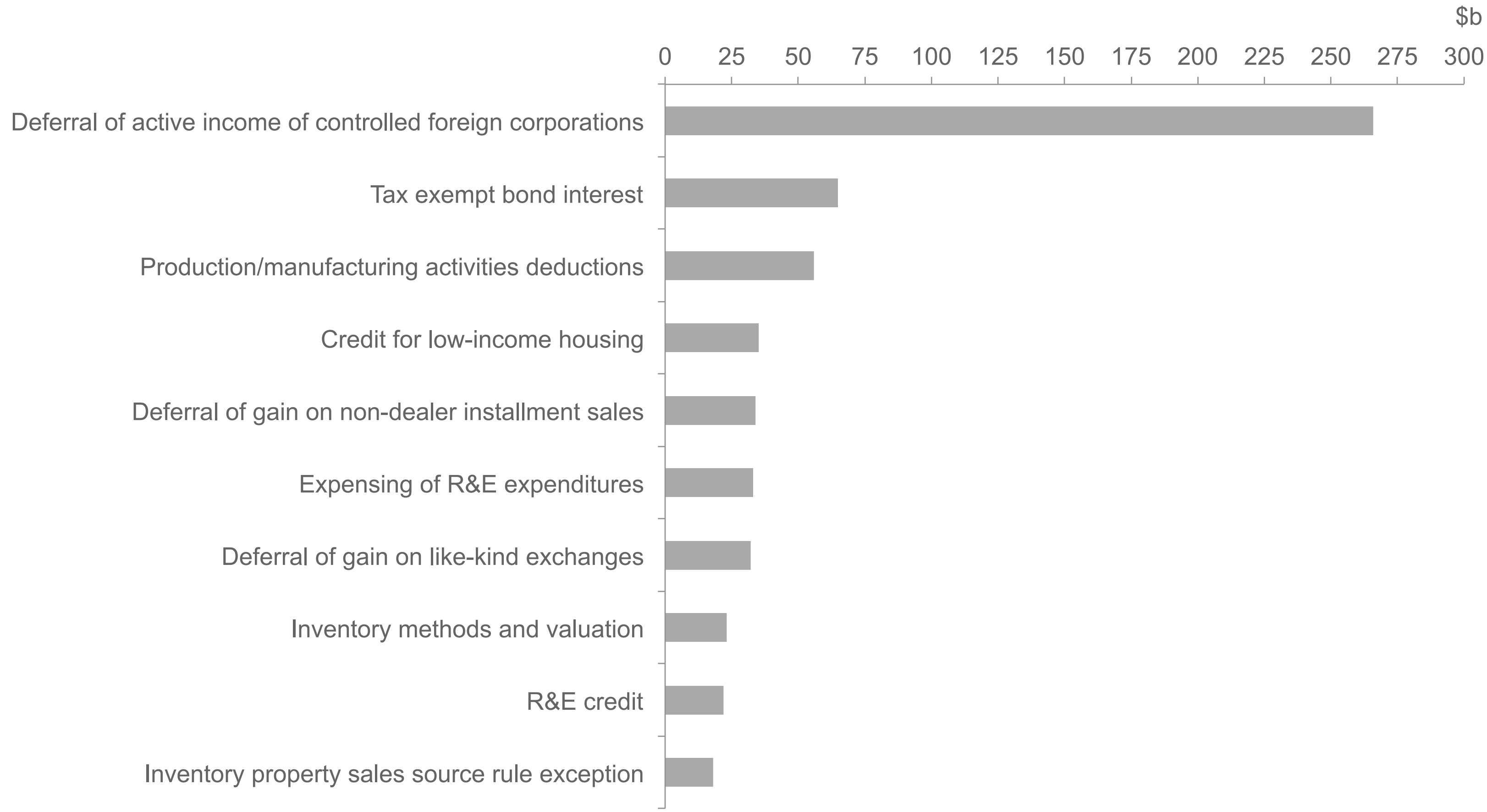
1. Deferral
2. Tax-exempt bond interest
3. Manufacturing activities deduction
4. Credit for low-income housing
5. Deferral of gain on non-dealer installment sales

Top 15 individual tax expenditures: FY2013–17



Source: Joint Committee On Taxation (JCS-1-13) and Ernst & Young LLP calculations.

Top 10 corporate tax expenditures: FY2013–17



Source: Joint Committee On Taxation (JCS-1-13) and Ernst & Young LLP calculations.

President’s framework for business tax reform: at a glance

Cut provisions to cut corporate rate

- 28% corporate rate
- No comprehensive list of provisions to be cut, but some highlighted:
  - LIFO, oil/gas, carried interest, jet depreciation
- Depreciation, deductibility of interest expense should also be considered

Manufacturing incentives

- Cut effective rate for manufacturers to 25% by refocusing Sec. 199 manufacturing deduction
  - Increased to 10.7%
- Permanent R&D credit
- Energy incentives

International tax

- Comes out against pure territorial system
- US-based companies to pay an unspecified minimum tax on foreign earnings

Small business

- Make tax filing simpler
- Allow expensing up to $1m in investments
- Allow cash accounting on businesses with up to $10m in gross receipts

Fiscal responsibility

- Plan revenue neutral, but $250b required to make permanent temporary provisions that are routinely extended
- Temporary provisions: paid for or eliminated

House Ways and Means Chairman Camp's tax reform "discussion draft" — key elements

Tax rate	Dividends received deduction	Transition rules	CFC rules	Subpart F	"Base-erosion" rules
▸ 25% maximum corporate rate (no offsets specified) ▸ (Stated intent for 25% individual top rate as part of broad reform)	▸ 95% deduction for the foreign-source portion of dividends received from CFCs ▸ 5% subject to tax (1.25% effective rate) ▸ No regime for allocating US – incurred expenses to foreign-exempt earnings ▸ 95% deduction for gain on disposition of stock in certain active CFCs (no deduction for losses)	▸ 5.25% mandatory tax on pre-effective date foreign earnings, which can be spread over a period of up to eight years (with interest) ▸ Actual distribution of these same earnings subject to an additional 1.25% tax	▸ Treat foreign branches as CFCs ▸ Treat foreign corporations that are not CFCs but have 10% US corporate shareholders (10/50 corps) as CFCs	Retains the framework of "subpart F" but repeals: ▸ The current inclusion rule for investment of earnings in US property ▸ The income exclusion for previously taxed earnings	▸ "Thin cap" rule: limit deductibility of net interest expense if a US company that is a member of a worldwide group fails a two-part test In addition, three proposed options: ▸ Treat "excess income" from transfers of intangible property as subpart F income ▸ Include a new category of subpart F income for "low-taxed cross-border income" ▸ Tax all of a CFC's foreign intangibles income as subpart F income subject to a 15% tax rate

OECD project on base erosion and profit shifting

- OECD report “addressing base erosion and profit shifting” (BEPS) released 12 February 2013
  - Project originated with G20 and also is closely linked with G8
  - Focus areas are same as those being considered as part of international tax reform in the US
- Background document that sets stage for future work by OECD and countries
  - Stresses importance of coordinated action by countries
- Initial comprehensive action plan issued in July 2013
  - 15 specific actions specified to address BEPS
  - Set deadlines to implement these actions – next 2 to 3 years
  - Identify resources needed and methodology to implement these actions

OECD BEPS: six “key pressure areas”

1. International mismatches in entity and instrument characterization
2. Application of treaty concepts to profits derived from delivery of digital goods and services
3. Tax treatment of related-party debt financing, captive insurance and other intra-group financial transactions
4. Transfer pricing, particularly in relation to shifting of risks and intangibles, artificial splitting of ownership of assets between legal entities, and transactions between related-party entities that would rarely take place between independent entities
5. Effectiveness of anti-avoidance measures, in particular general anti-avoidance rules (GAARs), CFC regimes, thin capitalization rules and rules to prevent tax treaty abuse
6. Availability of harmful preferential regimes

Federal tax reform – specific to state and local tax issues

Tax-writing committee hearings, working groups, and option papers

- House Ways & Means (W&M) Committee hearing on federal taxation and S&L government finance, March 15, 2013
  - Focused on state and local tax deductions, tax preferred bonds, tax exemption of state and municipal income and treatment of aid of construction for water utilities
- W&M had 11 tax reform working groups, none only on S&L
- Senate Finance Committee had 10 subject matters for member discussions, none only on S&L
- Senate Finance Committee issued 10 tax reform option papers
  - Infrastructure, Energy and Natural Resources: tax exempt bonds/credits
  - Economic and Community Development: S&L tax deductions and bonds

Potential effects on state and local governments

- Lower federal tax rates, absent any tax base changes
  - Reduces the value of deductions and tax-exemption
  - Increased rates on high-income taxpayers for 2013: Any positive effects?
- Potential loss or scaling back of specific S&L tax provisions
  - Tax-exempt bond financing
  - State and local tax itemized deductions
  - Builder bond tax credits
- Potential base expansion
  - Individual income tax
    - Potential switch from deductions to tax credits
    - Reduced exclusions, exemptions or deductions
  - Corporate income tax
    - Expanded tax base (e.g., repeal of accelerated depreciation, LIFO inventory with recapture, Sec. 199 domestic production deduction, thin capitalization, others)
    - Depends on state piggybacking and decoupling from federal tax base

Potential state tax increases from base expansions, if states don't lower rates

- Individual income tax
  - Potential switch from deductions to tax credits
  - Reduced exclusions, exemptions or deductions
  - Timing issues (e.g., conversions of traditional to Roth IRAs)
  - Distributional issues will be important for individual income tax issues
- Corporate income tax
  - Expanded tax base (e.g., repeal of accelerated depreciation, LIFO inventory with recapture, Sec. 199 domestic production deduction, thin capitalization, others)
  - Base broadening, particularly for corporations, could be significant, but much could be timing and could already be decoupled
  - Much of the action will be on international – potential reduction in income shifting, fewer interest deductions and more royalty payments
    - Most states already give 100% DRD for foreign source dividends, so move a territorial dividend exemption would not lose state revenue
  - Depends on state piggybacking and current decoupling from federal tax base

Some facts about S&L tax deductions and bonds

- On federal 2010 individual income tax returns:
  - 46.3 million tax returns claimed $445 billion of state and local tax deductions
  - 32% of the 143 million tax returns
  - 24% of total S&L general revenue from own sources
  - 7.2 million filed AMT return with S&L taxes of $177 billion
  - 6.1 million reported tax-exempt interest income of $75 billion
- From Federal Reserve Board Flow of Funds
  - $3.7 trillion of municipal loans and securities as of 2013Q2
    - $2.97t S&L governments; $236b non-profit organizations; $515b non-financial corporations (industrial revenue bonds)
    - $2.7t held by households directly or in money market or mutual funds
    - $861b held by financial institutions
- From BEA National Income and Product Accounts
  - $211b of interest payments in 2012, 9% of total current expenditures
  - Interest payments include interest accrued on actuarial liabilities of DB pension plans.

Other Federal state & local tax issues

- Exercise federal authority for uniformity of state tax rules
  - Digital Goods & Services Tax Fairness Act (113th Congress, Sens. Thune & Wyden)
  - Mobile Workforce State Income Tax Simplification Act (112th, Brown)
  - Telecommuter Tax Fairness Act (112th, Lieberman & Blumenthal)
- Authorize state to require out-of-state vendors to collect sales tax
  - Market Place Fairness Act (113th, Enzi, Durbin, Alexander)
- Prohibitions on certain S&L taxes
  - Permanent Internet Tax Freedom Act (113th, Ayotte)
  - Business Activity Tax Simplification Act (112th, Reps. Goodlatte & Scott)

From Senate Finance Committee Tax Reform Options Economic and Community Development

Federal tax reform – prospects

Conclusion: the future for federal tax reform?

- When, not if
- Scope still undetermined: individual, business, and/or corporate
  - No serious discussion of VAT until income tax reform is exhausted
- The Tax Council/EY Tax Reform Business Barometer (early September)
  - Over 70% of business respondents believe a detailed tax reform plan (substantial tax base broadening or changes in rates for corporate and/or individuals) will be worked on by House Ways & Means Committee
  - 43% expect House W&M Committee to pass tax reform legislation in 2013.
  - One-in-five expect tax reform legislation through the Senate Finance Committee in 2013.
  - One-quarter of respondents think federal tax reform will be enacted by the end of 2014.
  - Biggest hurdle to tax reform is the revenue neutrality vs. revenue raising issue (83% ranking first or second) followed by reluctance to reduce major individual tax expenditures (57%).
- Stay tuned. Federal tax reform will result in winners and losers among households, companies and the states.