Should the U.S. Tax System be Overhauled?

Lisa H. McKinney, CPA
The University of Alabama

Why is Tax Reform Needed?

Why is Tax Reform Needed?

Complexity

- Code is 2,600 pages
- Regulations, IRS guidance, court cases add 70,000 pages (26,000 pages in 1986)
- Tax compliance cost estimated at $409 billion
- Examples:
  - Sec. 7703 definition of marriage = 218 words
  - Education incentives = over 12 provisions, 100 pages of IRS instructions

Why is Tax Reform Needed?

Complexity

- Tax Preparer Fees
  2008: 41% of individuals used tax preparer
  2015: rose to 57%
- Tax industry consumed 6.1 billion hours of 3 million worker's time at $168 billion cost (*Source: National Taxpayer Advocate, 2012*)
- The National Taxpayer Advocate's annual report designates the complexity of the tax code as the #1 most serious problem facing taxpayers.

Why is Tax Reform Needed?

Uncertainty

- It's very hard to do business in such an atmosphere.
  Example: Extenders phase 2010-2016
  Example: Sec. 179
- Stability and responsiveness is important.

Why is Tax Reform Needed?

IRS Struggling

- 2016: IRS failed to answer 62% of phone calls.
- 2004: IRS answered 87% with average wait time of 2½ minutes.
  2012: IRS answered 68% with average wait time of 17 minutes.
- $21 billion in fraudulent tax refunds paid by IRS over 5 years as of 2012 (*Source: U.S. Treasury Inspector General*)

Why is Tax Reform Needed?

Why Reduction in Corporate Tax Rate?

- OECD study: Corporate tax was at top of list of most detrimental taxes on both job creation and economic growth.
- All other OECD countries are drastically lower than this.
- Most other OECD countries do not have double taxation.

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Why is Tax Reform Needed?

Why Reduction in Corporate Tax Rate?

- Corporate taxes can:
  - Reduce economic output.
  - Create distortions and misallocations of resources (reduce consumption)
  - Be a "drag on the economy"
- Economic efficiency argument

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Why is Tax Reform Needed?

"America's tax code is an **economic straightjacket**. What is needed is a modern tax code that will help boost the nation's economy, making the U.S. more competitive in the global marketplace, spark innovation, and create jobs. It should be simpler and much more efficient, giving everyone a chance to get ahead."

-- Sen. Ron Wyden (D-OR), Ranking Member, Senate Finance Committee

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Why is Tax Reform Needed?

"The tax code distorts the market and often drives the decisions businesses take. Instead of focusing on growth and hiring, businesses have to spend too much time and too many resources on taxes—both at home and abroad. Stop-and-go tax extender policies are another example of our broken tax code. The [extender] bill had a shelf life shorter than a carton of eggs. And now taxpayers are back in the dark, forced to guess if and when Congress will act. And any time Congress spends on extenders is time it's not spending on comprehensive reform."

-- Sen. Ron Wyden (D-OR), Ranking Member, Senate Finance Committee

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Why is Tax Reform Needed?

"First, Congress must continue to focus on domestic growth and job creation. Tax reform should take the straitjacket off our economy. The tax code should spark investment. I believe your economic recovery will go from a walk to a sprint when middle class families are seeing bigger paychecks. Second, our corporate tax system needs to be much more internationally competitive. That means lowering rates and helping American companies compete on a level playing field with the rest of the world."

-- Sen. Ron Wyden (D-OR), Ranking Member, Senate Finance Committee

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Why is Tax Reform Needed?

"Third, tax reform must be fiscally prudent. At a minimum, our efforts should create a sustainable revenue base to meet our country's needs over the long term. Congress cannot gamble with the nation's financial health by looking to budget gimmicks, timing shifts, or questionable, unproven math."

-- Sen. Ron Wyden (D-OR), Ranking Member, Senate Finance Committee

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Why is Tax Reform Needed?

"Finally, it's crucial that the tax reform process goes through regular order and not through budget reconciliation. If the goal is bipartisan policies, the process can't start with partisanship. And reconciliation is the partisan route. Tax reform has to yield sustainable policies that will stand the test of time. Undertaking tax reform through what has become an almost inherently partisan process jeopardizes its durability."

-- Sen. Ron Wyden (D-OR), Ranking Member, Senate Finance Committee

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Why is International Tax Reform Needed Specifically?

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Why is International Tax Reform Needed?

International Competitiveness

- Factors of production (especially capital!) are very mobile now
- To attract capital, need business taxes to be competitive
- Worldwide deferral system in US is **"uniquely uncompetitive"**

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Why is International Tax Reform Needed?

Background: International Tax System options

- Full inclusion worldwide tax system: use foreign tax credits to reduce double taxation
- Territorial (full exemption) tax system: generally do not use credits
- US worldwide hybrid system
  - Full inclusion approach with some income
  - Exemption approach with active income

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Why is International Tax Reform Needed?

- Full territorial exemption system: Has been adopted by all major trading partners of US
- OECD member countries (25 of 30 leading developed economies) have territorial system
- Remaining 4 OECD have worldwide system with deferral but with significantly lower tax rates

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Why is International Tax Reform Needed?

How is it "uniquely uncompetitive"?

- Locks out US reinvestment in foreign earnings
- Very high rate on repatriated foreign earnings
- Foreign tax credit limitation complexities over allocate domestic expenses and over limit use of creditable foreign taxes
- Very strict controlled foreign corporation anti-abuse rules (target active not just passive income)
- No OECD member country or significant trading partner has general expense disallowance rules relating to "foreign expenses"

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Why is International Tax Reform Needed?

Hoarding Overseas

- US has worldwide tax system
- Exception: For earnings permanently reinvested overseas, tax is deferred until earnings are repatriated back to U.S.
- Estimate $2 trillion earnings held overseas

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Why is International Tax Reform Needed?

Hoarding Overseas

- Biggest disadvantage of current system?
- **Lock-Out Problem:** Locks out US reinvestment in foreign earnings (Sec. 956)
- Very high rate on repatriated foreign earnings
  - US hybrid system is deferral system not exemption system
- Counterargument: But companies have found ways to repatriate without US tax.

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Why is International Tax Reform Needed?

Inversions & Corporate Flight

- Examples of corporate inversions in recent years
- Cancelled Pfizer-Allergan merger
- Corporate flight:
  1960: 17/20 of largest companies were U.S. based
  2015: dropped to 6/20

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Why is International Tax Reform Needed?

- US corporate tax rates higher than every country except UAE
- 1988: US tax rate was 12% below average G7 rate
  1998: 6% below
  2009: 5.5% <u>above</u>
- Enacted Sec. 7874: "The tax equivalent of the Berlin wall"

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Why is International Tax Reform Needed?

- 1965: US = more than 50% of world's outbound foreign direct investment
- 2010: U.S. = 17.9% of the world's outbound foreign direct investment
  —a drop of more than 64%

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Why is International Tax Reform Needed?

"What's the right business tax revenue design for the U.S. which promotes productive and desirable employment, enhances our citizen's standard of living and meet the reasonable revenue needs of the government, while at the same time promoting the long-term success of our American-based businesses?"

– P&G Vice President Timothy McDonald, 2010

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Why is International Tax Reform Needed?

"In a world of carrots and sticks, we in the US run our international tax policy using almost all sticks and no carrots, and we wonder, **'Why are there fewer rabbits than we would like?'** If our system was more competitive and similar to the rest of the developed world, perhaps there would be more new business opportunities occurring in the US and perhaps greater IP ownership in the US."

– P&G Vice President Timothy McDonald, 2010

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Why is International Tax Reform Needed?

"I believe that **globally successful U.S. headquartered companies** play a critical and disproportionate role in achieving these tax policy objectives. Proposals which focus on a theory but unilaterally deviate in uncompetitive ways from the rest of the world deprive American companies, such as mine, of earnings and cash flow for business activity in those other markets. This unilateral **loss of profitability and cash flow** will affect the longer term success and viability of even great U.S.-headquartered companies. In potentially losing the competitiveness race, we will lose our scale and longer-term competitiveness in the U.S. domestic market."

– P&G Vice President Timothy McDonald, 2010

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The Budget Deficit Issue

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The Budget Deficit Issue

- Raising individual income taxes is not going to be enough.
- Study by Brookings-Urban Institute Tax Policy Center in 2010
  - To get the budget deficit to 2% of GDP from 2015–2019 without raising taxes on people in the lowest income tax brackets, you would have to more than double income tax rates on people in the top three brackets
  - Top rate would have to increase from 35% (top in 2010) to 76%.
  - If only raise tax rates on people with incomes over $250,000 MFJ/$200,000 S, top rates would have to increase by 160% to a top rate of 91%.

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The Budget Deficit Issue

What if we raise corporate income taxes?

- "There is not enough money in the corporate income tax to make a dent in our projected budget deficits."
- 2010 projection: Would have to double the corporate income tax rate to 70% to get the deficit to two percent of GDP in the last five years of this decade, assuming no inversions.
- Treasury revenue estimates in 2010: Eliminating all corporate tax preferences including the domestic manufacturing deduction, accelerated depreciation and the R & D credit would raise only about $460 billion over five years—less than 12% of the revenue needed to get the deficit to 2% of GDP.

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The Budget Deficit Issue

What if we raise international taxes?

- 1997-2004: US collected only $13 billion a year in tax on foreign-source income of US companies
- 2010: Less than 1% of all US tax revenues

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The Budget Deficit Issue

- Tax Policy Center: "Reducing the federal budget deficit to a level that is sustainable over the long run will require either more comprehensive tax reform or tapping a new source of revenue such as a value-added tax."
- "You can't tax your way out of a fiscal gap."

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The Budget Deficit Issue

- Revenue Neutrality: Is this really the right question?
- Static vs. dynamic scoring
  - Dynamic: takes account of GDP effect

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House Republication Tax Plan: The Blueprint

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House Republican Tax Plan: The Blueprint

- "A Better Way: Our Vision for a Confident America—Tax"
- Significant tax reform and simplification
- Released in summer 2016
- Last of 6 policy proposals: Poverty, National Security, The Economy, The Constitution, Health Care, and Tax Reform
- Cornerstone = elimination of many tax expenditures for purposes of (1) simplification and (2) deficit reduction

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House Republican Tax Plan: The Blueprint

- "Numerous other exemptions, deductions, and credits for individuals riddle the tax code."
- Office of Management and Budget (OMB): 169 tax expenditures in the Code
- Cost of tax expenditures = $1.4 trillion vs. tax revenue collected = $3.3 trillion (2015)

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House Republican Tax Plan: The Blueprint

"Because these changes will significantly reduce the complexity and compliance burdens of the current system, the approach reflected in this Blueprint will mean that the revised tax filings for most Americans will be simple enough to fit on a postcard."

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Trump Administration Proposal

Trump Administration Proposal

Uniform Framework for Fixing Our Broken Tax Code

- Released 9/27/17 after 5 months collaboration with the Big 6 (the leaders of the House & Senate, the chairman of the chambers' tax writing committees, National Economic Council Director, & Treasury Secretary.)
- Released by Trump administration and Congressional GOP leaders

Trump Administration Proposal

- Significant tax cuts and simplification
- Provides "broad suggestions" to Congressional tax-writing committees for tax reform
- Delegates to the committees development of specific rules and regulations and legislative language

Trump Administration Proposal

INDIVIDUALS

- Lowering current rates with 3-brackets: 12%, 25%, 35%*
- Possibility of 4th bracket at the top
- But no release of income ranges for each bracket
- More accurate measure of inflation increases

*Blueprint had 33%

Trump Administration Proposal

INDIVIDUALS

"An additional top rate may apply to the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers."

Trump Administration Proposal

INDIVIDUALS

- Double Standard Deduction:
  Single $12,700   MFJ $24,000
- Simplification: Cutting those that take itemized
- Family of four:
  Old rules: $12,700 + $16,200 = $28,900
  Proposed rules: $24,000
- *Note: Blueprint & Trump campaign eliminated HH status*

Trump Administration Proposal

INDIVIDUALS

"Typical families in the existing 10% bracket are expected to be better off under the framework due to the larger standard deduction, larger child tax credit and additional tax relief that will be included during the committee process."

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Trump Administration Proposal

INDIVIDUALS

- Eliminate all itemized except:
  Home mortgage interest
  Charitable contributions
- Why? "These tax benefits help accomplish important goals that strengthen civil society, as opposed to dependence on government: homeownership and charitable giving."
- Eliminate personal and dependent exemptions (nonresident alien issue)

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Trump Administration Proposal

INDIVIDUALS

- Eliminate "numerous other exemption, deductions, and credits"
- But not those that are meant to encourage work, higher education, and retirement.
- Probably keeping EITC, AOTC, tuition deduction, student loan interest deduction*

* Blueprint: Streamline education provisions, consolidate retirement plans, more oversight & more incentive to work on EITC

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Trump Administration Proposal

INDIVIDUALS

- Significantly increase child tax credit
- Increase income limitations (now $110,000 MFJ and $75,000 S)*
- $500 credit for non-child dependents (in addition to current dependent care credit?)

*"The modified income limits will make the credit available to more middle-income families and eliminate the marriage penalty in the existing credit."

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Trump Administration Proposal

ESTATE TAX

- Eliminate estate tax & GSTT
- No mention of gift tax (presumably will still be in effect)
- Trump campaign: modified carryover basis for estate or deemed sale of capital asset at death with allowance of up to the first $10 million of gain recognized due to the deemed sale

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Trump Administration Proposal

AMT

- Eliminate AMT
- *Note: But this proposal eliminates those deductions that caused it anyways.*
- "[I]t no longer serves its intended purpose and creates significant complexity. This framework substantially simplifies the tax code by repealing the existing individual AMT, which requires taxpayers to do their taxes twice."

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Trump Administration Proposal

CORPORATE

- 20% corporate tax rate*
  - Trump said this is the perfect number and non-negotiable.
  - Might be phased-in
- Eliminate corporate AMT
  - Will unused minimum tax credits expire unused?

*Blueprint: 25% rate; Trump campaign: 15% rate

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Trump Administration Proposal

CORPORATE

"America's outdated tax code has fallen behind the rest of the world – costing U.S. workers both jobs and higher wages. In response, the framework puts America's corporate tax rate below the average of other industrialized countries and promotes greater investment in American manufacturing."

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Trump Administration Proposal

CORPORATE

- 100% bonus depreciation for investments for 5-year period beginning in 2017 (now 50%, scheduled to phase down to 30% by 2021)
- Excludes "structures" and land
- No specific mention of Sec. 179 expensing for small businesses, but "The committee may continue to work to enhance unprecedented expensing for business investments, especially to provide relief for small businesses."

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Trump Administration Proposal

CORPORATE

- Eliminate Sec. 199 DPAD
- Eliminate unspecified "special interests", which would broaden the tax base
- No change to R&D credit or low-income housing credit
- Fate of other business credits uncertain*

*Blueprint: eliminates all business credits other than R&D

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Trump Administration Proposal

Energy Credits

- No word on wind production tax credit or solar investment tax credit will be retained.
- Hopeful that electricity and liquid renewable fuels energy tax credits that expired in 2016 will be back.

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Trump Administration Proposal

CORPORATE

More on special interest deductions:

- "Special tax regimes" that apply to certain industries may be adjusted
- Adjustment would be made to reflect "economic reality" and to curb tax avoidance.*

*Blueprint: Taxes would be "tied to business cash flow" allowing for immediate expensing of both tangible and intangible assets. Logic: This would drive growth in jobs, payroll, and the economy.

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Trump Administration Proposal

CORPORATE

- Partial limitation on net interest expense of subchapter C corporations
(not full as originally proposed)
- Committees instructed to consider this for non-corporate taxpayers as well.
- No details on how to compute
  - Denial of a percentage of the net interest expense (30%, 40%) as in EU?
  - Denial of a percentage of a particular income base (EBITDA)?

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Trump Administration Proposal

PASS-THROUGH ENTITIES

- 25% rate for pass-through income
- But will need rules that will prevent the owners from converting compensation ordinary income to pass-through income, particularly in service businesses.
- "Small businesses drive our economy and our communities, and they deserve a significant tax cut. This framework creates a new tax structure for small businesses so they can better compete."

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Trump Administration Proposal

INTERNATIONAL

- One-time tax on repatriated profits (accumulated foreign earnings of a US shareholder's foreign subsidiaries brought back from overseas)
- 8.75%(?) rate if held in cash or cash equivalent
- 3.5%(?) rate otherwise
- Both payable over 8(?) years
- *Note: Could raise rate or move to single rate during the process. Rates above come from Blueprint.*

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Trump Administration Proposal

INTERNATIONAL: Need guidance on repatriation tax

- Whether only a US shareholder's "net positive foreign earnings" would be subject to the transition tax?
- Whether accumulated foreign earnings are determined separately for each foreign subsidiary: Do you net positive E&P and deficits?
- How will the US shareholder include accumulated foreign earnings in income?
- When must repatriation occur?
- When would accumulated foreign earnings be determined? When is cut-off date? (when switch to territorial system?)
- Can US shareholder use existing tax attributes (FTC, NOL's) to offset tax?

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Trump Administration Proposal

INTERNATIONAL: TERRITORIAL TAXATION OF GOBAL AMERICAN COMPANIES

- 100% exemption of dividends received by US corporation from foreign subsidiary in which there is at least 10% ownership (previously was 95%)
- Ends the "perverse incentive" to keep foreign profits offshore by exempting them when they are repatriated to the US.

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Trump Administration Proposal

INTERNATIONAL: TERRITORIAL TAXATION OF GOBAL AMERICAN COMPANIES

- Does not specify whether deductions would be denied for expenses allocated/apportioned to exempt income (but highly unlikely)
- Not specified whether the 100% exemption would apply either to foreign income directly earned by a US corporation through foreign branches or to capital gains recognized from the sale or exchange of shares in a 10%-owned foreign corporation.

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Trump Administration Proposal

INTERNATIONAL: Anti-abuse erosion provisions: STOPPING CORPORATIONS FROM SHIPPING JOBS AND CAPITAL OVERSEAS

- A minimum level of tax (reduced rate) on foreign earnings, to prevent shifting of profits to tax havens. What is considered a tax haven? (effective tax rate test instead of list of countries)
- "The committees will incorporate rules to level the playing field between [US]-headquartered parent companies and foreign-headquartered parent companies."

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House Blueprint, Not in Trump Proposal

- Capital gains, dividends, and interest: deduct 50% of the income so effective rates = 6%, 12.5%, 16.5%
- Repeal Net Investment Income Tax
- Repeal Additional Medicare Tax

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House Blueprint, Not in Trump Proposal

- "Destination-based tax system" aka "border adjustment tax"
  - Very controversial and highly criticized
  - Would the World Trade Organization permit?
  - Limited Republican support
- Taxes the location of <u>consumption</u> rather than location of production
- Imports would not be tax deductible
- Exports would not be taxed
- Projected to bring in $1 trillion in next 10 years

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What's Next: Recent Executive Activity & The Role of The Senate

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Trump Administration Proposal

What's Next?

- Tax-writing committees are working with US treasury officials on converting into legislation
- Will be introduced in House by Chairman Brady
- Senate expected to follow with its process to write a bill that will differ
- Then assigned to House-Senate conference committee to develop final tax reform bill

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Recent Executive Activity

Executive Order on 1/30/17

- Requires agencies to cut two existing regulations for every new rules introduced.
- Cost of new regulations should be paid entirely by revenue from repealed regulations (would be difficult to do, and probably not desirable)
- Has put a halt to publication of significant regulations, rulings, procedures

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Recent Executive Activity

Executive Order 13789 on 2/24/17

- Directs federal agencies to establish regulatory reform task forces to determine whether regulations (issued since 1/2016) are burdensome to the economy and job creation (impose undue financial burden, undue complexity, exceed statutory authority of IRS)
- Regulations in question
  - Sec. 6221 et seq. partnership audit regulations
  - Sec. 2704 business valuation discount regulations
  - Sec. 385 final debt-equity reclassification regulations
  - Sec. 7874 final corporate inversion regulations

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Reconciliation vs. Regular Order

Tax Reform Act of 1986

- Passed under regular order, not reconciliation
- Finance Committee bill passed 97 to 3
- Conference report received more than 2/3 vote in both House & Senate
- Congress & President Reagan came together – they met in the middle.

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The Role of The Senate

Sen. Hatch, chairman of Senate Finance Committee

- "Committed to a complete overhaul of our tax system, one that would simplify the Code."
- Senate Finance Committee in charge of "taxation and revenue"
- Will have significant influence even though do not have their own plan

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The Role of The Senate

"With a history that runs deep in bipartisanship, the Finance Committee has a real opportunity to unite behind smart, innovative policies that will lift the economy and bring prosperity to American people. … . We will take on the monumental challenges of the U.S. tax code in earnest and remake the system so that it's more efficient for families and individuals and keeps American businesses competitive with the world."

--Sen. Orrin Hatch (R-Ohio), early 2017

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The Role of The Senate

- Republicans have 52-48 majority, VP Pence gets deciding vote in tie.
- Cloture rule: 60 super-majority votes required to avoid filibuster.
  Cloture = cutting off filibuster and forcing a vote on a bill.
- EGTRRA of 2001 & JGTRRA of 2003 passed with 2010 sunset provision to avoid Cloture rule

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The Role of The Senate

- 10/19/17: Budget blueprint passed by Senate on a 51-49 vote.
- The "reconciliation instructions" state that a tax bill would be insulated from filibuster (unending debate) as long as it does not add more than $1.5 trillion to the deficit.
- Sen. Bob Corker (R-Tenn) voted against blueprint because of deficit concerns.

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The Role of The Senate

"I don't think we should act as if we're going to be in the majority forever."

-- Senator Mitch McConnell, Kentucky, Majority Leader

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The Role of The Secretary Treasury

Treasury Secretary Mnuchin

- Said in February 2017 that his goal was significant tax reform by August 2017 but said "That's an ambitious timeline. It could slip to later in the year."
- Said in September 2017 that the White House would prefer permanent tax reforms but "if we have it for 10 years, that's better than nothing."

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Unified Framework: Analysis

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Unified Framework: Analysis

- Will This Achieve Simplification?
  - Will need complex anti-abuse measures to ensure personal income and investment income are not characterized as business (corporate or pass-through) income.
- Why did Code and administrative and judicial law get so cumbersome??!!
  - Because of attempts by tax accountants and lawyers to find ways around the rules

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Unified Framework: Analysis

- Income taxation of trusts revolves around itemized deductions
- Effect on state income tax systems
  - Broadening base should increase state revenue
  - Adoption vs. decoupling

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Unified Framework: Analysis

Effect on Real Estate Industry

- Limitation on interest expense deduction
- 100% bonus depreciation will not include "structures" or land: What is a structure?
- No mention of repeal of Sec. 1031 like-kind exchanges
- No mention of carried interest reform

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Unified Framework: Analysis

Effect on Banking Industry

- Lower corporate rate increases future earnings and capital
- Adjustment for deferred taxes on financial statements: DTA write-downs?
- Eliminate corporate AMT
- Repatriation tax: Bank's CFCs often hold most assets in cash/cash equivalents – will they get a lower rate than the 8.75%?
- Unclear on whether income of foreign branches of US banks would be included in US taxable income (current law) or excluded (territorial law).

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Unified Framework: Analysis

Effect on Mining & Metals Industry

- Lower rates but elimination of preferences (percentage depletion)
- Elimination of corporate AMT
- Limitation on interest deduction
- Use of minimum tax credit carryovers?

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Unified Framework: Analysis

Effect on Oil & Gas Industry

- Lower rates and capital expensing are positive
- Elimination of corporate AMT
- What about intangible drilling and development costs?
  (70-100% immediate deduction)

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Unified Framework: Analysis

Effect on Power & Utilities

- Very capital-intensive: significant effect on financial condition and liquidity?
- Refunds required for utilities due to reduction in rate
- Utility sector has worked closely with Congress to stress why their interest deduction should not be limited.

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Unified Framework: Analysis

- Necessary to eliminate corporate tax expenditures but…
- The Great Irony: Would keep employer-provided insurance exclusion
  - Most costly provision at $211 billion per year
- Eliminate DPAD but…
  Want manufacturing to be competitive internationally

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Unified Framework: Analysis

- Reducing the corporate tax rate is not enough.
- Over 50% of business income in U.S. is not in corporate form.
- <u>If</u> there is no corresponding reduction in the pass-through rate, we might see a substantial migration of income from pass-through form to corporate form.
- Example: If corporate rate is 25%, and dividend rate is 20% (so 15% additional tax, 75% of 20%), 40% tax vs. 39.6% individual rate for pass-through income.

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Unified Framework: Analysis

Bonus Depreciation – does it affect spending?

- FedEx bonus depreciation: Purchased many more freighters as a result
- Statistic: Correlation between capital spending and jobs over last 60 years = 86%

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Unified Framework: Analysis

Itemized Deduction Elimination

- State & local taxes: indirect subsidy
- Real estate prices
- Charitable organizations
- Raise standard deduction
  - Currently: 1/3 of taxpayers itemize
  - Estimate: would be 5%

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Unified Framework: Analysis

What about VAT or Consumption Tax?

- National sales tax
- Consumption taxes = 32% of tax revenues in OECD countries (2010); only 16% in US
  Income taxes = 35% of tax revenues in OEDC countries (2010); 48% in US
- History: Countries who have enacted VAT tax have failed.
- VAT can be progressive if you give credit to people below certain income levels

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Unified Framework: Analysis

What about VAT or Consumption Tax?

- Domenici-Rivlin Debt Reduction Task Force 2.0 recommendations in 2010
- Corporate tax rate of 27%
- Subtraction-method VAT rate of 6.5%
- Eliminate corporate tax expenditures

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Unified Framework: Analysis

Lessons from Canada

- Theory: Business investment is increased by reducing the tax burden on corporations.
- Reduction in corporate income tax rates to average of 26% (combined federal/province)
- National VAT, provincial VAT (replace retail sales tax)
- Elimination of capital taxes
- Less special interest rates and deductions

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Unified Framework: Analysis

Lessons from Canada

- Reduced “marginal effective tax rate” gradually from 44% to 18%; METR = what you would expect to pay as tax if you were going to make a marginal investment on a particular project
- Territorial type international tax system
- No tax on active business earnings of foreign subsidiaries
- Natural resources: Tax on royalties and mining by provinces

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Unified Framework: Analysis

Lessons from UK
- 2010 Deficit reduction plan
- Revenue-neutral fundamental tax reform
- On track to have surplus by 2018/19
- Business tax reform to boost economic growth
  - GDP grew by 2.8% in 2014
  - Foreign direct investment grew by 8% in 2013
- "Most attractive investment destination in Europe"

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Unified Framework: Analysis

Lessons from UK
- Individual income tax
  - Reduction in top rate from 50% to 45%
  - Increase in personal allowance (standard deduction)
  - Clamped down on tax avoidance
- VAT & Excise Tax
  - Increase in VAT rate from 17.5% to 20%
  - 10% reduction in gas excise tax
- Property Tax - reform rates & basis

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Unified Framework: Analysis

Lessons from UK: Business Tax
- Gradual reduction in rates
- Increased support for R&D and innovation
- 10% rate for profits generated from patent/intellectual property
- Clamped down on tax avoidance: measures to protect against BEPS
- Diverted profits tax (25% vs. 20%)

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Unified Framework: Analysis

Other Options: Tax on Transfers of IP Overseas
- 2010 Treasury Green Book
- Introduced new category of subpart F income
- Tax the transfers of intellectual property (IP) overseas
- US companies are moving IP to overseas subsidiaries
- Current transfer pricing rules' "arm's length standard" do not adequately address
- 10% effective tax rate threshold where return on property is more than or equal to 30%

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Unified Framework: Analysis

Other Options: Tax on Transfers of IP Overseas
- Returns-based test vs. current transactional-based (transfer pricing) in Subpart F
- Triggers immediate US taxation
- Uncompetitive & unprecedented
- Concept of taxing "mobile income" above normal returns
- Slippery slope! Starts with 30% return and 10% rate…
- Does everything beyond a normal return "belong" to the US?

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Unified Framework: Analysis

Other Options: Fix Transfer Pricing Problems
- Some argue: Transfer pricing "arm's length" concept is full failure.
- "The arm's length method is in shambles."
- But US has spent many years on PR about transfer pricing!

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Unified Framework: Analysis

Argument Against Territorial System

"But is it in our best interest to compare our tax system to those of our trading partners based on a single element of the respective systems and then act on those comparisons by mimicking our trading partners? We need to look at and account for all the factors that impact the operation and relative competitiveness of companies in various regulatory environments."

-- Manal Corwin, International Tax Counsel, Office of Tax Policy, U.S. Department of Treasury

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Unified Framework: Analysis

Argument Against Territorial System

"There are in fact numerous factors that go into determining whether a company is more or less competitive in a particular market. Costs are certainly a consideration, and to the extent taxes are part of the cost of doing business, they are a factor that has to be taken into account. But they are by no means the only factor or even one of the critical factors in every circumstance. In other words, it is important to ask ourselves, if competitiveness of U.S. multinationals abroad is really the key to U.S. economic welfare, what is the best investment that the U.S. can make to maximize competitiveness and is reducing taxes really the place to start?"

-- Manal Corwin, International Tax Counsel, Office of Tax Policy, U.S. Department of Treasury

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Unified Framework: Analysis

Problem With International Tax Reform

- How do members of congress understand this?
- How do they explain to constituents?
- How do you K.I.S.S.?
- "We have got to do a better job of educating everybody about what's actually going on out here, because really, besides the people in this room, nobody really understands what we've been talking about here in great detail." – Alan Graf Jr. – FedEx CFO, 2010 at tax conference

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The Problem with Tax Reform

"I think it requires a full-blown public relations effort across the country with people in this country, the importance of a rational tax system for competitiveness, for job creation, for capital formation, for capital investment, because **people just don't get it**, and, therefore, if you don't make that case—and you're the ones with the money to spend to make that case—then you're going to always fall victim to those populists who will spew the stuff that sounds good and gets people nodding their heads about all the tax loopholes, corporate welfare, you name it. **So, that's my message—you ought to get your act together, spend some bucks to educate the country on the importance of a competitive tax system**."
– Former Congressman McCrery

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