Sutherland Tax Series – Session II
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The Tax Reform Movement: Where Does It Go From Here?

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Introduction

- "Tax reform" has become an increasingly important topic since the 2010 mid-term elections shifted the balance of power in the House of Representatives and brought the Senate into greater balance.
- Calls for tax reform have become louder on account of the 2012 presidential election.
- Shaping the debate
  - Domenici-Rivlin Plan (November 2010)
  - Simpson-Bowles Plan (December 2010)
  - The Ryan Plan (April 2011)
  - The "Gang of Six" Proposal (July 2011)
  - Deficit Reduction "Supercommittee" Proposals
    - Obama Administration – Deficit reduction proposal / Jobs Act / FY2012 Budget
    - Republican response – Jobs Through Growth Act
- Potential impact players – Republican presidential candidates
  - Mitt Romney
  - Newt Gingrich
  - Rick Perry

The Hard Facts

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- On November 15, 2011, the national debt went over the $15T threshold. As of December 1, 2011, the national debt was $15,088,441,787,407.62.
- The Congressional Budget Office issued a report in March 2011 that included the following statistics and predictions:
  - The amount of the national debt held by the public has almost doubled between FY2007 and FY2010, to over $9T at the end of FY2010. According to the Bureau of Public Debt, the debt held by the public is currently over $10T.
  - In 2010, individual income taxes made up 42% of annual revenue, followed by social insurance taxes (40%), corporate taxes (9%) and other revenues, including excise taxes, estate and gift taxes, etc. (approximately 10%)
  - Without changes to current laws, the national debt will equal 76% of GDP by the end of 2020.
  - Without changes to current laws, over the next 10 years, deficits will total $7T.

Tax Reform - Political State of Play

- **Factors Driving Corporate Tax Reform Proposals**
  - **What are the over-arching policy goals?**
    - Job creation
    - Deficit reduction
    - Economic Growth – Individual Relief
  - **Who pays if revenue neutral?**
    - Finding revenue within the corporate tax structure is difficult
    - Argument: larger corporate expenditures benefit companies with less to gain from rate reduction
    - Increases in individual income rates – untenable if broad-based
  - **What's in it for me?**
    - Revenue neutral vs. deficit reduction (increase revenue) vs. lower rates (sacrifice revenue)
    - Effectiveness and accuracy of revenue generators based on Congressional Budget Office (CBO) scores

Tax Reform - Political State of Play

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- **Implosion of the Supercommittee – A Case Study**
  - **Initial bargaining positions**
    - Wish lists with little flexibility on either side
    - 7^{th} Committee Member for each party – Medicare vs. Tax Pledge
    - Time lost to internal conflict management
  - **Congressional dynamics**
    - House vs. Senate
    - Leadership vs. Committee appointees
    - Staff vs. Members
  - **Accountability**
    - Sequestration
    - Congressional and Party leadership excluded
    - Consequences negotiable

Tax Reform - Political State of Play

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- **Congressional Stalemate on Corporate Tax Reform**
  - Camp (R-MI) (Republicans): reduction of corporate rate, repeal rules on the corporate tax rate on capital gain, shift to a territorial system
    - Lacks broad support outside of Committee as written
  - Levin (D-MI) (Democrats): corporate relief secondary to individual relief
    - Stronger transfer pricing rules, provisions to deal with tax “havens”
    - Caucus fractured, at best
- **Corporate tax reform now taking a back seat to payroll tax, unemployment insurance, and Medicare, plus environmental riders**
- **Companies seeking tax extenders, avoiding tax increases as “pay-fors” vis-à-vis payroll tax**
- **Sen. Portman (R-OH) proposing corporate tax reform plan in 2012: deficit neutral, with 25% corporate rate and territorial system – seeking bipartisan support from Sen. Max Baucus (D-MT)**

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Relevant 2011 Tax Legislation

2011 Legislation: VOW to Hire Heroes Act

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- **Repeals Imposition of Three-Percent Withholding on Certain Payments Made to Vendors by Government Entities**
  - Repeals 3% withholding on payments to persons providing property or services to the federal government (Code Sec. 3402(t)(1), Reg. §31.3402(t)-1(a))
  - Any payment made in connection with a government voucher or certificate program that acts as a payment for services or property is subject to the withholding requirement
  - Certain payments exempt: income taxes, real property, classified or confidential contracts, etc.
  - The House Ways and Means Committee concluded that requirement was an overly-broad approach to closing the tax gap (House Committee Report, H.R. Rep. No. 112-253)
  - However, legislation also expanded IRS authority to levy 100 percent of any payment for goods and services due to a federal vendor with unpaid federal tax liabilities.

2011 Legislation: VOW to Hire Heroes Act

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- **Work Opportunity For Unemployed Veterans – Extension of Credit**
  - **Provides an elective credit to employers that hire individuals from targeted groups that have a high unemployment rate (Code Sec. 51)**
    - Qualified veterans - veterans who are certified as a member of a family that receives certain federal aid for at least a three-month period and veterans with service-connected disabilities (Code Sec. 51(d)(3)(A))
    - Effective for individuals hired after November 21, 2011, a qualified veteran includes any veteran who is unemployed for at least four weeks but less than six months during the previous year, or for at least six months during the one-year period ending on the hiring date (long-term unemployed)
  - **Credit applies to wages paid to qualified veterans who begin work for the employer before January 1, 2013**
    - 40 percent of qualified wages paid to each member of a targeted group during the first year of employment if the employee performs at least 400 hours of service
    - 25 percent of qualified wages paid to each member of a targeted group during the first year of employment if the employee works less than 400 hours, but at least 120 hours
- **Enactment date: November 21, 2011**

2011 Legislation: Trade Promotion Agreement Implementation Acts

- **Corporate Estimated Taxes**
  - Estimated tax payments for 2014, 2015, and 2019 for corporations with assets of $1B or more were increased under previous legislation
  - New law increases payments for 2012, 2016
    - Estimated tax payment in July, August, or September of 2012 increased to 100.50 percent of the amount otherwise due
      - The next required installment is 99.50 percent of the amount otherwise due
    - Estimated tax payment in July, August, or September of 2016 also increased to 103.50 percent of the amount otherwise due
      - The next required installment is 96.50 percent of the amount otherwise due
- **Enactment date: October 21, 2011**

2011 Legislation: 1099 Taxpayer Protection & Repayment of Exchange Subsidy Overpayments

- **Repeal of 1099 Reporting Requirement (Patient Protection and Affordable Care Act – PPACA)**
  - Information reporting requirement for payments of $600 or more made to a corporation in the course of a trade or business
  - Tax years beginning after 2011
  - Information reporting requirements for all amounts paid in consideration for property, and other gross proceeds for both property and services repealed

2011 Legislation: Other IRC Amendments to Health Reform

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- **Free Choice Vouchers**
  - Rules requiring employers to provide free choice vouchers to employees who do not participate in employer-offered health plans repealed
  - Employer deduction rules also removed
- **Health Insurance Premium Tax Credit**
  - PPACA provides a refundable income tax credit (on a sliding scale) for individuals with incomes between 100 and 400 percent of the federal poverty line who purchased health insurance through an exchange
  - Federal government makes advance payments for insurance premiums for eligible individuals, reducing the credit; if advance payments exceed allowed credits, the excess increases the individual's tax liability for that year
  - New law modifies definition of modified AGI for purposes of determining eligibility to include certain Social Security benefits, and limits the amount of the increased tax liability
  - Revenue raiser for 1099 repeal - $166M

Tax Provisions of Health Reform: General Outlook

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- **Implementation**
  - W-2 reporting: delayed until 2013 (for 2012 W-2); new guidance
  - Section 105(h) nondiscrimination testing for insured benefits: delayed
  - Limits on health FSAs: $2,500, beginning in 2013
  - Increase in Medicare tax rate: beginning in 2013, rate will increase by .9% (from 1.45% to 2.35%) on wages over $200,000 for single filers, $250,000 for joint filers, $125,000 for persons married filing separately
  - Surtax on certain investment income: 2013
  - Individual mandate penalties: 2014
- **Judicial Review of the Individual Mandate**
  - 11th Circuit: mandate unconstitutional (commerce/tax), severable (Aug. 12, 2011)
  - 6th Circuit: mandate constitutional (June 29, 2011)
  - 4th Circuit: issues not ripe under the Tax Injunction Act (Sept. 8, 2011)
  - 5 ½ hours scheduled for argument, expected March 2012; decision, June 2012

Shaping the Debate

Domenici-Rivlin Plan (Nov. 2010)

- The Bipartisan Policy Center, Debt Reduction Task Force introduced a plan that included cutting domestic and defense spending cuts, controlling health care and social security costs, as well as comprehensive changes to the tax system.
- The tax proposals were estimated to result in savings of over $2T by 2020. The tax proposals included:
  - Reduce and replace individual income tax rates with two rates, 15% and 27%. Capital gains and dividends would be taxed at the same rate as ordinary income.
  - Reduce corporate tax rate to 27%.
  - Eliminate most deductions and credits for individuals and corporations.
    - On the individual side, replace mortgage interest and charitable contribute deductions with 15% refundable credits.
  - Introduce 6.5% national sales tax.
  - Cap exclusion for employer provided health benefits beginning in 1028 and eliminate over the next 10 years.

Simpson-Bowles Plan (Dec. 2010)

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- The National Commission on Fiscal Responsibility and Reform introduced a plan focused on discretionary spending cuts and savings related to health care, social security, and other mandatory programs, as well as comprehensive tax reform.
- The tax reform proposals included:
  - Adopt a territorial system where income earned by foreign subsidiaries would not be subject to U.S. tax. Passive income from foreign subsidiaries would still be taxed as under current law.
  - Reduce individual income tax rates to 12%, 22%, and 28%. Capital gains and dividends would be taxed at the same rate as ordinary income.
  - Reduce corporate tax rate to between 23%-29% (28% used as example).
  - Eliminate almost all deductions and credits for individuals and corporations.
    - On the individual side, 12% nonrefundable credits for mortgage interest and charitable contributions.
  - Gradually increase federal gas tax by 15 cents.
  - Cap exclusion for employer provided health insurance in 2018 and phase out thereafter.

The Ryan Plan (April 2011)

- Representative Paul Ryan and the House Budget Committee introduced a budget proposal focused on cutting spending, reforming health care, welfare, and social security systems, and enacting comprehensive tax reform.

- The tax proposals in the Ryan budget proposal included:

  - Reducing the number of individual income tax brackets and lowering the top rate to 25%.

  - Reducing the top corporate tax rate to 25%.

  - Eliminating most deductions and credits in order to offset the rate reductions.

The "Gang of Six" Proposal (July 2011)

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- The Senate's "Gang of Six" (including Democrats Kent Conrad, Dick Durbin, and Mark Warner, and Republicans Mike Crapo, Tom Coburn, and Saxby Chambliss) introduced its plan that was based off of the Bowles-Simpson plan recommendations.
- The tax proposals included:
  - Reduce the number of individual income tax brackets and individual income tax rates to: 8-12%; 14-22%; and 23-29%.
  - Reduce corporate rate to between 23% and 29%.
  - Move to a territorial system.
  - Reform, or eliminate, most deductions and credits.

Deficit Reduction “Supercommittee” Proposals

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Introduction

- The Joint Select Committee on Deficit Reduction (a.k.a., the Deficit Reduction "Supercommittee") was authorized by the Budget Control Act of 2011 (Pub. L. No. 112-25), which was passed earlier this year as the culmination of the negotiations concerning the nation's debt ceiling.
- The Committee was comprised of 12 members – 6 congressman and 6 senators – and was split evenly between Republicans and Democrats.
  - Rep. Jeb Hensarling (R-Texas), Co-Chair
  - Sen. Patty Murray (D-Wash.), Co-Chair
  - Sen. Max Baucus (D-Mont.)
  - Rep. Xavier Becerra (D-Calif.)
  - Rep. Dave Camp (R-Mich.)
  - Rep. James Clyburn (D-S.C.)
  - Sen. John Kerry (D-Mass.)
  - Sen. Jon Kyl (R-Ariz.)
  - Sen. Rob Portman (R-Ohio)
  - Sen. Pat Toomey (R-Pa.)
  - Rep. Fred Upton (R-Mich.)
  - Rep. Chris Van Hollen (D-Md.)

Deficit Reduction "Supercommittee" Proposals (cont'd)

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Committee Task & Consequences

- In brief, the Committee was charged with issuing a formal recommendation by Nov. 23, 2011, on how to reduce the national deficit by at least $1.5 trillion over the next 10 years.
- Because the Committee failed to achieve at least $1.2 trillion in deficit reduction, a new sequestration process will be used to cut spending across-the-board.
  - This process is designed to ensure that any debt limit increase is met with greater spending cuts.
  - Under the new sequestration process, the President may request up to $1.2 trillion for a debt limit increase, and if granted, across-the-board spending cuts would result that would equal that amount.
  - Across-the-board spending cuts will apply to FYs 2013-2021 and will apply to both mandatory and discretionary programs.
    - Total reductions will be split equally between defense and non-defense programs.
    - Across-the-board cuts also will apply to Medicare (providers only).
    - Other programs, including Social Security, Medicaid, veterans, and civil and military pay, are exempt.

The President's Proposals

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- The Administration's most recent tax reform proposals were included as part of its deficit reduction proposal made to the Deficit Reduction Supercommittee along with a related "Jobs Act."
  - Specifically, on Sept. 19, 2011, the President sent a plan to the Deficit Reduction Supercommittee outlining tax increases and spending cuts that are said to reduce the national deficit by approx. $3.2 trillion over the next 10 years.
  - Coupled with the $1.2 trillion in discretionary cuts from the Budget Control Act of 2011, the President contended that his plan would reduce the national deficit by approx. $4.4 trillion over the next 10 years.
  - **Note:** The deficit reduction plan includes some of the proposals that were included in the Administration's proposed Jobs Act, but the deficit reduction is more comprehensive.
- Tax increases make up $1.57 trillion of the $3.2 trillion that the President's proposal is said to produce.
  - $866 billion – Expiration of the 2001 and 2003 tax cuts.
  - $410 billion – Limiting deductions and exclusions for individuals earning more than $200,000 and families earning more than $250,000.
  - $300 billion – Eliminating "special interest tax breaks."
- In the context of this proposal, the President also touted the so-called "Buffett Rule," which, in very general terms, provides that no household with an income of at least $1 million should pay a lower tax rate than the middle class.

The President's Proposals (cont'd)

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Tax Proposals

- The $300 billion of revenue referenced in the President's proposal from eliminating "special interest tax breaks" includes the following items—
  - Repealing the LIFO method of tax accounting (scored at approx. $52B over 10 years)
    - Would result in increased taxable income for taxpayers required to change method because older (cheaper) inventory would be taken into account
    - Would require current LIFO taxpayers to write up inventory to FIFO value in year of change
    - Proposed to be effective for tax years beginning after Dec. 31, 2012
  - Repealing lower-of-cost-or-market inventory accounting method (scored at approx. $8B over 10 years)
    - Also would not allow subnormal goods method of accounting
    - Any resulting income recognized over 4-year period
    - Proposed to be effective for tax years beginning after Dec. 31, 2012

The President's Proposals (cont'd)

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Tax Proposals (cont'd)

- The $300 billion of revenue referenced in the President's proposal from eliminating "special interest tax breaks" also includes the following items—
  - Eliminating oil and gas tax preferences (scored at approx. $41B over 10 years)
  - Reinstating Superfund taxes (scored at approx. $19B over 10 years)
  - Clarifying worker classification rules (scored at approx. $15B over 10 years)
  - Permanently extending the 0.8% unemployment insurance surtax (scored at approx. $15B over 10 years)
  - Taxing carried interests as ordinary income (scored at approx. $13B over 10 years)

The President's Proposals (cont'd)

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Tax Proposals (cont'd)

- The $300 billion of revenue referenced in the President's proposal from eliminating "special interest tax breaks" also includes five international tax proposals that appear to be carried over from the FY2012 budget proposal (Feb. 2011)
  - Defer deduction of interest expense allocated to foreign-source income (scored at approx. $36B over 10 years)
    - Deduction would be deferred as long as U.S. tax on the income is deferred
    - Designed to better match timing of deductions and recognition of foreign source income
  - Determine foreign tax credits on a pooling basis (scored at approx. $53B over 10 years)
    - Foreign tax credits on receipt of dividends from foreign subsidiaries would be based on the consolidated e&p and foreign taxes of all of foreign subsidiaries
  - Tax currently "excess returns" associated with transfers of intangibles offshore (scored at approx. $19B over 10 years)
    - Designed to cover where section 482 or the transfer pricing rules might not have prevented income shifting
    - Excess return from transfer of intangibles offshore where there is “excessive income shifting” from the U.S. would be treated as subpart F income
  - Clarify the definition of intangible property for purposes of §§ 367(d) and 482 to prevent inappropriate shifting of income outside of the United States (scored at approx. $1B over 10 years)
  - Limit earnings stripping by expatriated entities (scored at approx. $4B over 10 years)
    - Revises section 163(j) to limit domestic corporation’s deductions of interest payments to “expatriated entities”
    - Carryforward for disallowed interest would be limited to 10 years and carryforward or excess limitation would be eliminated

The President's Proposals (cont'd)

Tax Proposals (cont'd)

- Other tax reform provisions in the Administration's FY2012 budget proposal include:
  - Accruing interest on forward sale of stock
  - Treating boot-within-gain repatriation as dividends
  - Modifying definition of "control" for §249 to include 80% owned indirect subsidiaries that are part of a controlled group

Republican Response – Jobs Through Growth Act

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- Sets maximum individual and corporate tax rates at 25%
- Includes both temporary and permanent repatriation incentives
- Moves to a territorial system
- Repeals PPACA and Dodd-Frank

Potential Impact Players – Republican Presidential Candidates

Republican Candidate Proposals

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Introduction

- Most of the Republican candidate proposals share common themes, including reducing the corporate tax rate and repealing PPACA and Dodd-Frank.
- Many proposals also include moving to a “territorial system.”
  - No clear definition of what a “territorial system” means in practice.
  - General principal that income should be taxed only once, in the jurisdiction where earned.
  - Intended to remove incentives for U.S. companies to keep profits offshore—generally exempts dividends from foreign subsidiaries from tax.
  - Fairness questions in domestic vs. multinational companies.
  - Presents transition issues (*e.g.*, treatment of existing profits/income).
  - Effectiveness likely depends on lowered corporate tax rate, and even with lowered rate, some incentives still remain for companies to leave cash offshore.

Republican Candidate Proposals (cont'd)

Mitt Romney

- "Fairer, Flatter, Simpler"
- Reduce corporate tax rate to 25%
- Move to a territorial system
- Repeal PPACA and Dodd-Frank
- Less dramatic change than other Republican proposals

Republican Candidate Proposals (cont'd)

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Newt Gingrich

- "Jobs and Prosperity Plan"
- Reduces corporate tax rate to 12.5%
- Allows for 100% expensing of new equipment
- Repeals PPACA and Dodd-Frank
- Supports moving towards flat tax or "Fair Tax" system
- On individual side, allows for optional flat tax

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Rick Perry

- "Cut, Balance, and Grow"
- Reduces corporate tax rate to 20%
- Moves to a territorial tax system
- Permanently reduces rate on repatriated earnings
- Repeals PPACA and Dodd-Frank
- On individual side, allows for elective flat tax
- Most dramatic reduction in tax revenues

Republican Candidate Proposals (cont'd)

Herman Cain (exited the race on Dec. 4, 2011)

- "9-9-9"
- Reduces corporate tax rate to 9%
  - Excludes purchases from other businesses, investments, and dividends from corporate tax base, but does not exclude, for example, employee salaries
- Imposes 9% national sales tax
- Imposes 9% personal income tax
- Intended to be transition to "Fair Tax" system
- **Note:** May serve as a starting point for discussion of more dramatic proposals and useful as comparison

Consolidated Returns

- Regulations regarding application of § 172(h) (corporate equity reduction interest loss rules) to a consolidated group.
- Final regulations under § 267 (losses between members of a controlled group).
- Regulations, generally, under § 1502, including regulations regarding the loss transfers of member stock.

Why should Congress have all the fun?

Administrative Proposals in the Priority Guidance Plan

Corporations

- Regulations under § 312 regarding the allocation of E&P between a transferor and transferee.
- Regulations for transactions under § 336(e) (election to treat sale or exchange of stock as a disposition of assets).
- Final regulations under § 355(a)(3)(B) (stock acquired in a taxable transaction within five years treated as boot).
- Regulations relating to the active trade or business requirement under § 355(b).
- Regulations under § 362(e) (importation or duplication of losses).
- Regulations under § 368 (continuity of interest).
- Guidance regarding the treatment of non-stock under § 382.
- Regulations regarding basis allocation in redemptions and reorganizations.

Employee Benefits

- Guidance on the rules applicable to IRAs (under §§ 408 and 408A) and ESOPs (under §§ 409 and 4975).
- Final regulations relating to hybrid plans.
- Guidance on issues relating to pension equity plans.
- Guidance under § 83, including model language on § 83(b) elections.
- Guidance under § 132(f) (use of smart cards, debit cards and credit cards for transportation fringe benefits).
- Final regulations under § 409A.
- Voluntary Classification Settlement Program.

Financial Products

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- Regulations under § 446 on notional principal contracts relating to the contingent nonperiodic payments.
- Guidance addressing character and timing of hedge gains and losses under §§ 1221, *et seq*., and Reg. § 1.446-4 for certain hedges.
- Regulations on prepaid forward contracts.
- Regulations relating to the accrual of interest (including discount) on distressed debt.

General Tax Issues

- Guidance under § 41 (research credit).
- Guidance on deductions for energy-efficient commercial buildings.
- Regulations regarding disregarded entities and excise taxes.
- Guidance regarding the scope and application of the rescission doctrine.

International Issues

- Guidance under § 954, including regulations under §954(d) relating to contract manufacturing.
- Guidance under § 956, including regulations on the treatment of loans to related foreign partnerships.
- Regulations under § 964 on accounting method elections.
- Regulations under § 7701(*l*) regarding conduit financing arrangements.
- Guidance under § 367(a) (including final regulations under § 367(a)(5) regarding outbound asset reorganization).
- Regulations under § 367(d) (transfers of intangibles to foreign corporations).
- Guidance under § 6038B (information reporting of transfers by partnerships to foreign corporations).

International Issues (cont.)

- Regulations under § 7874, including final regulations on definition of "surrogate foreign corporation."
- Guidance under § 482, including final regulations relating to cost-sharing arrangements.
- Regulations under § 482 on global dealing operations.
- Rev. Proc. updating procedures for the Advance Pricing Agreement Program.
- Regulations under § 861 (allocation and apportionment of interest expense).
- Update of Rev. Proc. on procedures for taxpayers requesting competent authority assistance.
- Final regulations under § 384 to prevent use of related corporations to avoid § 304.

Partnerships

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- Final regulations under § 108(e)(8).
- Final regulations under § 706(d) (varying interests).
- Regulations regarding noncompensatory options and convertible instruments.
- Regulations regarding disguised sales.

Tax Accounting

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- Regulations regarding elections to amortize start-up and organizational expenses.
- Final regulations regarding deduction and capitalization of expenditures for tangible assets.
- Regulations under § 460 addressing look-back rules as applied to pass-through entities.
- Guidance regarding the recurring-item exception and the all-events test.
- Regulations regarding the LIFO inventory method.

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