

10 Minutes on Tax Reform*

What you need to know about emerging topics essential to your business. Brought to you by PricewaterhouseCoopers.

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Will corporate tax reform bring relief, new burdens, or both?

Highlights

- Congress will hold tax reform hearings in 2008, but real action won't occur until after the next president takes office.
- Reform could provide for the most significant corporate tax revisions since 1986.
- Don't confuse tax reform with overall tax relief. Federal budget deficits will create pressure for tax reform to be "revenue neutral"—i.e., tax cuts will be offset by tax increases.
- With trillions of dollars of tax provisions under review, US companies must be alert to the potential risks of tax reform.

Political and economic events are on a collision course with a tax system that, like Cinderella's carriage, will disappear by midnight—in this case, midnight December 31, 2010. Nearly all individual income tax relief enacted in 2001 and 2003 will expire at that hour.

No one expects Congress and the next administration to wait until the clock strikes 12:00 to bring about reform of the tax code. But with changing political power and growing budget deficits, a simple extension of current law is unlikely.

While tax relief for individuals will drive tax reform, Congress also may consider business tax reforms to promote US investment and employment.

Yet with a tight government budget and a popular view against business tax relief, a key risk facing business is the potential for tax increases to more than outweigh any gains from tax reform.

What is at stake for business in tax reform?

- 1. Corporate rate reduction.** The US corporate statutory tax rate is the second highest in the 30-member Organisation for Economic Co-operation and Development (OECD). Expect bipartisan support for some reduction in the 35% tax rate.
- 2. Base broadening.** Budget constraints will require business reform to be revenue neutral. As a result, any corporate rate reduction would be offset by base-broadening provisions subjecting more income to tax.
- 3. Taxes on foreign earnings.** US companies that reinvest foreign earnings to expand foreign operations are permitted to defer US tax on this income until it is brought home. Look for attempts to increase tax on foreign operations, possibly by restricting the ability to defer US tax or limiting foreign tax credits.

At a glance

“The art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing.”

Jean Baptiste Colbert, 1619 – 1683,
Minister of Finance under King Louis XIV
of France.

Potential tax reform benefits:

- For individuals, tax reform can provide a permanent fix to the scheduled expiration of significant individual tax relief and the expanding burden of the individual alternative minimum tax (AMT).
- For corporations, tax reform can reduce corporate tax rates and help improve competitiveness for some sectors—but expect economy-wide improvements only if there is an overall reduction in business taxes.

Key challenges:

- Tight government budget constraints are likely to require tax reform legislation to be revenue neutral.
- Even if revenue neutral overall, business taxes could increase to pay for some of the cost of individual tax relief.
- Identifying your company’s potential risks and benefits from reform is the first step in protecting it from adverse legislation.
- Ultimately, your company must be prepared to make the case to Congress regarding the competitive costs and benefits of proposed tax legislation, informed by rigorous analysis and supported by your employees, suppliers, and other stakeholders.

Why tax reform is on the agenda

Several factors make tax reform—i.e., major tax legislation—a sure bet to begin in 2009.

First, the significant tax reductions for individuals enacted in 2001 and 2003 are all set to expire after 2010.

If Congress fails to act, key features of the tax code will revert to pre-2001 law, resulting in overnight individual tax increases of \$250 billion or more. Tax rates on wages, dividends and capital gains will all rise; low- and middle-income tax relief will disappear; and the estate tax, scheduled to be repealed for just one year in 2010, will spring back from the dead.

Second, the individual AMT is in urgent need of permanent repair.

The AMT was enacted in 1969 in an attempt to insure that high-income individuals could not use loopholes to avoid paying any tax, but the failure to adjust the AMT for inflation over decades makes this tax increasingly a tax on middle-income families.

Third, the new president will want to place his or her mark on the tax code.

History has shown that nearly every president has sought to make significant changes to the tax system in the first year of office.

Finally, while individual tax issues will be the driver of tax reform, corporate reforms may be the wild card.

There is growing concern among policymakers that the corporate tax system may limit the competitiveness of US business.

These competitiveness concerns will be balanced by demands that business pay its “fair share” of tax. However, the ultimate burden of the corporate tax rests either with workers through lower wages, with investors through lower returns, or with consumers through higher prices.

Can tax reform improve US economic growth and competitiveness?

The goals for tax reform include simplifying the tax system, raising taxes in a fair manner, reducing economic inefficiency, and raising American living standards through sustained economic growth.

Real tax reform would seek to achieve all of these objectives.

The truth of the matter is that if tax reform is required to be revenue neutral and scoring rules assume no increase in national income from an improved tax system—it is largely a zero-sum game. For every winner, there is likely to be a loser.

For business, this shift in tax burden from one company to another will result in some companies facing an increase in tax payments that vastly exceeds their share of the economy-wide gains from a more efficient tax system.

A 2007 Treasury Department analysis examined the long-run increase in economic growth under a reform that would significantly broaden the corporate tax base in exchange for a reduction

in the corporate tax rate to 28%. The analysis concluded that the reform would have “little or no effect” on the level of economic production in the long run because the growth-enhancing effects of the lower rate would be offset by growth-reducing effects of the broader base.

While in theory it may be possible to structure a revenue-neutral business tax reform that enhances growth, the practical implication of the Treasury Department analysis is that it is very difficult to know how to separate the wheat from the chaff.

Our take-away from the Treasury Department analysis is that revenue-neutral business tax reform is unlikely to sufficiently enhance the overall competitiveness of US businesses.

But projected long-run budget shortfalls make revenue-losing reforms an unlikely undertaking. Growth in outlays for Social Security, Medicare and Medicaid over the coming decades suggests that Congress will be eyeing the need for a tax system that will collect more tax revenues in the future, not less.

What key business provisions are in play?

What are the risks?

Corporate tax rate. The US corporate rate is much higher than the rates of most of our trading partners.

Including state and local levies on top of the 35% federal rate, the 39.3% US rate is the second highest in the OECD.

The US federal rate would need to decline to about 20% in order for the combined federal and local rate to match the average rate for the European Union. Based on current corporate earnings, such a rate reduction could reduce US corporate tax collections by \$1.5 trillion over the next 10 years, absent any offsetting provisions.

Taxes on foreign operations. The US economy today is more globally integrated than ever, both through exports and cross-border investment. The ability of US companies to grow and compete in the foreign markets that serve 95% of the world's consumers is essential to US economic growth in the future.

Like the US, about a third of OECD countries provide “deferral” rules under which active foreign earnings are taxed by the home country only when repatriated.

The remaining two thirds of OECD countries operate so-called “territorial” tax systems, under which active foreign earnings are not taxed at all by the home country. The important point is that all OECD members follow the principle of either deferral or not taxing a company's foreign earnings.

For many US companies, a key factor for maintaining competitiveness abroad is the ability to have deferral on their reinvested foreign earnings.

Increasingly, the principle of deferral has come under attack by some US policymakers, arguing—in our view, inaccurately—that deferral provides a tax incentive to locate production and jobs overseas rather than in the United States.

With major US companies earning 50% or more of their earnings abroad, recently proposed limitations on deferral could result in significantly higher tax burdens, even if paired with modest corporate rate reduction.

Higher taxes on these foreign operations could in turn significantly diminish the growth prospects of the US economy.

How can you best prepare for tax reform?

The case for Congress taking up significant individual tax legislation beginning in 2009 is compelling. Whether corporate tax changes are included will depend on the political environment, concerns for international competitiveness, and revenue constraints.

Companies should begin preparing now to understand how tax reform may affect them. Approaches examined by the Treasury Department and a comprehensive tax reform bill introduced by House Ways and Means Committee Chairman Charles Rangel provide a blueprint for the variety of tax reform options that may come under consideration.

Do the math on corporate rate reductions and offsets. Analyze the impact of corporate rate reductions and offsets on your company's cash flow and bottom line. Examine your exposure to the potential loss of special tax incentives. Key provisions at risk include:

- The recently enacted deduction for domestic production activities.
- The research tax credit.
- The last-in, first-out (LIFO) method of accounting.

Analyze the effects of changes to US international provisions. Examine the effects on your company's ability to compete internationally if deferral were restricted or repealed. Some proposals would repeal deferral in "tax haven" countries or when foreign-produced goods are sold to the United States. Other proposals would limit the use of deferral more generally or reduce the benefit of foreign tax credits. Given the increasing attacks on deferral and the substantial revenue that would be raised, deferral will remain a target for business tax reform.

Inform Congress and your workforce of the effects of possible legislation. Washington doesn't operate in a vacuum. Members of Congress know that a growing economy is best for their constituents. Make effective use of your knowledge of your business. Inform Congress and your workers of the competitiveness and financial effects of possible legislation.

Be prepared, be informed and share your knowledge with impact.

For further information on tax reform, please see our full white paper, available in print and online, at www.pwc.com/10minutes.

Upcoming 10Minutes topics:

How to best prepare for fair value's impact on your bottom line

Recent events in the capital markets are providing lessons and insights on the role fair value plays in financial reporting. 10Minutes discusses where fair value does and does not make sense and how companies can better prepare for its impact.

Increasing relevance of enterprise risk management

In the face of an accelerating rate of change and an increasingly complex global risk environment, the spotlight is shining on enterprise risk management (ERM) practices. Standard & Poor's recent announcement that enterprise risk analysis will be applied to credit ratings has Boards and senior executives taking stock. 10Minutes explores how ERM drives value and how effective risk management improves strategic decision-making.

Unwinding complexity in financial reporting

The SEC has been studying ways to simplify the US reporting system. Compelling solutions like moving to a more principles-based regime, increasing the use of judgment in financial reporting decisions, and refining materiality standards are being considered. But any change should justify the cost to companies in effort, time, resources, and dollars. 10Minutes clarifies what key solutions may be optimal.

Why climate change matters today

Concerns over energy security and costs are heating to uncomfortable levels, both at the gas pumps and in the boardrooms. Meanwhile, consumers, employees, and communities are increasingly expecting action from businesses. Climate change has become a matter of managing risks, costs, and reputation. 10Minutes explores how you can link your response to climate change more strongly to your business strategy and your corporate performance.

How PwC can help

To have a deeper discussion about tax reform and its potential impacts, please contact:

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