

# What you need to know about the coming debate on tax reform\*

Risks and opportunities for US business



# Table of contents

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The heart of the matter	2
<b>Will corporate tax reform bring relief, new burdens, or both?</b>	

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An in-depth discussion	4
<b>Political and economic events are shaping the tax reform debate</b>	
Tax reform drivers and lurking “time bombs”	5
2010 sunset of tax relief for individuals	8
Expanded reach for individual alternative minimum tax	10
Federal budget outlook: impact on tax reform	11
Tax reform and international business competition	15
Corporate tax rates and international competitiveness	17
US taxes on foreign income	19
Base broadening and corporate tax reform	22
Chairman Rangel’s reform legislation	22
Treasury base broadening options	24

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What this means for your business	28
<b>Tax reform presents both risks and opportunities for US business that companies should begin to evaluate now</b>	

The heart of the matter

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

Significant tax legislation will be on the agenda of the next president and the next Congress. Which scenario is likely to occur?

**Scenario 1:** Lower taxes, enhanced economic growth, and increased demand for products and services of US companies.

**Scenario 2:** Business taxes held constant overall, some domestic companies paying more and others paying less, while US-incorporated multinationals face a pronounced increase in tax burdens in response to concerns over the offshoring of jobs and “runaway plants.”

**Scenario 3:** Business taxes increased to pay for individual tax relief and new spending priorities of the next Administration.

Scenario 1 would be ideal, but it is unlikely. Concerns over the size of the federal budget deficit will likely require tax cuts to be offset by revenues from new taxes. Under either of the more likely scenarios, tax reform will create winners and losers, and create both risks and opportunities for business.

**Tax relief for individuals will necessitate tax reform.** No matter who is elected, early in the next presidential term, Congress and the Administration will have to grapple with the scheduled expiration after 2010 of significant individual tax relief enacted under President George W. Bush. Reform will also be required to prevent a vast expansion of the individual alternative minimum tax (AMT) to the middle class.

**While individual tax relief will drive the tax reform debate, corporate reforms may be the wild card.** Growing concerns over the competitiveness of the US tax system may provide the impetus for a reduction in the US statutory corporate tax rate.

**Tax relief will be weighed against budget pressures.** The budget cost of extending individual tax relief and fixing the AMT will exacerbate pressures for new revenue sources or a revamping of tax rules. A reduction in the corporate tax rate will likely be accompanied by “base broadening”—a scaling back of existing deductions, credits, and exclusions—to maintain total corporate tax revenues at or above current levels. Foreign earnings of US companies may face the most significant risk of a tax hike because of what we believe to be unfounded concerns that these operations contribute to US job loss.

**Be prepared, be informed; have an impact by sharing your knowledge.** Congress can benefit from the insights and experience provided by business. In turn, companies can best prepare by evaluating the risks and opportunities of tax reform to their business. Once informed, companies can then share this information with their stakeholders, employees, the media, and elected officials. Business has an essential role to play in informing Congress and others of the competitiveness and financial effects of possible reform.

An in-depth discussion

# Political and economic events are shaping the tax reform debate

## Tax reform drivers and lurking “time bombs”

This much we know: A bipartisan consensus is emerging on Capitol Hill and between the presidential candidates that tax reform will be a high priority beginning in 2009. Individual tax issues will drive tax reform, but corporate tax issues will be an important element as policymakers consider what is best for the growth of the US economy and the international competitiveness of US business.

The direction that tax reform takes will be influenced in part by political ideology, but the coming need for tax reform is entirely practical. On December 31, 2010, virtually all the individual tax relief enacted in 2001 and 2003 will expire. Unless these tax cuts are extended, taxpayers will face an overnight tax increase of \$250 billion per year starting in 2011.

Congress also has been unable to find a permanent solution to the expanding reach of the individual alternative minimum tax (AMT). The AMT, once intended to prevent a tiny percentage of high-income taxpayers from paying no tax, now directly hits the middle class due to the failure of Congress to adjust the AMT for inflation over decades.

While Congress is forced to deal with these individual income tax “time bombs,” business tax issues lie just below the surface. The US corporate tax rate—now second highest in the 30-member Organisation for Economic Co-operation and Development (OECD)—is believed by many policymakers to be a deterrent to US economic growth. Growing attention is also being placed on how US taxes influence foreign operations of US companies and how these operations affect domestic jobs and investment.

Budget pressures mean there will be no easy fixes. As the first baby boomers are entering retirement, the nation is reminded that the three major entitlement programs for the elderly—Social Security, Medicare, and Medicaid—are on a growth path that over decades runs the risk of bankrupting the economy. Congress has shown a renewed interest in not adding to these future burdens.

In this tight budget environment, US companies must first and foremost be alert to the potential risks of tax reform and, secondarily, look for potential opportunities that tax reform may provide to increase their competitiveness.

Unless current individual tax relief provisions are extended, taxpayers will face an overnight tax increase of \$250 billion per year starting in 2011.

# Lessons from the Tax Reform Act of 1986

The Tax Reform Act of 1986 (the “Act”) stands out as one of *the* most comprehensive revisions of the federal income tax system since its inception. The legislation was the product of nearly a three-year effort by the Treasury Department, the Reagan White House, and Congress to make the tax system fairer, simpler, and more efficient—and provided a revenue-neutral solution.

The Act reduced the top individual tax rate from 50% to 28% and lowered the corporate tax rate from 46% to 34%—at the time one of the lowest among industrialized countries. The legislation also shifted \$120 billion in taxes from the individual income tax system to corporations. This tax shift represented a 25% tax increase on corporations—its equivalent today would be a 5-year tax increase of over \$400 billion.

Three key lessons can be drawn from the 1986 legislation:

- Enactment of significant tax legislation took strong presidential and congressional leadership.
- The need for reform was driven by a sense that the tax system was unfair and riddled with loopholes.
- The basic formula of tax reform—rate reductions and base broadening—created winners and losers for a revenue-neutral outcome.

**Among business provisions**, the Act repealed the investment tax credit, which raised sufficient revenue on its own to finance the corporate rate reduction. Other significant business provisions scaled back depreciation deductions on real property and long-lived equipment, raised taxes by changing tax accounting rules, imposed a new corporate alternative minimum tax, and restricted the use of foreign tax credits.

## 2010 sunset of tax relief for individuals

The scheduled expiration after 2010 of key tax cuts enacted in 2001 and 2003 is the central reason why many policymakers view tax reform as inevitable.

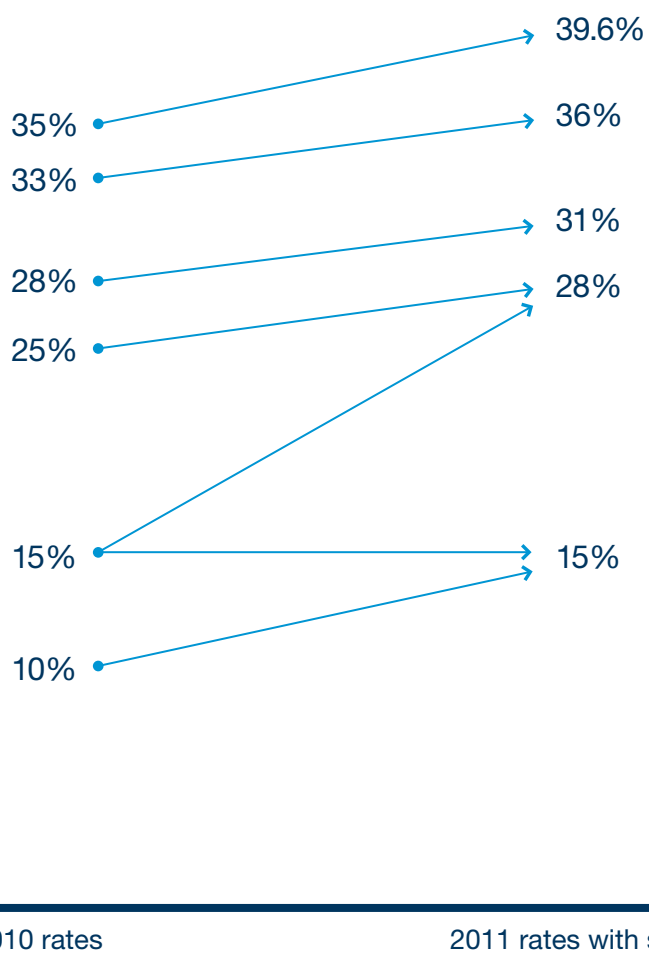
Unless new legislation is enacted, the individual tax code would largely revert to its pre-2001 status beginning in 2011. More than 116 million individual taxpayers would be affected by these changes, which would result in federal taxes growing by nearly \$3 trillion over the next decade:

- The current individual ordinary income tax schedule would revert to the pre-2001 rates, resulting in higher tax rates for most taxpayers beginning in 2011. The 10% bracket for low-income taxpayers would revert to 15%; a portion of the 15% bracket for married filers would be taxed at 28%; and other brackets would increase, with the top rate reaching 39.6% (Figure 1).
- The current capital gains tax rates of zero and 15% would revert to 10% and 20%.
- Dividends—currently taxed at zero and 15%—would be taxed as ordinary income, i.e., would be subject to a top rate of 39.6%.
- The estate tax, to be fully eliminated in 2010, would revert to a 55% top statutory rate with only a \$1 million exemption in 2011.
- The increased \$1,000 child tax credit would be halved, the increased standard deduction providing tax relief for married filers would decline by more than 15%, and many education incentives would expire after 2010.

More than 116 million individual taxpayers would be affected by 2010 tax relief sunsets, which would result in federal taxes growing by nearly \$3 trillion over the next decade.

**Figure 1. Tax rates for married couples filing jointly, 2010 and 2011 with sunsets**

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### **Expanded reach for individual alternative minimum tax**

The considerable cost of individual AMT reform is the second motivating factor for tax reform.

Unlike the tax brackets and personal exemptions under the regular income tax, the AMT is not adjusted for inflation. As a result, over time, an increasing number of individual taxpayers become subject to AMT simply by claiming personal exemptions, the standard deduction, or deductions for state and local taxes. The 2001 and 2003 tax cuts would have further increased the number of AMT taxpayers if not for the temporary increases in the AMT exemption that have been enacted since 2001—the so-called “AMT patch.”

Without action by Congress, the number of AMT taxpayers will increase dramatically. In fact, AMT taxpayers would rise to 26 million in 2008 from 4 million in 2007 unless Congress enacts another “patch” this year. By 2018, assuming no AMT relief and extension of the 2001 and 2003 tax reductions after 2010, AMT taxpayers would increase to approximately 55 million, or roughly half of all taxpayers with positive income tax liability.

Given the substantial cost of relief, there is broad agreement in Congress that the AMT issue can be addressed permanently only as part of tax reform legislation. If the 2001 and 2003 tax cuts are extended after 2010, permanently extending the “AMT patch” and indexing the AMT for inflation is estimated to increase the deficit by \$1.6 trillion over 10 years (2009–2018).

## **Federal budget outlook: impact on tax reform**

Tax reform will be considered against the fiscal backdrop of long-term federal budget deficits and alarming imbalances between projected long-run revenue and spending. While recent deficits are relatively low by historical standards as a percentage of GDP, federal spending on entitlements is projected to grow significantly in coming decades. Meanwhile, the threat of large future deficits increases the pressure on policymakers to maintain current deficits at manageable levels.

### *Near-term budget projections*

The budget deficit for 2008 is forecast to be on the order of \$400 billion, or 2.7% of GDP, up from \$163 billion in 2007. The Congressional Budget Office (CBO) projects the budget returning to surplus by 2012 under its baseline assumptions. However, these baseline assumptions assume significant fiscal restraint.

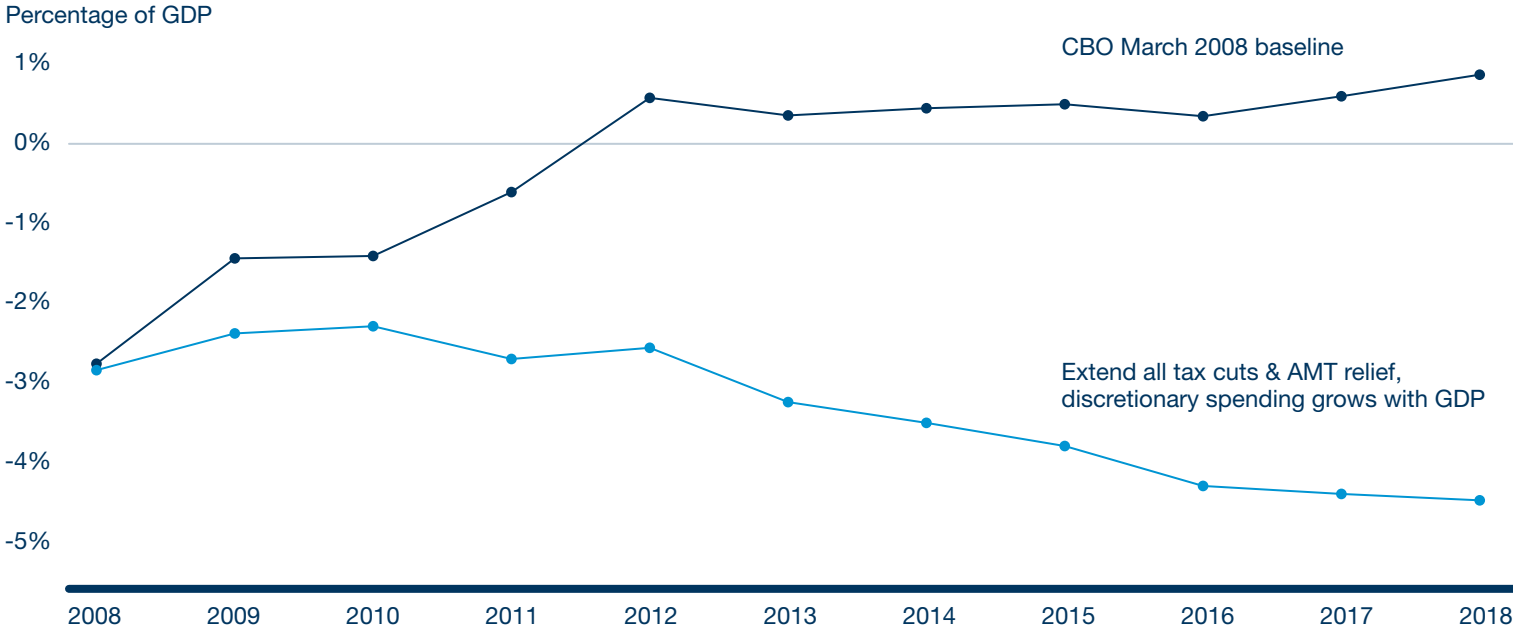
Specifically, CBO assumes: the expiration of the 2001 and 2003 tax cuts after 2010 as scheduled; no relief from the individual AMT; and growth in discretionary spending at *only* the rate of inflation or significantly below its historical rate of growth. Under these assumptions, the budget surplus would grow to about 1% of GDP by the end of the 10-year budget period in 2018. Tax receipts would reach 20.3% of GDP, about 2 percentage points greater than their historical average over the past 40 years. And spending would fall to 19.4% of GDP, about 1 percentage point below its historical average.

In contrast with the official CBO baseline, CBO also provides forecasts of budget deficits under alternative assumptions, some of which many budget observers would see as more realistic politically. One set of contrasting budget assumptions assumes extension of all individual tax provisions scheduled to sunset in 2010, indexation of the individual AMT for inflation, extension of miscellaneous annual expiring tax provisions, and higher spending by assuming future discretionary spending increases with the size of the economy rather than just inflation.

Under these alternative assumptions, the deficit would exceed 4% of GDP by 2018 (\$990 billion) (Figure 2). The cumulative deficit over the next 10 years would increase by \$6.6 trillion, of which the total tax relief and associated debt service would be responsible for \$5.0 trillion. To put some perspective on the magnitude of the ensuing deficits, corporate income tax payments cumulatively total \$3.5 trillion over the next 10 years.

Although the official CBO baseline may presume greater fiscal restraint than Congress is likely to muster, Congress is unlikely to allow deficits as large as those projected under the full set of alternative assumptions. This is especially likely given that, as discussed below, the deficit picture is only expected to worsen in the decades ahead. As a result, we anticipate that Congress will soon seek some marked increase in tax revenues.

**Figure 2. Effect of CBO alternative policy assumptions on budget surplus (deficit)**

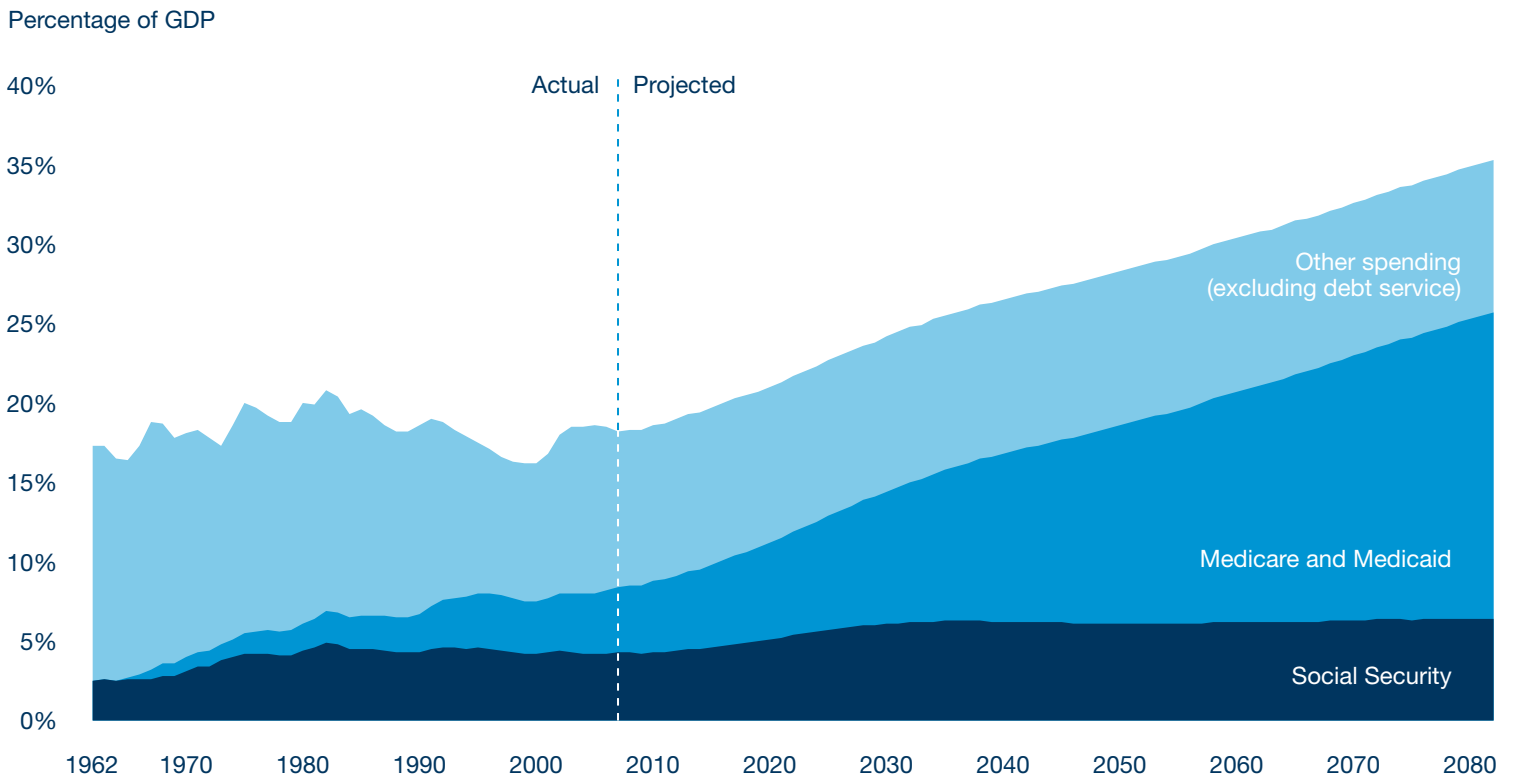


Source: Congressional Budget Office, March 2008, and PricewaterhouseCoopers calculations

### Long-term fiscal challenges

Projected increases in spending on Social Security, Medicare, and Medicaid in coming decades will require program reform to hold down their rate of growth and possibly higher future taxes. By 2050, CBO projects combined spending on these three programs to exceed 18% of GDP, up from about 8% in 2007 (Figure 3). To put this long-term spending projection in perspective, total federal revenue from all sources, including individual, corporate, payroll, and excise taxes, has averaged 18.3% of GDP over the past 40 years.

**Figure 3. CBO long-term budget projections**



Source: Congressional Budget Office, December 2007



## Tax reform and international business competition

The need to address individual tax issues will be the fundamental force behind the coming tax reform debate, but a growing appreciation by policymakers of the need for US business taxes to be competitive internationally could lead to significant changes. However, with political pressure for revenue neutrality, corporate tax reform is a classic zero-sum game, with some businesses winning and others losing.

The desire of policymakers for an internationally competitive business tax system simply reflects the increasing integration of the United States in the global economy. Low-cost communications and transportation have expanded the ability of corporations to operate on a global scale, both through exports and cross-border investment. Over the past 40 years, US exports have doubled relative to the size of the economy, while the share of corporate profits earned abroad by US corporations has more than tripled.

At the same time, the United States, which once dominated the ranks of the leading international companies, now is just one competitor among many. Worldwide, cross-border investment expanded from less than 6% of worldwide output in 1980 to 26% in 2006. In 1960, the United States accounted for more than half of outward cross-border investments; by 2006, it accounted for less than one-fifth. In 1960, the United States was home to 70 of the top 100 industrial corporations; it is now home to just 38.

The United States, which once dominated the ranks of the leading international companies, now is just one competitor among many.

The question facing US policymakers is how the changing patterns of foreign investment since the early 1960s should be incorporated into tax policy. No longer can US businesses be assumed dominant in world markets.

The increasing expansion by US companies into foreign markets has benefited the US economy. As US companies establish foreign operations to serve foreign customers, they can leverage their trademarks, patents, and R&D over a larger customer base, adding to US managerial jobs and frequently expanding US exports benefiting a large number of workers. This is the positive side of internationalization.

At the same time, global competition and rapid technological change have increased economic anxiety for many US workers, who fear their jobs will be threatened by these forces. So how can policymakers best harness the positive aspects of internationalization while minimizing the downside—and how can tax policy assist? Two key levers worth consideration are:

- the US corporate tax rate, and
- the tax rules applicable to foreign earnings of US companies.

## **Corporate tax rates and international competitiveness**

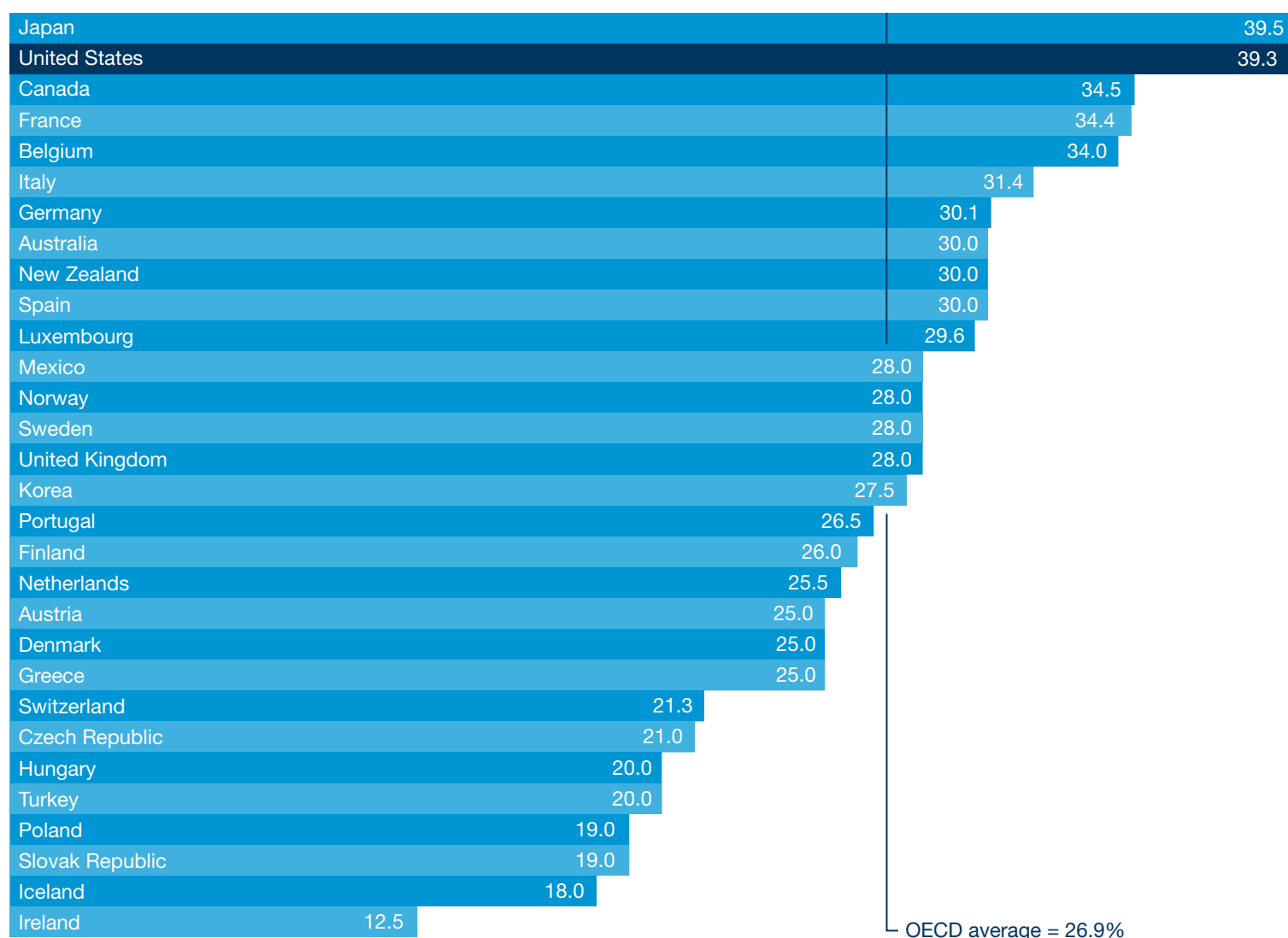
In 1986, the United States reduced its top corporate income tax rate from 46% to 34%, swinging immediately from having one of the highest corporate rates in the world to one of the lowest. In the years that followed, most other major industrial countries reduced their corporate tax rates below that of the United States.

Today, at 35%, the US federal corporate income tax rate is again one of the highest rates among developed countries. In fact, including state and local corporate income taxes, the US rate of 39.3% is second highest among the 30 countries of the OECD, and is more than 12 percentage points above the average tax rate of the other OECD members of 26.9% in 2008 (Figure 4). Within the European Union, the combined federal and local corporate tax rate is even lower, averaging 22.7% in 2008.

Overwhelmingly, the international trend is for lower taxes on corporations to enhance economic growth and provide higher paying jobs for a nation's workforce. In response, the President's Advisory Panel on Federal Tax Reform proposed a federal corporate tax rate of 31.5% in 2005. House Ways and Means Committee Chairman Charles Rangel, as part of his tax reform proposal introduced in Congress in 2007, proposed a 30.5% federal rate. A Treasury Department analysis in December 2007 considered a 28% rate.

A corporate rate reduction clearly would increase the competitiveness of US corporations. But even a 10% to 20% reduction in the federal corporate rate would still leave the combined federal, state, and local corporate tax rate significantly above the average rate within the European Union, and higher than significant competitors such as Germany and the United Kingdom. For example, at a 28% federal rate and assuming average state and local taxes of 6.6% (which, after deductibility, raise tax burdens by 4.7%), the combined US rate of 32.7% would remain more than 5 percentage points higher than the OECD average rate and rank the United States fifth highest in the OECD.

**Figure 4. Combined 2008 national and local corporate tax rates for OECD countries, %**



Source: PricewaterhouseCoopers and OECD

## US taxes on foreign income

The United States historically has followed the general principle that the worldwide income of a US corporation is subject to tax in the United States. But, in general, active business income of a foreign subsidiary of a US corporation is subject to US tax only at the time those earnings are paid to the US parent, typically as a cash dividend.

When payment of earnings to the US parent is delayed, this results in *deferral* of US tax. This deferral mirrors the tax treatment of individual shareholders in a domestic corporation, who are not subject to tax on the income earned by the corporation until it is paid to them as a dividend.

Increasingly, this principle of deferral has come under attack by some US policymakers, who argue—in our view, inaccurately—that deferral provides a tax incentive to locate production and jobs overseas rather than in the United States. The tax reform bill introduced by Chairman Rangel also shows that significant revenue is at stake. His proposal, which would increase the tax cost of companies using deferral, would increase tax revenues from US multinational corporations by \$106 billion over 10 years.

Proposals to restrict the use of deferral would have significant repercussions on the foreign activities of US multinational companies. All US trading partners either provide deferral or exempt the active foreign earnings of their companies from taxation. For example, within the OECD, the United States and eight other countries follow the practice of deferral while the remaining 21 countries exempt the active foreign earnings of their multinational companies from taxation. A change in US tax law to restrict deferral would make US-incorporated multinational companies less competitive relative to their foreign-incorporated counterparts who would continue to benefit either from deferral or exemption.

Given the high US statutory tax rate (even if reduced somewhat from its current level), US-incorporated multinational companies would generally face higher tax rates on their foreign earned income than their foreign-incorporated competitors. US multinationals, in addition to paying taxes in the foreign countries in which they operate, would be immediately liable for the amount by which US tax exceeds foreign taxes paid.

The argument for repealing deferral assumes that if the tax cost of foreign operations increased, US companies would locate these operations in the United States. But in many cases, such operations would not be viable domestically. US companies argue that foreign operations are established not to achieve tax savings but to serve foreign markets. By operating abroad, a company can establish a local foothold that allows it to market more effectively to consumers, lower transportation costs, and overcome formal and informal trade barriers.

Commerce Department data show that approximately 90% of what is produced abroad by US companies is sold to foreign customers. If US companies failed to operate abroad, in many cases these markets would not be served through US exports but would be supplied by foreign competitors.

As one US tax executive framed the issue, the choice is no longer “here or there”—whether to serve foreign markets by export or through local foreign operations, but “them or us”—whether the foreign customers will be served through local foreign operations of a foreign company or of a US company.

In our view, the establishment of tax rules that disadvantage the foreign operations of US companies relative to their foreign competitors can only serve to diminish the growth of US companies and have negative repercussions on the US economy. Today, world class companies must be global. Any company that fails to be competitive abroad runs the risk of being non-competitive in its domestic market as well.

In our view, the establishment of tax rules that disadvantage the foreign operations of US companies relative to their foreign competitors can only serve to diminish the growth of US companies.

## Why are US corporate taxes low relative to GDP?

While the United States has the second highest statutory corporate tax (behind Japan), US corporate income tax revenue (including federal and state) as a percentage of GDP paradoxically was much lower than the OECD average—2.2% in the United States versus an OECD average of 3.4%—over the 2000-2005 period.

Why this is the case may be important for the direction of tax reform. For example, some have inferred from the data that the US corporate income tax base is relatively narrow compared with the typical OECD member country tax base. We believe there is another important explanation that has received relatively little attention: US business and tax laws provide businesses with considerable flexibility in the legal form of organization.

Rather than organize as a regular corporation subject to two levels of tax (at the corporation and the shareholder levels), a business may organize as an S corporation, partnership, or limited liability company that is subject only to the individual

income tax and not the corporate income tax. After the top individual income tax rate was lowered below the corporate rate by the Tax Reform Act of 1986, the share of taxable business income earned through these non-corporate forms of business (including sole proprietorships) increased from 29% in 1987 to 52% in 2004.

If the same share of business income had been earned through regular corporations in 2004 as was the case in 1987, corporate income tax revenue would have been 45% higher, amounting to 3.2% (rather than 2.2%) of GDP in 2004. This would have placed the United States in the middle of OECD countries ranked by corporate tax revenue as a percent of GDP.

In summary, the relative low revenue yield of the corporate income tax can be largely explained by the unusually high share of US business income earned through entities not subject to corporate income tax, and does not result from a narrow measure of taxable income for a corporation.

# Base broadening and corporate tax reform

Given concerns over federal budget deficits and long-term fiscal imbalances, corporate tax reform is unlikely to result in a net tax reduction for business—it will either be revenue neutral or result in an increase in business taxes to pay for individual income tax relief. As a result, companies will have to weigh the potential trade-offs—that is, rate reduction in exchange for base broadening—that will be part of any significant corporate tax reform effort.

The business components of the tax reform proposal introduced by Chairman Rangel in October 2007 and other business tax reform proposals examined by the Treasury Department in December 2007 illustrate the potential trade-offs that could arise under tax reform.

## Chairman Rangel's reform legislation

Chairman Rangel's comprehensive tax reform bill (H.R. 3970) would reduce the corporate income tax rate from 35% to 30.5% and fully offset the lost tax revenue through business tax increases. The corporate rate reduction is estimated to reduce tax revenues by \$364 billion over 10 years.

Three corporate revenue-raising provisions account for most of the offsets proposed to pay for rate reduction:

- **Allocation of expenses to deferred foreign income and limitation of foreign tax credits:** The Chairman's bill would significantly increase the tax cost of deferral for US corporations with foreign earnings. One element of the proposal would require companies to defer the deduction of expenses allocable to a foreign subsidiary until the subsidiary's earnings are repatriated to the United States. These expenses would include an allocable share of the US group's interest expense and stewardship expenses. The proposal also would reduce the ability to claim currently foreign tax credits on highly taxed foreign income while deferring US tax on lower taxed foreign income. Under the proposal, foreign tax credits would be determined by taking into account only the percentage of foreign taxes equal to the percentage of foreign income that is currently taxed. This marked change in US taxation of the international operations of US-incorporated multinational companies would raise an estimated \$106 billion over 10 years.

- **Domestic production activities deduction:** The Chairman's bill would repeal the deduction for domestic production activities. Current law provides a 6% deduction for certain domestic income, including manufacturing income, increasing to 9% beginning in 2010. Given the current statutory corporate tax rate of 35%, the 9% deduction reduces the rate of tax on qualifying income to 31.85%. The proposed repeal is estimated by congressional revenue estimators to raise \$115 billion over 10 years, although the Treasury Department has estimated that the repeal could increase revenues by more than double this amount.
- **LIFO:** The Chairman's bill would repeal the last-in, first-out (LIFO) accounting method. During periods of rising prices, the cost of replacing items sold from inventory increases. For a firm with an increasing inventory, the LIFO method bases the cost of goods sold from inventory at their replacement cost rather than their historical value. The proposal would require any income recognized as a result of this change in accounting method to be spread over eight years. This proposal is estimated to raise \$107 billion over 10 years.

The effect of the Chairman's bill on companies would vary greatly by industry and degree of international exposure. For example, a domestic service company might receive the benefit of the corporate rate reduction without incurring any added tax cost from the base-broadening proposals. In contrast, a US-incorporated global manufacturing company might pay significantly more in tax on its foreign operations under the Chairman's proposal while receiving only a small reduction in tax on its domestic operations.

### **Treasury base-broadening options**

In December 2007, Treasury issued a report exploring the implications for the economy of revenue-neutral business tax reform. Of particular interest, Treasury considered a reform option that would reduce the federal corporate tax rate to 28% while achieving revenue neutrality through significant base broadening.

Among other changes, the broad base option would repeal the domestic production activities deduction and would not extend the expired research tax credit (as in common with Chairman Rangel's proposal). Roughly half of the base broadening would be achieved by eliminating accelerated depreciation and replacing it with a depreciation system providing for slower cost recovery. Unlike Chairman Rangel's approach, the base-broadening options considered by Treasury would not affect deferral of foreign earnings.

Figure 5 shows estimates of the revenue associated with the significant business provisions that would be eliminated under the base-broadening option described in the Treasury report.

**Figure 5. Potential business income tax base–broadening provisions**

	Revenue, FY 2008–2017 \$ billions		Total
	Corporations	Non-Corporate Businesses	
<b>Major business tax provisions</b>			
Deduction for US production activities	\$210	\$48	\$258
Research and experimentation (R&E) tax credit	132	1	133
Low-income housing tax credit	55	6	61
Exclusion of interest on corporate-owned life insurance	30	–	30
Inventory property sales source rules	29	–	29
Deductibility of charitable contributions	28	–	28
Special employee stock ownership plan rules	23	4	27
Exemption of credit union income	19	–	19
New technology credit	8	1	9
Special Blue Cross/Blue Shield deduction	8	–	8
Excess of percentage over cost depletion, fuels	7	–	7
Other business preferences <sup>1</sup>	27	28	55
<b>Total excluding depreciation</b>	<b>576</b>	<b>88</b>	<b>664</b>
Accelerated depreciation/expensing provisions	356	306	662
<b>Total revenue from business preferences</b>	<b>\$932</b>	<b>\$394</b>	<b>\$1,326</b>

Source: US Department of the Treasury, Office of Tax Analysis

<sup>1</sup> No business tax provision in this category exceeds \$5 billion over the 10-year budget period.

Like Chairman Rangel's approach, such a significant reform would have important effects across sectors of the economy, creating both winners and losers. Strikingly, however, Treasury estimates that this reform option would have little or no effect on the long-run growth of the US economy. Essentially, the growth-enhancing benefit of rate reduction would be offset by reduced incentives for new investment through repeal of business incentives.

Treasury's report considered other revenue-neutral corporate income tax reforms that are estimated to increase long-run output by 0.5% to 1.5%. The reform option with the greatest long-term economic benefits considered by Treasury would repeal the corporate income tax and make up for the lost revenues with a form of consumption tax similar to a value-added tax.

Treasury's findings have significant implications for all business tax reform. Revenue-neutral reform under which corporate rates are reduced but the tax base is expanded may not necessarily result in any additional economic growth. How the tax base is expanded matters as much for the overall economy as it does for individual companies.

Revenue-neutral reform under which corporate rates are reduced but the tax base is expanded may not necessarily result in any additional economic growth.

## The value-added tax and consumption taxes

All countries raise revenue in part through some form of tax on consumption, such as sales or excise taxes. Most OECD countries use a value-added tax (VAT) to raise a significant portion of overall revenue. The United States is the only OECD country without a VAT.

Treasury's December 2007 report considered use of a new federal consumption tax, a business activities tax (BAT), as a replacement for the corporate income tax. Yale Law School professor Michael Graetz has proposed using revenues from adoption of a VAT to reduce the top corporate tax rate to 15%–20% and the top individual tax rate to 20%–25%.

Taxes on consumption are generally one of two types:

- General consumption taxes, which are levied on a broad range of goods and services. These are usually levied in the form of a VAT or national sales tax. In the United States, sales taxes are levied at the state and local government level.
- Taxes on specific goods and services, such as federal excise duties on items like vehicle fuels, tobacco, and alcohol as well as imports.

### Revenue shares of major taxes in the United States and the OECD, 2005

	United States	OECD <sup>1</sup>	Difference
Personal income tax	35.1	24.6	+10.5
Corporate income tax	11.4	10.3	+1.1
Social security and payroll tax	24.7	26.4	-1.7
Property taxes	11.4	5.6	+5.8
Taxes on consumption	17.4	31.9	-14.5

Source: OECD, *Revenue Statistics 1965–2006*, Table C and Table 71. Includes national and local taxes.

<sup>1</sup> Unweighted average of all OECD countries

What this means for your business

**Tax reform presents both risks and opportunities for US business that companies should begin to evaluate now**

Both the new Congress and the next president will be expected to push for significant individual tax relief in 2009. Whether corporate tax changes become part of any reform measure will depend on the political environment, concerns for international competitiveness, and revenue needs.

There is a growing appreciation for the need to reduce the US corporate rate to bring it more in line with the lower rates of our trading partners. However, any reform measure that lowers the corporate rate likely will include other offsetting provisions to hold total business tax collections at or above current levels.

Tax reform thus presents risks as well as opportunities.

Even without a net increase in business taxes, corporate tax reform will create winners and losers as companies would be differentially affected by any base-broadening provisions relative to the benefit they may receive through rate reduction.

Risks to global businesses are high in this environment. The fragile political consensus that historically has embraced expanding world trade and investment to enhance American living standards remains vulnerable to assertions that global engagement no longer serves the best interest of the country.

A contraction of US international business activity resulting from any increased taxes on the foreign operations of US companies would have significant negative consequences for the US economy. Reduced exposure of US companies to the growing markets around the world is a recipe for stagnation and decline.

Other potential base-broadening proposals would create trade-offs for companies weighing the loss of provisions relative to the benefit of rate reduction. Key provisions in this mix include the deduction for domestic production activities, the LIFO method of inventory accounting, and the research credit.

It is critical for companies to model the impact on their taxes and profitability from the potential loss of these and other provisions at risk in the coming tax reform debate. By thoroughly understanding the impact of alternative proposals, companies can best plan and communicate whether tax reform can enhance their competitiveness.

Revenue-neutral tax reform is unlikely to bring about significant economic growth, but if the business community takes a firm, reasoned stand, it need not result in added burdens on business that would reduce US competitiveness.



To have a deeper conversation  
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