
Numerous business tax reform proposals included in report to Ways and Means Committee

May 9, 2013

In brief

The House Ways and Means Committee May 8 held a meeting covering the work of certain of its 11 bipartisan working groups on tax reform, with a second meeting covering the remaining groups expected to be held on May 17. The meeting follows the May 6 release of a [568-page report](#) by the staff of the Joint Committee on Taxation (JCT) entitled "Present Law and Suggestions for Reform Submitted to the Tax Reform Working Groups" (see [WNTS Insight: Joint Tax Committee staff issues report on Ways and Means tax reform working groups](#)).

The working groups were not asked to issue their own specific recommendations for reform, and similarly the JCT report does not include staff recommendations. The JCT report summarizes numerous public comments submitted through April 15 as posted on the Committee's website (without referencing by name the specific groups or individuals submitting the comments), and also provides a lengthy summary of present law and a brief summary of certain prior tax reform proposals.

As expected, the submissions reflect a broad array of opinions from stakeholders in tax reform, many addressing issues of great interest to corporate and pass-through businesses. Some commentators take positions contrary to those of other commentators; for example, some may call for expanding an existing tax incentive, while others may suggest repealing or limiting that incentive in the context of tax reform with rate reduction. Businesses may find the selected items listed below as helpful in understanding the input the Ways and Means Committee will be considering as it moves toward drafting tax reform legislation.

In detail

The largest portion of the JCT report (452 of 568 pages) provides a brief overview of the current-law federal tax system, followed by descriptions of present law organized by working group topic area. The next section of the report briefly

summarizes 12 selected comprehensive proposals to reform the federal tax system that have been presented over the past several years. The uniform organization of the report's summaries of those proposals allows for easier comparison of the various components of each proposal.

The last section of the report summarizes the more than 1,300 public comments received by the working groups. The comments include broad statements of support or opposition to various tax reform goals as well as recommendations with respect to specific tax provisions.

International

Adoption of dividend exemption system

One group of comments addresses adoption of a dividend exemption or similar source-based tax system – a move away from the current US worldwide system. In this group, key general recommendations include those proposing:

- a dividend exemption of no less than 95 percent;
- taxing a portion of foreign earnings on a current basis (as an alternative to expense allocation);
- do not exempt dividends out of income that would have been subject to subpart F but for the de minimis exception;
- extending dividend exemption to individuals and subchapter S corporations;
- retaining and making permanent the exemption from treatment as subpart F income for “active financing income”; and
- retaining and making permanent the controlled foreign corporation (CFC) “look-through rule.”

Specifics of international tax reform discussion draft

Numerous comments address specific aspects of the international tax reform “discussion draft” released by Ways and Means Committee Chairman Dave Camp (R-MI) in October 2011.

Regarding the structure of Chairman Camp’s participation exemption, the recommendations include:

- allowing netting of profitable and loss subsidiaries in determining the aggregate earnings and profits that may be subject to a toll charge;

- retaining the anti-splitter rules;
- retaining the current active and passive baskets (not combining them);
- repealing the separate foreign tax credit limitation for foreign oil and gas income;
- having the dividend exemption cover all active income, so only passive, portfolio-type income would be taxed; and
- not mandatorily deeming foreign branches to be CFCs for all Code purposes.

Commenters supported Chairman Camp’s recommendations to combine the active and passive baskets and to allow FTC carryforwards from pre-effective-date years.

Subpart F reform suggestions include:

- retaining the previously taxed income (PTI) concept;
- retaining the same-country subpart F exception;
- repealing the subpart F category for foreign base company sales and services income; and
- repealing the subpart F category of foreign base company oil-related income.

Regarding Chairman Camp’s three alternative base erosion options, the suggestions include:

For Option A,

- adding a rebuttable presumption that intangibles (as defined in Section 936(h)(3)(B)) have been used directly or indirectly in the relevant sales and services of the foreign base company; and
- using the current high-tax kick-out rate in Section 954 (90% of the

statutory corporate tax rate) without a sliding scale.

For Option B,

- expanding the same country exception by also providing an exception for manufacturing property that is exported; and
- increasing the foreign effective tax rate test to a rate higher than 10%.

For Option C,

- rejecting the proposal entirely based on administrability concerns;
- providing clear definitions of intangible income and foreign intangible income;
- simplifying the determination of intangible income by adopting a formulary approach; and
- revising Option C to ensure that it is compliant with World Trade Organization rules.

Regarding Chairman Camp’s thin capitalization proposal, suggestions include applying current Section 163(j) rules, eliminating the worldwide relative leverage test, and applying the limitation on a tax consolidated basis.

Expansion of current worldwide tax system

Some commentators favor repeal of deferral, a per-country foreign tax credit limitation, and adoption of a management and control standard for tax residency.

Other suggestions included restricting deductions associated with moving operations abroad and providing a credit for moving operations to the United States; imposing higher levels of tax on income associated with intangibles moved overseas; and tightening the transfer pricing rules to

prevent shifting of highly mobile income.

Other comments

Among the various other suggestions received by the international working group were recommendations to:

- eliminate the check-the-box regulations;
- expand the subpart F active royalty exception to royalties from related parties; and
- reduce the US corporate tax rate to align with those of our major trading partners.

Passthroughs and small business

Several comments received by the passthroughs and small business group express support for comprehensive tax reform that would include corporate, passthrough, and individual tax regimes.

Suggestions with respect to tax rates include:

- set the top individual income tax rate at an amount not higher than the top corporate income tax rate;
- reduce the top individual income tax rate below the top corporate income tax rate;
- create a business equivalency rate whereby business income of pass-through entities is taxed at the top corporate income tax rate; and
- reduce the employer's share of payroll taxes.

Other tax reform suggestions of note to pass-through entities include:

- permit tax deferral for corporations converting to pass-through form;
- change the tax treatment of property distributions (generally tax-free under current law);

- make Section 743(b) basis adjustments mandatory in the case of a sale or exchange of partnership property and repeal Section 704(c)(1)(C) with respect to contributions of built-in loss property;
- retain current Section 704 tax treatment of partnership special allocations;
- repeal Section 708(b)(1) regarding partnership technical terminations, in order to reduce additional compliance burden on partnerships and eliminate the restart of tax depreciation; and
- repeal the guaranteed payment rules.

Manufacturing

The majority of the comments received by the manufacturing working group urge consideration of comprehensive tax reform. Specific comments address several key issues for businesses.

Comments relating to the Section 41 research credit and the Section 199 domestic manufacturing deduction vary widely and include suggestions to retain the current rules, to make modifications to simplify the existing provisions or to benefit additional taxpayers, and to eliminate the provisions in connection with a significant reduction in the corporate tax rate.

With respect to capital expenditures, the working group received varying comments regarding accelerated depreciation, adjustments to cost recovery periods, and bonus depreciation. Some comments suggest requiring capitalization for items such as software development, product design, and patent costs.

Many inventory-related submissions related to use of the last-in, first-out

(LIFO) and lower of cost or market (LCM) inventory methods. There also were suggestions to repeal or simplify the UNICAP rules of Section 263A.

In the area of long-term contract accounting, there were suggestions related to the exception from Section 460 for certain construction contracts that recommend increasing the gross receipts limit.

Other comments urge preservation of current-law treatment for items such as interest expense and net operating loss (NOL) carryovers or propose new tax incentives for manufacturers.

Financial services

The comments submitted to the financial services working group can be classified into two main categories:

- comments on provisions relating to banks, insurance companies, equipment lessors, and other financial service providers; and
- comments on Chairman Camp's "discussion draft" on financial products tax reform, released January 24, 2013.

Comments on provisions relating to financial services providers include those suggesting:

- repealing the annual fee on health insurance providers (including the fee for stand-alone vision plans);
- retaining and strengthening the property and casualty insurance company tax deduction for loss reserves based on annual accounting and reporting to state insurance regulators;
- retaining current rules for property and casualty insurers permitting NOL carryforwards and carrybacks;
- preserving rules permitting carryforwards of the alternative

minimum tax (AMT) credit if the AMT is repealed;

- maintaining the deductibility of interest expense of property and casualty insurers without any new limits;
- rejecting proposals to further limit the dividends received deduction and loss deduction of life insurance companies connected with untaxed income;
- changing or retaining rules regarding the tax-free inside build-up of life insurance and annuity contracts;
- extending the active financing exception and CFC look-through exception to the subpart F rules applicable to international insurance business;
- rejecting proposals to increase taxes on reinsurance transactions with foreign affiliates; and
- simplifying reporting of mutual fund distributions or providing a de minimis threshold for such reporting.

Observation: Many large multinational financial services companies also will be interested in issues addressed by other working groups, such as those dealing with international tax rules and with debt, equity, and capital.

Comments on [the financial products discussion draft](#) include those suggesting:

- that the definition of a derivative that is subject to mark-to-market (MTM) treatment should be narrowed and further refined;
- that the MTM proposal in its current form could affect a wide variety of transactions and business arrangements entered

into in the ordinary course of business;

- that requiring mutual funds to mark derivatives to market without cash proceeds could make it difficult to meet distribution requirements and similarly, that an MTM regime requires the payment of tax in the absence of any realization event that could give rise to cash to pay the tax;
- that there could be discrepancies in the valuations of derivatives reported to taxpayers by market participants using differing valuation methods, resulting in additional complexity;
- that lack of clarity regarding the definition of a derivative could increase tax complexity;
- that the proposals could discourage the use of a wide variety of investment vehicles;
- that the provision related to the issue price of debt connected to debt modifications should be clarified regarding gain resulting from declines in value in purchased debt;
- that the proposed limit on the accrual of market discount on debt is too high;
- that the proposal regarding average cost basis of securities could add to complexity and burdens on taxpayers;
- that the provisions could increase complexity and compliance costs for industries that rely on low cost of capital and that require liquidity;
- that a tax hedge not subject to MTM treatment should be defined as a derivative position entered into by a taxpayer in its trade or

business to manage its business or investment risks;

- that the proposal regarding the tax hedge identification rules falls short of modernizing or expanding the hedging rules; and
- that the definition of embedded derivatives subject to MTM needs clarification and transition relief.

Observations: These comments generally seem to be directed to technical aspects of the discussion draft proposals, with a view towards narrowing the scope of certain proposals, such as MTM, and making sure that routine business transactions are not classified as derivatives.

Also, these proposals would seem to affect customers of financial services companies – such as hedge funds, investors, traders, and private equity funds – more than the companies themselves, many of which are already on some form of MTM.

Energy

The comments submitted to the working group on energy reflect four differing approaches to changes in this area:

- eliminating all tax preferences for energy;
- eliminating only oil and gas preferences;
- keeping existing oil and gas preferences; and
- enhancing some of the targeted renewable energy incentives.

Among specific comments, suggestions include:

- to modify the Section 856 real estate investment trust (REIT) rules to make it easier for REITs to install solar, wind, and other

renewable-power generators on REIT-owned buildings;

- regarding the Section 7704 rules on publicly traded partnerships (PTPs), some comments suggest keeping the PTP rules; others suggest expanding the rules to permit renewable technology and energy storage companies to operate as PTPs; one comment advised against expanding the PTP rules to include renewable technologies;
- to authorize the allocation of additional advanced energy project credits under Section 48C; and
- to extend and expand the eco-efficiency deduction under Section 179D.

Debt, equity, and capital

The working group on debt, equity, and capital received comments on a

wide range of issues, including the following suggestions:

- deny a deduction for interest expense that represents credit risk;
- provide uniform treatment of business profits by permitting a deduction for all dividends paid;
- tax publicly traded stock received in a corporate merger like cash received;
- treat equity (stock) like an option for tax purposes when the corporation's debt-equity ratio exceeds a threshold;
- require gain to be calculated to maximize gain and to bring basis up to value when a taxpayer sells stock and retains fungible stock;
- preserve capital gain treatment for carried interests of certain taxpayers;
-

count as contributed capital for carried interest purposes the amounts a developer puts at risk before creation of the partnership; and

- treat the choice to lease or finance the acquisition of equipment in a tax-neutral manner.

The takeaway

Tax reform legislation continues to be a high priority for Congress and President Obama. The JCT report should be helpful to businesses in understanding the input the Ways and Means Committee will be considering as it continues its work on tax reform legislation.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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