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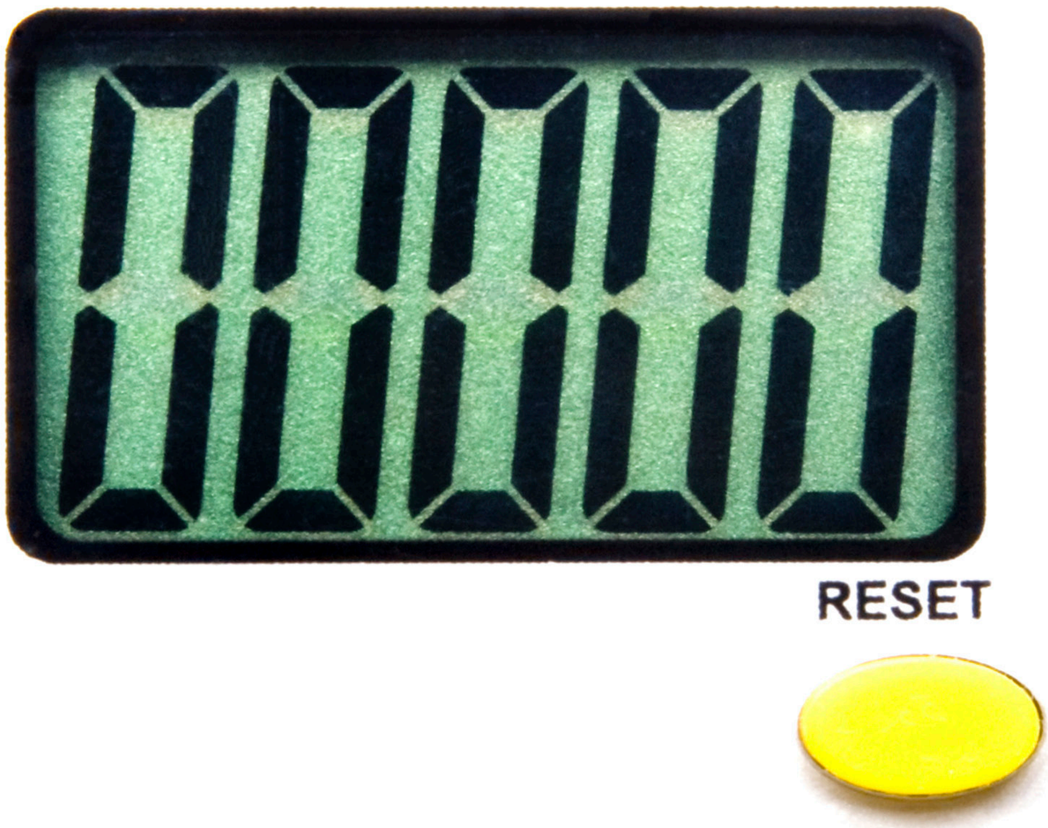

Resetting the code
Issues in corporate tax reform

November 2011

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Introduction: The call for reform

A mounting chorus across the political spectrum is calling for fundamental tax reform. With respect to the corporate income tax, three broad areas of consensus have emerged. First, in the view of most, if not all, policymakers, the corporate income tax rate must be reduced substantially. Second, in conjunction with lowering the tax rate, reformers are revisiting a host of "tax expenditures" that may be reduced or eliminated. Reduction of such expenditures is also promoted to simplify the income tax code and to reduce the importance of tax considerations in business decision making. Third, reformers agree that it is past time to reexamine the basis upon which the United States taxes multinational corporations. What is missing from the debate, however, is a consensus on the amount of corporate income tax to be collected and the details of reforms that reduce current-law benefits.

Reducing the rate by expanding the base

The design, and therefore the reform, of any income tax system can be reduced in simplistic terms to two fundamental questions: *What income is to be taxed?* and *What rate will apply?*

The current debate over tax reform appears to be proceeding from a view that the tax rate should be in the mid-20 percent range. This seemingly leaves as the next major challenge in reform the question of what income will be taxed. All else being equal, a low rate implies a large amount of income subject to tax. Unless corporate tax collections are to be reduced overall, agreement on a rate in the mid-20 percent range implies the elimination or substantial restriction of most present-law "tax expenditures," which the Congressional Budget and Impoundment Control Act of 1974 defines as "revenue losses attributable to provisions of the federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability.[1]"

In addition to curtailing exclusions and deductions, reducing the tax rate to the levels sought by reformers also would mean considering other expansions of the amount of income subject to tax and eliminating a host of current-law credits that otherwise would reduce tax.

Expanding the tax base, then, will require Congress to consider:

- Expanding the definition of gross income by limiting exclusions or tax exemptions;
- Eliminating deferrals of income;
- Reducing or eliminating some available deductions from gross income; and
- Delaying the deduction of other amounts.

This publication examines some of the tough choices that policymakers will face as they attempt to transform their desire for tax reform into legislative action and the potential impact of these changes on corporate taxpayers. It then looks at what corporate taxpayers can do to anticipate reform, navigate the transition to a new system, and thrive in a post-reform era. Finally, it considers the likelihood of significant action on corporate tax reform in the current political environment.

[1] Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-2010), Dec. 15, 2010. Tax expenditure estimates are reported by the Joint Committee as an annual revenue loss projection over a five-year budget window, indicating lost revenue from corporate receipts and individual receipts, and a five-year combined, total cost. Deloitte calculations throughout this document reflect total five-year cost from corporate receipts only and do not reflect revenue lost from individual receipts. Because the Joint Committee's numbers that were totaled were individually rounded, the Deloitte calculations may differ slightly from what the Joint Committee would calculate by totaling the unrounded detail and then rounding the five-year number.

Expanding the definition of gross income

Any effort to "buy down" the corporate tax rate by broadening the tax base will require Congress to consider expanding the definition of gross income by limiting exclusions or tax exemptions; eliminating deferrals of income; reducing or eliminating some available deductions from gross income; and delaying the deduction of other amounts. But cutting current-law expenditures could be very controversial, because many are viewed by taxpayers and some policymakers as essential elements in a "fair tax system" or as a necessary means to achieve desirable social or economic ends.

Exclusions, exemptions, and deferrals

Current law provides a number of exclusions or exemptions as well as certain deferrals of income that act to reduce the total amount of current income potentially subject to tax. The largest of these are the exclusion of interest on state and local government bonds, the exclusion of investment income on life insurance and annuity contracts, and the deferral of gain on like-kind exchanges. Others, while relatively much smaller, affect a specific segment of taxpayers for whom they are important provisions. These include, for example, the exemptions for credit union income and for investment income of small property-casualty insurance companies, and exclusions from income for disaster mitigation payments, contributions in aid of construction for water and sewer utilities, and gain or loss on the sale or exchange of brownfield property.

The difficulty that will face policymakers as they contemplate limiting or eliminating these provisions can be seen by looking at the history of the two largest ones: the exclusions from gross income for interest paid on state and local government bonds and investment income added to the cash value of life insurance policies ("inside build-up").

Interest on state and local bonds – The Joint Committee on Taxation (JCT) estimates that, when considered alone, the exclusion of interest on public purpose state and local government bonds held by corporate taxpayers will reduce their tax liabilities by about $45 billion over the years 2010 through 2014.[2] Separately, the exclusion of interest on certain qualified private activity bonds is also estimated to reduce tax liabilities by several billion dollars annually.

The size of tax exclusion benefits accorded holders of state and local public purpose and private activity bonds virtually guarantees that they will be examined as part of any corporate reform effort. Lawmakers will be forced to weigh the benefits these instruments provide to the development of U.S. infrastructure against the significant costs the provisions impose on the federal budget.

In fact, the discussion has already begun: Erskine Bowles and Alan Simpson, the co-chairs of the National Commission on Fiscal Responsibility and Reform (informally known as the Bowles-Simpson commission), put forward a plan that called for repeal of the exclusion;[3] Sens. Ron Wyden, D-Ore., and Dan Coats, R-Ind., have introduced legislation that would limit the cost of the federal subsidy by converting the tax exclusion to a tax credit bond system;[4] and President Obama has proposed limiting the value of the exclusion to that which would be realized by taxpayers in the 28 percent bracket.[5]

Since its enactment in 1913, the federal income tax has provided an exclusion from income for interest on public purpose bonds issued by state and local governments. These bonds are a mainstay of state and local infrastructure financing and fiscal management. Governments issue them to finance roads, schools, and other projects that benefit the general public and to anticipate revenue or refinance existing debt. Repeal of the exclusion would reverse nearly 100 years of policy and dramatically alter federal-state financial relationships.

Governments also issue "private activity" bonds that are used to finance projects that a governmental entity wishes to support or encourage and that provide benefits that are enjoyed by individuals or businesses in their private capacities. These bonds are repaid with income generated by the project itself, rather than general revenue dollars. Private activity bonds are generally taxable unless the bonds are used to finance certain activities specified in the tax code — such as the construction of government-owned airports, bus depots, and subway stations — and are issued in conformity with set volume caps.

[2] JCS-3-2010, *supra*, note 1.
[3] The National Commission on Fiscal Responsibility and Reform, *The Moment of Truth*, Dec. 2010.
[4] Sen. Ron Wyden, Sen. Dan Coats, *The Bipartisan Tax Fairness and Simplification Act of 2011*, Apr. 2011.
[5] Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals*, Feb. 2011.

Since volume limitations were first placed on the issuance of private activity bonds in 1968, the number of permitted uses and the volume caps have generally increased, not declined. Repealing tax-exempt private activity bonds, therefore, would require reversing that trend.

Such a policy reversal has been attempted before, but without success. As part of the negotiations leading up to the Tax Reform Act of 1986 (the 1986 Act), a comprehensive proposal put forward by the Reagan administration — the so-called "Treasury II" proposal — recommended repealing the tax exemption for private activity bonds in order to pay for lower tax rates while maintaining the exemption for public purpose bonds. Although the final tax reform bill did tighten restrictions on tax-exempt bond issues and treat interest on private activity bonds as a preference under the alternative minimum tax (AMT), the legislation retained the tax exemptions for both types of instruments.

Inside build-up – Another exclusion from corporate gross income — the exclusion for investment income credited to life insurance policies — is estimated to cost the government about $13 billion between 2010 and 2014.[6] This increase in the cash value of the policy — inside build-up — is not subject to tax if it is used to reduce the policyholder's future premiums or is effectively distributed as a death benefit under the policy.

This exclusion also has been in the law since 1913, but has been the subject of several legislative and tax reform proposals over the past few decades. For instance, the Reagan administration, as part of its Treasury II proposal, recommended the current taxation of inside build-up. Although the proposal was not adopted in the final legislation, the tax reform bill did require corporate policyholders to include income from inside build-up for purposes of the AMT.

In recent years, concerns over corporate-owned life insurance financed through policy loans and other large corporate insurance transactions also have led to repeated legislation. Legislation in the 1990s restricted interest deductions on policy loans and the Pension Protection Act of 2006 included restrictions on the tax-exempt treatment of death benefits.[7] All of these actions continued to allow tax-free inside build-up on "key-person" insurance by corporations and other businesses. Tax reform efforts, therefore, may reopen an issue that has already consumed significant congressional attention and that affected parties may regard as settled.

Each of the other exclusions, exemptions, and deferrals contained in current law will have its own history, constituency, and defenders. In each case, reform would likely reverse longstanding policy and affect parties whose expectations may be firmly established.

Capital recovery

Current law provides detailed rules for the recovery of capital costs incurred in a trade or business. Many of these are considered tax expenditures by the JCT and therefore are likely to be examined as part of any tax reform effort. The largest group of these tax expenditures consists of the rules providing for accelerated depreciation allowances in excess of straight-line recovery provided under the alternative depreciation system and the small business expensing allowance of section 179. Other tax expenditures related to the recovery of capital expenditures over time include allowances for percentage depletion, amortization of air pollution control facilities, amortization of geological and geophysical expenditures, and business startup costs.

In addition, the Internal Revenue Code provides for immediate expensing of a host of defined expenditures that the JCT views as benefiting more than one period and therefore also considers to be tax expenditures. These include qualified expenditures for research and experimentation; natural resource exploration and development costs; reforestation expenditures and timber-growing costs; and costs incurred for soil and water conservation, raising dairy and breeding cattle, and for fertilizer and soil conditioner.

Since 1954, the trend in capital cost recovery has been toward liberalization. Prior to 1954, business equipment was typically depreciated on a straight-line basis over tax lives that were largely determined by the taxpayer. The 1954 code authorized the use of certain accelerated depreciation methods, however, and Congress continued to act on many occasions during the subsequent decades to prescribe depreciation methods that allowed capital costs to be recovered more rapidly, including, most

6 JCS-3-2010, *supra*, note 1.

7 *Pension Protection Act of 2006* (Pub.L.109-280, sec. 863).

recently, several rounds of bonus depreciation and repeated increases in the expensing allowance for small businesses.

As a result, any tax reform effort that significantly lengthens recovery periods or moves away from accelerated depreciation and toward straight-line or economic depreciation would reverse a nearly 60-year trend toward increased incentives for capital investment.

The basic structure of the current depreciation system — the Modified Accelerated Cost Recovery System (MACRS) — was established by the Tax Reform Act of 1986, which modestly reversed the very dramatic acceleration of cost recoveries that occurred under the Economic Recovery Tax Act of 1981. Importantly, however, the 1986 Act also repealed the Investment Tax Credit — an action that significantly increased the after-tax present value cost of capital investments — demonstrating that in the context of an overarching reform effort, Congress can repeal major tax incentives.

Many of the other amortization or expensing rules identified as tax expenditures are less generally applicable. Some reflect longstanding tax policy choices in the context of circumstances in which the periods benefited by a tax expenditure may be less clear than is the case with purchases of equipment. Others represent congressional decisions to encourage or support specific industries or to reduce the after-tax cost of regulations that require businesses to make capital investments.

Deductions

Although any discussion of tax expenditures will speak to “exclusions, deductions, and credits,” remarkably few deductions associated with recurring expenses of a corporation constitute tax expenditures. The largest of these include charitable contributions, certain aspects of the reserve deductions of life and property-casualty insurance companies, and the carryback of net operating losses. The current reserving rules for insurance companies resulted from reforms enacted in 1984 and 1986. In recent years, Congress has liberalized net operating loss carrybacks in response to the recession. Taken together, these expenditures represented a reduction in tax liabilities of less than $8 billion during 2010.

Charitable giving – Proposals to limit charitable contribution deductions for individuals have sparked enormous controversy. The passions fueled by those debates could make limiting business charitable deductions difficult as well. Further, if charitable deductions were limited, businesses could conclude that some of their contributions were made for business purposes and, therefore, deductible in any event.

Business expenses – In considering tax reform and ongoing business expenses, it is interesting to note that reform efforts of the past have not stopped at reforming tax expenditures. In some cases, Congress has found policy justifications for limiting deductions that are otherwise consistent with a theoretical definition of income. For example, beginning with the 1986 Act, Congress acted to limit the deduction for business meals and entertainment expenses while legislation enacted in 1993 introduced limitations on the deduction of executive compensation under section 162(m).

Perhaps the most prominent deduction likely to be examined in conjunction with the current tax reform debate is that for business interest expense. In fact, members of the House Ways and Means and Senate Finance committees recently held a joint hearing to examine the relative tax treatment of debt and equity.

Under present law, businesses are permitted a deduction for interest expense but corporations are not permitted a deduction for dividends paid to shareholders. This disparity in tax treatment is ameliorated somewhat by the current reduced top rate on qualified dividend income for individuals of 15 percent (the taxation of dividend income is scheduled to revert to ordinary rates in 2013), but many still argue that the interest deduction skews financing decisions heavily toward debt and away from equity.

Deciding whether, or to what extent, interest or dividend payments should be deductible by corporations requires a conclusion as to the treatment of those payments by the individuals receiving them. However, very little consensus exists in this regard. Many conservatives argue that investment income should not be taxed at all, while some liberals — and even some bipartisan reform plans, such as the Bowles-Simpson plan — advocate for the taxation of such income at ordinary rates in a low-rate system. Answering these questions apart from individual tax reform is impossible and is highly controversial even in the context of individual reform alone.

Section 199 – Most observers believe that to lower the corporate income tax rate, Congress will be forced to consider eliminating the deduction for domestic production activities income under section 199 — a tax expenditure that carries a five-year cost of about $43 billion.[8] Such proposals have been made previously.

For instance, the former chairman (and current member) of the House Ways and Means Committee, Rep. Charles Rangel, D-N.Y., recommended repealing the section 199 deduction as part of his 2007 tax reform plan that would have lowered the top corporate rate to 30.5 percent.[9] Sens. Wyden and Coats also proposed to repeal the deduction, along with many others, in their bid to establish a flat corporate rate of 24 percent.[10]

The section 199 deduction was enacted as part of the American Jobs Creation Act of 2004 to encourage U.S. manufacturing and, under current law, generally allows a deduction for 9 percent of income generated by qualified production activities, limited to the lesser of 50 percent of wages paid or taxable income attributable to such activities.[11] The deduction for income from oil and gas production activities is computed at a 6 percent rate.

Accounting methods

A more complex set of deduction issues arises in connection with methods of accounting. In particular, the JCT treats several inventory methods as tax expenditures even though no provision of statutory law specifically provides for them. These are the last-in- first-out (LIFO) method, the lower of cost or market (LCM) method, and specific identification for homogeneous products. Other accounting methods listed as tax expenditures include special rules for returns to publishers and distributors of previously sold magazines and paperback books, the completed contract rules, and the allowance of cash accounting for certain businesses other than agriculture.

Accounting methods, whether or not they constitute tax expenditures, are likely to receive critical examination in any tax reform process. The 1986 Act, for example, included limitations on the cash method of accounting, the installment sale method, and accounting for long-term contracts, and required capitalization of inventory, construction, and development costs.

Credits against tax

Current law contains 40 specific tax credits that are identified as tax expenditures. Among the largest federal tax credits claimed by corporations are the research and experimentation credit under section 41 and the low-income housing credit under section 42. The low-income housing credit is estimated to cost the government about $27 billion in lost corporate receipts between 2010 and 2014,[12] while the research and experimentation credit's reported cost over the same period — $12 billion — will actually be much greater if the credit is extended beyond its scheduled expiration at the end of 2011.[13] Other large credit programs include nearly 20 energy-related tax credits and the new credit for small business health insurance purchases.

Although most of these credits are subject to sunset provisions, over the years most have been repeatedly renewed by Congress. However, they, too, will come under examination by lawmakers as they strive to pay for a reduced corporate tax rate.

Certain credits will survive — possibly in limited form — based on lawmakers' belief that their retention will be beneficial to the economy. For instance, the Tax Reform Act of 1986 continued the research and experimentation credit — which originally entered the code in 1981 — for that very reason, but reduced the credit rate from 25 percent to 20 percent of research expenditures.

Lawmakers may determine that other credits simply should be repealed. President Reagan, as part of his administration's Treasury II proposal, recommended that a host of tax credits benefiting the renewable energy and alternative fuels industries, as well as the investment tax credit and a credit for qualified rehabilitation expenditures, either be terminated or allowed to expire as scheduled.

[8] JCS-3-2010, *supra*, note 1.
[9] Rep. Charles Rangel, *The Tax Reduction and Reform Act of 2007*, Oct. 2007.
[10] *The Bipartisan Tax Fairness and Simplification Act of 2011, supra*, note 4.
[11] *American Jobs Creation Act of 2004*, (Pub.L. 108-357, Sec. 102).
[12] JCS-3-2010, *supra*, note 1.
[13] *Ibid.*

Not your father's tax reform

The current conversation about tax reform is premised on lowering individual and corporate tax rates into the mid-20 percent range by repealing all or substantially all current tax expenditures. Often this approach is analogized to the base broadening and rate reduction that occurred in the Tax Reform Act of 1986. Interestingly, however, the 1986 Act left the vast majority of the then-existing tax expenditures in place.

Of the 110 tax expenditures listed in the JCT's annual tax expenditure publication in March 1986, only 24 were gone when the list was published in 1987. Of these, five disappeared from the list because capital gains rates were increased to the level of ordinary rates. Notwithstanding the 1986 tax reform, the number of tax expenditures reported by the JCT in early 1987 had increased to 128. Between 1987 and 2007, the number of tax expenditures grew to 202. Of these, 100 were on the original 1987 list.[14]

It is also worth noting that of the 27 largest current-law business tax expenditures (listed on the first page of Appendix 1 in this publication), 22 relate to tax benefits that were available under the Internal Revenue Code as amended in 1986. Of course, provisions have been modified by subsequent legislation.

Within the corporate income tax, the 1986 Act reduced tax rates from 46 percent to 34 percent at a revenue cost of $117 billion over five years. At the same time, however, total corporate taxes were increased by $120 billion. The additional revenue raised from corporate taxpayers, which helped lower individual tax rates, came from a handful of major sources and a collection of lesser items. The major changes — inventory capitalization ($32 billion), the alternative minimum tax ($22 billion), insurance reforms ($11.5 billion), completed contract accounting ($9.6 billion), international tax changes ($9.2 billion), and depreciation changes ($7.7 billion) — accounted for two-thirds of the remaining increase.[15]

Corporate tax reform in a vacuum?

Any corporate tax reform that repeals significant business tax expenditures necessarily would have significant impact on noncorporate taxpayers. Unlike the pre-1986 era, corporate taxpayers do not make up the majority of the current business tax landscape. According the the IRS's *Statistics of Income Bulletin*, in 2007, nearly 40 percent of business receipts were reported on tax returns for passthrough entities — partnerships, limited liability firms, sole proprietorships, and S corporations. These represented nearly 95 percent of all business tax returns.

The largest business tax expenditures — accelerated depreciation, the section 199 deduction, and the exclusion of investment income on life insurance and annuity contracts — provide significant benefits to noncorporate taxpayers. If Congress were to eliminate all business tax expenditures and only lower the corporate tax rate, noncorporate taxpayers would lose significant tax benefits ***without*** receiving any benefit from a lower tax rate.

To address the challenge of businesses subject to tax under the individual income tax, policymakers have a range of options. In the past, reform of both individual and corporate tax has occurred simultaneously. An alternative approach suggested in some tax reform plans would be to convert the corporate income tax into a business income tax. Under such a system, business income would not be subject to tax at the individual level. Other possibilities in between these extremes include changes to the rules governing passthrough entities or special deductions related to business income earned by individuals that seek to equalize the tax burden between those taxpayers and corporations.

[14] *Ibid.*

[15] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), Table 2A, May 4, 1987.

The call for a territorial tax system

The United States employs a worldwide system for international taxation of business and personal income. U.S.-resident companies generally are taxed on their worldwide income, regardless of where the income is earned, and are allowed a credit for foreign taxes paid on net foreign-source income. Corporate income generally is not subject to U.S. tax when it is earned. Rather, tax is deferred until income is repatriated to the U.S. parent corporation, which is entitled to foreign tax credits associated with the income. Under the controlled foreign corporation (CFC) rules of subpart F, the United States taxes certain types of income earned by CFCs, whether or not it is distributed.

Historically, most of the United States' major trading partners also employed a worldwide system. But with the dramatic global economic changes of the last 50 years, other countries have changed their international tax systems, citing competitiveness concerns. Today, most other countries that belong to the Organisation for Economic Co-operation and Development (OECD) have some form of a territorial system. These systems generally exempt foreign-source income from domestic corporate tax, subject to varying restrictions.

In the last few years, Japan and the United Kingdom (U.K.) have adopted territorial systems, leaving Chile, Ireland, Mexico, Poland, South Korea, and the United States as the only OECD countries with worldwide systems. This movement, along with a relatively high stated U.S. corporate income tax rate, has led to serious concerns about the continued competitiveness of U.S. firms. As a result, the taxation of U.S.-based multinational corporations will be a central topic in any tax reform effort.

Issues to consider

Although the issue is often stated in binary terms — worldwide or territorial — the choices are less clear. No country employs a purely territorial or purely worldwide system. The current U.S. system has some territorial elements such as the deferral of active business income, and territorial systems retain some significant worldwide features in the form of "anti-abuse" rules. Thus, any new set of territorial rules likely will retain some aspects of the worldwide system.

If U.S. tax policymakers move in the direction of a territorial tax, they will need to address myriad policy concerns in its design, most notably:

- What current rules should be kept or modified to fit the new system?
- What rules should be abandoned?
- What income is defined as foreign-source exempt income?
- What is the impact of this system on the deduction of expenses incurred by U.S. multinationals?
- What anti-abuse rules are needed?
- What, if any, transition rules should be provided?

Countries around the world have addressed these concerns in different ways. The decisions they made and the ideas included in previous U.S. territorial proposals are likely to give Congress many examples to study or follow as it considers its options.

Dividend exemption

In most countries, not all foreign-source income is treated equally. Generally, only active business income qualifies for territorial treatment; interest and other passive income is typically subject to domestic taxation at normal rates. However, some systems give special preferences to certain types of passive income (see the discussion on intellectual property below), putting that income in a middle area between active and interest income.

Most countries have adopted a dividend exemption system. This is the approach most commonly discussed by U.S. policymakers. In such a system, when a foreign subsidiary pays a dividend representing active business income to the domestic parent or shareholder, the dividend is either partially or fully exempt from tax. The U.K. system has a 100 percent exemption, while others, like France, Germany, and Japan, exempt 95 percent. Further, not every dividend qualifies for the exemption because of ownership or "participation" threshold qualifications: the U.K., for example, generally requires ownership of at least 10 percent in the foreign subsidiary, while Japan requires 25 percent. The 5 percent of dividends subject to tax is often referred to as an offset to expenses deducted in the domestic return that are attributable to the dividend income.

A related question is one of entity choice. What if the foreign operations are performed by a branch (or a partnership) rather than a subsidiary? The treatment of branch income varies widely from country to country. Some, like France and Switzerland, take a more territorial approach and exempt branches as if they were separate foreign subsidiaries. Others, like Canada and Germany, employ the worldwide approach and treat the branch as part of the parent with its income fully subject to domestic taxation. Still others, like the Netherlands, apply a special regime for branches that acts as a hybrid. The U.K. generally taxes branches domestically, but it is possible for branches to elect exempt treatment. In 2005, President George W. Bush's tax reform advisory panel called for the adoption of a territorial plan. As part of that plan, the panel recommended that branches be treated like foreign subsidiaries and their income exempted from tax.[16] It should be noted that in many countries, a CFC system may further affect or limit branch rules (see discussion below).

Expenses

If a tax system provides an exemption for dividend income, should it allow deductions for domestic expenses other than interest — such as head office expenses and research and development — that are related to the production of the exempt income? Many countries allow these deductions, but a few, like Australia, do not. Notably, the territorial plan included in the 2005 Bush tax reform panel's report would not have allowed expense deductions.[17] Similarly, the territorial option examined as part of the 2007 Treasury Department report on U.S. competitiveness would fully or partially limit expense deductions.[18]

If the deductions are allowed, further questions arise because there may be mismatches between taxable income and deductible expenses. Disallowance of deductions requires a complex system of determining which expenses are attributable to exempt income. That is why some countries simply opt to exempt 95 percent of dividends from foreign subsidiaries as a surrogate to expense disallowance.

Even when expenses are generally deductible, interest expenses often are subject to different rules or restrictions than other expenses because of concerns about abuse from related-party financing. For example, the U.K. has thin-capitalization rules that apply to excessively leveraged finance structures. These rules predate the U.K. territorial system, but they were retained in the switch to the territorial regime. In addition, the U.K. adopted a worldwide debt cap that limits interest expense deductions in certain situations. Australia introduced specific rules in 2001 to permit interest deductions on funds used to generate exempt dividends subject to thin-capitalization limitations.

An added policy question in the United States concerns the earnings stripping rules of section 163(j), which deny interest expense deductions on related-party indebtedness in certain situations. Depending on the structure of a U.S. territorial system and its interest rules, it may be necessary to revisit these rules because of different effects on domestically controlled groups versus foreign-controlled ones.[19]

CFC rules

The United States was the first country to enact CFC rules almost 50 years ago, with the goal of strengthening the worldwide nature of the U.S. system by preventing U.S. multinationals from deferring tax on specified types of foreign-source income that Congress thought were subject to abuse.[20] The experience of other countries indicates that adopting territoriality does not mean abandoning an existing CFC regime.

Several countries, like Canada and the U.K., that had CFC systems prior to their switch to territorial regimes have retained their rules. In these countries, the CFC regime continues to impose current domestic taxation on some forms of foreign-source income. A few countries, like Switzerland, have territorial systems without CFC rules. The U.K. has announced it intends to modify its CFC system, but details on the changes will not be forthcoming until December 2011.

[16] Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair, and Pro-Growth: Proposals to Fix America's Tax System*, "The Simplified Income Tax Plan," Nov. 2005.

[17] *Ibid*.

[18] Department of the Treasury, Office of Tax Policy, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007.

[19] Joint Committee on Taxation, *Background and Selected Issues Related to the U.S. International Tax System and Systems That Exempt Foreign Business Income* (JCX-33-11), May 20, 2011.

[20] See generally S. Rep. No. 1881, 87th Cong., 2d Sess.

Foreign tax credits

Under the current U.S. system, a credit for foreign taxes paid is allowed on foreign-source income to prevent double taxation. In a territorial system with a full or near-complete dividend exemption, foreign tax credits would be unnecessary, but foreign tax credits would still be needed to prevent double taxation of nonexempt income.

Sale of subsidiary stock

Similar questions that determine what income is exempt apply to determine the treatment of gains and losses from the sale of foreign subsidiary stock. Should this gain get the same treatment as active business income (exemption) or should it be treated as investment income subject to domestic taxation? Countries differ on these rules. For example, Japan and Canada do not exempt the sale or transfer of foreign subsidiary stock from their capital gain rules, while Australia and France allow the gain to receive the same exemption under certain conditions.

Transfer pricing

The current U.S. system places great emphasis on transfer pricing rules under section 482 to ensure that taxpayers do not inappropriately shift income between domestic and foreign operations. Transfer pricing rules are equally important in a territorial system because in most dividend exemption systems, transactions between a foreign subsidiary and its domestic parent will move taxable income into or out of the territorial exemption.

Some argue that because of potential rate differentials between foreign-source and domestic income, pressure on transfer pricing rules would become even greater because of the potential to achieve rate arbitrage advantages through income shifting,[21] and, therefore, a territorial system will require even stronger transfer pricing rules.[22]

Intellectual property

Perhaps the greatest source of pressure on transfer pricing rules is the treatment of royalties and other intellectual property transactions between related parties, because these transactions are often the most contested issues between tax authorities and taxpayers. One way to address the issue is to exempt all or some royalty payments between foreign subsidiaries and the domestic parent. Few of the United States' major trading partners take this approach, however, as Australia, Canada, France, Germany, and Japan all tax royalties as domestic income.

The major trading partners that do differ in their treatment of intellectual property do so through a special preference regime that applies to intellectual property income that would normally be fully taxed as passive income. This regime, termed a "patent box," is usually elective and is seen as a way of encouraging domestic high-tech industry or research and development. For example, the Netherlands' "innovation box" regime taxes net income from qualifying property at an effective 5 percent rate. Similarly, the U.K. intends to establish a patent box in 2013 that will apply an effective tax rate of 10 percent for income that can be sourced to certain U.K.-patented intellectual property.

Implementation

The final issue Congress would have to address in a switch to a territorial system relates not to the system's design but rather to its implementation. What rules should be put in place for the transition from worldwide to territorial taxation? One of the biggest would involve the treatment that should apply to pre-effective-date earnings. Should anything repatriated after the effective date get the new treatment? Or should pre-effective date earnings be subject to the old rules or get treatment somewhere between the systems? Or should companies be allowed to elect the treatment they want? Alternatively, should a separate tax regime apply to pre-effective date earnings that encourages repatriation of these earnings?

Another issue is that of existing tax treaties, which were entered into and ratified under the worldwide system. Many contain double taxation articles and the denial of credits would override these treaties. Some of our trading partners may seek to renegotiate their treaties; however, there is less pressure on this issue if the U.S. tax rate is equal to or greater than the effective foreign tax rate imposed by the other country.

[21] See, e.g., Avi-Yonah, testimony before the House Ways and Means Committee, *2011 TNT 101-46*, May 24, 2011, and testimony before the Senate Finance Committee, *2011 TNT 175-44*, Sept. 8, 2011.

[22] See Parillo, "Panelists Describe the 'Right' Way for the U.S. to Do Territoriality," *2011 TNT 198-3*.

A first step: Camp's territoriality proposal

A growing number of voices ranging from the Bowles-Simpson commission to the House Republicans and leading contenders for Republican presidential nomination have called for adoption of a territorial tax system. The most detailed proposal to date for a U.S. territorial tax system was issued recently in the form of a discussion draft by House Ways and Means Committee Republicans led by Chairman Dave Camp of Michigan.

Camp's proposal calls for the United States to move to a territorial regime using a 95 percent dividend exemption system beginning in 2013 for active foreign business income. U.S. corporations that are at least 10 percent shareholders of CFCs would be allowed a 95 percent deduction for the foreign-source portion of dividends received from those CFCs, and the proposal would treat branches as CFCs with payments from the branch to the U.S. parent eligible for the deduction. However, the domestic companies would not be allowed to claim foreign tax credits against that income or deduct expenses incurred to generate it. As part of the transition to the new system, a one-time repatriation would require those shareholders to include in income the pro-rata share of the undistributed and previously untaxed foreign earnings of the CFC, subject to taxation at an effective rate of 5.25 percent. Subpart F would be retained so that certain "highly mobile" and passive income would continue to be currently taxed, but the draft also offers three options to address "base erosion caused by shifting intangible property and its related income."

While this draft is significant, it is only a first step. It is important to keep in mind that these international proposals are part of what the committee views as the beginning of a substantive debate about reforming the Internal Revenue Code.

Transition relief

A final consideration for Congress in reforming the corporate tax system will be what transition rules should be in place and whether any transition relief should be provided. Any transition rules and relief will depend heavily on what changes reform makes and how those changes affect different taxpayers. However, a compelling consideration for Congress will be that transition relief will reduce the revenue increases attributable to specific repeal actions and make it more difficult to lower rates generally. It is possible that Congress may provide some transition relief, but the current focus on base-broadening and simplification suggest that any relief may be limited.

The experience of the Tax Reform Act of 1986 can be instructive on this point. Its rate-reducing and base-broadening tax reform provided little in the way of broad-based transition relief for taxpayers. Most of the rules were fully effective in less than two years from the date of enactment. The tax consequences of some ongoing transactions were protected only when clear evidence such as binding contracts or substantial construction demonstrated a taxpayer's reliance on prior law. In other cases, such as the recognition of previously realized capital gain income after the effective date, no relief was provided.

Changes to widely applicable provisions were implemented with little transition and in some cases were retroactive. For example, in the 1986 Act, Congress repealed the investment tax credit, which had been available to most corporate taxpayers. Investment tax credits were eliminated retroactively to the beginning of 1986 (the Act was signed into law in October of that year). Investment tax credit carryforwards that taxpayers had accrued before 1986 were preserved; however, these carryforwards were subject to a haircut of 17.5 percent in the first year and 35 percent thereafter. The minimal transition and relief were driven by revenue concerns, as was the decision to reject a Reagan administration proposal to delay the effective date for the repeal until January 1, 1987.

Impact on financial statements

Tax reform will present four interrelated considerations for those responsible for the financial statements of affected firms.

Disclosures

First, as tax reform proposals are unveiled and legislative activity develops, companies will want to consider whether, and to what extent, disclosures related to the potential impacts of reform are appropriate in their Management Discussion and Analysis. As described below, tax reform may affect the tax burdens and benefits reflected in future income statements and is likely to affect current deferred tax assets and liabilities (DTAs and DTLs) and valuation allowances on the balance sheet.

Projections of earnings and taxable income

Second, as the substance of tax reform becomes clearer, taxpayers will want to consider revising projections of earnings and taxable income for future periods. Ultimately, these projections could reflect not only changes resulting from the application of new tax laws to projected income but also changes in the business model to reflect the impact of reform on markets and business structure. Such projections could assist in understanding tax reform's impact on future investment decisions and on the company's effective tax rates.

Balance sheet issues

Third, companies also will want to consider the impact of tax reform on their balance sheet as tax reform progresses. Generally Accepted Accounting Principles (GAAP) require that DTAs and DTLs be adjusted for the effect of a change in tax laws or rates in the financial reporting period in which such changes are enacted. A change in tax laws or rates may also require a reevaluation of a valuation allowance for deferred tax assets. For example, a reduction in the statutory rate will require businesses to reduce deferred tax assets and liability accounts to reflect the lower rates. The change would be reflected as an income statement tax expense or tax benefit in the financial reporting period of enactment. The significance of these changes to any particular company will vary. For many, the one-time adjustments may not be significant to business. For example, while reducing the value of the DTA established for a net operating loss carryforward could be seen as negative, the asset would still offset the same amount of future income as it would have before the change. Similarly, the reduction of a DTL, such as one reflecting accelerated depreciation, would reflect a beneficial rate arbitrage, but the income on which lower taxes are paid under a reformed tax code will be earned in an environment in which competitors also enjoy lower rates.

Companies will want to consider not only the impact of a corporate tax rate reduction on each deferred tax account but also its effects on a firm's overall net DTA or net DTL position. For example, a reduction in a net DTA position — the result for a company with significant net operating losses or deferred compensation — requires an increase to tax expense, which reduces shareholder equity and earnings. Conversely, reductions in a net DTL position — the result for a company with significant accelerated depreciation for tax — would boost accounting earnings and shareholder equity by decreasing tax expense.

If a company's net DTAs constitute a significant portion of shareholder equity, the decrease in shareholder equity caused by the rate reduction might require additional communications with stakeholders. Conversely, if net DTLs were substantial relative to net shareholder equity, a rate reduction would cause a substantial increase in shareholder equity.

Additionally, if tax reform resulted in significant reduction in net DTAs or DTLs, these changes in the overall balance sheet could affect compensation plans, loan covenants, and other business arrangements tied either to asset values, debt-to-equity ratios, or current earnings. Similarly, regulated entities subject to capital or surplus requirements could see an impact on those calculations.

State tax impact

Fourth, most states rely on portions of the federal taxable income laws to define elements in their calculation of taxable income. Companies will want to determine the impact of federal changes at the state level. In many cases, these may be adverse because broadenings of the tax base will not be accompanied by lower state tax rates. The same consideration, as previously discussed, should be given in those cases where the state tax base has also been altered by the federal changes.

In summary, whatever form tax reform takes, the financial statement impact — to the balance sheet accounts related to income taxes and to future income statements — will be significant. Effective stakeholder communications regarding financial statement changes and effective implementation planning for reform can be strengthened through better tax transparency, modeling of reform options, and scenarios planning. Once tax reform legislation has been enacted, companies will have to revise projections and earnings and update balance sheet accounts for the statutory change. The tough choices that the White House and Congress make in tax reform will create winners and losers. For companies filing GAAP financial statements, the wins and losses will be tallied on the income statement and balance sheet.

Anticipating reform

This publication has outlined the challenges policymakers will face in moving the current discussion of tax reform from general principles to enacted law. In preparing for such a reform, a helpful approach for corporate taxpayers is to consider the impact of reform over three distinct time periods — the pre-reform present, the transition period, and the post-reform period — and on four aspects of a business — business operations, owners (shareholders), employees, and products and services.

The present

The principal challenges prior to any reform include preventing the mere prospect of reform from imposing unnecessary costs, preparing the business for effective engagement in the reform discussions, and preparing key stakeholders for potentially significant changes.

The prospect of reform necessarily raises the question of whether current business planning should be delayed or modified. Although the question is a sensible one, an overreaction at this stage could result in missed opportunities. While current reform discussions bring the prospect of significant changes to the business environment, it remains true that U.S. tax policy is always uncertain. Successful businesses have learned to plan and act despite these perpetual uncertainties. Many of the tax benefits that are put at risk by reform discussions will survive. Backing away from current-law opportunities creates the risk of permanently lost benefits and the resulting competitive disadvantage.

Effective planning in the current environment is more challenging than usual since the scope of potential reforms increases the risk and opportunities. In day-to-day operations, important elements of a business's success become embedded in the normal course of the business. The first challenge of pre-reform planning, therefore, may be to better understand the business's stake in current tax spending. With this understanding, the business will be better positioned to actively participate in the reform process and better prepared to prosper in a post-reform era.

Taxpayers will want to assess their situation and understand how they operate under the current tax law — that is, understand the benefits or burdens of the current system that drive their tax planning or business decisions. A comprehensive assessment of tax reform risks would include modeling of potential impacts from various alternative proposals based on input from the tax department and operational units such as those concerned with asset acquisition and management, international investments, employee and executive benefits and compensation, shareholder reporting, cost and risk management, and product offerings.

While the investments that businesses make in information systems, forecasting, analytics, and modeling capabilities improve current operations and governance, they also should increase the transparency that management and the board will need to effectively understand and prepare for the risks and opportunities presented by tax reform.

As businesses work internally to understand the potential impacts of reform and in Washington to stay current and connected, they may also need to communicate with key stakeholders, including executives and employees, potential recruits, and investors. For example, reform can create concerns in a company's workforce or in the recruiting marketplace about the strategy or success of a particular product or service. Businesses will want to consider strategies to satisfy emerging employee needs ranging from tax and compensation planning to effectively developing and communicating a vision of the post-reform future that enhances recruitment and retention of employees.

Shareholders or other investors will be keenly interested in the potential effects of reform. Businesses will want to consider communications strategies that help investors understand the risks and opportunities presented as reform unfolds.

Transition

The principal challenges of the transition from an old to a new system will include securing benefits in current tax policy that will become unavailable post-reform and taking advantage of opportunities presented by the transition, including identifying competitors and others who may be less well prepared for change.

Transition from one tax regime to another always suggests paying special attention to planning opportunities. For example, as a result of anticipated rate increases in 1993 or tax cuts in 2001, individual and business taxpayers paid careful attention to the timing of income and deductions. Similarly, when rates go down, business taxpayers consider planning strategies such as carrying losses back to higher-rate years so as to preserve credit carryforwards for use in lower-rate years. Of course, Congress sometimes acts to minimize the advantages of such planning. At a more detailed level, if a specific credit or incentive were to be repealed, taxpayers would want to maximize their pre-repeal benefits to the extent permissible under applicable laws and regulations.

Tax changes can generate indirect economic effects that create transition risks and opportunities. They may affect the availability of or demand for specific goods or services.

Elimination of targeted tax expenditures could affect the value of investments, the profitability — or even viability — of a product or service line, or the demand for products or services benefited by the expenditure. For example, in the past, the expiration of alternative and renewable energy incentives has led to a perceived downturn in some of the affected activities.

As reforms develop over time, the legislation will change, expand, and contract. Businesses that have achieved real-time transparency to their own operations and forecasts and whose executives and boards have engaged in appropriate planning will be better prepared than others. Such businesses will manage the challenges of adapting to disruptions more effectively and will find that an ill-prepared competitor or supplier may create an opportunity for a strategic acquisition or a gain of market share.

Change may also affect a business's workforce. Employees and potential recruits may not be in a position to understand well the impacts of reform. They could become concerned that the future of a particular business or career field has been adversely affected. Employers will want to help employees understand the changes occurring in the business and the new opportunities that they present.

The post-reform world

The principal challenges of the post-reform period will include the implementation of new systems; the introduction of new or modified products; and a review of choice of entity, structure, and investment choices for tax efficiency. Tax reform also could bring with it new information system and governance requirements. This is most evident when complex restrictions are imposed on deductions or credits.

Many businesses are organized to be tax-efficient under present law. To the extent that tax reform changes the relative advantages of incorporating or operating as a flow-through entity, investing and deploying employees abroad or in the U.S., or securing capital through debt or equity, businesses will want to review and, as appropriate, modify existing structures.

Winners and losers

As tax reform unfolds, there may be only two certainties. First, reform will necessarily create winners and losers in the economy. Second, those who prepare well will claim a greater share of the winnings and be burdened with a smaller share of the losses.

Conclusion: What's possible in the current political environment?

Since the 112th Congress convened in January of 2011, the House and Senate taxwriting committees have held a series of "information gathering" hearings to educate members on issues in corporate and individual tax reform. But the reality is that lawmakers already are awash with information, ideas, options, and blueprints for overhauling the tax code. Just consider:

- Over the past twelve months, the Bowles-Simpson commission estimated that statutory corporate tax rates could be reduced to between 23 and 29 percent through the elimination of select corporate and individual tax expenditures;[23] the Bipartisan Policy Center recommended reducing the top tax rate for corporations and individuals to 27 percent through a combination of reduced business and individual tax expenditures and a 6.5 percent Debt Reduction Sales Tax;[24] and Sens. Wyden and Coats introduced their proposal to drop the corporate rate to 24 percent, reduce the number of individual tax rate brackets to three, and repeal or modify tax expenditures such as the section 199 deduction, deferral, and the foreign tax credit to help pay for the rate reduction.[25]
- "Historical" examples also abound. In its 2007 study on competitiveness, the Bush Treasury Department estimated that corporate tax expenditures narrow the corporate tax base by approximately 25 percent and that if these provisions were removed from the tax code the statutory corporate tax rate could be reduced from 35 to 27 percent.[26] That same year, then-Ways and Means Committee Chairman Charles Rangel unveiled his plan to cut the corporate rate to 30.5 percent in exchange for putting a host of corporate expenditures on the chopping block.[27]
- More proposals are on the way. The Obama Treasury Department is expected to release its whitepaper on corporate tax reform in the near term and several Republican presidential hopefuls have made lowering corporate tax rates a part of their respective campaign platforms.

Getting to 'yes'

So the central question is this: How does the process move from the gathering of information to the development of — and action on — a comprehensive set of recommendations? A comparison of the current situation with the political environment of 1985, when Congress last took up fundamental tax reform, suggests that Congress and the White House face a number of challenges in developing and moving concrete proposals:

- **Attention to detail** – To date, neither the president nor congressional Republicans have placed a detailed tax reform plan on the table. House Ways and Means Committee Republicans recently released a draft tax reform plan that would reduce the top corporate tax rate to 25 percent and move the United States to a territorial system for taxing foreign-source income. But the draft leaves some significant blanks when it comes to other corporate and individual tax reforms — including base-broadening measures. In contrast, by the time Congress began to focus on tax reform in 1985, the Treasury Department had already released over 800 pages of analysis, distributional tables, and revenue estimates covering various options for tax reform and the president had sent a nearly 500-page report to Capitol Hill detailing his recommendations.
- **Consensus and bipartisan support** – For reform to move forward, the leaders of the two congressional taxwriting committees — House Ways and Means Committee Chairman Dave Camp and Senate Finance Committee Chairman Max Baucus, D-Mont., will likely have to agree initially on the broad parameters of a deal. But even if consensus is reached at that level, it remains to be seen whether Camp and Baucus can sell a deal to their respective caucuses given the high level of partisanship in the current Congress. The 1986 Act was possible, in part, thanks to the formation of a bipartisan coalition of "traditional" Democratic reformers and loophole closers and new Republican rate cutters who were agreed on certain key goals of tax reform (the form of tax, the need to lower rates and broaden the base, the importance of revenue neutrality, and the desire to maintain the existing distribution of tax burdens between corporate and individual income taxes and across individual income classes).

[23] National Commission on Fiscal Responsibility and Reform, *supra*, note 3.
[24] Bipartisan Policy Center (Debt Reduction Task Force), *Restoring America's Future: Reviving the Economy, Cutting Spending and Debt, and Creating a Simple, Pro-Growth Tax System*, Nov. 2010.
[25] *The Bipartisan Tax Fairness and Simplification Act of 2011, supra*, note 4.
[26] *Approaches to Improve the Competitiveness of the U.S. Business Tax System in the 21st Century, supra*, note 18.
[27] *The Tax Reduction and Reform Act of 2007, supra*, note 9.

- White House leverage – President Obama came into office with a relatively strong electoral mandate, but many believe he quickly used up much of his political capital in his effort to move controversial health care reform legislation and the relationship between the White House and Congress has become marked by mutual distrust. Although he has stated that revenue neutral tax reform is a priority for his administration, he currently lacks the leverage necessary to lead the tax reform effort and move a plan through Congress. President Reagan made tax reform a central theme in his 1984 reelection campaign and the electoral mandate he received gave the White House considerable leverage when negotiating tax reform with key players on Capitol Hill.

Outlook: Action unlikely before 2013

The realities of the current political landscape suggest that action on tax reform is unlikely until sometime after the 2012 elections. The agenda of the 112th Congress has focused primarily on government spending issues rather than on tax legislation. With the end of 2011 in sight, neither the president nor congressional Republicans have placed a comprehensive, detailed tax reform plan on the table and we are unlikely to see one this year. Moreover, movement toward the level of detail reflected in President Reagan's nearly 500-page recommendation to Congress in 1985 is unlikely to happen in an election year. Perhaps a 2012 election fought over tax and spending reform is a necessary precursor to definitive action. Certainly, Congress will have difficulty moving major reform without the active engagement and advocacy of the executive branch.

Once legislative action begins, a disconcerting ebb and flow will test the public's vigilance. In the nearly two years between the release of the 1984 Treasury report on tax reform and the enactment of the Tax Reform Act of 1986, tax reform was pronounced dead and then resurrected several times. Each time tax reform was revived, it moved the process and the players a little closer to a final compromise. We find ourselves in a similar situation today: at the beginning of a debate that will necessarily create winners and losers, dramatically impact both current and future tax planning, and set the course for tax policy for the coming years. At this stage, it is too early in the debate to know what our tax system will look like in the future, but we know that the decisions made now will go far to determine how taxes are paid and collected for the coming generation.

Appendix 1: Business tax expenditures

The following table shows the cost to the government in 2010 of the tax deductions, credits, and other incentives currently available to business taxpayers. Note that most businesses organized as passthrough entities claim these benefits on an individual return.

Provision	Cost in 2010 claimed on corporate returns ($ billion)	Cost in 2010 claimed on individual returns ($ billion)
Depreciation of equipment in excess of alternative depreciation system	24.1	4.3
Inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument	21.1	1.7
Deferral of active income of controlled foreign corporations	12.5	0
Exclusion of interest on public purpose state and local government bonds	7.5	19.3
Inventory property sales source rule exception	7.2	0
Deduction for income attributable to domestic production activities	7.0	2.4
Credit for low-income housing	4.9	0.2
Expensing of research and experimentation expenditures	4.3	0.1
Credit for increasing research activities (section 41)	4.0	0.1
Inventory methods and valuation: *LIFO*	3.6	0.5
Reduced rates on first $10 million of corporate taxable income	3.2	0
Exclusion of investment income on life insurance and annuity contracts	2.5	25.4
Special treatment of life insurance company reserves	2.2	0
Deduction for charitable contributions to health organizations	1.8	2.5
Deferral of gain on like-kind exchanges	1.4	0.7
Five-year carryback of general business credits	1.3	0.3
Interest expense allocation: *Separate grouping of affiliated financial companies*	1.2	0
Deferral of active financing income	1.0	0
Credit for electricity production from renewable resources (section 45): *Wind*	1.0	*
Deduction for charitable contributions, other than for education and health	1.0	29.2
Special tax rate for nuclear decommissioning reserve fund	0.9	0
Special tax provisions for employee stock ownership plans (ESOPs)	0.9	0.5
Expensing of exploration and development costs, fuels: *Oil and gas*	0.7	*
Election to expense 50 percent of qualified property used to refine liquid fuels	0.7	0
Expensing of timber-growing costs	0.7	*
Interest rate and discounting period assumptions for reserves of property and casualty insurance companies	0.7	0
Exclusion of interest on state and local government qualified private activity bonds for private nonprofit and qualified public educational facilities	0.7	1.9

Provision	Cost in 2010 claimed on corporate returns ($ billion)	Cost in 2010 claimed on individual returns ($ billion)
Completed contract rules	0.6	*
Special rules for interest-charge domestic international sales corporations	0.5	0
Excess of percentage over cost depletion, fuels: *Oil and gas*	0.5	*
Depreciation of rental housing in excess of alternative depreciation system	0.5	4.5
Work opportunity tax credit	0.5	0.1
Exclusion of interest on state and local government qualified private activity bonds for private nonprofit hospital facilities	0.5	1.3
Credit for orphan drug research	0.5	*
Credit for electricity production from renewable resources (section 45): *Open-loop biomass*	0.4	*
Credit for investment in advanced energy property	0.4	0.1
Credit for rehabilitation of historic structures	0.4	0.1
Ordinary gain or loss treatment for sale or exchange of Fannie Mae and Freddie Mac preferred stock by certain financial institutions	0.4	*
Inventory methods and valuation: *Lower-of-cost-or-market*	0.4	0.1
Exemption of credit union income	0.4	0
Special deduction for Blue Cross and Blue Shield companies	0.4	0
Deduction for charitable contributions to educational institutions	0.4	5.1
Exclusion of Medicare benefits: *Exclusion of certain subsidies to employers who maintain prescription drug plans for Medicare enrollees*	0.4	0
Apportionment of research and development expenses for determination of foreign tax credits	0.3	0
Depreciation recovery periods for energy-specific items: *Five-year MACRS for certain energy property (solar, wind, etc.)*	0.3	*
Exclusion of interest on state and local government qualified private activity bonds for owner-occupied housing	0.3	0.7
Credit for employer-paid FICA taxes on tips	0.3	0.2
Proration for property and casualty insurance companies	0.3	0
New markets tax credit	0.3	0.4
Tax credit for small businesses purchasing employer insurance	0.3	1.6
Deduction for foreign taxes instead of a credit	0.2	0
Credits for alternative technology vehicles	0.2	0.6
Credits for investment in clean coal facilities	0.2	0
Credits for the production of energy-efficient appliances	0.2	0
Excess of percentage over cost depletion, fuels: *Other fuels*	0.2	*
Exclusion of interest on state and local government qualified private activity bonds for rental housing	0.2	0.6

Provision	Cost in 2010 claimed on corporate returns ($ billion)	Cost in 2010 claimed on individual returns ($ billion)
15-year recovery period for retail motor fuels outlets	0.2	0.2
Expensing under section 179 of depreciable business property	0.2	0.7
Depreciation of buildings other than rental housing in excess of alternative depreciation system	0.2	0.1
Exclusion of interest on state and local government qualified private activity bonds for private airports, docks, and mass-commuting facilities	0.2	0.5
Empowerment zone tax incentives	0.2	0.3
Build America Bonds (expired)	0.2	0.7
Eliminated requirement that financial institutions allocate interest expense attributable to tax-exempt interest	0.2	0
Disaster relief: *Midwest disaster relief*	0.2	0.9
Disaster relief: *National disaster relief*	0.2	0.2
Credit for holders of qualified zone academy bonds	0.2	0
Tonnage tax	0.1	0
Therapeutic research credit	0.1	0.1
Credit for alcohol fuels	0.1	0
Deduction for expenditures on energy-efficient commercial building property	0.1	0.1
Amortization of geological and geophysical expenditures associated with oil and gas exploration	0.1	*
Amortization of air pollution control facilities	0.1	0
Depreciation recovery periods for energy-specific items: *15-year MACRS for certain electric transmission property*	0.1	0
Depreciation recovery periods for energy-specific items: *15-year MACRS for natural gas distribution lines*	0.1	0
Expensing of exploration and development costs, nonfuel minerals	0.1	*
Excess of percentage over cost depletion, nonfuel minerals	0.1	*
Amortization and expensing of reforestation expenditures	0.1	0.1
Five-year carryback period of net operating losses attributable to farming	0.1	0.1
Exclusion of interest on state and local government small-issue qualified private activity bonds	0.1	0.2
Amortization of business startup costs	0.1	1.3
Small life insurance company taxable income adjustment	0.1	0
Tax-exempt status and election to be taxed only on investment income for certain small property and casualty insurance companies	0.1	0
Deferral of tax on capital construction funds of shipping companies	0.1	0
District of Columbia tax incentives	0.1	0.2

Provision	Cost in 2010 claimed on corporate returns ($ billion)	Cost in 2010 claimed on individual returns ($ billion)
Exclusion of interest on state and local government qualified private activity bonds for sewage, water, and hazardous waste facilities	0.1	0.2
Disaster relief: *Gulf Opportunity Zone*	0.1	0.6
Exclusion of interest on state and local government qualified private activity bonds for student loans	0.1	0.3
Credit for holders of clean renewable energy bonds (sections 54 and 54C)	*	0.1
Credit for holders of qualified energy conservation bonds	*	*
Credit for enhanced oil recovery costs	*	*
Credit for producing fuels from a nonconventional source	*	*
Energy credit (section 48): *Solar*	*	*
Energy credit (section 48): *Geothermal*	*	*
Energy credit (section 48): *Fuel cells*	*	*
Energy credit (section 48): *Microturbines*	*	*
Credit for electricity production from renewable resources (section 45): *Closed-loop biomass*	*	0
Credit for electricity production from renewable resources (section 45): *Geothermal*	*	0
Credit for electricity production from renewable resources (section 45): *Qualified hydropower*	*	0
Credit for electricity production from renewable resources (section 45): *Solar (limited to facilities placed in service before 1/1/2006)*	*	0
Credit for electricity production from renewable resources (section 45): *Small irrigation power*	*	0
Credit for electricity production from renewable resources (section 45): *Municipal solid waste*	*	0
Coal production credits: *Refined coal*	*	0
Coal production credits: *Indian coal*	*	0
Credits for alternative technology vehicles: *Hybrid vehicles*	*	*
Credits for alternative technology vehicles: *Other alternative fuel vehicles*	*	*
Credit for clean-fuel vehicle refueling property	*	*
Credit for energy-efficient new homes	*	0
Credit for certain alternative motor vehicles that do not meet existing criteria of a qualified plug-in electric drive motor vehicle	*	*
Exclusion of interest on state and local government qualified private activity bonds for energy production facilities	*	*
Expensing of exploration and development costs, fuels: *Other fuels*	*	*
Depreciation recovery periods for energy-specific items: *10-year MACRS for smart electric distribution property*	*	0

Provision	Cost in 2010 claimed on corporate returns ($ billion)	Cost in 2010 claimed on individual returns ($ billion)
Special depreciation allowances for certain reuse and recycling property	*	*
Special rules for mining reclamation reserves	*	*
Exclusion of contributions in aid of construction for water and sewer utilities	*	0
Exclusion of earnings of certain environmental settlement funds	*	0
Expensing of soil and water conservation expenditures	*	*
Expensing of the costs of raising dairy and breeding cattle	*	*
Exclusion of cost-sharing payments	*	*
Expensing by farmers for fertilizer and soil conditioner costs	*	*
Credit for rehabilitation of structures, other than historic structures	*	0.1
Exemptions from imputed interest rules	*	0.4
Expensing of magazine circulation expenditures	*	*
Special rules for magazine, paperback book, and record returns	*	*
Cash accounting, other than agriculture	*	1.0
Credit for the cost of carrying tax-paid distilled spirits in wholesale inventories	*	0
Expensing of costs to remove architectural and transportation barriers to the handicapped and elderly	*	0.1
Inventory methods and valuation: *Specific identification for homogeneous products*	*	*
Exclusion of gain or loss on sale or exchange of brownfield property	*	0
Income recognition rule for gain or loss from section 1256 contracts	*	0.8
Exclusion of interest on state and local qualified private activity bonds for green buildings and sustainable design projects	*	*
Exclusion of interest on state and local government qualified private activity bonds for highway projects and rail-trust transfer facilities	*	0.1
High-speed intercity rail vehicle speed requirement for exempt high-speed rail facility bonds	*	*
Renewal community incentives	*	0.2
Credit for Indian reservation employment	*	*
Issuance of recovery zone economic development bonds	*	*
Issuance of tribal economic development bonds	*	*
Qualified school construction bonds	*	0.1
Credit for employer-provided dependent care	*	*
Credit for disabled access expenditures	*	*
Exclusion of disaster mitigation payments	*	*
Exclusion of interest on state and local government qualified private activity bonds for veterans' housing	*	*

* Cost is less than $50 million.
Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), Dec. 15, 2010.

Appendix 2: Individual tax expenditures

The following table shows the cost to the government in 2010 of the tax deductions, credits, and other incentives currently available to individuals.

Provision	Cost in 2010 claimed on individual returns ($ billion)
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	105.7
Deduction for mortgage interest on owner-occupied residences	90.8
Reduced rates of tax on dividends and long-term capital gains	77.7
Making work pay credit	59.7
Earned income credit	56.2
Credit for children under age 17	55.1
Net exclusion of pension contributions and earnings: *Defined benefit plans*	38.9
Net exclusion of pension contributions and earnings: *Defined contribution plans*	32.5
Deduction of nonbusiness state and local government income taxes, sales taxes, and personal property taxes	30.7
Exclusion of Medicare benefits: *Hospital insurance (Part A)*	28.6
Exclusion of untaxed Social Security and railroad retirement benefits	26.8
Exclusion of benefits provided under cafeteria plans	26.4
Exclusion of capital gains at death	25.4
Exclusion of Medicare benefits: *Supplementary medical insurance (Part B)*	20.5
Individual retirement arrangements: *Traditional IRAs*	20.1
Deduction for property taxes on real property	15.0
Exclusion of capital gains on sales of principal residences	15.0
Net exclusion of pension contributions and earnings: *Plans covering partners and sole proprietors (Keogh plans)*	12.4
Deduction for medical expenses and long-term care expenses	10.8
Hope credit	9.6
First-time homebuyer credit	8.7
Carryover basis of capital gains on gifts	7.7
Exclusion of miscellaneous fringe benefits	6.6
Exclusion of Medicare benefits: *Prescription drug insurance (Part D)*	5.5
Exclusion of foreign earned income: *Salary*	5.1
Premium subsidy for COBRA continuation coverage	4.9
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	4.6
Exclusion of veterans' disability compensation	4.5
Exclusion of benefits and allowances to armed forces personnel	4.3
Exclusion of employer-paid transportation benefits	3.8

Provision	Cost in 2010 claimed on individual returns ($ billion)
Exclusion of workers' compensation benefits (disability and survivors payments)	3.4
Individual retirement arrangements: *Roth IRAs*	3.4
Exclusion of income earned by voluntary employee's beneficiary associations	3.2
Exclusion of other employee benefits: *Premiums on accident and disability insurance*	3.2
Credit for child and dependent care and exclusion of employer-provided child care	3.1
Exclusion of cash public assistance benefits	3.1
Exclusion of worker's compensation benefits (medical benefits)	3.0
Lifetime learning credit	2.3
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	2.3
Exclusion of scholarship and fellowship income	2.1
Additional standard deduction for the blind and the elderly	1.8
Credit for energy-efficiency improvements to existing homes	1.7
Exclusion of certain allowances for federal employees abroad	1.6
Exclusion of damages on account of personal physical injuries or physical sickness	1.5
Exclusion of other employee benefits: *Premium on group term life insurance (excludes payroll taxes)*	1.5
Exclusion of health insurance benefits for military retirees and retiree dependents enrolled in Medicare	1.4
Parental personal exemption for students aged 19 to 23	1.3
Deferral of interest on savings bonds	1.3
Exclusion of combat pay	1.2
Exclusion of foreign earned income: *Housing*	1.1
Exclusion of employee meals and lodging (other than military)	1.0
Deduction for interest on student loans	0.9
Exclusion of employer-provided education assistance benefits	0.9
Health savings accounts (HSAs)	0.9
Individual retirement arrangements: *Credit for certain individuals for elective deferrals and IRA contributions*	0.9
Exclusion of veterans' readjustment benefits	0.9
Exclusion of income attributable to the discharge of principal residence acquisition indebtedness	0.8
Exclusion of employer-provided transit and vanpool benefits	0.7
Exclusion of housing allowances for ministers	0.6
Exception for publicly traded partnerships with qualified income derived from certain energy-related activities	0.5

Provision	Cost in 2010 claimed on individual returns ($ billion)
Increased standard deduction for real property taxes	0.5
Exclusion for gain from certain small business stock	0.5
Adoption credit and employee adoption benefits exclusion	0.5
Special tax rate for qualified timber gain	0.4
Exclusion of tax on earnings of qualified tuition programs: *Savings account programs*	0.4
Exclusion of certain foster care payments	0.4
Deduction for premiums for qualified mortgage insurance	0.3
Exclusion of employee awards	0.3
Exclusion of military disability benefits	0.2
Residential energy-efficient property credit	0.2
Distributions in redemption of stock to pay various taxes imposed at death	0.2
Exclusion of employer-provided tuition reduction benefits	0.2
Credit for purchase of health insurance by certain displaced persons	0.2
Deduction for casualty and theft losses	0.2
Deduction for overnight-travel expenses of National Guard and reserve members	0.1
Exclusion of cancellation of indebtedness income of farmers	0.1
Deduction for higher education expenses	0.1
Exclusion of earnings of Coverdell education savings accounts	0.1
Exclusion of income attributable to the discharge of certain student loan debt and NHSC and certain state educational loan repayments	0.1
Exclusion of veterans' pensions	0.1
Credits and subsidies for participation in exchanges	0
Exclusion of energy conservation subsidies provided by public utilities	*
Treatment of income from exploration and mining of natural resources as qualifying income under the publicly traded partnership rules	*
Income averaging for farmers and fishermen	*
Exclusion of interest on educational savings bonds	*
Deduction for teacher classroom expenses	*
Exclusion of tax on earnings of qualified tuition programs: *Prepaid tuition programs*	*
Exclusion of special benefits for disabled coal miners	*
Exclusion of survivor annuities paid to families of public safety officers killed in the line of duty	*

* Cost is less than $50 million.

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10), Dec. 15, 2010.

Appendix 3: Tax reform planning matrix

The matrix below highlights the steps that corporate taxpayers can take as they prepare for the prospect of tax reform, navigate the transition period, and position themselves to thrive in a post-reform environment.

<table>
<tr><th rowspan="2">Affected party</th><th colspan="3">Planning period</th></tr>
<tr><th>Present (Pre-reform)</th><th>Transition</th><th>Post-reform</th></tr>
<tr><td>Business</td><td>• Strengthen forecasting, analytics, and modeling capability
• Analyze risk/timing of change; create contingency plan to address adverse developments
• Analyze benefits/burdens of current system that drive tax planning or business decisions
• Model alternative tax scenarios</td><td>• Consider maximizing benefits under incentives that will become unavailable
• Document entitlement to transition relief
• Manage timing of tax items in light of rate changes
• Consider opportunities for strategic acquisitions of competitors that were poorly prepared for tax reform</td><td>• Implement governance, information systems, and reporting requirements
• Review and realign choice of entity, structure, investment choices for tax effectiveness</td></tr>
<tr><td>Owners (Shareholders)</td><td>• Develop communication plan to keep investors apprised of potential risks and opportunities arising from tax reform
• Consider how and when to communicate effects of tax reform on financial statements</td><td>• Help investors understand the impact of tax changes on the business and the new opportunities they present</td><td>• Review investment portfolio and the manner in which returns are provided to shareholders</td></tr>
<tr><td>Employees</td><td>• Consider strategies to satisfy emerging employee needs (tax and compensation planning)
• Review recruitment and retention policies in the context of post-reform future
• Develop communication plan to keep executives and employees apprised of potential risks and opportunities arising from tax reform</td><td>• Revise compensation and benefits programs to reflect new tax rules
• Help employees and potential recruits understand the impact of tax changes on the business and the new opportunities they present</td><td>• Implement redesigned compensation and benefits programs</td></tr>
<tr><td>Products & Services</td><td>• Review product/service offerings in the context of current law and post-reform future
• Engage in contingency planning</td><td>• Accelerate contracting to qualify for prior-law benefits
• Withdraw products no longer effective under new rules
• Amend contracts to reflect changes required by new laws</td><td>• Introduce new products and services
• Focus on new or expanded markets</td></tr>
</table>

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