2011

The Road Ahead: Deficit Reduction and Tax Reform

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THE SPIRIT OF ENTERPRISE ★ U.S. CHAMBER OF COMMERCE ®

U.S. Chamber of Commerce

Economic Policy Division

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The Road Ahead: Deficit Reduction & Tax Reform

- ✓Short Term Outlook
  - ✓Jobs Plan
  - ✓Super Committee
- ✓Long Term Outlook
  - ✓Tax Reform
  - ✓Lame Duck 2012

Obama Jobs Plan

- Various Incentives
- Payfors
  - 5.6% surtax, effective in 2013, applicable to modified adjusted gross income above $1 million, adjusted for inflation
  - Applicable to modified adjusted income before itemized deduction, such as the mortgage deduction and charitable deductions, and includes all income such as wages, cap gains, dividends, interest, etc.

Obama Jobs Plan – How Big a Tax Hike?

- Beginning in 2013, for those earning over $1 million:
  - Would result in total marginal federal income tax rates of **almost 50%**
    - 39.6% top bracket with expiration of Bush/Obama tax cuts
    - 5.6% Reid surtax
    - 0.9% Medicare HI tax on income over $200K/$250K
    - Several percentage point increase due to PEP/Pease returning
  - Would hike taxes on investment income
    - Dividends taxed as ordinary income at rate of 39.6%, plus 3.8% Medicare unearned income tax, plus the Reid surtax of 5.6%, for **a total tax burden of 49%**, a hike of 227%.
    - Capital gains taxed at 20%, plus 3.8% Medicare surtax on investment income, plus Reid surtax of 5.6%, for **a total tax burden of 29.4%**, a hike of 96%.

Obama Jobs Plan - Ramifications

- **Raising taxes on incomes over $1 million will harm businesses**. (IRS SOI)
  - In 2009, there were 141,035 millionaires with income from partnerships or S-corporations, 39,662 with income from sole proprietorships, and 1,840 with income from farms.
  - The millionaire tax would affect about 35% of business income.
- **Those earning more already do contribute more. Per IRS SOI, for tax year 2009:**
  - Those with income over $1 million paid 20% of all income taxes, but only accounted for 10% of all adjusted gross income.
  - Average effective tax rates
    - Millionaires: 25%
    - Those making between $100,000 to $200,000: 16%
    - Those making under $100,000: less than 10% – often far less than 10%.

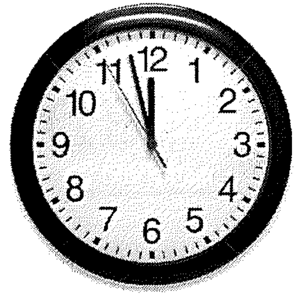
Obama Jobs Plan - Outlook

- Outlook
  - Vote failed to bring legislation to floor in Senate on October 11
  - Has been broken apart by Reid and is trying to move smaller pieces
    - State aid bill
    - Transportation bill
    - Veterans bill
  - Generally, pay-for remains pieces of surtax
  - Watch for use in political messaging; supercommittee
  - Expect continued discussion of a Buffett rule

Super Committee

- Result of debt ceiling legislation enacted in August
- Super Committee Goal
  - Find additional $1.5T in deficit reduction
  - If committee successful & legislation passes Congress, debt limit will increase by $1.5T
  - If the committee only recommends package that reduces deficit less than $1.2T, debt ceiling will only increase by $1.2T
  - Any increase in debt limit is subject to resolution of disapproval, which could be ultimately vetoed by President

Super Committee Deadlines



- <u>October 14</u>: Committees Recommendations to Joint Committee were due
- <u>November 23</u>: Date by which Joint Committee must vote on report (need 7 of 12 votes to approve; report and votes must be made public)
- <u>December 9</u>: Any House or Senate committee that has received referral of Joint Committee bill must report it to House or Senate. <u>No amendments to Joint Committee bill are allowed</u>.
- <u>December 23</u>: House & Senate must vote Joint Committee bill.
- <u>January 15, 2012</u>: Cuts across board triggered if bill not enacted

Super Committee

PHOTOS: GETTY IMAGES

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Super Committee: Recommendations

- What were Committee Recommendations?
  - <u>Senate Finance Republicans</u>:
    - Revenue-neutral corporate and individual tax reform that reduces top rates to 25% and would be paid for by unspecified provisions to broaden the tax base.
    - "increasing taxes in the name of deficit reduction would be both counterproductive and unnecessary"
    - Repealing AMT and 2010 health care reform law – including all of its revenue-raising provisions – and move to a territorial tax system.

Super Committee: Recommendations

- What were Committee Recommendations?
  - Ways & Means Democrats:
    - "Balanced approach" that includes significant revenues but also "encourage[s] economic growth and job creation"
    - Support for Obama's American Jobs Act
    - Support for revenue-neutral corporate tax reform that preserves present-law incentives for domestic manufacturing & research, including §199 deduction, accelerated depreciation, & R&D credit.
    - Support allowing 01/03 tax rates to expire; implement Buffett rule

  - Majority SFC and W&Ms: Because Finance Committee Chair Baucus and Ways and Means Chair Camp both sit on the Super Committee, the majority-party members of the tax-writing committees did not submit their own recommendations

Super Committee: Recommendations

- A Comparison of Recommendations

Policy	Erskine Bowles Plan	Democratic Offer	Republican Offer^	Bowles-Simpson	Obama	Ryan	Boehner-Obama
Temporary Jobs Bill	0	($450)	$0	$0	($450)	$0	$0
Chained CPI~	$200	$200	$200	$200	$0	$0	$200
Discretionary Spending	$300	$400	$250	$400	$0	$850	$0
Health Savings	$600	$475	$685	$500	$350	$1,400#	$350
Social Security	$0	$0	$0	$150	$0	$0	$0
Other Mandatory	$300	$250	$500	$200	$200	$975	$100
Revenues/Tax Reform	$800	$1,300	$200*	$1,950	$1,600	$0	$800 - $1,200
Interest	$400	$400	$350	$550	$350	$550	$300
Total	**$2,600**	**$2,600**	**$2,200**	**$3,950**	**$2,050**	**$3,800**	**$1,950**

Super Committee: What Happens If No Agreement?

- Sequestration

  - If committee fails to report legislation or Congress fails to enact recommendations, process of sequestration will be triggered

  - Sequestration will make up the difference between any deficit reduction, achieved by the Super Committee's recommendations and subsequent enactment in Congress, and $1.2T in deficit reduction over 10 years.

  - Sequestration is similar to the 1985 Gramm-Rudman-Hollings trigger and will be split 50% for defense spending cuts and 50% for non-defense spending.

Super Committee: What Can Be Cut?

- What Can Be Cut?
  - Defense: 50% of add’l cuts over 10 yrs come from defense

  - Non-defense: Everything subject to cuts except following payments to beneficiaries: Social Security, Medicaid, veteran benefits & pensions, federal retirement fund govt contributions, military salaries, pmts to women & kids
  - Medicare savings: Capped at 2% and limited to providers, payments to beneficiaries will remain untouched.

Super Committee: The Options?

- Outlook
  - Is Sequestration an Attractive Option?
    - Not attractive to Rs – contains hundreds of billions of dollars in automatic Pentagon cuts
    - Could leave top D priorities for beneficiaries (i.e., Medicaid, Medicare, Social Security and unemployment insurance) untouched BUT cuts to non-security discretionary spending would into other crucial government functions
    - Need to "go big"; allowing auto-cuts to go in effect shows Congress has done little to proactively address deficit problem
  - Will the Super Committee do fundamental tax reform?: No
    - Time constraints for tax reform?
    - Possible parameters for tax reform?
      - Camp plan

Super Committee: The Outcome?

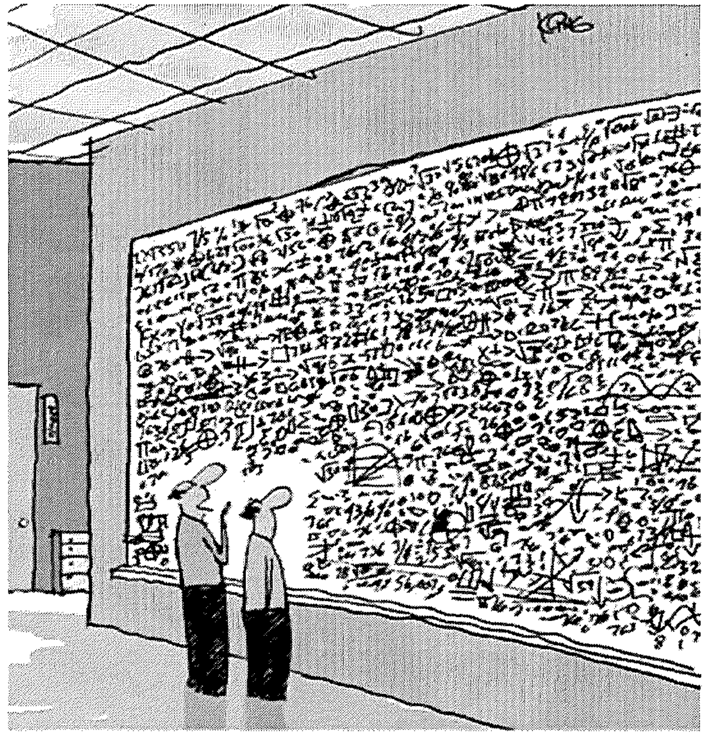
- Focus is now on leadership level discussions

- Need to watch for Ds moving on entitlement reform and Rs moving on taxes/revenues

- Possible agreement on certain amount of cuts ($600B?); sequestration to make up rest?

Tax Reform: Why Are We Talking About It?

We need a simple, pro-growth, pro-job tax code that can raise sufficient tax revenue while providing the U.S. with a level playing field to compete internationally.



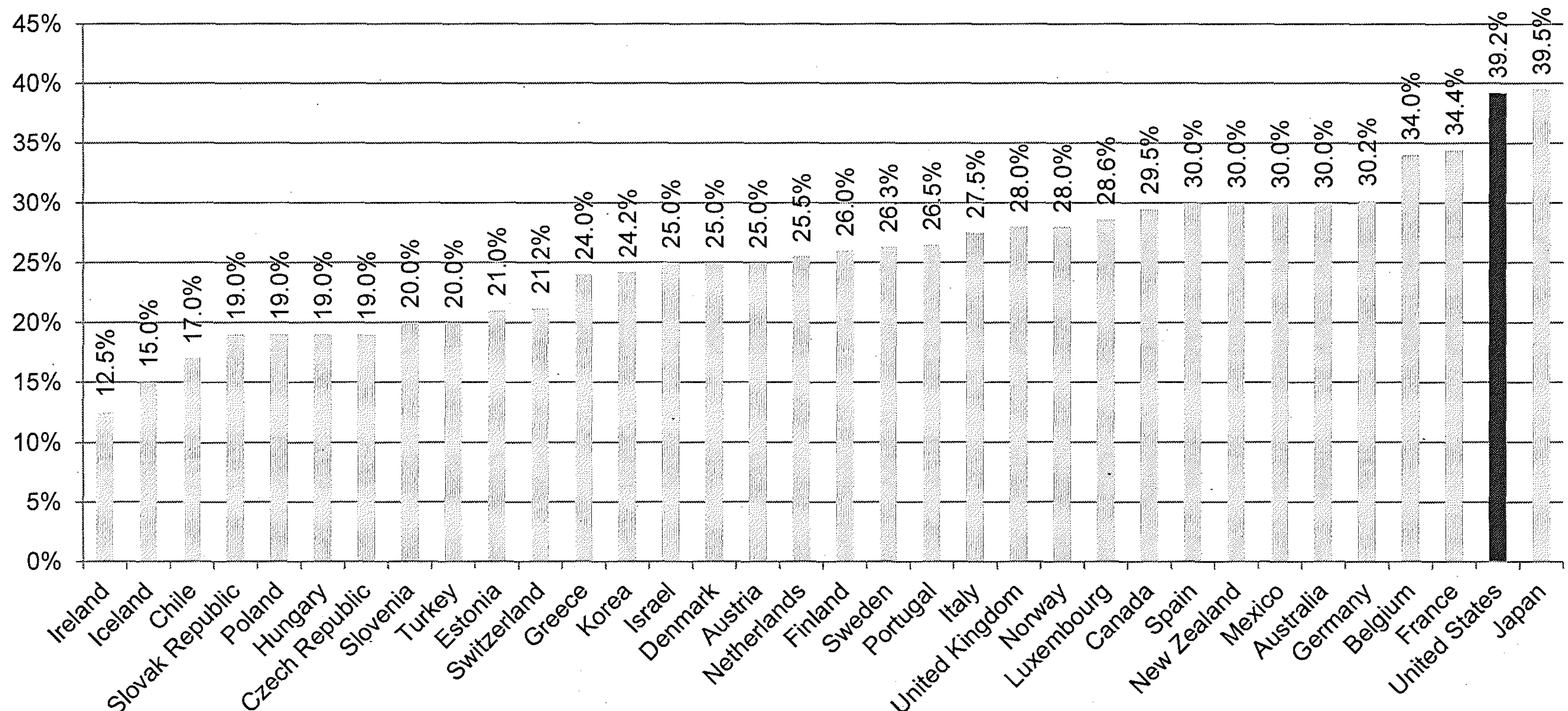
"...and that, in simple terms, is the new, proposed tax reform plan."

Future Outlook: Tax Reform

- What Rate?
- Overseas Income?
- R&D Costs?
- Revenue Issues?
- Transition Rules?

Tax Reform: What is the Right Tax Rate?

Combined Corporate Income Tax Rates (2010)
(Federal plus average state and local taxes)



Source: OECD tax database

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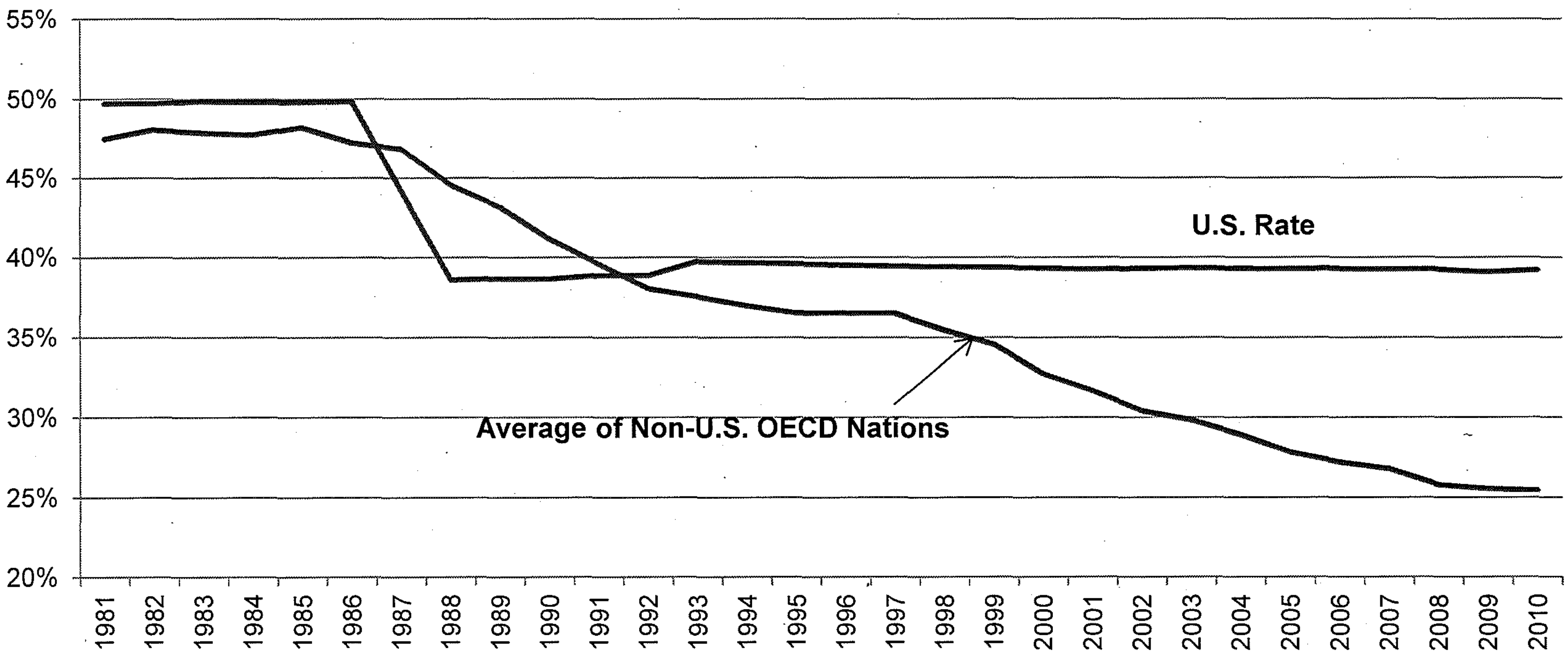
Tax Reform: What is the Right Tax Rate?

- U.S. has 2nd highest corporate tax rate among OECD countries
- 15 percentage points higher than OECD average of 25% and China's 25% tax rate
- Over the past four years, 75 countries have cut their corporate tax rates to be more attractive to business investment
  - Canada at 18%, going to 15%
  - UK at 26%, going to 23% by 2014

Tax Reform: What is the Right Tax Rate?

High U.S. corporate tax rates make it difficult for businesses to compete internationally. Other countries are reducing their corporate tax rates and the U.S. disadvantage is growing.

Combined U.S. Corporate Tax Rate Compared to OECD Averages, 1981 to 2010



Source: Tax Foundation

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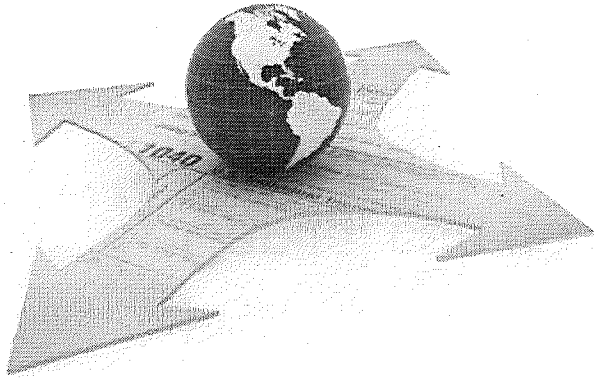
Tax Reform: What is the Right Tax Rate?

- 25%? 20%? - Varying Views
- JCT report: says can only get to 28%. Mr. Levin has seized on BUT report limited in 2 main ways:
  - **Estimates are NOT complete**
    - "not all provisions are estimated at this time" (In fact, 90 provisions are specifically identified as not yet estimated by JCT)
    - "estimates are very preliminary“ and "[t]he estimated 28 percent rate could change"
  - **Estimates are NOT comprehensive**
    - Because JCT was only asked to look at a narrow set of measures, this analysis ignored well-known measures available to tax writers to lower the corporate rate.
    - Doesn’t include provisions such as corporate jet depreciation, every single expenditure related to farming, a significant number of expenditures related to housing industry and commerce, 80% related to health provisions, etc

Tax Reform: Taxing Overseas Income?



- Worldwide System: US only major industrialized OECD nation which still has worldwide tax system; leads to double taxation of foreign profits

- Territorial System: Foreign companies are taxed under territorial system – they pay taxes on their home country profits in their home country & on their foreign profits in foreign country; double taxation of foreign profits is avoided.

Tax Reform: Taxing Overseas Income?

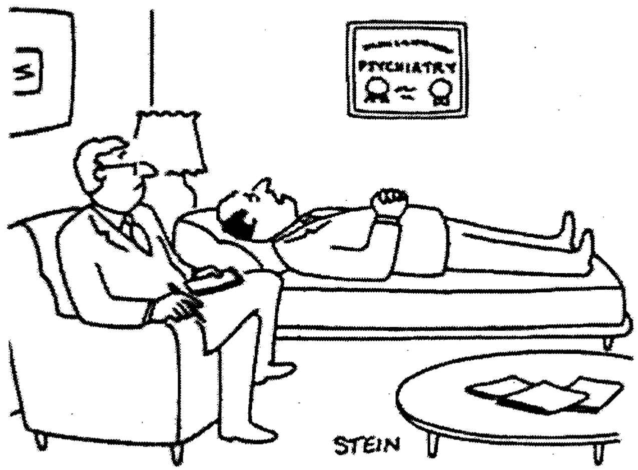
- The U.S. needs to adopt a territorial tax system – Why?
  - Align us with our global trading partners, making us more competitive; consider recent UK/Japan transitions
  - Permanent elimination of the lockout effect on foreign earnings
  - US companies would more efficiently manage their global assets and finances, making all their businesses more productive
  - Capital can go where it is welcome – most efficient allocation
  - CEN is obsolete when subsidiaries have access to global capital markets and can self-fund their expansion with retained earnings

Tax Reform: Taxing Overseas Income?

- Camp Plan
  - Has titles for business tax reform and individual reform but each of those sections will be blank to show intention of future discussion drafts (timing of which is unknown).
  - “International” reform section basically revenue neutral
  - Territorial system w/ 95% exemption, assumed 25% corporate rate
  - 8 year window for a "deemed repatriation" at 5% rate that changes $80b cost of the repatriation holiday into a significant revenue raiser.
  - “Thin cap” rules to prevent the U.S. from becoming a "debt haven"
  - 3 possible three proposals for bringing IP-related income into subpart F; asking for comments on those alternatives

Tax Reform: R&D Costs?

- How do we treat research and development (R&D) costs? How do we ensure ensuing intellectual property remains in United States?
- Do we make current credit permanent? Do we provide enhanced credit for intellectual property (basically sharp tax-rate reductions for income generated from patents and other intellectual property, known as "patent boxes" or "innovation boxes" which have been adopted across Europe?)
- Consider countries like China and India that have much stronger incentives for R&D
- Need to be careful with how incentivize R&D and make sure do not favor new capital over old capital
- <u>Bottom line</u>: Create system that will drive companies to conduct R&D in the US



"Thirty years in R& D, and what do I have to show for it? Not even one 'Eureka!'"

Tax Reform: Do We Pay For It?

- Should tax reform be "revenue neutral?"
- '86 Act
  - Revenue neutral
  - Need to consider revenue neutral at micro/ macro level and scoring method
- Revenue options?
  - VAT? STT? – not viable
  - Un-repatriated earnings? – Camp international payfor
  - Concept of revenue neutrality forces winners/losers
  - Should strive for a pro-growth tax code and consider tax take as percentage of GDP

Tax Reform: Transition Rules

- Issue: If we move to a new system to taxation, what rules do we need to get from here to there? How do we minimize economic burdens and allow adequate implementation time?
- Transition rules are rarely discussed yet are of the utmost importance in reform
- Only plan to date which has really addressed transition rules was Ryan Roadmap in 2010 and Camp discussion document to some extent

Future Outlook: Tax Reform

- Ingredients for Tax Reform
  - Presidential Leadership
  - Technical Staff
  - Congressional Commitment
  - Confidence and Trust – between parties, etc.
  - Engage the American people
  - Consensus on the Framework

Future Outlook

- Continued Jobs Bills
- Super Committee
- Extenders
- Repatriation
- FY13 Greenbook
  - Expiration of 01/03 rates for higher income earners
  - 2009 estate tax levels (45%/$3.5M/spouse)
  - International tax proposals hurting competitiveness
  - Changes in accounting methods (e.g., LIFO)
  - Industry punitive taxes – oil and gas, banking
- Lame Duck
  - Biggest issues in tax – the Bush/Obama tax cuts, AMT tax, health care reform tax increases, along with routinely expiring corporate and individual "extenders" provisions –now positioned to come to a head in a lame duck session in 2012
  - simultaneously with the next debt ceiling crisis....