U.S. Tax Policy Outlook: Potential and Peril

Spring Accounting Conference

American Gas Association | Edison Electric Institute

Newport Beach, CA | May 22, 2017

Todd Metcalf
Principal, Tax Policy Services
202.346.5119 | todd.Metcalf@pwc.com
Why Tax Reform? Why Now?
Issues influencing US tax policy

- Balance of power
- Economic concerns
- Federal budget deficits
- International competitiveness
- Global tax scrutiny
High statutory corporate tax rate and uncompetitive international tax system
No broadly applicable federal consumption tax
The US relies more on income taxes than other developed countries

Federal/State taxes as a share of total revenues, 2012

- **United States**
  - Taxes on income and profits: 47.9%
  - Social security: 22.3%
  - Goods & services: 17.9%
  - Other*: 11.8%

- **OECD, excl. US**
  - Taxes on income and profits: 33.2%
  - Social security: 26.3%
  - Goods & services: 33.2%
  - Other*: 7.4%

* Other is primarily property taxes.

What Lies Ahead?
Key tax policymakers in the 115th congress

Administration
- President Trump

US House of Representatives
- Speaker Ryan
- Minority Leader Pelosi

US Senate
- Majority Leader McConnell
- Minority Leader Schumer

Treasury
- Treasury Secretary Mnuchin

House Ways and Means Committee
- Chairman Brady
- Ranking Member Neal

Senate Finance Committee
- Chairman Hatch
- Ranking Member Wyden
First 100 Days seemed like a sail on rough waters ... what can we expect going forward?

- Top priorities for Administration and Congress this year remain Tax, Healthcare and Regulatory reform
- Nominations and budgets will continue to occupy Congress for a few months...
- ... while infrastructure and immigration will likely wait until year two
- Tax reform is focused on reducing corporate rates – today, 38.9% US (including state taxes) vs 24.2% average of other OECD countries – and increasing US economic growth
- President Trump has clearly communicated that these are his priorities:
  — Stem shifts towards offshore production by taxing imports
  — Focus on tax reform to promote domestic manufacturing
Looking back to past reform efforts

Tax Reform Act of 1986 (H.R. 3838)

- Treasury I - November 1984
- Treasury II – May 1985
- Ways and Means hearings – 30 days of hearings between February and July 1985
- Ways and Means markup – 26 days of markup sessions between September and December 1985
- House passage of H.R. 3838 on December 17, 1985
- Finance Committee hearings – 36 days of hearings between May 1985 and April 1986
- Finance Committee markup – 17 days of markup sessions between March and May 1986

- Senate passage of H.R. 3838, as amended – on June 24, 1986, after 12 days of floor action
- House/Senate Conference Committee – 4 days of formal conference committee meetings between July and August 1986
- House final passage of H.R. 3838 on September 25, 1986
- Senate final passage of H.R. 3838 on September 25, 1986
- President Reagan signs H.R. 3838 into law – October 22, 1986
Building Blocks for Bipartisan Reform?

- Deemed Repatriation
- International Reform
- Corporate Rate Reduction
- Middle Class Tax Relief and Simplification

Open Questions
- Revenue?
- Distribution?

U.S. Tax Policy Outlook:
Potential and Peril
PwC
But . . . political polarization may reduce incentives for bipartisan legislation

Source: Cook Political Report

U.S. Tax Policy Outlook:
Potential and Peril
PwC
## Legislative paths available for tax reform in 2017

### Regular legislative process (requires bipartisanship)

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Legislation can be enacted permanently</td>
<td>• 60 votes needed at every step in the Senate (i.e., to begin debate, vote on amendments, vote on passage, to conference, etc).</td>
</tr>
<tr>
<td>• No artificial restrictions on which measures can be included</td>
<td></td>
</tr>
</tbody>
</table>

### Budget reconciliation process (may be partisan)

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Key Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Requires only simple majority vote at every step in the Senate</td>
<td>• Legislation that increases the deficit outside of the budget window (typically 10 years) is subject to automatic sunset or other measures to avoid long term deficit effect</td>
</tr>
<tr>
<td>(no filibuster allowed)</td>
<td>• 60-vote Senate super-majority required to waive deficit rule</td>
</tr>
<tr>
<td>• Expedited consideration (time limits for amendments and overall</td>
<td>• Senate rules also require reconciliation to be used only to enact measures that have a fiscal effect on the federal budget</td>
</tr>
<tr>
<td>debate)</td>
<td></td>
</tr>
</tbody>
</table>
What’s Out There?

U.S. Tax Policy Outlook:
Potential and Peril
PwC

May 2017
## Comparison of Republican tax reform proposals

**Major business provisions excluding border tax adjustment**

<table>
<thead>
<tr>
<th>Proposal</th>
<th>Current law</th>
<th>2014 Camp bill (H.R. 1)</th>
<th>2016 House GOP Blueprint</th>
<th>White House</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate tax rate</strong></td>
<td>35%</td>
<td>25% (phased in over 5 years)</td>
<td>20%</td>
<td>15%</td>
</tr>
<tr>
<td><strong>International tax regime</strong></td>
<td>'Worldwide' system with deferral</td>
<td>'Territorial' system 95% foreign dividend exemption</td>
<td>'Territorial' system 100% dividend exemption system</td>
<td>'Territorial' system (original campaign proposal was for worldwide taxation without deferral)</td>
</tr>
<tr>
<td><strong>“Deemed” repatriation</strong></td>
<td>N/A</td>
<td>Previously untaxed foreign earnings: 8.75% cash &amp; cash-equivalents 3.5% non-cash assets Paid over 8 years; assume reduction in foreign tax credits</td>
<td>Same as H.R. 1</td>
<td>One-time tax on previously untaxed foreign earnings (rate not specified; campaign proposal had 10% rate)</td>
</tr>
<tr>
<td><strong>Cost recovery (full expensing)</strong></td>
<td>Recover over the investment’s applicable life (50% bonus depreciation for equipment in 2017, phased-out by end of 2019)</td>
<td>Repeal MACRS; implement ADS type system, with inflation</td>
<td>Full expensing for investments (tangible and intangible) excluding land</td>
<td>No proposal (campaign proposal allowed manufacturers to elect full expensing for investments)</td>
</tr>
<tr>
<td><strong>Business interest expense</strong></td>
<td>Deductible as incurred</td>
<td>Limit for thin capitalization</td>
<td>Deductible only against net interest income; special rules for financial services</td>
<td>No proposal (campaign proposal required manufacturers electing full expensing to forego interest expense deduction)</td>
</tr>
<tr>
<td><strong>Top individual tax rate</strong></td>
<td>39.6% plus 3.8% ACA tax and 1.2% income-based phase-out of itemized deductions</td>
<td>25%</td>
<td>33%</td>
<td>35%</td>
</tr>
<tr>
<td><strong>Pass-through businesses</strong></td>
<td>Taxed at individual rates</td>
<td>Same as current law</td>
<td>Taxed at individual rates not to exceed 25%</td>
<td>15% (unclear if distributions from large pass-through entities subject to additional dividend tax)</td>
</tr>
</tbody>
</table>

---

U.S. Tax Policy Outlook: Potential and Peril

PwC

May 2017

15
Plan A: The House Republican Tax Reform Blueprint
A Destination-Based Cash Flow Tax
House Republican Blueprint proposes significant reduction in business and individual tax rates

• Cut business tax rates and limit disparity between corporate and pass-through rates
  - 20% top corporate tax rate / 25% top rate for pass-through business income

• Cut individual tax rates
  - Reduce individual rate brackets from 7 to 3 (12%, 25%, 33%)

• Reduce investment tax rates
  - 50% exclusion for capital gains, dividends and interest (16.5% top individual rate)
Border adjustment is controversial key to House Republican plan to deliver corporate rate reduction

- Border Adjustment can be viewed as analogous to VAT, imposed on imports and taken off exports
- Applies to all cross-border purchases/sales: IP (e.g., royalties), raw materials, semi-finished, finished goods, and services
- Intended to remove US tax considerations from all location decisions; stem tax base erosion from moving entities or production offshore; eliminate US transfer pricing incentives
- Estimated revenues of $1.2T sufficient to fund 10-percentage point reduction in corporate tax rate over ten years
- Major importers objecting due to potential impact on profits and consumer prices
- Policy makers expect stronger dollar to reduce cost of imports and offset loss of deductibility to sustain margins while preserving tax policy objectives

<table>
<thead>
<tr>
<th>Major business provisions</th>
<th>10-year revenue cost (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce corporate rate to 20% and repeal corporate AMT</td>
<td>-$1,845</td>
</tr>
<tr>
<td>Expense investment; disallow net interest deduction on new loans</td>
<td>-$ 448</td>
</tr>
<tr>
<td>Territorial system</td>
<td>-$ 88</td>
</tr>
<tr>
<td>Deemed repatriation</td>
<td>$ 138</td>
</tr>
<tr>
<td>Border adjustments</td>
<td>$1,180</td>
</tr>
<tr>
<td>Repeal identified corporate tax expenditures</td>
<td>$ 172</td>
</tr>
</tbody>
</table>

Moving toward a cash flow tax model, House Blueprint proposes full expensing coupled with no deduction for net interest expense and eliminates most targeted credits and deductions

- **Capital cost recovery:** Full expensing for investments and intangibles (except land)
- **Interest Expense:** Net interest expense would not be deductible, but would carry forward indefinitely
- **Credits:** All credits repealed other than the R&E credit
- **Section 199:** The domestic production activities deduction would be repealed.
- **Transition:** Transition issues to be determined
House Republican Blueprint proposes to eliminate US tax on future foreign earnings

- **Territorial system**
  - Dividends from foreign subsidiaries of US corps. would be 100% exempt.
  - No limit on deduction of domestic expenses allocable to exempt dividends.
  - Presumably no credit or deduction for foreign taxes on exempt dividends.
  - Unclear how S corporations would be taxed

- **Direct foreign branches**: Not discussed, but presumably foreign branch receipts and expenses are outside of tax base.

- **Subpart F**: Repealed except for FPHCI (unclear how broadly this would apply).

- **Deemed repatriation**: Tax on accumulated deferred foreign E&P:
  - Taxed at an effective rate of 8.75% to the extent held in cash and equivalents and 3.5% otherwise. Payment of tax spread over 8 years.
  - No details are provided regarding the definition of cash equivalents or whether: tax is limited to post 1986 E&P, deficits may be netted, tax is applicable to non-controlled foreign corporations, or applicable to S corps
Mandatory tax on unrepatriated foreign earnings... the one sure bet in any tax reform plan

Tax at an effective rate of 8.75% to the extent held in cash and equivalents and 3.5% otherwise. Payment of tax spread over 8 years.

Source: Joint Committee on Taxation, Letter to Ways and Means Committee Chairman Kevin Brady (R-TX) and Committee Member Richard Neal (D-MA), Estimate of the total amount of undistributed, non-previously-taxed post-1986 foreign earnings (August 31, 2016), and IRS Statistics of Income, US Corporations and Their Controlled Foreign Corporations.
## Trump Administration Tax Reform Principles

<table>
<thead>
<tr>
<th>Category</th>
<th>Current Policy</th>
<th>Trump Proposal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Tax Rates</td>
<td>Seven tax brackets: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%</td>
<td>Three brackets: 10%, 25%, 35%</td>
</tr>
<tr>
<td>Standard Deduction</td>
<td>$6,350 for singles, $12,700 for married couples</td>
<td>Increases deduction so that a married couple may claim $24,000</td>
</tr>
<tr>
<td>AMT</td>
<td>Limits certain tax benefits for higher-income earners</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Capital Gains Tax</td>
<td>Top rate of 20%</td>
<td>No higher than 20%</td>
</tr>
<tr>
<td>Estate Tax</td>
<td>Taxes estate property valued at more than $5.5 million</td>
<td>Eliminated</td>
</tr>
<tr>
<td>Corporate Taxes</td>
<td>Top rate of 39%</td>
<td>No higher than 15%</td>
</tr>
<tr>
<td>Tax Deductions</td>
<td>Dozens of deductions and elections allow individuals and corporations to reduce their tax burden</td>
<td>Eliminates all tax breaks except those for mortgage interest and charitable giving.</td>
</tr>
</tbody>
</table>
What about the Senate? Where’s the Senate Finance Committee in all these discussions?

- As of April 18, 2017, the Senate Finance Committee is evaluating a range of tax reform options and engaged in bipartisan discussions.

  - “Things are moving forward rather rapidly ... hope to have tax reform proposal in one form or another to discuss publicly in the near future.”

- GOP consensus on pro-growth tax reform that lowers business and individual rates and moves to a territorial tax system.

  - “Major concern on tax reform is producing a bill that can get through the Senate.”

- Hopes to produce a bill that has bipartisan support—the 60-vote path—but prepared to use budget reconciliation to advance tax reform.

- With 52-seat GOP majority, Senate tax reform bill will require “near universal support to pass anything through reconciliation.”

- Senate bill likely to differ from any House-passed bill ... “that’s not a bad thing.”
Is there a Plan B if the House Blueprint falters?

The good news is, after years of tax reform efforts, there is a lot of product on the shelf. The less positive news is nothing has produced consensus support ... yet.

President Trump’s Principles
House Blueprint Lite
2014 Camp Draft (H.R. 1)
Camp Lite
Rates and Dates
Hatch Integration Proposal
International + Infrastructure
Cardin Proposal (Progressive Consumption Tax)
Renacci Proposal (VAT in lieu of corporate income tax)
Combination/Permutation TBD
Timeline for tax reform?

• President Trump has promised a “phenomenal plan” in short order.

• House Speaker Ryan has set August 1, 2017 target date for Congress completing tax reform legislation, as did Treasury Secretary Mnuchin.

- However, the House Ways and Means Committee effort to provide statutory language for House Blueprint remains a work in process.

• On March 9, 2017, Senate Majority Leader McConnell suggested an August deadline is unrealistic, saying, “Finishing on tax reform will take longer ... We do have to finish the health-care debate, up or down, win or lose, before we go to taxes ... There are some constraints here.”

• The ultimate deadline for tax reform will be the November 6, 2018 mid-term Congressional elections.
The one immutable law of tax policy: Tax reform was, is and forever will be a very difficult—taxing, if you will—exercise.