CCH Tax Briefing

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# THE PRESIDENT'S FRAMEWORK FOR BUSINESS TAX REFORM

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Special Report

## HIGHLIGHTS

- Reduced Corporate Tax Rate
- Manufacturing Incentives
- Elimination of Many Business Tax Expenditures
- Clean Energy Provisions
- Minimum Tax On Overseas Profits
- New Incentive to Return Work to U.S.
- Small Business Simplification

## INSIDE



# Administration Unveils Framework for Corporate Tax Reform

A reduced corporate tax rate, elimination of many business tax preferences, a new minimum tax on overseas profits, and much more are all part of President Obama's recently released Framework for Business Tax Reform (the "Framework"). The much-anticipated blueprint of the administration's plans for corporate tax reform was unveiled on February 22, 2012 in Washington, D.C.

The Framework contains a large number of general proposals which, according to the administration, will make the Tax Code less complicated for businesses and increase the nation's competitiveness in the global economy. A reduction in the corporate tax rate would be fully paid for by repeal of business tax preferences. The Framework also calls for a new minimum tax on overseas profits and encourages companies to return work to the U.S. by offering a new relocation tax incentive.

**IMPACT:** *At a news conference in Washington, D.C. on February 22, Treasury Secretary Timothy Geithner called the existing Tax Code not just outdated, but unfair and inefficient. Geithner characterized the current system of tax preferences and incentives as collectively amounting to subsidies and spending through the Tax Code. According to the Framework, current preferences and incentives distort the allocation of capital and benefit some businesses at the expense of higher effective rates on others.*

**IMPACT:** *Congressional reaction to the administration's Framework was mixed. Democrats in Congress generally applauded the Framework for laying out a plan to reduce the corporate tax rate, a proposal that enjoys bipartisan support in Congress. Republicans were less enthusiastic, but some GOP lawmakers said that the Framework could serve as a starting point for comprehensive tax reform. While the November elections certainly play a part in the release of the current proposals, major tax reform now is considered inevitable by most observers. The question remains, however, as to how it will play out.*

## OVERVIEW

The President's overall proposal, which is framed in very general terms and without any legislative language, is grounded in five elements:

- Eliminate tax expenditures and subsidies, broaden the corporate tax base, and cut the corporate tax rate
- Strengthen U.S. manufacturing and innovation
- Strengthen the international tax system
- Simplify and cut taxes for small businesses
- Restore fiscal responsibility and not add to the deficit

## CORPORATE TAX RATE

At the center of the Framework is a reduction in the top U.S. corporate tax rate. The rate cut would be funded by repealing many business tax preferences and tax extenders.

### *28 Percent Rate*

The Framework would reduce the top U.S. corporate tax rate from 35 percent to

28 percent. An enhanced Code Sec. 199 deduction (discussed below) would effectively lower the top rate to 25 percent for certain taxpayers.

**IMPACT:** *Due to a wide variation in current effective corporate tax rates among industries, the flattening of the base by reducing tax expenditures would create "winners and losers" when measured against the current system. For example, while construction, wholesale and retail trade and services in general now have an effective tax rate above the 28 percent level, mining, utilities and leasing now have effective rates below 20 percent.*

**COMMENT:** *Until there is some resolution of the tax rates for higher-income individuals, however, a 28 percent corporate rate would clearly favor incorporation as the preferred tax entity for doing business, depending upon the need to immediately distribute earnings. The Framework did not raise the issue of "double taxation" (in the form of the corporate tax on earnings followed by a dividends tax when those earnings are distributed) but undoubtedly it will be raised in the debate to follow. President Obama's fiscal year (FY) 2013 Budget, which proposed that higher-income taxpayers pay tax on dividends as ordinary income rather than capital gain, is likely to be included in that discussion. Currently, the highest corporate and individual income tax rates are the same 35 percent.*

### 25 Percent Effective Rate for Manufacturers

The Framework would further reduce the proposed 28 percent corporate tax rate to an effective rate of 25 percent for manufacturers. The Framework would achieve the reduction from 28 percent to 25 percent on manufacturing income by expanding the Code Sec. 199 deduction to 10.7 percent. Additionally, the Framework would increase the Code Sec. 199 deduction to an even higher level for "advanced manufacturing."

**IMPACT:** *Manufacturing holds a favored place in the President's Framework. The President has identified the manufacturing sector as playing a uniquely critical role in job creation, economic growth and competitiveness on the world stage. "[The Framework] cuts tax rates even further for manufacturers that are creating new products and manufacturing goods here in America," President Obama emphasized in a statement made at the release of the Framework.*

> "Any reduction in the corporate tax rate would be fully paid for by repeal of business tax preferences."

**COMMENT:** *The President's FY 2013 budget proposes to exclude oil and gas taxpayers from the Code Sec. 199 deduction. Since no statutory language is yet available under either the FY 2013 Budget or the Framework, questions remain over whether other "non-manufacturers" would be excluded. A variety of non-manufacturing activities covered under Code Sec. 199 include the construction of real property, including related engineering or architectural services, as well as qualified film production. The Framework explains that it "would focus the deduction* more *[emphasis added] on manufacturing activities," leaving open to speculation whether some purely non-manufacturing activities would remain qualified.*

## BUSINESS TAX PREFERENCES

In exchange for a lower corporate tax rate, businesses would have to give up many tax preferences. According to the administration, some business tax incentives would be preserved but only if they reach the broader economy.

**COMMENT:** *Treasury officials have indicated that for every tax preference retained, revenue would have to be raised elsewhere. Going forward, there would be no continuation of a business tax preference that is not offset, as was the case in past years.*

**LIFO.** Under the last-in, first-out (LIFO) method, inventory is taken at cost, but the items contained in the inventory are treated as being, first, those contained in the opening inventory, to the extent thereof, and second, those acquired during the tax year. The items deemed to be in the opening inventory are taken in order of acquisition, except for the first year in which the method is used. The Framework would repeal the use of LIFO.

**IMPACT:** *The administration noted that repeal of LIFO would bring the U.S. in line with international financial reporting standards. Manufacturers holding inventory would be especially hurt by this rule despite the Framework's overall efforts to promote more U.S. manufacturing.*

**COMMENT:** *President Obama also proposes to repeal LIFO in his FY 2013 budget (and in past budgets). Additionally, the President's FY 2013 budget would repeal the lower-of-cost-or-market (LCM) inventory method.*

**Oil and Gas Tax Preferences.** The Framework proposes to eliminate tax preferences for fossil fuels. Current tax preferences in this category, as listed in the President's FY 2013 Budget, include the enhanced oil recovery credit for eligible costs attributable to a qualified oil recovery project; tax credit for oil and gas produced from marginal wells; expensing of intangible drilling costs; deduction for costs paid or incurred for any tertiary injectant used as part of a tertiary recovery method; exception to passive loss limitations provided to working interests in oil and natural gas properties; the use of percentage depletion with respect to oil and gas wells; and two-year amortization of independent producers' geological and geophysical expenditures (which would be increased to seven years).

**COMMENT:** *President Obama's FY 2013 budget also calls for repeal of coal tax preferences, including expensing of exploration and development costs; percentage depletion for hard mineral fossil fuels; and capital gains treatment for royalties.*

**Carried Interest.** Carried interest is generally the share of any profits that the general partners of private equity and hedge funds receive as compensation. The Framework would tax carried interest as ordinary income.

**IMPACT:** *The Framework carries few details of the proposal to tax carried interest as ordinary income. President Obama's FY 2013 budget includes a proposal to tax as ordinary income a partner's share of income on an investment services partnership interest (ISPI) in an investment partnership, regardless of the character of the income at the partnership level. Such income would not be eligible for tax rates that apply to long-term capital gains. The partner would be required to pay self-employment taxes on such income.*

**COMMENT:** *The Framework does not provide for any exceptions for small partnerships.*

**Life Insurance.** The Framework carries a number of reforms targeted to life insurance companies and products. One proposal would not allow interest deductions allocable to life insurance policies unless the contract is on an officer, director or employee who is at least a 20 percent owner of the business. The Framework also would make other unspecified reforms to the treatment of insurance companies and products.

**IMPACT:** *The President's FY 2013 budget explains that purchases of life insurance by small businesses that depend heavily on the services of a 20 percent owner would be unaffected, but the funding of deductible interest expenses with tax-exempt or tax-deferred inside buildup would be curtailed.*

**Corporate Jets.** Airplanes used in the commercial or contract carrying of passengers are generally subject to a depreciation recovery period of seven years. The Framework proposes to increase the depreciation recovery period for non-commercial airplanes that carry passengers from five years to seven years.

## BUSINESS TAX EXTENDERS

A large number of business tax extenders expired after December 31, 2011 or are scheduled to expire after December 31, 2012. Under the Framework, apparently all of the business tax extenders would be allowed to expire except for the research tax credit.

**Research Tax Credit.** The research tax credit provides a 20 percent credit for qualified research and experimentation expenditures above a base amount. An alternative simplified credit of 14 percent is also available to eligible taxpayers. The research credit expired after December 31, 2011, after having been extended numerous times since its creation in 1981. The Framework would revive and make permanent the research tax credit. The Framework also proposes to increase the rate of the alternative simplified credit to 17 percent, thereby making the alternative form of the credit more attractive as well as providing a simpler method of filing for the credit.

**IMPACT:** *Uncertainty over expiration of the research tax credit has discouraged long-term research projects, to the detriment of U.S. competitiveness in general, according to the administration. Several attempts to extend the research tax credit by adding it to other legislation, such as the Middle Class Tax Relief and Job Creation Act of 2012, have failed, despite bipartisan support. One significant hurdle for extending the research tax credit is its cost. According to the President's FY 2013 budget, a permanent research tax credit would cost $108.5 billion over 10 years.*

**COMMENT:** *The Framework considers research especially important to the promotion of manufacturing, which is a technology-intensive sector. It also justifies enhancing this credit to match the more generous tax incentives for research provided by other countries, as well as pointing to the spillover benefits of research to society in general.*

**Other Expiring Provisions.** In addition to the research tax credit, many other business tax extenders expired after 2011, including (not an exhaustive list):

- 15-Year Recovery for Qualified Leasehold Improvements, Qualified Restaurant Property and Qualified Retail Improvements
- Seven-Year Recovery Period For Motorsports Entertainment Complexes
- Indian Employment Credit

### EFFECTIVE ACTUAL CORPORATE TAX RATES BY SELECTED INDUSTRY 2007-2008*

| Industry | Tax Rate |
|---|---|
| Construction | 31% |
| Wholesale and Retail Trade | 31% |
| Manufacturing | 26% |
| Real Estate | 23% |
| Transportation and Warehousing | 19% |
| Mining | 18% |
| Leasing | 18% |
| Utilities | 14% |

*Source: U.S. Treasury, Office of Tax Analysis

- Accelerated Depreciation for Business Property on Indian Reservations
- Special Expensing Rules for Certain Film and Television Productions
- Election to Expense Advanced Mine Safety Equipment
- Expensing of Brownfield Environmental Remediation Costs
- Employer Wage Credit for Activated Military Reservists
- Railroad Track Maintenance Credit
- Mine Rescue Team Training Tax Credit
- Basis Adjustment to Stock of S Corporations Making Charitable Contributions
- Enhanced Deduction for Corporate Charitable Contributions of Book Inventories
- Enhanced Deduction for Corporate Charitable Contributions of Computers
- Certain Empowerment Zone Tax Benefits
- Certain District of Columbia Enterprise Zone Tax Incentives

## CLEAN ENERGY

The Framework would use the Tax Code to encourage investment in clean energy projects.

**Renewable Electricity Production Credit.** Code Sec. 45 provides a temporary renewable electricity production tax credit. Qualified energy resources for purposes of the credit include (not an exhaustive list) wind, solar, geothermal, and certain other renewable sources. The base amount of the credit is 1.5 cents (indexed annually for inflation) per kilowatt-hour of electricity produced. The administration's framework would make permanent the credit for production of renewable electricity. Additionally, the credit would be made refundable.

**IMPACT:** *A cash grant in lieu of tax credit program (known as the "1603 program") expired after 2011. In his FY 2013 budget, President Obama proposes to extend the grant program to qualified property placed in service in 2012 (including property on which construction would begin in 2012). After 2012, the administration proposes to replace the grant program with a refundable credit. According to the administration, the refundable nature of the credit would make unnecessary certain inefficient tax planning using tax equity structures currently in use.*

**COMMENT:** *A taxpayer may make an irrevocable election to have certain qualified facilities be treated as energy property eligible for a 30 percent investment credit under Code Sec. 48 in lieu of the Code Sec. 45 renewable electricity production credit. It is unclear from the Framework if this election would continue.*

> "Congressional reaction to the President's framework was mixed."

**COMMENT:** *President Obama's FY 2013 budget calls for an enhanced tax credit for the production of advanced technology vehicles and a tax credit for medium and heavy duty alternative fuel commercial vehicles. The Framework does not specifically address these clean energy incentives.*

## INTERNATIONAL TAX SYSTEM

The Framework describes (but not in detail) the administration's proposed minimum tax on overseas profits and other international proposals.

**COMMENT:** *As discussions have heated up over international tax reform, commentators have debated whether the United States should have a territorial tax system, a worldwide tax system or a combination of the two. A territorial system would tax U.S.-source profits of multinational corporations but would exempt profits earned abroad, while a worldwide system would tax all income, wherever derived. The current system is a combination that theoretically taxes worldwide income, but defers (sometimes permanently) foreign-earned income that is not repatriated to the U.S.*

**Minimum Tax on Overseas Profits.** The Framework describes subjecting income earned by foreign subsidiaries of U.S. corporations to an unspecified minimum tax. Foreign income deferred in a low-tax jurisdiction would be subject to immediate U.S. taxation up to the minimum tax rate. To avoid double taxation, the U.S. corporation would be entitled to a foreign tax credit for income taxes paid to the host country.

**IMPACT:** *According to the administration, one goal of the minimum tax is to keep U.S. companies on a level playing field with competitors when engaged in activities that must occur abroad.*

**IMPACT:** *The administration has not indicated what the minimum tax on overseas profits would be, apparently leaving it to Congress to decide. Presumably, however, this revenue would factor into calculations for reducing the U.S. corporate tax rate to 28 percent.*

**New Incentive for Returning Work to U.S.** The Framework would give qualified taxpayers a 20 percent tax credit for the expense of moving operations back to the U.S.

**Eliminate Tax Incentives for Moving Work Overseas.** According to the administration, the Tax Code allows companies moving operations overseas to deduct their moving expenses and thus reduce their taxes in the U.S. The Framework would deny a tax deduction for moving operations overseas.

**Repatriation Holiday Nixed.** Although not discussed in the Framework, senior Treasury officials have reiterated the administration's opposition to a repatriation tax holiday, such as the one enacted in 2004. "The administration remains opposed to an earnings repatriation tax holiday," a Treasury official said on February 22. However, in a follow-up response, the official did not rule out the possibility that a repatriation holiday might be part of the legislative give-and-take as reform develops.

**Worldwide System Favored.** President Obama has come out strongly in favor of a worldwide tax system in which U.S. companies generally pay taxes on their worldwide income. According to Treasury, a purely territorial system would aggravate many of the problems of the current Tax Code. If foreign earnings of U.S. multinational companies are not taxed at all, for instance, these firms would have greater incentive to locate operations overseas, or use accounting mechanisms to shift profits out of the United States. Shifting profits abroad would also erode the U.S. tax base, requiring that more taxes be collected from U.S. taxpayers, according to Treasury.

**IMPACT:** *The President aims to reduce opportunities in the Tax Code to shift income and investment outside the U.S. According to the administration, international reforms, together with a lower statutory tax rate on corporate income, will improve the incentives for multinational corporations to invest in the U.S.*

**Transfer of Intangibles.** The Framework would tax currently the excess profits associated with shifting intangibles to low tax jurisdictions.

**IMPACT:** *By closing the gap between the rates of U.S. and foreign taxation of the income, the proposal would reduce tax incentives for transferring intangible assets abroad and collaterally reduce certain transfer-pricing issues.*

**Interest Expense Deferral.** The Framework would require that a taxpayer's deduction for interest expense attributable to overseas investment be delayed until the associated income is taxed in the U.S.

**IMPACT:** *According to the administration, the proposal would eliminate the tax advantage that inures to corporations that borrow money and invest it overseas, while, at the same time, taking an immediate deduction to reduce U.S. taxes, especially if they pay little or no U.S. taxes on the overseas investment.*

## SMALL BUSINESSES

The Framework includes several provisions designed to simplify the Tax Code for small businesses as well as provide a greater degree of tax relief for certain expenses incurred in investing in small businesses. A reduction in tax compliance costs for small businesses is a particular goal in this simplification effort.

**Small Business Expensing.** The Framework proposes to allow small businesses to expense up to a maximum of $1 million of qualified investments under Code Sec. 179. This would be a permanent provision, unlike recent temporary expensing allowances that varied in size and amount almost every other year.

**COMMENT:** *The Small Business Jobs Act of 2010 increased the Code Sec. 179 dollar and investment limitations to $500,000 and $2 million, respectively, for tax years beginning in 2010 and 2011. For tax years beginning in 2012, the dollar and investment limitations revert to $125,000 (inflation-adjusted) and $500,000 (inflation-adjusted), respectively.*

**Cash Accounting for Small Businesses.** The Framework would extend the use of the cash method to small businesses with up to $10 million in gross receipts.

**COMMENT:** *Generally, businesses with up to $5 million in gross receipts are allowed to use the simplified form of cash accounting. Under the cash method, income is not counted until actually received and expenses not counted until actually paid. Use of the cash method is easier than the accrual method, where income and expenses must be counted when incurred.*

**IMPACT:** *Use of the accrual method complicates tax compliance for many small business owners, who cannot always easily determine in which tax year income or expenses have occurred.*

**Start-Up Deduction.** The Framework would permanently double the amount of immediately deductible start-up expenses from $5,000 to $10,000, with a dollar-for-dollar phase-out beginning at $60,000 of qualifying expenses.

**IMPACT:** *The Small Business Jobs Act of 2010 temporarily enhanced the deduction for start-up costs. For tax years beginning in 2010, the amount of trade or business start-up expenses that may be deducted by a taxpayer increased from $5,000 to $10,000, and the threshold amount for reducing the limit increased from $50,000 to $60,000.*

**Code Sec. 45R Credit.** Code Sec. 45R provides a credit to help qualified small employers offset the cost of health insurance for their employees. The Framework would enhance the Code Sec. 45R small employer health insurance tax credit.

**IMPACT:** *The Framework would create a more generous phase-out schedule, streamline the rules, and benefit small businesses with up to 50 workers (an expansion beyond the current cap of 25 workers).*

### SELECTED BUSINESS TAX PREFERENCES TARGETED FOR REPEAL

| |
|---|
| Last-in, First-Out (LIFO) Method of Accounting |
| Tax Breaks for Oil and Gas Industries |
| Special Depreciation Rules for Corporate Jets |
| Many Business Tax Extenders |

**COMMENT:** *For tax years 2010 through 2013, the maximum credit is 35 percent for qualified small employers and 25 percent for qualified small tax-exempt employers. On January 1, 2014, the maximum credit is scheduled to increase to 50 percent (35 percent for qualified small tax-exempt employers).*

## CORPORATE TAX BASE

The Framework describes (but not in detail) several options that the administration proposes for consideration within the context of overall business tax reform.

**Parity.** One option would establish greater "parity" in the taxation of large corporations and large non-corporations, in order to discourage businesses from using noncorporate forms merely to avoid the corporate income. The Framework does not describe how parity would be accomplished but emphasizes that any changes should not affect small businesses.

**IMPACT:** *The popularity of non-corporate entities, such as S corporations and limited liability companies (LLCs), has exploded, in part because they offer the best of both worlds: corporate protections without corporate formalities and taxes. Any change to treat non-corporations more similarly to corporations for federal tax purposes would generate a groundswell of opposition.*

**Depreciation.** Without going into detail, the Framework identifies depreciation as one area for reform. According to the administration, current depreciation schedules generally overstate the true economic depreciation of assets. This accelerated depreciation may increase investment and job creation, but it might be more effective to use the savings from economic depreciation to finance lower tax rates.

**Debt Financing.** The administration would move the tax system to one that it describes as more neutral towards debt and equity, in order to reduce incentives to over-leverage, and also provide more stable business finances, especially in times of economic stress.

**COMMENT:** *Reducing the deductibility of interest for corporations is one proposal identified in the Framework. The Framework includes no details, but notes that the resulting tax savings could help finance lower tax rates.*