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Ernst & Young LLP's analysis of four hypothetical companies shows Wyden-Coats tax reform plan would lower tax burden for more companies than Deficit Commission plan

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US policymakers are increasingly examining ways to reform the tax code as part of a broader discussion about reducing budget deficits.

A number of reform plans have focused on reducing the 35% corporate tax rate and broadening the tax base by eliminating commonly used deductions, credits and other preferences. For example, a December 2010 plan from the President's National Commission on Fiscal Responsibility and Reform (the Deficit Commission plan) proposed reducing the corporate tax rate to 28% and eliminating all business tax expenditures. For an analysis of the effects that plan would have on both domestic and multinational companies, especially multinational manufacturers and mining and construction companies, see the Ernst & Young LLP Tax Insight, *Lowering business tax rates by repealing tax expenditures: an industry analysis*.

Notwithstanding the rate reduction proposed by the Deficit Commission plan, others have proposed pushing the corporate tax rate even lower while targeting the same pool of tax expenditures for elimination. The Republican House Budget and Ways and Means Committee Chairmen Paul Ryan (R-Wis.) and Dave Camp (R-Mich.), have called for reducing the corporate income tax rate to 25%. Senators Ron Wyden (D-Ore.) and Dan Coats (R-Ind.) introduced a tax reform proposal, known as the Wyden-Coats Bipartisan Tax Fairness and Simplification Act of 2011 (the Wyden-Coats plan), that would set the corporate tax rate at 24% while repealing many special tax provisions. President Barack Obama this month said he wants to reduce "spending in the tax code" by reducing tax expenditures by

\$1 trillion as part of a plan to cut the deficit by \$4 trillion over the next 12 years.

This analysis compares the Deficit Commission plan and the Wyden-Coats plan against current law and outlines their effects on four hypothetical companies. It does not include the recent Ryan proposal because it lacks sufficient detail on the tax side to perform a proper analysis. It also does not consider how more than \$1 trillion in unrepatriated foreign earnings would be taxed under any transition to a new system.¹

The four hypothetical companies in this analysis are a US domestic manufacturer (HomeGrown Inc.), a US-headquartered multinational manufacturer (GlobalSpan Corp.), a domestic service corporation (ServiceGiant Corp.) and a domestic high-tech corporation (TechLabs Co.). Each firm's profile was based on IRS data for firms in the industry and is a composite. Details on the companies' financial characteristics can be found in the Appendix.

This analysis concludes that domestic service industries in the broadest sense would be the biggest beneficiaries of both regimes, while gaining nearly twice as much in tax savings under the Wyden-Coats plan as under the Deficit Commission plan. Of the two proposals, only the Wyden-Coats plan, with its large reduction in the tax rate for firms organized in the corporate form, results in a net tax reduction for each of the four hypothetical companies.

In evaluating this analysis, companies should keep in mind that its findings are based on an analysis of composite characteristics of a typical company in each given industry. Each plan's effects on real companies may depend heavily on individual business characteristics such as debt load, capital intensity and whether the company is profitable. Within any industry there will be winners and losers, because the effects of tax reform depend on the relative profitability and relative intensity of using specific tax provisions. Accordingly, the hypothetical examples should be viewed as illustrative of the possible effects, as actual companies could well have substantially different effects depending on their circumstances.

Major provisions of tax reform plans

The Deficit Commission plan would reduce the corporate tax rate to 28%. To achieve this seven percentage point reduction, it would repeal many widely used provisions that keep companies' effective tax rates low. They include:

- ▶ Corporate income tax rate reduction from 35% to 28%
- ▶ Repeal of accelerated tax depreciation
- ▶ Repeal of the domestic production deduction
- ▶ Repeal of expensing of research and experimentation expenditures
- ▶ Repeal of special tax inventory rules
- ▶ Repeal of the corporate charitable deduction

- ▶ Repeal of general business tax credits
- ▶ Repeal of inventory property sales source exception rule
- ▶ Move to a territorial tax regime (85% exemption of dividends from active foreign-source income)

The Wyden-Coats tax reform plan achieves a 24% corporate tax rate by targeting the following business tax benefits:

- ▶ Repeal of accelerated tax depreciation
- ▶ Repeal of the domestic production deduction
- ▶ Repeal of lower-of-cost-or-market (LCM) tax inventory rule
- ▶ Indexation of interest paid deduction for inflation for corporations
- ▶ Repeal of inventory property sales source exception rule
- ▶ Move to worldwide current taxation with a per country limitation on foreign tax credits

Repeal of accelerated depreciation would require companies to use straight-line tax depreciation over the alternative depreciation system class lives. Because accelerated depreciation is a timing issue, Table 2 shows the effect of depreciation as the percentage change in deductions over 10 years. The repeal of last-in

first-out (LIFO) and LCM tax inventory accounting assumes the outstanding tax inventory balances are brought back into taxable income over several years. The Wyden-Coats interest deduction adjustment for inflation assumes a 25% reduction in the deduction for interest expenses (based on the Congressional Budget Office (CBO) forecast of future inflation).

The research credit is scheduled to expire at the end of 2011, along with a number of other business tax credits. Thus, under a revenue-neutral tax reform, making the research credit permanent would require including other base-broadeners or the corporate tax rate could not be reduced as much. Neither the Deficit Commission plan nor the Wyden-Coats plan would extend the research credit.

Tax reform effects on individual companies

How do these two alternative tax reform proposals affect specific companies? For the four hypothetical companies, here's how taxes would change and why:

ServiceGiant Corp.: The domestic services corporation would have a large tax reduction under both the Deficit Commission plan (-13%) and Wyden-Coats

plan (~25%) due to the lower corporate tax rate and the fact that it doesn't currently reap much benefit from the provisions the policymakers have targeted for repeal. The firm does not have foreign operations, does not benefit from the "domestic production deduction" and does not receive significant benefits from accelerated depreciation. The firm would lose some tax credits under the Deficit Commission's plan and would experience some base-broadening from the cutback on interest expense deductions under the Wyden-Coats plan.

TechLabs Co.: The high-tech firm is a domestic-only producer of software that would be adversely affected by repeal of the domestic production deduction, accelerated depreciation and expensing of research expenditures, as well as the cutback on interest deductions. The high-tech firm would face a 2% tax increase under the Deficit Commission's plan, but would benefit from a 14% tax reduction under the Wyden-Coats' plan. This is due largely to the Wyden-Coats' lower corporate tax rate at 24%.

HomeGrown Inc.: The domestic-only manufacturing corporation would have a 4% tax increase under the Deficit Commission plan, mostly due to the repeal of the domestic production activities deduction, accelerated depreciation and expensing of research expenditures provisions. The tax increase from base-broadening outweighs the benefits of reducing the corporate tax rate to only 28%. Under the Wyden-Coats plan, the firm would have a 10% reduction in its taxes because the lower 24% corporate tax rate more than offsets the proposed base broadening.

GlobalSpan Corp.: The multinational corporation (MNC) is a manufacturing company with half of its income from

Table 1: Percent change in tax liability under the Deficit Commission and Wyden-Coats plans for four firms

Firm	Deficit Commission tax reform	Wyden-Coats tax reform
	Percent change in liability	
ServiceGiant Corp. domestic services firm	(12.7%)	(24.7%)
TechLabs Co. domestic high-tech firm	1.7%	(14.3%)
HomeGrown Inc. domestic manufacturer	4.2%	(10.5%)
GlobalSpan Corp. multinational manufacturer	5.9%	(2.9%)

Source: Ernst & Young Center for Tax Policy calculations

Table 2: Detailed look at Deficit Commission and Wyden-Coats tax reform proposals on four firms (\$ millions)

	ServiceGiant Corp. domestic services firm			TechLabs Co. domestic high- tech firm			HomeGrown Inc. domestic manufacturer			GlobalSpan Corp. multinational manufacturer		
	C.L.	D.C.	W-C	C.L.	D.C.	W-C	C.L.	D.C.	W-C	C.L.	D.C.	W-C
Current law taxable income	150			500			670			2,680		
Base broadening provisions												
Domestic production deduction repeal		0	0		28	28		54	54		191	191
Accelerated depreciation repeal		0	0		51	51		48	48		192	192
Charitable deduction repeal		2	-		4	-		8	-		32	-
Index interest paid deduction		-	17		-	45		-	95		-	382
R&E expensing repeal		0	-		27	-		51	-		204	-
Special inventory method repeal		1	0		3	3		11	7		43	27
Foreign source dividend exemption		0	-		0	-		0	-		(57)	-
Eliminate deferral		-	0		-	0		-	0			1,206
Other base broadening provisions		2	1		5	3		7	3		27	13
Proposed corporate taxable income	150	155	168	500	618	628	670	848	877	2,680	3,312	4,691
Statutory marginal tax rate	35%	28%	24%	35%	28%	24%	35%	28%	24%	35%	28%	24%
Tax liability before credits	53	43	40	175	173	151	235	237	211	938	927	1,126
Foreign tax credits*	0	0	0	0	0	0	0	0	0	51	17	264
Non-R&E tax credits	3	0	3	5	0	5	7	0	7	27	0	27
Corporate tax liability after credits	50	43	37	170	173	146	228	237	204	860	910	835
Percent change		(13%)	(25%)		2%	(14%)		4%	(11%)		6%	(3%)

C.L. = Current law; D.C. = Deficit Commission plan; W-C = Wyden-Coats plan

*D.C. and W-C propose elimination of inventory property sales source rule exception, and W-C's per country foreign tax credit limitation affects available foreign tax credits.

Source: Ernst & Young Center for Tax Policy calculations. Numbers may not add due to rounding.

foreign operations. The company repatriates 10% of its current foreign-source income. GlobalSpan would face a 6% tax increase under the Deficit Commission plan due to the significant base broadening affecting manufacturers. The Deficit Commission's plan to move to a territorial tax system, in which 85% of active foreign-source income would be exempt from US taxation, is close to a wash for this company. An 85%

foreign dividend exemption is offset by a reduction in available foreign tax credits.

Under the Wyden-Coats' plan, the multinational manufacturer would have a 3% tax reduction. Domestic base broadening is roughly the same, with the Wyden-Coats limitation on the interest expense deduction replacing the repeal of expensing research expenditures and corporate charitable deductions. The

corporate tax base would be increased significantly with the inclusion of all worldwide income, whether repatriated or not, but higher foreign tax credits would offset some of that effect. The international tax provisions reduce the potential net tax savings. These particular facts, combined with a 24% corporate tax rate, make GlobalSpan a net winner under the Wyden-Coats plan.

The reduction in tax for all four hypothetical corporations under the Wyden-Coats plan reflects in large part the significant reduction in the corporate tax rate. Indeed, the Wyden-Coats plan has been reported to lower overall corporate income taxes. Taxes on households and companies operating as flow-through businesses would rise. In contrast, the Deficit Commission plan has been reported to be roughly revenue-neutral within the corporate sector as the additional revenue from base broadening offsets the cost of lowering the corporate tax rate to 28%.

Conclusion

US companies that operate only domestically would generally fare better than MNCs under both the Deficit

Commission plan and the Wyden-Coats plan, although both plans would result in winners and losers across every industry. A comparison of how these two plans would affect four hypothetical companies across four industries reveals three of them would pay more under the Deficit Commission plan, while all four would benefit from a net reduction in tax costs under the Wyden-Coats plan.

Corporate tax reform could have positive effects through reduced complexity, increased certainty, fewer tax-induced economic distortions and stronger US economic growth. While the four company examples illustrate the effects on companies' corporate tax liabilities, companies will also want to assess the effects of tax reform on their customers,

suppliers, investors, employees and the US economy, as well as their competitiveness in domestic and foreign markets.

Appendix

Financial characteristics of the four firms

Table 3 shows the financial characteristics of the four firms. Differences in their relative profitability and business characteristics as they interact with the proposed tax reform changes result in the changes in their US tax liability.

	ServiceGiant Corp. domestic services firm	TechLabs Co. domestic high-tech firm	HomeGrown Inc. domestic manufacturer	GlobalSpan Corp. multinational manufacturer
Domestic production activities deduction	0.0%	5.5%	8.0%	7.5%
Fraction of income from overseas operations	0.0%	0.0%	0.0%	50.0%
Interest paid deduction	45.0%	36.0%	57.0%	57.0%
Charitable deduction	1.2%	1.2%	1.2%	1.2%
LIFO inventory	0.0%	0.6%	1.6%	1.6%
LCM inventory	0.0%	0.5%	1.0%	1.0%
General business credits (excluding R&E)	2.0%	1.0%	1.0%	1.0%
R&E credits	0.0%	1.2%	1.5%	1.5%
New investment (not eligible for R&E expensing)	1.0%	95.0%	50.0%	50.0%
New investment eligible for R&E expensing	0.0%	18.0%	25.0%	25.0%

Source: Ernst & Young LLP Quantitative Economics and Statistics assumptions based upon IRS data from Statistics of Income division, www.irs.gov/taxstats, and Bureau of Economic Analysis data on investments by asset by industry

Endnotes

- ¹ For discussion of the major features of these and several other reform plans, see the side-by-side comparison included with Tax Alert 2011-615.

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