Companies Consider a Tax Readiness Framework Ahead of Tax Reform

Virtually no day passes without some mention in the press about business tax reform. As alternate tax proposals are debated, companies are considering ways to proactively prepare for the potential impact of reform on strategic planning.

The President described the problem succinctly and accurately: "As a result of [the] combination of a relatively narrow tax base and a high statutory rate, the U.S. tax system is uncompetitive and inefficient… The system is also too complicated—especially for small businesses."[1]

The fiscal challenge of balancing short-term economic recovery with long-term financial sustainability dictates that any effective reformation of business taxation will have to be at least revenue neutral.[2] The fact that over 70 percent of net business income in the U.S. is earned by entities that are not subject to corporate tax[3] makes it clear that reform of business taxation cannot logically occur without a concurrent examination of individual taxation.

To date the business tax reform discussion has been long on concept but short on detail. In the zero sum game that is created by budget constraints, the principal goal of significant rate reduction may be unattainable without an additional revenue source. Revenue neutrality will create winners and losers in the business sector. As a result, at least some tax reform objectives articulated by a variety of sources[4] may prove to be mostly aspirational.

Tax Readiness Considerations for Companies and their Boards

- Are we prepared to rapidly assess and prioritize the potential impact of multiple aspects of tax policy on business decisions such as mergers, acquisitions, and global strategy?
- Are company records adequate to rely on as inputs to tax reform scenario planning and analyses?
- Are we prepared with the resources necessary (in the tax department or other departments) to assess the potential impact of tax reform on enterprise risk management and financial statements during the transitional period that will precede a new tax regime?
- Are existing compliance programs adequate given the focus of regulators on greater transparency and accountability, with heightened scrutiny and penalties for failures to comply?
- Will our technology capabilities be sufficient to manage a tax reform transition?

[1] *The White House and the Treasury, "The President's Framework for Business Tax Reform," at 1 (Feb. 22, 2012) (the framework).*

[2] "Revenue neutrality" requires that tax proposals that lose revenue be offset by proposals that raise an equal amount. In the corporate tax context revenue neutrality requires that the revenue lost by a rate reduction be offset by a reduction or elimination of business tax expenditures.

[3] The framework, supra note 1 at 7

[4] Sources include the Administration, Chairman of the Ways and Means Committee, Chairman of the House Budget Committee, *the President's National Commission on Fiscal Responsibility and Reform (the Bowles-Simpson Task Force)* and the Report of the Debt Reduction Task Force, commissioned by the Bipartisan Policy Center. (the Domenci-Rivlin Task Force)

While consistent in some respects, there are significant differences among the proposals[5] and the lack of specificity raises a number of important questions. Generally, however, they can be grouped into three broad categories: the corporate rate and base, the taxation of foreign source income, and the interaction of corporate and individual taxes.

The Corporate Rate and Base: Reduction of the corporate rate is very important. Proponents believe this will make the U.S. more attractive for direct foreign investment and reduce incentives to move income off-shore. All the proposals to date espouse a reduction of the corporate tax rate to a range of 25 to 29 percent and assume an outcome that is at least revenue neutral. The unanswered question is how to achieve that revenue neutrality.

A Joint Committee on Taxation analysis[6] indicates that repeal of all the domestic business tax preferences that are attributable to corporations (including the manufacturing deduction, the research and experimentation (R&D) credit and accelerated cost recovery) could pay for a rate reduction to 28 percent. Additional repeal of the business tax preferences utilized by non-corporate taxpayers would permit a rate reduction to approximately 25.8 percent.[7]

It therefore appears to be *mathematically* possible to offset a rate reduction to nearly 25 percent. And there are other dials that can be adjusted to move toward 25 percent, including Administration proposals to reform international tax, expand the corporate tax base to include large pass-through entities, and limit corporate interest deductions.

However, enacting all elements of the Administration's plan is not likely, nor is it likely that all business tax expenditures would be eliminated for all business taxpayers. Therefore, the corporate rates cannot be lowered to the levels discussed simply by reducing or eliminating business tax preferences. At that point other sources may have to be considered, including increasing the tax rate on dividends and capital gains, using energy or financial transactions taxes, enacting a value-added tax, or increasing the tax rates on high-income individuals. The latter have been used recently by countries that have reduced their corporate tax rates.

Foreign Source Income: The appropriate way to tax foreign source business income is a particular point of contention. The current U.S. system taxes foreign source income at U.S. rates with a foreign tax credit to relieve double taxation. However, the income attributable to off-shore active business is not subject to U.S. tax until repatriated. The current system has been widely criticized on three grounds. The first is the "lock-out" effect. The deferral of tax on unrepatriated earnings creates an incentive for U.S. companies to keep a substantial amount of active business earnings off-shore or locked out of the U.S.[8] The second is the alleged base erosion that occurs as U.S. based multinational companies transfer highly mobile, highly profitable intangible assets to low tax jurisdictions. The third is the complexity of the law itself.

Most other developed countries use a form of territorial taxation under which active business income earned off-shore is taxed only at the source. Adopting some form of a territorial system in the U.S. eliminates the lock-out effect and some companies believe it enhances their ability to compete more effectively in the foreign jurisdictions.

Others assert that the territorial system provides an incentive for U.S. companies to locate businesses outside the U.S which may result in domestic job loss. Instead, they suggest eliminating or sharply reducing deferral by subjecting off-shore income to immediate

The Strategic Business Challenge

Continuing tax reform debates around U.S. corporate tax rates including repatriated cash rules, R&D, or depreciation will likely impact investment alternatives and the return on investment (ROI) in many different ways. Business analyses or frameworks that apply a critical public policy lens across the organization including customers, employees, business partners, and supply chains, in advance of final rules can help highlight risks and opportunities as the tax debate unfolds.

Adapting Business Strategy to the Regulatory Outlook, KPMG LLP, February 2012.

[5] For a broader discussion on current tax proposals, see KPMG Tax Governance Institute Webcast: *Business Tax Reform—Sorting the Moving Pieces*, Hank Gutman, March 2012. See also *How to Think About Real Tax Reform, Tax Notes*, Hank Gutman, August 6, 2012.

[6] *Joint Committee Taxation memo about the estimated revenue effects of corporate tax reform revenue raising provisions,* October 27, 2011. The Joint Committee on Taxation analysis does not account for the effects of likely transition relief or taxpayer behavioral responses.

[7] Id

[8] Unrepatriated foreign earnings are currently estimated between 1.3-1.7 trillion USD, Businessweek.com, January 2012.

U.S. taxation. That also eliminates the lock-out effect. The ultimate empirical question is whether the benefit to the U.S. economy of multinationals' ability to compete in a foreign jurisdiction compensates for the loss of domestic economic activity that is encouraged by a territorial system. These opposing views are reflected in the Administration's proposals on the one hand and the territorial tax proposal of Chairman Camp of the Ways and Means Committee on the other.[9] The dichotomy is also seen in the contrasting proposals of the Bowles-Simpson and Domenici-Rivlin Task Forces.

The Interaction of Corporate and Individual Taxes: The inextricable connection between the corporate and individual tax creates an additional dilemma. To the extent a reduction in the corporate rate is financed by a reduction or elimination of business tax expenditures for all business income, the result is a tax *increase* for those who earn business income in pass-through form. This would be an intensely debated trade-off in any public policy proposal.

The Tax Planning Challenge

Most finance and tax executives surveyed say that improving tax planning/tax-related decision support (47%) and improving the management of tax-related risk (42%) will be their tax functions' primary mandate over the next two years.

Under Pressure, Finance and Tax Executives on Tax Management in a Challenging Recovery, CFO Publishing, Inc., December 2011.

Lack of Consensus: The business community is by no means united in its support for tax reform. The initial question will be whether the net result of business tax reform for each company results in a higher effective tax rate. And the answer to that question will depend upon how the corporate rate reduction is financed.

The preferences selected to finance the rate reduction will affect industries differently. For example, manufacturers should focus on the fate of the domestic manufacturing deduction.[10] Capital intensive industries should focus on alterations to the capital cost recovery system. And research-heavy companies should pay attention to the disposition of the research and experimentation credit. Separately, multinationals should be concerned about whether existing tax preferences will be reduced or eliminated to pay for domestic rate reductions or a territorial system.

The Outlook: Many have commented that the goal of tax reform should be to replicate the results of the 1986 Tax Reform Act in which the individual and corporate tax rates were reduced, capital and wage income rates were made the same, and the corporate tax base was broadened.

There were relatively easy revenue sources available to finance these changes. And there was a stronger consensus between the Congress and the Reagan Administration about the objectives.

Today the challenges are very different. Congress and the Obama Administration are not in agreement on reform objectives and there are no easy revenue sources.

The looming "fiscal cliff" – the expiration of the "Bush" tax cuts, the extension of alternative minimum tax relief, payroll tax relief, the provisions that expired at the end of 2011, unemployment benefits and the "doc fix" as well as addressing "sequestration" mandated by the Budget Control Act,[11] and perhaps a debt ceiling increase—are the issues that a "lame duck" Congressional session will need to address. Business tax reform will likely be deferred until 2013 at the earliest. *In the meantime, corporate boards are asking how companies can prepare for the uncertainty of tax reform.*

A Framework for Tax Reform Readiness: The lack of specificity in the business tax proposals and the practical reality that debate and resolution in the short-term is unlikely do not diminish the need to begin preparing for potential changes. Those changes may come incrementally or as part of significant overall reform, similar to what happened in 1986. Regardless of the

[9] Dave Camp, Chairman, House Ways and Means Committee, March 1, 2012, waysandmeans.house.gov/taxreform. http://waysandmeans.house.gov/UploadedFiles/V_and_E_March_1_2012.pdf

[10] The "manufacturing deduction" refers to a provision in section 199 of the Internal Revenue Code that generally allows a percentage deduction of net income attributable to qualified domestic production activities. http://www.law.cornell.edu/uscode/text/26/199

[11] Budget Control Act of 2011 (Public Law - 112-25 - August 2, 2011)

timeline, companies can begin now to create a readiness framework that can be used to a company's advantage when tax laws change. Such a framework can provide management with a valuable perspective achieved by analyzing proposals and preparing for transition.

A Fixed Asset Challenge:

48% of respondents say that "accounting for fixed assets accurately, reliably, and transparently" is one of the most challenging activities, followed closely by complying with changing tax regulations governing fixed assets and depreciation (40%).

Under Pressure, a report prepared by CFO Research Services in collaboration with BNA Software, March 2012.

Analysis of Proposals

Analysis may include an in-depth understanding of particular provisions of proposed legislation (current as well as previously proposed legislation that did not become law but might be revisited), high-level estimates of the proposals' potential impact upon the overall tax liability of the enterprise, financial reporting considerations, the potential effects on costing, and business systems needed to implement each provision. As an illustration, the introduction of proposed new taxes may challenge an organization down to the product level. The recent excise tax on medical devices,[12] for example, may require systems and process changes across an organization in order to properly compute the tax.

Careful analysis can provide perspective and help better inform decision makers on what they should do about pending tax reform. For example, with this perspective, management may decide to do nothing until a future date and/or actively influence the direction of legislation.

Preparation for Transition

Responding to tax reform will likely require some type of transition and related adjustments. These transition adjustments may result from differences between the existing tax regime and provisions of the new tax regime. As such, a good place to begin preparation for transition is assessing the current state of existing tax operations.

Elements that can be reviewed include the level of comfort a company has with respect to existing tax elections, methods and accuracy of accounting, sources and reliability of data, and technical positions taken. This type of review may help identify opportunities for planning prior to transition, improve the reliability of scenario analysis that is based on historic data and positions taken, and reduce the probability of "surprises" when the actual impact of new rules is measured.

Looking Ahead

Although it is not certain when and how tax reform will take place, chances are good that significant changes to our tax regime are on the horizon. Given this uncertainty, organizations should ensure that their tax house is in order. Readiness can be achieved by creating a framework that helps crystallize a perspective on reform by analyzing the details of proposals and preparing for transition. Maintaining a readiness framework can enable companies to make better informed business decisions when reform is enacted.

[12] For additional information on the Supreme Court decision on PPACA, see *Public Policy Alert: Business Response to the Supreme Court Decision*, July 2012.

Contact us

Kapila Anand
KPMG LLP
Partner in Charge, Public Policy Business Initiatives
T: 312-665-5094
E: kanand@kpmg.com

Hank Gutman
KPMG LLP
Principal, Washington National Tax
T: 202-533-3044
E: hgutman@kpmg.com

Tim Zuber
KPMG LLP
Partner, New York
T: 212-872-6653
E: tazuber@kpmg.com

kpmg.com