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The Washington Scene

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The Fiscal Mess

US Debt Crisis: Will It Strike?

➤ Near-Term Prospects

- Public debt as a share of the economy has risen to near-record levels
 - Between 2009 and 2011, public debt rose from \$5.8 trillion (41% of GDP) to \$9.3 trillion (63% of GDP)
 - By 2020, net public debt is likely to reach 100-110% of GDP
 - At that level, interest alone would likely exceed \$800 billion
 - Public debt will equal GDP in 2011
 - Debt ceiling increased to \$16.4 trillion in August debt ceiling deal
 - Public debt today is \$14.98 trillion
 - Public debt increasing by \$3.98 billion daily since 2007
 - Each individual's share equals \$47,983
- Net public debt held by foreigners is 46% vs. 1% in 1945

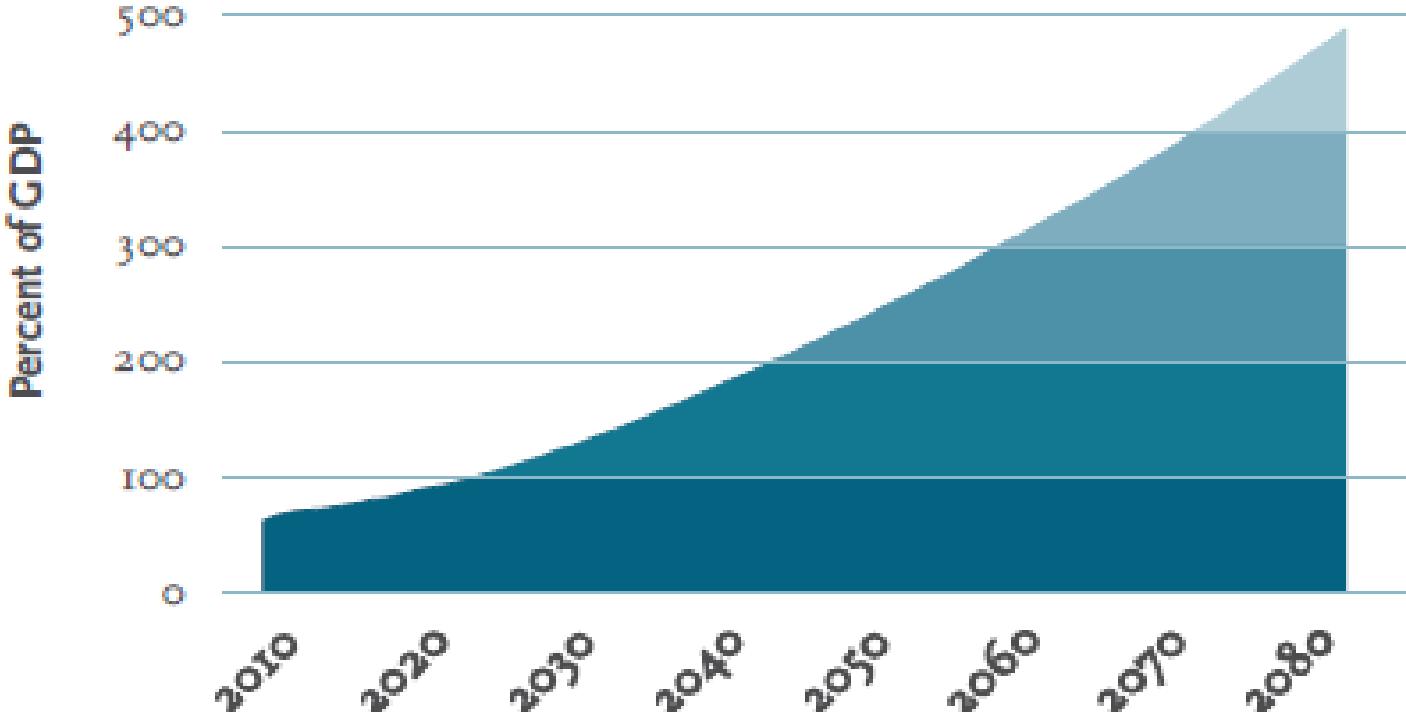
The Fiscal Mess

US Debt Crisis: Will It Strike?

➤ Long-Term Prospects

- In 2038, net public debt will reach **200%** of GDP
- By that year, on current trajectory, deficits would exceed an unprecedented **16%** of GDP
- And these are optimistic projections

Up, Up, and Away: National Debt as a Percent of GDP



Source: Pew Charitable Trusts, Getting Back in the Black (http://www.pewtrusts.org/our_work_detail.aspx?id=1016) (2010).

The Downgrade

S&P Government Debt Ratings

➤ AAA

- Australia
- Austria
- Canada
- Denmark
- Finland
- France
- Germany
- Guernsey
- Hong Kong
- Isle of Man
- Liechtenstein

- Luxembourg
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland
- United Kingdom

➤ AA+

- Belgium
- New Zealand
- **United States**

Fitch and Moody's rate the US AAA

Fitch rates the US stable; S&P and Moody's rate the US **negative**

Fiscal Calamity: When?

- Lessons from Yogi: “Predictions are hazardous, especially about the future.”
 - Ricardo Caballero: “Pretense of knowledge syndrome”
 - “Economists have predicted 9 of the last 2 recessions”
 - And been overly optimistic about recent growth forecasts
 - Herb Stein’s maxim: “If something can’t go on forever, it will stop.”
 - Lessons from Superfreakonomics
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How Are We Going to Get Out of the Mess?

➤ Denying the problem

- The one law voters clearly asked Congress to repeal is the law of arithmetic
- Health care reform
- 2010 year end tax extenders
- “Social Security doesn’t contribute to the deficit.”
- “Mediscare”
- Crying wolf one too many times

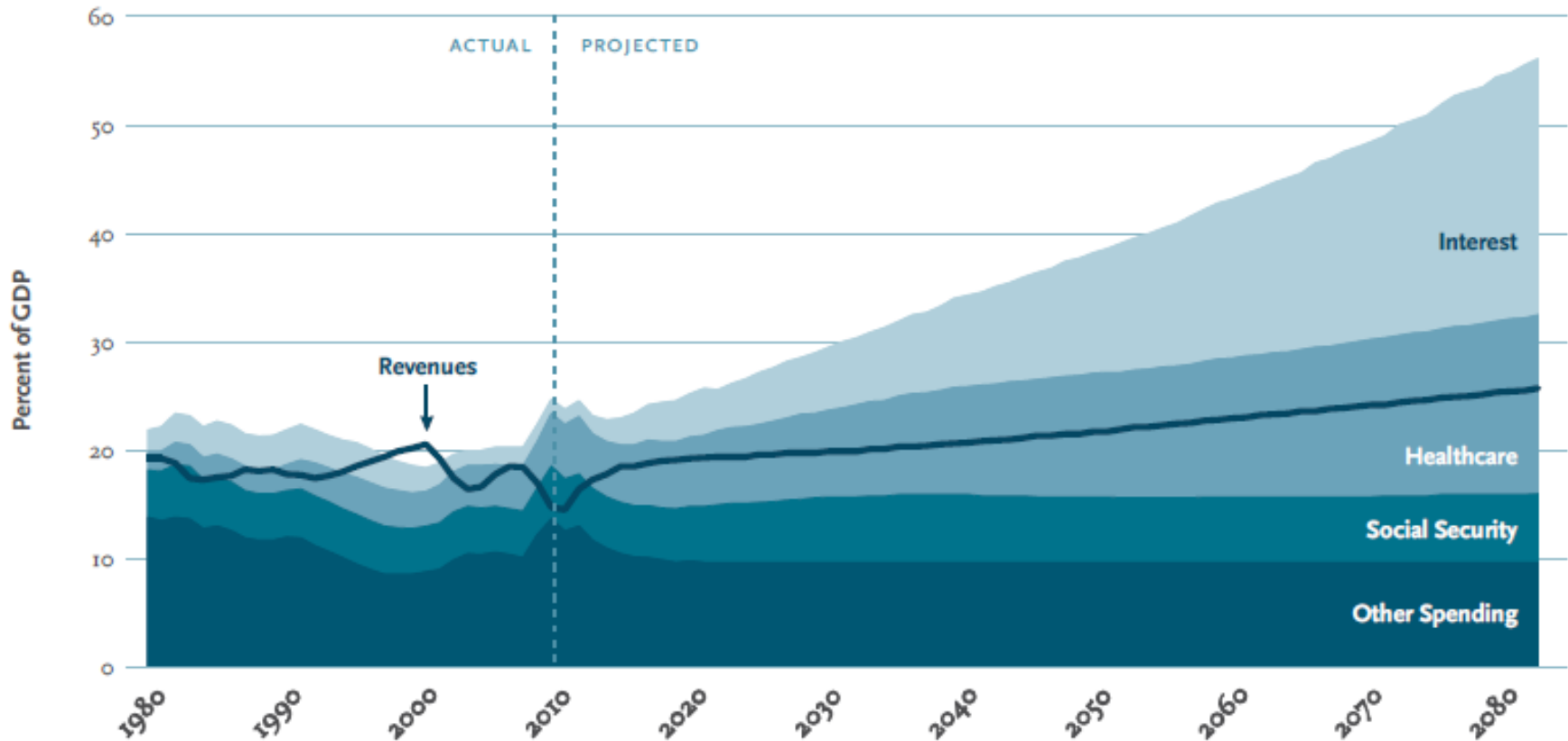
➤ Acknowledging the problem

- 11 (of 18) votes for the Deficit Reduction Commission report
- 64 senators deficit letter to President Obama
- 10 former CEA Chairs (Carter to Obama) *Politico* op-ed on the deficit
- Gang of 6. No, 5. No, 6. (Senators Chambliss, Crapo, Coburn, Conrad, Durbin, and Warner)

Getting to Agreement

- Political difficulties and realities
- Spending cuts
- Entitlement reform
- Increasing revenues

Spending to Survive: Interest and Healthcare Payments Dominate



Source: Pew Charitable Trusts, Getting Back in the Black (http://www.pewtrusts.org/our_work_detail.aspx?id=1016) (2010).

Deficit Reduction Legislation - Highlights

➤ **Budget Control Act – Summary**

- **Debt Limit**
 - Increases debt limit by \$2.1 trillion; limit can be increased by another \$300 billion
 - Increase occurs in three steps: \$400 billion immediately, then +\$500 billion, then the remainder after Congress votes on a Balanced Budget Amendment (BBA) and enacts further deficit reduction or following sequester
- **Spending Cuts**
 - Discretionary spending will be cut and capped, with projected savings of \$917 billion over 10 years
 - Process in place to lead to additional deficit reduction of \$1.2 - \$1.5 trillion over the next ten years
- **Revenue Increases**
 - No tax increases in Act – could be proposed by Joint Committee on Deficit Reduction created by Act

Joint Committee On Deficit Reduction

➤ Make-up

- 12 members of Congress appointed by congressional leaders:
 - 6 Democrats, 6 Republicans
 - 6 House, 6 Senate
 - Hensarling, Upton, Camp, Becerra, Clyburn, Van Hollen
 - Kyl, Portman, Toomey, Murray, Kerry, Baucus

➤ Goal

- Produce a bill that would reduce the deficit by \$1.5 trillion over 10 years.

➤ Logistics

- By November 23, seven or more members of the Committee must approve a bill
 - By December 23, bill gets a straight up-or-down vote in the House and Senate
 - Spending cuts and/or revenue increases require agreement of 7 of 12 members, *and* a majority of the House and Senate voting for the Committee's recommendation, *and* the President signing it into law
 - Failure to agree will trigger \$1.2 trillion of across-the-board spending cuts evenly split between defense and non-defense spending, sparing most entitlements
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What's Tax Reform Got to Do with It?

- The case for tax reform
 - Economic growth
 - Reducing complexity
 - Increasing stability
 - Improving fairness

No shortage of tax reform proposals

- Wyden-Coats
 - President's Economic Recovery Advisory Board
 - Deficit Reduction Commission (Simpson-Bowles)
 - Bipartisan Deficit Policy Center (Domenici-Rivlin)
 - President's Tax Reform Panel (2005)
 - Republican presidential candidate proposals
 - Cain 9-9-9
 - Perry flat tax
 - Camp draft international bill
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The Politics of Tax Reform

➤ Who will lead?

- The Administration?
 - Emphasizes the need for reform
 - Treasury has the pieces of a plan complete
 - Sees political risk in moving first or ahead
- Congress?
 - Tax writing committees – a year of hearings on tax reform
 - Joint Committee on Deficit Reduction

➤ See S&P and California

The Politics of Tax Reform

President Obama's Priorities –

- Avoid another vote on the debt ceiling
 - Debt ceiling bill sufficient to avoid another encounter with the Tea Party through early 2013
- Use Joint Committee for tax increases
 - “Since you can't close the deficit with just spending cuts, we'll need a balanced approach where everything is on the table.”
- Fair Share
 - “It also means reforming our tax code so that the wealthiest Americans and biggest corporations pay their fair share. And it means getting rid of taxpayer subsidies to oil and gas companies, and tax loopholes that help billionaires pay a lower tax rate than teachers and nurses.”

The Politics of Tax Reform

- What shape will reform take?
 - Comprehensive
 - Corporate tax reform vs. business tax reform
 - Individual tax reform
 - Consumption vs. income vs. both
 - Payroll tax

The Politics of Tax Reform

- Addressing the tax code's biases and distortions
 - Choice of entity: pass-through entities (partnerships, S corporations) and sole proprietorships vs. double-taxed C corporations
 - Expanding the double tax
 - Corporate integration
 - Debt vs. equity
 - Retaining earnings vs. paying dividends
 - Reinvesting foreign profits in the U.S.
 - Tax expenditures

Business Tax Reform Themes

- Relatively high U.S. statutory corporate income tax rate
 - U.S. statutory corporate income tax rate is 50% higher than the OECD average, and dividends bear a second level of tax
 - Start-up companies have growing incentives to organize in more business-friendly jurisdictions
 - U.S. dominance could fade quickly: in 1960, it took 20 years for a third of the Fortune 500 companies to change; today, it takes only four years
 - Worldwide taxation
 - Aside from China, next largest countries with a worldwide system are Korea and Mexico
 - Repatriation holiday
 - Temporary tax code
 - Global competition for investment
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OECD Corporate Tax Rates (2011)



Top Tax Expenditures (2010 JCT Staff Analysis)

Top 15 Individual Tax Expenditures	FY10-14 (\$billions)
Employer-provided health insurance exclusion	\$659
Net exclusion of pension contributions and earnings	\$597
Mortgage interest deduction	\$484
Reduced rates of tax on dividends and long-term capital gains	\$403
Exclusion of Medicare benefits	\$335
Earned income tax credit (including refundable portion)	\$269
Deduction for charitable contributions	\$246
Deduction of non-business state and local taxes	\$237
Exclusion of capital gains at death	\$194
Exclusion of untaxed social security and railroad retirement benefits	\$173
Exclusion of investment income on life insurance and annuity contracts	\$137
Exclusion of interest on public purpose state and local government bonds	\$127
Child tax credit	\$122
Deduction for property taxes on real property	\$121
IRAs	\$115

Top 10 Corporate Tax Expenditures	FY10-14 (\$billions)
Accelerated depreciation in excess of alternative depreciation system	\$78
Deferral of active income of controlled foreign corporations	\$71
Exclusion of interest on public purpose state and local government bonds	\$45
Deduction for income attributable to domestic production activities	\$43
Expensing of R&E expenditures and tax credit	\$39
Inventory property export source sales rule	\$38
5-year delay of inclusion of income arising from business indebtedness discharged in 2009 or 2010 by the reacquisition of a debt instrument	\$29
Low-income housing tax credit	\$27
Inventory methods and valuation, including LIFO and LCM	\$22
Reduced rates on first \$10 million of corporate taxable income	\$16

Revenue Neutral?

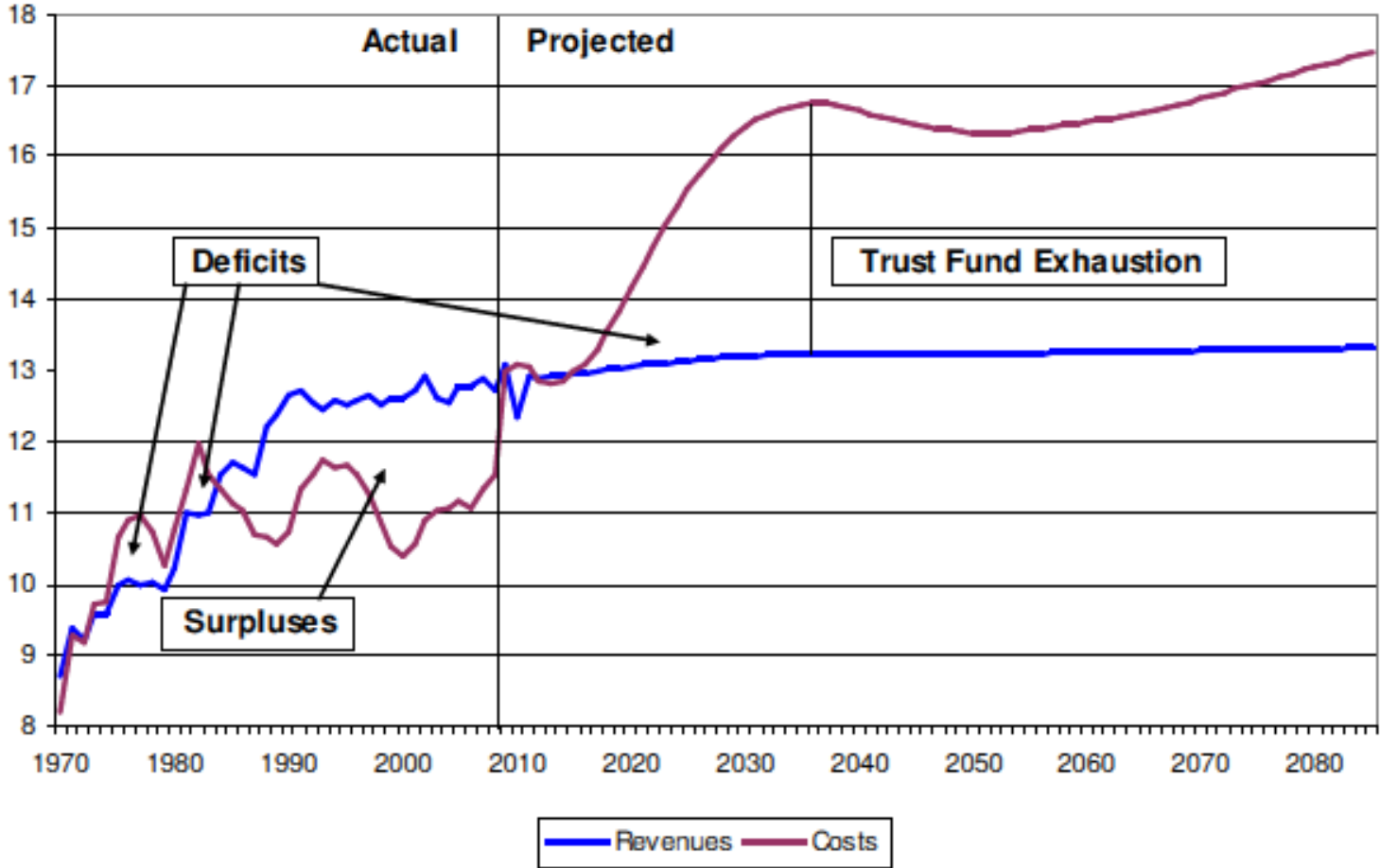
- Obama Administration has set revenue neutrality as a marker for tax reform
- Revenue neutrality within each tax base?
- Does revenue neutrality simplify or complicate?
- Against what measure should revenue neutrality be judged?
 - Current policy baseline?
 - Current law baseline?
 - Historical average? (Approximately 18% of GDP since 1959.)

Revenue Neutral?

- What about the deficit?
- Does revenue neutral reform –
 - Set the stage for spending cuts?
 - Set the stage for higher rates?
 - Set the stage for a second tax base?
 - All of the above?

Social Security Exhaustion – the Lockbox Flaw

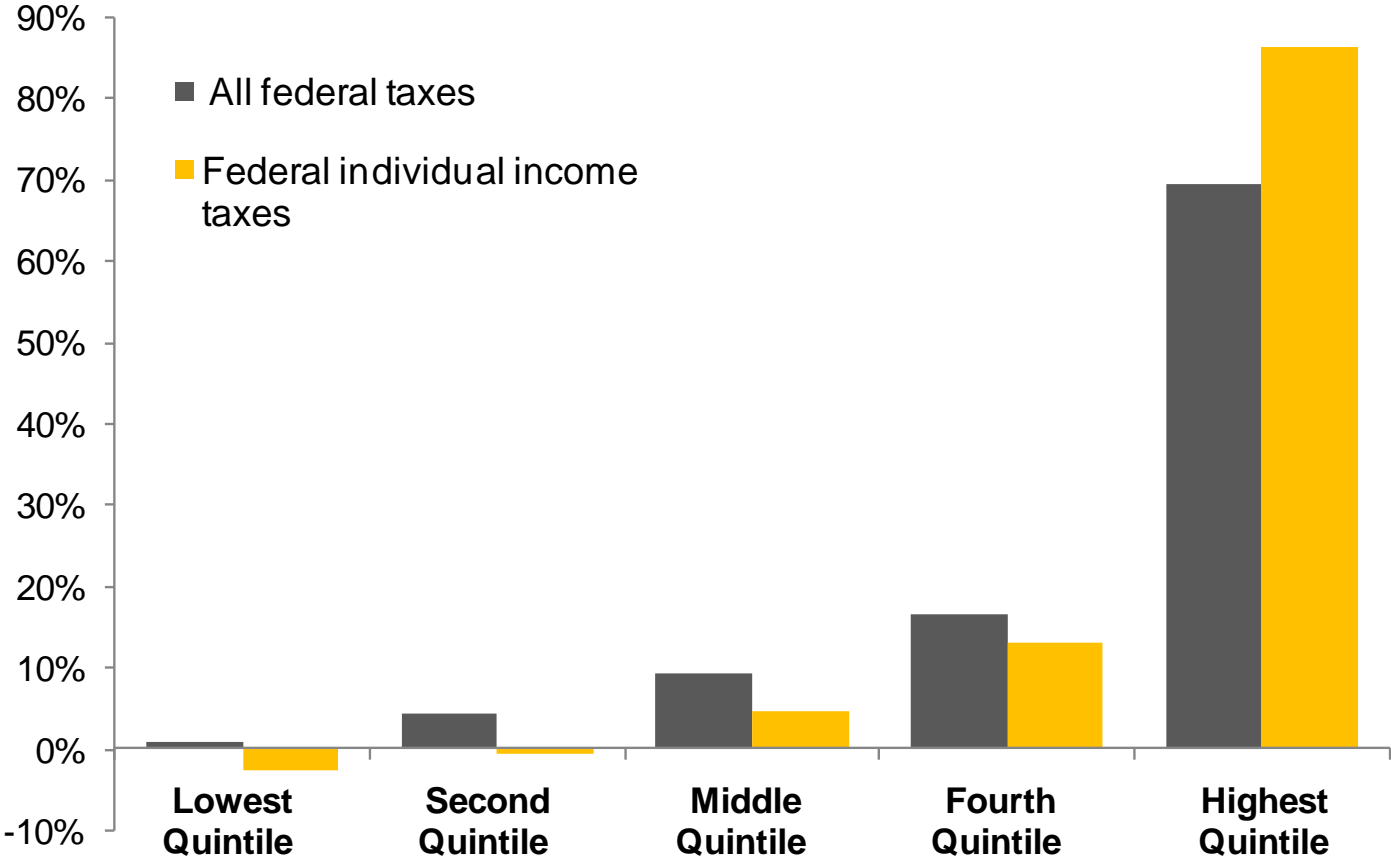
Percent of Taxable Payroll



Who Should Pay?

- What level of progressivity is appropriate?
- What level of progressivity is stable?
- Removal of individual taxpayers from the rolls
 - Proliferation of tax credits
 - Impact of a lack of “skin in the game”
- Measuring who bears the burden of taxes
 - Employer’s share of payroll
 - Corporate income tax
- Deficit spending creates an intergenerational shift of burden through higher inflation/interest rates

Share of all Federal and Individual Income Taxes, 2006



Source: Congressional Budget Office (CBO) Historical Effective Federal Tax Rates, April 2009

Non-Income Tax Options: Carbon Tax

- Carbon tax as an alternative to cap and trade
 - Both are market-based instruments that make emissions costly
 - Carbon tax imposes direct cost by taxing the carbon content of fuels
 - Cap and trade requires companies to relinquish emissions permits in proportion to the carbon content of fossil fuels
- Proposal developed by the American Enterprise Institute would:
 - Tax carbon at \$15 per metric ton
 - Collect about \$80 billion per year
 - Increase the price of gasoline by 13 cents per gallon
 - Increase the price of electricity from natural gas by 0.6 cents per kWh
 - Increase the price of electricity from coal by 1.4 cents per kWh

Non-Income Tax Options: Value-Added Tax

- President George W. Bush's Advisory Panel on Federal Tax Reform considered a value-added tax (a "VAT") that would resemble a single-level retail sales tax collected at each stage of the production process
 - The plan coupled the VAT with reduced rates of income tax
 - All entities providing taxable goods and services would impose the tax on sales to all purchasers and then collect it
 - To determine VAT liability, a business would multiply total taxable sales by the VAT rate and subtract from that figure the VAT paid for the business's purchases of goods and services
 - The proposal contemplated a broad tax base encompassing almost all domestic consumption
 - A 2006 CRS study: each one percentage point of a broad based VAT raises \$50 billion
 - Taxation of financial services raises issues
 - Every major U.S. trade partner uses a VAT; so do all of our minor trade partners
 - Cain's 9-9-9 plan includes a national retail sales tax
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Non-Income Tax Options: Financial Transactions Tax

- The European Union has proposed a financial transactions tax that would apply to a percentage of the value of certain transactions
 - A 0.1 percent tax would apply on trading of stocks and bonds
 - A 0.01 percent tax would apply on derivatives contracts
 - Certain exemptions would apply, including with respect to central bank transactions and the “primary market,” which includes sovereign and corporate bond auctions
- Estimated revenue from a EU financial transactions tax is \$78 billion per year
- The UK Treasury has indicated that such a levy would need to apply globally, lest it drive business out of regions where it applies
 - Secretary Geithner has opposed US adoption of a financial transactions tax on the basis that it would create “frictions” that would exacerbate financial crises without reducing volatility or risk-taking

Ways and Means Committee Hearings

➤ May 12, 2011 – Territorial Tax System

- Witnesses
 - Greg Hayes, CFO of United Technologies Corporation
 - Edward Rapp, CFO of Caterpillar Inc.
 - Jim Crines, CFO of Zimmer Holdings, Inc.
 - Mark Buthman, CFO of Kimberly-Clark Corporation
- Issues
 - Expansion overseas effect on US jobs
 - Tax on foreign income – discourages repatriation
 - Tax expenditures – limiting could discourage US manufacturing activity

Ways and Means Committee Hearings

➤ May 24, 2011 – Territorial Tax System

- Witnesses
 - Frank Schoon, Partner, Dutch Desk, Int'l Tax Svcs., Ernst & Young
 - Jorg Menger, Partner, German Desk, Int'l Tax Svcs., Ernst & Young
 - Gary Thomas, Partner, White & Case LLP
 - Steve Edge, Partner, Slaughter and May
 - Reuven Avi-Yonah, Professor, Univ. of Michigan Law School
- Issues
 - Revenue loser? Revenue neutral? Revenue raiser?
 - Impact on choice of headquarters location
 - Transfer pricing concerns

Ways and Means Committee Hearings

- June 2, 2011 – Business Tax Reform and Job Creation
 - Witnesses
 - Ashby Corum, KPMG LLP
 - Walter Galvin, Vice Chairman of the Board, Emerson Electric Co.
 - Judy Brown, Executive Vice President, & CFO, Perrigo Company
 - James Zrust, Vice Present, Tax, Boeing Company
 - James Mispion, Vice President, Tax Sears Holding Management Corp.
 - Mark Stutman, National Managing Partner of Tax Svcs., Grant Thornton
 - Issues
 - *Lower tax rate*: Agreement that R&D and Section 199 credit should be on the “chopping block” when considering lower corporate tax rate
 - *Worldwide competitive advantage*: Galvin - lower corporate tax rate and limitation on interest expense will keep smaller business from being acquired by foreign-based companies and jobs will remain in the US
 - *VAT*: NRF says a VAT is regressive, would reduce consumer spending and growth
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Finance Committee Hearings

- July 27, 2011 – CEOs Discuss Tax Reform
 - Witnesses
 - Michael Duke, President and CEO, Wal-Mart Stores, Inc.
 - Thomas Falk, Chairman and CEO, Kimberly-Clark Corporation
 - Gregory Lang, President and CEO, PMC-Sierra, Inc.
 - Larry Merlo, President and CEO, CVS Caremark Corporation
 - Issues
 - Lower corporate tax rate
 - Broadened tax base
 - Territorial tax system
 - Global competition for R&D investment

Ways and Means Committee Hearings

➤ July 26, 2011 – Consumption Tax Issues

- Witnesses

- Mike Huckabee
- Lawrence Kotlikoff, Harvard University
- Bruce Bartlett
- Michael Graetz, Columbia University
- Roseanne Altschuler, Rutgers University
- Robert Carroll, Ernst & Young
- Jim White, Government Accountability Office
- Dan Mitchell, Cato Institute
- Simon Johnson, MIT

- Issues

- National retail sales tax
 - VAT as a reform of the current system or as an add-on to generate more revenue
-

Joint Committee Hearing

➤ July 13, 2011 – Tax Treatment of Debt, Equity

- Witnesses

- Thomas Barthold, Joint Committee on Taxation
- Victor Fleischer, University of Colorado
- Mihir Desai, Harvard University
- Simon Johnson, MIT
- Self

- Issues

- Evidence of corporate and individual overleverage
 - Contribution to financial crisis
 - Means of addressing the tax code's pro-debt bias
 - Reducing the corporate tax rate
 - Interest deduction limitation
 - Corporate integration/consumption tax
-

Chairman Camp's Draft International Bill

- Unveiled October 26, 2011 as discussion draft with solicitation of comments
 - Major components
 - 25% corporate rate
 - Territorial system
 - Immediate repatriation at 5.25% rate
 - Base protection options
 - Excess returns proposal, inclusion of low-taxed cross border income, or inclusion of foreign intangibles income at a reduced rate of 15%
 - Thin cap interest disallowance rule
 - Other offsets TBD
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