



The COMING STORM:

How Business Can Prepare for Federal Income Tax Reform

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When the U.S. government was established under the Constitution, Ben Franklin commented on its apparent stability by observing, “in this world nothing can be said to be certain, except death and taxes.” But the notions of death and taxes held different meanings for Franklin than they do for us. In Franklin’s day, the average adult was lucky to live to age 45. Today, improved health care and a better standard of living have pushed the average life expectancy to 77, and a growing number of adults, like Franklin himself, live well into their 80s and 90s. Similarly, in Franklin’s day, taxes paid for general government and the debts incurred during the Revolutionary War. Today, we have learned how to borrow for more than prior military necessity. While taxes remain certain, they are no longer certain to be paid by the generation doing the current spending.

These demographic changes and mounting federal debt, when combined with a much larger government than even the imaginative Ben Franklin could have conceived, will soon compel dramatic tax and entitlement reforms. Most observers believe that, as with past efforts to address chronic budget shortfalls, the solution will require a combination of spending and tax actions, and that reduced entitlement spending will be necessary. Our focus here is primarily on the tax side of this equation and how business can best prepare for the coming changes.

The window of opportunity for reform is closing, and it is likely that reform needs to occur during the next presidential term. If it does not, the political costs and economic dislocations of making the more dramatic changes necessitated by delay will be extraordinary. Whenever they occur, the reforms will have far-ranging direct and indirect consequences for business.

Simply stated, if left unabated, the combined burden of Medicare and Medicaid benefits, Social Security benefits, and servicing the interest on a staggering accumulation of public debt threatens to bankrupt the federal government during the working careers of those entering the workforce today.



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These problems will become increasingly apparent in stages. First, beginning in FY09, the Social Security surplus, which has masked the true extent of federal deficit spending, will disappear from the last of the 10 years for which the federal budget is projected. After 2017, Social Security expenditures are expected to exceed employer and employee payroll tax collections.

Once the surplus from Social Security has dissipated, the federal budget would quickly deteriorate. Without intervening changes in policy¹, the projected deficit could reach 5.3 percent of gross domestic product (GDP) by 2019 (see Figure 1). Left unaddressed, deficits of this magnitude quickly compound into unsustainable levels of public debt. On the present path, debt held by the public would exceed 100 percent of GDP by 2027 — something that has occurred only twice in our history, when spending during World War II pushed public debt to 106.2 percent of GDP in 1945 and 108.6 percent in 1946 (see Figure 2). Without tax increases or entitlement reforms, the 2027 deficit could only be brought into balance by eliminating discretionary spending — including military spending. By 2047, tax receipts would no longer be sufficient to pay interest on the national debt.

Obviously, Congress and the White House will act to forestall these bleak outcomes. The more salient issues to consider are when they will act and what they will do. Broad agreement exists that the United States cannot grow its way out of these challenges.

WHY TAX REFORM IS INEVITABLE

When Congress and the White House turn their attention to our long-term fiscal challenges, they will find that the current U.S. tax system cannot meet their needs. It will require reform for four reasons:

Corporate and individual tax rates cannot be increased significantly. The individual and corporate income taxes, in their current forms, cannot raise

sufficient revenue in a sustainable manner. An array of politically popular incentives ranging from mortgage interest deductions and education credits to the research and experimentation credit and the production activity deduction leaves too little that can be taxed at reasonable rates. In addition, the corporate tax rate is too high: at 35 percent, it is higher than that of any of our major trading partners. Most observers agree that the U.S. rate must be reduced substantially to sustain U.S. global competitiveness; however, replacing the lost revenue will not be easy.

On the individual side, the looming expiration of the Bush tax cuts after 2010 seems to offer an automatic tax increase, but it is likely that a substantial portion of those cuts will survive into the next decade. A political consensus appears to support continuation of the Bush tax cuts for middle-class Americans. Even with respect to high-income individuals, few would support a top tax rate significantly above the roughly 40 percent that was in place before the Bush cuts. As a result, efforts to increase revenue from the individual sector would necessarily involve attacking enormously popular incentives such as the mortgage interest deduction, state and local tax deductions, and exclusions for employer-provided medical insurance.

The current individual alternative minimum tax (AMT) is unsustainable. Additionally, the individual income tax is threatened by the AMT, which, if left unreformed, would rapidly become the tax base for the vast majority of middle-class taxpayers over the next decade. The Joint Committee on Taxation estimates that by 2010, over 85 percent of taxpayers with incomes of \$100,000,

Figure 1: Surplus/Deficit as % of GDP 1947-2047

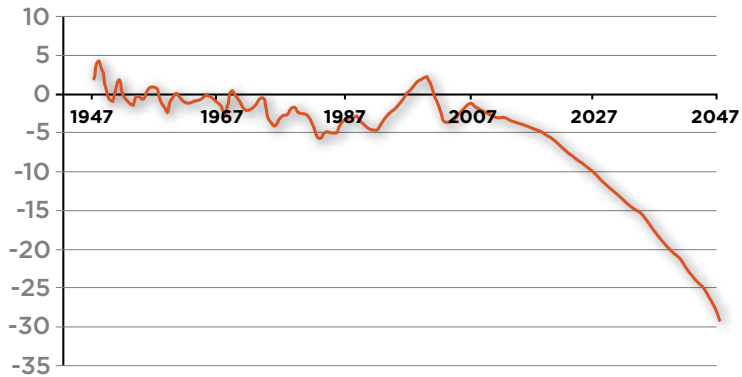
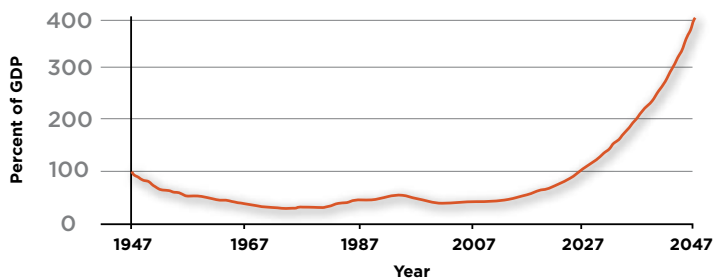


Figure 2: Public Debt as % of GDP 1947-2047



Sources: OMB Historical Tables and GAO August 2007 Alternative Analysis

but less than \$200,000, would pay AMT. Some would say that this is acceptable as a backdoor approach to a flat tax. In reality, the AMT results almost entirely from two things: having children and paying state and local taxes. A tax that treats children as tax shelters is neither sound policy nor good politics. Unfortunately, repealing the AMT would reduce federal revenues by \$1.3 trillion over 10 years, assuming extension of the Bush tax cuts.

The current system is too complex, but many specific complexities are vigorously defended by those whose tax bills are lowered as a result. Closely related to the U.S. tax system's inability to raise revenue in a sustainable fashion is its unacceptable complexity. Most all of the complexity comes from one of three sources:

- *The desire of Congress to give, and taxpayers to receive, better tax treatment than would occur under a theoretically pure system.* These provisions include broadly utilized rules such as choices in inventory methods, the research and development credit, capital cost recovery rules, and deferred compensation provisions. They also include a host of narrowly available or industry-specific exceptions to general tax rules.
- *The desire to provide taxpayers with choices.* For example, the U.S. system provides at least 18 different savings vehicles explicitly focused on retirement.
- *The necessity to provide consistent tax answers for economically equivalent transactions.* This is the source, for example, of rules for the taxation of interest-free loans and original issue discount.

Demographic changes will require re-examination of key tax assumptions. Changes in population demographics will also create pressures for change in the current system. By 2050, 35 percent of the U.S. population will be retirement age. This change is coming relatively rapidly, starting in just a few years as baby boomers begin to retire. These shifts will call into question current tax policies. For example, present law provides "marriage penalty" relief for most married couples. The necessary result of these rules is that the tax on a single person is substantially higher than that on a married individual earning the same income. As the population ages, an increasing number of widows and widowers may begin to question a perceived bias in favor of young married couples at the expense of the elderly. Similarly, declining numbers of families and smaller family size could reduce political support for child credits and education subsidies.

The income of these retirees typically is composed of a relatively larger share of investment income, which is currently subject to favorable rates. To the extent that the system continues to favor investment income, shifts in relative tax burdens within income classes and between income classes and an inherent erosion of the tax base will occur. At the same time, of course, these retirees will bring with them significantly increased demand for health care and other federal, state and local services.

NOT YOUR FATHER'S TAX REFORM

Many seem to expect that when Congress and a new administration address these pressures on the tax system, they will look to another 1986-style reform in which lower rates were exchanged for a significant broadening of the

tax base. We do not think that can happen. The conditions that allowed the Tax Reform Act of 1986 to occur do not exist. In 1986, the formula of lower rates and a broader base without a tax increase or decrease was broadly accepted. Today, we have none of those core agreements from which to build. Conservatives, moderates and liberals are far apart in their views about both the size of the federal government and the revenue needed to support it. They are similarly far apart on what kind of tax system ought to produce whatever revenue the government needs. While some would completely replace the income tax with a national sales tax or a consumption tax, others would institute a comprehensive income tax with virtually no preferences, incentives, or special exclusions. In addition to the philosophical splits that exist, even pragmatic reformers are troubled by the reality that the 1986 reform did not survive. After 1986, rates went up and significant new incentives were introduced. Although the case is probably

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overstated, one must be sympathetic with those who say the Internal Revenue Code is worse today than it was in 1985.

When we draw back from the details of the coming debate, we believe that a likely outcome will find taxes restructured in three distinct pieces. For individuals, tax rates — including capital gains and dividend rates — are likely to increase, but not significantly above the levels that existed at the end of the Clinton administration. Top ordinary tax rates have not exceeded 40 percent since 1986. The tax rate on capital gains has been 25 percent or less for 42 of the 63 years that have passed since the end of World War II. We believe that a majority consensus has emerged in support of a ceiling on tax rates no higher than those historical levels.

For business, income tax rates will come down substantially to bring the United States in line with other major jurisdictions. That said, total taxes on business are more likely to increase than decrease. Congress will look both at repealing important existing incentives that economists say distort economic choices and at perceived abuses in international tax that some say favor investment offshore.

After all the politically achievable modifications to individual and corporate income taxes are made, Congress likely will not have enough revenue to do all that we ask of the federal government. That will force consideration of an additional federal levy in the form of some kind of a consumption tax. The question will be whether the tax will be a broad-based consumption tax burdening the purchase of most goods and services or whether it will be more narrowly focused on specific forms of consumption such as consumer goods, energy or carbon.

WHAT DOES THIS MEAN FOR GLOBAL BUSINESS LEADERS?

Although looking straight ahead at the tax and spending challenges of the next decade is sobering, there is some cause for optimism. If the United States moves quickly to address these issues, the impact on global business will be positive. Moreover, the United States is not alone in its challenges. The other more developed nations and China all face sharp increases in the share of their population that is age 65 or older. By 2050, half of the population of Europe will have reached retirement age. If the United States can move quickly and effectively to address its budget outlook, then U.S. businesses stand to reap the rewards of a relative advantage.

This potentially dramatic level of change creates both risks and opportunities that business leaders must manage effectively. These risks and opportunities may arise in any of three areas of the business—tax, operations or sales—and during any of three episodes of reform—short-term PAYGO-related reforms, active consideration of comprehensive reform, and implementation of new or modified tax regimes.

Although it may be tempting to wait until the options are clearer before starting to manage this process, delay would likely be a mistake. Previous major tax restructurings and reforms have happened relatively quickly.



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The 1986 reform started in earnest with a May 1985 Treasury report and ended in October 1986 when President Reagan signed the new law. Businesses that wait for the threat to emerge will find that even an 18-month legislative process effectively forecloses many of their options.

The first step in assessing risks and opportunities will be a solid understanding of those key aspects of present law upon which the business relies to minimize tax liability or to drive sales. Obviously, therefore, effectively managing risks and opportunities will require involvement from more than the tax department. Business unit leaders throughout the organization— from HR to product design to procurement— may have important contributions to make.

As a second step, leaders will want to fashion a robust set of Washington relationships that assure them that they are able, directly or through other companies and associations that share their interests, to anticipate developments. Such early detection creates options for companies. They can engage Washington processes to turn back an adverse proposal or obtain favorable transition relief. Or, they can quickly implement strategies that respond to the new tax environment more effectively. Additionally, as tax departments begin to see risks of adverse legislation, businesses can consider accelerating investments or other actions that can maximize current shareholder value by minimizing current tax under favorable rules while those rules are available.

A third component of risk and opportunity assessment is to read beyond the initial headlines on reform options. Reforms never conclude in the manner in which they started. The U.S. and global economies and our governmental processes are highly complex, as are the structures, instruments and businesses to which a tax law must apply. That being the case, even simple tax reform proposals may well produce complex and surprising results. In tax reform, a simple answer is likely to turn out to be a wolf in sheep's clothing. For example, the "simple" step of exempting all investment income from taxation would necessarily require that interest payments — including mortgage interest and interest on corporate debt — be nondeductible. It would remove the comparative tax advantage under present law of qualified retirement savings, annuities and cash value life insurance, and many tax-deferral arrangements. It also would require a whole new set of anti-abuse rules that prevent the conversion of business profit or compensation into investment returns.

Even when tax reform answers are more complex, the very process of reform can bring legislation that taxpayers did not anticipate. For example, many businesses advocate that the United States abandon its current worldwide tax system in favor of a territorial system. Such a move promises relief from U.S. tax on foreign-source income. If, however, U.S.- and foreign-source income were redefined in the process, a territorial tax could just as easily lead to a substantial tax *increase* as it could to a tax cut. More generally, the corporate taxpayer experience in 1986 is instructive. The 1986 Act was designed to be revenue neutral in the aggregate, across income classes and within the individual and corporate sectors. In total, corporations were not going to pay more than they had before. When the process was over, however, corporate income taxes, which had been running at about \$60 billion a year, went up to over \$80 billion a year. Individual income taxes were cut by a similar amount.

As a fourth step, businesses should look beyond Washington and the business of legislation into the marketplace where the larger impact of tax reform — and, potentially, new taxes — will be felt. The larger impact includes business opportunities and disruption created by the discussion of change, macro-economic consequences of change, changes in consumer appetites for products and services, and effects on corporate investment strategies and structures. We see four risks that businesses should be prepared to address.

- *First, the mere discussion of tax reform and new taxes can influence markets.* Continuing uncertainty over the long-term federal budget outlook influences financial markets and the value of the dollar. Concrete steps to address this outlook likely could reduce pressure on long-term interest rates and strengthen the dollar. At a more detailed level, preferences in the choice of long-term savings vehicles could be affected by anticipation of a substantial tax rate increase. Discussion of a significant energy or carbon tax could influence both financial market evaluation of specific businesses and consumer choices between products.
- *Second, during any debate on tax reform, keep a watchful eye on transition issues.* Tax laws frequently alter the anticipated treatment of existing invest-



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ments. In many cases, transition relief is appropriate but must be sought. Less easily dealt with are the deferred tax assets that many taxpayers carry on their balance sheets. These sometimes comprise a significant portion of shareholder equity. Reform can adversely affect the value of these assets. A reduction in rates can simply reduce their value; a change in rules can eliminate an asset, such as a credit carryforward, altogether.

- › *Third, as tax reforms or new taxes are enacted, be prepared to respond on a variety of fronts.* New tax rules may require reconsideration of various products and investments. This reconsideration would be obvious in the face of change that directly affects the after-tax cost of products. For example, an energy tax or carbon tax could increase the after-tax cost of particular products and increase the market appeal of others. Similarly, restrictions on mortgage interest deductions or health care exclusions could affect the markets for homes and for health care services. More difficult analysis would be required when reform changes the overall composition of the tax base. This could happen through changes in international tax rules, changes in the incentives for savings and investment, enactment of a consumption tax as part of the mix of taxes, or an integration of corporate and individual taxes. Any of these types of changes could have broad market impacts and would certainly suggest that corporations reconsider the tax effectiveness of their corporate organizational and financing structures.

- › *Finally, if all of this tax uncertainty were not enough, changes in government spending and reductions in entitlements will have their own impacts on business.* Most directly, changes in government spending priorities will affect the sales of businesses producing products or services for consumption through federal programs. Additionally, changes in entitlement spending will affect compensation planning. Employers with defined benefit pension plans that are integrated with Social Security could experience an increase in their liabilities if Social Security benefits are reduced. Changes in Medicare would need to be considered by employers providing post-retirement health benefits and by insurance carriers offering Medigap coverage.

The U.S. constitutional government has outlasted death and taxes as Ben Franklin would have understood them. The coming decade will determine how we reshape our fiscal compact under that Constitution to win a third century of stability. If we can go at this task with the inventiveness of Franklin, we will make some fascinating and useful discoveries. For well-prepared businesses, this change can become a source of growth and opportunity rather than merely a threat. DR

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Endnotes

- 1 This "current path" reflects an "alternative simulation published in the GAO report "The Nation's Long-Term Fiscal Outlook: August 2007 Update." Generally, under that simulation, all expiring tax provisions are extended through 2017 and revenues return to the 40-year historical average of 18.3 percent of GDP. Social Security spending is projected using the 2007 Social Security Trustees' intermediate projections after 2017. Medicaid spending is projected to grow with GDP per capita plus 1 percent over the long term. Medicare projections assume that the scheduled reduction in physician payments does not occur. Discretionary spending increases at the rate of economic growth after 2007.



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