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Navigating a path forward

2014 Tax Legislative Outlook

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The heart of the matter

The challenges faced by Congress in enacting tax reform—divided government and competing legislative goals—will increase in 2014 due to election year politics and an early change in tax-writing committee leadership. Meanwhile, a global focus on tax avoidance has led to a push by G20 countries and the OECD to address the ability of business to erode countries' tax bases. The enhanced focus on global tax avoidance could result in a wave of unilateral governmental action that significantly increases the risk of double taxation and a proliferation of cross border disputes.

The outlook for US tax reform and other tax legislation in 2014 continues to be influenced by ongoing debates in Congress and the public over federal budget deficits and the role of government in providing health care and other services. Last year, President Barack Obama and Congressional Republicans and Democrats were unable to agree on how to address long-term budget issues, and in 2014 leaders of both political parties are expected to remain divided over appropriate levels of government revenues and spending. Many Republicans in the House and Senate have signalled their intention to remain focused on delaying or modifying implementation of the Affordable Care Act (ACA) in advance of the 2014 mid-term Congressional elections.

At the same time, President Obama and Congressional leaders continue to call for tax reform to promote US economic growth and job creation. House Ways and Means Committee Chairman Dave Camp (R-MI) has said he will continue his effort in early 2014 to complete committee work on a comprehensive tax reform bill. Senate Finance Chairman Max Baucus (D-MT) released four Finance Committee staff discussion drafts in late 2013 as part of his efforts to enact tax reform legislation during the current Congress.

Many have questioned whether House and Senate leaders will support holding votes on tax reform legislation during this election year. The likelihood for tax reform being enacted in 2014 further diminished after President Obama announced in December that he was nominating Finance Chairman Baucus to serve as US ambassador to China. Senator Baucus' expected confirmation by the Senate would result in a change of leadership at the Finance Committee. Senator Ron Wyden (D-OR), the third-ranking Democrat on the Finance Committee, will take the chairman's gavel. Senator Wyden in the past has twice introduced tax reform bills with a Republican co-sponsor illustrating his support for tax reform.

Meanwhile, the research credit and more than 50 other business and individual tax provisions expired on December 31, 2013. Senate Democrats made a late effort in December 2013 to extend all expiring provisions – notably without any offsets – but faced various objections. There appears to be broad support in the House and Senate for renewing these provisions retroactively, but 'tax extenders' legislation has not recently been enacted as a stand-alone bill. Congress in 2014 will likely address the future of these expired provisions as part of tax reform or some other legislation.

Overview

President Obama will set forth his legislative goals for 2014 in his January 28 State of the Union address and in his FY 2015 budget, which by law is due by the first Monday in February. Although he has consistently called for action on business tax reform, President Obama also said recently that addressing 'income inequality' and increasing the federal minimum wage are top priorities for his second term, along with immigration reform and climate change.

While this tax policy outlook focuses on the prospects for tax reform and other tax legislation, Congress' ability to consider significant tax legislation will be affected by how much time it devotes to controversial legislative issues.

Senate Majority Leader Harry Reid (D-NV) has said that he expects the Senate in early 2014 to consider an increase in the $7.25-an-hour federal minimum wage. Congress last approved a federal minimum wage hike in 2007, when George W. Bush was President. House Republicans last year defeated a proposal to increase the federal minimum wage to $10.10 an hour.

The Senate is considering an extension of emergency unemployment benefits, which expired on December 28, 2013 for 1.3 million individuals. At this writing, it remains to be seen whether the Senate can agree on this legislation, and how to offset its cost. The Congressional Budget Office (CBO) has estimated that this short-term extension would cost $6.5 billion over 10 years. A full-year extension is estimated to cost approximately $25 billion. Any Senate legislation still would need to be considered in the House of Representatives.

House Speaker John Boehner (R-OH) has said that he does not expect the House to act on comprehensive immigration reform along the lines of the bill approved by the Senate last year. Speaker Boehner has said that the House instead may consider specific proposals to reform US immigration laws and increase border security.

It appears unlikely that Congress will act on climate change legislation in advance of the 2014 midterm elections, but climate change issues may be debated in the context of proposals to reform US energy policy and regulations issued by the Obama Administration.

President Obama begins 2014 with key tax policy advisors in place. Congress last year confirmed Jack Lew as Treasury Secretary, Mark Mazur as Treasury Assistant Secretary for Tax Policy, and John Koskinen as IRS Commissioner. Koskinen's term expires in November 2017.

Bipartisan Budget Act

The Bipartisan Budget Act (the Act) adjusted federal spending levels for the remainder of FY 2014 through September 30, and all of FY 2015, which begins October 1, 2014. Signed into law by President Obama on December 26, 2013, the Act amended the Budget Control Act of 2011 (BCA) to provide $63 billion in relief from current discretionary spending caps for FY 2014 and FY 2015, split evenly between defense and non-defense programs.

The Act more than offset the cost of this additional spending through savings from mandatory spending programs and increases in non-tax revenues totaling approximately $85 billion, including $28 billion from extending for two additional years BCA mandatory spending caps; these caps include limits on Medicare service provider reimbursement levels. Increased non-tax revenue provisions include higher Pension Benefit Guaranty Corporation (PBGC) premiums, airline fee increases, and extended customs user fees. Overall, the agreement is estimated to reduce federal deficits by $23 billion.

The agreement's primary goal was to help avoid the risk of another government shutdown. This goal was met when Congress passed an 'omnibus' spending bill combining 12 separate measures to fund federal departments and agencies for the remainder of FY 2014, which runs through September 30.

The Act also provides a temporary Medicare physician 'doc fix' to avoid a scheduled January 1, 2014 reduction in physician reimbursement rates under a current law Medicare Sustainable Growth Rate (SGR) payment formula. This temporary measure is in effect through March 31, 2014. Congress is expected to continue work on a permanent replacement of the Medicare SGR formula.

While providing a short-term compromise on FY 2014 and FY 2015 spending levels, some provisions in the budget agreement may be revisited this year. For example, a number of Democrats and Republicans have called for restoring military pension cost-of-living-adjustments (COLA) for service members who retire before age 62 that were reduced by the Act. Senate Armed Services Committee Chairman Carl Levin (D-MI) promised to revisit the issue in early 2014.

Senator Jeanne Shaheen (D-NH) and Rep. Dan Maffei (D-NY) have introduced legislation (S. 1844 and H.R. 3794) that proposes to offset the $6 billion cost of restoring the military pension COLA by treating certain foreign companies managed and controlled in the United States as domestic companies for tax purposes. Senator Kelly Ayotte (R-NH) and Rep. Michael Fitzpatrick (R-PA) have introduced legislation (S. 1869 and H.R. 3788) to offset the cost of repealing the military retiree COLA changes by requiring Social Security numbers to claim a refundable child tax credit.

Current law calls for the House and Senate each year to agree on a new budget resolution by April 15, but it is unclear whether Congress will complete action on another budget agreement during the current election year. Congress must act on new spending bills for FY 2015, which begins on October 1, 2014.

A confidence building measure

House Budget Committee Chairman Paul Ryan (R-WI) and Senate Budget Committee Chairman Patty Murray (D-WA) both noted that the budget agreement they negotiated was narrow in scope. However, President Obama and many members of Congress from both parties welcomed passage of the legislation as a sign that the Republican-controlled House and the Democratic-led Senate could work together.

During House floor debate, Chairman Ryan said that the Act "reduces the deficit—without raising taxes. And it does so by cutting spending in a smarter way. It doesn't go as far as I'd like, but it's a firm step in the right direction. This agreement will stop Washington's lurch from crisis to crisis. It will bring stability to the budget process and show both parties can work together."

"This deal is a compromise, and it doesn't tackle every one of the challenges we face as a nation. But that was never our goal," Chairman Murray said during Senate floor debate. "This bipartisan bill takes the first steps toward rebuilding our broken budget process, and, hopefully, toward rebuilding our broken Congress."

While it appears unlikely that comprehensive tax reform can be enacted this year, the ability of a divided Congress to reach a limited budget deal provides hope for the House and Senate to approve tax extenders legislation.

Debt limit increase remains a point of contention

The Act did not address the need for an increase in the federal debt limit, which was suspended through February 7, 2014 as part of legislation enacted last October to re-open the federal government. At that time, President Obama and Senate Democrats refused to negotiate over the federal debt limit, and also insisted that the Treasury Department retain its ability to use 'extraordinary measures' to meet the federal government's fiscal obligations on a temporary basis when the federal debt limit has been reached.

Under current law, on February 8, 2014, the federal debt limit will be reinstated at the level that reflects federal debt obligations on that date. As of December 18, 2013, the amount of federal debt that would be subject to the federal debt limit was $17.3 trillion.

In a December 19, 2013 letter, Treasury Secretary Lew urged Congress to take "prompt action to protect the full faith and credit of the United States" and increase the federal debt limit before February 7. Secretary Lew wrote that the Treasury Department "would be able to extend the nation's borrowing authority only until late February or early March 2014" by relying on 'extraordinary measures'—including internal transfers and delaying the investment of federal employee pension contributions—to pay existing fiscal obligations.

Noting that this forecast is "subject to inherent variability," Secretary Lew stated that the Treasury Department does not foresee any reasonable scenario in which extraordinary measures would last for an extended period of time because the government will experience large net cash outflows in February and March due to tax refunds. Secretary Lew added that extending the federal government's borrowing authority "is not a bargaining chip to be used for partisan political ends." CBO on November 20, 2013, projected that the Treasury Department might be able to rely on extraordinary measures for a more extended period, depending on the flow of tax receipts and refunds before April 15.

House Budget Committee Chairman Ryan on December 15, 2013, said that House and Senate Republicans planned "to meet and discuss what it is we want to get out of the debt limit. We don't want to get nothing out of the debt limit." Senate Minority Leader Mitch McConnell (R-KY) on December 17 said that he "doubted that the House, or the Senate for that matter," would be willing to give President Obama "a clean debt-ceiling increase."

It remains unclear whether Congressional Republicans will continue to pursue changes to the ACA or reductions in future mandatory spending as part of a debt limit agreement. Last year, some suggested that House and Senate Republicans should seek action on revenue-neutral tax reform in exchange for a debt limit increase, but other GOP priorities have included approving the Keystone XL oil pipeline from Canada to the United States and overturning regulations issued by the Obama Administration.

White House officials continue to insist that President Obama will not negotiate with Congressional Republicans over a debt limit increase. "We're not prepared to bargain with the full faith and credit of the United States," Jason Furman, chairman of the White House Council of Economic Advisers, said on December 18, 2013. "There's still a lot of things that could force a discussion about our fiscal future, but threatening default isn't one of them."

Tax reform seen as pro-growth economic policy

President Obama and members of both political parties on Capitol Hill generally have agreed that pro-growth tax reform is needed to make the United States more competitive globally. There is a consensus that US tax laws have not kept pace with shifting global economic power and the tax laws of other countries. With a 39.1-percent combined federal and state corporate tax rate, the United States has the highest corporate tax rate among industrialized countries, 14 percentage points greater than the average (25.1 percent) for the other Organisation for Economic Co-operation and Development (OECD) countries. This disparity is seen as distorting business investment decisions and making American businesses less competitive than their foreign counterparts in both global markets and within the United States.

The United States is expected to fall even more out of line with other countries in coming years if no action is taken to lower the US corporate tax rate. The United Kingdom this year will continue recent corporate rate reduction policies by lowering its rate to 21 percent effective April 1, 2014, with plans to lower the UK rate to 20 percent by April 1, 2015. Japan lowered its corporate rate by approximately 2.7-percentage points in April 2012 and has proposed advancing a scheduled additional 2.4-percentage point reduction from 2015 to April 2014. Canada, the largest bilateral US trading partner, reduced its federal corporate tax rate to 15 percent in 2012 and has a combined federal and provincial tax rate of approximately 26 percent.

The United States also is one of the few developed countries to tax foreign earnings under a worldwide tax system. All other G8 countries and 28 of the 34 OECD countries use territorial tax systems, which generally exempt from tax 95 or 100 percent of qualified foreign subsidiary dividends. Many analysts believe the present US worldwide system reduces the ability of American companies to compete effectively in foreign markets. There also is a general recognition that present law discourages US companies from reinvesting foreign subsidiary earnings in the United States because repatriated earnings would be subject to the high US corporate tax rate (i.e., the so-called "lock-out" effect).

Revenue remains the sticking point for tax reform

The major issue dividing Congress on comprehensive tax reform is whether it should raise revenue or be revenue-neutral. Some proponents see tax reform as an opportunity to improve the global competitiveness of American businesses, attract investment to the United States, and increase domestic job growth. Others – eyeing projections of significant future deficits – believe comprehensive tax reform affecting businesses and individuals also could be an important element of an overall deficit reduction package in which spending cuts are combined with revenue increases.

In his fiscal 2014 budget, President Obama called for revenue-neutral business tax reform, while proposing a substantial increase in revenue from upper-income individuals to be used for deficit reduction. Beginning with a July 2013 speech in Chattanooga, President Obama also has called for using 'one-time revenues' from business tax reform to fund job-training initiatives and infrastructure programs. While Congressional Republicans have called for revenue-neutral individual and corporate tax reform, House and Senate Democrats generally insist that any tax reform effort should contribute to deficit reduction. Congressional Republicans have called for reforming mandatory spending programs to reduce the federal deficit.

This disagreement was evident in the Senate in 2013. Majority Leader Reid last year said that tax reform "can't be even close to neutral" and suggested as a starting point the $975 billion 10-year revenue increase target in the FY 2014 Senate budget resolution passed on a party-line vote by all but four Senate Democrats. In response, Minority Leader McConnell said that any effort to increase revenues through tax reform would be a "stumbling block to even getting started" in the Senate.

Senate Finance Committee Chairman Baucus has said that tax reform must raise 'significant' revenue, although he opposed the Senate budget resolution proposal last year to raise almost $1 trillion in new revenues. Finance staff summaries accompanying the series of tax reform discussion drafts (discussed below) released in late 2013 stated that "while the Chairman believes tax reform as a whole should raise significant revenue for deficit reduction, the package of business reforms in this and other staff discussion drafts is intended to be revenue-neutral in the long-term (i.e., in a steady state), with corporate base broadeners paying for a significant reduction in the corporate tax rate."

Allocating a portion of the revenue that otherwise could be raised from tax reform to deficit reduction would affect the extent to which tax rates could be lowered. At the same time, seeking to raise additional revenue from individuals could complicate the ability of Congress to agree on comprehensive tax reform in part because a large amount of business income is earned by unincorporated businesses and is taxed at individual tax rates.

Obama Administration officials and Congressional Democrats also have expressed concerns about the 'out-year' budget costs of using timing differences that accelerate revenue collection on a one-time basis to offset the cost of permanent rate reductions.

Focus on base erosion

In the debate surrounding tax reform in the United States, the Obama Administration has stated that "income-shifting behavior by multinational corporations is a significant concern that should be addressed through tax reform." Recent international tax reform proposals, including those issued by Ways and Means Committee Chairman Camp and Senate Finance Committee Chairman Baucus, have included proposals designed to prevent base erosion and profit shifting (BEPS), discussed below. Attention on base erosion also has been increased as a result of recent hearings by the Senate Permanent Subcommittee on Investigations (PSI).

For all their differences in many areas, base erosion as an integral part of tax reform has emerged as an area of common concern among Republicans and Democrats.

Global tax scrutiny

The US focus on base erosion comes at a time of global tax scrutiny by G8 and G20 countries seeking to prevent aggressive tax avoidance. In response to these concerns, the OECD in 2013 issued a report on BEPS, followed by an action plan to address specific areas of concern. The OECD also has called for increased transparency and disclosure requirements.

The OECD's project has no force of law on its own, but it may play a role in advancing legislative initiatives by the United States and other nations to reform their international tax rules. The level of activity and the accompanying political support for these endeavors suggest that the question is not if change will come, but rather how soon it will arrive and how extensive it will be.

Laying the foundation for tax reform

It appears that Congress faces considerable obstacles to enacting tax reform legislation in 2014, given ongoing political differences over federal revenues, competing legislative priorities, and a change of leadership at the Finance Committee. At a minimum, actions taken this year by the House Ways and Means and the Senate Finance Committees will undoubtedly shape efforts in future Congresses to provide the United States with a more competitive, growth-oriented tax system. How specific reform options are defined and which existing tax provisions are proposed to be modified or repealed to offset the cost of lower tax rates should be of great interest to business and individual taxpayers.

The release of a comprehensive tax reform bill in 2014 by Chairman Camp, followed with action by the Ways and Means Committee and the House of Representatives, would be a significant accomplishment in terms of defining a path forward for reducing corporate and individual tax rates, reforming US international tax rules, and simplifying the code. This will be a critical year for Chairman Camp, who is term-limited under House Republican Conference rules and is required to give up his gavel at the end of the 113th Congress. Ways and Means members Kevin Brady (R-TX) and Paul Ryan both have announced their candidacies to succeed Chairman Camp.

Assuming Senator Wyden becomes Finance Committee Chairman as expected in 2014, it remains to be seen whether he and other Finance Committee members will build on the tax reform efforts of Chairman Baucus and his staff, or shift their focus to Senator Wyden's own previously introduced tax reform bill.

An in-depth discussion

Balance of power

In the House, a 218-vote simple majority generally enables the party in control to pass its legislative agenda. There currently are 232 Republicans and 200 Democrats in the House of Representatives, with three vacant seats to be filled by special elections.

In the Senate, there are 55 Democrats (including two Independents) and 45 Republicans. Under Senate rules, most legislation generally needs 60 votes to advance. A key exception to this requirement is legislation considered under budget reconciliation rules, which may be passed with a simple majority. However, budget reconciliation rules impose significant limitations, including a requirement that legislation enacted under reconciliation may not be permanent if it would result in a revenue loss beyond the period covered under a budget resolution. For more on budget procedures, see Appendix A.

Last year, by a vote of 52 to 48, Senate Democrats adopted a limited change in rules that had previously required 60 votes to limit debate and end a filibuster. While the change was limited to executive branch and non-Supreme Court judicial nominations, effectuating the change by a simple majority (i.e., the so-called 'nuclear option') rather than garnering the 67 votes normally required could have spill-over effects for future tax and spending legislation. For example, there may be less willingness on the part of Republicans to work with Democrats on a range of issues. At the same time, there have been calls by some Senate Democrats to extend the rule change to allow all legislation to pass with a simple majority.

President Obama can veto legislation he opposes, with a two-thirds majority of both the House and Senate required for a veto override. However, President Obama has vetoed only two bills since he was first elected. While he has threatened to veto many bills passed by the Republican-controlled House, the Democratic-led Senate generally has blocked bills opposed by President Obama from getting to the White House.

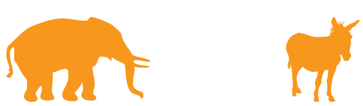
House and Senate tax committees

The House Ways and Means Committee is led by Chairman Camp, with Rep. Sander Levin (D-MI) serving as Ranking Democratic Member. Last December, Rep. Brady and Rep. Ryan both announced their candidacies to become House Ways and Means Committee chairman in 2015. On the Ways and Means Committee, Rep. Brady is the third-ranking Republican and Rep. Ryan is the fourth-ranking Republican. The second-ranking Republican, Rep. Sam Johnson (R-TX), has not indicated that he would seek to become chairman. Rep. Devin Nunes (R-CA), the fifth ranking Republican, also has expressed interest in the chairmanship.

Assuming Senator Baucus is confirmed as US ambassador to China (which seems likely), the Senate Finance Committee in 2014 is expected to be chaired by Senator Wyden. Senator Orrin Hatch (R-UT) will continue to serve as Ranking Republican Member. Senator Baucus's departure from the Senate Finance Committee also will create an opening for another Democrat to join the committee in 2014.

A listing of House and Senate tax committee members and other tax policymakers is provided in Appendix B.

Figure 1: Current composition of the 113th Congress



	Republicans	Democrats	Vacancies
House	232	200	3
Senate	45	55*	

*Includes two Independents: Senators Bernie Sanders (I-VT) and Angus King (I-ME).

Looking ahead to the 2014 midterm Congressional elections

All 435 seats in the House are up for election every two years. Assuming each party retains vacant seats in upcoming special elections that they had previously held, Democrats would need to achieve a net gain of 17 seats in the 2014 elections to gain control of the House. At this writing, 18 House Republicans and 11 House Democrats have announced plans to retire or seek other office, including Ways and Means Committee members Jim Gerlach (R-PA) and Tim Griffin (R-AR).

Figure 2: 2014 Congressional legislative schedule

Senate convened	January 6
House convened	January 7
Recess period	January 20 – 24
President's State of the Union address	January 28
Temporary farm program extension expires	January 31
President's FY 2015 budget submission due	February 3
Federal debt limit suspension period ends	February 7
Presidents' Day recess	February 17 - 21
Recess period	March 17 - 21
Temporary Medicare "doc fix" expires	April 1
Spring recess	April 14 - 25
Recess period (House only)	May 12 – 16
Memorial Day recess (House)	May 23 – 27
Memorial Day recess (Senate)	May 26-30
Recess period (House only)	June 2 - 6
Independence Day recess	June 30 – July 4
Labor Day recess	August 4 - September 5
Recess period (House only)	September 22-26
FY 2015 begins	October 1
Recess period (House only)	October 6 -31
Recess period (House only)	November 3 - 7
Election Day	November 4
Veterans Day	November 11
Thanksgiving recess (House)	November 24 - 30
Target adjournment (House)	December 12
Target adjournment (Senate)	To be determined

Note: Senate leaders have provided a tentative schedule for 2014.

Roughly one-third of all Senate seats are subject to election every two years. In the upcoming 2014 election cycle, 20 seats currently held by Democrats and 13 seats currently held by Republicans are up for election. Republicans would need a net gain of six seats to hold a 51-seat majority in the Senate next year.

While the large number of seats being defended by Senate Democrats in 2014 is viewed by most observers as providing a competitive opportunity for Republicans to take control of the Senate in the next Congress, Republican primary contests and other factors during the 2010 and 2012 elections played a role in Senate Democrats retaining control of the Senate when Republicans had a similar numerical advantage.

In 2014, five Republican Senate incumbents face primary challengers, including Minority Leader McConnell and Finance Committee members John Cornyn (R-TX), and Pat Roberts (R-KS). Only one Senate Democrat has a significant primary contest: Brian Schatz (D-HI), who was appointed to fill the seat of late Senator Daniel Inouye.

Looking further ahead to the 2016 election cycle, a presidential election year, 23 Senate seats currently held by Republicans and 10 seats currently held by Democrats will be up for election.

A list of all Senators whose seats are subject to election in 2014 is included in Appendix C. With Senator Baucus expected to leave early to become US ambassador to China, four other Senate Democrats, including Finance Committee member John D. (Jay) Rockefeller IV (D-WV), and two Senate Republicans currently have announced plans to retire at the end of 2014.

Long-term budget outlook

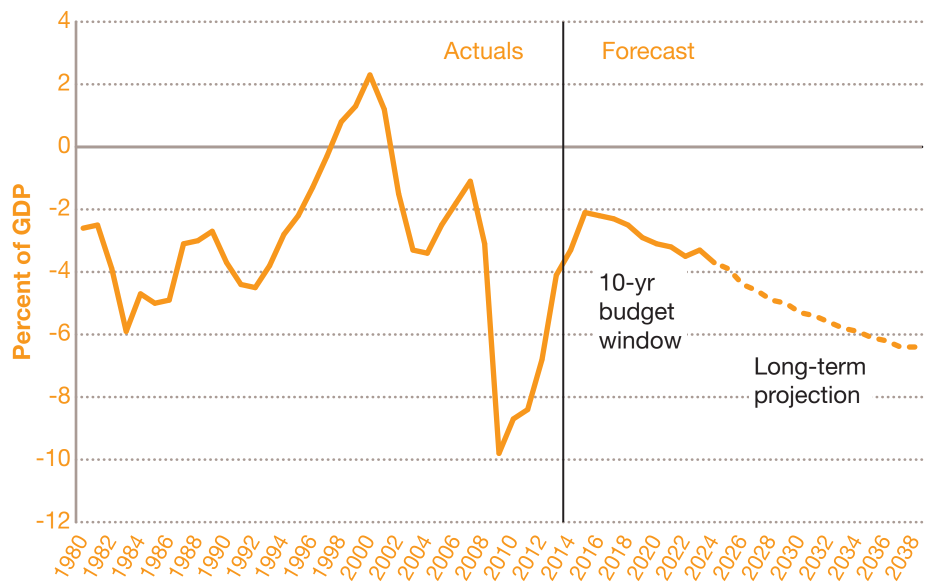
Debate over how best to address future federal deficits continues to be a key factor affecting the outlook for tax reform and other tax legislation. While some improvement in near-term deficits is expected, long-term projections continue to indicate that the federal budget is on an unsustainable path.

Current projections for the federal budget show deficits continuing to shrink over the next several years. In FY 2010, when the deficit peaked, it was $1.4 trillion, or 9.8 percent of gross domestic product (GDP). In FY 2013 the deficit fell to $680 billion, or 4.1 percent of GDP. Deficits are projected to fall to 2.1 percent of GDP in 2015 and remain below 2.5 percent through 2018.

Projections beyond 2018, however, show a steadily deteriorating federal budget picture, as demonstrated in Figure 3. By 2023, the end of the federal government's 10-year budget window, the deficit is projected to climb to 3.3 percent of GDP. In 25 years, the deficit is estimated to exceed 6 percent of GDP.

Demographic changes associated with aging of the population, expected increases in healthcare costs, and new federal subsidies for insurance received through exchanges as part of the ACA will increase federal spending on Social Security, Medicare, and other health programs from 9.6 percent of GDP in 2013 to 14.3 percent by 2038. This increase of 4.7 percentage points exceeds average defense spending over the past 40 years.

Figure 3: Federal budget deficit, 1980-2038



Source: CBO, "The 2013 Long-Term Budget Outlook," September 2013.

Higher Treasury debt, interest payments

To cover these deficits, the federal government will have to issue more Treasury debt. In 2007, federal debt held by the public amounted to $5.0 trillion, or 35 percent of GDP. At the end of FY 2013, it had climbed to $12.0 trillion, or 72 percent of GDP.

The costs associated with this rapid increase have not yet appeared in the form of higher federal interest payments as a share of GDP. Federal net interest payments as a share of GDP have averaged 1.5 percent since 2007, well below the 40-year average of 2.2 percent. However, under current projections, net interest payments are projected to climb steadily over the projection period, reaching 3.1 percent by 2023 and 4.9 percent by 2038.

The increased share of the federal budget devoted to servicing federal debt will put new pressure on other parts of the federal budget if deficits are to be held in check.

In addition to increasing the budget deficit, high debt levels could pose hurdles to future economic growth:

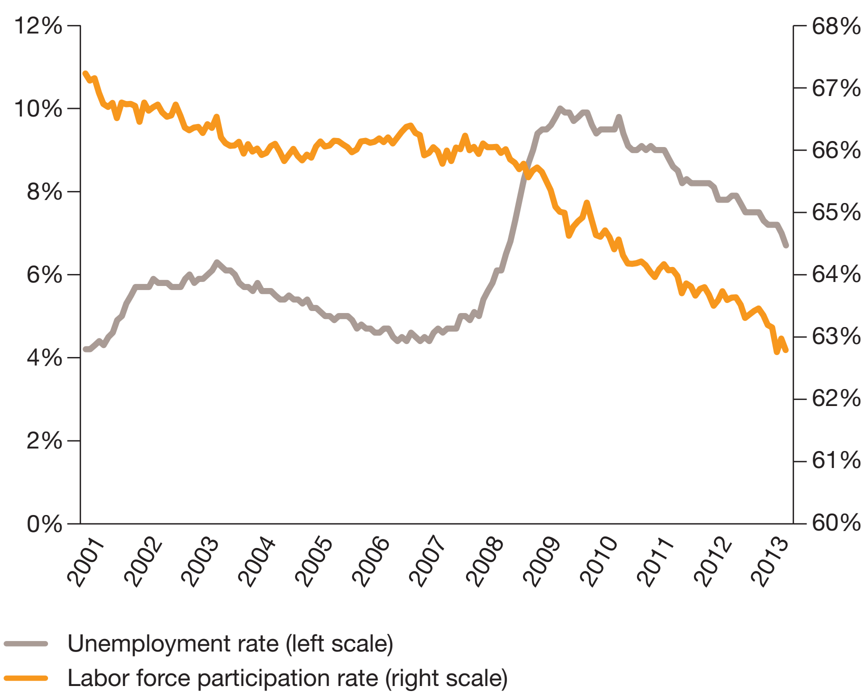
- First, growing debt might crowd out private investment because federal borrowing will compete with private borrowers for capital.
- Second, increased levels of federal debt could cause investors to lose confidence in the federal government's ability to cover its debt service costs. If this loss of confidence were sudden, it could result in a rapid rise in interest rates and a decline in the value of the dollar, creating a risk of a financial market crisis and severe recession.
- Finally, a high level of debt constrains the federal government's ability to respond to future economic downturns. In the most recent recession, the federal government was able to implement robust fiscal stimulus, cutting taxes and increasing spending to address the economic downturn. At current levels of US debt, it is not clear that markets would be as willing to absorb a similar expansion of US government debt in response to another recession.

Economic outlook

Stronger economic growth would help to reduce future federal deficits. For this reason, some have suggested that Congress should enact pro-growth tax reform legislation.

The improvement in the short-term budget outlook is partially attributable to the improving US economy. However, the recovery from the 2007-2009 recession has been markedly slower than past recoveries, and it is only recently that the economy appears to be on more solid footing. Improvements in labor markets, consumer balance sheets, and global markets have helped strengthen the US economy.

Figure 4: Unemployment and the labor force participation rate



Source: Bureau of Labor Statistics, January 2014.

Stronger economic growth forecast for 2014

Economic forecasts released by the Federal Reserve in December project growth in GDP in the 2.8-3.2 percent range in 2014 (fourth-quarter to fourth-quarter) increasing to 3.0-3.4 percent in 2015. Official government estimates of actual GDP growth for 2013 will not be available until the end of January, but private sector estimates indicate that the economy expanded by about 2.5 percent (fourth-quarter to fourth-quarter).

The CBO estimates that growth in 2013 was reduced by about 1¼ percentage points due to fiscal tightening in 2013 from the start of sequestration and higher taxes, including expiration of the temporary payroll tax holiday and income tax increases on higher-income taxpayers due to certain provisions of prior law expiring. This fiscal restraint – while generally continuing – will not represent additional restraint relative to 2013 on the economy in 2014. Additionally, the reduction in sequestration in 2014 and 2015 under the Bipartisan Budget Act should provide near-term support to the economy.

Labor market improvement

Employers added 2.2 million jobs in 2013. Total payroll employment has increased by 7.6 million since February 2010 but it is still 1.2 million less than employment at the peak of the past economic cycle in December 2007. The unemployment rate declined from 7.9 percent in January 2013 to 6.7 percent in December. An estimated 10.4 million people were reported as being unemployed. By comparison, in October 2009, the unemployment rate was 10 percent and 15.4 million were unemployed.

A portion of the improvement in the unemployment rate and number of unemployed is attributable to individuals who have given up looking for work or have retired. In December 2007, the peak of the past economic cycle, 66 percent of the adult population participated in the labor force. In December 2012, the labor force participation rate had fallen to 63.6 percent (see Figure 4). Since then, the rate has fallen lower, reaching 62.8 percent in December 2013. If the December 2007 labor force participation rate had applied in December 2013, another 8 million workers would have been in the labor force. These workers would have represented 4.9 percent of the labor force.

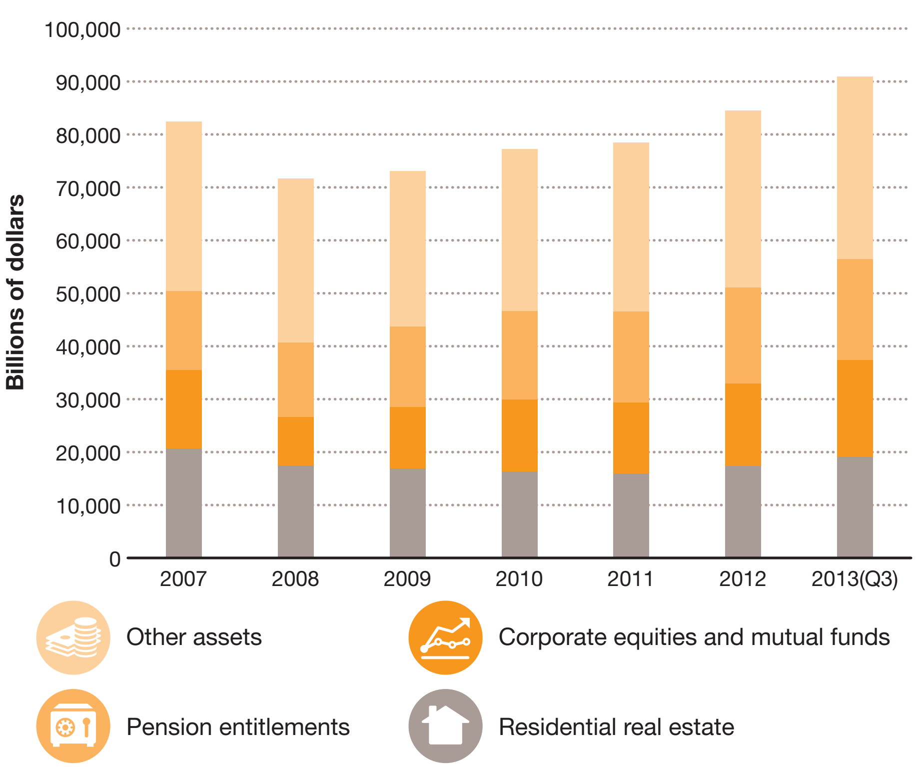
Some of these individuals are retirees who have opted to leave the workforce, but many are individuals still in prime working ages. Of the population between the ages of 25 and 54, the labor force participation rate has declined by 2.4 percentage points since December 2007.

At the end of 2013, the temporary federal program providing extended emergency unemployment benefits expired. Under this program, unemployed workers who exhaust their regular state unemployment insurance benefits (generally 26 weeks of insurance) can receive 14 to 47 additional weeks of benefits, depending on state unemployment rates. An estimated 1.3 million unemployed persons were receiving extended unemployment benefits when the program expired.

Congress currently is considering legislation to temporarily extend the program for three months, which CBO estimates will cost $6.5 billion over 10 years. CBO estimates that a one-year extension of the program would have a net cost to the Federal government of $25 billion.

CBO estimates that the net impact of a one-year extension would be to increase GDP in 2014 by 0.2 percent and increase employment by 0.2 million by the fourth quarter of 2014. The increase in economic activity in the short run could have longer-term consequences. The cost of the extension would either raise the deficit or consume spending cuts or tax increases that could have been used to lower future deficits.

Figure 5: Household assets, 2007-2013.



Source: Federal Reserve, "Financial Accounts of the United States," December 9, 2013.

Stronger consumer balance sheets

Improvements in labor markets have been accompanied by stronger household balance sheets. In the third quarter of 2013, household net worth is estimated to have increased to $77.3 trillion. By the end of 2012, household assets had recovered the losses associated with the recession, and they increased further in 2013. By type of asset, owner-occupied residential real estate remained slightly lower in the third quarter of 2013 compared to the levels at the end of 2007. Corporate equities and mutual funds, whose value declined by half between 2007 and 2008, had increased by over 20 percent relative to year-end 2007 by 2013 (see Figure 5).

While assets have grown, overall household liabilities have fallen by 5 percent between 2007 and 2013. The improvement in household balance sheets may increase consumer confidence and boost consumer spending in 2014.

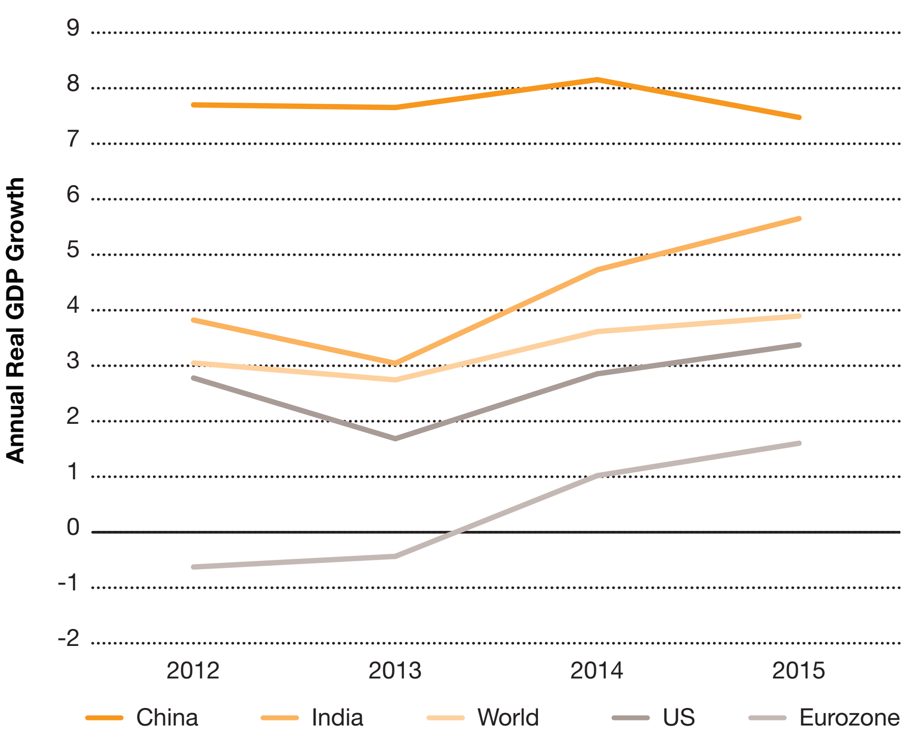
Federal Reserve tapering begins

On December 18, 2013, the Federal Reserve announced that it would begin to reduce its monthly purchases of longer-term Treasury securities and agency mortgage-backed securities beginning in January 2014, initially lowering its purchases from $85 billion per month to $75 billion. The Federal Reserve stated that it anticipates taking further steps to reduce its pace of asset purchases in future Fed meetings assuming that labor market conditions continue to improve and inflation – which has been running below the Fed's target – moves toward the Fed's 2 percent target. The Fed's balance sheet has increased from less than $1 trillion in 2007 to over $4 trillion at the end of 2013 through its various asset acquisition programs.

At the same time the Fed made its tapering announcement, it gave further guidance on its intentions to keep short-term interest rates low. The Fed stated that it anticipates keeping the federal funds rate between zero and 0.25 percent "well past the time" that the unemployment rate declines below 6.5 percent, provided that inflation remains in check.

Over the past 12 months, the yield on the Treasury 10-year note has increased by more than a percentage point. Longer-term interest rates can be expected to continue to rise in 2014 as the Fed continues its tapering, although most economists forecast a smaller increase in long-term rates in 2014 than experienced in 2013.

Figure 6: Projected real GDP growth



Source: OECD Economic Outlook, December 2013.

The global economy

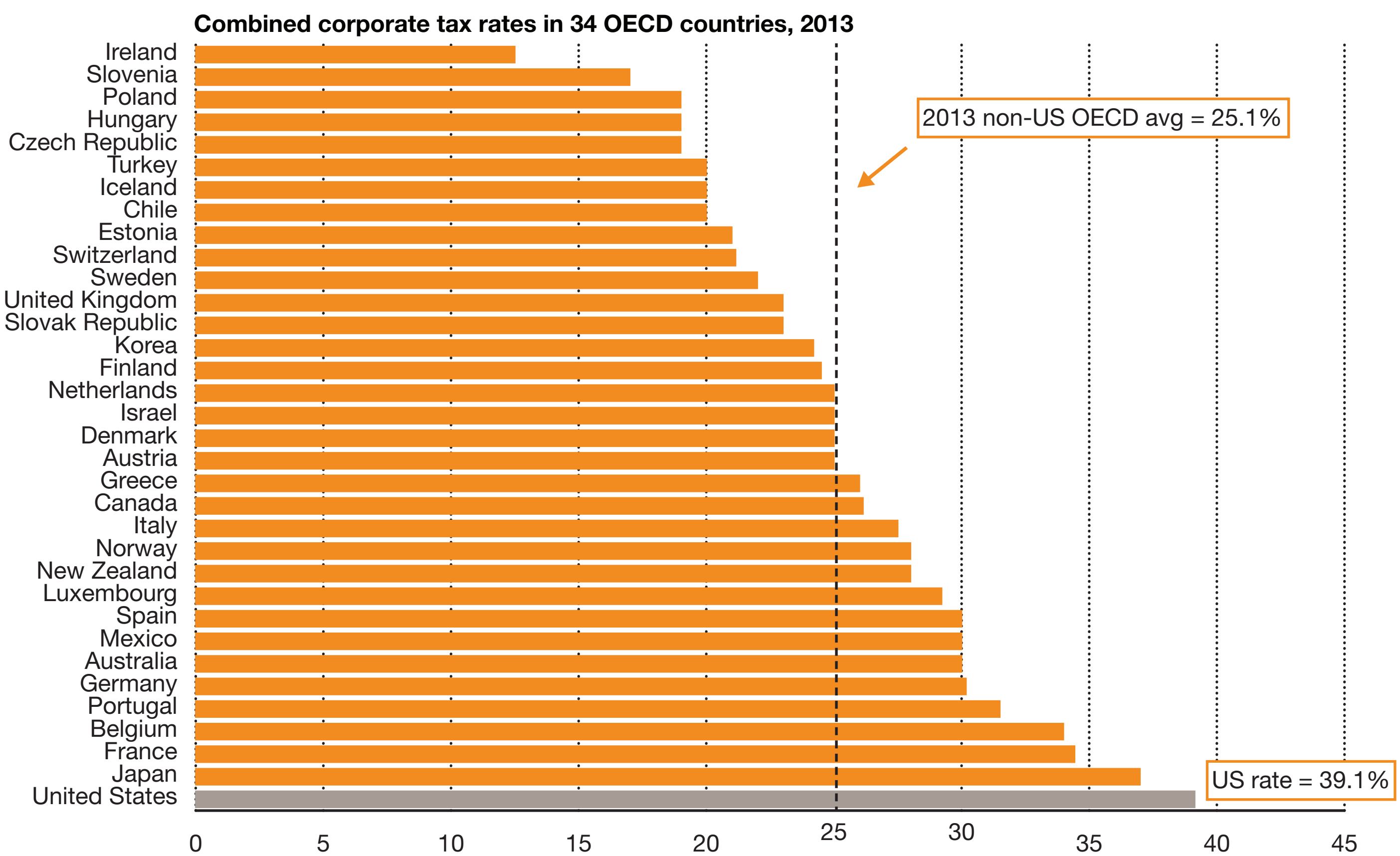
The global economy appears to be emerging from the slowdown experienced over the past several years. Current OECD projections show slow improvements across all regions in 2014 and generally continuing in 2015 (see Figure 6). World GDP growth is expected to be 3.6 percent in 2014 and 3.9 percent in 2015.

Focus on tax reform

Corporate tax reform

A major bipartisan objective of corporate tax reform is to provide significant rate reduction to improve the attractiveness of the United States for investment and job growth and the ability of US multinationals to compete in the global economy. Since Japan reduced its corporate tax rate in April 2012, the United States has had the highest corporate tax rate among advanced nations. Including state taxes, the United States' combined statutory tax rate of 39.1 percent is more than 50 percent higher than the 25.1-percent average statutory corporate tax rate of other OECD countries in 2013.

Figure 7: Combined corporate tax rates in 34 OECD countries, 2013



Source: OECD Tax Database and PwC Worldwide Tax Summaries, http://www.pwc.com/gx/en/worldwide-tax-summaries/index.jhtml
Note: Estonia tax rate shown for distributed income (retained income is exempt).

A 25-percent federal corporate rate, which is advocated by Congressional Republicans, would result in a combined federal and state rate of just under 30 percent. This would move the United States from having the highest tax rate in the 34-country OECD to the eighth highest, and from the highest in the G7 to the fourth highest.

In a July 30, 2013 letter to House Ways and Means Committee Ranking Member Levin, Joint Committee on Taxation (JCT) staff estimated that a proposal to provide a 25-percent top corporate tax rate and repeal the corporate alternative minimum tax (AMT) would reduce federal revenues by $1.3 trillion over 10 years.

Figure 8: Combined national and sub-national top corporate tax rate

Note: The current US rate is based on the 35-percent federal tax rate and average state tax rates of 6.35 percent. Since state taxes are deductible from federal taxes, the net combined tax rate is 39.1 percent.
Source: OECD Tax Database and PwC Calculations

High statutory and high effective rates of taxation

Although there is increasing recognition that the United States has a higher statutory corporate tax rate than other OECD countries, it is less well known that the effective tax rate (ETR) of American companies also generally is higher than that of companies headquartered outside the United States.

Statutory tax rates are the rates that apply to taxable income, after taking into consideration deductions, exclusions, credits, and preferences. ETRs, in contrast, measure the rate of tax relative to alternative measures of income. 'Book' ETRs, for example, measure tax payments relative to financial statement income. Both statutory tax rates and ETRs are important for assessing the overall impact of the US corporate tax system on American companies.

According to a comprehensive cross-country study of financial statement information by academic researchers, American companies on a worldwide basis had the second highest ETR among multinationals from all countries.

Figure 9: Average book effective tax rates, 2006-2009

Source: Calculations of Global Effective Tax Rates prepared for the Business Roundtable by PwC using data from S&P's Global Vantage database (April 14, 2011).

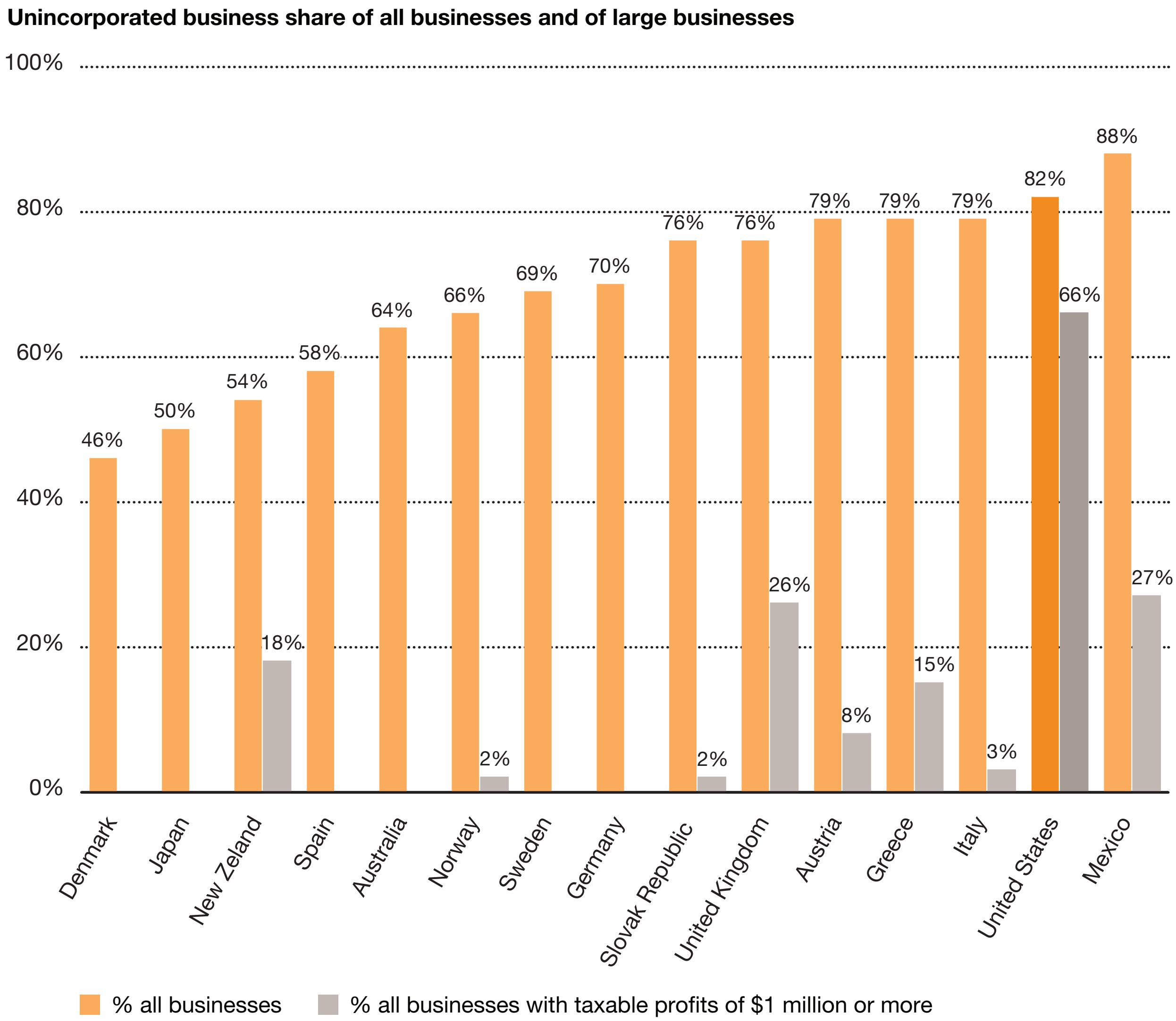
The study estimates the ETR of US multinationals between 2005 and 2009 to have been 30 percent, with Japan having the highest ETR at 39 percent. ETRs for multinationals based in other G7 countries were 26 percent for Canada, 28 percent for France, 29 percent for Germany, and 26 percent for the United Kingdom.

A PwC study for the period 2006-2009 found that among the 2,000 largest companies in the world, US companies had an ETR five percentage points higher than the average of companies headquartered in other OECD countries and 11 percentage points higher than the average rate of companies headquartered in non-OECD countries (see Figure 9).

Some argue that the US corporate ETR is lower than that of other advanced economies, citing the fact that the amount of corporate income tax revenue in the United States as a percentage of GDP is below the OECD average. For example, between 2007 and 2011, corporate taxes as a share of GDP averaged about 2.2 percent in the United States, compared to about 3.2 percent in the rest of the OECD.

However, the United States has a substantially greater share of businesses, especially larger businesses that operate in forms not subject to corporate-level taxation – i.e., sole proprietorships, partnerships, and S corporations – than do other OECD countries (see Figure 10). According to the IRS, more than half of business income in the United States is earned by businesses that are taxed directly under the individual income tax system rather than through the corporate tax system. As a result, comparisons of corporate tax collections as a share of GDP in the United States with other countries can be misleading.

Figure 10: The United States has among the largest unincorporated business sector within the OECD



Note: Although they are flow-through businesses, S corporations are counted here with other corporations because they are incorporated.
Source: US Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness, Background Paper," July 23, 2007

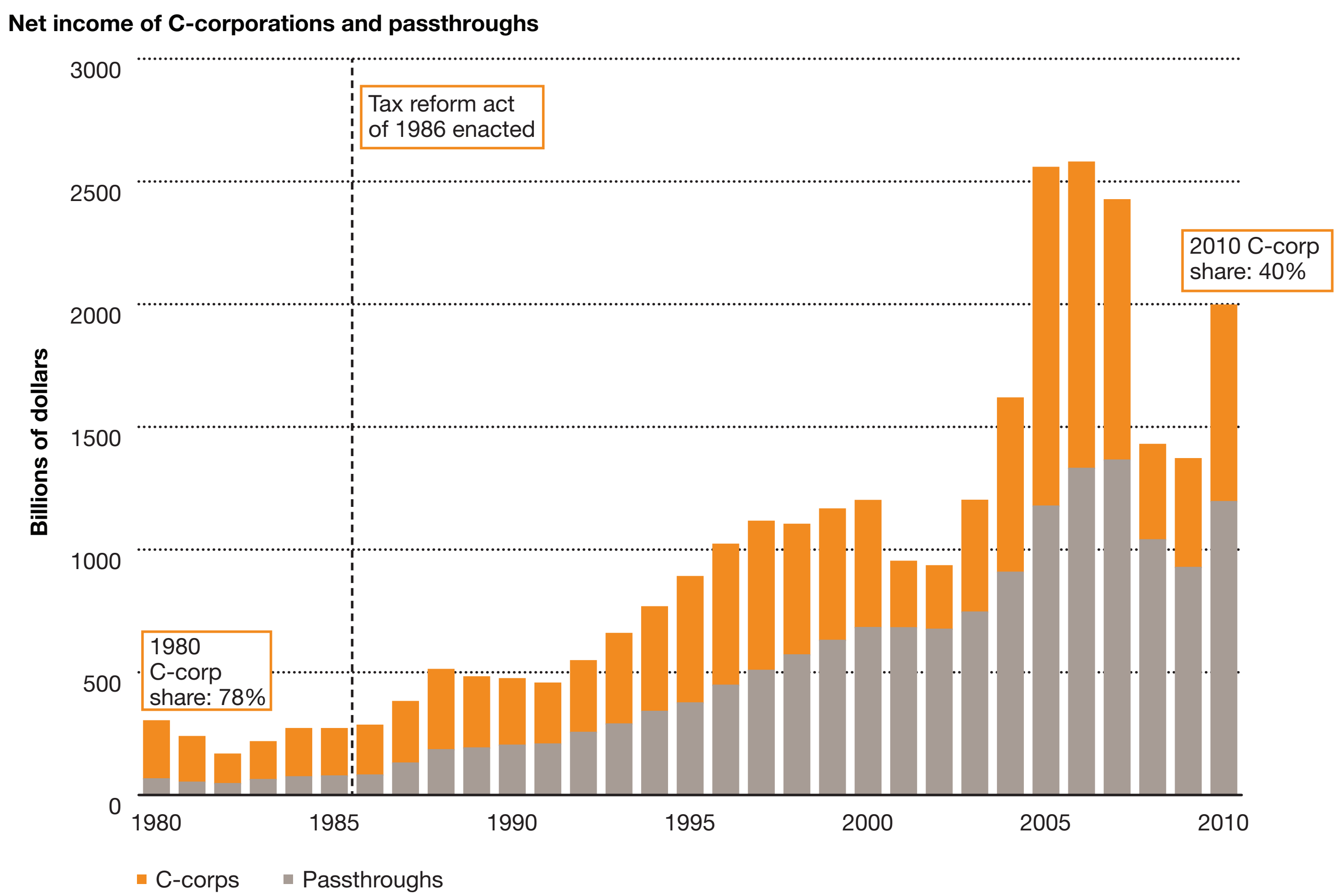
Non-corporate businesses

The issue of non-corporate business taxpayers has become more important as the share of business income from passthrough business has increased (see Figure 11). In 2010, for example, 60 percent of business net income was attributable to passthrough entities.

As a result, many believe that business tax reform must address tax rates on all business income, not just corporate income. Further, base broadening on all businesses, for example, to pay for a reduction in the corporate tax rate, would result in a net increase in non-corporate business taxes unless passthrough tax rates also were reduced.

Some believe there should be a rough parity between the top tax rates on corporate income and passthrough income. Unlike corporate income, which is subject to a 'double tax' (taxed once at the entity level and taxable a second time when the profits are distributed to the shareholder level), however, income from passthrough entities is taxed only at the owner level. How lawmakers address non-corporate businesses will be a key challenge to enacting comprehensive tax reform.

Figure 11: Net income of C-corporations and passthroughs



Excludes net income of regulated investment companies and real estate investment trusts.
Source: Internal Revenue Service, Statistics of Income, Integrated Business Data.

Tax expenditures

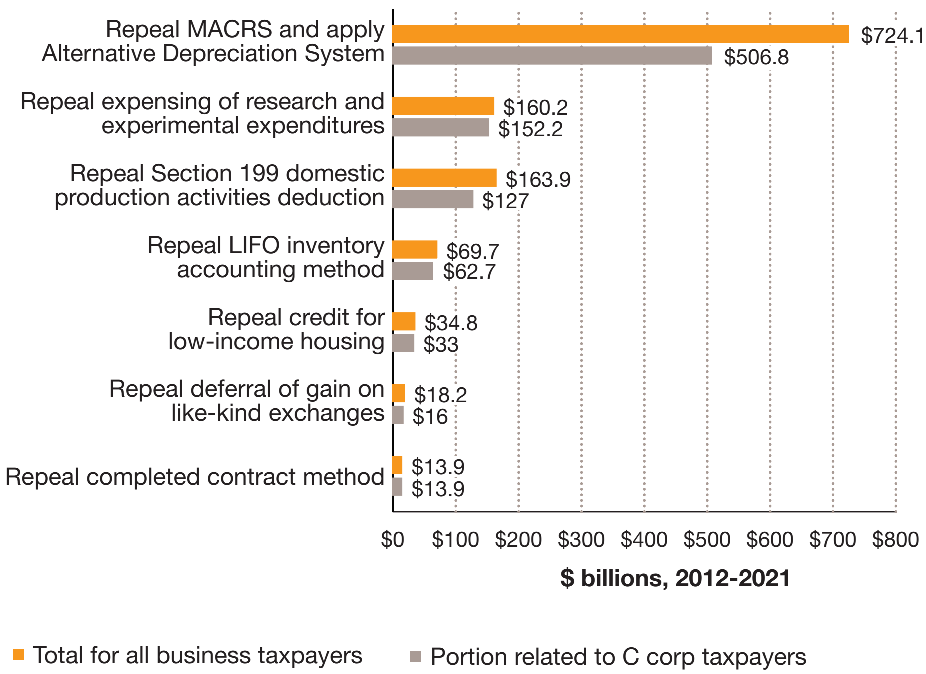
One challenge of advancing revenue-neutral tax reform involves potential trade-offs between limiting tax preferences, lowering tax rates, and reforming the taxation of international income. This challenge grows substantially if part of the revenue from individual and corporate base broadening is to be used for deficit reduction or additional discretionary spending, as President Obama and many Congressional Democrats have proposed.

Base-broadening proposals include tax expenditures, which JCT staff define as "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." The JCT and the Administration annually publish separate, but very similar, lists of tax expenditures.

Note: Many of the tax reform proposals discussed below include measures that would modify or limit current federal tax deductions that are not defined as 'tax expenditures,' such as deductions for advertising.

The chart below shows some of the most significant business tax expenditures. A summary of selected federal tax expenditures also is provided in Appendix D.

Figure 12: Estimates for repealing selected business tax expenditures ($ billions, 2012 – 2021)



Source: JCT letter to Rep. Levin, October 27, 2011. The Congressional Budget Office has provided updated estimates for certain of these proposals. For example, CBO estimates repeal of LIFO would raise $112 billion over the 2014-2023 budget period (CBO, *Options for Reducing the Deficit: 2014 to 2023*, November 2013).

Individual tax reform

The goal of enacting comprehensive tax reform has been complicated by differing opinions regarding the treatment of individual taxpayers. Democrats generally have proposed using revenues from higher taxes on upper-income individuals for deficit reduction. Republicans have focused instead on offsetting the cost of lower individual rates with revenue-neutral proposals that would modify or eliminate existing income tax exclusions, deductions, preferences, and credits.

As noted above, the United States has a large number of passthrough businesses that would be affected by how Congress addresses individual tax rates.

A further consideration in reducing individual tax rates (shown on Figure 13) is a desire to maintain the current share of tax paid by each income group. The tax policy goal of 'distributional neutrality' was a key principle of the Tax Reform Act of 1986.

Reducing individual tax rates

Paying for reduced individual tax rates would require politically sensitive decisions regarding popular individual provisions, such as deductions for mortgage interest, state taxes, and charitable contributions (see Figure 14).

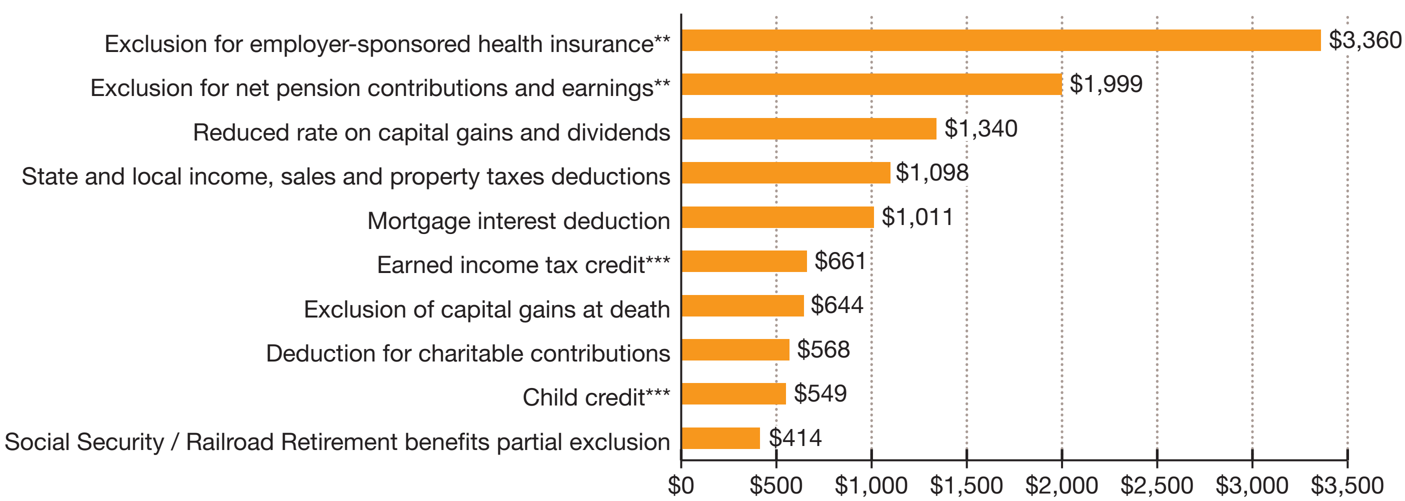
Since 2011, House Republicans have passed annual budget resolutions calling for a top individual tax rate of 25 percent, with a 10-percent rate for lower levels of taxable income. In a July 18, 2013, letter to House Ways and Means Committee Ranking Member Levin, JCT staff estimated that a proposal to provide two tax brackets at 10 percent and 25 percent and to repeal the individual AMT would reduce federal revenues by $3.8 trillion over 10 years.

Figure 13: Individual tax brackets

Taxable income			2014 marginal tax rates
Single	**Joint**	**Head of household**	**Present law**
$0 to $9,075	$0 to 18,150	$0 to $12,950	10%
$9,076 to $36,900	$18,151 to $73,800	$12,951 to $49,400	15%
$36,901 to $89,350	$73,801 to $148,850	$49,401 to $127,550	25%
$89,351 to $186,350	$148,851 to $226,850	$127,551 to $206,600	28%
$186,351 to $405,100	$226,851 to $405,100	$206,601 to $405,100	33%
$405,101 to $406,750	$405,101 to $457,600	$405,101 to $432,200	35%
Above $406,750	Above $457,600	Above $432,200	39.6%

Source: IRS Rev. Proc. 2013-35 (2013-47 IRB, Nov. 18, 2013)

Figure 14: Select individual tax expenditures* (2014-2023)



*Excludes business related tax expenditures
**Includes effect on payroll taxes
***Includes effect on outlays

Source: Congressional Budget Office, "Distribution of Major Tax Expenditures in the Individual Income Tax System, May 2013

Recent tax reform developments

Obama Administration approach to tax reform

President Obama in April 2013 submitted to Congress his FY 2014 budget proposals that 'reserved' more than $300 billion in international and other business tax increases for revenue-neutral corporate tax reform. President Obama also proposed individual and business revenue-raising proposals to reduce the federal budget deficit or offset new spending, discussed below.

The budget does not propose a target corporate tax rate, but references the President's 2012 framework for business tax reform, which called for a 28-percent top corporate tax rate and reduced rates for certain domestic manufacturing activities. According to the White House, this rate reduction would be paid for by cutting corporate tax loopholes and eliminating perceived tax distortions with respect to investment, entity, and financing decisions. The plan did not specify what provisions would be modified to pay for the lower rates.

In an effort to discourage US-based multinationals from moving their operations overseas, the President's plan calls for a minimum corporate tax on foreign earnings. Administration officials have expressed opposition to a 'pure' territorial tax system. For a summary of international tax proposals in the President's FY 2014 budget, see Appendix E.

In July 2013, the Administration laid out a plan for corporate-only tax reform. Although the plan is described as being revenue-neutral, under traditional scoring conventions it would be a net tax increase. The proposal is projected to generate a one-time boost in revenue when taxpayers transition to the new system. While the White House did not provide details on how this revenue would be generated, the White House proposes to use the one-time transitional revenue to fund new spending on job-training initiatives and infrastructure rather than to finance a lower corporate tax rate.

Other proposed business tax increases reserved for tax reform in the President's FY 2014 budget would:

- Repeal the last-in, first-out (LIFO) and lower-of-cost-or-market (LCM) inventory accounting methods
- Eliminate certain tax preferences for oil, natural gas, coal, and other hard mineral fossil fuels
- Modify the tax treatment of insurance companies and products
- Require that derivative contracts be marked-to-market with the resulting gain or loss treated as ordinary income
- Modify depreciation rules for non-commercial general aircraft
- Repeal gain limitation for dividends received in reorganization exchanges
- Limit the importation of losses under related-party loss limitation rules
- Deny deductions for punitive damages.

Although not discussed in the Administration's FY 2014 budget, the President's 2012 framework for business tax reform sets forth a menu of options for base broadening that included proposals to:

- Reduce the benefits of accelerated depreciation on capital investment
- Reduce the 'bias toward debt financing'
- Establish greater parity between large corporations and large businesses that are taxed at the individual level (e.g., partnerships and S corporations).

The framework does not detail specific proposals in these areas. Instead, the framework states, for example, that "steps like reducing the deductibility of interest for corporations should be considered" and cites past options to modify the tax treatment of large passthrough businesses.

Congressional efforts to reform US tax laws

House Ways and Means Committee Chairman Camp and Senate Finance Committee Chairman Baucus have been working together for the past few years to advance comprehensive tax reform. Since 2011, the House and Senate tax committees have undertaken extensive public hearings and have held a series of 'Members-only' discussions to develop tax reform proposals.

Tax reform activities in 2013 included a series of discussion drafts, bipartisan working groups, bipartisan meetings to discuss options papers, and 'Max and Dave' roadshows, in which the two tax committee chairmen sought to build public support for overhauling the US tax code.

House Ways and Means Committee action

While Chairman Camp has not yet released a detailed tax reform bill, he has said that he supports a comprehensive approach to tax reform with top tax rates of 25 percent for both corporations and individuals and a modern, competitive international tax system. Base-broadening likely will be part of any revenue-neutral tax reform proposal, but Chairman Camp has not indicated what particular exclusions, deductions, credits, and other preferences (referred to as tax expenditures) would be eliminated or modified to pay for rate reductions.

In January 2013, Chairman Camp released a discussion draft on reforming the tax treatment of financial products. A discussion draft on the taxation of small business and passthrough entities issued in March 2013 includes two options to reform the tax treatment of S corporations and partnerships: (1) revisions to the existing tax rules or (2) a new, unified passthrough regime.

Chairman Camp also is expected to build on an international tax reform draft he released in October 2011, discussed below.

The Ways and Means Committee in February 2013 formed 11 bipartisan tax reform working groups to examine designated tax issues, including international, manufacturing, pensions and retirement, energy, financial services, and debt, equity and capital. The working groups engaged in fact finding and information gathering, but were not directed to make any policy recommendations. The working groups generally completed their work on April 15. On May 6, JCT staff released a 568-page report summarizing current law, certain prior tax reform proposals, and numerous public comments received by the working groups.

Senate Finance Committee action

In March 2013, Chairman Baucus outlined his plan for the Finance Committee to develop tax reform legislation. As part of the plan, Chairman Baucus and Ranking Member Hatch held weekly bipartisan member meetings to discuss a series of options papers on a wide range of tax reform issues, including international taxation and business investment and innovation.

Senators Baucus and Hatch announced in a June 2013 'Dear Colleague' letter their 'blank slate' approach to tax reform – starting with a tax code without any current business and individual tax expenditures – and solicited input from their colleagues on which tax expenditures should be added back to the code.

In late 2013, Chairman Baucus released a series of tax reform discussion drafts focusing on international tax rules, tax administration, cost recovery and tax accounting, and energy. Further discussion drafts are expected in 2014. He stated that these proposals should be considered as a package, rather than standing alone.

Chairman Baucus last year did not specify a target corporate rate, but generally expressed support for lowering the US corporate rate below 30 percent. While his staff noted that Chairman Baucus believes that tax reform as a whole should raise significant revenue for deficit reduction, the business reforms detailed in recent staff discussion drafts are intended to be revenue-neutral in the long-term, with corporate base broadeners paying for a "significant reduction in the corporate tax rate."

Senator Baucus' likely confirmation by the Senate would result in a change of leadership at the Finance Committee. As noted above, Senator Wyden appears likely to take the chairman's gavel; in the past, Senator Wyden has introduced bills (discussed below) expressing his own views on comprehensive tax reform.

Tax reform discussion drafts

International tax reform discussion drafts

Chairman Camp's international tax reform discussion draft

In October 2011, House Ways and Means Chairman Camp released an international tax reform discussion draft, which included a structure to move the United States from a worldwide taxation system to a 'participation exemption' system similar to that used by most OECD nations.

The participation exemption system in the Ways and Means staff discussion draft provides a 95-percent dividends received deduction (DRD) for qualified foreign-source dividends received by a corporate 10-percent US shareholder from a controlled foreign corporation (CFC), provided the stock of the CFC has been held for at least one year. Given the 25-percent corporate tax rate assumed in the discussion draft, the tax rate on qualifying foreign-source dividends would be 1.25 percent (25 percent of five percent). No foreign tax credits (FTCs) would be available to offset this tax.

As part of a transition to the new participation exemption system, previously untaxed earnings and profits (E&P) of foreign subsidiaries would be included in the income of 10-percent-or-greater US shareholders in the last year ending before the territorial system would be effective. An 85-percent DRD would be allowed, and credits for 15-percent of indirect foreign taxes would be allowed. Thus, the maximum tax rate on pre-enactment income would be 5.25 percent (35 percent of 15 percent). A taxpayer could elect to spread the tax owed over a period of up to eight years with an interest charge. The proposal treats all previously untaxed E&P the same, whether held in cash and equivalents or reinvested in plant and equipment.

Chairman Baucus' international tax reform discussion draft

In November 2013, Chairman Baucus released a Finance staff international tax reform discussion draft that proposes to repeal or modify the current deferral system. In its place, the discussion draft provides statutory language for two differing regimes that would generally impose current taxation on all CFC income at a minimum rate, discussed below.

The discussion draft proposes a one-time tax on foreign subsidiaries' pre-effective date earnings that have not been subject to US federal income tax. A portion of the foreign taxes paid on these accumulated earnings would be creditable. The Finance staff summary of the discussion draft suggests that this one-time tax could be "for example, 20 percent, paid over eight years."

The discussion draft includes additional proposals that allow the CFC look-through rules to expire, eliminate 'check-the-box' for international tax purposes, disallow the deduction of interest expense allocable to exempt foreign income, codify the 'realistic alternatives' transfer pricing test, restrict the use of FTCs and prevent foreign investors from using regulated investment companies (RICs) and real estate investment trusts (REITs) to avoid US taxation.

Comparing anti-base erosion options

Proposals to address base erosion are an integral part of the international tax reform discussion drafts prepared by the House Ways and Means Committee and the Senate Finance Committee staffs.

Note: Both tax writing committees' discussion drafts present their anti-base erosion options in fully developed form, but bracket specific numerical thresholds and income tax rates as tentative.

House Ways and Means Committee approach

The Ways and Means staff discussion draft has three alternative anti-base erosion proposals – Options A, B, and C – that would expand the anti-deferral rules of subpart F to address concerns that increased income shifting might occur under a territorial tax system, particularly with respect to intangible property.

Option A was based on an Obama Administration proposal to tax the 'excess returns' of US CFC income attributable to intangibles transferred from the United States. Option B would treat all income (including active income) of a CFC that is taxed at a foreign effective rate of 10 percent or less as subpart F income, with a same-country exception for active income earned through a local office or fixed place of business.

During a June 2013 hearing, Chairman Camp said that Option C, which provides a 'carrot and stick' approach, continues "to receive the most support from the business community," adding that work with JCT staff "leads us to believe it is an effective safeguard."

Option C would focus on addressing erosion of the US tax base through shifting income attributable to intangible property (IP). The stated goal of the proposal is to provide companies with less incentive to shift IP to low-tax jurisdictions because the income would be taxed at the same rate – whether it is earned in the United States or abroad.

Option C would create foreign base company intangible income (FBCII) as a new subpart F category for income CFCs derive from IP—the 'stick' of the carrot and stick approach. FBCII would be all of a CFC's income from transactions in property or providing services, to the extent the income is attributable to IP used in connection with the transactions or services. As a 'carrot,' Option C would create a 40 percent deduction for US corporations' income from intangibles that is attributable to foreign market sales whether earned directly by the US parent or indirectly by the CFC and treated as FBCII. Thus, in general, intangible income of a foreign subsidiary would be taxed at the same rate as if owned by the US parent (i.e., 25 percent if attributable to domestic market sales and 15 percent if related to foreign market sales).

Senate Finance Committee approach

Central to the Finance Committee staff international tax discussion draft is the inclusion of anti-base erosion Options Y and Z, which apply the concept of a minimum level of current US corporate income taxation on active foreign subsidiary income. Options Y and Z have some similarity to Option B in the 2011 discussion draft from Ways and Means Chairman Camp, but differ significantly from Chairman Camp's preferred Option C (the 'carrot and stick' approach).

Options Y and Z have a broader focus than IP-related income. Option Y also would adopt a participation exemption for foreign subsidiary dividends, but only to income from an active foreign business on sales for foreign use that is taxed above a minimum foreign rate of tax. Thus, Option Y would create two new subpart F categories: 'US-related income' for CFCs' income derived from sales or services ultimately destined for consumption or use in the United States, and 'low-taxed income' for CFCs' income with a foreign ETR less than 80 percent of the US corporate tax rate. Option Y also would repeal all the foreign base company income categories of current law.

Option Z would tax all CFC income on a current basis, with a [40 percent] exemption for 'active foreign market income.' Active foreign market income is income, other than effectively connected with a US trade or business, derived from active production or sale of property for consumption or use outside of the United States and from providing services to persons located outside of the United States. Option Z also would repeal certain existing definitions under subpart F.

Weighing anti-base erosion options

Both the Finance Committee and Ways and Means Committee international discussion drafts generally would exclude from subpart F inter-CFC dividends and repeal Section 956, which tax a CFC's investments in certain US property that are viewed as disguised foreign earnings repatriations. Options Y and Z would make permanent and modify the special subpart F regimes for active finance and insurance income. In addition, they would not extend the 'CFC look-through' rules. The Ways and Means discussion draft does not address extension of the active finance and CFC look-through rules.

In addition, Finance Committee and Ways and Means international discussion drafts each would modify the FTC rules. Both would repeal the Section 902 indirect ('deemed-paid') credit and narrow the application of the Section 960 indirect credit to subpart F inclusions. Options Y and Z would increase the number of Section 904(d) FTC limitation 'baskets' to six and three, respectively, while the Ways and Means Committee discussion draft would reduce the number of FTC limitation baskets from two to one.

Figure 15: Comparison of international tax reform discussion drafts

Proposals	Chairman Camp (2011)	Chairman Baucus (2013)
Corporate rate	25%	Support for <30%
DRD/Exemption	95%	100%
Anti-base erosion	Prefers option C—carrot and stick	Minimum tax or repeal deferral for most income
Transition tax rate on historic earnings	5.25%	20% with E&P deduction provision
Payment period for 'deemed repatriation'	Payable, with interest at underpayment rate, over eight years.	Payable, interest-free, over eight years.
Territorial	Yes	Yes
Check-the-box	Present law	Eliminated for non-U.S.
Interest deductibility	Thin cap	Interest expense allocated to non-U.S. taxed income

Chairman Camp's financial products discussion draft

Chairman Camp's financial products discussion draft, released in January 2013, would significantly affect taxpayers that execute financial transactions as part of a trading or investment strategy, such as hedge funds, mutual funds, and individual investors/traders. Specifically, the proposal provides that:

- An investor must mark-to-market on an annual basis all derivatives (broadly defined) in the taxpayer's portfolio. The resulting income or loss would be ordinary.
- A taxpayer no longer could specifically identify by 'lot' the security that it sells for purposes of determining cost basis. Instead, the proposal requires that cost basis be computed under an 'average cost' methodology.
- Taxpayers must accrue market discount into interest income on a current basis.

The discussion draft contains a proposal applicable to businesses that use financial products to hedge their ordinary business operations. The mark-to-market proposal—although clearly designed to affect investors/traders—also could affect businesses that use derivatives to manage currency, interest rate, and price risk. The proposal, however, provides an exception to the mark-to-market regime for transactions that qualify as tax hedges.

In defining this hedging exception, the proposal provides some relief from the current-law requirements for making tax-specific identifications of hedges. Specifically, the proposal effectively deems a tax hedge identification to have been made in situations in which the transaction is properly treated as a hedging transaction in a taxpayer's audited financial statements.

Chairman Camp's small business and passthrough discussion draft

Chairman Camp's small business and passthrough discussion draft, issued in March 2013, features proposals affecting both large and small partnerships and S corporations, including a proposal to provide a new rule limiting the use of the cash method of accounting to businesses with gross receipts of $10 million or less.

The discussion draft offers two options to modernize the tax treatment of partnerships and S corporations:

- **Option 1**—revisions to Subchapter K and Subchapter S—incorporates a number of proposals from the S Corporation Modernization Act (H.R. 892) sponsored by Ways and Means members David Reichert (R-WA) and Ron Kind (D-WI), intended to provide 'greater flexibility' to S corporations in their day-to-day operations. Option 1 also includes proposals to eliminate certain perceived tax abuses in Subchapter K, to clarify certain partnership rules, and to align certain partnership rules with S corporation rules.
- **Option 2**—a new, unified passthrough regime—would repeal current law Subchapter K and Subchapter S and provide a 'simple, uniform set of rules' that would apply to non-publicly traded businesses for federal tax purposes regardless of how the business is organized.

Chairman Baucus' discussion draft on cost recovery and tax accounting reform

In November 2013, Chairman Baucus released a discussion draft focusing on cost recovery reforms to certain depreciation and amortization proposals and other tax accounting reforms.

Key proposals on cost recovery include:

- **Depreciation of tangible property**—replace the current modified accelerated cost recovery system and alternative depreciation system with a pooled cost recovery system and a straight-line cost recovery system. The proposal eliminates the need for businesses to calculate depreciation separately for each individual asset, reduces the number of depreciation rates used for computing annual depreciation expense, and results in a single set of depreciation rules that apply to all taxpayers. The discussion draft also repeals the like-kind exchange rules on the premise that these rules are replaced by the inherent deferral mechanism of the new proposed pooling regime.
- **Amortization of intangible assets**—increase the amortization recovery period for Section 197 intangibles from 15 years to 20 years and repeal the Section 197 anti-churning rules.
- **Amortization of research and experimentation expenditures**—repeal expensing of research and experimentation expenditures under Section 174. Future research and experimentation expenditures would be capitalized and amortized ratably over a five-year period. The optional 10-year recovery of these costs for AMT purposes under Section 59(e) also would be repealed.

- **Repeal of LIFO and LCM**—repeals the use of the LIFO inventory method and the LCM method to value ending inventory below cost and prohibits any write-down for subnormal goods. For taxpayers required to change their method of accounting from LIFO or LCM, any net positive Section 481(a) adjustment could be taken into account over eight tax years.

Chairman Baucus requested public comments by January 17, 2014, on the discussion draft. The staff summary notes that the discussion draft is not intended to address tax incentives for activities such as innovation and manufacturing. Comments were requested on whether and how certain tax incentives, such as the research and development credit and the Section 199 deduction for manufacturing, should be adjusted in light of the proposals in the staff discussion draft. The summary states that the Chairman's staff is considering expanding and making permanent the research and development credit, which expired at the end of 2013.

Chairman Baucus' tax administration reform discussion draft

Also in November 2013, Chairman Baucus released a tax administration reform discussion draft that includes three broad sets of reforms: tax filing reforms, measures to address the tax gap, and reforms to combat tax-related identity theft. The discussion draft also includes a variety of technical corrections to legislation enacted over the last several years and identifies numerous out-of-date and obsolete provisions that potentially could be repealed without making any substantive change in the tax law.

The tax filing reforms include several proposals to modernize tax administration through expanded use of technology, such as electronic filing. These proposals attempt to facilitate taxpayers gathering information required for tax return preparation by changing certain return filing deadlines. The draft also proposes to increase the threshold for JCT reviews of tax refunds, from $2 million to $5 million in the case of a C corporation.

The second set of reforms focuses on efforts to address the tax gap by expanding certain information reporting obligations and expanding IRS collection tools. These proposals generally impact reporting requirements related to bank accounts, mortgage interest, and tuition payments, but also include reporting related to insurance contracts.

In addition, proposals to combat tax-related identity theft are designed to reduce access to taxpayer identification information, provide identity theft victims a single IRS point of contact, and establish criminal penalties for the misappropriation of another person's tax identity.

Chairman Baucus requested public comments by January 17, 2014, on the discussion draft and other issues not addressed in the draft.

Chairman Baucus' discussion draft on energy tax reform

In December 2013, Chairman Baucus released an energy tax reform discussion draft that focuses on simplifying approximately 40 current energy tax incentives into two basic categories of activity: clean electricity production and clean transportation fuel production. Within these two categories, taxpayers would be able to choose either a production tax credit (PTC) or an investment tax credit (ITC). The clean electricity PTC would be up to 2.3 cents per kilowatt hour, and the ITC would be up to 20 percent. The clean fuels PTC would be up to $1 per gallon, and the ITC would be up to 20 percent. The amount of each credit available for a specific project would be based on a sliding scale measured by how clean the electricity or fuel is relative to baseline standards.

Of significance, these credits would phase out based on specified improvements in greenhouse gas intensity of the underlying activity, rather than a calendar sunset date like most current energy incentives. Specifically, the clean electricity credit would phase out over a three-year period beginning the year after the overall US electricity sector is certified by the Environmental Protection Agency (EPA) to be 25 percent cleaner than it was in 2013. The clean fuel credit would phase out over three years after the year in which EPA certifies that greenhouse gas intensity of all transportation fuels is 25 percent cleaner than in 2013.

Finally, the discussion draft proposes extending through December 31, 2016 the existing tax credit for renewable electricity production; the investment tax credit for electricity; the credit for residential renewable electricity investments; and the credits for transportation-grade, renewable, and alternative fuels. It also would repeal or not renew 11 other tax provisions.

Chairman Baucus requested public comments by January 31, 2014, on the energy tax reform discussion draft and other issues not addressed in the draft.

Other energy tax proposals

Tax preferences for fossil fuels

Consistent with prior-year budget proposals, President Obama's FY2014 budget includes proposals to eliminate expensing for intangible drilling costs, percentage depletion for coal mining and for oil and natural gas wells, and several other provisions applicable to these industries. Similar proposals have been included in several Congressional Democratic tax bills over the past year, and they are likely to remain under discussion during 2014.

Alternative capital structures for renewable energy

During 2013, Senators Chris Coons (D-DE), Jerry Moran (R-KS), Debbie Stabenow (D-MI), and Lisa Murkowski (R-AK) introduced the MLP Parity Act, which would allow renewable energy assets to qualify for master limited partnership structures in the same manner that oil and gas investments can. Many industry observers argue that this would improve access to the public capital markets for renewable energy projects. Although the legislation has attracted a bipartisan list of cosponsors, it does not appear likely to be enacted as a stand-alone proposal. In the interim, investors and developers have focused their attention on alternative structures such as holding portions of renewable energy projects in REITs and packaging renewable energy projects into publicly-traded "YieldCo" investment entities.

Other tax reform proposals

Senator Wyden's tax reform proposals

Senator Wyden's likely assumption of the chairmanship of the Senate Finance Committee puts a spotlight on the Senator's prior efforts to craft a bipartisan comprehensive tax reform package. In each of the last two Congresses, Senator Wyden introduced comprehensive tax reform legislation with a Republican co-sponsor.

In February 2010, Senator Wyden introduced a comprehensive tax reform bill (S. 2018) jointly with then-Senator Judd Gregg (R-NH). In April 2011, a modified bill (S. 727) was introduced by Senator Wyden with Senator Dan Coats (R-IN).

Although the bill was not reintroduced in the current Congress, Senator Wyden has been a strong advocate of the need to reform both the domestic and international tax regimes. He also has stated reservations about a territorial tax system.

The 2011 bill proposed to lower the corporate tax rate to 24 percent and broaden the business tax base. For individuals, the legislation proposed to reduce the number of tax brackets from six to three – 15, 25, and 35 percent – and expand the standard deduction. The legislation retained certain individual tax deductions, including those for home mortgage interest and charitable donations. The legislation also proposed to repeal the individual and corporate AMT.

Note: At the time the 2011 bill was drafted, the top individual rate was 35% and the individual AMT was being modified on a periodic basis to prevent it from capturing tens of millions of additional taxpayers. After enactment of the American Taxpayer Relief Act of 2012, the top rate is 39.6% and the individual AMT has been modified permanently to prevent it from capturing these additional taxpayers.

Major business base broadeners to offset the cost of a 24 percent corporate tax rate included:

- Current taxation of all foreign income without benefit of deferral and adoption of a per-country FTC limitation
- Repeal of the Section 199 domestic production deduction
- Replace Modified Accelerated Cost Recovery System (MACRS) depreciation with the slower alternative depreciation system (ADS)
- Reduce corporate interest deductions by disallowing the portion of interest expense reflecting inflation
- Repeal of provisions for intangible drilling costs and percentage depletion
- Limit the FTC for dual capacity taxpayers
- Repeal of sales source rules for export of inventory property.

Unlike the original bill, the 2011 bill proposed a temporary 5.25-percent dividend repatriation rate as transition relief for the international tax changes and to "bring money home to help grow the economy."

Another change from the earlier bill is that the 2011 bill dropped a provision to repeal the LIFO inventory accounting method (although it retained a provision from the 2010 bill to repeal the LCM inventory accounting method).

The 2011 bill also directed the CBO to identify 'corporate welfare provisions' and report to Congress the 'least productive' direct payments and indirect subsidies to businesses each year.

Revenue estimates

In preliminary JCT revenue estimates of the original Wyden-Gregg bill released in November 2010, the business tax reform revisions were shown to be approximately revenue-neutral, and the non-business individual tax changes were scored as raising approximately $500 billion relative to a baseline that extended the Bush tax cuts (which originally were scheduled to expire after 2010), over the 10-year budget period. (Revenue estimates for the 2011 legislation were not publicly released.)

Some of the initial JCT revenue estimates for key business offsets proposed in the original 2010 legislation include:

Figure 16: Revenue estimates for select business base broadeners

2010 Proposal	10-Year Revenue Estimate, in billions (2011-2020)
Apply per-country FTC rules and repeal deferral for active income of foreign subsidiaries	$582.7
Repeal depreciation on equipment in excess of ADS	$568.6
Index corporate interest deduction for inflation	$162.7
Repeal domestic manufacturing deduction (Section 199)	$154.3
Repeal sales source rules for export of inventory property (Section 863(b))	$76.5

Source: Joint Committee on Taxation (November 2010).

It remains to be seen whether Senator Wyden may seek to update his earlier proposals to reflect more recent discussions within the Finance Committee and the Finance staff discussion drafts released recently by Chairman Baucus.

Additional tax reform proposals

- On April 19, 2013, Erskine Bowles and Alan Simpson, the co-chairs of President Obama's 2010 fiscal commission, issued A Bipartisan Path Forward to Securing America's Future, outlining $2.5 trillion in comprehensive deficit reduction. Bowles, a former White House chief of staff during the Clinton Administration, and Simpson, a former Republican senator from Wyoming, led the 18-member National Commission on Fiscal Responsibility and Reform in 2010, which was tasked with developing a deficit reduction proposal to be sent to Congress. The bipartisan co-chairs developed a plan that failed to win the commission's approval, but that has since, for some policymakers, served as a benchmark for subsequent deficit reduction efforts.
- The 2013 Bowles-Simpson plan proposes comprehensive tax reform that would eliminate or scale back most tax expenditures. Almost $600 billion of the revenue raised from those reforms would be used for deficit reduction, with the rest used for corporate and individual rate reductions. The plan would achieve additional savings from healthcare reform, cuts in mandatory spending, and stronger limitations on discretionary spending.
- On February 11, 2013, Senator Carl Levin (D-MI) introduced the Cutting Unjustified Tax (CUT) Loopholes Act. In the international area, this bill (S. 268) includes new proposals for eliminating CFC look-through and 'check-the-box' rules. In addition, it treats CFC loans to US shareholders as dividends to the extent of aggregate CFC earnings. The bill includes proposals drawn from previous bills on deferral of interest expenses allocable to untaxed foreign earnings, pooling of FTCs, limits on outbound transfers of intangible property, and further limits on earnings-stripping by inverted companies. The bill also treats certain foreign companies managed and controlled in the United States as US companies.
- On September 19, 2013, Senator Levin introduced the Stop Tax Haven Abuse Act (S. 1533), an updated version of the legislation that he had previously sponsored in 2005, 2007, 2009, and 2011. The proposals of the new Levin bill are very similar to the international provisions of his CUT legislation, but differ in two respects in that S. 1533 does not include (1) the proposal to limit earnings-stripping by expatriated entities and (2) a CFC exception that had been included in earlier versions of management and control proposals.
- Senator Bernie Sanders (I-VT) on February 7, 2013, introduced the Corporate Tax Fairness Act (S. 250), which would repeal deferral for active income of CFCs, enact a per-country FTC limitation, limit FTCs for integrated oil companies that are dual-capacity taxpayers, and treat foreign companies as US tax residents if managed and controlled in the United States. Rep. Janice Schakowsky (D-IL) introduced a companion House bill (H. 694) on February 13, 2013.
- On December 5, 2013, Reps. Lloyd Doggett (D-TX) and Rosa DeLauro (D-CT) introduced the Sequester Delay and Stop Tax Haven Abuse Act, which would reduce various international tax preferences and use the resulting revenue to replace the across-the-board sequestration budget cuts to discretionary programs for FY 2014 and FY 2015 and reduce the sequester-mandated cuts for FY 2016. Specifically, the bill includes proposals on intangible property transfers, country-by-country reporting, repeal of check-the-box, and CFC look-through, and limits on Section 965 loans. Rep. Doggett, a member of the Ways and Means Committee, has sponsored similar legislation in the past.
- The Joint Select Committee on Deficit Reduction—the 'super committee' established by the Budget Control Act of 2011 agreement increasing the federal government's borrowing authority—considered corporate tax reform proposals in the Fall of 2011 as part of a comprehensive deficit reduction plan. Ultimately, the committee failed to agree on a deficit reduction plan. Senator Rob Portman (R-OH), one of the 12 members of the Select Committee, at that time said that a conceptual corporate tax reform proposal, featuring a 25-percent corporate rate and a territorial system, had been scored as deficit neutral by the JCT staff.
- Also during the last Congress, Senate Finance Committee member Mike Enzi (R-WY) introduced the Job Creation and International Tax Reform Act of 2012 (S. 2091), proposing a territorial tax system with a 95-percent DRD similar to that under Chairman Camp's international tax reform discussion draft. However, Senator Enzi's bill differs from Chairman Camp's discussion draft in several aspects, including an anti-base erosion measure that treats as subpart F income overseas earnings on a per-country basis that are taxed at an ETR of less than half the maximum US corporate statutory rate (i.e., 17.5 percent based on a 35-percent statutory rate).

Additional 2014 tax policy issues

Expired tax provisions

The American Taxpayer Relief Act of 2012, enacted in early 2013, included retroactive extensions through December 31, 2013, of certain business and energy tax provisions that had expired at the end of 2011 and 2012. This includes the research credit, CFC look-through, and subpart F exceptions for active financing income. Of particular importance to the energy sector, that legislation modified the expiration date for the renewable electricity PTC to construction beginning before the end of 2013.

Note: The wind PTC has been the subject of recent debate, with support and opposition breaking across party-lines. A bipartisan group of Senators on December 17, 2013, called for allowing the wind PTC to expire at the end of 2013. Prominent supporters of renewing the wind PTC include Senator Wyden and Finance Committee member Charles Grassley (R-IA).

The American Taxpayer Relief Act extended permanently individual tax rates, the estate tax, and individual AMT relief. The 2012 Act extended temporarily through December 31, 2013, certain individual provisions, including the federal deduction for state sales taxes and an increased tax exclusion for employer-provided mass transit fringe benefits.

Senate Majority Leader Reid on December 19, 2013, asked for unanimous consent for the Senate to consider a tax extenders bill (S. 1859) that would have extended 55 expiring business and individual tax provisions, including 'bonus' depreciation, for one year through the end of 2014. Senator Reid did not propose any revenue-raising provisions to offset the cost of that bill.

Senate Minority Leader McConnell objected to the request to consider S. 1859 after Senator Reid objected to his proposal to consider tax extenders as an amendment to a House-passed bill (H.R. 2668) that would delay the ACA individual and employer health insurance mandates until 2015.

Subsequently, Finance Chairman Baucus said that he hopes to see action on expired tax provisions in early 2014. Finance Ranking Member Hatch said that the Finance Committee staff is working on a bipartisan retroactive tax extenders package that could be considered early this year.

Expiring federal highway programs

Congress in 2012 enacted a two-year federal surface transportation bill (P.L. 112-141) that extended the authority to spend Highway Trust Fund revenues through September 30, 2014. In general, the 2012 legislation extended the taxes dedicated to the Highway Trust Fund at their present law rates through September 30, 2016, and for the heavy vehicle use tax, through September 30, 2017.

Figure 17: One-year extension of selected expired tax provisions

	Estimated cost of extending select provisions for one year, from January 1, 2014 through December 31, 2014	Approximate 10-year amount ($ billions)
Business provisions	Research credit	-$7
	Active financing	-$6
	CFC look-through	-$1
	15-year recovery for qualified leasehold, restaurant and retail property	-$2
	Energy Provisions	-$5
	50% bonus depreciation	-$5
	Other business tax extenders	-$5
Individual provisions	Deduction for State and local general sales taxes	-$3
	Deduction for qualified tuition and related expenses	-$1
	Other individual tax provisions	-$2
	Selected tax extenders	**-$37**

Source: PwC calculations based on Joint Committee on Taxation estimate of HR 8 as passed, January 1, 2013.

The House and Senate this year will need to act on a new surface transportation bill. Transportation Department Secretary Anthony Foxx on January 15, 2014, noted that "President Obama has put forth the idea to fund transportation that link infrastructure investment to corporate tax reform." It is unclear what specific proposals President Obama may include in his FY 2015 budget to address expiring federal highway programs.

Revenue-raising proposals

As discussed above, President Obama and Congressional Democrats have proposed using tax increase proposals to fund spending priorities or reduce the deficit. Congressional Republicans generally have opposed tax increases, and instead have called for reforming mandatory spending programs and additional spending cuts to reduce the deficit.

The President's FY 2014 budget calls for $580 billion in increased revenue from upper-income individuals for deficit reduction, including:

- Limiting to 28 percent the value of all itemized deductions and certain tax exclusions, including tax-exempt interest, employer-sponsored health insurance, and retirement contributions, for individuals with taxable incomes in the 33, 35, and 39.6-percent tax brackets. A similar limitation would apply under the AMT. JCT estimates this proposal would raise $480 billion over 10 years.
- Implementing a 'Buffett Rule' minimum tax on incomes in excess of $2 million, to be phased in beginning at incomes over $1 million. The tentative 'fair share' tax equals 30 percent of adjusted gross income (AGI) less a credit for charitable contributions. The proposal is estimated to raise $70 billion over 10 years.
- Taxing carried interest partnership income as ordinary income for tax years beginning after December 31, 2013. This proposal is estimated to raise $17.4 billion over 10 years.

The President's budget also identifies several revenue-raising proposals to offset the cost of middle-class tax relief proposals, including imposing a limit on an individual's total accrued balance of tax-preferred retirement accounts and reinstating the estate tax at 2009 levels, with a top rate of 45 percent and a $3.5 million exemption.

Additional revenue-raising proposals

Significant revenue-raising measures in the Administration's FY 2014 budget include the imposition of a financial crisis responsibility fee, which is estimated to raise $49.5 billion over 10 years; the reinstatement of Superfund taxes ($21.1 billion over 10 years); and increased application of payroll taxes with respect to worker classification ($8.7 billion over 10 years).

A listing of selected potential revenue-raising proposals is provided in Appendix F.

Global tax scrutiny

Austerity measures implemented in many countries in response to the 2007-2009 global financial crisis have placed a spotlight on tax obligations and enforcement. Non-governmental organizations (NGOs) have raised issues related to tax fairness and 'tax morality,' and several governments have held public hearings on issues related to aggressive tax avoidance and tax planning that may result in 'double non-taxation.' These developments have led to a focus by G8 and G20 countries on addressing tax avoidance.

OECD BEPS report and action plan

In response to these concerns and with political support from G8 and G20 countries, the OECD issued a February 2013 report, *Addressing Base Erosion and Profit Shifting*, which provides a comprehensive evaluation of existing international tax rules. The February report describes recent changes in the economy and the impact they have had on global business models, as well as the influence of tax competition on corporate taxation.

The report provides an overview of key principles underlying the taxation of cross-border activities, as well as the opportunities for BEPS under current tax rules. The report also analyses several tax structures that the OECD views as presenting opportunities for BEPS, even though they are in compliance with existing laws. In addition, the report notes the need to address the balance between source and residence taxation.

The OECD identified six key areas to be addressed:

- International mismatches in entity and instrument characterization, including hybrid mismatch arrangements and arbitrage
- Application of treaty concepts to profits derived from the delivery of digital goods and services
- The tax treatment of related-party debt-financing, captive insurance, and other intra-group financial transactions
- Transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents
- The effectiveness of anti-avoidance measures, including General Anti-Avoidance Rules (GAARs), CFC regimes, thin capitalization rules, and rules to prevent tax treaty abuse
- The availability of harmful preferential regimes.

The resulting OECD Action Plan on Base Erosion and Profit Shifting (Action Plan), which was released in July 2013, includes 15 workstreams to address the issues described in the February BEPS Report. The Action Plan notes the many ways in which globalization has benefited national economies, but also asserts that acceptable tax planning to minimize tax burdens under the existing rules nonetheless have harmed governments, individual taxpayers, and domestic businesses.

The Action Plan notes that the digital economy (which is not defined) poses particularly challenging issues for international taxation, and that there are fundamental questions regarding how enterprises add value in the digital economy. The plan makes repeated references to determining the jurisdiction where value is created. The Action Plan also refers to 'frictions' caused by the interaction of different tax systems as leading to potential double taxation, but makes clear that the gaps that lead to corporate income being not taxed at all or only 'unduly lowly taxed' are the more serious problem.

The need for consensus is stressed, without which there is a danger of countries enacting unilateral measures "which could lead to global tax chaos marked by the massive re-emergence of double taxation." In contrast to the February BEPS Report, the Action Plan disclaims any intent to alter the balance between source and residence taxation. The stated goal of the Action Plan is to "better align rights to tax with economic activity." The Action Plan does not contemplate incremental changes, but rather makes reference to fundamental changes and new international standards.

What's next for BEPS?

The OECD will continue its consensus-based approach in conducting the BEPS work and has invited G20 countries that are not OECD members (Argentina, Brazil, China, India, Indonesia, Russia, Saudi Arabia, and South Africa) to participate in the project. The technical work will be done by the subsidiary bodies of the Committee on Fiscal Affairs. Consultation with non-governmental representatives also is contemplated.

Since the Action Plan was released in July, stakeholders have questioned whether the proposed two-year time frame for fundamental revision of existing international tax standards is realistic, but a December 2013 OECD press release reconfirmed that the OECD intends to stick to that goal. A calendar included with the release provides estimated time frames for when drafts will be issued on several major topics, deadlines for providing comments, and when public consultations will be held.

Discussion drafts on the digital economy, hybrid mismatch arrangements, and tax treaty abuse are set to be released in March 2014, with a very short 30-day deadline for comments.

Tax transparency

Along with substantive changes to tax rules to address BEPS, the OECD Action Plan proposes increased transparency and disclosure requirements. Greater transparency is expected to have a prophylactic effect in combating BEPS, both by enabling better risk assessment to allow tax authorities to more effectively use their resources and by moderating 'aggressive' tax planning by multinationals.

Various initiatives around the world also focus on greater transparency related to tax issues. For example, in June 2013 the G8 agreed to a number of specific commitments around tax and transparency, including commitments to establish the automatic exchange of information between tax authorities as the new global standard, to create a common template for multinationals to report to tax authorities where they make their profits and pay their taxes across the world (so-called 'country-by-country reporting'), and to publish national Action Plans to make information on who really owns and profits from companies and trusts (beneficial ownership information) available to tax collection and law enforcement agencies. Stakeholders have responded that such proposals appear not to take into consideration the cost, complexity, relevance, usefulness, and potential for misuse of the information potentially subject to disclosure.

The draft on transfer pricing documentation and the template for country-by-country reporting are scheduled to be released in February 2014, with only 21 days for comments. Public consultations on those topics are planned for March and April.

Other initiatives

In addition to the OECD work on BEPS, other projects have been initiated to address similar issues, including:

- An EU Action Plan on Tax Evasion and Avoidance
- A French Report on Taxation of the Digital Economy
- A Brazil, Russia, India, and China (BRIC) Communique on Prevention of Cross Border Tax Evasion and Avoidance
- An Australian Specialist Reference Group on Taxation of Multinational Entities (MNEs).

Some government officials have conducted public hearings criticizing the tax planning of large multinationals to reduce their corporate tax liability in an effort to build support for stricter tax rules.

In the United States, the Senate Permanent Subcommittee on Investigations (PSI) conducted hearings on offshore profit shifting in September 2012 and May 2013 that resulted in calls for strengthening transfer pricing rules regarding migration of intangibles, reforming the check-the-box and CFC look-through rules, and stricter enforcement of the same country and manufacturing exceptions to subpart F.

In the United Kingdom, the Public Accounts Committee (PAC) conducted public hearings and issued reports regarding the tax planning of several US multinationals and the role of public accounting firms in such planning. The PAC concluded that there is not a clear distinction between acceptable tax planning and aggressive tax avoidance, the tax laws are out of date and need revision, greater transparency regarding tax planning by multinationals would increase pressure for them to pay their 'fair share' of tax, and Her Majesty's Revenue & Customs (HMRC) is not able to defend the public interest effectively when its resources are more limited than those of the large accounting firms.

Risk of double taxation

As the BEPS Action Plan noted, coordinated action and consensus on tax reforms are needed to avoid the danger of unilateral measures and the threat of double taxation, which could impede cross-border trade and investment. That danger has become real, as countries are not waiting for the OECD to complete its work and instead have used the attention generated by the OECD's work as a justification to propose unilateral measures to protect their tax bases.

For example, Mexico in late 2013 enacted tax reform legislation that includes several provisions to combat base erosion:

- No deduction for certain related-party payments when the recipient (1) is a transparent entity whose owners are not subject to tax in its jurisdiction, (2) considers the payment to be disregarded, or (3) does not include the payment as part of its taxable income under its jurisdiction's rules.
- No deduction of payments that also are deducted abroad, unless the corresponding income is included in the related entity's taxable income in the same or a subsequent tax year.
- Gives the Mexican tax authorities the ability to require that the foreign related party provide a sworn statement that the item of income for which a treaty benefit is claimed would otherwise be subject to double taxation.
- New 10-percent withholding tax on dividends.

Similar proposals have emerged in several other countries, reflecting themes outlined in the BEPS Action Plan. Correspondingly, concepts from the Action Plan also are being used to justify aggressive positions by tax authorities in audits that appear to deviate from historic international tax principles.

The emerging lack of uniformity on critical issues and concepts may result in a surge in cross-border disputes and consequent increase in the incidence of double taxation. As such, it will be important to enhance dispute resolution mechanisms as part of the process.

Although the changes that may grow out of the BEPS project and related initiatives are uncertain at this point, BEPS will continue to be a high priority for the OECD and other international organizations, the Administration, Congress, and governments around the world.

Healthcare

The 2014 calendar year brings the rollout of a number of key provisions, taxes, and fees under the Affordable Care Act (ACA).

Major ACA provisions begin in 2014

Some of the ACA's most important provisions for health insurance come into effect in 2014. These include the new health insurance exchanges and the expansion of Medicaid. The roll-out of the health care exchanges has been widely criticized as an administrative debacle, and the expansion of Medicaid has been rejected in many states with Republican governors. Despite these implementation issues, 2.1 million people had signed up for coverage through the exchanges and 3.9 million people had been found eligible for Medicaid, as of December 28, 2013.

This year also marks the start of the guaranteed issue and renewal of insurance provisions, the prohibition of annual coverage limits, premium and cost-sharing subsidies for lower income individuals and families purchasing plans in the individual exchange markets, and rate banding in the individual and small group markets such that insurance premiums can vary only by age, tobacco use, geographic location, and the composition of family members being covered by the plan.

In addition, 2014 is the first year for the individual mandate, which requires US citizens and legal residents to have insurance that meets the minimum standards defined under the ACA. Individuals that do not have qualifying insurance generally will be subject to a penalty. In 2014, the penalty is the greater of $95 for adults and $47.50 for children or one percent of family income.

Employers are impacted in 2014 despite mandate delay

The employer mandate—a requirement for employers with more than 50 full-time equivalent (FTE) workers to offer health insurance—has been delayed until January 1, 2015. Employers, however, still will be affected by changes in 2014, and some employers may choose to make changes now rather than wait for the mandate to come into effect.

With the individual mandate effective in 2014, many employees who previously have not signed up for insurance through their employer are expected to do so. Conversely, some firms (primarily small firms and firms with lower-wage workers) may decide to stop offering insurance; their employees would have to purchase plans in the ACA exchange markets or through Medicaid.

Legislative outlook

With the ACA's insurance expansion now in place, Congressional Republicans may seek more targeted reforms instead of focusing solely on repeal. For example, this focus may shift to health reform proposals that include medical malpractice reform, allowing insurance to be sold across state lines, and expanding tax-exempt health savings accounts.

In addition, Rep. Paul Ryan is reported to be preparing an alternative health insurance plan for release early in 2014. The plan is said to be similar to the Patients' Choice Act (PCA), first introduced by Ryan and Senator Tom Coburn (R-OK) in 2009.

The PCA utilized the repeal of the tax exemption on employer-sponsored health insurance to fund health insurance tax credits for individuals and families. The PCA included many consumer protections similar to those in the ACA, such as prohibiting exclusions for pre-existing conditions, requiring insurance to meet minimum coverage standards, and establishing state-based health insurance exchanges. Unlike the ACA, the PCA did not penalize individuals for failing to have health insurance, but did feature automatic insurance enrollment unless beneficiaries opted out.

With Democrats controlling the White House and the Senate, Republican alternatives to the ACA will continue to face a steep up-hill battle for the rest of the year.

Some changes to the ACA with bipartisan support may be more successful. For example, efforts to repeal the ACA's excise tax on medical devices continues to attract bipartisan support. However, targeted changes in some instances can cause broader difficulties as one modification can impact the larger whole. For instance, repealing the ACA's individual mandate while leaving the prohibition on exclusions for pre-existing conditions and the guaranteed issue provision intact could cause insurance premiums to increase significantly, causing fewer people to sign up for insurance.

IRS Commissioner John Koskinen

The Senate on December 20 voted 59 to 36 to confirm John A. Koskinen to be Commissioner of Internal Revenue for a term expiring November 12, 2017. In confirmation hearings before the Senate Finance Committee, the 74-year old Koskinen stated that he "signed on to this challenge because I have had a longstanding commitment to public service and most of my career has been spent helping large organizations respond to significant financial and management challenges."

After beginning his career in government, Koskinen spent many years in the private sector leading an organization that helped turn around distressed businesses. Koskinen was Chairman of the Board of Freddie Mac following the 2007 financial market crisis. He previously served during the Clinton Administration as Deputy Director for Management at the OMB and later led the government's Y2K transition.

IRS under pressure

The IRS in 2013 was an agency under siege, facing allegations that politically conservative groups had been inappropriately targeted for extra scrutiny in connection with Section 501(c)(4) tax-exempt applications. Acting Commissioner Stephen Miller resigned, and Dan Werfel, a former Obama Administration White House Office of Management and Budget (OMB) official, was temporarily appointed as Acting Commissioner.

John Koskinen was sworn in as IRS Commissioner on December 20, 2013, shortly after being confirmed by the Senate. Commissioner Koskinen takes over an agency that likely will continue to be the subject of Congressional oversight hearings and investigations and to face low employee morale, a situation with which Koskinen is familiar from his time at Freddie Mac following the 2007 financial market crisis. Much of the senior leadership at the IRS has changed, leaving relatively few seasoned executives with significant institutional knowledge.

As the agency struggles to regain the confidence of the American people and members of Congress, resources and funding will be a critical agency management issue in 2014. Already suffering the effects of budget cuts and sequestration, the FY 2014 spending bill recently approved by Congress reduced the agency's budget to $11.3 billion, a $526 million, or 4.6 percent, decease compared to the previous year's funding level.

The impact of resource constraints already is being felt in IRS audits. For a number of years the agency has contemplated shifting resources away from the largest corporations toward middle-market taxpayers and passthrough entities, but the allocation of resources now has become a critical issue. The IRS is considering doing away with the Coordinated Industry Case (CIC) designation for the largest taxpayers and discontinuing continuous audits – relying largely on Schedule UTP to identify issues – and then allocating appropriate resources to conduct targeted issue-specific audits on the largest corporate taxpayers.

In addition, the agency has taken steps to streamline audits through more efficient information document request (IDR) procedures and enforcement mechanisms. Taxpayers will be expected to collaborate with their examination teams to produce issue-specific IDRs that can be responded to within an agreed upon and somewhat compressed timeframe or else face possible summons enforcement.

Steps also are being taken to improve the efficiency of the Appeals process, which has been plagued by significant backlogs in recent years. Appeals officers are being instructed to return to a more quasi-judicial approach to cases and not engage in fact-finding at the Appeals level. Both taxpayers and exam teams will continue to be encouraged to use a variety of alternative dispute resolution vehicles to resolve issues at the earliest point possible.

Finally, the prospect of increased involvement of IRS counsel in the IDR process has caused some to question whether this could affect the timely issuance of guidance by the agency, as resources may be diverted from regulation and ruling projects to specific taxpayer disputes.

Recent cases illustrate uncertainty in judicial doctrines

While the economic substance doctrine codified in 2010 remains largely untested, several decisions in the federal courts in 2013 added to the continuing uncertainty with respect to the application of the economic substance doctrine and related judicial doctrines. These cases, which involve transactions entered into by taxpayers in the 1990s and early 2000s, evidence expanded application of various judicial doctrines to disallow benefits associated with transactions considered 'too aggressive' by the courts. Although the cases do not involve the codified economic substance doctrine, they demonstrate the willingness of the courts to employ various doctrines to deny anticipated tax benefits.

Two recent decisions involving similarly structured FTC transactions (commonly known as STARS transactions) demonstrate the uncertainty regarding the economic substance doctrine. In *Bank of New York Mellon v. Commissioner*, the Tax Court determined foreign taxes are economic costs to be taken into account in evaluating pre-tax profit potential for purposes of the economic substance analysis. In *Santander Holdings USA, Inc. v. Commissioner*, the US District Court of Massachusetts concluded a counterparty payment was not a rebate and the amount was properly included for purposes of determining whether the taxpayer had a reasonable prospect of a pre-tax profit under the economic substance doctrine. Such conflicts increase uncertainty when evaluating the potential for pre-tax profit with respect to prospective transactions.

Two decisions applying the substance-over-form doctrine also send mixed messages. In *John Hancock Life Insurance Company v. Commissioner*, while the taxpayer respected the form of lease transactions, the Tax Court denied the tax benefit, concluding the substance of the transactions was more akin to financial and loan arrangements. In contrast, in *Barnes Group, Inc. v. Commissioner*, the Tax Court, applying the same doctrine, evaluated the extent to which the taxpayer followed the form of the plan. Finding the taxpayer failed to respect the form of its plan, the court concluded the taxpayers failed to have a valid business purpose.

These and other cases reveal a common theme–tax transactions deemed aggressive by the courts are not being respected. The disparate nature of the decisions, however, provides little guidance to taxpayers on the acceptable boundaries of legitimate tax planning under the codified economic substance doctrine.

State tax legislation

Several bills affecting state and local taxation were reintroduced in 2013 but have not been enacted. These key issues may be considered again in 2014.

Marketplace Fairness Act

States continue to await Congressional action to address collection of sales tax by out-of-state retailers. On May 6, 2013, the Senate passed the Marketplace Fairness Act (S. 743), which provides that full member states under the Streamlined Sales and Use Tax Agreement and non-member states that meet certain minimum simplification requirements may require remote sales tax collection. The bill was referred to the House Judiciary Committee, and on September 18, 2013, Judiciary Chairman Bob Goodlatte (R-VA) released a statement of seven principles intended to guide discussion and generate solutions to the issues surrounding sales tax collection by remote sellers. A number of states passed legislation in 2013 requiring simplification of their sales and use taxes if Congress enacts the Marketplace Fairness Act or similar legislation.

Rejecting without comment two cases challenging a New York online sales tax law that expands the concept of physical presence, the US Supreme Court on December 2, 2013, denied certiorari in *Amazon.com v. New York State Department of Revenue* and *Overstock.com v. New York State Department of Revenue*. This action may increase interest by Congress in addressing this issue.

Mobile Workforce State Income Tax Simplification Act

Legislation intended to provide administrative simplification and aid compliance with respect to nonresident income tax liability and employer withholding was introduced in the House by Rep. Howard Coble (R-PA) (H.R. 1129), and in the Senate by Finance Committee member Sherrod Brown (D-OH) (S. 1645). These bills would implement a 30-day threshold for both the state taxation of nonresident employees' income and for the employer's requirement to withhold state taxes on nonresident employees' wages. H.R. 1129 has been referred to the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law. S. 1645 has been referred to the Senate Finance Committee. The House in the last Congress approved an earlier version of the Mobile Workforce State Income Tax Simplification Act. Senator Brown also introduced an earlier version of this legislation in the last Congress.

Business Activity Simplification Act

H.R. 2992, introduced on August 2, 2013 by Rep. James Sensenbrenner (R-WI), would expand Public Law 86-272 protection, codify a physical presence nexus standard, and require that apportionment provisions follow the *Joyce* standard, effective for tax periods beginning on or after January 1, 2014.

Under Public Law 86-272, no state may impose a net income tax on a person whose only activities within the state are the solicitation of orders for tangible personal property and those orders are sent outside of the state for approval and filled by delivery from outside the state. Under the *Joyce* standard, each member of a unitary group stands alone in the determination of the sales factor numerator. Under this rule, a state is precluded from including in the numerator of the sales factor sales made by a member of a unitary group where the member itself does not independently have nexus in the state.

Digital Goods and Services Tax Fairness Act

This bill is intended to prevent discriminatory and duplicative taxes on digital goods and services.

CBO in September 2012 estimated that the cost of implementing a 2011 version of this legislation, in terms of foregone revenue to state and local governments, would total more than $3 billion in the first full year of enactment.

On July 25, 2013, Senator Wyden introduced a revamped digital goods bill (S. 1364) that defined a digital transaction and clarified the jurisdiction that has the right to tax it. S. 1364 has been referred to the Finance Committee. A similar bill (H.R. 3724) was introduced on December 12, 2013 by Rep. Lamar Smith (R-TX). H.R. 3724 has been referred to the House Judiciary Committee.

Organizations representing state and local governments have opposed the legislation.

Wireless Tax Fairness Act

H.R. 2309, introduced on June 11, 2013 by Rep. Zoe Lofgren (D-CA), has more than 200 cosponsors. The legislation would place a five-year moratorium on any new state or local discriminatory taxes or fees on wireless services. A discriminatory tax is defined as one that is imposed on mobile services that generally is not imposed on, or is imposed at a lower rate than, other services involving tangible personal property or persons engaged in businesses other than mobile services. H.R. 2309 has been referred to the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law. A companion Senate bill (S. 1235) was introduced by Senator Wyden on June 26, 2013, and referred to the Finance Committee.

Internet Tax Freedom Act

A number of bills (H.R. 434, H.R. 3086, S. 31, and S. 1431) have been introduced to make permanent the moratorium on state and local governments taxing internet access or imposing discriminatory taxes on electronic commerce. The original legislation has been extended three times and will expire November 1, 2014. The legislation has taken on greater significance because of a recent Illinois Supreme Court ruling that the current federal moratorium pre-empted that state's 'click thru' nexus law.

H.R. 434 was introduced by Rep. Steve Chabot (R-OH), and H.R. 3086 was introduced by House Judiciary Chairman Goodlatte; both bills have been referred to the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law. S. 31 was introduced by Senator Kelly Ayotte (R-NH), and S. 1431 was introduced by Senator Wyden; both bills have been referred to the Senate Finance Committee.

Tax treaties and other international agreements

No new US treaties or protocols have entered into force since 2010. In June 2011, the Senate Foreign Relations Committee approved proposed tax agreements with Hungary, Switzerland, and Luxembourg. However, because Senator Rand Paul (R-KY) subsequently placed a 'hold' on Senate floor consideration of the three pacts, all three were returned to the Foreign Relations Committee for reconsideration at the end of the last Congress, and there has been no further action by the Foreign Relations Committee. The US-Chile treaty was sent to the US Senate for approval in May 2012, and several other treaties and protocols have been signed since then. The timing for consideration and ratification of these agreements remains uncertain due to the ongoing objections raised by Senator Paul about information-sharing agreements that generally are part of all new US tax treaties.

Note: It has been widely reported that the United States and Switzerland have agreed to return to the negotiating table; however, it is not expected that formal negotiations will take place prior to the entry into force of the pending protocol. Although details have not been made public, it is expected that among the items to be discussed are possible elimination of tax on certain parent/subsidiary dividends and a potential revision to the limitation of benefits (LOB) article to be more in line with recent US tax treaties that have tightened the requirements for eligibility.

Recently negotiated tax treaties

Poland treaty—On February 13, 2013, the United States and Poland signed a new income tax treaty that would replace the 1974 income tax treaty. As expected, the new treaty includes a modern LOB article. Unlike other recent treaties, the pending US-Poland treaty does not eliminate source-state taxation on intercompany dividends, certain types of interest, or royalties.

Japan protocol—On January 24, 2013, Treasury announced that a new protocol to the 2003 US-Japan treaty had been signed, which is intended to bring the treaty into closer conformity with the current tax treaty policies of the two countries. The existing treaty provides for elimination of tax on certain parent/subsidiary dividends; the protocol expands the category of direct dividends eligible for exclusive residence-state taxation. The protocol eliminates source-state tax in certain circumstances. The protocol amends the treatment of capital gains in a way that more closely aligns with the US domestic law provisions related to the taxation of foreign investment in US real property (FIRPTA). In addition, the protocol provides for mandatory binding arbitration, provisions to enable the competent authorities to assist each other in the collection of taxes, and full exchange of information between competent authorities.

Spain protocol—On January 14, 2013, Treasury announced that a new protocol and memorandum of understanding related to the 1990 US-Spain treaty had been signed. The new protocol is intended to modernize the existing treaty and bring it into closer conformity with the two countries' current tax treaty policies. The new protocol provides for exclusive residence-state taxation of interest, royalties, certain parent/subsidiary dividends, and most capital gains. This is a significant revision compared to the existing treaty, which did not provide for an exemption from source-state tax on interest or royalty income. The protocol also adds Spain to the growing list of US treaties that permit exemption from source-state tax on parent/subsidiary dividends, provided certain requirements are met. Consistent with certain other recent US tax treaties, the new protocol contains a mandatory binding arbitration provision. The new protocol includes an updated LOB article with some significant changes, and an updated exchange of information article.

Other treaties

It was reported in January 2013 that the United States and the United Kingdom have reached an agreement on revisions to the US-UK treaty, and that there are ongoing negotiations between the United States and Vietnam. In November 2012, a Treasury official reported that discussions are underway with Romania, one of the few remaining jurisdictions with which the United States has a treaty that does not contain an LOB article. It has been reported that negotiations with Brazil and Colombia are underway. Discussions with Israel continue, although agreement does not appear imminent. There has been correspondence with South Korea, but negotiations are not anticipated in the near term. Discussions are underway with Venezuela and the Netherlands Antilles, and early discussions are underway with Malaysia. Treasury has not yet concluded that it should pursue a treaty with Singapore or Hong Kong despite strong support from the business community for such treaties.

New US Model Treaty, other guidance

Treasury has announced that it is planning to publish a new model treaty that would supersede the existing US Model Treaty published in 2006. Public comments by a Treasury official in January 2013 indicate that a revised discretionary grant of benefits provision within the LOB article, such as the one included in the recent protocol to the US-Spain treaty, is being considered for inclusion in the next US model treaty.

The 2013-2014 Treasury-IRS Priority Guidance Plan again includes a project to provide guidance under Section 894 on issues under income tax treaties, including the application of various treaty provisions to payments through hybrid entities.

The 2013-2014 Plan also includes a project to provide guidance updating Rev. Proc. 2006-54 on procedures for taxpayers requesting Competent Authority assistance under tax treaties. Notice 2013-78, which was issued in November 2013, provides for public comment on a proposed revision to the procedures for requesting assistance from the US Competent Authority under the provisions of an income, estate, or gift tax treaty to which the United States is a party. According to the notice, the proposed revenue procedure would substantially restate Rev. Proc. 2006-54 to improve clarity, readability, and organization and would reflect structural changes undertaken by the IRS since 2006. It is also intended to effect a limited number of significant substantive changes.

Trends in US tax treaty policy

The United States is expected to continue to strive in its treaties for effective protection against 'treaty shopping.' Other priorities include strong exchange of information commitments, modernization of the treatment of cross-border retirement plans, and changes to the personal services articles of treaties (mainly, the policy of eliminating the independent personal services article as being redundant of the business profits article). In addition, Treasury likely will continue its recent policy of including binding arbitration as a means of deciding Competent Authority cases that otherwise are unresolved.

Competent Authority agreements

During 2013, the United States reached two Competent Authority agreements with Norway and one with Belgium. The January 31, 2013 agreement with Norway addresses the circumstances under which an item of income paid to an entity that is fiscally transparent under the tax laws of either jurisdiction will be seen as received by a resident of one of the two countries. The February 11, 2013 agreement with Norway clarifies, for purposes of paragraph 3 of Article 4A (Offshore Activities), when a resident of a state that operates tugboats and similar vessels in the other state in connection with offshore activities will be exempt from tax in that other state. The July 16, 2013 agreement with Belgium relates to the application of the business profits article of the treaty, and refers to the OECD transfer pricing guidelines and the 'authorized OECD approach' for purposes of determining the business profits attributable to a permanent establishment (PE).

FATCA Intergovernmental agreements

On January 17, 2013, Treasury and the IRS issued comprehensive final regulations implementing the information reporting and withholding tax provisions commonly known as the Foreign Account Tax Compliance Act (FATCA). Enacted by Congress in 2010, these provisions target non-compliance by US taxpayers using foreign accounts. The issuance of the final regulations marked a key step in establishing a common intergovernmental approach. The final regulations provide for a phased-in approach to the implementation of the FATCA requirements, between 2014 and 2017.

Treasury has collaborated with foreign governments to develop two alternative model intergovernmental agreements to facilitate implementation of FATCA. As outlined in Notice 2013-43, Treasury released the model agreements, under which reporting foreign financial institutions (FFIs) would satisfy their FATCA requirements by reporting information about US accounts to their respective tax authorities, followed by the automatic exchange of that information on a government-to-government basis with the United States (Model 1), or FFIs would report specified information directly to the IRS in a manner consistent with the final regulations, supplemented by government-to-government exchange of information on request (Model 2). Treasury has concluded several bilateral intergovernmental agreements (IGAs) on the basis of the model agreements.

According to Notice 2013-43, a jurisdiction will be treated as having in effect an IGA if the jurisdiction is so listed on the Treasury website. In general, Treasury intends to include on this list jurisdictions that have signed but have not yet brought into force an IGA. A jurisdiction may be removed from the list if the jurisdiction fails to perform the steps necessary to bring the IGA into force within a reasonable period of time.

In 2013, agreements were reached under Model 1 with the Cayman Islands, Costa Rica, France, Germany, Guernsey, Ireland, the Isle of Man, Jersey, Malta, the Netherlands, Norway, and Spain (adding to the list that already included Denmark, Mexico, and the United Kingdom, which reached agreements with the United States in 2012), and under Model 2 with Bermuda, Japan, and Switzerland. On January 10, 2014, the Treasury Department announced it had signed an IGA with Italy based on Model 1. To date, as reported by the Treasury, in addition to these 18 IGAs, the United States has 11 agreements in substance, and is engaged in related discussions with many other jurisdictions.

Trade and tariff legislation

Trade Promotion Authority

Congress may address the renewal of Trade Promotion Authority (TPA) in early 2014. TPA, which expired in 2007, has been renewed and amended multiple times since it originally was enacted in 1974. Also known as fast-track trade negotiating authority, TPA gives the President authority to negotiate comprehensive reciprocal free trade agreements with major trading partners and to have those agreements considered under an expedited Congressional legislative process that allows for only limited debate (i.e., no filibuster), and an up-or-down vote once all debate time has expired.

The Obama Administration would like the Congress to renew TPA as the Administration seeks to negotiate regional trade agreements with countries in Asia and Europe. On January 9, 2014, House Ways and Means Committee Chairman Camp, Senate Finance Committee Chairman Baucus, and Finance Committee Ranking Member Hatch introduced bipartisan, bicameral legislation (H.R. 3830, S. 1900) to renew TPA to negotiate trade agreements, subject to certain conditions that include Congressional consultation and access to information. However, 23 House Republicans have said that they oppose TPA renewal, and two-thirds of House Democrats have said that they are not inclined to vote for TPA renewal unless it gives them broad oversight and authority over trade negotiations.

Ways and Means Ranking Member Sander Levin is working with the House Trade Working Group, an informal group of House members led by Rep. Michael Michaud (D-ME), on a separate TPA process that would expand Congressional consultation in this area and ensure that all Congressional committees are briefed on aspects of trade negotiations that are within their jurisdictions. The Levin-Michaud approach would allow Congress to overturn the fast track process if lawmakers do not want to accept particular free trade agreement. The House Trade Working Group includes a number of Democrats and one Republican, Rep. Walter Jones of North Carolina.

Trans-Pacific Partnership

Trade ministers from the United States, Japan, and 10 other countries met in Singapore in early December in the hopes of finalizing negotiations of a Trans-Pacific Partnership (TPP) free trade agreement by the end of 2013. TPP is intended to reduce and eliminate tariffs and non-tariff barriers to create a comprehensive and high standard free trade agreement. If successful, TPP could advance a wider Asia-Pacific free trade area as well as serve as a US policy response to the rapidly increasing economic and strategic linkages among the Asian-Pacific states. It is expected to cover almost 40 percent of global gross domestic product and over 25 percent of world trade.

Although Congress may consider TPP in 2014, it almost certainly would require a renewed TPA authority to be in place to govern consideration. This linkage was made more explicit when two-thirds of House Democrats said they would oppose TPP absent a new TPA that increases Congressional consultation and oversight in trade negotiations.

Transatlantic Trade and Investment Partnership

In February 2013, the United States and the EU announced plans to launch negotiations for a comprehensive Transatlantic Trade and Investment Partnership (TTIP). In March 2013, the Obama Administration formally notified Congress of its intention to negotiate with the EU on TTIP. The EU is initiating its own internal procedures necessary to launch the TTIP negotiation.

Issues in the negotiation of TTIP could include tariff reduction and elimination, regulatory compatibility and standards, improved market access for services, investment protection, enhanced government procurement opportunities, intellectual property rights protection and enforcement, and greater agricultural market access. Other issues to be addressed could include trade facilitation, state-owned enterprises, digital trade, and supply chains.

EU-US trade relations are likely to be among the key policy issues confronting Congress in 2014. Congress could examine the impact of greater transatlantic trade liberalization on US economic growth, the future of US trade policy and other trade agreements, efforts to promote solutions to third countries issues, and trade liberalization through multilateral negotiations.

As with the TPP agreement, it is unlikely that any TTIP agreement would be considered by Congress absent a renewal of TPA.

Miscellaneous Tariff Bill

On July 17, 2013, Ways and Means Chairman Camp, Ranking Member Levin, Trade Subcommittee Chairman Devin Nunes (R-CA), and Trade Subcommittee Ranking Member Charles Rangel (D-NY) introduced the US Job Creation and Manufacturing Competitiveness Act of 2013 (H.R. 2708), which would amend the Harmonized Tariff Schedule of the United States to suspend or reduce temporarily certain duty rates on specified chemicals and other items. The legislation also would extend through December 31, 2015 certain existing duty suspensions, reductions, and other modification for specified chemicals, food, and other items.

The introduction of the legislation, which includes provisions from more than 2,000 bills introduced by individual members of Congress during the miscellaneous tariff bill (MTB) process, is intended to set the stage for moving the MTB forward in the 113th Congress. The bill would provide temporary tax relief to help US manufacturers better compete, expand, and create jobs by lowering the cost of manufacturing inputs and some finished products not made or available in the United States.

Passage of any miscellaneous tariff bill has been complicated for several years by concerns that such bills are in fact ‘earmarks’ and violate a Congressional earmark ban. This remains a stumbling block in the path of successful enactment of any targeted tariff relief measure.

Other trade-related legislation

On November 13, 2013, House Rules Committee Ranking Member Louise Slaughter (D-NY) introduced the Reciprocal Market Access Act of 2013 (H.R. 3467), which would instruct US negotiators to eliminate foreign trade barriers before reducing US tariffs. The legislation also would allow tariffs to be reinstated if a trading partner does not live up to its commitments to remove a trade barrier. In addition, the bill would instruct the US International Trade Commission to conduct an assessment of the impact of any proposed free trade agreements on US market opportunities and barriers for products and services.

WTO Doha Round

The World Trade Organization (WTO) Doha Round is the latest round of multilateral trade negotiations among the WTO countries. Officially launched in November 2001, the Doha Round’s aim is to achieve major reform of the international trading system through the introduction of lower trade barriers and revised trade rules.

The Doha Round has been characterized by persistent differences among the United States, the EU, and advanced developing nations on major issues, such as agriculture, industrial tariff and nontariff barriers, services, and trade remedies. Developing countries have sought to reduce agriculture tariffs and subsidies among developed countries, enhance non-reciprocal market access for manufacturing sectors, and increase protection for their services industries. Developed countries have sought to increase access to developing countries’ industrial and services sectors, while attempting to retain some measure of protection of their agricultural sectors. Given these differences, WTO members have not been able to reach a comprehensive Doha Round agreement.

In December 2013, WTO members at the WTO ministerial in Bali, Indonesia adopted an ambitious package of trade liberalization measures. Expectations ahead of the Bali meeting had been low, but member countries reached a trade facilitation agreement that the International Chamber of Commerce estimates could add 21 million jobs to the global economy. In addition, the OECD estimates that such an agreement will reduce trade costs by 10 percent in advanced economies and up to 15.5 percent in developing countries, translating into hundreds of billions of dollars in global savings.

What this means for your business

Divided government–as well as disagreements between Republicans and Democrats in Washington over the roles of increased revenues and spending cuts as part of the budget and debt ceiling–will be a challenge for tax reform and other significant tax legislation this year. Meanwhile, the enhanced focus on global tax avoidance could result in a wave of unilateral governmental action that significantly increases the risk of double taxation and a proliferation of cross border disputes.

Despite the slowdown in advancing tax reform, it remains important for companies to stay engaged in the legislative process, as decisions made this year could directly impact continuing tax reform efforts and potential corporate tax increases. Providing feedback on tax reform proposals and discussion drafts can give business leaders an active voice in shaping tax legislation in 2014 and beyond.

Businesses also will need to watch carefully the actions of international organizations, such as the OECD. The OECD has committed to an aggressive timeframe for revising international tax standards. With discussion drafts on key topics such as transfer pricing documentation, country-by-country reporting, the digital economy, hybrid mismatch arrangements, and tax treaty abuse expected from the OECD early in the year, multinational companies will have a short window of opportunity for providing comments.

Constructive business input on the OECD BEPS Action Plan is needed to ensure that any measures developed are workable in practice. Taxpayers should monitor the progress of the OECD workstreams, proactively perform internal risk assessments of existing and planned structures, and engage with policymakers to explain the potential impact of these changes on business, including the need for enhanced dispute resolution mechanisms as part of the process.

Appendix A: Congressional budget process

Congressional hearings on the President's annual budget proposals typically take place in February and March, after which Congress generally adopts a budget plan ('budget resolution') that provides an overall framework for consideration of subsequent tax and spending legislation for the budget period.

The Obama Administration is required to submit a proposed federal budget for FY 2015 by the statutory due date of the first Monday in February (February 3, 2014), but there is no penalty for submitting a budget beyond this deadline. Last year, the White House delayed submitting a budget to Congress until April 10, 2013.

The statutory deadline for Congress to pass a budget resolution is April 15, but there also is no penalty for missing this date and it has slipped often in the past. Because a budget resolution binds only Congress, it does not require the President's approval.

Both the House and Senate passed a budget resolution last year. While a 29-member budget conference committee of House and Senate members was convened, the budget agreement principally negotiated by House Budget Chairman Ryan and Senate Budget Committee Chairman Murray bypassed the budget conferees and was introduced as the Bipartisan Budget Act of 2013 and enacted on December 28, 2013. As discussed above, the Bipartisan Budget Act set spending levels for FY 2014 and FY 2015, but Congress may revisit spending and revenue levels for FY 2015 when considering new budget resolutions this year.

Budget reconciliation process

The budget reconciliation process is designed to facilitate consideration of deficit reduction legislation that otherwise would face filibusters or other procedural delays. Reconciliation bills receive expedited consideration and have special procedural protections that facilitate passage. This is especially true in the Senate, where reconciliation bills cannot be filibustered and require a simple majority to pass.

Under Senate rules, there are a number of limitations on the use of budget reconciliation. The Senate, in May 2007, adopted a rule barring the use of reconciliation in a manner that would increase the deficit or reduce a surplus. This rule can be waived only with a 60-vote supermajority. Another rule requires a 60-vote supermajority to approve provisions that lose revenue beyond the 10-year budget window. The 2001 and 2003 tax rate reductions were enacted using budget reconciliation, and thus were subject to this rule requiring the tax cuts to 'sunset' at the end of the budget period. The Senate in 2007 approved a rule change preventing the use of budget reconciliation for net tax relief.

Note: The Taxpayer Relief Act of 2012, which was not a reconciliation measure, repealed particular sunset provisions from the 2001 and 2003 Acts.

PAYGO

Congress in 2010 passed a pay-as-you-go law ('PAYGO') generally requiring tax increases or reductions in permanent spending to offset the cost of tax cuts or new mandatory spending programs. Congress can waive the PAYGO law by declaring specific spending or tax reductions to be emergency legislation.

The House has a 'cut-as-you-go' rule that requires any bill that increases mandatory spending to be offset by spending reductions and not by tax increases. The House rule provides an exception for certain measures designated as emergency under the statutory PAYGO Act. The Senate does not have a similar rule.

Appendix B: Tax policymakers

House and Senate leadership in the 113th Congress

House leadership

Speaker of the House	John Boehner (R-OH)
Majority Leader	Eric Cantor (R-VA)
Majority Whip	Kevin McCarthy (R-CA)
Chief Deputy Whip	Peter Roskam (R-IL)
Republican Conference Chair	Cathy McMorris Rodgers (R-WA)
Republican Conference Vice Chair	Lynn Jenkins (R-KS)
Republican Campaign Committee Chair	Greg Walden (R-OR)
Republican Conference Secretary	Virginia Foxx (R-NC)
Republican Policy Committee Chair	James Lankford (R-OK)
Minority Leader	Nancy Pelosi (D-CA)
Minority Whip	Steny Hoyer (D-MD)
Assistant Minority Leader	Jim Clyburn (D-SC)
Democratic Conference Chair	Xavier Becerra (D-CA)
Democratic Conference Vice Chair	Joseph Crowley (D-NY)
Democratic Campaign Committee Chair	Steve Israel (D-NY)
Democratic Steering and Policy Committee Co-chairs	Rosa DeLauro (D-CT) and Rob Andrews (D-NJ)

Senate leadership

President of the Senate	Vice-President Joe Biden (D)
President Pro Tempore	Patrick Leahy (D-VT)
Majority Leader	Harry Reid (D-NV)
Assistant Majority Leader	Richard Durbin (D-IL)
Democratic Conference Vice Chair and Chair of the Democratic Policy Committee	Charles Schumer (D-NY)
Democratic Conference Secretary	Patty Murray (D-WA)
Democratic Senatorial Campaign Committee Chair	Michael Bennet (D-CO)
Chief Deputy Whip	Barbara Boxer (D-CA)
Minority Leader	Mitch McConnell (R-KY)
Assistant Minority Leader	John Cornyn (R-TX)
Republican Conference Chair	John Thune (R-SD)
Republican Conference Vice Chair	Roy Blunt (R-MO)
Republican Senatorial Campaign Committee Chair	Jerry Moran (R-KS)

Tax-writing committee memberships

House Ways and Means Committee

The Ways and Means Committee currently is comprised of 23 Republicans and 16 Democrats.

House Ways and Means Committee members, 113th Congress

Republicans	Democrats
Dave Camp (R-MI), Chairman	Sander Levin (D-MI), Ranking Minority Member
Sam Johnson (R-TX)	Charles Rangel (D-NY)
Kevin Brady (R-TX)	Jim McDermott (D-WA)
Paul Ryan (R-WI)	John Lewis (D-GA)
Devin Nunes (R-CA)	Richard Neal (D-MA)
Patrick Tiberi (R-OH)	Xavier Becerra (D-CA)
Dave Reichert (R-WA)	Lloyd Doggett (D-TX)
Charles Boustany Jr. (R-LA)	Mike Thompson (D-CA)
Peter Roskam (R-IL)	John Larson (D-CT)
Jim Gerlach (R-PA)*	Earl Blumenauer (D-OR)
Tom Price (R-GA)	Ron Kind (D-WI)
Vern Buchanan (R-FL)	Bill Pascrell Jr. (D-NJ)
Adrian Smith (R-NE)	Joe Crowley (D-NY)
Aaron Schock (R-IL)	Allyson Schwartz (D-PA)**
Lynn Jenkins (R-KS)	Danny Davis (D-IL)
Erik Paulsen (R-MN)	Linda Sanchez (D-CA)
Kenny Marchant (R-TX)	
Diane Black (R-TN)	
Tom Reed (R-NY)	
Todd Young (R-IN)	
Mike Kelly (R-PA)	
Tim Griffin (R-AR)*	
Jim Renacci (R-OH)	

** Retiring*
*** Running for Governor*

Senate Finance Committee

The Finance Committee currently is comprised of 13 Democrats and 11 Republicans.

Senate Finance Committee members, 113th Congress

Democrats	Republicans
Max Baucus (D-MT), Chairman**	Orrin Hatch (R-UT), Ranking Minority Member
John Rockefeller IV (D-WV)*	Charles Grassley (R-IA)
Ron Wyden (D-OR)	Mike Crapo (R-ID)
Charles Schumer (D-NY)	Pat Roberts (R-KS)
Debbie Stabenow (D-MI)	Michael Enzi (R-WY)
Maria Cantwell (D-WA)	John Cornyn (R-TX)
Bill Nelson (D-FL)	John Thune (R-SD)
Robert Menendez (D-NJ)	Richard Burr (R-NC)
Thomas Carper (D-DE)	Johnny Isakson (R-GA)
Benjamin Cardin (D-MD)	Rob Portman (R-OH)
Sherrod Brown (D-OH)	Patrick J. Toomey (R-PA)
Michael Bennet (D-CO)	
Robert Casey, Jr. (D-PA)	

** Retiring*
** Nominated to serve as US Ambassador to China*

Key Treasury and other Administration officials

Jack Lew was confirmed by the Senate in February 2013 to serve as Treasury Secretary. Secretary Lew previously served as White House Chief of Staff and OMB Director.

President Obama in September announced that he will appoint Jeffrey Zients, former Deputy and Acting Director of the OMB, to serve as Director of the White House National Economic Council. Zients takes over for Gene Sperling, who had served in the position since 2011. The President also assigned Zients to a temporary position to oversee efforts to fix problems with the healthcare.gov website.

Sylvia Matthews Burwell was confirmed by the Senate in April 2013 as the Director of the OMB. Burwell previously served as President of the Walmart Foundation.

Jason Furman is the Chairman of the Council of Economic Advisers. He was confirmed by the Senate in August 2013. Prior to this role, Furman served as Assistant to the President for Economic Policy and the Principal Deputy Director of the National Economic Council.

Mark Mazur is Treasury Assistant Secretary for Tax Policy. Mazur had served as Deputy Assistant Secretary for Tax Analysis since 2009.

John Koskinen was confirmed as IRS Commissioner by the Senate on December 20, 2013; his term will expire on November 12, 2017.

William (Bill) Wilkins continues as IRS Chief Counsel.

Key members of the Obama Administration economic and tax policy team

Treasury Secretary	Jack Lew
Director, National Economic Council	Jeffrey Zients
Director, Office of Management and Budget	Sylvia Mathews Burwell
Chair, Council of Economic Advisers	Jason Furman
Treasury Assistant Secretary for Tax Policy	Mark Mazur
IRS Commissioner	John Koskinen
IRS Chief Counsel	William (Bill) Wilkins

Appendix C: Senate seats up for election in 2014

Senators up for election in 2014

Democrats	Republicans
Baucus, Max (D-MT)*	Alexander, Lamar (R-TN)
Begich, Mark (D-AK)	Chambliss, Saxby (R-GA)*
Booker, Cory (D-NJ)	Cochran, Thad (R-MS)
Coons, Chris (D-DE)	Collins, Susan (R-ME)
Durbin, Richard J. (D-IL)	***Cornyn, John (R-TX)***
Franken, Al (D-MN)	***Enzi, Michael B. (R-WY)***
Hagan, Kay (D-NC)	Graham, Lindsey (R-SC)
Harkin, Tom (D-IA)*	Inhofe, James M. (R-OK)
Johnson, Tim (D-SD)*	Johanns, Mike (R-NE)*
Markey, Ed (D-MA)	McConnell, Mitch (R-KY)
Landrieu, Mary L. (D-LA)	Risch, Jim (R-ID)
Levin, Carl (D-MI)*	***Roberts, Pat (R-KS)***
Merkley, Jeff (D-OR)	Scott, Tim (R-SC)**
Pryor, Mark (D-AR)	Sessions, Jeff (R-AL)
Reed, Jack (D-RI)	
Rockefeller, John D., IV (D-WV)*	
Schatz, Brian (D-HI)**	
Shaheen, Jeanne (D-NH)	
Udall, Mark (D-CO)	
Udall, Tom (D-NM)	
Warner, Mark (D-VA)	

* Not running for re-election
** Running to finish term ending January 3, 2017
Senate Finance Committee members shown in bold italic

Appendix D: Selected federal tax expenditures

Selected federal tax expenditures

	5–year FY 2013–2017 tax expenditure estimate ($ billions)
Corporations	
Deferral of active income of controlled foreign corporations	265.7
Exclusion of interest on public purpose State and local government bonds	48.5
Deduction for income attributable to domestic production activities	55.9
Inventory property sales source rule exception	17.6
Depreciation of equipment in excess of the alternative depreciation system	-18.4*
Credit for low-income housing	34.6
Expensing of research and experimental expenditures	33.0
Last-in, first-out inventory method (LIFO)	23.1
Reduced rates on first $10,000,000 of corporate taxable income	18.8
Exclusion of investment income on life insurance and annuity contracts	13.9
Credit for increasing research activities (section 41)	21.6
Special treatment of life insurance company reserves	13.2
Deferral of gain on non-dealer installment sales	34.3
Deferral of gain on like-kind exchanges	32.4
Individuals	
Exclusion of employer contributions for health care, health insurance premiums, and long-term care insurance premiums	760.4
Deduction for mortgage interest on owner-occupied residences	379.0
Reduced rates of tax on dividends and long–term capital gains	616.2
Net exclusion of pension contributions and earnings for defined benefit plans	212.2
Earned income credit	325.9
Deduction of non-business State and local government income taxes, sales taxes, and personal property taxes	277.6
Net exclusion of pension contributions and earnings for defined contribution plans	335.6
Exclusion of capital gains at death	258.0

Selected federal tax expenditures

	5–year FY 2013–2017 tax expenditure estimate ($ billions)
Deduction for charitable contributions, other than for education and health	178.3
Exclusion of Medicare Benefits: Hospital Insurance (Part A)	170.3
Exclusion of untaxed Social Security and railroad retirement benefits	179.6
Exclusion of benefits provided under cafeteria plans	192.3
Exclusion of investment income on life insurance and annuity contracts	143.6
Exclusion of Medicare Benefits: Supplementary medical insurance (Part B)	147.6
Credit for children under age 17	291.6
Deduction for property taxes on real property	152.9
Exclusion of interest on public purpose State and local government bonds	142.6
Exclusion of capital gains on sales of principal residences	129.8
Individual retirement arrangements: Traditional IRAs	72.0
Net exclusion of pension contributions and earnings for plans covering partners and sole proprietors (Keogh plans)	64.1
Deduction for medical expenses and long–term care expenses	71.6
Exclusion of miscellaneous fringe benefits	38.5
Credits for tuition for post-secondary education	126.4
Exclusion of Medicare Benefits: Prescription drug insurance (Part D)	40.1
Deferral of gain on non-dealer installment sales	10.5
Deferral of gain on like-kind exchanges	14.9
Carryover basis of capital gains on gifts	12.0
Deduction for charitable contributions to educational institutions	30.4
Deduction for health insurance premiums and long-term care insurance premiums by the self-employed	29.6
Exclusion of foreign earned income: Salary	30.3
Exclusion of veterans' disability compensation	30.8
Exclusion of benefits and allowances to armed forces personnel	26.6
Individual retirement arrangements: Roth IRAs	24.8

Selected federal tax expenditures

	5–year FY 2013–2017 tax expenditure estimate ($ billions)
Credits and subsidies for participating in health insurance exchanges	237.5
Exclusion of employer-paid transportation benefits	28.8
Depreciation of rental housing in excess of alternative depreciation system	19.0
Exclusion of cash public assistance benefits	25.9
Exclusion of income earned by voluntary employees' beneficiary associations	15.1
Exclusion of workers' compensation benefits (disability and survivors payments)	23.4
Tax credit for small businesses purchasing employer insurance	9.2
Deduction for income attributable to domestic production activities	22.3
Exclusion of employment benefits for premiums on accident and disability insurance	19.9
Exclusion of workers' compensation benefits (medical benefits)	25.6
Deduction for charitable contributions to health organizations	15.5
Credit for child and dependent care and exclusion of employer-provided child care	17.3
Exclusion of medical care and TRICARE medical insurance for military dependents, retirees, and retiree dependents not enrolled in Medicare	13.9
Additional standard deduction for the blind and the elderly	17.8
Exclusion of scholarship and fellowship income	14.1
Exclusion of interest on State and local government qualified private activity bonds for private nonprofit and qualified public educational facilities	13.5
Parental personal exemption for students aged 19 to 23	25.4
Build America bonds	19.0

* Includes bonus depreciation and general acceleration under MACRS.

Note: The methodology used by JCT staff to estimate tax expenditures differs from the methodology used to estimate revenue-raising proposals.

Source: Joint Committee on Taxation. Estimates of Federal Tax Expenditures for Fiscal Years 2012–2017. JCS-1-12 Washington: GPO 2013. Print.

Appendix E: Summary of international tax proposals in the President's FY 2014 budget

The following are some of the Administration's significant international tax proposals that may be reproposed for FY 2015. Note that the descriptions below for existing proposals generally reflect draft legislative language that the Administration provided in September 2011. The President's FY 2014 budget was silent on extensions of CFC look-through and the subpart F active financing exception.

Deferring interest expense deductions allocable to deferred foreign earnings

Under this Administration proposal, deductions for interest expense allocable to foreign assets would be allowed only to the extent that a US taxpayer earns foreign-source income (FSI). The provision would defer any such deduction that is properly allocable or apportionable to FSI not currently taxed in the United States until an equivalent amount of deferred FSI becomes taxable in the United States. This proposal seeks to match the timing of interest expense deductions more closely with the timing of income inclusion.

This proposal represents a narrowing of an earlier Administration proposal that would have deferred all 'foreign-related deductions.' In May 2013, JCT staff estimated that this provision would raise about $52 billion over the 10-year budget window.

Determining deemed-paid foreign tax credits on a pooled basis

This proposal would restrict a US-based multinational corporation's indirect, 'deemed-paid' FTCs to the average rate of total foreign income tax actually paid on total foreign earnings. Existing US federal income tax rules treat each US multinational's foreign subsidiary as having its own pool of earnings and taxes. The US parent can claim an indirect FTC for foreign taxes those subsidiaries have paid. If each subsidiary has its own pool, the US parent may be able to choose when to claim the FTCs for the respective high-taxed and low-taxed foreign income. The Administration's 'blended foreign tax pool' approach would fundamentally change the existing rules and effectively eliminate a multinational's ability to cross-credit its foreign subsidiaries' high-taxed and low-taxed income.

The proposal would not apply to foreign taxes that a US taxpayer pays directly. In 2013, JCT staff estimated that this provision would raise approximately $42.9 billion over 10 years.

Currently tax 'excess' returns associated with IP transfers offshore

This proposal is one of two reflecting concerns about the taxation of intangible property (IP) transferred offshore by a US person to a related foreign person. For the third consecutive year, the Administration has proposed a new subpart F category for income associated with certain outbound IP transfers to low-taxed CFCs.

This provision addresses situations in which a US person has transferred IP from the United States to a related CFC that earns income subject to a low foreign effective tax rate (ETR). When certain criteria would deem such income to be 'excessive' relative to associated expenses, the new subpart F income category would apply, with a separate FTC limitation basket.

In the FY 2014 budget, the Administration generally retains the previous years' version of this proposal, with the specific ETR thresholds in the September 2011 legislative language. In 2013, JCT staff estimated that this provision would raise $21.6 billion over 10 years. Chairman Camp's international reform discussion draft includes a similar proposal, without the separate FTC basket provision, as one of its anti-base erosion options (Option A).

Limit income-shifting through IP transfers offshore

The Administration's budget has included this proposal for four budget cycles, attempting to prevent 'inappropriate' shifting of income outside the United States through certain IP transfers offshore. The proposal would identify the types of IP subject to an outbound toll tax, specifically including workforce-in-place, goodwill, and going concern value. The proposal also would authorize the IRS to value multiple IP transfers on an aggregate basis and to use the 'realistic alternative' valuation approach, valuing IP at its highest and best use.

In 2013, JCT staff estimated that this provision would raise $1.8 billion over 10 years. A similar proposal also appears in Chairman Baucus' tax reform discussion draft. Chairman Camp's international reform discussion draft does not have a similar proposal.

Limit earnings-stripping by expatriated entities

This proposal, which the Administration has maintained for years with little change, would further limit 'expatriated' entities' deductibility of related-party interest expense. The provision would affect entities created by corporate inversions occurring after July 10, 1989 (rather than March 4, 2003, as under the existing anti-corporate inversion statute). In 2013, JCT staff estimated that this provision would raise $2.7 billion over 10 years.

Tax gain from the sale of a partnership interest on a look-through basis

This new proposal addresses concerns that inbound taxpayers have not been following Rev. Rul. 91-32's look-through approach for taxing sales of interests in partnerships with US effectively connected income (ECI). The Administration seeks to codify that ruling.

The proposal provides that gain or loss from the sale or exchange of a partnership interest would be treated as ECI to the extent attributable to the transferor partner's distributive share of any partnership unrealized gain or loss attributable to ECI-generating property. As ECI, the gain would be subject to net US federal income tax, which generally would not be the case under current law (treating the gain as capital gains, generally nontaxable for a foreign transferor).

JCT staff estimated that this proposal would raise $2.6 billion over 10 years. A similar proposal also appears in Chairman Baucus' tax reform discussion draft.

Disallow deductions for excess non-taxed reinsurance premiums paid to affiliates.

The Administration has not yet proposed legislative language on this issue, but the proposal is similar to bills introduced by Rep. Richard Neal (D-MA). The provision would disallow insurance companies a deduction for nontaxed reinsurance premiums paid to their foreign affiliates with respect to most risks, and would not take into account certain items of income allocable to the nontaxed premiums paid.

JCT staff estimated that this proposal would raise $12.6 billion over 10 years. A similar proposal also appears in Chairman Baucus' tax reform discussion draft.

Prevent the use of leveraged distributions from related foreign corporations to avoid dividend treatment

This proposal, first offered in the FY 2014 budget, targets tax planning techniques involving a foreign corporation (the 'funding corporation') that funds a related foreign corporation (the 'foreign distributing corporation'). When transactions have a principal purpose of avoiding dividend treatment on distributions to a US shareholder, the proposal would not take into account the US shareholder's basis in the distributing corporation's stock when determining the distribution's treatment under Section 301. This proposal addresses the monetization of foreign assets without generating US income. JCT staff estimated that this proposal would raise $3.2 billion over 10 years.

Other Administration international tax proposals from the FY 2013 budget

The Administration's FY 2014 budget also included other international tax proposals that were not enacted in 2013 and could be carried over to the FY 2015 budget. These include proposals that would:

- Modify the tax rules for dual-capacity taxpayers
- Extend Section 338(h)(16) to certain asset acquisitions
- Remove foreign taxes from a Section 902 corporation's tax pool when earnings associated with those taxes are eliminated.

Additional proposals with international tax impact

In an effort to limit the movement of US jobs offshore, the Obama Administration has reiterated in 2013 its proposal to provide tax incentives for locating jobs and business activity in the United States, and disallow tax deductions for moving jobs overseas.

In addition to creating a new business credit for insourcing jobs, the proposal would disallow deductions for expenses incurred in connection with outsourcing a US trade or business, to the extent that this action resulted in a loss of US jobs. JCT staff estimated that the US and foreign elements of this proposal would cost approximately $90 million on net.

Other proposals from the FY 2014 budget with international tax implications that might reappear in the coming year include:

- Repeal non-qualified preferred stock designation (Section 351(g))
- Repeal gain limitation for dividends received in reorganization exchanges (Section 356 - 'Cash D')
- Limit the importation of losses under Section 267(d).

Appendix F: Selected potential revenue-raising proposals

Selected potential revenue-raising proposals

Provision	Source of proposal	Revenue estimate over 10 years ($ millions)
International		
Defer deduction of interest expense related to deferred income of foreign subsidiaries	Administration FY 2014 Budget	51,978
Determine Foreign Tax Credits on a Pooling Basis	CBO	43,900
Tax currently excess returns associated with transfers of intangibles offshore	Administration FY 2014 Budget	21,563
Disallow the deduction for non–taxed reinsurance premiums paid to foreign affiliates	Administration FY 2014 Budget	12,633
Modify tax rules for dual capacity taxpayers	Administration FY 2014 Budget	7,896
Modify the rule for the sourcing of income from exports	CBO	6,400
Limit earnings stripping by expatriated entities	Administration FY 2014 Budget	2,730
Limit shifting of income through intangible property transfers	Administration FY 2014 Budget	1,754
Tax Accounting and Corporate		
Increase corporate income tax rates by 1 percentage point	CBO	113,000
Repeal last-in, first-out (LIFO) method of accounting for inventories	Administration FY 2014 Budget	78,299
Make the 0.2-percent unemployment insurance surtax permanent	Administration FY 2014 Budget	14,377
Increase certainty with respect to worker classification	Administration FY 2014 Budget	8,698
Repeal gain limitation for dividends received in reorganization exchanges	Administration FY 2014 Budget	645
Financial Services		
Impose a financial crisis responsibility fee	Administration FY 2014 Budget	49,456
Tax carried (profits) interest in investment partnerships as ordinary income	Administration FY 2014 Budget	17,401
Reinstate superfund environmental income tax	Administration FY 2014 Budget	12,923
Reinstate and extend superfund excise taxes	Administration FY 2014 Budget	8,153
Repeal lower-of-cost-or-market (LCM) inventory accounting method	Administration FY 2014 Budget	4,845
Employee Benefits		
Tax Social Security and railroad retirement benefits like defined-benefit pensions	CBO	388,000
Include employer–paid benefits for income-replacement insurance in employees' taxable income	CBO	326,000
Employment Taxes		
Increase the maximum taxable earnings for the Social Security Payroll Tax	CBO	460,000
Expand Social Security coverage to include newly hired State and Local government employees	CBO	81,100

Selected potential revenue-raising proposals

Provision	Source of proposal	Revenue estimate over 10 years ($ millions)
Energy		
Impose a tax on emissions of greenhouse gases	CBO	1,060,000
Increase excise taxes on motor fuels by 35 cents and index for inflation	CBO	452,000
Repeal domestic manufacturing deduction for oil and natural gas companies	Administration FY 2014 Budget	19,392
Repeal expensing of intangible drilling costs (IDCs)	Administration FY 2014 Budget	13,698
Repeal percentage depletion for oil and natural gas wells	Administration FY 2014 Budget	11,118
Increase the Oil Spill Liability Trust Fund financing rate by one cent and update the law to include other sources of crude	Administration FY 2014 Budget	1,863
Increase geological and small integrated geophysical amortization for independent producers to seven years	Administration FY 2014 Budget	1,251
Repeal capital gains treatment for royalties	Administration FY 2014 Budget	603
Repeal percentage depletion for hard mineral fossil fuels	Administration FY 2014 Budget	595
Repeal expensing of exploration and development costs	Administration FY 2014 Budget	591
Repeal domestic manufacturing deduction for coal and other hard mineral fossil fuels	Administration FY 2014 Budget	489
Repeal exception to passive loss limitation for working interests in oil and natural gas properties	Administration FY 2014 Budget	181
Repeal deduction for tertiary injectants	Administration FY 2014 Budget	89
Tax Administration		
Require a certified taxpayer identification number (TIN) from contractors and allow certain withholding	Administration FY 2014 Budget	387
Individual		
Eliminate the deduction for state and local taxes	CBO	954,000
Raise all tax rates on ordinary income by 1 percentage point	CBO	694,000
Limit the value of itemized deductions	CBO	352,000
Curtail the deduction for charitable giving	CBO	212,000
Include investment income from life insurance and annuities in taxable income	CBO	210,000
Eliminate certain tax preferences for educational expenses	CBO	155,000
Raise ordinary income tax rates in the following brackets by 1 percentage point: 28 percent and over	CBO	152,000
Use an alternative measure of inflation to index some parameters of the tax code	CBO	140,000

Selected potential revenue-raising proposals

Provision	Source of proposal	Revenue estimate over 10 years ($ millions)
Raise ordinary income tax rates in the following brackets by 1 percentage point: 35 percent and over	CBO	98,000
Further limit annual contributions to retirement plans	CBO	88,700
Raise the tax rates on long-term capital gains and dividends by 2 percentage points	CBO	53,400
Convert the mortgage interest deduction to a 15 percent tax credit	CBO	51,700
Provide short–term tax relief to employers and expand Federal Unemployment Tax Act (FUTA) base	Administration FY 2014 Budget	11,748
Lower the investment income limit for the earned income tax credit and extend that limit to the refundable portion of the child tax credit	CBO	10,900
Insurance		
Increase the payroll tax rate for Medicare hospital insurance by 1 percentage point	CBO	859,000
Expand pro rata interest expense disallowance for corporate-owned life insurance	Administration FY 2014 Budget	6,765
Modify proration rules for life insurance company general and separate accounts	Administration FY 2014 Budget	4,832
Modify rules that apply to sales of life insurance contracts	Administration FY 2014 Budget	857
Estate and Gift		
Require a minimum term for grantor retained annuity trusts (GRATs)	Administration FY 2014 Budget	3,384
Require consistency in value for transfer and income tax purposes	Administration FY 2014 Budget	1,551
Other		
Increase all taxes on alcoholic beverages to $16 per proof gallon	CBO	63,800
Levy a fee on the production of hardrock minerals to restore abandoned mines	Administration FY 2014 Budget	1,345
Increase levy authority for payments to Medicare providers with delinquent tax debt	Administration FY 2014 Budget	802
Deny deduction for punitive damages	Administration FY 2014 Budget	345

Source: Administration's FY 2014 Budget: "Estimated Budget Effects of the Revenue Provisions Contained in the President's FY 2014 Budget Proposal" May 10, 2013, JCX-11-13. CBO: Congressional Budget Office "Options for Reducing the Deficit: 2014 to 2023," November 2013.

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