

HOW PROPOSED LEGISLATION COULD AFFECT CORPORATE TAXES

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ABSTRACT

The purpose of this thesis is to explore in detail three tax reform proposals and to determine the effects that each would have on three different industries, manufacturing, service based, and technology. This study looks at the detailed tax reform plans of Congressman Dave Camp, Congressman Devin Nunes, and Senators Marco Rubio and Mike Lee. In order to determine the effects that each of these plans would have on the three industries, the financial statements of Lockheed Martin, Liberty Mutual, and Facebook are analyzed as representatives of their industries. This analysis revealed the effects that the proposals would have on each. The conclusion from this analysis shows which plan would benefit each company and industry. This thesis also goes into greater detail on heavily debated points within the tax proposals, such as full expensing and the territorial system. Other areas researched within this study are the current lobbying spending of Lockheed Martin, Liberty Mutual, and Facebook with regard to tax policy, the tax reform plans of the 2016 Presidential candidates, and the actual legislative process that each tax reform proposal would have to go through in order to become law.

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LIST OF ABBREVIATIONS

ABC Act	American Business Competitiveness Act
ADS Rules	Alternative Depreciation System
AMT	Alternative Minimum Tax
BUILD	Business United for Interest and Loan Deductibility
C-Corporation	A corporate that is taxed separately than from its owners
CBO	Congressional Budget Office
CPI Rate	Consumer Price Index
CUT Loopholes Act	Cut Unjustified Tax Loopholes Act
GDP	Gross Domestic Product
IRS	Internal Revenue Service
LIFO Method	Last-In-Fist-Out Method
MACRS	Modified Accelerate Cost Recovery System
NPV	Net Present Value
OECD	Organization for Economic Corporation and Development
R&D	Research and Development
UNICAP	Uniform Capitalization Rules

CHAPTER I: INTRODUCTION

Tax reform has been a major topic of discussion in the media and for Congress and the companies that any reform would affect. Advocates of tax reform point to several reasons why tax reform should be a priority of the United States government. One of the first points always raised is that the current tax laws are unnecessarily complicated for both companies and individuals. Another point raised is that the current United States corporate rate is the highest among developed countries. This high tax rate hurts employment, pushes many companies to participate in offshoring, profit-sharing, inversions, and other activities that are a deterrent to the United States economy, and discourages foreign companies to open locations or to place their headquarters within the United States. The high corporate tax rate, in addition to the United States being the only country to not utilize the territorial system, places U.S. companies at a disadvantage.

The call for reform has led numerous Congressmen and Senators to formulate their own tax reform plans. While many of the reform plans do have some overlapping ideas, they also all differ in some way. Additionally, each industry within the U.S. might be affected in different ways by each tax reform plan. The point of this thesis is to examine how three different tax reform proposals would affect three companies that operate within three different industries. The industries selected for this thesis are manufacturing, service, and technology. These three industries were selected because

they are all very different in the assets and liabilities that they have, the goods and services they provide, and represent the major segments of the U.S. economy.

Another purpose of this thesis is to evaluate the tax reform plans of Dave Camp, Devin Nunes, and Marco Rubio and Mike Lee and to analyze their impact on three companies in different industries in order to determine which plan benefits each industry the most. Additionally, this thesis touches on the feasibility of each tax reform plan being passed. In order to accomplish this, the legislative process for a tax bill, the Presidential Candidates' tax reform plans, and the current tax lobbying efforts of the three companies were examined. The topic of this thesis came about from a conversation with a Big Four accounting firm's managing director of their Washington National Tax Tax Policy Group in which he stated that a big question from clients that he gets is what the effects of full expensing, the territorial system, and different tax reform plans as a whole would have on their company and industry. He stated that this was a hot topic within the tax world today.

In order to present a background on tax law, the first chapter of this thesis includes an explanation of current tax law, an examination of the differences between full expensing and business interest expense deductions, and a review of the territorial tax system. Next, the legislative process, as well as dynamic scoring, are explained in detail in order to understand the process a tax reform proposal would need to go through in order to become law. The next chapter outlines in detail the Camp, Nunes, and Rubio/Lee plans. The Presidential candidates tax proposals are then discussed in order to determine which candidate would be the most favorable for one of the tax reform proposals. Following this, the effects of each proposal are reviewed. This includes detailed current income tax expense information of each of the selected companies, the actual changes of

each proposal that would effect each company, and a review of current lobbying efforts of each company. Lastly, key factors were chosen in order to determine the impact of each proposal on the selected companies and their respective industries. These key factors were evaluated to determine which proposal would benefit each company and their industry the most.

CHAPTER II: CORPORATE TAX LAW BACKGROUND

This chapter contains an examination of current corporate tax laws in order to gain a better understanding what the current status is and also what law makers want to change. Next, the differences between full expensing and business interest expense deduction are explained. These two methods are one of the main points for discussion within tax reform plans. Last is a discussion of the territorial tax system that is a major part of several tax reform proposals.

Current Corporate Tax Law

Section 179: Election to Expense Deduction

This section allows businesses to deduct the full purchase price of certain equipment and software that is purchased or financed during the tax year. This full purchase price deduction is in place as an incentive for business to invest in equipment and as a result help grow the economy. The main target group of Section 179 is small businesses. Section 179 offers a \$500,000 deduction on new or used equipment that is purchased, leased, or financed. There are some current limits within Section 179; it caps the total amount that can be spent on equipment at \$2,000,000 before there is a dollar for dollar limitation of the \$500,000 deduction implemented. Companies are also allowed to partially expense these equipment and software purchases. Additionally, in order for the equipment or software to qualify it must be used at least 50 percent of the time for business purposes (26 U.S. Code § 179).

Section 471: Inventories

Section 471 focuses on inventory counts and states that if the amount of inventory needs to be known in order to determine the income of the business, then inventories should be taken and should conform to the accounting practice of that business. Inventory shrinkage should be determined by a physical inventory count. Section 471 also defers the deduction of the cost of inventory from the Cost of Good Sold until the inventory is actually sold (26 U.S. Code § 471).

Section 263A: Uniform Capitalization Rules (UNICAP)

Section 263A dictates that businesses that produce real or tangible property must capitalize the direct costs and the appropriate allocation of indirect costs that it takes to produce the property. Indirect costs under Section 263A include service costs, where service costs can be identified with a specific department or function of production (26 U.S. Code § 263A). Additionally, all indirect costs should be generally allocated to departments or production activities. More items must be capitalized under UNICAP than under financial accounting and most businesses, especially manufacturing companies, must use UNICAP. Businesses are required to allocate these costs by way of a specific identification method, a standard cost method, a burden rate method, or any other reasonable method. Non-manufacturing costs do not have to be capitalized and these include marketing, selling, advertising, distribution, and research and experimentation expenses (26 U.S. Code § 263A).

Section 168: MACRS

The Modified Accelerated Cost Recovery System (MACRS) is described in Section 168. This section allows for a reasonable allowance for the wear and tear of business property as a depreciation deduction. The two ways to determine the

depreciation allowance are the general depreciation system or the alternative depreciation system. Both methods calculate the deduction based on the depreciation method, and recovery period, which is determined by class life or statute, and convention (26 U.S. Code § 168).

All of these code sections would be affected by at least one of the tax reform proposals discussed in this thesis. Therefore, it is important to understand these sections in order to fully understand the changes provided for in each tax proposal.

Full Expensing vs. Business Interest Expense Deductions

Full Expensing

Full expensing allows companies to deduct, or write off, the full expense of an investment immediately from taxable income in the year that the investment is made. Devin Nunes' and Rubio and Lee's tax reform proposals both call for full expensing. The Mercatus Center at George Mason University released a report January 2015 advocating for full expensing. The Mercatus Center is "the world's premier university source for market-oriented ideas-bridging the gap between academic ideas and real-world problems" (Mercantus Center: "About." n.d.). In the report, Jason Fichtner and Adam Michel state: "expensing incentivizes investment by allowing businesses to write off all expenditures in the year they occur" (Fichtner, 2015). Full expensing results in companies paying a zero effective tax rate on their investment. The current depreciation system increases the cost of investments by lowering the return on investment and "distorts consumer and investor decisions" (Fichtner, 2015). This distortion can damage the economy. Also the existence of accelerated depreciation and expensing allows for the tax code to be tailored to special interest groups. This is because accelerated depreciation

and bonus depreciation can be more helpful and economically beneficial to certain depreciable assets and therefore the industries in which these assets are used. The Mercatus Report claims that full expensing will lower the effective tax rate by lowering the taxes that will be paid on future investments.

According to the Heritage Foundation many companies prefer overall tax rate reductions to expensing. This makes more sense for labor-intensive firms that do not have as many investments that would benefit from full expensing. Capital-intensive firms, such as manufacturers, that have investments would benefit from the change from the current depreciation standards to full expensing. The Heritage Foundation predicts that companies, even those that would benefit greatly from full expensing, prefer overall rate cuts because tax rate cut benefits go straight into a company's financial statements and earnings. While "expensing improves current net cash flow and future profitability" and reduces the current tax burden slightly, it does not alter the earnings and profits on financial statements. Because current reported earning and profits remain greatly unaffected by full expensing, companies have the bias towards overall rate cuts and short-term results (Foster, 2013). Another argument in favor of overall rate cuts rather than expensing is to make the United States more competitively internationally with regards to tax rates. A Heritage Foundation report states "the high tax rate is the biggest threat facing the economy right now" (Dubay 2011). The U.S. rate has ranked among the highest of the Organization for Economic Corporation and Development (OECD)'s developed countries since 2004. The U.S. rate currently is ranked at the highest rate. This report argues that with the United States tax rate being well above the international average, other corporate tax issues, such as expensing, should be dealt with after the rate

is lowered. This high tax rate has caused investment to be pushed overseas rather than within U.S. markets. Decreasing the rate would be more successful in increasing investment in the U.S. than allowing full expensing.

Business Interest Expense Deductions

Under current law, a business is allowed to deduct interest that is paid or accrued related to its trade or business within the tax year from its taxable income. Interest is defined as related to trade or business if proceeds from the loan are used for trade or business expenses. Additional requirements include the business being “legally liable for the debt”, the business and “the lender intend that the debt be repaid”, and the business and “the lender have a true debtor-creditor relationship”. Allowing interest to be deducted encourages expansion, investment, and growth within the business community. However, with the introduction of full expensing, this business interest deduction would be eliminated because if both expensing and the current business interest deduction were kept in the code, businesses would have a negative tax rate on investments and essentially be receiving a subsidy from the government for investing. Those in favor of full expensing over business interest deductions state that the current business interest deduction puts an unnecessary and negative pressure on companies to carry debt. The pressure to take out unnecessary debt also causes companies to save less because their borrowing habits require less on hand cash. The additional debt that has been taken on by companies due to favorable treatment can “lead to higher bankruptcy rates, higher administration costs, and excessive risk taking” (Solomon, 2012). The elimination of this pressure in favor of the benefits of full expensing will benefit companies more in the long term according to these advocates.

In opposition to eliminating the business interest deductions is a group called the BUILD Coalition, which stands for Businesses United for Interest and Loan Deductibility. The BUILD Coalition states, “capping the deduction would dampen willingness to borrow for capital improvements and other expenses” (Heller 2013). BUILD argues that limiting the amount of interest deductions will halt job growth by raising the cost of expansion and investment. Businesses will not be as incentivized to take on debt in order to grow. The Organization for International Investment also urges that business interest deduction stay in place because “debt finance plays an important role in facilitating investment by all types of U.S. companies—including those headquartered abroad” (Heller 2013). Ernst and Young states in a report prepared for the Private Equity Growth Capital Council that “an across-the-board limitation on the corporate deductibility of interest would adversely impact investment” (Carroll, 2012). The report states that the limitation on interest deductibility will increase the cost of investment more than a decrease in the corporate tax rate would lower the cost of investment. Additionally, the cost of investment in the United States will increase and make the United States less competitive internationally. A country’s tax rate is a key consideration made when determining if a business should invest in a country. A high corporate tax rate causes a higher cost of investment. This higher cost of investment pushes business investments away and to other countries because businesses are less likely to invest in a country with a high corporate tax rate and more likely to invest in one that has a lower rate. If the United States continues to be viewed as an expensive place to invest, it will continue to decrease in competitiveness against foreign countries (Dubay 2011).

Review of Territorial Tax System

Currently the United States has a worldwide tax system, which means that when a corporation has its headquarters within the U.S., the corporation is required to pay the U.S. corporate taxes on all of its income. This income includes both the corporation's income earned within the U.S. and also income earned abroad. This system does allow a credit for the amount of foreign taxes paid on the income.

Devin Nunes' tax proposal, as well as Rubio and Lee's tax proposal calls for the United States to switch to a territorial system instead of the current worldwide tax system. Under this system, the U.S. would only tax income that is earned within the United States and most or all of foreign income would be exempt from taxation. So that the tax base would not dramatically shrink, "a territorial system could still cover income from financial assets held by a foreign subsidiary that could easily be held by the U.S. company" ("Territorial vs. Worldwide", 2012).

Many policy makers argue in favor of changing to a territorial system because they believe that U.S. corporations are left at a disadvantage because of it. This is because the worldwide system leaves foreign competitors with a higher after-tax income than U.S. businesses. Additionally, the United States is the only developed country that does not use the territorial system. The Senate Republican Policy Committee has released six negative effects of the current worldwide system. These include: (1) the U.S. subjects its own corporations to the "highest corporate tax rate in the world"; (2) the system encourages businesses to keep their foreign income abroad and to not repatriate the income; (3) it "rewards foreign investment over U.S. investment"; (4) it has increased compliance costs due to complex rules; (5) "results in fewer global businesses being

headquartered in the U.S.”; and (6) “Worldwide taxation is bad economics” (“Territorial vs. Worldwide”, 2012). Arguments against the worldwide system include that it “rewards foreign investment over U.S. investment”. This argument is based on the fact that companies are able to reinvest foreign income overseas in order to avoid paying U.S. taxes on foreign income. Companies would choose to do this because of the high corporate tax rate that the U.S. has. Additionally, a U.S. company is able to deduct interest payments on money borrowed within the U.S. that is then used to finance investments overseas. This allows a company to receive a deduction from the federal government when they do not even repatriate their income from the foreign investment. Their final argument is that the worldwide system does not follow Adam Smith’s four requirements for a good tax system, which are equality, certainty, convenience, and economy. Their claim is that the worldwide tax system does not have horizontal equity because U.S. corporations are subject to higher taxes than foreign corporations with the same income. The system also does not follow the requirements of certainty or economy due to the complexity of the U.S. tax laws that results in high compliance costs.

The Tax Policy Center claims that the most important argument against the territorial system is that, “by exempting foreign income it would reinforce an already strong tax incentive to locate both economic activity and profits in low-tax counties”. The Tax Policy Center goes on to state that this would cause a decrease in the United States’ corporate income tax base. Many believe that a territorial system will encourage U.S. global corporations to bring capital back to the U.S. and that this capital would then be invested back in the U.S. and create jobs. To counter this argument, those in opposition to a territorial system point to 2004. In 2004, Congress enacted tax amnesty on foreign

earnings repatriation for one year. As a result of this \$360 billion in foreign revenue was repatriated. According to the Congressional Research Service though, the majority of the repatriated revenue was given to shareholders through dividends instead of new investments. As a result, there was not the job creation that many expected. In fact, the Congressional Research Service determined that “the top ten repatriating U.S. Corporations actually reduced employment by 447,000 after repatriating about \$99 billion” (Prestowitz, 2012). The Center for Budget and Policy Priorities fears that if the U.S. corporate tax base decreases, higher taxes will be imposed on smaller and domestic companies to compensate for the loss in revenue.

CHAPTER III: LEGISLATIVE PROCESS

In order to become law, a tax proposal must go through an extensive legislative process. This process is the reason that many people are discouraged about the possibility of tax reform actually happening. The purpose of this section is to better understand the process, what would need to happen for a tax reform plan to be implemented, and why so many are discouraged about it. Additionally, this chapter covers dynamic scoring and how the change to it could benefit tax reform proposals. Lastly, the current lobbying efforts of Lockheed Martin, Liberty Mutual, and Facebook are discussed in order to determine what each company is currently pushing for Congress to enact and if this lines up with any of the tax reform proposals examined in this thesis.

Federal Legislative Process for Tax Proposals

Per the United States Constitution, tax legislation must originate in the House of Representatives. The Ways and Means committee is responsible for all legislation that concerns tax, making it one of the most powerful committees in Congress. Hearings are scheduled by the Ways and Mean committee in which people testify about the legislation. Other witnesses include administrative officials and private interest group representatives. An example of an administrative official is the Director of the Office of Management and Budget. Witnesses answers questions asked by Committee members on how proposed legislative would affect the economy, as well as specific groups of people (*Writing and Enacting Tax Legislation*, 2010). Executive Session occurs after all hearings have taken place and the committee marks up the legislation during this time. The

markups are used to revise the legislation. These sessions are open to the public and attendees typically include media outlets, interest groups, representatives from the Administration, and representatives from Congressional offices. Administration representatives often advise Committee members. As the markup comes to a close, the Committee drafts the proposal into legislative language. In addition, the Committee develops a report on the proposed tax legislation. This report is detailed so that the Internal Revenue Service (IRS) and courts could use it as interpretation of the proposed tax legislation. After the legislation's language and report are finalized and the Committee votes to approve the report, the bill will be introduced to the House of Representatives for debate on the floor.

After a tax bill passes in the House, the Senate Finance Committee formally begins work on the bill (*Writing and Enacting Tax Legislation*, 2010). Hearings similar to ones held by the House Ways and Means Committee are held but instead of addressing the tax proposal, the hearings address the bill passed by the House. Markup of the bill, similar to the House markup, then occurs. The bill typically leaves the Senate markup looking differently than the bill that was passed by the House. Then the committee must approve a report, which explains the Finance Committee's amendments to the bill. The report is then presented to the full Senate on the bill to determine floor action and this report is filed with the bill. If there are no amendments made to the House Bill and the Senate passes this version, the bill will be sent directly to the President for consideration. If the Senate passes a version that does include amendments, then the bill is sent back to the House. In the House, if they do not want to accept the Senate's amendments the House can "motion to disagree with the Senate amendments" (*Writing and Enacting Tax*

Legislation, 2010). If this motion occurs, a Conference Committee is appointed “to adjust the differences between the two versions of the bill” (*Writing and Enacting Tax Legislation*, 2010). The President of the Senate and the Speaker of the House appoint members to the Conference Committee. Each chamber, the House and the Senate, vote as a unit. This means that the House members appointed to the committee all vote the same, as will all of the Senate members that are appointed. Therefore, the majority party therefore has control over how the unit votes. Additionally, the Administration and interest groups try to persuade the members appointed to the Conference Committee. After a compromise version is approved, the Conference Committee presents the new version to the House and Senate and then the House and Senate vote on this version. If both the House and the Senate adopt the compromise version, the revised bill will be sent to the President. The Secretary of the Treasury will advise the President on the provisions of the approved bill. Before deciding to sign or veto the tax bill, the President will also seek guidance from other Federal agencies. If the President signs the bill, it becomes law. If it is vetoed, it will be sent back to the House along with a statement explaining why the President opposes sections of the bill. If a tax bill becomes law, the Treasury Department will issue regulations and the Internal Revenue Service will develop tax forms and instruction booklets for taxpayers. If the bill is vetoed, the House will either make the changes the President desires and outlines in his or her statement or override the veto (*Writing and Enacting Tax Legislation*, 2010).

Dynamic Scoring

The Congressional Budget Office and Joint Committee on Taxation give a score, or nonpartisan financial projection, to proposed Congressional legislation to show the

effect the legislation will have on the federal budget. In the past, the Congressional Budget Office and the Joint Committee on Taxation used static scoring. Static scoring does not consider the potential economic effects of the tax proposals that are being graded. Static scoring assumes that people will not spend or invest any of the money they saved from the reduced taxes and therefore the only effect from reduced taxes is a reduction in revenue. In contrast, dynamic scoring considers the microeconomic effects of legislation. Dynamic scoring assumes that people's spending and investment habits will increase with a reduction in taxes. This increased spending and investment activity will better the economy and create jobs, which will in turn increase the revenue flow to the government. The Pro-Growth Budgeting Act, which calls for the implementation of dynamic scoring for major pieces of legislation, passed the House of Representatives in 2014 with a vote of 224 to 182. These major pieces of legislation are defined as "affecting the economy annually by 0.25 percent of gross domestic product, or \$43 billion per year" (Delany, 2015).

During the Joint Economic Committee's Hearing on Dynamic scoring, which was entitled "Dynamic Scoring: How Will It Affect Fiscal Policymaking?", Chairman Dan Coats discussed how static scoring does not account for how the two largest drivers of the United States economy are affected by policies. He listed these drivers to be labor supply and private investment. He states that dynamic scoring is useful because it does take into account how the economy and drivers of the economy will be affected by different policies. The Honorable Phil Graham, who was a witness for the hearing, stressed that dynamic scoring should not replace static scoring but instead be used as a supplement with static scoring. He believes that if both dynamic and static scoring are used policy

makers will be able to better see the costs and benefits of policies. Another witness, Dr. John Diamond from the Baker Institute of Public Policy, explained that dynamic scoring shows the deficit and economic effect differences between legislation proposals. He explained that static scoring would not show these and legislation with different economic and deficit effects could be scored the same. Dynamic scoring also provides macro-economic effects of policies.

John Buckley, the former Chief of Staff to the Joint Committee on Taxation, expressed his concerns with the implementation of dynamic scoring and the interpretation of the results. Buckley stated that the Joint Committee for Taxation and the Congressional Budget Office use different approaches, models, and assumptions with regards to dynamic scoring. It concerned him that policies could receive different scores from the two bodies. Congresswoman Maloney, a Democrat from New York, stressed her opposition to dynamic scoring. She pointed to the fact that there is no consensus as to which dynamic scoring model is the most accurate as a reason for concern. She also stated that there are different assumptions that each model is based off of, quality control could be difficult, and that biases could pollute analysis. She also discussed how while there is a requirement for a single revenue estimate, dynamic scoring revenue estimates for one piece of legislation can differ by hundreds of billions of dollars. She fears that policy makers will choose the revenue estimate that is the most favorable and as a result the integrity of the revenue estimates will be diluted (“Dynamic Scoring”, 2015).

Additionally, the new Speaker of the House and former Chairman of the House Ways and Means Committee, Paul Ryan, supports dynamic scoring. Speaker Paul Ryan supports dynamic scoring because he argues that static scoring does not take into

consideration the impact the legislation would have on people, which ultimately affects the economy as a whole. With reference to this Speaker Ryan said, “Think about that. We all know that that is not true. People respond to incentives” (Kasperowicz, 2014).

The change from static scoring to dynamic scoring could greatly affect the future of tax reform proposals. With the inclusion of economic effects, tax reform plans that call for a cut in the tax rate will no longer just be scored in a way that states they will decrease revenue. Dynamic scoring could make it easier for these plans to be passed because the potential positive effects of them will be included under dynamic scoring.

Lobbying Reports Review

Lockheed Martin Corporation

During 2013, 2014, and 2015, Lockheed Martin paid for lobbyists to lobby on their behalf for several tax issues that pertain to the tax proposals discussed in this paper. Lockheed Martin lobbied in favor of making the Research and Development Credit permanent, increasing it to 20 percent, and extending it two years. Lockheed Martin favored making bonus depreciation permanent. Their lobbyists also lobbied for the American Research and Competitiveness Act of 2015 to “revise the formula for calculating the amount of the research tax credit, make such revised credit permanent, and allow a portion of the research credit as an offset against the alternative minimum tax of an eligible small business”. Lockheed Martin had lobbying efforts in support of the following changes included in the Dave Camp tax reform; a lowered corporate rate; enhancement of the Research and Development Credit and making the Research and Development Credit permanent (*Lockheed Martin Corporation Lobbying Report, 2014*) (*Lockheed Martin Corporation Lobbying Report, 2015*).

Liberty Mutual Holding Company

During 2013, 2014, and 2015, Liberty Mutual paid for lobbyists to lobby on their behalf for several tax issues. They lobbied in favor of general tax reform and for specific issues related to the insurance industry but not for items that are in the tax reform proposals that are the subject of this study (*Liberty Mutual Holding Company Inc. Lobbying Report, 2014*) (*Liberty Mutual Holding Company Inc. Lobbying Report, 2015*).

Facebook Inc.

During 2013, 2014, and 2015, Facebook paid for lobbyists to lobby on their behalf for several tax issues, but Facebook's lobbying reports included less specific details about their tax lobbying efforts. Their reports stated that their lobbying efforts were focused on "discussions regarding corporate tax issues" (*Facebook Inc. Lobbying Report, 2013*) (*Facebook Inc. Lobbying Report, 2014*) (*Facebook Inc. Lobbying Report, 2015*). The only item specifically mentioned that was relevant to this study was the extension of the Research and Development Credit.

CHAPTER IV: CORPORATE TAX REFORM PROPOSALS

The tax reform plans analyzed in this thesis are the plans of Dave Camp, Devin Nunes, and Marco Rubio and Mike Lee. These plans were selected based on the suggestion of a Big Four Washington National Tax Tax Policy Group's managing director. He suggested these plans because the three of them show the differences of utilizing full expensing or the territorial system or both.

Congressman Dave Camp's Draft Legislation, Tax Reform Act of 2014

Former Chairman of the House Way and Means Committee, Congressman Dave Camp's last proposal before retiring was the Tax Reform Act of 2014. His proposal called for a corporate tax rate decrease from the current 35 percent to 25 percent over a span of 5 years. The plan called for long-term capital gains and dividends to be taxed as ordinary income but also exempted 40 percent of such income from taxation. Based on the phase-in provision of the plan, if it had been enacted in 2014, the tax rate would have been 33 percent in 2015, 31 percent in 2016, 29 percent in 2017, 27 percent in 2018, and finally to 25 percent in 2019. Personal service corporations would not be entitled to these gradually decreased rates that fall below 35 percent. Personal service corporations include companies whose main activity falls in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and such services that are substantially performed by employee-owners. Corporations would no longer be able to deduct lobbying expenses that correspond with influencing a local government's legislation. In the past, local lobbying expenses were deductible while

expenses related to state and federal government lobbying were not. This change would treat local government lobbying the same as state and federal government lobbying. It is estimated that this would have increased revenues by \$.6 billion between 2014-2023.

With regards to the accelerated cost recovery system reform, the class lives of assets would more closely match the true economic life of the assets by repealing the MACRS recovery periods and methods and rules that are similar to ADS rules would be applied. Straight-line depreciation would need to be used. Additionally, a company could take a depreciation deduction to account for the effects of inflation, which would be calculated by “multiplying the year-end adjusted basis in the property by the chained CPI rate for the year” (Camp, n.d.). Special depreciation provisions, including bonus depreciation, special recovery periods for Indian reservation property, special allowance for second-generation biofuel plant property, special allowance for specific recycling property, and special allowance for qualified disaster assistance property, would be repealed. These provisions would have increased revenues from 2014-2023 by \$265.5 billion. Pollution control facilities would no longer have special election for amortization and would be subject to the normal depreciation rules. Revenues would have increased from this by \$7.9 billion from 2014-2023. All research and experimental expenditures would be amortized over a five-year period. Fifty percent of advertising expenses would be currently deductible, while the other fifty percent would be amortize ratably over ten years. Intangibles’ amortization period would be extended to twenty years. Reducing the deduction to six percent beginning in 2015 and three percent beginning in 2016 would phase out the domestic production deduction. The interest limitation rule that pertains to debt issued with respect to corporate acquisitions would be repealed. A gain or loss from

the “disposition of a self created patent, invention, model or design, or secret formula or process” would be considered ordinary (Camp, n.d.). The LIFO method would be no longer allowed for inventory accounting under Camp’s bill. Based on the Joint Committee of Taxation’s analysis, the Tax Reform Act of 2014 would have created 1.8 million new private sector jobs and increase the GDP by twenty percent, which equals an increase of up to \$3.4 trillion.

Congressmen Devin Nunes’ Informal Draft Legislation, American Business Competitiveness Act (ABC Act)

Congressman Devin Nunes is a Republican Congressman from California and has served on the House Ways and Means Committee for 10 years. His tax reform plan is known as the American Business Competitiveness Act (ABC Act). The plan calls for a reduction in tax rates for all businesses to a maximum 25 percent. This reduction to 25 percent would not happen automatically, but rather be phased in over a span of 10 years. Non-business income taxation will stay the same, except for interest income. Interest income will be taxed at the rate that dividends and capital gains are taxed. Nunes labels this plan as pro-growth because it will allow for 100-percent expensing. The creation of full expensing is believed to “create a powerful incentive for businesses of all sizes” to invest, grow, and create jobs (Nunes, n.d.). Businesses will deduct their full investment costs in their year of acquisition, including land, inventory, buildings and other tangible and intangible property. Compensation expenses would also be able to be deducted. Depreciation deductions will not change and will continue to be deducted under the current schedules for assets purchased before the enactment of full expensing. All special loopholes will be eliminated to create “a simple, fair, and flat tax” (Nunes, n.d.).

Deductions and credits will also be eliminated and replaced with full expensing, with the exception of property depreciation deductions. The elimination of loopholes, deductions, and credits will reduce the compliance costs, as well as stop the distortion of the tax impact on the economy. If expensing exceeds a business' taxable income, they can carry forward the expensing with interest or carry back the expensing in order to reduce previous years' taxes. Net-operating losses can also be carried back 5 years and can be carried forward indefinitely. According to Nunes, this drafted bill is scored as revenue neutral under the conventional scoring method of the Joint Committee on Taxation. With regards to the draft bill's international provisions, it shifts the US tax system towards territoriality. Under the proposal, only income connected with a business or trade located within the United States would be taxed and therefore eliminates foreign tax credits. Nunes' proposal also calls for a five percent tax on the undistributed foreign earnings of a company. The new territorial tax provisions "will make U.S. businesses more globally competitive" (Nunes, n.d.). The Alternative Minimum Tax (AMT) is removed with regards to both corporations and individuals. Firms will no longer feel pressured to carry debt because the business interest deduction will be removed and the tax on interest income will decrease. The interest deduction will be phased out over 10 years. Home mortgage interest expense is the one exception that will continue to be deducted. Lastly, the cash method of accounting will be required. The cash method will require that income "be reported in the year received" and expenses to "be deducted in the year they are paid" (Nunes, n.d.).

Senators Marco Rubio and Mike Lee's Informal Draft Legislation

Senators Marco Rubio and Mike Lee's tax reform proposal, similar to the previous two proposals, sets the tax rate for all C-corporations and pass-through entities at 25 percent, with some businesses with a lower income paying only 15 percent. This plan also moves the United States to a territorial system, which will as a result increase U.S. firms' investments abroad as well as their domestic investments. The Rubio-Lee plan would additionally eliminate the double taxation of the current code by no longer taxing shareholder's capital gains and dividends. This plan also eliminates the depreciation factor with regard to asset recognition, which will allow companies to expense the full cost of assets at the time at which they are purchased. Lastly, interest income would not be taxed under this proposal and deductions will not be given to borrowers.

Specifically, this proposal calls for full expensing for all businesses. Businesses will be able to deduct 100 percent of their expenses and account for the costs of capital investments immediately during the year that investments are made. Businesses would only have to pay taxes on the earnings remaining after the expense deductions from taxable income have been made. This full expensing will be applicable to all of a business' investments in structures, inventories, land, and equipment. Double taxation of income will be eliminated. C-corporations will have a corporate tax rate of 25 percent and its dividends and capital gains on stock will not be subject to an additional tax. The taxation of pass-through entities will be the same as the current system. The pro-debt bias that currently exists will no longer exist by eliminating the deductibility of interest on new debt. Interest income will also be removed from the tax base. After 15 years, the net

present value of future depreciation on an investment made under the past code whose depreciation is still being realized will be recognized (Rubio & Lee, n.d.).

CHAPTER V: PRESIDENTIAL CANDIDATES' TAX PLANS

As of January 2016, there are fifteen Presidential candidates. Three of these candidates are Democrats and they include former Secretary of State Hillary Clinton, former Maryland Governor Martin O'Malley, and U.S. Senator Bernie Sanders. The twelve Republican candidates include former Florida Governor Jeb Bush, Dr. Ben Carson, New Jersey Governor Chris Christie, U.S. Senator Ted Cruz, Carly Fiorina, Former Virginia Governor Jim Gilmore, Former Arkansas Governor Mike Huckabee, Ohio Governor John Kasich, U.S. Senator Rand Paul, U.S. Senator Marco Rubio, Former U.S. Senator Rick Santorum, and Donald Trump. Senator Marco Rubio's plan with Senator Mike Lee is evaluated throughout this paper but in addition to Senator Rubio, other Presidential candidates have tax plans. Each candidate's plan is discussed in this chapter. These plans are based on the public statements made by each candidate starting January 2015 in order to accurately reflect their current views and plans. The possibility of one of the three tax reform proposals evaluated within this thesis being passed and placed into law will be affected based on who is elected President in November 2016. It is important to examine the tax plans of each Presidential candidate in order to determine which tax plans would be favored by the Presidential candidates.

With regards to the corporate income tax rate, ten out of the fifteen candidates have a specific proposal. Former Governor Jeb Bush's plan is to lower the top corporate tax rate to 20 percent. Governors Chris Christie and John Kasich plan to lower the top corporate rate to 25 percent. Senator Ted Cruz's plan is to implement a 16 percent business transfer

tax in replacement of the current corporate income tax. This business transfer tax would apply to all labor payments and capital income. Former Governor Jim Gilmore plans to lower the top corporate rate to 15 percent. Former Governor Mike Huckabee wants to eliminate the corporate income tax in favor of the FairTax. The FairTax is a 23 percent federal sales tax that includes monthly rebates for low-income households. The FairTax rate is equal to a pre-tax price of goods and services rate of 30 percent. Senator Rand Paul's plan is similar to Cruz's in replacing the corporate tax in favor of a business transfer tax that includes all labor payments and capital income. Senator Paul's plan has the business transfer tax rate at 14.5 percent rather than Cruz's 16 percent. As discussed previously Senator Marco Rubio's plan is to lower the top corporate rate to 25 percent. Former Senator Rick Santorum's plans is to lower the top corporate rate to 20 percent and to initially lower the rate for manufacturing corporations, such as Lockheed Martin, to 0 percent and gradually increase the rate afterwards. Lastly, Donald Trump plans to lower the top corporate rate to 15 percent just like Jim Gilmore. Dr. Ben Carson, former Secretary of State Hillary Clinton, Carly Fiorina, former Governor Martin O'Malley, and Senator Bernie Sanders do not have corporate income tax rate plans.

Nine out of the fifteen Presidential candidates have plans that pertain to the taxation of corporate capital investment. Bush, Christie, Cruz, Gilmore, Kasich, Paul, Rubio, and Santorum all have plans to move to the full expensing of investment costs. Huckabee's plan, also known as the FairTax, eliminates the corporate income tax, thus rendering the treatment of capital investment with regards to taxation irrelevant. Again, Carson, Clinton, Fiorina, O'Malley, and Sanders do not have a specific proposal. In addition, Trump does not have a capital investment taxation proposal.

The most candidates, thirteen, have specific proposals about international corporate income taxation. Bush's proposal is to shift to a territorial tax system, while implementing a deemed repatriation of 8.75 percent of foreign income. Carson's plan would allow corporations to repatriate international income at a 0 percent tax rate for six months. The condition of this tax-free repatriation is that corporations use 10 percent of the international income to create jobs for unemployed workers or in enterprise zones. Christie would enact a deemed repatriation rate of 8.75 percent on international income. Clinton's proposal "imposes an 'exit tax' on unrepatriated earnings of U.S. firms going through inversions" in order to strengthen the rules that prevent inversions. Cruz's plan also shifts to a territorial tax system but his plan implements a 10 percent deemed repatriation on foreign income. Gilmore's plan only includes a shift to the territorial system. Huckabee's FairTax plan eliminates the need to address foreign income taxes. Kasich's proposal calls for the shift to a territorial system and it allow deferred earnings to be repatriated with no tax. Paul's proposal is to shift to the territorial system. Rubio's plan, as discussed throughout this paper, is to shift to the territorial tax system and to put into place a deemed repatriation of 6 percent on foreign income. Sanders' proposal would end the deferral of foreign income and create limits on the current foreign tax credit. He would also limit corporate inversions. Santorum calls for the implementation of a 10 percent deemed repatriation of international income. Lastly, Donald Trump's plan "ends the deferral of overseas corporate income but preserves the foreign tax credit". It also calls for a 10 percent deemed repatriation of foreign income. Carly Fiorina and O'Malley are the only two candidates who do not have proposals about taxes on international income.

In addition to the previously discussed parts of the Presidential candidates' tax plans there are some other sections of their plans. Bush's plan also eliminates all other corporate tax expenditures, the corporate Alternative Minimum Tax, and the deductibility of interest expenses. Carson's plan eliminates the graduated tax system currently used in favor of a flat rate of 14.9 percent. It also eliminates all other credits and deductions that do not pertain to cost recovery, the deductibility of interest expenses, the deduction for employer-side payroll tax, and the corporate Alternative Minimum Tax. Santorum's plan eliminates business tax deductions and credits and the deductibility of business interest paid. Donald Trump plans to eliminate all other corporate tax expenditures and the corporate Alternative Minimum Tax. His plan also puts a cap on the deductibility of interest expenses.

Comparing the Presidential candidates' plans with the three plans researched throughout this thesis, (David Camp's plan, Rubio-Lee plan, and Devin Nunes' plan) Jeb Bush's plan most closely resembles Rubio and Lee's tax plan. Rubio and Lee's plan reduces the corporate tax rate to 25 percent and Jeb Bush's plan reduces the corporate tax rate to 20 percent. Both plans implement the territorial system and full expensing. Also, both plans call for the elimination of interest expense deductions. Lastly, both call for repatriation. Rubio and Lee's plan call for repatriation of 6 percent and Bush's plan calls for repatriation of 8.75 percent. Additionally, Ben Carson's plan closely resembles Devin Nunes' plan. Both of these plans include reducing the corporate tax rate, even though to different percentages, the implementation of the territorial system, the elimination of credits and deductions, and the implementation of full expensing. If either Marco Rubio

or Jeb Bush were elected, the Rubio and Lee plan would be most likely to be supported and have a better chance of being passed and put into law.

Based on the Tax Foundation’s calculations, the chart below shows the predicted effects of the Presidential candidates’ tax plans. This chart only includes candidates who have comprehensive specific proposals (“Comparing the 2016 Presidential”, 2015).

Table 1

	Jeb Bush	Ben Carson	Ted Cruz	Rand Paul	Marco Rubio	Rick Santorum	Donald Trump	Hillary Clinton	Bernie Sanders
10-Year GDP Growth	10%	16%	13.9%	12.9%	15%	10.29%	11.5%	(1.0%)	(9.5%)
10-Year Capital Investment Growth	28.8%	46.6%	43.9%	40.5%	48.9%	29%	29%	(2.8%)	(18.6%)
10-Year Wage Rate Growth	7.4%	10/9%	12.2%	11.4%	12.5%	7.3%	6.5%	(0.8%)	(4.3%)
Added Jobs (Millions)	2.7	5.2	4.9	4.3	2.7	3.1	5.3	(0.3)	(5.9)
10-Year Static Revenue Estimate	(\$3,665)	(\$5,617)	(\$3,666)	(\$1,797)	(\$6,055)	(\$3,223)	(\$11,980)	(\$498)	(\$11,980)
10-Year Dynamic Revenue Estimate (Billions)	(\$1,610)	(\$2,472)	(\$768)	\$737	(\$2,401)	(\$1,093)	(\$10,135)	(\$191)	(\$10,135)

Based on the data in this chart, all of the tax plans would benefit from the transition to dynamic scoring over static scoring. Additionally, all of the tax plans proposed by the Republican candidates have a more positive overall effect on the economy than the plans proposed by the two Democrat candidates.

CHAPTER VI: REFORM EFFECT REVIEW

This chapter includes the current corporate income tax information of Lockheed Martin, Liberty Mutual, and Facebook in order to have a background on the current taxes each company pays without one of the three reform plans in place. Additionally, this chapter determines how changes in each proposal would affect each company. This is done in order to start to determine which company and their respective industries would benefit the most from each tax reform proposal.

Detailed Income Tax Expense Information

Lockheed Martin Corporation:

Table 2: 2014 Income Tax Provision (Data is Listed in Millions)

Federal Income Tax Expense (Benefit)	
Current	\$2,020
Deferred	(387)
<hr/>	
Total Federal Income Tax Expense	1,633

Table 3: 2014 Income Tax Expense Reconciliation (Data is Listed in Millions)

Income Tax Expense at the U.S. Federal Statutory Tax Rate	\$1,840
U.S. Manufacturing Deduction Benefit	(127)
Research & Development Tax Credit	(66)
Tax Deductible Dividends	(82)

Goodwill Impairment (Non-Deductible Portion)	30
Other, Net	49
<hr/>	
Income Tax Expense	\$1,644

Liberty Mutual Holding Company:

Table 4: 2014 Income Tax Provisions (Data is Listed in Millions)

Current Tax Expense (Benefit):

U.S. Federal	\$286
U.S. Federal Benefit of Net Operating Losses	(401)
State	3
Foreign	132
<hr/>	
Total Current Tax Expense	20

Table 5: 2014 Rate/Income Tax Expense Reconciliation (Data is Listed in Millions)

Expected U.S. Federal Income Tax Expense \$926

Tax Effect Of:

Nontaxable Investment Income	(122)
Change in Valuation Allowance	(1)
Goodwill	-
Revision to Estimates	7
General Business Credits	(40)
Audit Settlement	(60)
State	3
Foreign	42
Other	2
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Actual Income Tax Expense	\$757
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Facebook Inc.:

Table 6: 2014 Income Tax Provision (Data is Listed in Millions)

Current:

Federal	\$1,999
State	130
Foreign	96
Total Current Tax Expense	2,225

Deferred:

Federal	(240)
Provision for Federal Income Taxes	\$1,985

Table 7: 2014 Rate Reconciliation (Data is Listed in Percentages)

U.S. Federal Statutory Income Tax Rate	35.0%
State Income Taxes, Net of Federal Benefit	1.4
Research Tax Credits	(1.1)
Share-Based Compensation	6.5
Effect on Non-U.S. Operations	(3.6)
Other	1.9
Effective Tax Rate	40.1%

Tax Reform Proposal Effects

This section contains an analysis of the financial statements of manufacturing, service-based, and technology corporations in order to determine the potential tax effects

of each corporate tax reform proposal. All of the financial statements that were analyzed are from 2014. The effective tax rates used in the analysis were self reported and the specifics of the calculated rates are unknown.

Manufacturing Corporation: Lockheed Martin Corporation

Effects of Congressman Dave Camp's Draft Legislation

Under Dave Camp's proposal the following would affect Lockheed Martin's taxes. Currently, Lockheed Martin's statutory corporate rate is 35 percent and effective rate is 31.3 percent (*Lockheed Martin Corporation 2014 Annual Report, 2014*). Dave Camp's proposal calls for the corporate tax rate to be 25 percent, so this would reduce the overall rate that Lockheed Martin would have to pay. Capital gains and dividends will be considered normal income and 40 percent of it will be exempt from tax. Lockheed Martin paid \$1.8 Billion in dividends. The cost recovery system will be based on economic life and straight-line depreciation will be used. Additionally, special depreciation will be eliminated. Currently, Lockheed Martin has accumulated depreciation of \$8,740 million. Lockheed Martin's property plant and equipment include \$99 million of land, \$5,724 million in buildings, \$7,036 million in machines and equipment, and \$636 million in construction in progress. Research and experimental investments can be amortized over 5 years and Lockheed Martin had \$751 million of unreimbursed research and development cost of sales. The interest limitation rule that pertains to debt issues with respect to corporate acquisitions will be repealed and Lockheed Martin had \$900 million in acquisitions. Lastly, intangible amortization is to be expanded to 20 years. Lockheed Martin has goodwill impairment of \$119 million, which increased their effective tax rate by .6 percent (*Lockheed Martin Corporation 2014 Annual Report, 2014*).

Effects of Congressman Devin Nunes' Informal Draft Legislation

Under Devin Nune's proposal the following tax code changes would affect Lockheed Martin. Devin Nunes' proposal also calls for the corporate tax rate to be 25 percent. Lockheed Martin's currently has a corporate tax rate of 35 percent and effective tax rate of 31.3 percent. Interest income will be taxed the same as dividends and capital gains. Lockheed Martin reported interest expense of \$5,592 million but no interest income. Full expensing will be phased in over 10 years and special loopholes will be eliminated. Deductions and credits will be eliminated with the exception of property. Lockheed Martin currently benefits from the U.S. manufacturing deduction, and the research and development tax credit. Due to the U.S. manufacturing deduction, Lockheed Martin was able to deduct \$127 million and had a decrease of 2 percent in their taxes. Lockheed Martin's benefit from the research and development tax credit was \$66 million and the credit decreased Lockheed Martin's effective rate by .9 percent. The deductions and credits decreased the tax expense from \$1,840 million to \$1,664 million. Under Nunes' proposal companies can carry forward expensing with interest or carry back expensing. A territorial system will be implemented. This will affect Lockheed Martin because they have \$9,015 million in international net sales. The business interest deduction will be removed so that there is no longer pressure for companies to carry debt. Lockheed Martin holds long-term debt of \$6,169 million. Since they will no longer receive a deduction for the amount of interest paid, which is \$5,592 million, Lockheed Martin could be encouraged to not carry as much debt. The cash method of accounting will be used and currently Lockheed Martin uses the percentage of completion method

for sales with the U.S. government and the services method for non-U.S. government customers (*Lockheed Martin Corporation 2014 Annual Report*, 2014).

Effects of Senators Marco Rubio and Mike Lee's Informal Draft Legislation

Rubio and Lee's plan will affect Lockheed Martin's taxes in the following ways. The Rubio and Lee proposal also calls for the corporate tax rate to be 25 percent. Lockheed Martin currently has an effective tax rate of 31.3 percent. The territorial system will be implemented, which will affect Lockheed Martin because they have international sales of \$9,015. There will no longer be a double tax on shareholder capital gains and dividends. Lockheed Martin paid dividends of \$1.8 billion. Full expensing will be implemented. Interest income will be removed from the tax base and borrowers will not receive deductions. Lockheed Martin did not report any interest income but they did pay \$5,592 million of interest. Lockheed Martin holds \$6,169 of long-term debt. The R&D tax credit would not be extended based on this plan as well. In 2014, Lockheed Martin benefitted from the research and development tax by \$66 million (*Lockheed Martin Corporation 2014 Annual Report*, 2014).

Service Based Corporation: Liberty Mutual Holding Company

Effects of Congressman Dave Camp's Draft Legislation

The following are the effects of Dave Camp's proposal on Liberty Mutual. Dave Camp's proposal also calls for the corporate tax rate to be 25 percent, which is lower than the 2014 effective tax rate of Liberty Mutual, which was 29% (*Management's Discussion*, n.d.). Liberty Mutual paid \$757 million in income taxes. Capital gain and dividends will be considered normal income and 40 percent will be exempt from taxation. Liberty Mutual had dividend income of \$74 million. The cost recovery system will be

based on economic life and straight-line depreciation will be used. Liberty Mutual has \$966 million in depreciation and amortization. However, Liberty Mutual already used straight-line depreciation so this depreciation regulation will not affect them. The interest limitation rule that pertains to debt issues with regards to corporate acquisitions will be repealed. Liberty Mutual acquired Uni, Asia Feneral Insurance Berhad for \$32 million, Primero Fianzas for a currently undisclosed amount, Hughes Insurance for approximately \$73 million, and Quinn Insurance Limited. Liberty Mutual purchased 900,000 ordinary shares of Quinn Insurance Limited. Intangible amortization is to expand to 20 years. Liberty Mutual recognized \$52 million for intangible amortization expense related to acquisitions. These intangible assets related to acquisitions included \$358 million for the Safeco agency relationship, \$95 million for the Ohio Casualty agency relationship, \$229 million for trademarks, \$82 million for state licenses, and \$6 million for other intangibles. Amortization was applied as follows: Safeco agency, 15-years on the straight-line method; Ohio Casualty, 20 years straight-line method; and 10 years using the present value mid-year convention for other intangible assets. These intangible assets are net of accumulated amortization of \$323 million as of December 31, 2014. (*Liberty Mutual Holding Company Inc. 2014 Annual Report, 2014*).

Effects of Congressman Devin Nunes' Informal Draft Legislation

Devin Nunes' tax proposal will affect Liberty Mutual in the following ways. Devin Nunes' proposal also calls for the corporate tax rate to be 25 percent. Liberty Mutual paid \$757 million or 29 percent in income taxes. Non-business income tax will remain the same with the exception that interest income will be taxed the same as dividends and capital gains. Liberty Mutual has taxable interest income of \$2,207 million

and tax-exempt interest income of \$399 million. Full expensing will be implemented and phased in over 10 years. Liberty Mutual has \$898 million in property and equipment purchases. Special loopholes will be eliminated, along with deductions and credits with the exception of those for property. Liberty Mutual benefitted from the general business credit by \$40 million. Territoriality will be implemented, as well as a 5 percent tax on undistributed foreign earnings. Liberty Mutual has offices in 19 countries and the Liberty International Strategic Business Units, which consists of insurance companies that sell property, casualty, life, and health insurance products to individuals and businesses, are in 18 countries. The business interest deduction will be removed. Liberty Mutual has long-term debt of \$7,232 million and an interest expense of \$4,944 million. The cash method of accounting will be used. (*Liberty Mutual Holding Company Inc. 2014 Annual Report, 2014*).

Effects of Senators Marco Rubio and Mike Lee's Informal Draft Legislation

Rubio and Lee's proposal's effects on Liberty Mutual are discussed below. The Rubio and Lee proposal also calls for the corporate tax rate to be 25 percent. Liberty Mutual had an effective rate of 19 percent. The territorial system will be implemented and this will affect Liberty Mutual because they have offices in 19 countries and Liberty International Strategic Business Units are in 18 countries. Full expensing will be implemented. Liberty Mutual purchased \$898 million of property and equipment. Interest income will be removed from the tax base and borrowers will no longer receive deductions. Liberty Mutual has taxable interest income of \$2,207 million and tax-exempt interest income of \$399 million. They also have long-term debt of \$7,232 million and an

interest expense of \$4,944 million (*Liberty Mutual Holding Company Inc. 2014 Annual Report*, 2014).

Technology Company: Facebook Inc.

Effects of Congressman Dave Camp's Draft Legislation

The following tax code changes within Dave Camp's proposal would either positively or negatively affect Facebook's taxes. Camp's plan reduces the corporate tax rate of 25 percent and the effective tax rate for Facebook is 40 percent. The effective tax rate of Facebook in 2013 was 46 percent and in 2012 was 89 percent (*Facebook Inc. 2014 Annual Report*, 2014). In 2014, Facebook paid \$1,970 million in income taxes. The cost recovery system will change to be based on the economic life and straight-line depreciation will be used. Facebook's network equipment has useful lives of 2-5 years, buildings have useful lives of 4-20 years, and computer software has useful lives of 3-5 years. Facebook's depreciation and amortization expense totaled \$1,243 million. Additionally, research and experimental investments would be amortized over 5 years and in 2014, Facebook had \$2,666 million in research and development expenses. Research and development accounts for 21 percent of their revenue. Facebook has \$135 million in advertising expenses and based on Camp's plan 50 percent of advertising expenses will be deducted currently. The other 50% will not be allowed to be deducted in order to determine taxable income. The interest limitation rule that pertains to debt issued with respect to corporate acquisitions will be repealed. Facebook has no long-term debt but acquired WhatsApp and Oculus, along with some other items, this year. Facebook acquired WhatsApp with a \$17,193 million purchase consideration and paid with \$4.6 billion cash and 23 million shares of Class A common stock and acquired Oculus with a

purchase consideration of \$1,853 million and paid with \$400 million cash and 23 million shares of Class B common stock. Their other acquisitions had a purchase consideration of \$485 million (*Facebook Inc. 2014 Annual Report*, 2014).

Effects of Congressman Devin Nunes' Informal Draft Legislation

Devin Nunes' tax proposal would affect Facebook's tax liability in the following ways. Nunes' plan also reduces the corporate tax rate of 25 percent and the effective tax rate for Facebook is 40 percent. Full expensing will be used and phased in over 10 years. Facebook purchased \$1,831 million worth of property and equipment in 2014 and it would be able to fully expense these costs under the plan. Facebook benefitted from a research tax credit by 1.1 percent. The territorial system will be implemented and will affect Facebook because it has data centers and offices in 25 countries and non-US revenue of \$6,817 million, which is greater than its US revenue of \$5,649 million. The business interest deduction will be removed. Facebook has no long-term debt but it did pay \$14 million in interest. The cash method of accounting will be used. Facebook has 9,199 employees and 1,837 million in share-based compensation (*Facebook Inc. 2014 Annual Report*, 2014).

Effects of Senators Marco Rubio and Mike Lee's Informal Draft Legislation

Like Camp and Nunes plans, the Rubio/Lee plan reduces the corporate tax rate to 25 percent. Rubio and Lee's plan calls for the implementation of a territorial tax system. Facebook has data centers and offices in 25 countries and has revenue of \$6,817 that is earned outside of the United States. Full expensing will also be implemented and Facebook purchased property and equipment for \$1,831 million in 2014. Interest income

will be removed from the tax base and borrowers will no longer receive deductions.

Facebook had interest income of \$4 million and paid \$14 million in interest in 2014.

CHAPTER VII: ANALYSIS AND CONCLUSION

In order to determine which proposal benefits each company the most, the following key factors are compared for Lockheed Martin, Liberty Mutual, and Facebook: the amount of capital investments, the amount of long-term debt and interest expense, foreign income taxes, and tax credits. Capital investments are significant because full expensing will directly affect them and capital investment will be more favorable as a result of full expensing. If the business interest expense deduction is eliminated, the amount of long-term debt and interest expense will be affected. The percentage that foreign income taxes makes up of all income taxes paid illustrates the percentage of business each company does outside of the United States. This foreign business would be affected in a positive way by the implementation of the territorial system. Lastly, the amount of tax credits and deductions each company has determines the effect of the removal of these credits and deductions on each company.

Capital Investment Analysis

Table 8

Capital Investment	
<i>Company</i>	<i>Amount (in millions)</i>
Lockheed Martin	\$845
Liberty Mutual	\$898
Facebook	\$1,083

In 2014, Facebook had the highest amount of capital investments and therefore if this trend continues would benefit the most from full expensing, which would be implemented under both the plans Congressman Devin Nunes and Senators Marco Rubio and Mike Lee. This conclusion was surprising because it seemed reasonable that a manufacturing company would spend the most on investments in property, plant, and equipment and thus benefit the most from full expensing.

Long Term Debt and Interest Expense Analysis

Table 9

Long Term Debt	
<i>Company</i>	<i>Amount (in millions)</i>
Lockheed Martin	\$6,169
Liberty Mutual	\$7,232
Facebook	No Long Term Debt

Table 10

Interest Expense	
<i>Company</i>	<i>Amount (in millions)</i>
Lockheed Martin	\$5,592
Liberty Mutual	\$4,944
Facebook	\$14

Facebook would be least affected by the elimination of business interest deductions, which are called for in Congressman Devin Nunes’ plan, as well as Senators Marco Rubio and Mike Lee’s plan. The elimination has been proposed in order to stop

the preference that companies have for debt financing over equity financing. Facebook already has no long-term debt and also has the lowest, by a large amount, interest expense in 2014. As a result of both of these factors, no longer being able to deduct business interest will not be a great detriment to Facebook. This elimination would have a more substantial potentially negative effect on Lockheed Martin and Liberty Mutual. Congressman Dave Camp's plan does not call for the elimination of business interest expense deductions. Instead of implementing full expensing in place of business interest deductions, Dave Camp's plan leaves the current business interest expense deductions in place. Liberty Mutual has the highest amount of long-term debt and Lockheed Martin has the greatest interest expense and would benefit more from the current business interest deductions, included in Congressman Dave Camp's plan, more than the full expensing both the plans of Congressman Devin Nunes and Senators Marco Rubio and Mike Lee provide.

Foreign Income Taxes Analysis

Table 11

Foreign Income Taxes	
<i>Company</i>	<i>Percentage of Foreign Income Tax Expense to Total Income Tax Expense</i>
Lockheed Martin	0.67%
Liberty Mutual	17.9%
Facebook	5.4%

Since all of the companies have operations located outside of the United States, they would all benefit from the implementation of the territorial system that is proposed

in both the plans of Congressman Devin Nunes and Senators Marco Rubio and Mike Lee. Liberty Mutual currently has the highest percentage of their total income tax expense as foreign income tax expense, which might suggest that Liberty Mutual has the highest percentage of total income located abroad. Based on this assumption, Liberty Mutual would benefit the most from the introduction of the territorial system.

Tax Credits Analysis

Table 12: amounts listed in millions

Lockheed Martin:

US Manufacturing Deduction	\$127
<u>Research & Development Tax Credit</u>	<u>\$66</u>
Total	\$193

Liberty Mutual:

General Business Tax Credits	\$40
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Facebook:

Research Tax Credit	\$61.9
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Lockheed Martin currently benefits the most from tax credits overall, and for research and development specifically. As a result the elimination of these deductions, as proposed in Congressman Devin Nunes’ plan, would have the greatest impact on Lockheed Martin, followed by Facebook. Additionally, the policy of amortizing research and development costs over 5 years as proposed in Congressman Dave Camp’s plan would have the greatest impact on Lockheed Martin as well, followed by Facebook. Liberty Mutual did not utilize any research and development tax credits and therefore would not be affected by this change to amortization.

Conclusion

Additionally, if other companies in each industry have similar attributes as the selected companies, these conclusions might be generalized to that industry. Facebook would seem to benefit the most from Rubio/Lee plan because full expensing is more beneficial for Facebook than business interest deductions because Facebook both had the most capital investments in 2014 but also the lowest amount of long term debt and interest expense. Additionally, this plan does not call for the removal of tax credits and deductions or a change to amortization for research and development costs. Lastly, Facebook has a significant presence internationally and would benefit from the territorial system that would be implemented under this plan. The Rubio/Lee plan might be the most beneficial to the technology industry as a whole. Lockheed Martin would benefit the most from the plan of Senators Marco Rubio and Mike Lee. Lockheed currently benefits the most from the current tax credits and deductions, specifically the U.S. Manufacturing deduction and the research and development credit, which are not taken away with the Rubio and Lee plan. The manufacturing industry as a whole might also benefit from keeping these credits and deductions. Liberty Mutual would benefit more from the current business interest deductions because it carries the most long-term debt and had the greatest interest expense and these amounts were greater than the amount of capital investment Liberty Mutual made. This factor points to Congressman Dave Camp's plan. Additionally the tax credit elimination proposed by Congressman Devin Nunes' plan would not hurt Liberty Mutual as much compared to Lockheed Martin and Facebook. Additionally, the amortization of research and development costs, as proposed by Congressman Dave Camp, would not hurt Liberty Mutual because they did not claim any

research and development costs. Lastly, Liberty Mutual would benefit the most from the territorial system, which was proposed by Congressman Devin Nunes and Senators Marco Rubio and Mike Lee, due to the large percentage of foreign operations that it has. Based on these observations, Liberty Mutual and the service-based industry as a whole, would benefit greatly from any of these plans being enacted.

According to the bipartisan Joint Committee on Taxation's analysis and scoring of Congressman Dave Camp's Tax Reform Act of 2014, the changes proposed in the plan would "result in an increase in economic output relative to present law" (*Macroeconomic Analysis*, 21). According to the analysis this is because the broadening of the tax base through eliminating deductions, exemptions, and tax credits will allow the tax rates to decrease which in turn increases the need for labor and the demand for goods and services. The Joint Committee on Taxation also reported that the Tax Reform Plan of 2014 would create 1.8 million new private sector jobs and increase Gross Domestic Product by up to \$3.4 trillion ("Camp Releases", 2014).

The tax reform plans of Congressman Dave Camp, Congressman Devin Nunes, and Senators Marco Rubio and Mike Lee all call for a reduction in taxes, which when looked at through static scoring lowers the amount of revenue the government will receive. This fact will cause a static scoring of the bill to not be favorable. The use of dynamic scoring will help all of these tax reform proposals because they all aim to at the very least be revenue neutral and hope to increase revenue through the positive impact each claim they would have on the economy. As discussed previously in this thesis, dynamic scoring takes into effect these economic factors and all of these plans would also receive a more favorable score from dynamic scoring compared to static scoring.

Tax reform is typically viewed as a daunting task due to the amount of scrutiny each reform plan receives from different committees within both the Senate and the House of Representatives, the Joint Committee on Taxation, and from the public. Additionally, who the President is and the party that he or she is affiliated with also plays a major role. From comparing the Presidential tax proposals with the tax proposal of Congressman Dave Camp, Congressman Devin Nunes, and Senators Marco Rubio, one of these proposals will be more likely to be passed if a Republican is in the White House. More specifically the plans of Senators Marco Rubio and Mike Lee and Congressman Devin Nunes would be more likely to be supported and eventually passed if that Republican is either John Kasich, Jeb Bush, Jim Gilmore, Marco Rubio, or Ted Cruz. Both of these plans include the implementation of full expensing and the territorial system and so do all of these Republican candidates' plans. Corporations would study and evaluate the specific potential benefits any proposed plans would have on the company and the company's industry and would push lobbying efforts on a specific tax reform plan that provides the most benefits. Additionally, the public should learn about the economic growth the plans would bring from more jobs and higher wages and ask for corporate tax reform. If company lobbying efforts are focused on specific tax reform that also have general public support, needed tax reform might be legislated all the way through the federal process and become law.

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