November 14, 2014
Issue No: 14/46

US Economics Analyst

Economics Research

Tax Reform: Getting Closer

- The probability of tax reform next year has risen over the last several months, in our view, as a result of a shrinking budget deficit, the recent focus on international tax issues (e.g., inversions), and Republican majorities in Congress following the midterm election.

- However, there are several obstacles to enactment. First, many lawmakers are hesitant to limit tax reform to the corporate sector, but there is less political consensus on individual tax reform. Second, the White House and congressional Republicans agree that corporate reform should not result in a tax increase, but disagree on how to judge this. Third, even if partisan differences can be bridged, tax reform will inevitably create winners and losers.

- If it does manage to become law, some aspects of a potential corporate tax reform package look fairly likely. First, we expect that it would include a low-tax repatriation of untaxed foreign profits. However, we would only expect to see this enacted as part of broader tax reform, and do not expect another temporary tax "holiday" like the one enacted in 2004 to enacted on a standalone basis.

- Second, corporate reform would likely change incentives related to corporate investment, by increasing the effective tax rate on investment in equipment and potentially research, while lowering the tax burden on investment in structures.

- Third, effective tax rates across industries would likely converge. The health care and technology sectors, for example, benefit from low taxation of foreign income and income from intellectual property like patents. Effective tax rates on these sources would probably rise, while rates on domestic sources would probably fall.

Tax Reform: Getting Closer

With Republicans set to control majorities in the House and Senate starting in January 2015, there are a wide range of views regarding whether tax reform—or anything else, for that matter—can be accomplished before the next election. We continue to believe that the probability of business tax reform has risen for three reasons:

- **The election result increases the likelihood of action on tax reform.** In our view, a Republican majority in the House and Senate makes it likely that Congress will begin to act on reform in the coming year. Both parties highlighted reform as a priority, but Republicans have put it at the top of their agenda. With control of both chambers, there will now be pressure on Republican leaders to move a proposal forward.
- **Smaller deficits reduce the pressure to raise revenue.** Several years ago, tax reform was discussed mainly as a means of deficit reduction: the Bowles-Simpson commission contemplated reform as a means of raising revenue, and the issue was considered as part of a "grand bargain" on fiscal policy. However, with the budget deficit now under 3% of GDP and likely to remain there for the next few years, the pressure on lawmakers to raise revenue (or cut spending) has dissipated, though longer-term imbalances must still be addressed.
- **Inversions have highlighted the need for corporate reform.** Inversions generated a substantial political response when the trend began to accelerate earlier this year. The Treasury issued new rules in September, which have reduced the flow of these deals at least temporarily, although it remains to be seen how long this pause will last. Some inversion transactions are still moving forward, so the issue may attract renewed attention if they are completed in coming months.

That said, while we expect a substantive debate on tax reform over the next year and believe the issue will attract a good deal of attention, reform legislation still faces an uphill climb to become law in light of a number of obstacles and unanswered questions:

- **Corporate, business or comprehensive tax reform?** There is fairly broad consensus on the need to improve the corporate tax but also some resistance to addressing it outside of broader tax reform. Partnerships, sole proprietorships, and other pass-through businesses are taxed at individual rates and it could be politically difficult to exclude them. Lowering rates on business income taxed at the individual as well as the corporate level would address this but would be difficult politically. The alternative is broad tax reform, but this requires thorny distributional issues to be addressed regarding personal income taxes.
- **What does "revenue neutral" mean?** The White House and Republicans agree that revenue gained by limiting corporate tax breaks should be used to lower corporate tax rates, but disagree on how to measure this. Republicans prefer a starting assumption that expiring corporate tax breaks are extended; the White House starts with a scenario that assumes expiration (most expired at the start of 2014). Second, many Republicans, including potential House Ways and Means Chairman Paul Ryan (R-WI), have urged budget scorekeepers to count indirect revenue gains (or losses) due to macroeconomic feedback in estimates of budgetary effects. Third, the some Democrats worry that tax changes that appear revenue neutral over the next decade—the standard time frame for budgetary estimates—but would reduce net revenue in later periods.
- **Winners and losers.** To significantly lower rates, most major tax preferences would need to be curtailed. Once these changes become clear, affected constituencies will inevitably push back against the changes. This is particularly challenging regarding personal taxes; to achieve a sizable rate reduction, deductions for mortgage interest,

state and local taxes and/or the exclusion of employer-sponsored health insurance would need to be limited or repealed, among others.

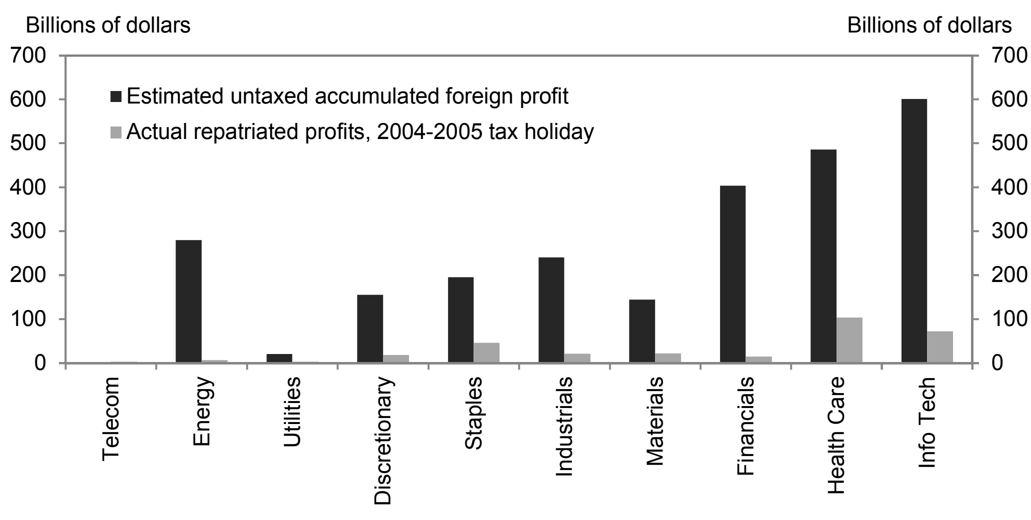
Early views on potential effects

Given what we see as rising probability of some type of reform—notwithstanding the many challenges noted above—and the increasing attention we expect the issue to receive over the coming year, we highlight four of the most important aspects of potential changes to the corporate tax code:

1. There is a high probability of low-tax repatriation as part of tax reform, but only as part of tax reform. Any tax reform proposal that could become law over the next year is likely to include a low-tax repatriation of accumulated foreign profits, in our view. One model was proposed by retiring Ways and Means Chairman Camp earlier this year, which would tax future foreign earnings at a 1.25% rate. In order to transition to the new system, any accumulated overseas earnings that had not been taxed by the US would be taxed at 8.75% if held in cash, or 3.5% if reinvested in foreign assets.

However, we continue to be skeptical that a standalone repatriation holiday will be enacted outside of tax reform, since reform proponents will want to save the prospect of profit repatriation as an incentive for companies to support broader reform legislation. More importantly, most repatriation proposals have been estimated to reduce revenues when enacted on a standalone basis.

Exhibit 1: Accumulated foreign profits by sector



Source: Internal Revenue Service Statistics of Income Division. Goldman Sachs Global Investment Research.

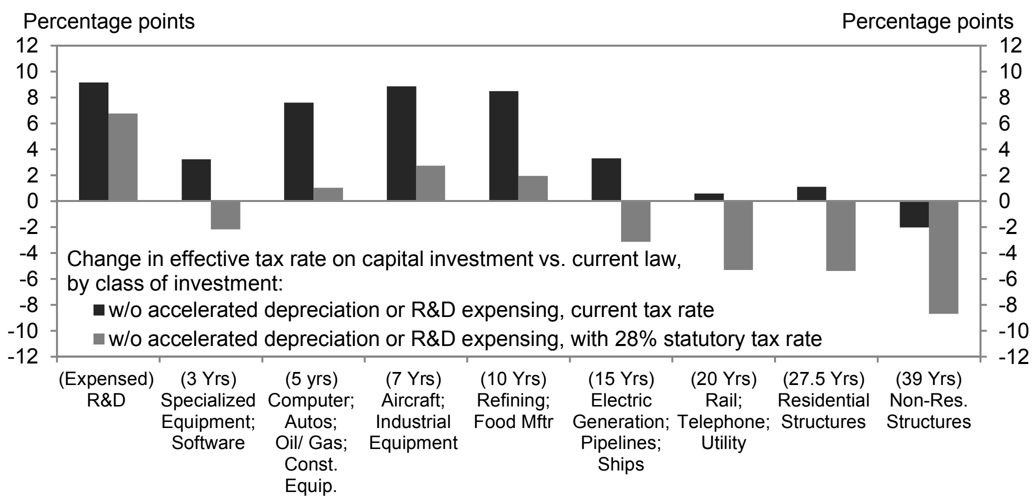
If low-tax repatriation were to be enacted, the flow of cash to US parent companies would be substantial. Since the last repatriation tax holiday in 2004, US multinationals have accumulated $2.5 trillion in untaxed profits in overseas subsidiaries.[1] Not all of this is held as cash, but much of it is. While aggregate figures by sector are not readily available, we can get a general sense from IRS data on controlled foreign corporations (CFCs). The most recent data as of 2011 show $1.7 trillion in untaxed foreign earnings, concentrated in the

[1] This figure is derived by cumulating "reinvested earnings" from direct investment income on assets in the Commerce Department's U.S. International Transactions report (Table 4.2).

information technology, health care, and financial sectors. Exhibit 2 shows the distribution of these accumulated earnings by sector.[2] Only a portion of these earnings are held in cash.

2. Corporate investment incentives would change. Current tax rules front-load depreciation deductions, which reduce the effective tax rate on investment in an average interest rate environment. A separate policy allows for the immediate expensing of research costs and front-loaded expensing of many other intangibles. The result is an incentive to invest in intellectual property and shorter-lived equipment and less relative incentive to invest in structures. We expect that corporate tax reform would probably change this; Exhibit 2 estimates the change in the effective tax rate on investment if accelerated depreciation and research expensing were replaced with straight line depreciation over the life of an asset (representative types of investment are listed for each asset class), and a second scenario that combines straight line depreciation with a lower 28% corporate tax rate. Most reform proposals follow this pattern, because it is difficult to reduce the statutory corporate rate very far without repealing one or both.

Exhibit 2: Current depreciation system favors research and equipment over structures



Source: Bureau of Economic Analysis. Internal Revenue Service. Congressional Research Service. Goldman Sachs Global Investment Research.

3. Tax rates across sectors would probably converge. Technology and health care companies have the lowest median tax rates among the ten sectors in the S&P 500. This is probably due in large part to the importance of intellectual property in these sectors and, related to this, the large share of income attributed to overseas activities, since intellectual property assets are highly mobile. We can see this, for example, by comparing the tax rates shown in Exhibit 3 with the share of unrepatriated earnings accounted for by these sectors. The importance of intellectual property—particularly patents—also likely plays a role: pharmaceutical firms alone held 37% of the stock of R&D-related intellectual property in 2013, with technology firms and other manufacturers accounting for most of the rest.

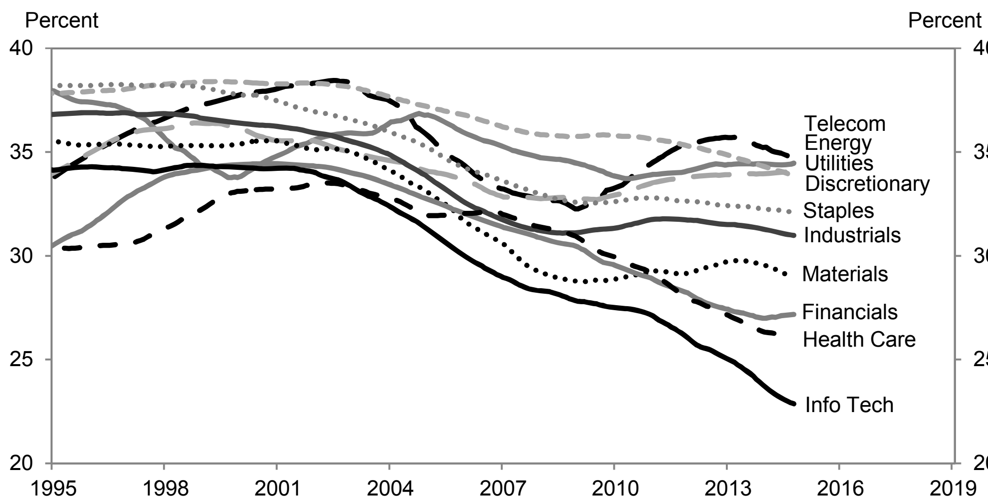
Tax reform proposals vary in how they would treat income from foreign sources and/or intangible income, but in general they raise the tax rate on foreign income from intangibles while lowering the rate on other forms of foreign income—though they differ quite a bit on

[2] We make two simplifying assumptions: first, we allocate accumulated earnings in holding companies, which are reported separately, to each sector based on its accumulated earnings; second, levels by sector have been increased proportionately to equal the current level of reinvested earnings reported by the Commerce Department.

how much lower the rate on other foreign income would be. The Camp plan, for example, would tax foreign income from intangibles at a 15% rate but tax foreign income from general business at only 1.25%. By contrast, the President's corporate tax reform framework includes a similar proposal regarding income from intangibles, but would impose a higher minimum rate on other foreign income (that plan does not specify a rate, but a similar proposal from former Senate Finance Chairman Max Baucus proposed a rate of 17% to 22%, for example).

The upshot is that while the tax rate on repatriated foreign earnings seems likely to fall in general, the tax rate on income from intangibles and other mobile sources is likely to rise.

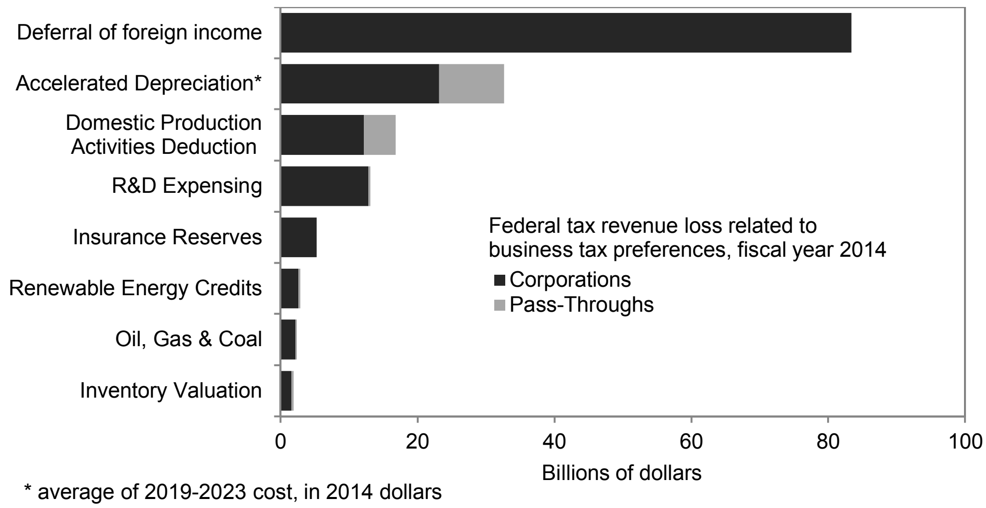
Exhibit 3: Effective tax rates vary widely by sector



Source: Compustat. Goldman Sachs Global Investment Research.

4. Industry-specific tax benefits would also be scaled back under reform. Any foreseeable corporate tax reform plan would need to reduce or eliminate most industry-specific tax preferences to offset the effect that lower statutory rates would have on revenues. It is far too early to predict which preferences would end and which might survive, but it is worth noting three areas where tax preferences have been targeted. First, firms can deduct 9% of "domestic production activity" from income related to manufacturing, construction, electricity generation, software development and a few other activities. This appears likely to disappear as part of tax reform, though some proposals (e.g., Rep. Camp's) would retain other preferences for manufacturers. Second, energy-related provisions are likely to come under scrutiny. The White House has proposed for several years to repeal tax benefits for fossil fuel production, and opposition to some provisions incentivizing renewable energy has increased among congressional Republicans. The financial sector is also an area that might see increased taxation. Apart from any new taxes that might be considered, the insurance industry—particularly life insurance—benefits from a number of provisions that have been targeted for repeal in several proposals.

Exhibit 4: Corporate tax preferences



Source: Joint Committee on Taxation. Treasury Department.

The path forward for tax reform

If tax reform is to have a fighting chance of becoming law in 2015, work will need to begin soon. The first task will be to clear out unfinished business, namely the renewal of expired and soon-to-expire corporate tax provisions (so-called "tax extenders"). The Senate Finance Committee has passed a two-year extension of nearly all expired measures (through 2015) while the House has passed legislation to make several key items permanent, including bonus depreciation and the research and experimentation credit. Our expectation is that the two-year extension will prevail, with selected items made permanent (e.g., the research credit).

After new Republican chairmen have settled into their roles on the House and Senate tax-writing committees in early 2015, we expect to see draft tax reform proposals dealing with corporate and individual tax reform. The window of opportunity for passage of reform legislation would probably close by late Q3 or Q4 2015, when Congress is likely to be preoccupied with another debt limit increase, passing spending bills for 2016, and the onset of presidential election campaigns. If tax reform doesn't become law in 2015—and we believe there is only about a 30% probability that any type of reform will—we would nevertheless expect enough progress to be made that it would lay the groundwork for potential enactment in 2017 or 2018.

Alec Phillips

The US Economic and Financial Outlook

(% change on previous period, annualized, except where noted)

	2013	2014 (f)	2015 (f)	2016 (f)	2017 (f)	2014 Q1	2014 Q2	2014 Q3	2014 Q4	2015 Q1	2015 Q2	2015 Q3	2015 Q4
OUTPUT AND SPENDING													
Real GDP	**2.2**	2.2	3.1	3.0	3.0	**-2.1**	**4.6**	**3.5**	2.7	3.0	3.0	3.0	3.0
Consumer Expenditure	**2.4**	2.3	2.9	2.7	2.5	**1.2**	**2.5**	**1.8**	3.2	3.0	3.0	3.0	3.0
Residential Fixed Investment	**11.9**	1.7	9.0	12.3	12.3	**-5.3**	**8.8**	**1.9**	8.0	10.0	10.0	12.5	12.5
Business Fixed Investment	**3.0**	5.8	5.7	5.5	5.4	**1.6**	**9.7**	**5.5**	3.8	6.1	6.1	5.5	5.5
Structures	**-0.5**	8.1	5.6	5.0	5.0	**2.9**	**12.6**	**3.7**	6.5	5.0	5.0	5.0	5.0
Equipment	**4.6**	6.1	6.4	6.1	5.9	**-1.0**	**11.2**	**7.2**	2.3	7.5	7.5	6.0	6.0
Intellectual Property Products	**3.4**	3.9	4.7	5.0	5.0	**4.7**	**5.5**	**4.2**	4.0	5.0	5.0	5.0	5.0
Federal Government	**-5.7**	-1.8	-0.7	-1.3	-0.6	**-0.1**	**-0.9**	**9.9**	-5.0	-3.0	0.0	0.0	-2.0
State and Local Government	**0.5**	1.0	1.9	2.0	2.0	**-1.2**	**3.4**	**1.3**	1.6	2.0	2.0	2.0	2.0
Net Exports ($bn, '09)	**-420**	-431	-449	-485	-506	**-447**	**-460**	**-410**	-408	-422	-440	-458	-477
Inventory Investment ($bn, '09)	**64**	61	73	86	92	**36**	**85**	**63**	63	71	71	71	77
Industrial Production, Mfg	**2.7**	3.3	3.7	3.5	3.5	**1.4**	**6.7**	**3.5**	3.2	3.5	3.5	3.5	3.5
HOUSING MARKET													
Housing Starts (units, thous)	**930**	1,008	1,166	1,313	1,460	**925**	**985**	**1,024**	1,097	1,117	1,151	1,179	1,216
New Home Sales (units, thous)	**430**	447	521	597	686	**431**	**427**	**446**	486	500	514	527	543
Existing Home Sales (units, thous)	**5,073**	4,905	5,140	5,349	5,484	**4,603**	**4,867**	**5,120**	5,030	5,064	5,114	5,165	5,217
Case-Shiller Home Prices (%yoy)*	**9.9**	4.2	3.1	2.0	1.4	**9.0**	**6.5**	5.2	4.2	3.2	3.7	3.4	3.1
INFLATION (% ch, yr/yr)													
Consumer Price Index (CPI)	**1.5**	1.7	1.3	2.3	2.3	**1.4**	**2.1**	**1.8**	1.6	1.4	1.0	1.0	1.6
Core CPI	**1.8**	1.8	1.9	2.1	2.2	**1.6**	**1.9**	**1.8**	1.9	1.9	1.8	1.8	1.9
Core PCE**	**1.3**	1.4	1.5	1.7	1.9	**1.2**	**1.5**	**1.5**	1.5	1.5	1.5	1.5	1.5
LABOR MARKET													
Unemployment Rate (%)	**7.4**	6.2	5.6	5.2	4.8	**6.7**	**6.2**	**6.1**	5.8	5.7	5.6	5.5	5.4
GOVERNMENT FINANCE													
Federal Budget (FY, $ bn)	**-680**	**-483**	-525	-575	-550	--	--	--	--	--	--	--	--
FINANCIAL INDICATORS													
FF Target Range (Bottom-Top, %)^	**0-0.25**	0-0.25	0.5-0.75	1.5-1.75	2.75-3	**0-0.25**	**0-0.25**	**0-0.25**	0-0.25	0-0.25	0-0.25	0.25-0.5	0.5-0.75
10-Year Note^	**2.72**	2.50	3.00	3.50	3.75	**2.71**	**2.56**	**2.42**	2.50	2.60	2.75	2.85	3.00
Euro ($/€)^	**1.35**	1.23	1.10	1.05	1.00	**1.37**	**1.37**	**1.33**	1.23	1.20	1.18	1.15	1.10
Yen (¥/$)^	**100**	109	120	125	125	**102**	**102**	**103**	109	112	114	115	120
Brent Crude Oil ($/bbl)^	**111**	85	85	90	90	**107**	**112**	**97**	85	83	80	85	85

* Weighted avg of metro-level HPIs for 366 metro cities where the weights are dollar values of single-family housing stock reported in the 2000 Census.
** PCE = Personal consumption expenditures. ^ Denotes end of period
NOTE: Published figures are in bold.

Source: Goldman Sachs Global Investment Research.

Economic Releases and Other Events

Date		Time (EDT)	Indicator	Estimate GS	Consensus	Last Report
Mon	**Nov 17**	8:30	Empire Manufacturing Survey (Nov)	n.a.	+11.2	+6.2
		9:15	**Industrial Production (Oct)**	**+0.1%**	**+0.2%**	**+1.0%**
		9:15	**Manufacturing Production (Oct)**	**+0.2%**	**+0.3%**	**+0.5%**
		9:15	**Capacity Utilization (Oct)**	**79.2%**	**79.3%**	**79.3%**
Tue	**Nov 18**	**8:30**	**Producer Price Index, Final Demand (Oct)**	**Flat**	**-0.1%**	**-0.1%**
			Ex Food & Energy	**+0.1%**	**+0.1%**	**Flat**
		10:00	Homebuilders' Survey (Nov)	n.a.	55	54
		16:00	Total TIC Data (Sep)	n.a.	n.a.	+$52.1bn
Wed	**Nov 19**	**8:30**	**Housing Starts (Oct)**	**+1.0%**	**+0.9%**	**+6.3%**
		14:00	Minutes of Oct 28/29 FOMC Meeting			
Thu	**Nov 20**	**8:30**	**Consumer Price Index (Oct)**	**Flat**	**-0.1%**	**+0.1%**
			Ex Food and Energy	**+0.16%**	**+0.1%**	**+0.1%**
			Consumer Price Index NSA	**237.420**	**237.298**	**238.031**
		8:30	Initial Jobless Claims	n.a.	284,000	290,000
		8:30	Continuing Claims	n.a.	2,385,000	2,392,000
		9:45	Markit PMI—Prel (Nov)	n.a.	56.5	55.9
		10:00	**Philadelphia Fed Survey (Nov)**	**+18.0**	**+18.3**	**+20.7**
		10:00	Existing Home Sales (Oct)	n.a.	-0.4%	+2.4%
		10:00	Leading Indicators (Oct)	n.a.	+0.5%	+0.8%
Fri	**Nov 21**	11:00	Kansas City Fed Survey (Nov)	n.a.	6	4

Source: Goldman Sachs Global Investment Research.