Tax reform plan & the defense industry

An overview of the proposed tax reform plan and its effect on the defense sector

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Tax reform timeline: the White House aims to sign legislation before the end of 2017

GOP leadership's projected tax reform timeline

Nov 1, 2017

The House Ways and Means Committee released tax legislation (H.R. 1) to the public on November 1

Nov 9, 2017

The Senate Finance Committee released a detailed outline of its tax reform bill; the House Ways and Means Committee passed H.R. 1 along party lines

Nov 2017

The House will consider H.R. 1 the week of November 13th; the Senate is expected to vote on its bill after Thanksgiving

Dec 2017

Treasury Secretary Mnuchin believes the House and Senate can reach compromise on tax reform by Christmas. The president wants to sign tax reform legislation by the end of 2017

Congress faces important deadlines before the December recess

Both chambers in session
Major legislative deadline
Senate in session only

November

			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30		

December

					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

Dec. 8 – Budget/appropriations extension

The new fiscal year began October 1st, but Congress passed legislation in September to fund the government only though December 8th. This prevented the threat of a shutdown, but Congress must vote on a budget again before that date to avoid risk of a shutdown before the holidays.

Dec. 8 – Debt ceiling limit expires

If Congress does not raise the debt ceiling, as some in the Freedom Caucus have suggested, the U.S. Treasury would not be able to make all of its payments and will need to use extraordinary measures, delaying a debt ceiling crisis potentially until March 2018.

Sources: Nick Timiraos and Richard Rubin, "Treasury Secretary says tax bill on track for completion next month," Wall Street Journal, November 10, 2017.

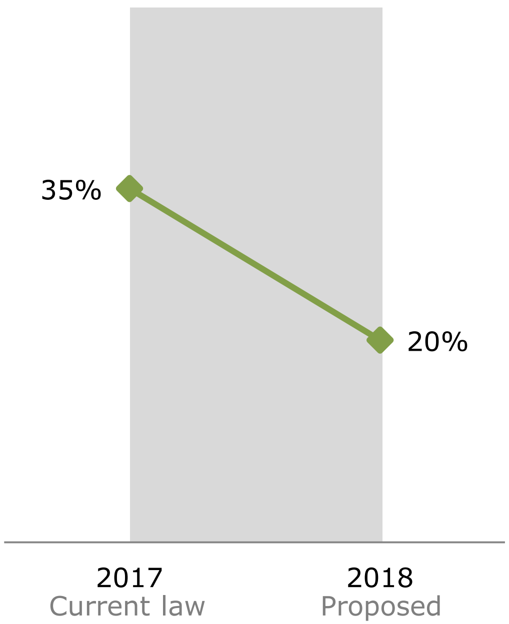
Corporate tax reform: main proposals

Current law	House bill	Senate bill
Income tax Seven individual tax rates: 10%, 15%, 25%, 28%, 33%, 35% and 39.6%	Reduces to **four brackets: 12%, 25%, 35% and 39.6%**	Keeps **seven brackets: 10%, 12%, 22.5%, 25%, 32.5%, 35%, 38.5%**
Corporate taxes Top corporate rate of 35% on taxable income over $10m a year	**Cuts corporate tax rate to a permanent 20% immediately,** taking effect in 2018	**Cuts corporate tax rate to a permanent 20% one year later**, taking effect in 2019
Pass-through business Business income from partnerships, S corporations and sole proprietorship is taxed at individual tax rates	**Creates special 25% rate** for pass-through income; in many cases only 30% of business owner's income is eligible, with other 70% classified as wage income. Establishes lower **9% rate** on first $75,000 for some taxpayers	**Creates new deduction** that sets top rate for pass-through income in the low 30s
Repatriation Corporations defer US taxes until they choose to bring foreign profits back	One-time tax of **14%** on liquid assets, **7%** on illiquid assets	One-time tax of **10%** on liquid assets, **5%** on illiquid assets
Foreign excess profits No minimum tax	Subject to effective **10%** tax with 80% foreign tax credit	Subject to **20%** tax with a 37.5% deduction as well as a 80% foreign tax credit
Net interest expense 100% deductible	Limited to **30% of adjusted taxable income**, carry forward 5 years	Limited to **30% of adjusted taxable incom**e, carry forward indefinitely

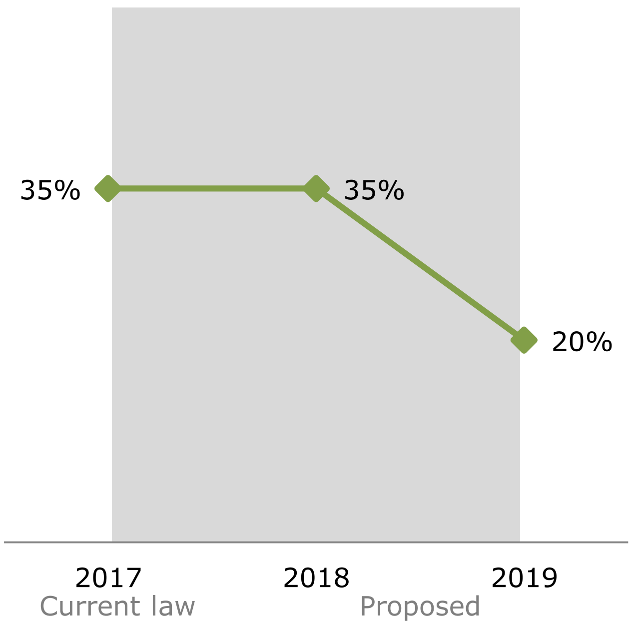
Sources: National Journal Research 2017; House Ways and Means Committee; Senate Finance Committee.

Corporate tax rate

House



Senate



One of the biggest differences between the House and Senate tax reform bills is the corporate tax rate.

While both chambers would lower the rate from 35% to 20%, the Senate would delay this change until 2019 to help pay for tax cuts.

However, the president supports an immediate cut to the corporate tax rate.

Sources: Herb Jackson, "Tax reform: Senate version of bill will delay corporate tax cuts one year," USA Today, November 9, 2017.

Deemed repatriation on accumulated offshore income for multinational companies

Asset type	House's proposed tax rate	Senate's proposed tax rate
Cash	14%	10%
Noncash	7%	5%

Currently the US international tax system allows multinational corporations to defer US tax payments on income earned by foreign subsidiaries until it is repatriated to the US in the form of dividends. Combined with a high domestic corporate tax rate, this encourages corporations to leave profits in low-tax countries rather than bring them back to the US.

The House and Senate tax bills would institute a territorial tax system, allowing multinational corporations to bring dividends back tax-free. However, existing overseas income would be subject to a one-time repatriation tax on liquid and illiquid assets.

Sources: House Ways and Means Committee; Senate Finance Committee; Tony Nitti, "Senate released tax bill: here's how it compares to current law & the House plan," Forbes, November 10, 2017.

Minimum tax on excess foreign profits

House proposal

10%

Half of excess foreign profits, i.e. returns on investment of tangible assets (buildings, plants, etc.) above 7% plus inflation, would be subject to a **20%** surtax. Companies would also receive a credit for 80% of the tax already paid in local taxes.

Senate proposal

20%

Minimum tax on above-routine foreign earnings (global intangible low-tax income) on a current basis at a rate of **20%**, subject to a 37.5% deduction as well as a 80% foreign tax credit

The goal of the House and Senate bills' proposed minimum tax on excess foreign profits is to discourage multinational corporations from moving IP, patents and other intangible assets to foreign tax shelters.

Sources: House Ways and Means Committee; Senate Finance Committee; McDermott Will & Emery, "Senate tax proposal includes comprehensive business tax reform measures," November 12, 2017.

House and Senate tax bills limit net interest deductibility to 30% of adjusted taxable income

Overview of interest deductibility proposals

✓

Under current law — businesses can generally fully deduct net interest expenses from their adjusted taxable income

30% × EBITDA

House bill — businesses can fully deduct net interest expenses, up to a limit of 30% of their adjusted taxable income

- Business interest not allowed to be deducted in a taxable year can be carried forward for five years
- The limit wouldn't apply to real estate firms and small businesses with gross receipts of $25 million or less
- Some companies with debt-financed high-cost inventory (i.e. car dealers) have the option to completely deduct interest expenses but would not be able to immediately deduct capital expenditures

30% × EBITDA

Senate bill — businesses can deduct net interest expenses up to a limit of 30% of their adjusted taxable income

- Business interest not allowed to be deducted can be carried forward indefinitely
- The limit wouldn't apply to real estate businesses and small businesses with gross receipts of $15 million or less

Sources: National Journal Research 2017; Tony Nitti, "6 hidden business changes in the House tax bill," Forbes, November 3, 2017; House Ways and Means Committee; Senate Finance Committee.

Controversial excise tax aimed at preventing corporate inversions and offshoring is watered down in committee

Overview of the proposed excise tax

The problem — currently, multinational corporations often use foreign subsidiaries or merge with foreign entities (inversions) in countries with lower tax rates to avoid US corporate taxation

The excise tax — the Tax Cuts and Jobs Act originally proposed a 20% excise tax applying to cross-border transactions within a single multinational company

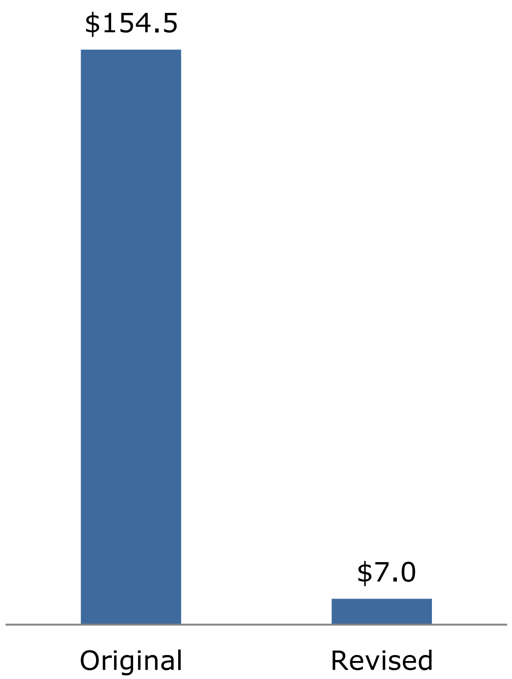
The result — under the Tax Cuts and Jobs Act, the 20% excise tax would be higher than the proposed 20% corporate tax a company would face under the IRS' jurisdiction, because the excise tax would apply to total sales rather than profits

November 6th amendment — businesses, including foreign-based auto makers, railed against the provision, and successfully influenced Republicans on the Ways and Means Committee to change it on a party-line vote

What was changed — the amendment added provisions to prevent double taxation by the foreign nation and other technical changes. While not removed completely, the revised excise tax would raise significantly less revenue over the next 10 years, according to the Joint Committee on Taxation

Revenue raised from excise tax on multinational corporations

BILLIONS OF DOLLARS, FISCAL YEARS 2018-2027



Sources: Richard Rubin, "House Lawmakers Face $74 Billion Revenue Gap in Tax Bill After Amendments," WSJ, November 8, 2017; Bob Bryan, "This could be the biggest looming fight over the Republican tax plan," Business Insider, November 7, 2017.

Additional corporate/business items

Item	Current law	House	Senate
C corporations forced onto accrual method	Receipts > $5 million	Receipts > $25 million	Receipts > $15 million
All business with inventory forced onto accrual method	No threshold	Receipts > $25 million	Receipts > $15 million
Forced switch from the completed contract method to percentage of completion for accounting for long-term contracts	Receipts > $10 million	Receipts > $25 million	Receipts > $15 million
Requirement to apply Section 263A Unicap rules to inventory	No threshold for producers, receipts > $10 million for resellers	Receipts > $25 million	Receipts > $25 million
Net operating losses	Carry back 2 years, forward 20 years	No carry back, carry forward indefinitely (limited to 90% of taxable income)	No carry back, carry forward indefinitely (limited to 90% of taxable income)
Section 179 expense	Limited to $500,000	Limited to $5 million	Limited to $1 million
Immediate expensing of assets with life < 20 years	None unless section 179	For the next 5 years	For the next 5 years
Entertainment expenses	50% deductible	Nondeductible	Nondeductible
Section 199 manufacturers' deduction	Up to 9% of domestic production activities	Eliminated	Eliminated

Sources: Tony Nitti, "Senate released tax bill: here's how it compares to current law & the House plan," Forbes, November 10, 2017.

Aerospace Industries Association supports revenue-neutral tax reform

Aerospace Industries Association (AIA) represents American aerospace and defense manufacturing companies and supports a tax code that enables business expansion and job growth. AIA member companies make up **13% of the US manufacturing base** and include Boeing, General Dynamics, Lockheed Martin, Northrop Grumman and Raytheon.

AIA's "Principles for Reforming the U.S. Tax Code" include:

- Attracting business investment to the US through globally competitive corporate rates
- Enacting fiscally responsible reforms that are revenue-neutral and do not add to the deficit
- Replacing the worldwide tax base with a territorial tax system in which US companies would owe taxes on domestic profits only
- Ensuring tax change revenue is not diverted to fund non-tax incentives
- Allowing repatriation of accrued overseas income if coupled with the switch to a territorial tax system moving forward

*"The introduction this week of the "Tax Cuts and Jobs Act" (H. R. 1) by House Ways and Means Committee Chairman Kevin Brady is a critical first step in the legislative process. Many of the bill's provisions would provide **positive and significant relief to U. S. aerospace manufacturers and their workers**, including a nationwide supply chain comprising thousands of small businesses.*

*...The path forward for tax reform builds business confidence and leads to critical investments in the Aerospace and Defense industry's uniquely innovative manufacturing and exporting capabilities. **AIA strongly urges both chambers of Congress to pass tax reform legislation that reinvests in American manufacturing."***

– **David F. Melcher,** president & CEO of the Aerospace Industries Association

Sources: "Principals for Reforming the US Tax Code," Aerospace Industries Association, 2017; David F. Melcher, "AIA supports House Tax Reform Bill," Aerospace Industries Association, November 3, 2017.

The Congressional Budget Office proposes cuts to defense spending to reduce deficit

The tax reform plan and defense budget tug-of-war

"There is a natural tension between tax cuts and defense budget increases because both drive up the deficit.
There are limits to how much Republicans, particularly the more fiscally conservative wing of the party, are willing to increase the overall deficit. And making offsetting cuts in other parts of the budget to balance out tax cuts and higher defense spending is politically difficult because the vast majority of the remainder of the federal budget goes to Social Security, Medicare, Medicaid, and veterans benefits and services."

– **Todd Harrison,** director of defense budget analysis & the Aerospace Security Project, senior fellow at the Center for Strategic and International Studies

The Congressional Budget Office (CBO) proposed options to reduce the deficit that target defense discretionary spending. Among these were cuts to military size, to DoD operations and maintenance appropriations, and to shipbuilding aircraft and personnel accounts

Similar tax cuts with increased defense spending between 2001 and 2003 led to the current mandated budget caps we have in place today and, the Truman National Security Project's Justin Rubin says, have undermined military readiness and equipment modernization

Doc Syers, vice president for legislative affairs at the Aerospace Industries Association, says tax reform is a top priority for some defense companies. "They want the certainty that comes with permanent tax changes over a decade that allow them to make basic business decisions on investments in R&D, on whether to modernize plants, whether to do hires and which technologies to explore."

Sources: "Principals for Reforming the US Tax Code," Aerospace Industries Association, 2017; David F. Melcher, "AIA supports House Tax Reform Bill," Aerospace Industries Association, November 3, 2017; Justin Rubin, "A national security case for tax reform," Defense News, November 10, 2017; Joe Gould, "US defense industry to Congress: Don't let tax cuts add to the deficit," Defense News, October 28, 2017.

Opinions in Congress: support

House and Senate leaders back tax cuts & increased defense spending

Rep. Mac Thornberry (R-TX)
Chairman of the House Armed Services Committee

"Revenue goes down, economic growth goes up, you know. How I look at it is: What do we need to do in the world [militarily] and how do we support the men and women who are risking their lives? We need to do that. Everything else is secondary."

Sen. John McCain (R-AZ)
Chairman of the Senate Armed Services Committee

"We have a military where we're losing men and women's lives because we haven't funded them for training and equipment. That has nothing to do with tax cuts."

Rep. Mark Meadows (R-NC)
Chairman of the House Freedom Caucus

"When they've been under sequestration for so long, it's difficult to suggest we'd put downward pressure there… If you're saying I'd rather have higher tax rates to finance my military, the answer is no."

Sources: National Journal Research, 2017; Joe Gould, "US defense industry to Congress: Don't let tax cuts add to the deficit," Defense News, October 28, 2017.

Opinions in Congress: oppose

House and Senate leaders voice concern over tax cuts & increased defense spending

Sen. Dick Durbin (D-IL)
Senate minority whip & ranking member on the Senate Defense Appropriations Subcommittee

"Of course they do [add pressure on future defense budgets], particularly if they increase the deficit, the debt of this country; it makes it more difficult to talk about investing more in the military. You can't have it both ways. You can't give a tax cut to big corporations and wealthy individuals, take the money out of the Treasury to do that and expect to have plenty to spend on defense, let alone nondefense."

Rep. Adam Smith (D-WA)
Ranking member of the House Armed Services Committee

"They will put us so far in debt that they will cripple us economically in order to pay for the tax cuts, and then they will also vastly increase defense spending because they just don't care."

Sources: Joe Gould, "US defense industry to Congress: Don't let tax cuts add to the deficit," Defense News, October 28, 2017.