

NAVIGATING BUSINESS TAX REFORM

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ONE HUNDRED FOURTEENTH CONGRESS
SECOND SESSION

APRIL 26, 2016



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PUBLISHING OFFICE

24-574—PDF

WASHINGTON : 2017

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

COMMITTEE ON FINANCE

ORRIN G. HATCH, Utah, *Chairman*

CHUCK GRASSLEY, Iowa	RON WYDEN, Oregon
MIKE CRAPO, Idaho	CHARLES E. SCHUMER, New York
PAT ROBERTS, Kansas	DEBBIE STABENOW, Michigan
MICHAEL B. ENZI, Wyoming	MARIA CANTWELL, Washington
JOHN CORNYN, Texas	BILL NELSON, Florida
JOHN THUNE, South Dakota	ROBERT MENENDEZ, New Jersey
RICHARD BURR, North Carolina	THOMAS R. CARPER, Delaware
JOHNNY ISAKSON, Georgia	BENJAMIN L. CARDIN, Maryland
ROB PORTMAN, Ohio	SHERROD BROWN, Ohio
PATRICK J. TOOMEY, Pennsylvania	MICHAEL F. BENNET, Colorado
DANIEL COATS, Indiana	ROBERT P. CASEY, Jr., Pennsylvania
DEAN HELLER, Nevada	MARK R. WARNER, Virginia
TIM SCOTT, South Carolina	

CHRIS CAMPBELL, *Staff Director*

JOSHUA SHEINKMAN, *Democratic Staff Director*

CONTENTS

OPENING STATEMENTS

	Page
Hatch, Hon. Orrin G., a U.S. Senator from Utah, chairman, Committee on Finance	1
Wyden, Hon. Ron, a U.S. Senator from Oregon	3
Thune, Hon. John, a U.S. Senator from South Dakota	4
Cardin, Hon. Benjamin L., a U.S. Senator from Maryland	6

WITNESSES

Barthold, Thomas A., Chief of Staff, Joint Committee on Taxation, Washington, DC	9
Hines, James R., Jr., Ph.D., Richard A. Musgrave collegiate professor of economics and L. Hart Wright collegiate professor of law, University of Michigan, Ann Arbor, MI	11
Toder, Eric J., Ph.D., institute fellow, Urban Institute, and co-director, Urban-Brookings Tax Policy Center, Washington, DC	13
Zinman, Sanford E., CPA and owner, Sanford E. Zinman, CPA, PC, Tarrytown, NY	14
Goschie, Gayle, vice president, Goschie Farms, Inc., Silverton, OR	16

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Barthold, Thomas A.:	
Testimony	9
Prepared statement	35
Cardin, Hon. Benjamin L.:	
Opening statement	6
Goschie, Gayle:	
Testimony	16
Prepared statement	43
Hatch, Hon. Orrin G.:	
Opening statement	1
Prepared statement with attachments	45
Hines, James R., Jr., Ph.D.:	
Testimony	11
Prepared statement	49
Thune, Hon. John:	
Opening statement	4
Toder, Eric J., Ph.D.:	
Testimony	13
Prepared statement	53
Wyden, Hon. Ron:	
Opening statement	3
Prepared statement	66
Zinman, Sanford E.:	
Testimony	14
Prepared statement	66

COMMUNICATIONS

American Bar Association (ABA)	73
American Council of Life Insurers (ACLI)	75
American Farm Bureau Federation	76
American Public Power Association (APPA)	77

IV

	Page
Cash to Accrual Accounting Stakeholder Coalition	80
CRANE Coalition	83
Financial Executives International (FEI)	85
Like-Kind Exchange Stakeholder Coalition	87
National Conference of CPA Practitioners	88
National Multifamily Housing Council (NMHC) and National Apartment Association (NAA)	92
NRS Inc.	102

NAVIGATING BUSINESS TAX REFORM

TUESDAY, APRIL 26, 2016

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 9:30 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Orrin G. Hatch (chairman of the committee) presiding.

Present: Senators Grassley, Crapo, Thune, Isakson, Portman, Coats, Heller, Scott, Wyden, Stabenow, Carper, Cardin, Bennet, and Casey.

Also present: Republican Staff: Tony Coughlan, Tax Counsel; Jim Lyons, Tax Counsel; Eric Oman, Senior Policy Advisor for Tax and Accounting; and Mark Prater, Deputy Staff Director and Chief Tax Counsel. Democratic Staff: Chris Arneson, Tax Policy Advisor; and Joshua Sheinkman, Staff Director.

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Good morning. It is a pleasure to welcome everyone to today's hearing, which we have entitled "Navigating Business Tax Reform." I think this title accurately describes the challenges we have before us moving forward on business tax reform specifically, and on comprehensive tax reform more generally.

In the recent past, identifying and developing certain bipartisan policy proposals and moving them through the legislative process have proven especially difficult. But I am an optimist, and I believe we can and should find common ground on a path forward for comprehensive tax reform.

Of course, as I have said in the past, successful tax reform will take a President who truly makes it a priority and works closely with Congress to get it over the finish line. Currently, I think it is safe to say that we have not met that prerequisite with this administration, which most acknowledge means that for now we have to wait. But in the interim, this committee will continue to lay the foundation and develop pro-growth proposals for when the appropriate opportunity arises. That is why last year, Senator Wyden and I asked members of our committee to work on various tax reform working groups to help identify issues and develop consensus, if possible, around tax policy proposals.

Today, we will focus our attention on business tax reform issues, including topics that were covered in the report issued by the bipartisan Business Income Tax Working Group. I want to thank the co-chairs of that working group—Senators Thune and Cardin—as

well as other members of the working group: Senators Roberts, Burr, Isakson, Portman, Toomey, Coats, Stabenow, Carper, Casey, Warner, Menendez, and Nelson. A lot of time and effort went into examining these issues and compiling this report. I appreciate everyone's willingness to help advance this cause.

Tom Barthold, the Chief of Staff for the Joint Committee on Taxation, is with us today to provide background on business tax reform issues and highlight some of the major topics reviewed in the working group's report. We appreciate his work, and we appreciate him being with us.

We have a great group of additional witnesses here today as well, who will provide important insights and recommendations about broad design issues of the business tax system and practical on-the-ground issues that are important for us to keep in mind as we further develop and refine proposals in the business tax space.

I want to take a minute to discuss one particular business tax issue that was discussed in the working group report that I believe warrants real consideration by everyone here today: corporate integration. In very general terms, corporate integration means eliminating double taxation of certain corporate business earnings. Under current law, a corporation's earnings are taxed once at the entity level and then again at the shareholder level when those earnings are distributed to the shareholders as dividends.

In other words, under our system, if a business is organized as a C corporation, we tax the earnings of the corporation itself and those same earnings when paid out to the individual owners of the business. This creates a number of inequities and distortions, and my staff and I have been working for a few years now to develop a proposal to address this problem.

I was glad to see that the business tax working group addressed corporate integration in its report, noting that, "Eliminating the double taxation of corporate income would reduce or eliminate at least four distortions built into the current tax code: one, the incentive to invest in non-corporate businesses rather than corporate businesses; two, the incentive to finance corporations with debt rather than equity; three, the incentive to retain rather than distribute earnings; and four, the incentive to distribute earnings in a manner that avoids or significantly reduces the second layer of tax."

Now, depending on its design, corporate integration could have the effect of reducing the effective corporate tax rate and help address some of the strong incentives we are seeing today for companies to relocate their headquarters outside of the United States. It would also have the likely effect of making the United States a more attractive place to invest and do business.

Now, I will have much more to say on this topic in the coming weeks and months, but I plan to raise this issue in general terms here today.

Once again, I want to welcome our witnesses. I look forward to a robust and informative discussion.

With that, I am glad to turn to Senator Wyden for his opening remarks, and then we will hear from the two co-chairs of the business tax working group, who will give brief opening remarks. We

will start with Senator Thune and then Senator Cardin after Senator Wyden completes his remarks.

[The prepared statement of Chairman Hatch appears in the appendix.]

The CHAIRMAN. Senator Wyden?

**OPENING STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON**

Senator WYDEN. Thank you very much, Mr. Chairman. I very much look forward to working with you and our colleagues.

I too want to commend Senator Thune and Senator Cardin for their outstanding work. We had just the right people heading that part of the working group, and I appreciate it.

Colleagues, if you own a small business in America today, often you go to bed at night believing that you are in danger of being ensnared by an outdated, overgrown tax code that Americans spend 6.1 billion hours and more than \$100 billion complying with each year. That tax system is punishing to those who do not have a fleet of accountants and the luxury of time to plan investments around taxes.

The American tax code tells small businesses that their dollar is worth less compared to sophisticated firms that can afford to make the rules work for them. That is why today I have released the Cost Recovery Reform and Simplification Act of 2016. This proposal is all about making the tax code more attractive for the risk-takers who go out and start a small business, people who are, more often than ever before, going to be minorities or women.

So this proposal would modernize the tax code and strip away much of the unfairness to small business by radically simplifying our system of depreciation. For the small, cash-strapped firms to grow and create jobs, they need to invest in basic priorities like a new cash register, an office computer, or farm equipment when it makes sense, not when it makes tax sense.

Today, to figure out the tax deductions on these investments, a small businessperson has to navigate more than 100 sets of tax rules. My proposal dumps that headache and lays out six categories for depreciation that are far easier for a small businessperson to work with.

Today, you have to do the math as many as three separate times under different programs for each and every asset. My proposal says one round of math is enough. Small businesses should not have to do individual calculations for every car on the lot, every computer in the lab, or every machine in the shop.

Today's rules come from yesteryear, from the last century. They are stuck in an era of fax machines and VCRs that predates the technology boom that has transformed the way in which Americans live and work.

My proposal says our business tax rules should reflect a 21st-century economy and help our cutting-edge entrepreneurs thrive, not hold them back. It makes no sense to cling to an outdated system that taxes some high-tech investments, such as computer servers and MRI machines, at more than double the rate of other investments.

A start-up should not be told that they are not allowed to use a work laptop in a coffee shop or otherwise they are going to face a big financial hit on their taxes. And in my view, the tax code should not get in the way of public-private partnerships that want to build new roads, bridges, and highways across the country.

So my proposal would fix these issues with new rules grounded in common sense and a realistic appreciation of how our businesses, particularly the small businesses, operate today. It is my hope that we are going to be able to look at these proposals and more as our committee considers, again, on a bipartisan basis, how to bring our tax code up to date.

So I very much look forward to today's hearing. I am especially pleased that Gayle Goschie of Goschie Farms in Silverton, OR is with us today. The hundreds of acres of hops they grow at Goschie Farms are a big part of what makes Oregon beer the best that money can buy. And just for those kind of historians in the room, Goschie Farms just celebrated their 112th hops harvest.

So speaking for Oregonians and for small businesses, we could not have a better witness than Ms. Goschie to represent Oregon.

Mr. Chairman, again, like you, I would like to express our appreciation to Senator Thune and Senator Cardin for the excellent work that they have done.

[The prepared statement of Senator Wyden appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

Senator Thune, we will hear your remarks at this time.

**OPENING STATEMENT OF HON. JOHN THUNE,
A U.S. SENATOR FROM SOUTH DAKOTA**

Senator THUNE. Thank you, Mr. Chairman. I thank you and Ranking Member Wyden for the opportunity to make an opening statement today and for the opportunity to co-chair the Business Income Tax Reform Working Group with Senator Cardin last year.

While undoubtedly there remain significant differences on tax reform between the political parties, I believe that our working group demonstrated that there is genuine bipartisan agreement in a number of areas. The bipartisan report that we issued last July underscores that Senators in both parties understand the importance of reforming our tax system and are willing to think creatively about how we address some of the most vexing challenges of business tax reform.

Our report considered a wide range of issues, from tax policies promoting innovation to simplification reforms to addressing structural biases in the tax code. However, given that my time is limited this morning, I wanted to briefly discuss two areas that our report identified as threshold issues, meaning that any successful business tax reform effort will need to resolve these challenges.

The CHAIRMAN. Senator, may I interrupt you for a moment? I have to open up the Senate. I would like you to chair this hearing until I get back. Is that all right?

Senator THUNE. Yes, I would be happy to.

The CHAIRMAN. Thank you. I appreciate it.

Senator Thune [presiding]. Thank you, Mr. Chairman.

The first of those issues that our working group report recognized was that a more competitive U.S. corporate tax rate is going to be integral to any effort to modernize our business tax system.

America is losing ground as other nations continue to lower their corporate tax rates, highlighted by the fact that the U.S. combined State and Federal rate of over 39 percent is the highest corporate tax rate in the developed world. This high tax rate is not sustainable if we want American companies to compete and win in the global economy, and if we want our country to continue to be an attractive location for foreign investment.

A number of our major competitors, such as Canada, Japan, and the UK, have demonstrated in recent years that lowering the corporate tax rate is achievable. Our working group report reinforces the notion that while there are differing approaches to get there, a lower corporate tax rate remains at the center of any bipartisan approach to business tax reform.

Secondly and just as importantly, our group expressed the view that business tax reform needs to be about all businesses, both large and small. The reality is that pass-through businesses, those businesses taxed at the individual tax rates, employ 55 percent of the private-sector workforce and earn more than 60 percent of all net business income. If you include sole proprietorships, pass-through businesses account for more than 90 percent of all businesses in America. As such, our report found that, and I quote, "Clearly, business tax reform needs to ensure that these businesses are not ignored in an effort to reduce the corporate tax rate. Pass-through businesses need to benefit from business tax reform for any such effort to be considered a success."

I believe we need to keep this perspective foremost in mind as we move forward. So I would say to members of our committee, our colleagues, that our working group found that a modern, more efficient system for taxing business income is critical to boost economic growth, raise incomes, and increase wages.

We recognized that achieving meaningful tax reform will require difficult decisions on a range of complex issues, and it will require leadership both in Congress and from the White House. But I believe that we should remain optimistic, because with each passing day, tax reform becomes less a question of "if" and more a question of "when" and "how." Our outdated tax code is, without question, holding America back, and the clear recognition of that fact is one of the most important elements to come out of last year's working group process.

I want to thank Senator Cardin for his leadership, and for the opportunity to work with him, and thank all the members of our working group and their staffs for their input and for helping us lay the groundwork for our tax reform effort.

I look forward to hearing from today's witnesses and for a continuation of the robust debate over how best to reform our business tax system.

With that, I would recognize the Senator from Maryland, Senator Cardin.

**OPENING STATEMENT OF HON. BENJAMIN L. CARDIN,
A U.S. SENATOR FROM MARYLAND**

Senator CARDIN. Well, Senator Thune, thank you, and thank you so much for your leadership on the business tax working group.

I also want to join you in thanking Senator Hatch and Senator Wyden for their leadership in convening this hearing, but also in establishing the working groups.

Our working group produced a report of 140 pages. I particularly want to thank Mr. Barthold and the Joint Committee on Taxation for their extraordinary work. I said at the conclusion that I learned a lot and I thought that we were gaining Senate continuing education credits, though we did not have to pay any tuition for them. So it was a great learning experience for all of us, and I thank you for that.

I agree with Senator Thune in that our high tax rate on businesses in America is making America uncompetitive. We are definitely at a disadvantage in international competition because of the high business tax rates, and I think Democrats and Republicans agree we have to do something about it.

The C corporation rate at 35 percent is not competitive, compounded by the fact of double taxation, and Senator Thune and Senator Hatch and others have brought forward proposals in this regard, and the chairman just commented about it. It is an area that we certainly need to take a look at so that the business entity form does not discriminate against businesses. That is clearly an issue that we need to deal with.

But as Senator Thune pointed out, 90 percent of American businesses do not pay the C rate, they pay the individual rate. That rate, at 39.6-plus percent, is not competitive. So we need to deal with the realities of both the C rate and the individual rate in dealing with business taxes in our country.

Although we want to talk about major tax reform, we should not lose sight that during this process, there are so-called smaller reform issues that can help a great deal, like S corporation reform, that we should do, and we should try to get that done as quickly as possible in order to help America's businesses.

The challenges in dealing with the high rates are incredible, and I just really want to put this on the table so our colleagues understand the challenges we have if we are really going to do major reform for business taxes in America.

First, it is a huge revenue issue in trying to reduce the rates under the existing structure. If we use the existing structure, for every 1 percentage point reduction in the C rate, Joint Tax has estimated that would cost \$100 billion over 10 years. So you can do the math. Most people want to reduce it by as much as 10 percentage points. That is \$1 trillion. And that does not deal with the individual rate.

As we have talked about, we need to understand that there is need for help on the individual rate with business income, and that could add anywhere between 60 percent to 80 percent more to the cost of any proposal that deals with reducing the rates.

So on the other side, if we say, well, let us do what we did in 1986, and that is, let us just spread the burden and reduce the rates, that lasted until 1987. So I would suggest, politically, I am

not sure that is possible for us to leave the tax code alone for any significant length of time.

So I just really want to challenge the committee with something which is somewhat counterintuitive. That is that the United States, among all the OECD countries, is one of the lowest on its reliance on the governmental sector for its services. So why should we have the highest marginal rates of the OECD countries? We should have the lowest marginal rates of the OECD countries.

The reason, quite frankly, as it was pointed out during our study, is that we are the only OECD country that does not have a national consumption tax. There have been 150 countries globally that use a national consumption tax for part of their revenues to finance government.

So for those reasons and many others, in the last Congress, I introduced the Progressive Consumption Tax that would replace some of our income tax with a national consumption tax. It dramatically simplifies our income tax code, particularly on personal income, by starting it at \$100,000 of taxable income, with the highest rate being 28 percent for that taxable income for families over \$500,000.

It would reduce the corporate tax rate to 17 percent, giving us a significantly lower corporate tax rate, and would establish a national consumption tax at 10 percent using the credit invoice system, which we think is the most efficient way to do it.

It is progressive, starting the income tax at \$100,000, and the Earned Income Tax Credit and the Child Tax Credit are actually cashed out in order to keep it progressive. It is revenue-neutral, and it contains a circuit-breaker in the event the Joint Tax numbers are not exactly accurate and we produce more revenue than expected—there would be a trigger mechanism to return those excess taxes to the taxpayers.

The result is, we would have, on average, about a 5 percentage point lower average on all of our taxes, income and consumption, than the OECD countries, giving us a competitive advantage rather than a competitive disadvantage on international issues.

Mr. Chairman, I just really want to make this point. I think this committee needs to be in the leadership on tax reform. I think we can be in the leadership on tax reform. I think with the work that was done by the working groups, we have become, I think, more understanding of the challenges we have, and I would just urge us to work together so America, in fact, can have a tax code that is a lot easier and simpler and more efficient on capital and growth than our current tax code.

Senator THUNE. Thank you, Senator Cardin.

I am just going to take a couple of minutes here and introduce our panel of five witnesses today.

First, we are going to hear from Mr. Tom Barthold, who, as mentioned earlier, is the Chief of Staff for the Joint Committee on Taxation. Tom is no stranger here and really should not need much of an introduction. He has worked for the Joint Committee staff since 1987, when he started as a staff economist. He then worked his way up the ladder to become Senior Economist, Deputy Chief of Staff, and Acting Chief of Staff, before being named in his current position in May of 2009.

Prior to his work here in Washington, Tom was a member of the economics faculty of Dartmouth College. Tom received his bachelor's degree from Northwestern University and later received his doctorate in economics from Harvard University and, I would add, is indispensable in terms of the work that we were doing on the working groups, providing insight and counsel as we went through that process.

So, good having you here, Tom.

The second witness will be Dr. James Hines, the Musgrave professor of economics and Wright collegiate professor of law at the University of Michigan. Dr. Hines also currently serves as the research director of the Office of Tax Policy Research at the University of Michigan.

He is a research associate of the National Bureau of Economic Research, research director of the International Tax Policy Forum, former co-editor of the *Journal of Economic Perspectives*, and once, long ago, was an economist in the U.S. Department of Commerce.

Dr. Hines has held visiting appointments at Columbia University, the London School of Economics, the University of California-Berkeley, and Harvard Law School. He graduated with a B.A. and M.A. from Yale University and a Ph.D. from Harvard, all in economics.

Third, we will hear from Dr. Eric Toder, an institute fellow at the Urban Institute and co-director of the Urban-Brookings Tax Policy Center. Dr. Toder's recent work includes papers on what the U.S. can learn from other countries' territorial tax systems, issues in designing a carbon tax, corporate tax reform, net benefits of payroll tax expenditures, and many other issues.

Dr. Toder previously held a number of positions in tax policy offices in the U.S. Government and overseas, including service as the Deputy Assistant Secretary for Tax Analysis at the U.S. Treasury Department, Director of Research at the IRS, Deputy Assistant Director for Tax Analysis at the Congressional Budget Office, and consultant to the New Zealand treasury. Dr. Toder received his Ph.D. in economics from the University of Rochester.

Our fourth witness will be Sanford Zinman, president of Sanford E. Zinman, CPA, PC in New York. Mr. Zinman is licensed in New York, Florida, and Connecticut, and has worked in public accounting for more than 30 years. His diversified clientele includes architectural firms, attorneys, authors, child care providers, construction and real estate developers, insurance professionals, interior designers, medical professionals, restaurants, and retail operations.

Mr. Zinman provides tax services for businesses and individuals. Among other things, he is a member of the National Conference of CPA Practitioners, where he serves as the vice president and the chair of the Tax Policy Committee. He is also a member of the American Institute of Certified Public Accountants, the National Society of Accountants, and the National Association of Tax Professionals. In other words, he hangs out with a lot of accountants. [Laughter.] Mr. Zinman graduated from Iona College with an MBA in public accounting.

Finally, as Senator Wyden pointed out, we are going to hear from Ms. Gayle Goschie, vice president of Goschie Farms, Inc. Ms. Goschie is a fourth-generation farmer and business owner in Sil-

verton, OR. She works with her two brothers to manage the operation of the family farm that specializes in hops and wine grapes, among other crops.

Goschie Farms grows 550 acres of hops and sells to some of the Nation's top breweries. The farm also grows 150 acres of wine grapes and more than 300 acres of other crops, including grass seed, corn, and wheat.

Goschie Farms has been a leader and innovator in sustainable farming techniques, including powering a portion of its operations through solar energy. Ms. Goschie was also the first woman hop grower to be awarded the International Order of the Hop in 2009.

I want to thank all of you for coming. I know this is an expansive topic, and the more insight and perspective that we can get, the better. We are grateful to have your expertise and experience to inform us on business tax issues, and we will look forward to hearing from all of you.

Hopefully, you can come up with a way to make this all a little bit more understandable and hopefully easier—no, I do not think it is going to be easier for us to get this done. There are some very complex issues, as we found in our business tax working group, but it is a subject that we need to tackle and, as noted earlier, the sooner, the better.

So we will proceed from left to right, my left and your right, starting with Mr. Barthold.

Tom, please proceed with your opening statement.

**STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF,
JOINT COMMITTEE ON TAXATION, WASHINGTON, DC**

Mr. BARTHOLD. Thank you, Senator Thune, members of the committee.

For today's hearing, Chairman Hatch and Ranking Member Wyden have asked me to briefly review some of the business tax reform issues raised by the committee's bipartisan Business Income Tax Working Group. I also note that my colleagues prepared for you more detailed background information that was released last Friday in our Joint Committee document JCX-35-16.*

It is important to remember that in assessing any tax system reform, there are really four key dimensions that we always look at.

First, does the tax system promote economic efficiency? Does the tax system promote economic growth? Is the tax system fair? Is the tax system administrable, both for the taxpayer and the Internal Revenue Service?

Now, there may be other policy considerations as to where we fit in the budget picture, but invariably it is the case that these different policy goals are in conflict. Policy designed to promote economic neutrality may conflict with goals of fairness. Policy designed to promote fairness may lead to complexity and increased compliance costs. So those were issues that the Business Income Tax Working Group was always grappling with when thinking about the issues before them.

*For more information, *see also*, "Background on Business Tax Reform," Joint Committee on Taxation staff report, April 22, 2016 (JCX-35-16), <https://www.jct.gov/publications.html?func=startdown&id=4903>.

Some of the proposals undertake comprehensive tax reform by broadening the base and lowering rates. As Senator Cardin pointed out, lowering the top rate of the corporate income tax by 1 percentage point from its current statutory rate of 35 percent to 34 percent, we have estimated, against the current policy baseline, would cost \$100 billion over the 10-year period.

By comparison, among our staff estimates of the largest corporate tax expenditures, only a modest handful, in fact, exceed \$50 billion. So, if we broaden the base to lower rates, it takes elimination of a lot of tax expenditures or other ideas.

This was an approach that was taken by former House Ways and Means Committee chairman Dave Camp in his H.R. 1, which reduced the corporate income tax rate to 25 percent, but did so generally by slowing depreciation rules. It required amortization of 50 percent of advertising expenditures over 10 years, required amortization of research and development expenditures, repealed LIFO accounting, repealed lower of cost or market methods of accounting, phased out the section 199 deduction for manufacturing activities, and a number of other base broadeners.

I think it is also important in this context, when we talk about conflicting goals, to recognize that some of the tradeoffs that can arise are exhibited in H.R. 1. If we lower corporate tax rates, that is good for investment. But if we slow depreciation, if we slow cost recovery of investment, that is bad for investment. So there is inherently always a tradeoff.

Other issues that the working group looked at, as, again, noted in your opening statements, were the differences between pass-through entities in the United States as a business form and C corporations. As the next slide notes, a substantial amount of net business income in the United States is earned by enterprises that are not C corporations. So some business tax reform options have been proposed with the intent of maintaining a sense of parity between taxation of corporate and pass-through entities.

However, the working group found that it is really not clear what parity should mean. Owners of C corporations, as noted by the chairman, generally bear two levels of tax that in total can exceed 50 percent. However, if you look at it in terms of earnings of the C corporation that are not distributed, the current tax burden of those earnings is 35 percent.

On the other hand, owners of pass-through entities generally do not bear a tax rate greater than 44 percent, but that tax rate may apply regardless of whether the earnings are distributed or retained.

The slide before you gives you a more detailed analysis. It is not actually a simple comparison of one situation to another situation, a consequence of some of the other complexities that we currently have for business income taxation. Recognition of two levels of tax applicable to income of C corporations has led some to propose what is called corporate integration. The chairman described this. There are basically two approaches. One is referred to as complete integration and the other partial integration.

In complete or full integration, you eliminate double taxation of both dividends and retained corporate earnings by including in shareholder income the distributed and undistributed earnings of

the business entity. This is the way we tax S corporations under present law.

On the other hand, partial integration is generally a form of dividend relief, reducing double taxation on distributed earnings only, with no change in tax on retained earnings. You might characterize our current-law lower rate of tax on qualified dividends as a form of partial integration.

I know that I am exceeding my time here and that you want to hear from your other experts, but let me just make a brief note of one other important area that the working group looked at, and that was the role of innovation on the U.S. economy and the role of innovation in future growth.

It was noted in the working group that outside the United States, a number of countries have established intellectual property regimes or patent boxes, as they have been called, which offer preferential tax treatment on income attributable to intellectual property. The goal here has been to increase domestic investment in research and development or encourage business enterprises to locate the ownership of that intellectual property in that particular country.

Now, in the United States, we do have incentives, and significant incentives, for research and development. The PATH Act modified and made permanent our section 41 research credit, and we do allow full expensing of all research activities.

The working group explored the notion of creating a patent box-type system for the United States, and I want to note that adopting a U.S. innovation box really presents, I think, some unique policy design and administrative issues for the members to consider, including what is in the box. Is it just patents? Is it a broader range of intellectual property, including trade secrets, and how do we define those in terms of applying this system administratively?

Other questions are, what is the role of nexus, which has been important in terms of the European consideration of these patent box proposals, and then how would the income from this intellectual property be taxed?

Well, the working group did review a number of other proposals, including some that have been offered by members of this committee, but I know that you want to take more time dealing with the distinguished witnesses that you have before you to my left, so I will conclude at this point, and I am happy, as always, to answer any questions that the members might have.

[The prepared statement of Mr. Barthold appears in the appendix.]

Senator THUNE. Thank you, Mr. Barthold.

Dr. Hines?

STATEMENT OF JAMES R. HINES, JR., Ph.D., RICHARD A. MUSGRAVE COLLEGIATE PROFESSOR OF ECONOMICS AND L. HART WRIGHT COLLEGIATE PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN, ANN ARBOR, MI

Dr. HINES. Good morning.

It is terrific that the committee is looking into business tax issues, because U.S. businesses currently face heavy tax burdens, and these tax burdens depress business activity, somewhat distort

it, and, as a result, create fewer economic opportunities for Americans, especially American workers.

The challenge that you face is the following. If you want to enact a reform that is revenue-neutral within the business sector, it is going to be impossible to lower business tax burdens very much. That is pretty much obvious, because if you implement a reform that is revenue-neutral, it will not greatly change the average tax rate that businesses face.

There is good that can be done by revenue-neutral reform, but let us be clear that there is a limit to how effective that is going to be in addressing the problems of heavy tax burdens on U.S. businesses, because any reform that is revenue-neutral will lower the tax on some activities and raise the tax on others and, as a result, will not greatly change the burdens.

Now, within the constraints of revenue neutrality or really for any business tax setup, there are smarter ways to tax business income. Those efforts should be guided by principles, and economic theory says there are two principles we should apply. One, we want lighter tax burdens on activities that generate positive economic spillovers, and two, we want lighter tax burdens on activities that are more responsive to taxation.

The challenge in taxing business, or really taxing anything, is that when you tax income, you discourage the production of income, and our goal should be to try to do the least damage to the economy that we can while raising the tax revenue that we need to fund government.

So what does that mean in practice? On the spillovers question—some of this has already been discussed this morning—there are very strong reasons to have favorable tax treatment of research expenditures, because research creates positive spillovers for the economy and contributes to economic growth; for low-income housing, because low-income housing offers positive spillovers to communities; and to other activities that generate positive benefits that are not entirely captured by the people who undertake the activities.

The second principle is that you want lower tax rates on activities that are highly responsive to taxation. An example might be domestic manufacturing. We currently have section 199, the domestic production activities deduction, that offers a favorable tax treatment of qualifying activities. There is pretty good evidence now that that deduction has been successful in stimulating more manufacturing investment than we otherwise would have had, and further evidence that manufacturing investment itself is more responsive to its tax treatment than is investment in other industries.

As a result, tax reform that would be directed at lowering, say, the statutory corporate tax rate and financing some of that reduction by eliminating the section 199 deduction, based on the evidence that we have, probably would have the effect of reducing overall investment in the economy. It is true that a lower statutory rate encourages investment, but the problem is that if you finance it by removing the deduction for domestic production activities, then, on net, you discourage so much manufacturing investment by

removing the deduction that you do not make it entirely back with the lower statutory rate.

The issue of corporate integration has come up this morning as well. Economic theory does not actually say that we want equal tax treatment of debt-financed and equity-financed investment. But it says that the difference in the taxation of these two forms of investment, if there should be one, should be related to the responsiveness of this activity to taxation.

We currently have a quite different tax treatment of debt- and equity-financed investment. In particular, as noted, equity-financed investment is taxed much more heavily, and efforts to integrate the corporate and personal tax systems and thereby reduce the heavy burden on equity-financed investment would surely be a movement in the direction of economic efficiency.

The general implication of economic theory is that you do not actually want equal taxation of every economic activity. You do not. And the reason is that our tax system discourages economic activity. It just does. That is part of the cost of government.

What we want to do is to discourage economic activity as little as possible while raising the revenue as well and as fairly as we can. So we should try to design the system with the responsiveness of different activities in mind, and that will be a nuanced system. It will be a system with differences in the taxation of different activities. But if we do it right, we will preserve as much as possible of the economic vibrancy of the country, and the whole country will benefit, particularly American workers.

[The prepared statement of Dr. Hines appears in the appendix.]

Senator THUNE. The chairman is back.

Thank you, Dr. Hines.

Dr. Toder?

**STATEMENT OF ERIC J. TODER, Ph.D., INSTITUTE FELLOW,
URBAN INSTITUTE, AND CO-DIRECTOR, URBAN-BROOKINGS
TAX POLICY CENTER, WASHINGTON, DC**

Dr. TODER. Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me to appear today to discuss business tax reform. The views I am expressing are my own and should not be attributed to the Tax Policy Center or to the Urban Institute, its board, or its funders.

Current U.S. business income taxes have many harmful effects. They discourage domestic investment, place U.S.-based firms at a competitive disadvantage, and have encouraged them to accrue over \$2 trillion in overseas assets. They favor corporate debt over equity, retained earnings over distributions, and pass-through businesses over companies that must pay corporate income tax.

There is bipartisan agreement that the corporate income tax rate needs to be cut and the tax on repatriated dividends reduced or eliminated. There is less agreement on how to pay for rate reduction and how to prevent additional tax avoidance through shifting profits to tax havens.

A 1986-style tax reform that pays for lower rates by eliminating business preferences is not sufficient to pay for the needed rate cuts in the long run, and some of the base-broadening measures

under consideration would reduce domestic investment and not necessarily make them more productive or efficient.

I suggest, therefore, that Congress look beyond business-only tax reforms to other revenue sources to pay for corporate rate cuts. One approach would raise taxes on shareholders to help pay for lower corporate rates. Taxes based on shareholder residence fit better in today's global economy than taxes based on either corporate residence or source of corporate income.

A corporation's tax residence may bear little relationship to the location of its production, sales, shareholders, or even top management, and the source of its income is difficult to determine when an increasing share of profits reflects returns to intangible assets not tied to a fixed location. In contrast, because a shareholder-level tax depends only on the residence of the shareholder, neither the residence of the corporation nor the source of its income would affect tax liabilities.

Alternatives are to raise tax rates on realized capital gains and dividends, shift the taxation of shareholder income to an accrual or mark-to-market basis, or integrate the corporate and personal income taxes. In my written statement, I discuss the advantages and problems with each of these approaches.

Another approach would replace a portion of the corporate and individual income taxes, as Senator Cardin suggests, with a new consumption tax, such as the destination-based VAT in use in over 150 countries around the world. Unlike the corporate income tax, a VAT would not discourage saving and investment and would not affect firms' choice of tax residence or location of production.

A final alternative would introduce a carbon tax to address global climate change and use a large share of the new revenues for corporate rate reduction. This approach, though controversial, could appeal to both business and environmental groups.

All of these options can be designed to raise the same revenues as under current law and make the tax burden as progressive or more progressive than it is now.

I conclude that paying for the major corporate rate cut the U.S. needs requires that we look beyond the business tax base for additional revenues. I am encouraged that this committee is open to broader approaches.

[The prepared statement of Dr. Toder appears in the appendix.]

The CHAIRMAN. Mr. Zinman, we will now take your statement.

**STATEMENT OF SANFORD E. ZINMAN, CPA AND OWNER,
SANFORD E. ZINMAN, CPA, PC, TARRYTOWN, NY**

Mr. ZINMAN. Chairman Hatch, Ranking Member Wyden, members of the committee, thank you for inviting me to discuss this topic. I am the vice president and tax policy chair of the National Conference of CPA Practitioners, NCCPAP. NCCPAP members serve more than 1 million business and individual clients and have long advocated for tax simplification and tax equality.

When taxpayers understand the laws, they are more accepting of the rules. I will address the current business tax structure in the United States and its impact on the small and micro-businesses.

My 35 years as a CPA sole practitioner have involved working with and advising a variety of these businesses. What is already

known is that small businesses make up an overwhelming majority of the number of businesses in our country. According to a GAO report published in June 2015, small businesses, as defined by less than \$10 million in total revenue, make up roughly 99 percent of all businesses. That same report states that 69 percent of those small businesses are individual taxpayers, while 31 percent come from partnerships and corporations. The report also indicates that 20 percent of small business populations hire at least one employee and produce about 71 percent of total small business income.

The small business community is vital to America. Many mom-and-pop businesses, which I call micro-businesses, operate the same way they did 50 years ago. Many are sole proprietors or subchapter S corporations.

To start a business, the owner often seeks advice from his or her attorney and just as often gets the opinion of a qualified tax advisor, usually a CPA. The form of organization is often irrelevant to the business owners. They just want to make some money.

These micro-business owners want to better their lives and keep as much of their profits as they legitimately can for themselves. That is the American way.

When these individuals want to start a business, the first thing they want to know is, what is the simplest type of business to open which will protect their existing assets and cost them the least amount of tax? Of course, this is never a standard C corporation.

Life was simpler 50 or 60 years ago, but we are not there anymore. New types of business organizations have been created. Each one has potential benefits and potential pitfalls. The CPA will explain the nuanced differences between a C corporation, an S corporation, a partnership, and an LLC. Ultimately, the differences are not extremely significant in the big picture. However, these differences can cause unnecessary complications in the decision-making process.

In the interview process, the CPA tries to determine a business owner's understanding of the tax law and tax regulations, and only after conversations with the owner can a CPA provide meaningful guidance. Yet, issues raised do not necessarily help the business owner in achieving his true objective: to put food on the table.

Additionally, although the form of business entity chosen may meet the current needs of the owner, these needs may change over time. Then the organizational structure which was originally correct may no longer be the proper one.

The similarities and differences amongst business entities often make the choice a difficult one. There should be a simpler common approach to taxation of various business entities.

Thank you again for allowing me to address the committee today. We know that Congress cannot stop people from coming up with clever new forms of business organizations, but Congress can ensure a level playing field in business taxation.

There are unnecessary inequities and complexities in our current system of business taxation which affect all businesses, both small and large. A simpler, equitable tax structure would allow business owners to better understand potential tax liabilities and make better business decisions.

Allowing for a single level of tax for all business sizes will provide an understandable equity.

Thank you again for the opportunity to present today, and I welcome your questions.

[The prepared statement of Mr. Zinman appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Zinman.

Ms. Goschie, we will turn to you now.

**STATEMENT OF GAYLE GOSCHIE, VICE PRESIDENT,
GOSCHIE FARMS, SILVERTON, OR**

Ms. GOSCHIE. Chairman Hatch, Ranking Member Wyden, co-chairs of the Business Income Bipartisan Tax Working Group, and members of the Finance Committee, I would like to thank you for giving me the opportunity to testify today.

My name is Gayle Goschie. I am a fourth-generation farmer. I am here today to represent Goschie Farms, Incorporated.

Our family farm has a staff of 80 full-time and seasonal employees. Our customers include breweries located in multiple States throughout the country, some of which you would be representing here today. We also grow wine grapes for three Oregon companies.

As you all know, the business of farming is fraught with uncertainty. A growing season can turn from an economic gain to an economic loss overnight. A change in the weather, product prices, labor supply, or our customers' needs, can have an extreme, often unforeseen, impact on our business.

The agriculture industry has many uncertainties. Taxes should not be one of them. Taxes influence how we invest in our business. Tax rates affect the equipment we buy and when we buy it, the types of crops we grow, and our hiring and labor decisions.

When there is uncertainty with taxes, we are unable to invest with confidence in our business. Fixing the present tax code is one of the ways Congress can help ensure that farms like mine can be positioned to grow.

Congress has already enacted some changes that will have a positive impact on the farming sector. In December 2015, they permanently extended the small business expensing limitation and phase-out amounts of section 179. Prior to being made permanent, the amount allowed to be expensed was unknown, and needed investments were delayed. In addition, hundreds of purchases needed to be recorded and tracked independently, with inequalities from one industry to the next. For example, a tractor in agriculture is depreciated over 7 years, where that same tractor in construction would be over 5. It would be helpful to have uniform depreciations for similar items and allow items to be pooled together as opposed to being listed separately.

Expensing also impacts our development costs. There are a number of expenses that come with the development of a vineyard. They include pre-productive costs of land clearing, soil and water conservation, and direct and indirect costs of vine, trellis, and irrigation systems. The pre-productive period costs of vines must be capitalized into the cost of the vines. With perennial crops like wine grapes, they are not depreciated until their first commercial harvest, a standard of 3 years.

As you can see, the tax code for small business owners, farmers like me, is complicated. Goschie Farms does not have accountants on staff to analyze every decision as it is made or maneuver each decision to maximize the tax benefits. Our time and efforts are needed in the fields to meet the demands of our customers. The work we do every day as farmers is a business story about the safe U.S.-grown quality products that are our livelihood. Both hop and wine-grape growers farm with certifications in best practices, sustainability, and energy conservation. With the hope of consistent energy tax incentives, these are just the beginnings of ongoing environmental investments.

Another tax issue that would impact farms like ours is the Craft Beverage Modernization and Tax Reform Act, which was introduced by Senators Wyden and Blunt. Though this legislation does not directly impact hop and grape growers, it would recalibrate the Federal excise tax for craft beer, wine, and spirit products. When the craft beverage industry finds relief through a reduction in excise taxes, the grower will find expanding markets, increased demand, and a bolstered confidence in continuing to work with craft producers.

It should come as no surprise that, in addition to the majority of the alcohol industry, this bill has the support of farm groups like the Hop Growers of America, the Oregon Wine Growers Association, and the National Barley Growers Association.

With this unique example, a simplified tax code could bring relief to breweries, wineries, farmers, and the consumer.

Thank you again for inviting me to testify today.

[The prepared statement of Ms. Goschie appears in the appendix.]

The CHAIRMAN. Thank you, Ms. Goschie.

We appreciate all of you being here today.

I have two articles here written by Mr. Mark Bloomfield, President of the American Council for Capital Formation. One of the articles, entitled "Bipartisanship on Tax Reform," was printed in the *Wall Street Journal* and specifically commented on the work of the Business Tax Reform Working Group. I was pleased with that.

The other article was featured in *Fortune* magazine and is titled "This is the Fairest Way to Tax America." Now, this article is a broader commentary on the tax reform debate.

Mr. Bloomfield, as most of us know, is no stranger to this committee. I appreciated his comments in these articles.

I ask unanimous consent that they be included in the record.

Without objection, they will be included in the record.

[The articles referred to appear in the appendix beginning on p. 46.]

The CHAIRMAN. Dr. Hines and Dr. Toder, I was very interested to read in both of your testimonies about the caution you suggest Congress take in addressing revenue-neutral business tax reform through lowering tax rates and broadening the tax base. You mentioned that corporate integration could potentially be a path forward.

As I mentioned earlier, I am preparing a corporate integration proposal that I think will help address many of the problems we see in the business tax space today.

Would you both elaborate on whether and to what extent corporate integration, in general, and its design, in particular, can strengthen the global competitiveness of U.S. companies, encourage more business activity in the United States, and go a long way in helping address multiple international tax issues that we are certainly going to be faced with and that we are seeing today, including inversions and earnings stripping?

Mr. Barthold, I would like to hear your comments as well.

Let us start with Dr. Hines, then Dr. Toder, and then Mr. Barthold.

Dr. HINES. Thank you. A thoughtful corporate integration reform certainly could address some of the competitiveness issues that face American businesses, but as long as the United States maintains a worldwide tax system, we are never going to be competitive relative to any of the other G7 countries or really any of the major capital exporting countries, all of which have territorial systems.

So I understand the spirit of the question in that, if we had corporate integration along with other beneficial reforms, would it be part of what contributes to the competitiveness of U.S. firms? The answer would be "yes."

The CHAIRMAN. I do not see any reason not to. I think they are complementary—a territorial system and corporate integration.

Dr. HINES. I see it the same way.

The CHAIRMAN. Please continue.

Dr. HINES. The advantage of corporate integration is, it lowers the taxation of equity-financed corporate investment, and we have a very heavy tax burden on that as it currently stands. But in addition, we would want to address some of the specific international issues if we are thinking about competitiveness more broadly.

The CHAIRMAN. Dr. Toder?

Dr. TODER. I think one of the advantages of corporate integration is, if it is designed in a way that it pushes the burden at the individual level, so individuals are taxed once on their business income, you get less determination of where the corporation earns money or invests affecting its tax liability.

Now that, of course, depends on the corporation being interested in the tax liability of the shareholders. So one of the advantages of the Australian system is, if companies shift money overseas and do not pay Australian tax, then credits do not go out to the shareholders when they pay dividends. They are only going out when the tax is paid.

So people can see that as one way of reducing some of the income-shifting problems while maintaining a territorial system, which is what they have.

I think there are several challenges that you have to deal with. One is, you are still going to have a very high tax on corporate retained earnings. So those companies that do not distribute profits are not really going to get necessarily the benefit of that system, and that is going to be a tax at the corporate level, which could raise the cost of capital.

A second problem is how to deal with the tax-exempts. In the United States, by our calculations, only about a quarter of dividends actually go to taxable U.S. shareholders. The rest go to tax-exempts or foreign shareholders or pension funds or retirement

funds. So essentially what you are doing currently is, you are taxing those funds on their corporate equity income, because they are paying the corporate tax before it comes out. You have to deal with the issue that you might have to make that taxation a little bit more explicit or face a very large revenue loss.

So it would be a matter of communicating to them, look, we are not really raising your taxes, we are just collecting it in a different way. But I think that is an issue you are going to have to wrestle with.

The CHAIRMAN. Thank you.

Senator Wyden?

Senator WYDEN. Thank you very much, Mr. Chairman. It has been an excellent panel.

I want to start with you, Ms. Goschie and Mr. Zinman, because for me, the ballgame here is small business. That is where you have most of the jobs in America. That is going to be the litmus test of real tax reform.

I also want to note that the *Wall Street Journal* recently said that the number of businesses owned by Asian-Americans, Hispanics, and African-American women grew faster than almost any other group during and after the recession. So what we are talking about is what the American economy is really all about. That is our priority when we talk about small business.

It seems to me there are really two tax codes in America. One is for the large multinational corporations that have this fleet of tax attorneys and accountants who can figure out a way to manipulate the byzantine rules of the tax system to maximize their tax benefits, and the other is what you described, Ms. Goschie, this kind of la-la land of trying to guess what you are going to owe and you are trying to make the best decisions for your business and the like.

I gather that what you are saying is that small businesses really do not have many specifics about what the tax consequences are going to be when they go out and invest in new equipment. That is what I read in your testimony, sort of reading between the lines. Is that correct?

Ms. GOSCHIE. Exactly. I mean, we do not have those accountants on staff. So it does take a phone call to be able to answer a question, to be able to decipher the consequences of a decision, and sometimes business gets in the way and we just need to make that decision.

Senator WYDEN. So you make the decision and kind of keep your fingers crossed. Like I said in my opening statement, you make the decision, you keep your fingers crossed, and you go to bed at night, that particular evening when you made this kind of call without all the accountants, saying, "I sure hope I do not hear from the IRS in the future."

Ms. GOSCHIE. That is correct.

Senator WYDEN. All right. Mr. Zinman, is that a fair assessment, in your view, with respect to what small businesses are dealing with when they are wrestling with their taxes?

Mr. ZINMAN. It is a very fair assessment. There are a number of issues that small businesses deal with, and as Ms. Goschie indicated—she is absolutely right—if you had a room of accountants

here and you were asking questions about the tax code and depreciation schedules, they would say, "Well, that is why God made computers and tax software."

But the reality is that, as a small business, you are trying to wrestle with, do I have enough money today, what taxes will come up? In an S corporation, I constantly have, at the end of the year, owners who have a successful business, and they pay themselves a reasonable salary, and they are falling within the tax guidelines, and yet, all of a sudden, their business shows a profit. They have phantom income. They have to pay tax on that income that was unexpected, and they have not actually drawn out the money at that moment, and they have to wrestle with understanding the tax code and the complexities of what is supposed to be a simple S corporation and what to do with it.

Senator WYDEN. So you both have had a chance to look at the proposal that I released today, the Cost Recovery Reform and Simplification Discussion Draft, and the whole point of this is to end the water torture for small businesses. That is, in a nutshell, how I think we ought to look at this question and, in particular, to make sure that we end the day when small businesses face a situation where their dollar is worth less compared to the sophisticated firms that can afford to make the rules work for them.

I would be interested in your reaction, because I know the staff has talked to both of you. Starting with you, Ms. Goschie, and then you, Mr. Zinman, in the time remaining, I would like your take on whether the simplification proposal we released today at least begins to respond to your concerns.

Let us start with you, Ms. Goschie.

Ms. GOSCHIE. Sure. Absolutely, it addresses my concerns. Again, it is simplification. It takes out the inequities and it puts us on a fair playing field.

Senator WYDEN. Mr. Zinman?

Mr. ZINMAN. Years ago, I went through hours and hours of training on MACRS and ACRS trying to figure out and trying to explain now to people about accelerated depreciation, straight-line depreciation, section 179 and how it plays into the tax return, and we wind up, as accountants, doing a lot of work in the depreciation area and in projections for our clients because of the complexity of this depreciation.

Any kind of simplification would be welcomed by business owners. The accountants do not mind making a couple of extra bucks by doing projections and doing analysis work. The business owners do want the simplification.

Senator WYDEN. Thank you both. The point of this really is—I know that you have had multiple generations on the farm in Oregon, Ms. Goschie, and we are so glad that you are here. The point of this particular part of the proposal is, this is a metaphor for what the debate is going to be all about. The big guys are going to have a lot of advocates—the multinational companies, the C corporations.

I am so glad that both of you have focused your remarks on the small business people. That is going to be my top priority in the debate.

I thank you for being here.

The CHAIRMAN. Thank you, Senator.

Senator Carper, you are next.

Senator CARPER. Thanks, Mr. Chairman.

I want to thank you and Senator Wyden for pulling this together. We thank our witnesses for joining us from across the country.

In the past 4 years, this committee has attempted not once, but twice, to reform our outdated and inefficient tax system. I do not think we should give up.

I want to especially thank my colleague to my right, Senator Cardin, and Senator Thune, who is not here—yes, he is here—for their leadership on the business tax reform initiative for the last year.

One thing that this process has made clear is the enormity of the complexity and the structural obstacles to reform, and, if we are going to lower business tax rates—and I think most of us on both sides of the aisle are interested in doing that—then we would need to find enough permanent revenue to offset the cost of permanent rate reduction.

That leaves us with a choice between base-broadening or identifying an alternative source of revenue, such as a value-added tax. Both courses are, I believe, worth pursuing. Neither is easy. Even my persistent optimism is tested when I try to fathom the likelihood of a tax overhaul within the next year.

So the question is, what do we do until then? In the meantime, while the business community waits for Congress to make the necessary tradeoffs to achieve tax reform, U.S. companies are choosing or, in some cases, being forced to choose between inversions, offshoring, and profit shifting. These ongoing and growing threats to our international competitiveness are some of the main reasons that I continue to support the efforts of some of our colleagues, particularly Senator Schumer—Senator Portman is involved in this, and others—to enact a rifle-shot international tax reform.

While we wait for and look forward to broader reform to occur, I think it makes sense to begin the reform process by first tackling some of our most pressing international tax challenges.

I have questions, and I want to direct them to two of our witnesses. One is Dr. Toder; the other is Dr. Hines.

I would just ask you, must tax reform be accomplished in one fell swoop, or, given political obstacles to comprehensive reform, is it possible to envision a multi-stage process where we bite off one piece at a time, sort of like we eat an elephant one bite at a time?

I would welcome your comments on that, both of you.

Dr. TODER. So I guess I have two responses to that. One is, there is a lot of complexity we have in the tax law, which, unfortunately, is going to be there because the world is complicated. But there is also what I call gratuitous complexity, where you could make things a lot simpler within the framework of current policy.

I think of Senator Wyden's proposal as one that accomplishes that. Any place you can do that, you should do that. I mean, that does not require a large agreement on broad conceptual reform directions.

So I think there are a lot of pieces both in the business code and in the individual tax code where that could be done. I have been

encouraging that for years. The Taxpayer Advocate has written a lot about things like that. So I think there are a lot of measures.

The other area is international reform, where there seems to be at least a conceptual agreement on measures that would accompany eliminating the repatriation tax; that is, having a one-time tax on assets abroad and having some minimum tax going forward on foreign profits.

I think that would make our current international system a little more efficient than it is and lower the cost, because you would not have this disincentive to repatriate. However, I do not think it solves the fundamental problems of competitiveness, inversions, or the shifting of income overseas.

So, while I would encourage doing that, I think you need to go further.

Senator CARPER. All right. Was your term "gratuitous"? What was that term?

Dr. TODER. Yes. I use the term "gratuitous" to refer to——

Senator CARPER. There were two words, gratuitous——

Dr. TODER. Complexity.

Senator CARPER. Yes. What would be the opposite of that?

Dr. TODER. I would say that there is some complexity that we just have to have because the world is complicated. So, if you want to have an income tax—you know, I use a car in my business. You do not want me to deduct the car for my personal use, but you do want me to deduct it for my business use; it is a little complicated to do that.

Senator CARPER. Thank you. Thanks.

Dr. Hines, same question, please.

Dr. HINES. Sure. Yes. We can do international-only reform, and we should do international-only reform if the alternative is to do nothing. But I think everyone in this room agrees that it would be nice to do more than just that, to try to address a lot of issues, including the complexity that small business owners face and lots of other ways to improve the efficiency of the tax code.

But if the choice was nothing versus moving in the direction of a territorial tax system, like every other capital exporting country has, the answer is "yes."

Again, I am not sure that everybody agrees on the details, such as the need for minimum taxes abroad and things like that. In fact, I am quite sure that they do not agree on that. But this committee, I am sure, would do an excellent job of hammering out the details of international reform.

Senator CARPER. Your confidence in us is appreciated. [Laughter.] Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Thune?

Senator THUNE. Thank you, Mr. Chairman.

Our group produced this little document here, which I would recommend for nighttime reading. But actually, staff did a great job of breaking down the issues related to the business part of the tax code, and we had a number of overlapping working groups, so some of these issues were dealt with on some level in other committees as well.

But one of the issues that we got at, or tried to at least, was this tension, the trade-off, if you will, when it comes to faster cost recovery versus a lower rate through base-broadening and what is the best way to achieve economic growth. There are different proposals out there, some that call for full expensing right away. The Camp proposal actually, last year, slowed depreciation in an effort to reduce rates in a revenue-neutral manner.

So I guess my question is, of those two approaches, in your view, what is the best way to generate economic growth? And if Congress could choose either a tax reform plan that cut the corporate rate more aggressively but lengthened depreciation schedules, or one that cut the corporate rates less aggressively but allowed businesses to write off their investment more quickly, what factors would we want to consider in making that decision?

I have another question. So if you can answer that quickly—that is a big subject to answer quickly, but give me your best answer on what is the best way to get growth.

Anybody?

Dr. HINES. If you have more generous capital cost recovery provisions, then you stimulate investment. Lowering the statutory rate also stimulates investment but, on the capital investment side, will do so much less dollar-for-dollar than you get by capital cost recovery.

The thing about the lower statutory rate is, it has effects on all kinds of other decisions too: debt versus equity, foreign versus domestic income, things like that. So you have to add them together.

The thrust of almost all of the economic analysis is that it is not a very cost-effective bargain to finance lower statutory rates with reduced capital cost recovery, because you get a lot less investment. It is true you get benefits on other margins of business decision-making, but the cost of that reduced investment is pretty substantial.

Senator THUNE. Does anybody have a different view on that? Do you agree generally?

Dr. TODER. I agree as far as what Jim said, but I would actually caution you against going the other direction to full expensing as well, because that creates sheltering opportunities unless you restrict interest deductions. And then if you move toward what might be called a consumption tax model at the business level, you have contradictions between how you are treating businesses and how you are treating individuals.

So I guess I would say there is no really simple answer to this. I do not think moving in one direction or another is going to improve matters that much.

Senator THUNE. Tradeoffs. All right. The other thing I want to ask about—because I did mention in my opening remarks that addressing the challenge of reforming the taxation of pass-through businesses is going to be key if we are going to get this done. It seems, to me at least, that we want to do everything we can to reduce the top individual tax rate, but it is going to be a very difficult proposition in this environment.

So we did not have jurisdiction over individual tax rates in our working group, but we did examine some potential alternative approaches. One was a business equivalency rate where pass-

throughs and corporate income are subject to the same rate; second was a targeted tax benefit approach for pass-throughs involving higher expensing limits and cash accounting limits; or, third, a flow-through business deduction whereby pass-through businesses receive a deduction on their business income so as to lower their effective tax rate.

Which of those approaches do you think would be the most equitable for pass-through businesses in a business tax reform effort that is also cutting the corporate tax rate?

Dr. TODER. I will try first and let Dr. Hines correct me.

I guess I am never a fan of targeted benefits, but I think that is probably the best way, given the alternatives, to approach this situation, meaning more generous expensing and other kinds of capital recovery benefits for small businesses.

I think the difficulty with a rate differential is, it is very hard to tell what is the margin between a small business and an employee when you get to closely held companies, and you are going to have a lot of gaming between the rates on compensation and the rates on business profits, and I think that would create some very difficult problems. So I would not go in the direction of a special rate.

I think, also, I would point out that there is an advantage to being a small business or being a pass-through, even if you pay a higher rate, because you are not paying two levels of tax. You are not paying a second tax on distributions.

So the real issue has to be with small companies that—if the corporate rate were lowered relative to the pass-through rate—would try to incorporate. So you might have to have rules that define what kinds of entities could be pass-throughs and what could be corporations.

Senator THUNE. Dr. Hines, quickly.

Dr. HINES. I agree with Dr. Toder. The targeted benefits make more sense than the broad rate differential because of the endogenous formation of small businesses, that people who otherwise would be employees can become self-employed and take advantage of the lower rate, if it is available.

We should really apply the principles. Where you want the more favorable tax treatment is where activities generate economic spillover benefits or where activities are highly responsive to taxation, and I think they both point in the direction of more favorable treatment of investments by small businesses.

Senator THUNE. Thank you, Mr. Chairman. Thank you all.

The CHAIRMAN. Senator Cardin?

Senator CARDIN. Thank you, Mr. Chairman.

I want to thank the panel. I found this extremely helpful.

Mr. Chairman, I appreciate you mentioning Mark Bloomfield and the American Council for Capital Formation. It has worked in a bipartisan manner, bringing together many of us on both sides of the aisle to look at better ways to do our tax policy. I remember his predecessor, Charles Walker, very well as a person who provided a good deal of information to us.

To Senator Carper's point, all of us are interested in making progress whenever we can. We understand that it is unlikely in the next month or two that we are going to pass a major tax reform

proposal, and we want to make progress where we can make progress.

There has been a lot of information that Senator Thune and I explored in our work that can lead to, I think, some significant improvements in our tax code. I mentioned earlier the reform of S corporation provisions; it is not controversial, it would help, and we should get it done.

But the fundamental points that you all are raising, which are high tax rates on business, which are not competitive; the lack of simplification, so you need to have an accountant on your fast dial in order to get information because you just cannot figure this out; and I would also add the predictability of our tax code, which affects investor decisions, all were the goals of the 1986 tax reform.

I remember our predecessors saying, we accomplished it, and, obviously, they did not accomplish it. It led to the tax code that we have today.

So I really want to get to the proposal that I brought forward that was discussed in our working group that, if we were able to substitute part of our income tax revenues with a national consumption tax that would be at least as progressive as our current tax code so that middle-income families are not going to be more burdened, that gives us rates that are, on average, 5 percentage points below the OECD countries, as I explained earlier.

What impact would that have on the type of questions that we have been raising on American competitiveness globally, on the international side, on dealing with the challenges of small businesses, on complexity, and on giving predictability for investment in America?

Dr. Hines?

Dr. HINES. It would do all of that. A move like that would reduce the inefficiencies in the current system, stimulate investment and growth, and make the system more competitive.

Senator CARDIN. Dr. Toder?

Dr. TODER. I agree with Dr. Hines on all of his points. I would add, though, that you are comparing a system that is designed perfectly with no exemptions in the value-added tax, and, when you get through the process here, you might have some exemptions in the value-added tax. It might not look as good. So I think that is just a caution.

Senator CARDIN. I am not interested in getting rid of the Senate Finance Committee. [Laughter.]

I understand the challenges every year that we are going to have to deal with. But let me just correct one statement. We use a credit method, not a subtraction method, which is, as you know, a difference, and we feel pretty strongly that using a credit method is a better way and a fairer way to have a national consumption tax.

Dr. TODER. When I use that term, I mean the credit method. So we are in agreement.

Senator CARDIN. I just wanted to make sure that that point was made. Does anyone else want to comment?

[No response.]

Senator CARDIN. Let me then raise an issue directly dealing with small businesses. Small businesses generally use the personal in-

come tax rates. A lot of them are pass-throughs. A lot of them just use the schedule and the income tax for income.

Therefore, if we were to deal just with the corporate rate and not deal with the individual rate, what impact would that have, if any, on small businesses?

Mr. ZINMAN. Well, you have to remember that a lot of small businesses are paying a higher rate because of the pass-through, and it is important to look at a broad spectrum and keep all businesses competitive.

When you have an individual in an S corporation who is making a reasonable salary, whatever that may be, and is looking to stay out of AMT—I come from the New York area, and, if you look at the New York area, an individual who is running a business, if he owns a house and has two kids ready for college, automatically he is paying AMT.

So you are looking for a way to provide equity to the small business as well as the big business. The big businesses are hit with the double taxation, and that is absolutely true, and yet the small business owners very often wind up paying as high a rate as some of the top corporate rates.

Senator CARDIN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Coats?

Senator COATS. Mr. Chairman, thank you. I am juggling several things this morning, so I was not able to hear some of the testimony by our witnesses.

I think one of the areas that I would like to talk about goes to what has already been talked about. So I hope I do not duplicate that effort.

As chairman of the Joint Economic Committee, last week I held a hearing, and we were talking essentially about the complexity of the tax code and its impact, in particular, upon small business. We did not want to cut down several Capitol trees, which would have been necessary to provide an example of the number of pages of the current tax code, so we had empty boxes stacked up in the hearing room, and it was a pyramid of some dimension.

We had testimony from a small business owner from Indiana whom I invited to come. He has a cybersecurity business, clearly qualifies as a small business. He gave a compelling testimony relative to what he has to go through in order to file his taxes.

We have all heard this, but he said, “The large corporations can have stables of tax accountants sitting in the backroom to deal with the complexity,” he said, “but I have to deal with a lot of the same complexity, and I cannot afford to have a back room of accountants working for me.”

So he said, “There was an issue where I wanted to make an additional investment in a certain business, and so I took it to a tax accountant. He charged me a lot of money to give me advice, saying, ‘This is what you can do and this is what you cannot do.’” He said, “I thought I ought to double down and get somebody else, because I did not want to make a mistake, because I sensed that he was not totally certain that the advice he had given me was the correct advice. Well, the second accountant gave me exactly the opposite advice. So I have to break the tie here. So I go to a third, and he gave me a third indication of what it would mean for me

from a tax standpoint. So three well-qualified," he said, "all totally qualified, highly paid, highly respected tax lawyers, basic advisors, basically gave me three different pieces of advice. And so I am a small business guy sitting here. Do I want to buy into this new business which would increase my employment or what? And what do I do?"

I did not have an answer for him, and we do not have an answer for him. So whether it is the complexity, the need for simplicity, the differentiation between what the small guy and the big guy can do, it is extraordinarily frustrating to the people I talk to.

I know, Ms. Goschie—I am sorry I was not here. I think Senator Wyden, my staff tells me, asked you a question and you responded to this. I guess I am here to make more of a statement than I am to hear your answers, because I do not want to duplicate what has already been said.

But it has been a long, long time of talking and not getting it done. So I am hoping this committee can take action with the House. Obviously, it is going to have to be after the election and in a new year. I will not be here, but I guess I would say to my colleagues, there really is an urgency in terms of maintaining the ability of small businesses to address something so complicated.

I had three tax courses in law school. I would be in jail if I did my own tax returns. [Laughter.]

So I think it is time that we step up to the plate here. I know the chairman wants to do that.

I guess one question I have in the few seconds that I have left is just your take—I am sorry if you have already talked about this—on the separation of business tax reform from comprehensive tax reform. Is this something that is desirable, something that is just absolutely necessary because we cannot get there any other way?

Our businesses are hurting. We are not competitive. But there is a lot of concern among the small business people I talk to about how they are going to get left out in the cold.

Are there any really quick responses to that?

Dr. TODER. Very quickly, because I think I said this in my remarks also, I do not think looking at corporate reform only is viable. I think you need to go through to business and you also need to go through to the owners of corporations as individuals.

So I do not think—I think you really need to go broader than just business only.

Senator COATS. Does anybody disagree with that?

Dr. HINES. I think there are valuable things we can do with business-only tax reform, but they are very limited. In that sense, I agree with Dr. Toder. There is a limit to how much good you can do with business-only reform, but there are ways to improve things that way. It is just that you will do better still if you integrate the whole thing.

Mr. ZINMAN. One issue that I want to raise is, when you start putting band-aids on some of these tax rules, it makes things more complicated. As a matter of fact, on the plane down here, I was talking to somebody next to me. He has an S corporation.

He said, "This whole thing with the 2-percent owners' health insurance"—and a lot of people do not understand it, accountants do

not even understand it sometimes, but basically what happens is, if you are a 2-percent shareholder in an S corporation and you have health insurance paid for by the corporation, you add it back into your income and then you go to your personal tax return and you take it out of your income, and that is a band-aid approach to what happened before.

Senator COATS. Thank you all. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Heller?

Senator HELLER. Mr. Chairman, thank you and thanks for holding this hearing.

I want to thank all of our witnesses for being here, and everybody else on this committee. We really do appreciate your insight and your help on some of these issues.

I want to thank Senators Thune and Cardin for their hard work in the working group for small business, and also Senators Portman and Schumer on the international tax reform side. A lot of research has gone on lately in this committee. Whether or not it becomes law or legislation, I am not certain at this point, but I think a lot of us know what the problem is.

The problem is that we have more small businesses in America that are going out of business than new startups. It is historical data—since World War II, we have not seen that.

So what is wrong? What is wrong? Why are businesses, more businesses, going out of business as opposed to new startups?

The second problem we have is inversions. We have had over 1,300 inversions in the last 10 years. I mean, we are talking big companies here in America that have multiple accountants. So you have multiple accountants, and you still cannot make it work.

So what do you do? You are inverting companies like Louisville Slugger, Burger King, and the problem is not getting better. The problem is getting worse. We are going to see this continue to advance if we do not do something about the tax structure we have here in this country.

I want to share a quick story about a company back in Nevada, a good company, not a multinational company, although they do international work. It is called the Hamilton Company. They do robotics. They also do medical devices. Talking with the owner—we sat down a couple of weeks ago—he says, “You know, it costs me \$10 million for my business to stay here in America, and,” he says, “I am willing to pay it. I am willing to pay it, but it costs me an additional \$10 million to do business right here in the United States.”

He is a patriot. He is a good citizen. So he is willing to pay it. “But,” he says, “I will tell you what will happen when I get too old to run this company and we merge or get a buyout. What they are going to do is, they are going to move this company to outside the country because of more favorable regulations, tax rates, and fees.”

So I guess my question is, how do you keep—I know we are repeating this question over and over, but I think it is the issue of this particular hearing. Starting with you, Dr. Hines, how do you keep the Hamilton Company in America?

Dr. HINES. Two things. One, we have to adopt a territorial tax system like every other large country has; and two, we have to

lighten business tax burdens. If you do those two things, then you will keep a lot more companies in America.

Senator HELLER. I thought that would be your answer.

Dr. Toder?

Dr. TODER. I would actually add that I do not think a territorial system is necessarily sufficient to accomplish that, because foreign-owned companies operating here in the United States have a tremendous advantage with the ability to strip profits out of the U.S.—out of their U.S. subsidiaries.

So I think you really need to look at the issue more broadly and all the ways in which foreign-owned companies might be advantaged relative to U.S. companies, and some of that might have to do with limits on interest deductions.

The Treasury has taken a step in that direction. I think it is a rather blunt instrument what they have done, but I think a legislative solution to that problem or legislative action in that area is certainly called for.

Senator HELLER. Mr. Zinman, you have talked about the corporate tax rate and the fact that individuals in pass-throughs actually pay a higher rate. If you were to lower the corporate tax rate, would you see a movement back to C corps from these pass-throughs if the rate were to be competitive at 20 percent?

Mr. ZINMAN. Yes. When people want to start a company, the first thing they do is, a lot of times, they go to an attorney and they say, "We want to open up a restaurant, we want to own a building, we want to rent property." Often, the attorneys will recommend a corporation because that is what they know.

LLCs have been around for quite a while, but they are still somewhat new. There is more tax law and case study on corporations.

So they go with the corporations, and then they go to the accountants and they say, "My attorney told me to come over to see you. Should I be a C corporation or should I be an S corporation?"

Well, on a small business level, sometimes it is irrelevant because, depending on the amount of income, depending on the shareholders, the owners, what kind of salaries they want to take, you can strip a lot of the profit out of a corporation just by paying a salary, which is not necessarily a bad thing, because when somebody pays a salary, they pay into Social Security, they get the pension benefits, et cetera.

So, yes, if you lower the C corporation profit tax percentage, you might get some turning toward that rather than using the S corporation as a device.

Senator HELLER. Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator.

Senator Portman, you are next.

Senator PORTMAN. Thank you, Mr. Chairman.

I have really enjoyed the testimony today, and I thank you all for being here.

Thanks to my colleagues, Senators Thune and Cardin, for putting out a great report. Also, thanks to Senator Schumer on our report on international taxation.

We do have a lot of the information, and I think we are poised to act. We just need a little political will to do so.

I thought the chairman gave a great speech on the floor last week. He said there was a glimmer of hope with the findings and recommendations of the Finance Committee's bipartisan International Tax Reform Working Group. However, as is too often the case, that glimmer of hope may well be overtaken by the politics of the moment. We have to get beyond the politics of the moment because of everything you guys said here today.

With all due respect to my colleagues who say this is about small businesses versus big businesses, this is about people. This is about workers. I will tell you, in my home State of Ohio today, we are losing workers and losing investment because of the fact that our tax code is not competitive. It is not about the boardroom. The boardroom is going to be fine. When you do these inversions—I could not agree more with my colleague, Senator Heller, on this, and I could not agree more with Senator Carper on this when he talked about the need to address this.

If we do not address this, what is going to happen is, you are going to continue to see more pressure on wages, salaries. That is what the Joint Committee on Taxation has said, and that is what the CBO has said. That is the impact here. It is on workers, and, specifically, when you have these inversions, that is the tip of the iceberg.

It is really the foreign takeovers, it is the foreign acquisitions of U.S. companies; they take workers with them. And as we sit here today, it is happening in my home State of Ohio. The Eaton Corporation, a great corporation in Ohio with a great storied history, finally had to kind of say “uncle” because the tax code was hurting them so much. So they went over to Ireland, inverted with a smaller company about a quarter of their size. They are going to save hundreds of millions on their tax bill.

Now, you see what is happening. Some workers are leaving Ohio, and they are going overseas to get away from the net of the U.S. tax code. This is outrageous, and we cannot let politics stop us from dealing with it.

Look, I am a small business owner. I grew up in a pass-through entity. I totally agree with this thought that we need to help the small businesses. All of you have said we need to simplify. Put me at the top of that list and at the head of that line. I could not agree more. Let us do that.

I would like to have total reform of our tax code, of course—we know we need that—but we do not have the consensus on that at this point.

The issue that no one has raised here today is that the other side of the aisle and the administration insist on a couple trillion dollars of new taxes in order to do reform. That is what is in the President's budget. I think it is even higher than that this year.

That is the reality. So we are not going to get to that. We cannot find common ground there. Where we can find common ground is to deal with simplification, as you all have said, particularly on the business side.

Ms. Goschie gave some great comments on that. By the way, we all loved your comments particularly on hops and beer. That was my favorite part. We have now 115 craft brewers in Ohio. Thank

you for supporting Senator Wyden's legislation. I think that is really important to get passed.

But the second thing is this international piece. We are going to continue to have more and more of our workers lose their jobs or not have their pay go up as it should because of the fact that our tax code is not competitive. Every single day, these companies are competing with one hand tied behind their back.

So I just want to thank you for being here and for making this so clear to all of us. I loved when you said we need—I think it was Dr. Hines—a smarter way to tax business income.

Dr. Toder, you talked about the \$2 trillion-plus locked up overseas. That is another huge issue. Not only are we losing workers—and again, it is happening right now in my home State—but we are not taking advantage of \$2 trillion-plus that are locked up overseas that the Europeans and others are going after now through not just the BEPS project, but also these state aid cases. In other words, this is revenue that ought to come back here and be invested in jobs and infrastructure.

So I guess, Dr. Hines, I would just ask you a question, if I could. You talked about adopting what is called a territorial tax system rather than a worldwide tax system. Talk about not just what would be good about it, but what are the consequences for U.S. businesses and for U.S. workers if we do not move in this regard?

Dr. HINES. The consequence is we will continue to lose in competition with foreign businesses, resulting in depressed investment in the United States and less demand for American labor.

The more vibrant and competitive the American business sector is, the greater the opportunities for American workers. Workers are paid based on their productivity in a competitive economy like the United States, and the more productive we can make businesses, the more productive is capital and labor. We do not have a competitive tax system, so it reduces the productivity of labor and thereby reduces job opportunities.

Senator PORTMAN. So if we do nothing, we are going to continue to see that loss of workers.

Dr. Toder, I just have 8 seconds remaining, but I would love to hear your comments on that: if we do nothing.

Dr. TODER. Well, bad things are going to happen if we do nothing, but I think a territorial system by itself without safeguards to prevent shifting of profits and investment overseas by U.S. firms is—

Senator PORTMAN. You saw our report, and we had that in our report.

Dr. TODER. Yes.

Senator PORTMAN. You need to do that as well, and I think it is necessary not just for U.S. companies, but you would say also for foreign companies invested here.

Dr. TODER. Yes.

Senator PORTMAN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Scott?

Senator SCOTT. Thank you, Mr. Chairman.

I thank each of the panelists for being here this morning and having an important conversation about an issue that seems to be

a burden to the taxpayers from a corporate perspective, but also to every single American, because at the end of the day, the biggest taxpayer in the country is the individual who bears the burden of all the tax reform. All that conversation ends up on the shoulders of the individual.

Speaking of individuals, I think back to South Carolina, where I am from, where we have a wide range of life sciences companies that reflect the growing diversity of the life sciences industry across the United States. The life sciences sector employs almost 14,000 South Carolinians, and, specifically, about 8,000 are concentrated in the biopharmaceutical and medical device sectors.

Over time, the life sciences industry has grown rapidly to include companies that are contracted to specifically oversee and carry out the development and commercialization phase of the other companies' developed IP.

These companies face the same pressures to compete in the global marketplace that any other U.S. multinational company is facing today, including the pressure to locate facilities and plants either in the U.S. or abroad, threatening the livelihood of thousands of U.S. workers.

One of the most effective tax incentives utilized by several European nations is the patent box.

My question to you, Dr. Hines, is, given the growing diversity of companies in the life sciences industry, the increasingly specialized roles of these companies in bringing IP to market, and the hundreds of thousands of high-paying jobs in the commercialization, development, and manufacturing of these products, how do you suggest that we equitably allocate benefits in the context of a patent or innovation box model specifically as it relates to our competitors around the world who are already moving in this direction?

I know this, to me, appears to be a complication to the tax code, but at the same time, without these companies, we would have fewer dollars coming in from this specific area.

Dr. HINES. We cannot ignore international competition. The question for the committee is, if the United States is not going to adopt some form of an intellectual property box or patent box, then what are we going to do?

Are we going to just ignore what is going on in the rest of the world? It hardly seems like a good idea. But the downside, and people have noted this, of the patent boxes or intellectual property boxes is that, unless they are carefully crafted, you can have a serious problem of encouraging too much property being included in the patent box and you get a lot of revenue erosion that way, and it is pretty undesirable.

The issue really is, what are we trying to achieve with the intellectual property box, patent box, and I think the answer should be that we want to encourage activities that we would otherwise lose. If we find ourselves in that situation, then we should try to figure out a way to craft one of these things. The rest of the world is doing it, and we ignore them at our peril.

Dr. TODER. I think I have a different perspective on this.

Senator SCOTT. Certainly.

Dr. TODER. Some of the articles by Marty Sullivan in *Tax Notes* have described a lot of the problems with patent boxes. I see this

as something that may end up not increasing innovation and just being another vehicle for corporate income shifting, and I would much rather, if you want to increase innovation, to just have tax credits or more generous tax credits for activities in the United States.

With regard to what other countries are doing, yes, they are engaged in a race to the bottom to try to subsidize their multinationals in various ways. They are also moving toward taxing our multinationals, and I think we may need to start going after some of theirs before the situation comes back into balance.

But it is a troubling situation, and that is why I am very much in favor of moving away from the corporate level and more toward the individual level taxing of individual income that comes from corporations.

Senator SCOTT. Any thoughts, Dr. Hines, on how we would attract other countries' companies to our 35-percent tax rate and make it competitive?

Dr. HINES. Well, it is hard as long as you have a 35-percent rate, that is for sure, and as long as you have a worldwide tax system.

But the issue with the intellectual property boxes, the justification, the strongest justification, is not that they encourage research activities, but that these are businesses that you would not otherwise have unless you offered a favorable treatment.

It is not that any one business would necessarily do more intellectual property development as a result of the box, but it is part of the whole package in attracting companies.

Senator SCOTT. It appears to me—thank you, Mr. Chairman, for the time.

I would suggest that if we do not figure out how to engage in this conversation, it appears to me that IP is the first iteration of the conversation, manufacturing may be the last, and ultimately they are all gone.

Thank you.

The CHAIRMAN. Senator Schumer?

Senator SCHUMER. I am going to be very brief, because we only have 1 minute or 2 left on the vote. So I will just maybe ask some questions in writing.

First, I want to welcome Mr. Zinman, a fellow New Yorker from Westchester County. Thank you for being here.

Second, I just want to say I heard what Senator Carper, Senator Portman, and Senator Hatch said on the floor. I believe in international reform. I believe we have to do something about inversions. I believe we have to make our companies competitive, and international reform is a lot easier to bite off than broad corporate tax reform, even though that is desirable, in my opinion, as well.

I am still ready to work with the chairman and with all the others, and I know Senator Wyden is as well, and Senator Carper, Senator Warner, Senator Brown—people who were part of our little international tax reform group—to get something done. Even if we could get it done this year, I am game to do it, because I think it is really important for American competitiveness.

My advice would be, let us do the international side first, then we can deal with all the complicated issues elsewhere.

With that, Mr. Chairman, I am going to yield back my time, because I know we have a vote coming up.

The CHAIRMAN. Thank you, Senator Schumer. I appreciate your hard work in this area, and I intend to work with you, and we will find a way of doing it.

I want to thank all of you for being here.

Mr. Barthold, I had questions for you, but we have run out of time, but we will get those to you separately. This has been a very interesting hearing, and I appreciate the time that you have given. I just wish we had more time, but we have three votes occurring now, so we are going to recess until further notice.

Thanks so much for being here.

[Whereupon, at 11:20 a.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF THOMAS A. BARTHOLD, CHIEF OF STAFF,
JOINT COMMITTEE ON TAXATION

NAVIGATING BUSINESS TAX REFORM¹

My name is Thomas Barthold. I am the Chief of Staff of the Joint Committee on Taxation. The purpose of today's hearing is to discuss issues arising in attempting to reform the Federal tax system. For today's hearing, Chairman Hatch and Ranking Member Wyden have asked me to briefly review some of the business tax reform issues raised by the committee's bipartisan Business Income Tax Working Group.² Some business tax reform proposals maintain the basic structure of income taxation, while others offer a structural change in income taxation. In addition, some proposals may be more accurately characterized as consumption-based taxes. My written testimony provides additional details and includes further information.³ Members have separately been provided with several charts and tables to which I will refer during my oral testimony.

In assessing any tax system or reform, policymakers make their assessment across four dimensions.

1. Does the tax system promote economic efficiency? That is, is the tax system neutral or does it create biases in favor of or against certain economic activities when compared to choices taxpayers would make in the absence of taxes?
2. Does the tax system promote economic growth? How does the tax system affect the potential for citizens to be better off in the future than they are today?
3. Is the tax system fair? Are similarly situated taxpayers treated similarly? Are tax burdens assessed recognizing that different taxpayers have different abilities to pay?
4. Is the tax system administrable for both the taxpayer and the Internal Revenue Service? Does the tax system minimize compliance costs for taxpayers and administrative costs of the tax administrator?

There may, of course, be other important policy considerations.

How one addresses these questions shapes the reform. It is invariably the case that these different policy goals are in conflict. Policy design to promote economic neutrality may conflict with goals of fairness. Policy design to promote fairness may lead to complexity and increased compliance costs. Additional constraints that may also shape reform include: maintaining budget neutrality as conventionally estimated, maintaining the current distribution of tax burdens across income groups, and not achieving low tax rates on C corporate business income at the expense of

¹This document may be cited as follows: Joint Committee on Taxation, *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Finance Hearing on Navigating Business Tax Reform* (JCX-36-16), April 26, 2016. This document can also be found on the Joint Committee on Taxation website at <http://www.jct.gov>.

²The Business Income Tax Working Group report is available at <http://www.finance.senate.gov/download/?id=B4AEDDC8-9E94-4380-9AF4-9388953FB347>.

³For additional background information and brief description of a number of the business tax reform proposals reviewed by the working group, see, Joint Committee on Taxation, *Background on Business Tax Reform* (JCX-35-16), April 22, 2016.

higher taxes on passthrough business income. There are always tradeoffs. Many business tax reform proposals are the result of such tradeoffs.

Base Broadening to Lower Rates

Some proposals undertake comprehensive tax reform by broadening the tax base and lowering tax rates. Lowering tax rates in an economy as large as that of the United States results in substantial revenue losses as conventionally estimated. The Joint Committee staff estimates that relative to the current baseline forecast reducing the highest statutory income tax rate of the corporate income tax by one percentage point would result in a \$44 billion revenue loss over the first 5 years of the budget period and a 10-year revenue loss of \$100 billion.

Joint Committee Staff Estimate of Revenue Effect of One Percentage Point Decrease in Top Statutory Corporate Income Tax Rate

Billions of dollars	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2017–2026
Change in Revenues	– 6.1	– 8.7	– 9.1	– 9.8	– 10.3	– 10.5	– 10.9	– 11.3	– 11.7	– 12.2	– 100.7

Source: Joint Committee on Taxation staff estimate.

Note: This option would take effect for tax years beginning after December 31, 2017. Estimates are relative to CBO's January 2016 baseline projections.

By comparison, among the Joint Committee staff 5-year estimates of corporate tax expenditures, only a modest handful exceed \$50 billion.⁴

Largest U.S. Corporate Tax Expenditures 2015–2019

Corporate Tax Expenditure	Total Amount (Billions of Dollars)
Deferral of active income of controlled foreign corporations	563.6
Deduction for income attributable to domestic production activities	61.5
Deferral of gain on like-kind exchanges	57.4
Exclusion of interest on public purpose State and local government bonds	50.5
Credit for low-income housing	41.2
Expensing of research and experimental expenditures	27.6
MEMORANDUM	
Depreciation of equipment in excess of alternative depreciation system	– 20.9

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2015–2019* (UCX–141R–15), December 7, 2015.

Former House Ways and Means Committee Chairman Dave Camp took the approach of broadening the tax base to achieve a lower statutory tax rate on corporate income.

- Tax Reform Act of 2014⁵
 - a. Introduced in December 2014 by Mr. Camp (then House Ways and Means Committee Chairman).

⁴A tax expenditure calculation is not the same as a revenue estimate for the repeal of the tax expenditure provision. First, unlike revenue estimates, tax expenditure calculations do not incorporate the effects of the behavioral changes that are anticipated to occur in response to the repeal of a tax expenditure provision. Second, tax expenditure calculations are concerned with changes in the reported tax liabilities of taxpayers and may not reflect timing of tax payments. Third, the tax expenditure estimate includes only income tax effects and not interactions between income tax provisions and other Federal taxes. Fourth, the tax expenditure estimates reported here reflect provisions in Federal tax law enacted through September 30, 2015, and are based on the January 2015 Congressional Budget Office (“CBO”) revenue baseline, while the revenue estimates reflect present law and the current CBO revenue baseline. Nevertheless the orders of magnitude of revenue loss are represented fairly.

⁵H.R. 1 (113th Cong.), introduced December 10, 2014, by then Chairman Dave Camp. Additional Joint Committee on Taxation staff analysis of H.R. 1 can be found in *Technical Explanation, Estimated Revenue Effects, Distribution Analysis, and Macroeconomic Analysis of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code* (JCS–1–14), September 2014. This document can also be found on the Joint Committee on Taxation website at <http://www.jct.gov>.

- b. Reduces corporate income tax rate to 25 percent.
- c. Changes depreciation rules.
 - i. Expands expensing permitted under section 179.
 - ii. Allows bonus depreciation to expire.
 - iii. Requires straight-line method of cost recovery over applicable recovery period.
 - iv. Makes available election to index basis to chained consumer price index for all urban consumers ("CPI-U").
- d. Requires amortization of 50 percent of advertising expenditures over 10 years.
- e. Requires amortization of research and experimentation expenditures over 5 years.
- f. Repeals last-in, first-out ("LIFO") and lower of cost or market ("LCM") methods of accounting.
- g. Phases out section 199 domestic production activities deduction.
- h. Proposes other base-broadening measures.

H.R. 1 illustrates tradeoffs in tax policy. In the context of business income tax reform, lower tax rates at the expense of lengthening capital cost recovery periods is an important tradeoff. For example, if to achieve a revenue neutral tax change, the corporate tax rate were reduced at the same time that tax depreciation were made less generous, these two changes would have offsetting effects on the user cost of capital. The net impact could increase, decrease, or have no net effect on the user cost of capital. Economists on the Joint Committee staff have studied the issue and have published a study simulating the macroeconomic effects of a number of hypothetical proposals that would reduce the top statutory corporate tax rate from 35 percent to 30 percent.⁶ One of the proposals involved financing a revenue neutral reduction in the corporate tax rate with a partial repeal of the Modified Accelerated Cost Recovery System ("MACRS").⁷ The study found that the proposal would lower the economy's long-run capital stock by between 0.2 and 0.4 percentage points. These simulation results suggest that slowing down cost recovery methods could reduce investment even if the corporate tax rate is reduced at the same time.

Maintaining Parity Between Corporate and Passthrough Entities

More so than in a number of other countries, substantial business income in the United States is not subject to a separate entity level tax such as our corporate income tax but rather is passed through to an individual's income tax return and taxed as part of the business owner's individual income.⁸ For example, in 2012, more than 40 percent of all business income reported in the United States was earned by S corporations, partnerships, and nonfarm sole proprietorships.⁹

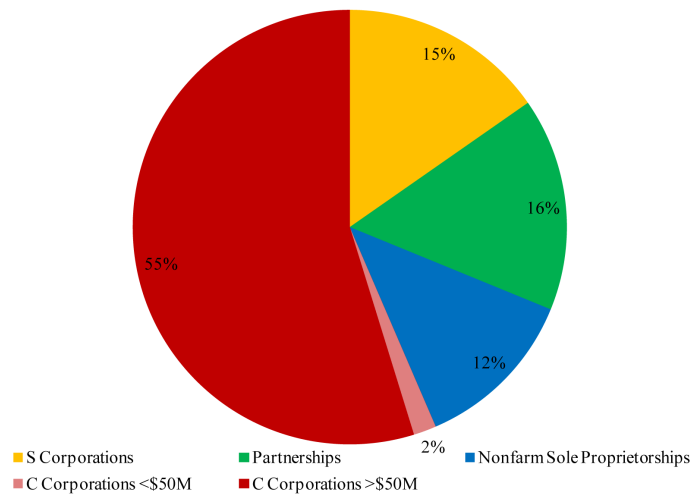
⁶See Nicholas Bull, Timothy A. Dowd, and Pamela Moomau, "Corporate Tax Reform: A Macroeconomic Perspective," *National Tax Journal*, vol. 64, no. 4, December 2011, pp. 923–941.

⁷*Ibid.*

⁸In a study analyzing corporate and individual shares of net income from business activities in five countries, it was observed that "[t]he corporate share of net income from business operations was 81.9 percent in Australia, 74.5 percent in Canada, and 67.5 percent in the United Kingdom in 2009, while it was 34.1 percent in Germany in 2007 and 43.8 percent in the United States in 2009. In 2010, roughly equal shares of business income were earned by corporations and individuals in Japan." Joint Committee on Taxation, *Foreign Passthrough Entity Use in Five Selected Countries*, October 2013, p. 11. This document is available on the Joint Committee on Taxation website at <http://www.jct.gov>.

⁹The partnership data reported here, as compiled by the Statistics of Income Division of the Internal Revenue Service, include partnerships whose partners are C corporations. In 2012, approximately two-thirds of the income reported on partnership returns was ultimately reported on individual returns. Therefore, there may be some double counting of partnership income that flows to partners that are C corporations.

Net Income by Business Form in 2012



Source: Internal Revenue Service, Statistics of Income, published and unpublished data and Joint Committee on Taxation staff calculations.

Some business tax reform options have been proposed with the intent of maintaining parity between corporate and passthrough entities; for example, by attempting to equalize the top corporate tax rate with the top individual tax rate. However, it is not clear what parity should mean.

Owners of C corporations generally bear two levels of tax that in total can exceed 50 percent. However, if the earnings of the C corporation are not distributed the current tax burden of those earnings is 35 percent or less. On the other hand, owners of passthrough entities generally do not bear a tax rate greater than 44 percent, but that rate of tax may apply regardless of whether the earnings of the entity are distributed or retained.

The top marginal 2016 Federal tax rate on income of business entities depends on three principal factors. The first is the tax classification of the business: C corporation, S corporation, or partnership. C corporations have a top marginal rate of 35 percent, though distributed income—generally in the form of a dividend—is also taxed in the hands of shareholders. By contrast, S corporations and partnerships are passthrough entities generally not taxed at the entity level, only at the shareholder or partner level, whether or not the income is distributed to shareholder or partner. Limited liability companies (“LLCs”) can be treated as partnerships for tax purposes.

The second factor, applicable only to C corporations, is whether the income is distributed to equity holders or not, and if distributed, whether it is a qualified dividend or an ordinary dividend in an individual equity holder’s hands. An individual is taxed on a qualified dividend at top rate of 23.8 percent, which is the sum of the income tax rate of 20 percent, plus the 3.8 percent net investment income (“NII”) tax. An individual is taxed on an ordinary dividend at the top rate of 43.4 percent, which is the sum of the income tax rate of 39.6 percent, plus the 3.8-percent NII tax.¹⁰ Taking into account the top corporate rate of 35 percent, the “all-in” Federal tax rate on distributed corporate income of an individual is either 50.47 percent (for qualified dividends) or 63.21 percent (for ordinary dividends). Undistributed corporate income is taxed only at the corporate level at the “all-in” rate of 35 percent.

The third factor, applicable to individual owners of S corporations and partnerships, is whether the individual is active (or performs services) in the entity’s busi-

¹⁰ However, dividends received from C corporations by individuals are more commonly qualified dividends.

ness, or is a passive investor. This factor determines whether the 3.8-percent NII tax applies (or, in the case of a limited partner, the Medicare hospital insurance (“HI”) component of the self-employment tax applies, also at 3.8 percent). Neither the self-employment tax nor the NII tax generally applies to active S corporation shareholders: the “all-in” top rate on S corporation business income is 39.6 percent. This is the top individual marginal income tax rate. The “all-in” rate on individuals who are passive shareholders of an S corporation is 43.4 percent, the sum of the 39.6-percent income tax rate and the 3.8-percent NII tax rate. The “all-in” rate on partners who are individuals is generally 43.4 percent, the sum of the 39.6 percent income tax rate and the 3.8-percent NII tax (or the 3.8-percent HI component of the self-employment tax). The S corporation or partnership itself is not taxed, and the S corporation shareholders or partners are taxed whether or not the income is distributed to them.

On distributed income, the partners and S corporation shareholders have an “all-in” Federal tax rate of either 39.6 or 43.4 percent. Distributed income of a C corporation has an “all-in” Federal tax rate of either 50.47 percent or 63.21 percent.

On undistributed income, the partners and S corporation shareholders again have an “all-in” Federal tax rate of either 39.6 or 43.4 percent. Undistributed income of a C corporation has an “all-in” Federal tax rate of 35 percent.

Top Marginal 2016 Tax Rates on Distributed and Undistributed Net Income of C Corporations, S Corporations, and Partnerships

Income	C Corporations	S Corporations	Partnerships
Qualified dividend received by individual	35% + (20% + 3.8% (NII) on after-tax distribution) (15.47%) = 50.47%		
Ordinary dividend received by individual	35% + (39.6% + 3.8% (NII) on after-tax distribution) (28.21%) = 63.21%		
Undistributed corporate income	35%		
Share of business income of individual active S shareholder		39.6%	
Share of business income of individual passive S shareholder		39.6% + 3.8% (NII) = 43.4%	
Share of most business income of individual partners			39.6% + 3.8% (HI) = 43.4%
Share of business income of individual limited partner not performing services			39.6% + 3.8% (NII) = 43.4%

Corporate Integration

Recognition of the two levels of tax applicable to the income of C corporations has led some to propose what is called corporate integration as a business tax reform. There are two broad categories of integration: (1) complete integration and (2) partial integration in the form of dividend relief.

Complete (or “full”) integration eliminates double taxation of both dividends and retained corporate earnings by including in shareholder income both distributed and undistributed earnings. S corporations are taxed under a regime of complete integration since earnings of an S corporation, whether retained or distributed, are treated as income of the shareholders for tax purposes.

Dividend relief, unlike complete integration, reduces the double taxation on distributed earnings, with no change in the taxation of retained earnings. Dividend relief may be accomplished by reducing tax at either the corporate or shareholder level. At the corporate level, the tax burden on distributed earnings may be alleviated by means of a dividends paid deduction or a lower corporate income tax on distributed versus retained income. At the shareholder level, the tax burden on dividends may be reduced by allowing shareholders to exclude from gross income, or deduct, dividends received, or by providing shareholders with a credit equal to all or a portion of the corporate-level tax paid by the corporation.

Innovation

Outside of the United States, a number of countries have established intellectual property regimes (or “patent boxes”), which offer preferential tax treatment on in-

come attributable to intellectual property. Policymakers have adopted “patent boxes” or “innovation boxes” to increase domestic investment in research and development and to encourage companies to locate intellectual property in their countries. Federal income tax rules provide incentives for research activities by providing a deduction for research expenditures in the year incurred, as well as a credit for certain qualified research expenditures. However, there are currently no Federal income tax provisions that provide for preferential rates, deductions, or credits for profits derived from the sale or license of intellectual property or products using or incorporating intellectual property.

Adopting a U.S. innovation or patent box presents unique policy and administrative issues, including the types of intellectual property that would qualify (for example, limiting to patents or expanding to include a broader range of intellectual property, such as trade secrets); whether a nexus requirement should be adopted to require development of the intellectual property to take place in the United States; how the intellectual property income would be taxed; and identifying what types of intellectual property income will receive preferential treatment. A primary question related to this last issue is whether qualifying income should include income from foreign-use of the intellectual property in question. European Union countries cannot limit their innovation box regimes to income from domestic use due to European Union treaty obligations. The United States, however, could design an innovation box that requires domestic use. While the Working Group focused more on the policy effects of these types of provisions, the resolutions of these issues would affect the efficacy and cost of any innovation or patent box proposal.

Other Business Income Tax Reform Proposals

The Working Group also reviewed a number of other business income tax reform proposals, which are included and summarized on pages 7 through 11 of the accompanying materials.

Joint Committee Staff Estimate of Revenue Effect of One Percentage Point Decrease in Top Statutory Corporate Income Tax Rate

Billions of dollars	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2017–2026
Change in Revenues	– 6.1	– 8.7	– 9.1	– 9.8	– 10.3	– 10.5	– 10.9	– 11.3	– 11.7	– 12.2	– 100.7

Source: Joint Committee on Taxation staff estimate.

Note: This option would take effect for tax years beginning after December 31, 2017. Estimates are relative to CBO’s January 2016 baseline projections.

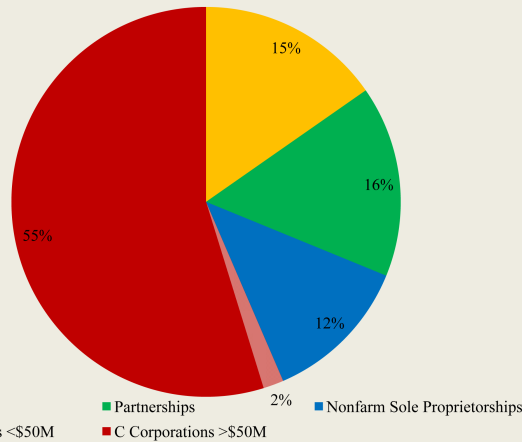
Largest U.S. Corporate Tax Expenditures 2015–2019

Corporate Tax Expenditure	Total Amount (Billions of Dollars)
Deferral of active income of controlled foreign corporations	563.6
Deduction for income attributable to domestic production activities	61.5
Deferral of gain on like-kind exchanges	57.4
Exclusion of interest on public purpose State and local government bonds	50.5
Credit for low-income housing	41.2
Expensing of research and experimental expenditures	27.6
MEMORANDUM	
Depreciation of equipment in excess of alternative depreciation system	– 20.9

Source: Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2015–2019* (JCX–141R–15), December 7, 2015.

Net Income by Business Form in 2012

4



Source: Internal Revenue Service, Statistics of Income, published and unpublished data and Joint Committee on Taxation staff calculations.

Top Marginal 2016 Tax Rates on Distributed and Undistributed Net Income of C Corporations, S Corporations, and Partnerships

Income	C Corporations	S Corporations	Partnerships
Qualified dividend received by individual	$35\% + (20\% + 3.8\% \text{ (NII) on after-tax distribution}) (15.47\%) = 50.47\%$		
Ordinary dividend received by individual	$35\% + (39.6\% + 3.8\% \text{ (NII) on after-tax distribution}) (28.21\%) = 63.21\%$		
Undistributed corporate income	35%		
Share of business income of individual active S shareholder		39.6%	
Share of business income of individual passive S shareholder		$39.6\% + 3.8\% \text{ (NII)} = 43.4\%$	
Share of most business income of individual partners			$39.6\% + 3.8\% \text{ (HI)} = 43.4\%$
Share of business income of individual limited partner not performing services			$39.6\% + 3.8\% \text{ (NII)} = 43.4\%$

Corporate Integration Approaches

- ☐ Some alternative approaches to integration of corporate and individual levels of tax on corporate income
 - ☐ “Full integration”—shareholder allocation method (treat corporate income like passthrough income)
 - ☐ Partial integration approaches (“dividend relief”)
 - ☐ Corporation deducts dividends paid to shareholders

- ☐ Tax on corporate income applies partially at shareholder level, corporation withholds tax on distributions
- ☐ Reduced tax rate for shareholders on dividends received and gains on stock sale/exchange
- ☐ Shareholders exclude from income (or deduct) dividends received
- ☐ Shareholders get a tax credit for some corporate-level tax paid on distributed amounts

Features of Selected Tax Reform Proposals

-
- ☐ **Tax Reform Act of 2014, introduced December 10, 2014 by Mr. Camp (H.R. 1, 113th Congress)**
 - ☐ Corporate tax rate reduced to 25 percent
 - ☐ Repeals numerous present-law business tax provisions
 - ☐ International business: moves to dividend exemption approach
 - ☐ Individual tax rate structure reduced to 10, 25, 35 percent
 - ☐ 40-percent deduction for individuals' dividends, capital gains
 - ☐ **Five largest non-international business revenue raisers (over 10 years)**
 - ☐ Depreciation changes (\$269.5 billion)
 - ☐ Amortize R&E expenditures (\$192.6 billion)
 - ☐ Amortize advertising expenditures (\$169.0 billion)
 - ☐ Phase out section 199 manufacturing deduction (\$115.8 billion)
 - ☐ Repeal LIFO accounting (\$79.1 billion)

Source: Joint Committee on Taxation, *Estimated Revenue Effects of the "Tax Reform Act of 2014"* (JCX-20-14), February 26, 2014.

Consumption Tax Proposals—Progressive Consumption Tax Act of 2014, introduced December 11, 2014 by Senator Cardin (S. 3005, 113th Congress)

-
- ☐ Adds credit-invoice VAT at 10 percent rate
 - ☐ Exports zero rated
 - ☐ Exemption provided for
 - Specified financial products and services
 - Residential housing
 - Residential rent
 - De minimis supplies
 - ☐ Reduces top corporate income tax rate to 17 percent
 - ☐ Reduces top individual income tax rate to 28 percent
 - ☐ Provides income tax exemption of \$100,000 for joint filers (\$50,000 for single) to provide progressivity
 - ☐ Rebates VAT in a manner intended to replace repealed income tax credits (EITC, CTC, ACTC)
 - ☐ Rebates excess VAT if revenues from it exceed 10 percent of GDP for the calendar year

Consumption Tax Proposals—FAIR Tax Act of 2015, introduce January 13, 2015, by Senators Moran, Perdue, and Isakson (S. 155, 114th Congress)

- ☐ Repeals individual and corporate income tax, self-employment and payroll tax, and estate and gift tax
- ☐ Imposes sales tax on use or consumption in the U.S. of taxable property and services
- ☐ Rate is 23 percent for 2017
 - ☐ Thereafter, rate is 14.91 percent general revenue rate increased by OASDI and HI rates
- ☐ Credit against tax for
 - ☐ Exports and intermediate sales for a business purpose
 - ☐ Business use of purchased property
 - ☐ Bad debts, insurance proceeds, sales that are refunded
- ☐ Family consumption allowance (rebate) based on poverty level and family size
- ☐ Authority provided for States to collect tax in conjunction with State sales tax
- ☐ Repealed if 16th Amendment (income tax) not repealed within 7 years after enactment

Cost Recovery and Tax Accounting—Bipartisan Tax Fairness and Simplification Act of 2011, introduced April 5, 2011, by Senators Wyden, Coats, and Begich (S. 727, 112th Congress)

-
- ☐ Unlimited expensing of depreciable assets and inventories for small businesses
 - ☐ Average annual gross receipts of \$1M or less
 - ☐ Eliminates depreciation on tangible property in excess of ADS for businesses other than small business
 - ☐ Repeals LCM

Cost Recovery and Tax Accounting—Economic Growth and Family Fairness Tax Reform Plan of Senators Rubio and Lee, published March 2015

-
- ☐ Full expensing of capital purchases for all businesses
 - ☐ Immediate expensing of all investment in equipment, structures, inventories and land
 - ☐ No depreciation
 - ☐ Businesses pay taxes on earnings after deducting all expenses from taxable income

PREPARED STATEMENT OF GAYLE GOSCHIE, VICE PRESIDENT,
GOSCHIE FARMS, INC.

Chairman Hatch, Ranking Member Wyden, Co-Chairs of the Business Income Bipartisan Tax Working Group, and members of the Finance Committee, I would like to thank you for giving me the opportunity to testify today.

Senators Cardin and Thune, I also thank you for your efforts on the Working Group's report to address the challenges of our present tax code. Your interest in tax fairness and certainty is appreciated, as is your willingness to consider innovative approaches to dealing with challenges posed by current tax law.

My name is Gayle Goschie, and I am here today to represent Goschie Farms, Inc. and the Hop Growers of America. I am a fourth generation farmer. My two brothers and I run Goschie Farms in Silverton, Oregon. Our land, which has been in our family for more than 130 years has 1,000 acres; 550 of which are devoted to hops.

Another 150 acres is farmed with wine grapes. We supply hops and grapes to craft breweries and independent wineries throughout the United States.

Goschie Farms, Inc. has a staff of 80 full-time and seasonal employees. Our customers include 20 breweries located in Oregon, Washington, California, Colorado, Wisconsin and Michigan, and we grow wine grapes for three Oregon companies.

As you all know, the business of farming is fraught with uncertainty. A growing season can turn quickly from an economic gain to an economic loss overnight. A change in the weather, product prices, labor supply, or our customers' needs can have an extreme, often unforeseen impact on our business. Furthermore, the complex and sometimes arbitrary and inequitable nature of our tax laws can impact how we buy equipment, what type of crops we plant and our hiring practices. The agriculture industry has many uncertainties, taxes should not be one of them.

Taxes influence how we invest in our business. Tax rates affect the equipment we buy and when we buy it, the type of crops we grow and our hiring/labor decisions. When there is uncertainty with taxes we are unable to invest with confidence in our business. Fixing the present tax code is one of the ways Congress can help ensure that farms like mine are positioned for growth.

Stated simply, perhaps the greatest thing Congress could do for millions of American small businesses is to streamline and simplify our incredibly complex tax code. Real tax reform will help us do what we do best—run our small businesses.

Congress has already enacted some changes that will have a positive impact on the farming sector. In December 2015, Congress permanently extended the small business expensing limitation and phase-out amounts in section 179 when it passed the PATH Act. Prior to section 179 being made permanent we did not feel confident making needed purchases throughout the growing season. The amount allowed to be expensed was unknown and needed investments were delayed. This permanent extension has allowed us to invest in renewable energy as well as water and energy savings practices and we are hoping to do more.

This is a step in the right direction. We hope that it will encourage Congress to focus on other issues like the current depreciation schedule we follow under "Uniform Capitalization," a tax concept governed by Internal Revenue Code (I.R.C.) section 263A, which is complicated and time consuming. In addition, hundreds of purchases need to be recorded and tracked independently and there are inequalities from one industry to the next. For example, a tractor in agriculture is depreciated over 7 years, whereas depreciation for the same tractor in construction would be over 5 years. It would be helpful to have uniform depreciations for similar items and to allow items to be pooled together as opposed to being listed separately.

It also impacts our development costs. There are a number of expenses that come with development of a vineyard, they include land clearing, soil and water conservation, direct and indirect costs of vine, trellis, and irrigation systems, and preproductive costs. The general rule under I.R.C. § 263A is that all preproductive costs incurred during the preproductive period of vines must be capitalized into the cost of the vines. Depreciation on those capitalized costs would begin when the vines have experienced their first commercially harvestable crop, a period of at least 3 years. The plant and trellis pre-production costs in hops can be written off much sooner than wine grapes, but most crops have no restrictions at all.

As you can see, the tax code for small business owners, farmers like me, is complicated and difficult to interpret. Goschie Farms does not have accountants on staff to analyze every decision as it is made or to maneuver each decision to maximize the tax benefits. Our time and efforts are needed in the fields to meet the demands of our customers.

The work we do every day as farmers is a business story about the safe, U.S. grown, quality products that are our livelihood. It is my generation's responsibility to carry our farming business practices forward with soil that is healthy, and an environment that is productive and safe. Both hop and wine grape growers farm with certifications in best practices, sustainability and energy conservation. Additionally, our farm has invested in a grid-tied solar system that harnesses up to 32 kW of direct current power and our total hop acreage is efficiently watered and fed through more than 250 miles of drip tubing. With the hope of consistent energy tax incentives, these are just the beginnings of ongoing environmental investments.

Another tax issue that would impact farms like ours is the Craft Beverage Modernization and Tax Reform Act (S. 1562), which was introduced by Senators Wyden

and Blunt. Though this legislation does not directly impact hop and grape growers, it would recalibrate the federal excise tax for craft beer, wine and spirits producers.

The majority of our customers would use savings from this legislation to grow their business, invest in larger tanks, and increase their purchase of supplies—such as hops and grapes. Their savings will impact how they purchase ingredients and in many cases allow them to be more consistent, something that would significantly impact the agriculture producers who supply them with their ingredients. It should come as no surprise that in addition to the majority of the alcohol industry this bill has the support of farm groups like the Hop Growers of America, the Oregon Winegrowers Association and the National Barley Growers Association.

The cost of growing hops, like grapes, is not insignificant for a farmer. With the number of craft breweries in the United States over 4,000 and growing the demand for hops increases year after year, but there are many factors a hop farmer must take into account when evaluating the feasibility of growing their hop production; capital, labor, natural resources, crop yield, cultural practices, input prices, prices of hops, management skills, size of the operation, type and size of machinery, and irrigation systems are all factors that must be considered (Galinato and Tozer, 2015, p. 1).

When the craft beverage industry finds relief through a reduction in excise taxes, the grower will find expanding markets, increased demand and a bolstered confidence in continuing to work with the craft producers. With this unique example, a simplified tax code could bring relief to breweries, wineries, farmers and consumers.

In conclusion, I want to thank you again for inviting me here today to testify. I know you have heard many stories like mine and that you agree that our federal tax code must be reformed. Streamlining and simplifying the Internal Revenue Code must be a top priority for the Congress. Tax reform will create a tremendous economic benefit for businesses small and large—and for the American people.

Reference: Ms. Suzette P. Galinato and Dr. Peter R. Tozer (2015). *2015 Estimated Cost of Establishing and Producing Hops in the Pacific Northwest* (Report). School of Economic Sciences, Washington State University, Pullman, WA.

PREPARED STATEMENT OF HON. ORRIN G. HATCH,
A U.S. SENATOR FROM UTAH

WASHINGTON—Senate Finance Committee Chairman Orrin Hatch (R-Utah) today delivered the following opening statement at a hearing to explore ways Congress can reform the business tax code to make it more globally competitive and to consider the findings of the committee's bipartisan business income tax working group:

Good morning. It's a pleasure to welcome everyone to today's hearing, which we've titled "Navigating Business Tax Reform."

I think this title accurately describes the challenges we have before us in moving forward on business tax reform specifically and on comprehensive tax reform more generally. In the recent past, identifying and developing certain bipartisan policy proposals and moving them through the legislative process have proven especially difficult. But I am an optimist, and I believe we can, and should, find common ground on a path forward for comprehensive tax reform.

Of course, as I've said in the past, successful tax reform will take a President who truly makes it a priority and works closely with Congress to get it over the finish line. Currently, I think it's safe to say that we haven't met that prerequisite with this administration, which, most acknowledge, means that, for now, we have to wait. But, in the interim, this committee will continue to lay the foundation and develop pro-growth proposals for when the appropriate opportunity arises.

That is why, last year, Senator Wyden and I asked members of our committee to work in various Tax Reform Working Groups to help identify issues and develop consensus, if possible, around tax policy proposals. Today we will focus our attention on business tax reform issues, including topics that were covered in the report issued by the Bipartisan Business Income Tax Working Group.

I want to thank the co-chairs of that working group—Senators Thune and Cardin—as well as the other members of the working group: Senators Roberts, Burr, Isakson, Portman, Toomey, Coats, Stabenow, Carper, Casey, Warner, Menendez,

and Nelson. A lot of time and effort went into examining these issues and compiling this report. I appreciate everyone's willingness to help advance this cause.

Tom Barthold, the Chief of Staff for the Joint Committee on Taxation, is with us today to provide background on business tax reform issues and highlight some of the major topics reviewed in the working group's report. We have a great group of additional witnesses here today as well that will provide important insights and recommendations about broad design issues of the business tax system and practical, on-the-ground issues that are important for us to keep in mind as we further develop and refine proposals in the business tax space.

I want to take a minute to discuss one particular business tax issue that was discussed in the working group report and that I believe warrants real consideration by everyone here today: corporate integration.

In very general terms, corporate integration means eliminating double taxation of certain corporate business earnings. Under current law, a corporation's earnings are taxed once at the corporate entity level and then again at the shareholder level when those earnings are distributed to shareholders as dividends.

In other words, under our system, if a business is organized as a C corporation, we tax the earnings of the corporation itself AND those same earnings when paid out to the individual owners of the business. This creates a number of inequities and distortions, and my staff and I have been working for a few years now to develop a proposal to address this problem.

I was glad to see that the business tax working group addressed corporate integration in its report, noting that "eliminating the double taxation of corporate income would reduce or eliminate at least four distortions built into the current tax code: (1) the incentive to invest in non-corporate businesses rather than corporate businesses; (2) the incentive to finance corporations with debt rather than equity; (3) the incentive to retain rather than distribute earnings; and (4) the incentive to distribute earnings in a manner that avoids or significantly reduces the second layer of tax."

Depending on its design, corporate integration could have the effect of reducing the effective corporate tax rate and help address some of the strong incentives we are seeing today for companies to relocate their headquarters outside of the United States. It would also have the likely effect of making the United States a more attractive place to invest and do business. I'll have much more to say on this topic in the coming weeks and months. But, I plan to raise this issue in general terms here today.

Once again, I want to welcome our witnesses. I look forward to a robust and informative discussion.

[From the *Wall Street Journal*, July 9, 2015]

"WHO WOULD HAVE GUESSED? BIPARTISANSHIP ON TAX REFORM"

By Mark Bloomfield

The Senate Finance Committee announced Wednesday that five bipartisan working groups had completed reports analyzing the tax code and ways to make it simpler, fairer, and more efficient. It's rare that Democrats and Republicans find common ground on any major issue in Washington, but on tax reform it is monumental. Business groups, interest groups, and other stakeholders in today's system are scouring the reports to identify winners and losers among the recommendations.

Amid the many pages was a nugget that could have big ramifications for tax policy, the 2016 presidential election, and the economy.

Senators Ben Cardin (D-MD) and John Thune (R-SD), the co-chairmen of the working group in business income, note on Page 40 of their report to the Finance Committee: "Making a fundamental shift to consumption-oriented taxation is a major change that may not necessarily be undertaken in the near term. However, given the pro-growth effects of consumption taxes, the working group believes that the issues above and consumption-based tax systems in general deserve the attention of the committee as tax reform efforts continue."

These few words confirm the consensus of many mainstream economists: a consumption tax produces more growth than an income tax.

The need for pro-growth solutions to economic malaise has reached global levels. Greece is desperate to find a way out of its austerity and bailout policies and to put itself on a path that creates jobs and growth.

Here at home, the need for economic growth to revive our still sluggish economy has transcended party lines. Hillary Clinton has stumped on it. Senators from across the political spectrum, including Ben Cardin, Rand Paul, Mike Lee, and Marco Rubio, have proposed versions of a consumption tax. Unlike the stigmatized European VAT, Senator Cardin has proposed what he calls a “progressive consumption tax.” Senator Paul suggests a “business activities tax.” The business-income working-group report says the joint reform plan of Senators Rubio and Lee “contains several provisions that would shift the tax code in the direction of a consumption tax.” On the business side of the Rubio-Lee plan, capital investment would be immediately expensed. On the individual side, investment income from capital gains, dividends, and interest would be tax-free.

This is not about importing a European-style VAT. Progressives, tea-partyers, and all points in between could craft a consumption tax tailored to the political, cultural and economic needs of our country.

To address conservatives’ concerns that traditional VATs pull in too much revenue for government coffers, Senator Cardin proposes a rebate to taxpayers if revenues from a consumption tax exceed 10% of the economy. To counter charges of a “tax on the poor,” Senator Paul would repeal the regressive payroll tax paid by the working poor and exempt from income tax the first \$50,000 of wages.

These proposals capture the spirit of Ben Franklin’s admonition that a penny saved is a penny earned, while working around European pitfalls.

As Senators Cardin and Thune noted, a consumption tax is unlikely to be adopted in the near term. But the 2016 presidential election may be the first and best chance to build a true mandate for tax reform, particularly for Republican candidates looking for a way to stand out in a crowded field.

[From *Fortune* magazine, April 13, 2016]

“THIS IS THE FAIREST WAY TO TAX AMERICA”

By Mark Bloomfield

There’s a better way beyond taxing workers’ paychecks.

The tax deadline is upon taxpayers this week. Our insufferable forms and surrender of hard earned money to the U.S. Treasury causes one to think that there’s got to be a better way. The hope of tax reform springs eternal; it won’t happen this year but it could happen in 2017 with a new president and Congress, when major policy initiatives historically can get done.

To judge the current U.S. tax regime, there are three criteria most economists agree upon—fairness, efficiency and simplicity. Tax reform is not just about what the tax rate should be, but a question of what should be taxed. A consumption tax is better than a tax on income under the three criteria.

First, let’s take a look at fairness. Jared Bernstein, Vice President Biden’s former chief economist recently commented on the fairness of Paul Ryan’s tax plan in the *Washington Post*, citing the Tax Policy Center’s “distribution” tables: the top 0.1% get a tax cut of \$1 million; middle-class families just a couple of thousand dollars; the bottom fifth, a tax cut of a \$560. Bernstein highlighted an interview CNBC’s John Harwood had with Paul Ryan where Harwood asked, “aren’t you worried the blue-collar Republicans are saying ‘you’re taking care of people at the top more than me?’”

This brings us to the issue of fairness, which is in the eye of the beholder. According to the same Tax Policy Center “the top 1% of U.S. earners were projected to pay nearly half of Federal income taxes in 2014; the bottom 60%, less than 2%.” But Bernstein also fundamentally missed something about the psyche of Americans best explained to me by my French wife: If you’ve got a French farmer who has three cows, his neighbor five cows, the less fortunate farmer will scream “there is something crooked going on here. The only fair thing to do is to redistribute the cows so both of us have four cows.” The American farmer’s response would be, “It’s

good that my neighbor has three, great the other fellow has five, but I'm going to work real hard and get 10 cows."

Harvard economist Greg Mankiw addressed another aspect of fairness. Consider the story of twin brothers—Spendthrift Sam and Frugal Frank. Sam lives the high life, enjoys expensive vacations and throws lavish cocktail parties. Frank, meanwhile lives more modestly. He keeps his fortune invested in the economy where it finances capital accumulation, new technology and economic growth. Who should pay higher taxes? Under Bernstein's preference of an even more progressive income tax, both twins would be taxed the same.

Under a consumption tax, however, Frugal Sam would be taxed much less and more fairly than his brother. It's not just what the tax rate should be, but about also what is taxed—income or consumption?

"Efficiency," another one of the three important criteria for a good tax policy, is an economist's term for eliminating tax barriers to economic growth and job creation. Perhaps the time for a new tax system has arrived—taxing consumption rather than income. The *Washington Post* editorial board thinks it should be given serious consideration.

They commended "(Senator) Ben Cardin's creative proposal for tax reform," which is called a Progressive Consumption Tax (PCT). The liberal Senator's proposal is a massive shift in taxation from household and corporate income to consumption. It addresses the liberal concerns about regressivity and conservative concerns about being a "money machine." The *Washington Post* also recognizes the political reality that it may no longer be possible to fix the income tax because of entrenched tax preferences: "a grand swap of fewer loopholes for lower rates may no longer be politically or fiscally practical."

Last July, the Senate Finance Committee released the report of its bipartisan Working Group on Business Income, co-chaired by Cardin and Senator John Thune (R-SD). The report noted making a fundamental shift to a consumption-oriented tax as a major change. "However, given the pro-growth effects of a consumption tax, the working group believes that consumption tax systems in general deserve the attention of the committee as tax reform efforts continue." These few words confirm the consensus of many mainstream economists: a consumption tax provides more growth than the income tax.

The average OECD corporate income tax rate (Federal and local) was 28.8%; for the U.S., 39%, according to the most recent OECD data. What's more, a recent Ernest and Young report found that the U.S. has the highest integrated tax rate of capital (combined corporate level tax with individual investor level tax on dividends and capital gains) among OECD countries. If there is anything one can learn from the electorate today, it is that economic growth and job creation is the big priority. Moving toward taxing consumption, rather than saving and investment would be a great help.

Finally, there is the third criterion of "simplification." Our current tax code is 64,680 pages. Critics say it's the well-connected, the wealthy, the crony capitalist who knows how to manipulate the code to his or her advantage. Credit is due to any tax reform, which would simplify the code for the benefit of those who are not 1 percenters or the millionaires or billionaires who now benefit from complexity.

Tax reform is not an overnight phenomenon. It took years of pent-up demand and hard work to provide the conditions that favored substantive tax reform in 1986. That is also the case today with former tax writing committee chairmen Senator Max Baucus and Congressman David Camp working almost full-time in 2013–14, crisscrossing the country, conducting endless hearings and educating their colleagues, the media and important constituencies from businesses to senior citizens to Joe Six Pack. In the end, Chairman Camp produced a tax reform plan that did not go anywhere because the time wasn't ripe for tax reform; it had an outdated economic and political formula and it didn't have the right leadership on board.

Tax reform, to paraphrase GOP presidential candidate Donald Trump, is more about the art of the deal. In the 1986 tax deal Democrats wanted to close loopholes for the wealthy and corporations; Republicans wanted lower tax rates to spur economic growth. The Tax Reform Act of 1986 gave both what they wanted and that's why it became law. Again, today it may no longer be possible to fix the income tax because of entrenched tax preferences. It explains in part why Camp's plan to reform the income tax was stillborn. It also explains the growing interest in turning

the current tax code upside down, taxing spending rather than income to encourage saving and investment.

Senator Cardin's creative consumption tax proposal might provide a formula for a deal today. For liberals, it would tax the conspicuous consumption of millionaires and billionaires, their yachts, and their million-dollar birthday; for conservatives, it would encourage the wealthy to put their riches into jobs and investment that would not be taxed. Both Democrats and Republicans would be pleased with replacing the corporate income tax with a consumption tax because it could end corporations fleeing abroad: forget parking corporate profits overseas. Forget corporate inversion mergers. Cardin's proposed formula addresses liberal concerns about regressivity with tax exemptions and credits and conservative fear of a "money machine" with a cap on revenue that could be raised.

Tax reform requires bipartisan leadership. In 1986, the people who mattered—President Ronald Reagan, Republican Senate Finance Committee Chairman Bob Packwood and Democratic Ways and Means Chairman Dan Rostenkowski—wanted to do tax reform and it happened. The picture in 2017 is cloudy.

PREPARED STATEMENT OF JAMES R. HINES, JR., PH.D., RICHARD A. MUSGRAVE COLLEGIATE PROFESSOR OF ECONOMICS AND L. HART WRIGHT COLLEGIATE PROFESSOR OF LAW, UNIVERSITY OF MICHIGAN

Mr. Chairman and members of this distinguished committee, it is an honor to participate in these hearings on business tax reform. I teach at the University of Michigan, where I am the Richard A. Musgrave Collegiate Professor of Economics in the department of economics and the L. Hart Wright Collegiate Professor of Law in the law school, and where I serve as Research Director of the Office of Tax Policy Research in the Stephen M. Ross School of Business. I taught for years at Princeton and Harvard prior to joining the Michigan faculty, and have been a visiting professor at Columbia University, the London School of Economics, the University of California—Berkeley, and Harvard Law School. I am a Research Associate of the National Bureau of Economic Research, Research Director of the International Tax Policy Forum, and former Co-Editor of the American Economic Association's *Journal of Economic Perspectives*.

Business activity constitutes the core of the U.S. economy, and Americans benefit greatly from the opportunities provided by a thriving U.S. business sector. Heavy tax burdens threaten the vitality of U.S. businesses by discouraging business investments and reducing funds available for business expansions. A tax system that imposes undue burdens on U.S. businesses reduces the productivity of the U.S. economy, and in so doing reduces the wages and employment opportunities of Americans. Given the economic challenges facing the country now and in the future, it is important that U.S. businesses operate in a tax environment that does not excessively discourage investment and that is conducive to normal business operations.

This committee is well aware of the challenging features of the current U.S. system of taxing business income. From the standpoint of C corporations, the U.S. corporate income tax rate of 35 percent is one of the highest in the world, and well above the OECD average; furthermore, the United States is the only major capital exporting country that taxes the active foreign business income of its resident corporations. From the standpoint of the millions of U.S. businesses such as partnerships, subchapter S corporations, and LLCs that are taxed on a pass-through basis, the progressive U.S. individual income tax system imposes tax rates that can exceed the 35 percent corporate rate. And from the standpoint of family farms and other family-owned businesses, U.S. estate and gift taxes can make intergenerational transfers of business assets problematic.

There are features of the existing U.S. tax system that mitigate the burdens associated with high tax rates. These features include the deductibility of interest expense; accelerated depreciation of plant and equipment investment and R&D; tax credits for low income housing investment and incremental research expenditures; the deduction for domestic production activities; deferral of U.S. taxation of unrepatriated foreign income; and many others. As a result of these and other aspects of the U.S. tax system, and the variety of taxpayer situations, business tax rates measured as ratios of tax payments to some measures of pretax business income may differ significantly from statutory rates, and in particular are often lower than statutory rates.

It is true that these base-narrowing aspects of the U.S. tax system produce for many taxpayers average burdens that are somewhat below those suggested by statutory tax rates; but there are also many taxpayers who benefit little from them—and it is important not to be misled by some simple average tax rate calculations to conclude that the U.S. tax system imposes light burdens on U.S. firms. Tax obligations are the product of statutory provisions and taxpayer behavior, so heavy taxation that redirects business activity or discourages it altogether may generate only modest tax revenue even as it imposes significant burdens. For example, the Tax Reform Act of 1986 greatly expanded the number of “baskets” used in the foreign tax credit calculation, thereby increasing U.S. taxation of income earned by international joint ventures, and in the process (and until repealed 10 years later) significantly reducing the extent to which U.S. firms undertook joint ventures in foreign countries. This imposed a burden on U.S. firms in the form of lost foreign business opportunities, but much of the burden did not appear in the ratio of tax payments to income.

As the result of high U.S. tax rates together with other tax provisions that only partly mitigate the burden of high rates, U.S. businesses are currently taxed to an extent that business activity, and the employment opportunities that accompany it, is significantly reduced. Cross-country statistical evidence consistently shows that countries with heavier business tax burdens have lower rates of business formation, expansion, and capital investment. Indirect evidence of the impact of U.S. tax burdens appears in the induced use of substantial debt finance to produce interest deductions that help to mitigate tax burdens, and in the examples of U.S. corporations that undertake complicated and costly inversion transactions in order to become taxable by Canada, Britain, the Netherlands, or Ireland, rather than the United States.

The tax system has two effects on the business sector. The first is that it collects revenues from income generated by businesses, and thereby reduces the extent of business formation and expansion. The second is that the tax system influences the character of business operations. Some of the behavioral influence of the tax system is deliberate; for example, the research and experimentation credit is designed to encourage and reward research spending, and the low-income housing credit is designed to encourage and reward provision of low-income housing. As a result of these tax provisions, the U.S. economy has more research and more low-income housing than it would otherwise. But many of the behavioral effects of the tax system, such as encouraging the greater use of debt finance, affecting business organizational forms, and discouraging dividend payments and plant and equipment investment, are the undesired byproducts of a system that taxes investment returns.

An obvious solution to the problems caused by heavy tax burdens is to reduce statutory tax rates on business income. The difficulty of course is that the government needs revenue with which to operate, so to the extent that lower tax rates reduce tax collections the resulting revenue shortfall would need to be financed with higher taxes on something else, spending cuts, or greater government borrowing, none of which may be a particularly attractive alternative.

It is tempting in this situation to conclude that the most promising direction of reform is to broaden the business tax base and lower business tax rates in a revenue-neutral manner. Such a conclusion must be approached very cautiously. It is certainly true that sensible revenue-neutral tax reforms have the potential to improve the efficiency and fairness of the tax system by replacing undesirable tax provisions with better alternatives, but it is challenging to generate significant reductions in average business tax burdens with revenue-neutral business-only tax reforms, for the simple reason that a tax reform that is revenue-neutral within the business sector leaves average business tax burdens largely unchanged.

A revenue-neutral business tax reform that lowers statutory tax rates while expanding the tax base nonetheless has the potential to change incentives for different business activities, but to be clear, what such a change would do is to encourage some business activities while actively discouraging others. For example, a reform that limited the deductibility of interest expense and used the accompanying revenue to finance a reduction in statutory tax rates would encourage investment by some firms and discourage investment by others, the difference reflecting the ability and willingness of different taxpayers to finance their investments with debt. Proposals to reduce the deductibility of interest expense are typically motivated by a desire to level the playing field between debt and equity, and by a desire to finance a tax rate reduction. It is true that reducing the deductibility of interest expense reduces the attractiveness of debt finance, and it is also true that a statutory tax rate reduction by itself would encourage investment, but in this example it is not

true that for the business sector as a whole this revenue-neutral reform necessarily increases investment incentives, because the loss of interest deductions also affects incentives to invest.

This example is just one illustration of a much broader principle, which is that it is impossible to find a tax reform that reduces every marginal tax rate while keeping average rates unchanged. Marginal tax rates influence behavior, and the problem caused by taxation is that it produces positive marginal rates: a system that taxes income discourages the production of income. There is no avoiding this problem if the system is to raise revenue, since raising revenue requires a positive average tax rate, and the average tax rate in the economy, or in the business sector, is just the combination of the marginal rates. The implication for tax reform is that any revenue-neutral income tax reform increases some marginal tax rates and reduces others, discouraging income production by some taxpayers and encouraging income production by others.

While this principle of taxation is obvious once stated, it is useful to stress its application to specific policies. If a tax reform were to repeal section 199, the domestic production activities deduction, and use the revenue thereby generated to finance a reduction in statutory tax rates, then the reform would encourage investment by firms that currently benefit little from the domestic production activities deduction and discourage investment by firms that currently benefit more than average from the deduction. If instead a tax reform were to impose further limits on the ability of corporate taxpayers to use loss carryforwards, using the revenue from this change to reduce statutory corporate tax rates, then the net effect of the change on aggregate corporate investment is unclear, since firms differ in the extent to which they anticipate possibly needing to use loss carryforwards in the future, and the degrees to which they value the form of tax insurance that loss carryforwards provide. This last example illustrates that even if a tax reform repeals favorable tax provisions not directly related to investment, and uses the revenue to finance statutory rate reductions, the effect of removing the favorable tax provisions is to increase tax burdens, and reduce investment, by firms that are significantly affected.

What principles should guide tax reform, understanding that any reform that is revenue-neutral within the business sector will necessarily encourage some business activities and discourage others? Economic theory notes that an efficient tax system imposes the lightest tax burdens on two types of activity: those that generate positive spillover benefits for the economy, and those that are the most responsive to taxation. Research spending is a common example of the former. Studies consistently find that the social rate of return to research endeavors significantly exceeds the private return, implying that innovators capture only a portion of the benefits they provide the economy. As a result, the level of research activity undertaken by private researchers in the absence of external support is less than the level that maximizes economic performance, and in order to improve the efficiency of the economy it is necessary to provide additional inducements for research. This is, indeed, the standard justification for the tax system's favorable treatment of research expenditures.

It is important to recognize that there are two ways in which the research and experimentation credit and favorable research cost recovery provisions encourage research undertaken in the United States. The first is by encouraging individual taxpayers to adjust their production processes in the direction of greater research intensity: for example, an electronics firm might spend more on research and less on advertising in response to a more favorable tax treatment of research. There is a good body of accumulated evidence that firms respond to the research credit in this way. The second channel is possibly even more consequential, and it is that the favorable tax treatment of research expenditures reduces the tax burden on firms that are research-intensive, and as a result these firms expand their operations more than do otherwise similarly-situated firms that are less research-intensive. This second channel does not require that any individual taxpayer modify its production process in reaction to research tax benefits, but the economy effectively does so by expanding the operations of some firms more than others.

The second implication of economic theory is that business activities that are highly sensitive to taxation should be taxed at lower rates than business activities that are less sensitive to taxation. This reflects what is known as the Ramsey Rule, a proposition originally derived in the context of commodity taxes but that applies quite generally to settings in which taxes distort the economy. Business taxation is certainly one of those settings, because the imposition of business taxes necessarily reduces the level of business activity. The challenge for smart business tax design

is to find a program that does the least possible damage to the economy while collecting the revenue that the government needs. In this context it makes little sense to attempt to impose heavy tax burdens on highly responsive business activities, since such taxes greatly depress investment and employment in the relevant business sectors, and if the heavy taxes were instead directed at less responsive activities, the results would not be great, but at least they would not impose as many economic costs.

International shipping offers an example of a highly responsive business sector. Shipping firms can be headquartered anywhere, and the ships of course go everywhere, so any attempt to impose heavy home-country taxes on international shipping income is doomed simply to encourage shipping assets and shipping companies to sail out of the U.S. tax jurisdiction. And that is exactly what has happened to the U.S. international shipping fleet over the last 40 years.

To some degree the same process is responsible for the waves of corporate inversions and foreign takeovers of U.S. companies, and for the far greater number of other international business transactions that receive less attention but are nonetheless similar to inversions and takeovers. The worldwide tax system operated by the United States puts U.S. companies at a competitive disadvantage relative to firms from other countries, and as a result, foreign firms expand in third country markets at the expense of U.S. firms. This process goes on every day, and while not as visibly dramatic as a corporate inversion or a foreign takeover of a U.S. company, it has much of the same impact, in that a business asset that otherwise would have been owned and controlled by a U.S. company is instead under the control of a foreign company. The evidence is that foreign direct investment is extremely responsive to taxation, and also that when U.S. companies expand their foreign operations they correspondingly expand their domestic operations, so the disadvantage created by the U.S. tax system has the effect of significantly shrinking the size of the U.S. business sector relative to what it would be otherwise. This in turn reduces the demand for U.S. labor, and thereby depresses wages and employment opportunities in the United States.

The evidence that international business activities are highly responsive to taxation, together with the reality that every other major capital exporting country operates a territorial tax system, implies that the U.S. attempt to subject active foreign business income to significant U.S. taxation is inconsistent with optimal tax principles. The same principles also carry implications for the taxation of domestic business operations. There is evidence that investment in domestic manufacturing industries is particularly responsive to taxation, which in turn implies that an efficient domestic tax system imposes a lower tax on returns to manufacturing investment than on returns to investment in other industries. This domestic production activities deduction is largely directed at domestic manufacturing, and to the extent that the activities that it covers in fact are highly responsive to taxation, this deduction is a sensible feature of an optimal tax system.

Similar considerations may apply to patent boxes of the type recently introduced by European countries. These patent boxes offer favorable tax rates on certain forms of intellectual property income. A common justification for adopting patent boxes is that the favorable tax treatment of patent box income gives appropriate incentives in settings in which ownership of intellectual property has spillover economic benefits that cannot be addressed in some other way. A second and likewise important consideration is that the activities of firms that are apt to hold certain types of qualifying intellectual property may be particularly responsive to taxation, either because these firms and their assets are internationally mobile, or because the nature of competition and demand in their industries makes their operations likely to diminish significantly if confronted with competitors located in more favorable tax environments.

The general point is that economic theory does not imply that it is efficient to have a level playing field in which all business activities and income are taxed to the same degree. Efficient tax burdens vary with spillovers associated with economic activity and with degrees of responsiveness to taxation. If businesses in different industries and lines of activity are equally responsive to taxation and produce the same economic spillovers, then they should be taxed equally; otherwise they should not.

The propositions of optimal tax theory apply to a world of complete information in which behavioral elasticities and economic spillovers are readily identified and measured, and tax laws can be crafted with precision to distinguish taxpayers in different situations. The real world differs from this stark description. As a result,

it may be difficult or impractical to introduce some of the distinctions between taxpayers that are implied by theory, and efforts to do so could be hampered by misinformation or create unanticipated opportunities for inefficient tax avoidance. It is natural in such a setting to conclude that an appropriate default position is that the tax playing field should be level unless there is a very strong reason to think otherwise.

This position is perfectly reasonable, but it is inconsistent with our understanding of the effects of taxation on economic efficiency, and risks consigning the economy to a lower level of performance than is necessary given the tax burdens required to finance government expenditures. A more appropriate default, one that promotes economic efficiency, is that tax burdens should reflect the responsiveness of different activities to taxation, with more responsive activities subject to lower tax burdens. To the extent that it is difficult or costly to maintain and enforce tax distinctions among business activities with differing response elasticities, of course these practical considerations influence the desirability of attempting to draw such distinctions. But given the imperative of offering the best possible economic opportunities to American workers, entrepreneurs, customers, and others, and the significant burdens that taxes already impose on the U.S. business sector, it is important to tailor the U.S. tax system in a way that causes the least possible economic disruption.

Several existing aspects of the U.S. tax system appear to be designed in this spirit, including provisions such as the domestic production activities deduction and the research and experimentation credit. It follows that an across the board reduction in business tax expenditures used to finance lower business tax rates is unlikely to improve the efficiency of the U.S. system. More targeted reforms, including the adoption of a territorial tax regime, are far more promising.

Another promising direction of reform lies in efforts more effectively to integrate corporate and personal taxes. As many have noted, equity-financed corporate investment in the United States is taxed very heavily, and in particular is taxed more heavily than debt-financed investment. To the extent that equity and debt finance are imperfect substitutes from the standpoint of borrowers the optimal taxation of the two is not identical, and there are reasons why debt financed investments may be somewhat more tax responsive than equity financed investments; but the magnitude of the difference in current tax treatment of debt and equity surely exceeds that implied by optimal tax theory. As a result, reforms that move in the direction of integrating corporate and individual taxes on corporate income have considerable appeal from an efficiency standpoint. They also have appeal from the standpoint of taxpayer equity, imposing less of a double burden on corporate income and better distinguishing shareholder/taxpayers with greater ability to pay from those with less ability to pay.

It is important to address these and other significant issues in the design of U.S. business taxes, in part because the tax burdens on U.S. businesses are so substantial and their consequences so dramatic for the U.S. economy. American workers bear the brunt of these taxes in the form of diminished employment opportunities. Business tax reductions would stimulate business formation, expansion, and investment; improve productivity; and thereby create greater opportunities for American workers. At any rate of tax and level of business tax burden, however, it is valuable and necessary to design the tax system to cause the fewest economic disruptions, and theory indicates that simply broadening the base and lowering rates is unlikely to move the system in that direction. The existing U.S. tax system has many features that reflect the nuances of economic realities, and our goal should be to modernize and improve this system with attention to the details of taxpayer behavior and a sense of the appropriate level of business taxation in a modern economy.

PREPARED STATEMENT OF ERIC J. TODER, PH.D.,* INSTITUTE FELLOW, URBAN
INSTITUTE, AND CO-DIRECTOR, URBAN-BROOKINGS TAX POLICY CENTER

APPROACHES TO BUSINESS TAX REFORM

Chairman Hatch, Ranking Member Wyden, and members of the committee, thank you for inviting me to appear today to discuss corporate tax reform.

*The views expressed are my own and should not be attributed to the Tax Policy Center or the Urban Institute, its board, or its funders. I thank Len Burman and Howard Gleckman for helpful comments and Lydia Austin for help in preparing this testimony.

No one is satisfied with the current rules for taxing income of corporations. The U.S. corporate tax system discourages investment in the United States, encourages U.S. multinational corporations to report income in low-tax foreign jurisdictions, places some U.S.-based multinationals at a competitive disadvantage compared with foreign-based firms, and has encouraged U.S. companies to accumulate over \$2 trillion in assets overseas.

At the same time, the U.S. corporate tax raises less revenue as a share of gross domestic product (GDP) than the corporate taxes of most of our major trading partners. Corporate receipts have been fairly steady at about 2 percent of GDP for most of the past 3 decades. However the Congressional Budget Office (2016) is now projecting that corporate receipts will decline to 1.6 percent of GDP in 2026, as U.S. multinationals continue to shift reported profits to low-tax foreign countries and more U.S. corporations “re-domicile” themselves as foreign-based corporations.

The current corporate tax system is outdated because it has failed to adjust for four major developments: the increased globalization of economic activity, the reduction in corporate tax rates in other major countries and their shifts to territorial tax systems, the increased share of business wealth in the form of intangible property, and the increased share of economic activity in the United States by businesses that are not subject to corporate income tax.

The current administration and leading Republicans agree that the top U.S. corporate tax rate needs to be lowered and that the United States should no longer tax foreign profits when U.S. corporations repatriate them by paying dividends to the U.S. parent company. There is less agreement, however, on how to make up the revenues from a reduced corporate rate. There is agreement that a tax on current overseas profits and new minimum taxes going forward on low-taxed foreign income should accompany elimination of the repatriation tax. But there are wide differences on the exact form these taxes should take and the rates that should be imposed.

In my statement, I review the main problems with the corporate income tax and discuss why I believe that 1986-style tax reform that pays for reducing the corporate rate by broadening the business tax base is an insufficient solution. I make the case that revenue neutrality should not be sought within the business tax base alone. I discuss two approaches for paying for a reduced corporate income tax rate—increased taxation of shareholder income and introduction of new revenue sources.

PROBLEMS WITH THE CORPORATE INCOME TAX

The corporate income tax has long-standing problems that would exist even apart from the four major developments I just listed. It favors debt over equity finance for corporations because interest payments are deductible, though dividends are not deductible. It encourages corporations to retain profits instead of distributing them because dividends payments are taxable immediately and taxes on capital gains can be deferred until realization. It favors businesses organized as pass-through enterprises, such as limited liability partnerships and subchapter S corporations, over corporations organized under subchapter C of the Internal Revenue Code (C corporations). C corporations face two levels of tax, one at the corporate level and then a second tax on dividends and realized capital gains attributable to retained earnings. Between 1980 and 2012, the share of net business receipts from companies organized as pass-through enterprises, including sole proprietorships, increased from 14 to 39 percent and their share of taxable profits increased from 25 to 64 percent.¹

These distortions cause corporations to incur more debt and pay fewer dividends than they would in the absence of a corporate tax, encouraging excessive leverage and weakening shareholder control over corporate behavior. They encourage firms to organize themselves as pass-through enterprises instead of C corporations and encourage the expansion of industries in which the pass-through form of business is more prevalent at the expense of those mostly characterized by publicly traded companies that cannot use the pass-through forms.

Even bigger distortions result from the attempt of single countries to tax the income of corporations that are global in scope. Tax experts have long debated the choice between a worldwide system that taxes U.S.-resident corporations on their worldwide income with a credit for foreign income taxes, and a territorial system that taxes U.S. corporations only on their U.S.-source income. Worldwide taxation

¹Excluding regulated investment companies and real estate investment trusts, the shares of net business receipts have increased from 15 to 32 percent and the shares of taxable profits increased from 21 to 53 percent.

is in theory neutral between domestic and foreign investment of U.S.-resident companies, but would place these companies at a disadvantage compared with foreign-resident companies that do not pay home country tax on their foreign-source income. Territorial taxation is, in theory, even-handed in its treatment of U.S. and foreign-based multinationals, but it would encourage U.S.-based multinationals to shift real investments and reported income to low-tax foreign countries. When countries impose different tax rates on corporate income, the United States acting alone cannot create both a level playing field between the domestic and foreign investments of its resident companies and a level playing field between U.S. and foreign-based companies because the United States cannot tax profits of foreign-based multinationals that are earned outside of the United States.

The United States addresses this tradeoff between the conflicting objectives of international policy with a hybrid tax system that is neither purely worldwide nor purely territorial. By allowing U.S.-based multinationals to defer tax on most profits until they are repatriated, the United States taxes foreign-source income at a much lower effective rate than it taxes domestic source income of U.S. multinationals. Deferral creates an additional problem, however, because it encourages U.S. multinationals to retain foreign profits overseas instead of repatriating them to the U.S. parent company so they can be paid as dividends to shareholders or used for domestic investment. The result is that U.S. multinationals in recent years have accrued over \$2 trillion in overseas assets.²

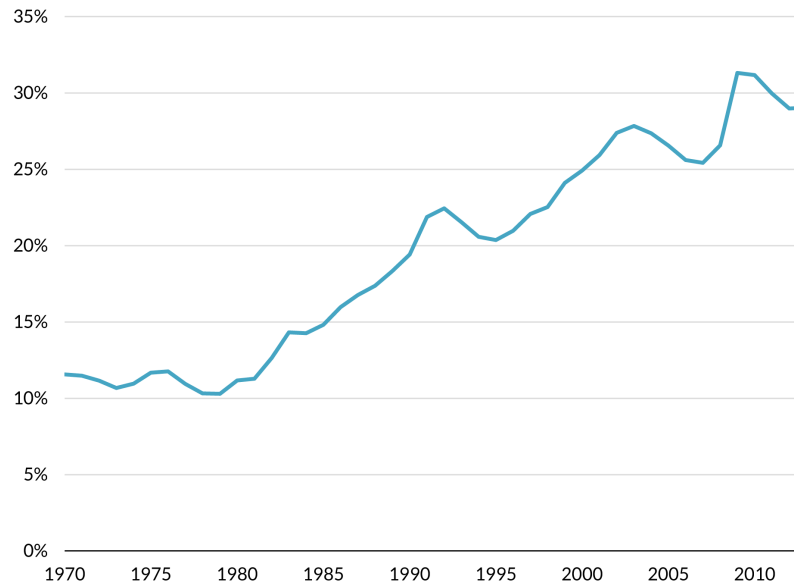
No country uses a pure model of either worldwide or territorial taxation. Even countries with territorial systems usually impose taxes on some forms of foreign-source income to limit income-shifting techniques that would erode their domestic tax bases. These anti-avoidance rules also may affect the taxation of inbound investment from foreign companies, which may enjoy an advantage over domestic firms to the extent that anti-avoidance rules affect home-based companies only and do not limit the shifting of reported profits of inbound investments by foreign-based companies.

These economic distortions pale before the real-world distortions because of the inability to define in an economically meaningful way either the source of corporate income or the residence of multinational corporations. The *source* of profits may have been meaningful when most business wealth was in the form of fixed assets, such as plant and equipment. Today, however, a substantial share of business wealth is in the form of intangible assets that are not location-specific, such as patents, goodwill, business reputation, and corporate governance. Multinationals often shift ownership of intangibles to affiliates in low-tax jurisdictions. While these firms may have little production, employment, or sales in these countries, this shift still allows them to reduce tax on a substantial share of their global profits. In theory, the United States could tax the value of intangible assets when their ownership is initially transferred to a foreign affiliate, but often it is very difficult to value the intangible at the time of transfer before its contribution to profitability is established.

According to data compiled by the Bureau of Economic Analysis, aggregate investment in intellectual capital as a share of total investment in structures, equipment, and intellectual property has increased from around slightly over 10 percent in the 1970s to around 30 percent in the first decade of the 21st century (Figure 1). These figures probably understate the growth in intellectual property as a share of business wealth because they count only outlays for different types of investments and not the capital gains that accrue when highly successful new technologies and products are introduced.

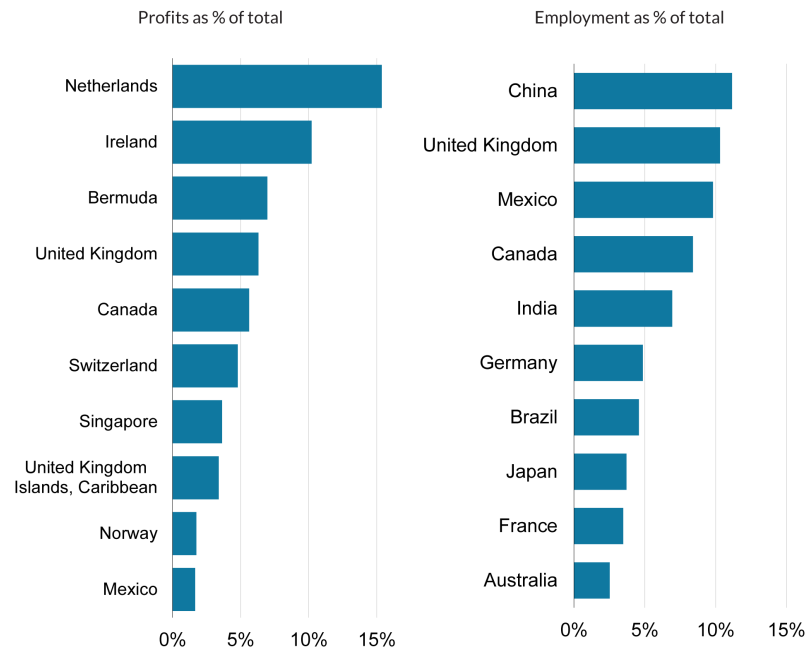
²Richard Rubin, "U.S. Companies Are Stashing \$2.1 Trillion Overseas to Avoid Taxes," *Bloomberg* March 4, 2015, <http://www.bloomberg.com/news/articles/2015-03-04/u-s-companies-are-stashing-2-1-trillion-overseas-to-avoid-taxes>.

FIGURE 1. Aggregate Investment in Intellectual Capital as a Share of Investment in Structures, Equipment, and Intellectual Property Products, 1970–2013



Source: U.S. Department of Commerce, Bureau of Economic Analysis, author's calculations.

FIGURE 2. Foreign Profits and Employment by U.S. Multinationals, 2012



Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2014.

TABLE 1. Profits and Employment of U.S. Multinationals as Share of Total, 2012

	Net Income (billions of dollars)	Profits as a percentage of total	Employment as a percentage of total
Netherlands	180.3	15.4%	1.7%
Ireland	119.8	10.2%	0.8%
Bermuda	81.8	7.0%	N/A
United Kingdom	74.0	6.3%	10.3%
Switzerland	56.2	4.8%	0.8%
Singapore	42.6	3.6%	1.4%
UK Islands, Caribbean	39.7	3.4%	0.0%
China	24.9	2.1%	11.2%
Australia	20.7	1.8%	2.5%
Norway	20.6	1.8%	0.3%

Source: U.S. Department of Commerce, Bureau of Economic Analysis, 2014.

Note: N/A = not available.

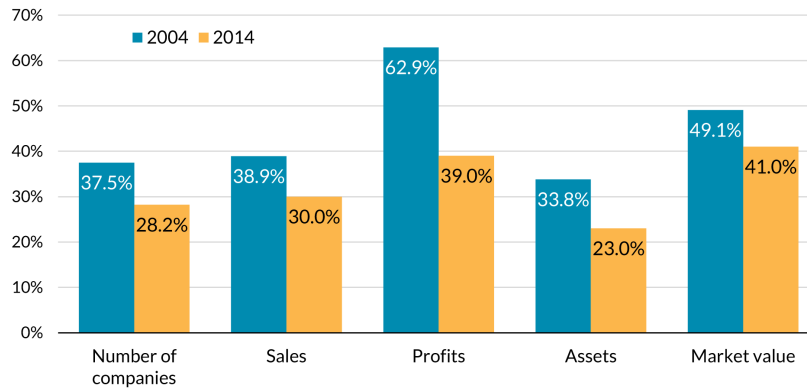
U.S. multinationals have been successful in shifting the reporting of profits to low-tax jurisdictions, which are often places where little economic activity occurs. For example, in 2012, Bermuda, Ireland, and the Netherlands accounted for about 33 percent of the net foreign-source income of U.S. multinational corporations, but only 2.5 percent of their foreign employment. (Figure 2 and Table 1).

The *residence* of multinationals is also highly mobile. It too can bear little connection to real measures of corporate economic activity, such as assets, employment, sales, or the residence of shareholders. Multinationals have an incentive to establish residence based on tax considerations because this residence choice entails little real economic cost—and has little or no impact on where their production or sales occur or even where their top executives reside. However, this choice can substantially affect worldwide tax obligations.

Inversion transactions in which U.S. companies merge with smaller foreign companies and then become the subsidiary of a foreign parent have raised awareness of how changing the place of incorporation can reduce the tax liabilities of U.S. companies. Though inversions, and the efforts by Congress and the administration to limit them, have received much attention, the share of economic activity accounted for by U.S.-resident multinationals can also decline through other channels. These include mergers of equal-sized firms that then establish foreign residence, foreign buyouts of smaller U.S.-resident companies or divisions of larger U.S.-resident companies, changes in the residence of startups, and shifts in the shares of worldwide activity between existing U.S.-resident and foreign-resident multinationals. Over the past decade, the share of sales and profits of the world's top multinationals that come from U.S.-based companies has been declining, although this may reflect mainly the growth in multinationals in emerging economies such as China more than any major tax-driven shift in the multinationals' choice of corporate residence.

Between 2004 and 2014, the United States share of the top 2,000 global companies declined from 37 to 28 percent (Figure 3). Among the top 2,000 firms, U.S.-resident companies accounted for 39 percent of sales, 63 percent of profits, 34 percent of assets, and 49 percent of market value in 2004. By 2014, these shares had declined to 30 percent of sales, 39 percent of profits, 23 percent of assets, and 41 percent of market value. By any measure, the relative importance of U.S.-resident multinationals has been shrinking, although U.S.-resident companies are still dominant players in global markets.

FIGURE 3. Shares of U.S.-Resident Companies in the Global 2000



Source: *Forbes* Global 2000 (2004 and 2014) and author's calculations.

WHY THE U.S. CORPORATE TAX RATE NEEDS TO BE CUT

Higher corporate rates relative to our major trading partners encourage both U.S. and foreign-based multinationals to invest overseas instead of in the United States and to report profits in other jurisdictions (Clausing 2011, 1,580; Djankov et al. 2010; Gravelle 2014; Grubert 2012;). Beyond this, companies can shift reported income without moving real economic activity through aggressive transfer pricing, debt-equity swaps, allocation of fixed costs to high-tax countries, and other techniques. Rules to enforce the sourcing of income are imperfect and are imperfectly enforced. It is especially difficult to determine transfer prices of unique intangibles in the absence of comparable arms-length transactions between independent firms.

A firm's decision on where to locate investment is influenced by marginal effective tax rates on new investments, which are determined both by statutory tax rates and by other provisions affecting net investment returns, including capital recovery provisions and tax credits. The tax penalty that high U.S. corporate rates impose on domestic investment is partially offset by more favorable capital recovery provisions (Gravelle 2014 and Hassett and Mathur 2011). Corporations may not perceive much benefit to the tax deferral that accelerated depreciation provides, however, if they have to report a deferred tax liability to their shareholders when they claim accelerated depreciation deductions. A firm would, in this view, respond more to a lower statutory rate than to an equivalent cut in its effective tax rate produced by more generous capital recovery allowances.

WHY 1986-STYLE TAX REFORM DOES NOT DO THE JOB

Many recent reform plans would reduce corporate tax rates and eliminate business tax preferences. Some plans would also combine individual tax rate reduction with reduction of individual tax preferences. These plans include notably the tax reform proposal developed by former House Ways and Means Chairman Dave Camp in 2014 and the less-specific proposal by the President's 2010 National Commission on Fiscal Responsibility and Reform headed by former Senator Alan Simpson and former White House Chief of Staff Erskine Bowles. Both would have lowered the corporate tax rate to 25 percent, eliminated most business tax preferences, and also reduced individual tax rates and individual preferences. Some of President Obama's past budgets proposed to reduce the corporate tax rate to 28 percent and to eliminate some business preferences, but did not specify enough base-broadening measures to pay for the rate reduction. These reforms are all modeled on the Tax Reform Act of 1986, which reduced the top corporate rate from 46 to 34 percent and eliminated the investment tax credit, removed or scaled back many other business preferences, and, on balance, increased corporate tax revenue within the budget window to pay for reduced individual income taxes.

Reforms that reduce the corporate rate and broaden the business tax base can increase economic efficiency if they reduce targeted subsidies that encourage over-expansion of subsidized sectors. The goal is to encourage businesses to choose investments based on their real economic returns instead of tax considerations. How-

ever, some investments, such as research and development, may have positive spillover effects that are not fully captured by those making the investments and therefore may merit some public subsidy.

There are other limitations to the traditional approach of paying for a lower corporate rate through additional base broadening. First, there are not enough business preferences to pay for the long run revenue loss of reducing the corporate rate to 25 or 28 percent, as leading political figures propose. Reform plans that cut rates to those levels have met 10-year revenue neutrality goals by counting revenues from one-time taxes on existing overseas assets and through proposals—such as the elimination of accelerated depreciation—that change the timing of business deductions.

Further, the biggest source of higher revenues, the elimination of accelerated depreciation for machinery and equipment, creates many problems.³ When combined with lower rates, accelerated depreciation would provide a windfall gain to income from existing investments, and raise the cost of capital for new investments. In addition, eliminating accelerated depreciation for machinery and equipment would not necessarily create a more level playing field within the domestic sector as a whole, given that most intangible investments—which comprise a growing share of business investments—already benefit from immediate expensing and would continue to do so under most proposals (Foertsch and Mackie 2015).

The bottom line is that revenue-neutral business tax reform is a much less attractive proposition than it was in 1986. There are not enough business tax preferences to pay for the amount of corporate rate reduction that policymakers are discussing. To the extent one can come close to paying for lower rates, it is through removing preferences that benefit domestic investment. In addition, base-broadening provisions that raise revenue in the 10-year window by accelerating tax payments pay for a much smaller rate cut in the long run than they do in the first 10 years.

ALTERNATIVE WAYS OF FINANCING CORPORATE TAX REFORM

Because business-only tax reform has limited benefits, I encourage the Committee to pursue broader and bolder approaches. There are a number of alternatives worth exploring. The alternatives fall into two general categories: (1) shifting the collection of taxes on corporate income from the corporate to the shareholder level; and (2) considering new revenue sources that would shift the tax burden from income to consumption or address environmental concerns.

Shifting the Tax Burden from the Corporate to the Shareholder Level

Corporate profits belong to the owners of corporate equity—the shareholders. Under current law, the taxation of corporate profits is bifurcated. The corporation is liable for a tax on its net profits, after deducting wages paid to employees, interest paid to shareholders, purchases of materials and services from other firms, and depreciation of capital equipment. Shareholders pay a second level of tax, at lower rates than applied to other income, on dividends paid out of those profits and on capital gains from the sale of corporate shares.

The two levels of tax have different economic effects in a global economy. Corporations can avoid or defer the tax on their profits from investments in the United States by investing overseas or by shifting the reporting of income to countries with lower tax rates. To the extent they invest more overseas in response to the U.S. tax, they reduce the capital to labor ratio in the United States, lowering real wages and shifting a portion of the tax burden to workers (Randolph, 2006). As I discussed, this shifting of investment and income could be countered by taxing worldwide income of U.S. corporations on a current basis, but full worldwide taxation would place U.S.-resident firms at a bigger competitive disadvantage than they are at today. And the corporate income tax would continue to discourage foreign-resident corporations from investing in the United States.

In contrast, shareholder level taxes on dividends and capital gains apply to the worldwide income of U.S. investors in corporate shares. They do not distinguish between investments in U.S.-resident and foreign-resident corporations and do not make a distinction between whether the dividends and capital gains come from profits generated by economic output in the United States or output in other countries.

³The largest business tax expenditure, as reported by the Joint Tax Committee (2015), is deferral of tax on foreign-source profits. As discussed in this testimony, however, elimination of deferral would hurt the competitiveness of U.S. multinationals and encourage a shift to foreign residence and is therefore not a likely candidate for inclusion in tax reform proposals.

Therefore, the shareholder level taxes do not discourage investment in the United States and do not place U.S.-resident corporations at a competitive disadvantage.

For these reasons, in an economy open to trade and international capital movements, it is better to base tax liability on the *residence of individual taxpayers* than on either the *tax residence of multinational corporations* or the *source of their profits*. As discussed above, both the source of corporate income and corporate residence can easily be shifted in response to international tax differentials. In contrast, to avoid taxes based on U.S. residency, shareholders would have to relocate overseas. And because the United States taxes worldwide income of individuals on a citizenship instead of a residency basis, people would have to take the additional step of renouncing their U.S. citizenship—a step few are willing to take.

There are several options for shifting the taxation of corporate profits from the corporate to the shareholder level. All have their advantages and disadvantages.

1. Lowering the Corporate Tax Rate and Raising the Rate on Capital Gains and Dividends

One simple option would be to lower the corporate tax rate and replace the revenue by increasing tax rates on capital gains and dividends. Altshuler, Harris, and Toder (2010) have analyzed a reform of this type, noting that other countries have moved in a similar direction in recent years, reducing their corporate rates and increasing tax rates on dividends. The United States, however, reduced the top rates on capital gains and dividends to 15 percent in 2003, while continuing to leave the corporate rate unchanged.

The main drawback to this approach is that higher tax rates on capital gains would reduce capital gains realizations and could lower revenues from capital gains taxes if the rates are increased too much (*see, for example* Dowd et al. 2012). Since 2012, and including the high-income surtax, the top rate on capital gains realizations has increased from 15.0 to 23.8 percent. There is now much less room for offsetting the loss from corporate rate cuts with higher revenues from realized gains and dividends than there was several years ago.⁴

2. Lowering the Corporate Tax Rate and Taxing Accrued Income of Shareholders

An alternative approach that is outlined in a paper I co-authored with Alan Viard of the American Enterprise Institute (2014) would replace the corporate income tax with an annual mark-to-market tax on accrued income from corporate share ownership. Individuals who hold shares of publicly traded corporations would be taxed on their sum of dividends and accrued capital gains during the year at the rates applied to ordinary taxable income. Because individual taxpayers would no longer be able to game the timing of losses, we would allow them each year to deduct any net capital losses from other income. Investors in nonpublicly traded firms would be taxable under rules currently applied to income from S corporations and partnerships and would continue to pay tax on capital gains as realized, with current law preferred rates and loss limitations.

The main benefit of this proposal is that it would tax income U.S. residents receive from share ownership only once at the marginal rates that apply to their other sources of income. The tax code would no longer encourage corporate debt over equity and retained earnings over distributions, and would be much more even-handed in its treatment of C corporations and businesses subject to flow-through taxation. It would no longer favor foreign over U.S.-resident corporations and would encourage both U.S. and foreign-resident companies to invest more in the United States.

Our original proposal had some real and perceived disadvantages, including a net loss in federal receipts, problems associated with increased volatility of the tax base, loss of revenue indirectly collected through the corporate income tax from non-profits and foreign investors, and issues in defining the boundary and rules for transitions between firms whose assets are subject to individual accrual taxation and firms taxed under current rules for S corporations and partnerships. We are developing a modified version of the original proposal that would retain a 15 percent corporate income tax, impose a withholding tax on interest paid to non-profits and retirement plans to offset the benefit they receive from the lower corporate rate, introduce a credit to offset the corporate income tax burden of taxable shareholders, in-

⁴The proposal in the President's fiscal year 2017 budget (U.S. Treasury Department, 2016) to tax unrealized capital gains at death would reduce the response of realizations to higher capital gains taxes because taxpayers would only be able to defer tax by holding onto assets with gains, not escape tax permanently.

clude rules for smoothing the fluctuations in annual taxable income that result from annual swings in stock prices, impose a low rate tax on accrued gains of firms that go public, and address a number of other issues with the proposal. The revised proposal will be roughly revenue-neutral and make the tax law slightly more progressive. We expect to release our revised paper soon.

An alternative approach developed by Grubert and Altshuler (2015) would also reduce the corporate tax rate to 15 percent and replace the lost revenue by taxing gains and dividends of individuals at ordinary income rates. Grubert and Altshuler would continue to impose capital gains taxes upon realizations but with an interest charge designed to capture the benefit of deferring realization of gains, backed up by a tax on the transfer of unrealized gains at death. The intent of the deferral charge is to make individuals indifferent between realizing gains immediately or in the future and therefore to eliminate the increased lock-in to existing assets that higher capital gains rates would otherwise produce.

The advantage of the deferral charge approach for taxing gains is that it could be applied equally to both privately held and publicly traded firms because it does not require valuation of assets that have not been traded. In contrast, we believe that applying the mark-to-market approach to assets in closely held businesses would create insurmountable valuation problems (Toder and Viard 2014). This requires Toder and Viard to maintain separate taxing regimes for publicly traded firms subject to market to market and closely held firms for which gains are taxed on realization. However, differences in combined individual and shareholder tax rates between the two types of firms would be much less than the differences in tax rates between C corporations and flow-through businesses under current law.

The disadvantage of the deferral charge approach is that the tax rate on realized gains would be very sensitive to assumptions about the appropriate interest rate to charge, the assumed growth in the asset's value over time, and the assumed marginal tax rates in earlier years when the accrued gains should have been taxed and the accrued losses are deducted. There could be also be substantial sticker shock, as the deferral charge could make the tax rate applied to the gain when realized significantly higher than the taxpayer's current marginal tax rate.

Both of these methods of shifting tax obligations from corporations to shareholders also raise issues of political acceptability. Individuals ultimately bear the burden of corporate income taxes through lower investment returns, lower wages, or higher prices. It will, however, be challenging to defend a proposal that raises taxes on individual taxpayers to pay for a cut in the corporate income tax. The simple answer is that shifting tax liabilities from corporations to their shareholders just amounts to a different way of collecting taxes on the profits shareholders' investments earn, but persuading the public of this may be a hard sell.

The methods of collecting tax from individuals will also raise objections. With the mark-to-market approach, it will be challenging to explain to people that their income is going up when the prices of the shares they own increase, even though they have not actually converted the gain into cash that can be used for personal consumption or other investments. Some shareholders may have to liquidate assets to pay the tax. With the deferral-charge approach, it will be challenging to explain why taxpayers will often be required to include more than 100 percent of their current year's realized gains in taxable income.

3. Integrating the Corporate and Individual Income Taxes

An alternative approach would integrate the corporate and personal income taxes, so that only one level of tax is imposed on corporate dividends. Various methods of corporate integration have been suggested, some of which would reduce corporate liability and others that would reduce individual tax liability by allowing dividend recipients to claim credits for corporate taxes paid. Proposals for corporate integration have been introduced by the Ronald Reagan and George W. Bush administrations (Council of Economic Advisors 2003; U.S. Department of the Treasury 1984) and were included in Treasury reports published during the Gerald Ford and George H.W. Bush administrations (Bradford and U.S. Treasury Tax Policy Staff 1984; U.S. Department of the Treasury 1992).

One option for corporate integration could be modeled on the system Australia currently uses (Graetz and Warren 2014). Australia allows corporate shareholders to claim credits for corporate level taxes paid to Australia when they receive "franked" dividends from Australian resident companies. When they pay corporate taxes, Australian companies accumulate these franking credits that they can attach to dividends; if they pay no corporate tax to Australia, the dividends do not come

with franking credits attached. Anti-streaming rules attempt to prevent companies from allocating franked dividends to Australian taxpayers who can use the credits and unfranked dividends to foreign shareholders who cannot.

Australian shareholders in Australian companies must gross up their dividends for the franked credits they receive and report these gross dividends as taxable income. They then can claim the credits to offset the individual income taxes they would otherwise pay. The result is that they are taxed once on the income corporations use to pay them dividends at the marginal rate that applies to them under the Australian individual income tax.

An advantage of the Australian system is that it reduces the incentive for Australian companies to shift reported profits to low-tax jurisdictions. To the extent they can reduce their corporate tax liability, the tax saving is offset by higher taxes on shareholders who receive dividends that do not carry with them franking credits. The Australian system also more generally reduces benefits that firms receive from any corporate tax preferences because the value of the preference can be washed out when they pay dividends.

Although this system reduces the incentive to use preferences, it does not entirely eliminate it if a corporation is retaining and reinvesting some of their profits. For example, suppose a company pays out 50 percent of its profits in dividends and is able to reduce its corporate tax liability 50 percent through income shifting and the use of domestic tax preferences. The amount of franked credits would then be sufficient for all the dividends it plans to pay, and it would benefit fully from the tax preferences it uses. Additional use of preferences, however, would come at an offsetting cost in terms of lost credits to shareholders.

An Australian-type integration system would not necessarily work as well in the United States. In Australia, a much larger share of dividends is eligible for credits than would be the case in the United States because Australia taxes the income people accrue within qualified retirement plans (so-called “superannuation” plans). In contrast, in the United States, taxable shareholders hold only about 24 percent of equities issued by U.S. corporations (Rosenthal and Austin, forthcoming). This means that U.S. companies would use up franking credits much more quickly than Australian companies and therefore would retain incentives to avoid U.S. corporate income taxes. In addition, the proposal would create incentives for portfolio specialization among investors, with non-taxable shareholders (tax-exempt organizations and qualified retirement plans) holding shares of U.S. companies with low effective tax rates (because they cannot use the credits) and taxable shareholders investing in companies with high effective tax rates (to maximize use of the credit).

My understanding is that Senator Hatch is developing a plan for corporate tax integration. I welcome this direction in tax policy and look forward to seeing details of the forthcoming proposal.

In conclusion, there are many advantages to proposals that shift some of the tax burden from corporations to the individual shareholder level. All the proposals under study are complex and involve difficult design decisions and trade-offs. No approach will be perfect, but this general direction promises a real reduction in the economic costs that the corporate income tax imposes on the U.S. economy without sacrificing revenues or providing large reductions in tax burdens for the high income individuals who own most corporate shares.

New Revenue Sources

Two new revenue sources that reformers might consider as replacements for reduced corporate income tax receipts are a new Federal value-added tax (VAT) and a tax on carbon emissions.

1. Replacing Corporate Revenues with a Value Added Tax

VATs are in place in over 150 countries throughout the world and have some important advantages as components of an overall revenue system. First, because they allow firms to immediately deduct the costs of capital purchases, they do not tax the normal return to investment—that is, the portion of the investment return that compensates savers for the time value of money. In that sense, a VAT is neutral between a household’s choice of consuming today or consuming tomorrow.

Because of this feature, a VAT, if included as part of a revenue-neutral reform that lowered income tax rates, would improve incentives to save and invest. This would contribute in the long run to larger economic output and improved living standards, as the nation accumulates additional capital. And it would help to re-

verse a long-term decline in the national saving rate that reflects both rising deficits and a reduced private saving rate.

Second, because VATs in place around the world exempt exports and tax imports (are destination-based), they do not interfere with production location decisions. Under a destination-based VAT, the tax rates imposed on goods and services consumed in the United States would be independent of where the goods are produced. A VAT would also make no distinction between products of U.S.- and foreign-resident companies. Therefore, if a VAT is used to replace part of the revenue from the corporate income tax, it will reduce the problems caused when multinational corporations change their corporate residence and the source of their income to reduce tax liability.

The one major drawback of a VAT is that it could make the tax system less progressive because it is imposed at a flat rate instead of graduated rates and because normal returns to capital, which a VAT exempts, are a larger share of income for high-income than for low-income households. A VAT that replaced only a portion of individual and corporate taxes need not make the tax system less progressive, however, if an income tax is retained for upper-income taxpayers and additional refundable credits are provided for lower-income households.

In 2014, Senator Cardin introduced a bill that would impose a new consumption tax and maintain a progressive tax system.⁵ Goods and services would be taxed at 10 percent, and income tax exemptions would be expanded to \$50,000 for single filers, \$75,000 for head of household filers, and \$100,000 for joint filers (indexed for inflation). Cardin would impose a top marginal individual income tax rate of 28 percent on taxable income over \$500,000 for joint filers, and would retain deductions for charitable contributions, state and local tax payments, mortgage interest payments, and tax preferences for health and retirement benefits. The alternative minimum tax and lower rate on capital gains would be eliminated. Cardin would also cut the corporate tax rate to 17 percent and maintain business preferences.

Cardin's plan follows the outline of a tax reform plan originally developed by Professor Michael Graetz (2002). Graetz would also remove most individual income taxpayers from the tax rolls, retain a corporate tax and an individual income tax for high-income taxpayers to maintain a progressive tax system, and provide additional credits for low-income households.

Nunns and Rosenberg (2013) have recently updated earlier estimates (Nunns, Toder, and Rosenberg 2012) of the Graetz plan. They find the proposal would be revenue neutral and make the distribution of tax burdens by income group slightly more progressive than under current law at a VAT rate of 12.9 percent, a corporate rate of 15 percent (with business base broadening) and a three bracket individual rate structure on income in excess of \$50,000 (\$100,000 for joint returns) of 14 percent, 27 percent, and 31 percent. Measures to offset the burden of the VAT for low-income households would include a refundable pre-child rebate of \$1,500, phased out at incomes of \$150,000 and over, and a per worker rebate of 15.3 percent, also phased out at high incomes.

Introducing a VAT would be a major change in the U.S. tax system and would raise many concerns, including the additional costs of administering a VAT alongside the income tax and the need to coordinate a federal VAT with state retail sales taxes. As with the shift in taxation of corporate income from the corporate to the shareholder level, there are complex issues that need to be resolved. Nonetheless, such an approach offers a promising way to reduce the burden of the U.S. corporate income tax, without sacrificing revenue or making the tax laws less progressive.

2. Replacing Corporate Revenues With a Carbon Tax

Economists across the political spectrum generally support the use of pricing mechanisms as the best way to reduce the environmental damage from greenhouse gas emissions. Higher carbon prices would encourage energy conservation and substitution of less carbon-intensive or renewable energy sources in electric power generation, transportation, and other activities without dictating the specific reactions of firms or households. And a planned trajectory of higher carbon prices would encourage the development of new and cleaner energy technologies.

Phasing in a carbon tax is one way to raise carbon prices and over time address the worldwide problem of climate change. But a carbon tax would hurt affected in-

⁵Progressive Consumption Tax Act of 2014, S. 3005, 113th Congress, <https://www.congress.gov/bills/113th-congress/senate-bill/3005>.

dustries, raise the cost of power generation and other business inputs, and could reduce economic growth. Reduction in other taxes, especially those with high economic costs such as the corporate income tax, could offset any short- or medium-term economic harm from a carbon tax.⁶

Marron and Toder (2013) estimated that a carbon tax that raised \$1.2 trillion over 10 years could finance a reduction in the top corporate rate to 25 percent, without any other measures.⁷ Such a tax shift would be regressive, however, so an alternative would be to distribute some of the revenues in a more progressive fashion. Marron, Toder, and Austin (2015) estimate that if half the revenues were used to reduce the corporate tax rate and half to provide an equal refundable per capita credit to all households, tax burdens would decline in the bottom and top portions of the income distribution and increase slightly in the middle. Other ways of using carbon tax revenues also merit consideration and could promote other goals such as providing targeted relief for workers in affected industries or communities and promoting basic energy research (Marron and Morris 2016). Nonetheless, combining a carbon tax with significant corporate tax relief is one way of creating a coalition among environmentalists and business groups and promoting simultaneously the apparently unrelated goals of reducing the harm from climate change and reforming the taxation of business income.

TABLE 3. Distributional Effects of Using Carbon Tax Revenue to Pay for Corporate Tax Cuts and a Refundable per Capita Credit

	Net tax change as a share of pre-tax income
Lowest quintile	− 0.25
Second quintile	− 0.16
Middle quintile	0.07
Fourth quintile	0.14
Top quintile	− 0.02

Source: Marron (2015).

CONCLUSIONS

The current system for taxing corporate income is broken and in dire need of reform. However, the traditional approach of broadening the business tax base to pay for corporate rate reduction has limited potential. Eliminating business preferences will not raise enough money in the long run to pay for a very large cut in the corporate income tax rate. And even absent political considerations, there are important arguments for retaining some of the largest tax preferences—including deferral, incentives for research, and accelerated depreciation.

The business tax environment has changed significantly since 1986 and different reform approaches are needed today. I have argued that paying for the major reductions in the corporate tax rate that are needed requires that we look beyond the business tax base for additional revenues. A number of alternatives are promising, including substitution of higher shareholder-level for corporate-level taxes, integrating the corporate and individual income taxes, and substituting new consumption taxes for a portion of corporate and/or individual income taxes. All the options that are under discussion raise complex issues and none are perfect. I find it encouraging, however, that Congress is open to considering broader approaches to corporate tax reform.

REFERENCES

- Altshuler, Roseanne, Benjamin H. Harris, and Eric Toder. 2010. “Capital Income Taxation and Progressivity in a Global Economy.” Washington, DC: Urban-Brookings Tax Policy Center.
- Bradford, David F. and the U.S. Treasury Tax Policy Staff. 1984. *Blueprints for Basic Tax Reform*, 2d ed. Arlington, VA: Tax Analysts.

⁶In the long run, a carbon tax could make economic growth higher than it might otherwise be by lowering the economic damage that might result from global climate change.

⁷The revenue estimate for a carbon tax was based on an estimate by the congressional budget of the revenue effect of introducing a tax at \$20 per ton of carbon and increased the tax rate 5.6 percent per year.

- Clausing, Kimberly A. 2011. "The Revenue Effects of Multinational Firm Income Shifting." *Tax Notes*. March 28, 2011.
- Congressional Budget Office. 2016. *The Budget and Economic Outlook: 2016 to 2026*. Washington, DC: Congressional Budget Office. <https://www.cbo.gov/publication/51129>.
- Council of Economic Advisers. 2003. *Economic Report of the President*. Washington, DC: U.S. Government Printing Office. <https://www.gpo.gov/fdsys/pkg/ERP-2003/pdf/ERP-2003.pdf>.
- Djankov, Simeon, Tim Ganser, Caralee McLiesh, Rita Ramalho, and Andrei Shleifer. 2010. "The Effect of Corporate Taxes on Investment and Entrepreneurship." *American Economics Journal: Macroeconomics* 2: 31–64.
- Dowd, Tim, Robert McClelland, and Athiphat Muthitacharoen. 2012. "New Evidence on the Tax Elasticity of Capital Gains." Washington, DC: Congressional Budget Office.
- Foertsch, Tracy and James Mackie. 2015. "Tax Reform, Depreciation Methods, and Tax Uniformity." Unpublished paper. Presented at the National Tax Association 108th Annual Conference on Taxation, November 19.
- Graetz, Michael J. 2002. "100 Million Unnecessary Returns: A Fresh Start for the U.S. Tax System." New Haven, CT: Yale Law School Faculty Scholarship Series.
- Graetz, Michael J. and Alvin C. Warren Jr. 2014. "Unlocking Business Tax Reform." *Tax Notes* (145): 707.
- Gravelle, Jane G. 2014. "International Corporate Tax Rate Comparisons and Policy Implications." Washington, DC: Congressional Research Service.
- Grubert, Harry. 2012. "Foreign Taxes and the Growing Share of U.S. Multinational Company Income Abroad: Profits, not Sales, are Being Globalized." *National Tax Journal* 65(2):247–282.
- Grubert, Harry and Rosanne Altshuler. 2015. "Shifting the Burden of Taxation from the Corporate to the Personal Level and Getting the Corporate Tax Rate Down to 15 Percent."
- Unpublished paper. Presented at the National Tax Association 108th Annual Conference on Taxation, November 20.
- Hassett, Kevin A., and Aparna Mathur. 2011. "Report Card on Effective Corporate Tax Rates—United States Gets an F." American Enterprise Institute. February 9.
- Joint Committee on Taxation. 2015. "Estimates of Federal Tax Expenditures For Fiscal Years 2015–2019." Washington, DC: Joint Committee on Taxation.
- Marron, Donald and Eric Toder. 2013. "Carbon Taxes and Corporate Tax Reform." Washington, DC: Urban-Brookings Tax Policy Center.
- Marron, Donald, Eric Toder, and Lydia Austin. 2015. "Taxing Carbon: What, Why and How." Washington, DC: Urban-Brookings Tax Policy Center.
- Marron, Donald and Adele Morris. 2016. "How Should Governments Use Revenue from Corrective Taxes?" Washington, DC: Urban-Brookings Tax Policy Center.
- Nunns, James R., Joseph Rosenberg, and Eric Toder. 2012. "Using a VAT to Reform the Income Tax." Washington, DC: Urban-Brookings Tax Policy Center.
- Nunns, James R. and Joseph Rosenberg. 2013. "Updated Tables for 'Using a VAT to Reform the Income Tax.'" Washington, DC: Urban-Brookings Tax Policy Center.
- Randolph, William C. 2006. "International Burdens of the Corporate Income Tax." Congressional Budget Office.
- Randolph, William C. 2006. "International Burdens of the Corporate Income Tax." Working Paper 2006–09. Washington, DC: Congressional Budget Office.
- Rosenthal, Steven M. and Lydia Austin. Forthcoming. "The Dwindling Share of U.S. Corporate Stock Held in Individual Taxable Accounts." To be submitted to *Tax Notes*.
- Toder, Eric and Alan D. Viard. 2014. "Major Surgery Needed: A Call for Structural Reform of the U.S. Corporate Income Tax." Washington, DC: American Enterprise Institute.

U.S. Department of the Treasury. 1984. *Tax Reform for Fairness, Simplicity, and Economic Growth: the Treasury Department Report to the President*. Washington, DC: U.S. Department of the Treasury.

U.S. Department of the Treasury. 1992. *Integration of the Individual and Corporate Tax Systems—Taxing Business Income Once*. Washington, DC: U.S. Department of the Treasury.

U.S. Department of the Treasury. 2016. *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*. Washington, DC: U.S. Department of the Treasury.

PREPARED STATEMENT OF HON. RON WYDEN,
A U.S. SENATOR FROM OREGON

If you own a small business today, you're in danger of being ensnared in an outdated, overgrown tax code that Americans spend 6.1 billion hours and more than \$100 billion complying with each year. The code is punishing to those who don't have a team of accountants and the luxury of time to plan investments around taxes. The tax code tells small businesses that their dollar is worth less, compared to sophisticated firms that can afford to make the rules work for them. I see an enormous opportunity to modernize the code and strip out a lot of that unfairness by radically simplifying our system of depreciation. That's why today I released the Cost Recovery Reform and Simplification Act of 2016.

For small, cash-strapped firms to grow and create jobs, they need to invest in basic things like new cash registers, office computers, or farm equipment when it makes business sense—not when it makes tax sense. Today, to figure out the tax deductions on these investments, you have to navigate more than 100 sets of tax rules. My proposal gets rid of the headache and lays out six categories for depreciation that are easy to work with.

Today, you have to do the math as many as three separate times under different programs for each and every asset. My proposal says one round of math is enough, and businesses shouldn't have to do individual calculations for every car on the lot, every computer in the lab, or every machine in the shop.

Today's rules were written in the 1980s. They're stuck in an era of fax machines and VCRs that predates the tech boom that transformed the way Americans live and work. My proposal says our business tax rules should reflect our 21st century economy, and they should help cutting-edge entrepreneurs thrive, not hold them back.

It makes no sense to cling to an outdated system that taxes some high-tech investments, such as computer servers and MRI machines, at more than double the rate of other investments. A startup owner shouldn't be told they're not allowed to use a work laptop in a coffee shop, or they'll face a financial hit on their taxes. And in my view, the tax code shouldn't get in the way of public-private partnerships that want to build new roads, bridges and highways around the U.S. So my proposal will fix these issues with new rules based on common-sense and a realistic appreciation of how businesses operate today.

It's my hope that we're able to take a look at these proposals and more as the committee considers how to bring our tax code up to date. I look forward to today's hearing, and I thank our witnesses for being here. I'm especially thrilled that we're joined by Gayle Goschie of Goschie Farms in Silverton, Oregon. The hundreds of acres of hops they grow at Goschie Farms are a big part of what makes Oregon beer the best that money can buy. So I'm thrilled to have her here today.

PREPARED STATEMENT OF SANFORD E. ZINMAN, CPA AND OWNER,
SANFORD E. ZINMAN, CPA, PC, TARRYTOWN, NY

Chairman Hatch, Ranking Member Wyden, and members of the committee: thank you for inviting me to discuss this important topic. My name is Sanford Zinman, and I am the Vice President and Tax Policy Chair of the National Conference of CPA Practitioners—NCCPAP. NCCPAP is the country's second largest CPA organization, comprised mostly of small CPA firms. NCCPAP members serve more than 1 million business and individual clients. NCCPAP has long advocated for tax sim-

plification and tax equality. When taxpayers understand the laws they are more accepting of the rules.

My testimony today will address the current business tax structure in the U.S. and its impact on the small and “micro” businesses. My 35 years as a CPA sole practitioner involves working with and advising a variety of these businesses. My clients include grocery stores operating as cooperative corporations, building contractors and home builders, medical professionals, attorneys and everything in between.

SMALL BUSINESS AND MICRO BUSINESS—AN OVERVIEW

What’s already known is that small businesses make up an overwhelming majority of the number of businesses in our country. According to a GAO report published in June of 2015, small businesses, as defined by less than \$10 million in total revenue, make up roughly 99 percent of all businesses. That same report States that 69 percent of those small businesses are individual taxpayers while 31 percent come from partnerships or corporations. The report also indicates that 20 percent of the small business population hire at least one employee and produce about 71 percent of total small business income. The small business community is vital to America. It’s vital to our economy and it’s vital to keeping alive the American dream for all. Today, small business deals with massive hurdles brought on by the burden of dealing with tax compliance related activities. These compliances vary depending on the type of business entity, industry type, number of employees, asset size, to name a few. Without going into the overwhelming number of separate items which would necessitate the conversation for sweeping tax reform, we need to now resolve the tremendous cost burden that the small business owners must endure.

Many Mom and Pop businesses, which I call “micro” businesses, operate the same way they did 50 years ago. Many are sole proprietors or Subchapter S corporations. The life of a business often begins when the owner seeks advice from his or her attorney. Just as often, the attorney recommends that the owner gets the opinion of a qualified tax advisor—usually a CPA. The form of organization is often irrelevant to the business owners. They just want to get out there and make some money.

What do these “micro” business owners want? They want to better their lives and keep as much of their profits as they legitimately can for themselves. It’s safe to say that this is the American way. When these individuals come to me and want to start a business, the first thing they want to know is what is the simplest type of business to open that will protect their existing assets while costing them the least amount of tax. Of course, this is never a standard “C” corporation.

Life was simpler 50 or 60 years ago, but we aren’t there anymore. New types of business organizations have been created. Each one has potential benefits and potential pitfalls. CPA’s will explain the nuanced differences between a corporation, an S corporation, a partnership and an LLC. Ultimately, the differences are not extremely significant in the big picture. However, these differences can cause unnecessary complications in the decision making process.

The interview process requires the CPA to determine a business owner’s sophistication regarding the tax law and tax regulations. Do they understand the payroll process along with the filing and paying of payroll taxes? Are they responsible to pay their own quarterly estimated taxes? What are their medical insurance needs? Only after these conversations can a CPA provide meaningful guidance. Yet the issues raised do not necessarily help the business owner in achieving his or her true objective: to put food on the table. Additionally, although the form of business entity chosen may meet the current needs of the owner, these needs may change over time. Then the organizational structure, which was originally correct, may no longer be the proper one. Over the years I have met with business owners believing that their lawyer or CPA caused problems because they set things up wrong. After some prodding I find that the nature of the business changed and what was correct before no longer is.

We try to help our clients choose a business structure that is right for them. The similarities and differences among business entities often make the choice a difficult one. There can be a simpler common taxation approach to the various business entities.

TYPES OF BUSINESS ENTITIES—AN OVERVIEW

(Sources: Internal Revenue Service and Small Business Administration)

This section is not meant to be a complete review of all types of business entities or the related taxes.

C CORPORATIONS

In forming a corporation, prospective shareholders exchange money, property, or both, for the corporation's capital stock. A corporation generally takes the same deductions as a sole proprietorship to figure its taxable income. A corporation can also take special deductions. For federal income tax purposes, a C corporation is recognized as a separate taxpaying entity. A corporation conducts business, realizes net income or loss, pays taxes and distributes profits to shareholders. The profit of a corporation is taxed to the corporation when earned, and then is taxed to the shareholders when distributed as dividends. This creates a double tax. The corporation does not get a tax deduction when it distributes dividends to shareholders. Shareholders cannot deduct any loss of the corporation.

S CORPORATIONS

S corporations are corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for Federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level.

All States do not tax S corps equally. Most recognize them similarly to the Federal Government and tax the shareholders accordingly. However, some States (like Massachusetts) tax S corps on profits above a specified limit. Other States don't recognize the S corporation election and treat the business as a C corporation with all of the tax ramifications. Some States (like New York and New Jersey) tax both the S corps profits and the shareholder's proportional shares of the profits. The corporation must file the Form 2553 to elect "S" status within 2 months and 15 days after the beginning of the tax year or any time before the tax year for the status to be in effect.

To qualify for S corporation status, the corporation must meet the following requirements:

- Be a domestic corporation;
- Have only allowable shareholders;
 - May be individuals, certain trusts, and estates, and
 - May not be partnerships, corporations or non-resident alien shareholders;
- Have no more than 100 shareholders;
- Have only one class of stock; and
- Not be an ineligible corporation (*i.e.*, certain financial institutions, insurance companies, and domestic international sales corporations).

An S corporation is created through an IRS tax election. An eligible domestic corporation can avoid double taxation (once to the corporation and again to the shareholders) by electing to be treated as an S corporation.

What makes the S corporation different from a traditional corporation (C corporation) is that profits and losses pass through to the shareholder's personal tax return. Consequently, the business is not taxed itself. The corporation must furnish copies of Schedule K-1 (Form 1120S) to the partners by the date Form 1120 is required to be filed, including extensions. There is an important caveat, however: any shareholder who works for the company must pay him or herself "reasonable compensation." Basically, the shareholder must be paid fair market value, or the IRS might reclassify any additional corporate earnings as "wages."

ADVANTAGES OF AN S CORPORATION

- **Tax Savings.** One of the best features of the S Corp is the tax savings for the owners and the business. While members of an LLC are subject to employment tax on the entire net income of the business, only the wages of the S Corp

shareholder who is an employee are subject to employment tax. The remaining income is paid to the owner as a “distribution,” which is taxed at a lower rate, if at all.

- **Business Expense Tax Credits.** Some expenses that shareholder/employees incur can be written off as business expenses. Nevertheless, if such an employee owns 2% or more shares, then benefits like health and life insurance are deemed taxable income.
- **Independent Life.** An S corp designation also allows a business to have an independent life, separate from its shareholders. If a shareholder leaves the company, or sells his or her shares, the S corp can continue doing business relatively undisturbed. Maintaining the business as a distinct corporate entity defines clear lines between the shareholders and the business that improve the protection of the shareholders.

DISADVANTAGES OF AN S CORPORATION

- **Stricter Operational Processes.** As a separate structure, S corps require scheduled director and shareholder meetings, minutes from those meetings, adoption and updates to by-laws, stock transfers and records maintenance.
- **Shareholder Compensation Requirements.** A shareholder must receive reasonable compensation. The IRS takes notice of shareholder red flags like low salary/high distribution combinations, and may reclassify distributions as wages. An owner could pay a higher employment tax because of an audit with these results.

PARTNERSHIPS

A partnership is the relationship existing between two or more persons who join to carry on a trade or business. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business. A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, any profits or losses pass through to its partners. Each partner includes his or her share of the partnership's income or loss on his or her tax return. Partners are not employees and should not be issued a Form W-2. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions. Because partnerships entail more than one person in the decision-making process, it's important to discuss a wide variety of issues up front and develop a legal partnership agreement. This agreement should document how future business decisions will be made, including how the partners will divide profits, resolve disputes, change ownership (bring in new partners or buy out current partners) and how to dissolve the partnership. Although partnership agreements are not legally required, they are strongly recommended and it is considered extremely risky to operate without one.

TYPES OF PARTNERSHIPS

There are three general types of partnership arrangements:

- **General Partnerships** assume that profits, liability and management duties are divided equally among partners. If partners opt for an unequal distribution, the percentages assigned to each partner must be documented in the partnership agreement.
- **Limited Partnerships** (also known as a partnership with limited liability) are more complex than general partnerships. Limited partnerships allow partners to have limited liability as well as limited input with management decisions. These limits depend on the extent of each partner's investment percentage. Limited partnerships are attractive to investors of short-term projects.
- **Joint Ventures** act as general partnership, but for only a limited period of time or for a single project. Partners in a joint venture can be recognized as an ongoing partnership if they continue the venture, but they must file as such.

To form a partnership, the partners register the business with resident State, a process generally done through the Secretary of State's office. A business name must be established. The legal name is the name given in the partnership agreement or the last names of the partners or a fictitious name (also known as an assumed name, trade name, or DBA name, short for “doing business as”).

Most businesses will need to register with the IRS, register with State and local revenue agencies, and obtain a tax ID number or permit. A partnership must file an “annual information return” to report the income, deductions, gains and losses from the business’s operations, but the business itself does not pay income tax.

Partnership taxes generally include:

- Annual Return of Income;
- Employment Taxes; and
- Excise Taxes.

Partners in the partnership are responsible for several additional taxes, including:

- Income Tax;
- Self-Employment Tax; and
- Estimated Tax.

ADVANTAGES OF A PARTNERSHIP

- **Easy and Inexpensive.** Partnerships are generally an inexpensive and easily formed business structure. The majority of time spent starting a partnership often focuses on developing the partnership agreement.
- **Shared Financial Commitment.** In a partnership, each partner is equally invested in the success of the business. Partnerships have the advantage of pooling resources to obtain capital. This could be beneficial in terms of securing credit, or by simply doubling seed money.
- **Complementary Skills.** A good partnership should reap the benefits of being able to utilize the strengths, resources and expertise of each partner.
- **Partnership Incentives for Employees.** Partnerships have an employment advantage over other entities if they offer employees the opportunity to become a partner. Partnership incentives often attract highly motivated and qualified employees.

DISADVANTAGES OF A PARTNERSHIP

- **Joint and Individual Liability.** Similar to sole proprietorships, partnerships retain full, shared liability among the owners. Partners are not only liable for their own actions, but also for the business debts and decisions made by other partners. In addition, the personal assets of all partners can be used to satisfy the partnership’s debt.
- **Disagreements Among Partners.** With multiple partners, there are bound to be disagreements. Partners should consult each other on all decisions, make compromises, and resolve disputes as amicably as possible.
- **Shared Profits.** Because partnerships are jointly owned, each partner must share the successes and profits of their business with the other partners. An unequal contribution of time, effort, or resources can cause discord among partners.

LLCS

A limited liability company is a hybrid type of legal structure that provides the limited liability features of a corporation and the tax efficiencies and operational flexibility of a partnership. The “owners” of an LLC are referred to as “members.” A Limited Liability Company (LLC) is a business structure allowed by State statute. Each State may use different regulations. Depending on the State, the members can consist of a single individual (one owner), two or more individuals, corporations or other LLCs. Unlike shareholders in a corporation, LLCs are not taxed as a separate business entity. Instead, all profits and losses are “passed through” the business to each member of the LLC. LLC members report profits and losses on their personal federal tax returns, just like the owners of a partnership would.

A few types of businesses generally cannot be LLCs, such as banks and insurance companies. There are special rules for foreign LLCs. Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a corporation, partnership, or as part of the LLC’s owner’s tax return (a “disregarded entity”). Specifically, a domestic LLC with at least two members is classified as a partnership for Federal income tax purposes unless it files Form 8832 and affirmatively elects to be treated as a corporation. And an LLC with only one member is treated

as an entity disregarded as separate from its owner for income tax purposes (but as a separate entity for purposes of employment tax and certain excise taxes), unless it files Form 8832 or Form 2553 and affirmatively elects to be treated as a corporation. An LLC that does not want to accept its default Federal tax classification, or that wishes to use its classification, uses Form 8832, Entity Classification Election, to elect how it will be classified for federal tax purposes. Generally, an election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. An LLC may be eligible for late election relief in certain circumstances.

In the eyes of the Federal Government, an LLC is not a separate tax entity, so the business itself is not taxed. This is similar to an S Corporation or a partnership. Instead, all Federal income taxes are passed on to the LLC's members and are paid through their personal income tax. While the Federal Government does not tax income on an LLC, some States do. Since the Federal Government does not recognize an LLC as a business entity for taxation purposes, all LLCs must file as a corporation, partnership, or sole proprietorship tax return. As noted above, LLCs that are not automatically classified as a corporation can choose their business entity classification. To elect a classification, an LLC must file Form 8832. This form is also used if an LLC wishes to change its classification status. There is always the possibility of requesting S-Corp status for an LLC by making a special election with the IRS to have the LLC taxed as an S-Corp using Form 2553. The LLC remains a limited liability company from a legal standpoint, but for tax purposes it can be treated as an S-Corp.

ADVANTAGES OF AN LLC

- **Limited Liability.** Members are protected from personal liability for business decisions or actions of the LLC. This means that if the LLC incurs debt or is sued, members' personal assets are usually exempt. This is similar to the liability protections afforded to shareholders of a corporation.
- **Less Recordkeeping.** An LLC's operational ease is one of its greatest advantages. Compared to an S-Corporation, there is less registration paperwork and there are smaller start-up costs.
- **Sharing of Profits.** There are fewer restrictions on profit sharing within an LLC, as members distribute profits as they see fit. Members might contribute different proportions of capital and sweat equity. Consequently, it's up to the members themselves to decide who has earned what percentage of the profits or losses.

DISADVANTAGES OF AN LLC

- **Limited Life.** In many States, when a member leaves an LLC, the business is dissolved and the members must fulfill all remaining legal and business obligations to close the business. The remaining members can decide if they want to start a new LLC or part ways. However, the operating agreement can include provisions to prolong the life of the LLC if a member decides to leave the business.
- **Self-Employment Taxes.** Members of an LLC are considered self-employed and must pay the self-employment tax contributions towards Medicare and Social Security. The entire net income of the LLC is subject to this tax.

Thank you again for allowing me to address this committee today. My primary focus today was about business taxation for small business. We know that Congress cannot stop people from coming up with clever new forms of business organizations. But Congress can insure a level playing field in business taxation. There are unnecessary inequities and complexities in our current system of business taxation which affect all business both small and large. A simpler, equitable tax structure would allow business owners to better understand potential tax liabilities and make better business decisions. To do this, the effect of income tax on the overall profitability of a business must be taken out of the equation. Allowing for a single level of tax for all business sizes will provide an understandable equity.

Thank you for the opportunity to present today, and I welcome your questions.

COMMUNICATIONS

AMERICAN BAR ASSOCIATION (ABA)

321 North Clark Street
Chicago, IL 60654-7598
(312) 988-5109
Fax: (312) 988-5100
abapresident@americanbar.org

April 26, 2016

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
U.S., Senate
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
U.S. Senate
Washington, DC 20510

Re: Today's Hearing on "Navigating Business Tax Reform," the Need to Preserve
Cash Accounting for Law Firms and Other Personal Service Businesses, and
Concerns Over Burdensome Mandatory Accrual Accounting Proposals

Gentlemen:

On behalf of the American Bar Association ("ABA"), which has over 400,000 members, I am writing to express our views regarding an important aspect of the tax reform legislation that your Committee and its tax reform working groups are in the process of developing. In particular, we strongly oppose those proposals—such as Section 51 of the Committee's staff discussion draft bill to reform cost recovery and tax accounting rules prepared during the 113th Congress and other similar proposals now under consideration—that would require personal service businesses with annual gross receipts over \$10 million to switch from the traditional cash receipts and disbursements method of accounting to the more complex and costly accrual method. These mandatory accrual accounting proposals are also strongly opposed by the Utah State Bar, Oregon State Bar, and over 30 other state, local, and specialty bars throughout the country. We ask that this letter be included in the record of today's hearing.

Although we commend you and your colleagues for your efforts to craft legislation aimed at simplifying the tax laws—an objective that the ABA and its Section of Taxation have long supported—we are concerned that mandatory accrual accounting proposals like Section 51 would have the opposite effect and cause other negative unintended consequences. These far-reaching proposals would create unnecessary new complexity in the tax law by disallowing the use of the cash method; increase compliance costs and corresponding risk of manipulation; and cause substantial hardship to many lawyers, law firms, and other personal service businesses by requiring them to pay tax on income long before it is actually received. Therefore, we urge you and your colleagues not to include these or any other similar mandatory accrual accounting proposals in the new tax reform legislation that is currently being developed.

Under current law, businesses are permitted to use the simple, straightforward cash method of accounting—in which income is not recognized until cash or other payment is actually received—if they are individuals or pass-through entities (*e.g.*, partnerships or Subchapter S corporations) or their average annual gross receipts for a three year period are \$5 million or less. In addition, all personal service businesses—including those engaged in the fields of law, accounting, engineering, architecture, health, actuarial science, performing arts, or consulting—are exempt from the revenue cap and can use the cash method of accounting regardless of their an-

nual revenues, unless they have inventory. Most other businesses are required to use the accrual method, in which income is recognized when the right to receive the income arises, not when the income is actually received.

Mandatory accrual accounting proposals like Section 51 would dramatically change current law by raising the gross receipts cap to \$10 million while eliminating the existing exemption for law firms and other personal service businesses, other sole proprietorships and pass-through entities, and farmers. Although these proposals would allow certain small business taxpayers with annual gross receipts in the \$5 million to \$10 million range to switch to—and thereby enjoy the benefits of—the cash method of accounting (a concept that the ABA does not oppose), the proposals would significantly complicate tax compliance for a far greater number of small business taxpayers, including many solo practitioner lawyers, law firms, and other personal service businesses, by forcing them to use the accrual method.

Sole proprietors, partnerships, S corporations, personal service corporations, and other pass-through entities favor the cash method because it is simple and generally correlates with the manner in which these business owners operate their businesses—*i.e.*, on a cash basis. Simplicity is important from a compliance perspective because it enables taxpayers to better understand the tax consequences of transactions in which they engage or plan to engage. In this regard, simplicity helps to mitigate compliance costs, which already are significant, and to improve compliance with the tax code.

If law firms and other personal service businesses are required to use the more complex accrual method of accounting, they would be forced to calculate and then pay taxes on multiple types of accrued income, including work in progress, other unbilled work, and accounts receivable (where the work has been performed and billed but payment has not yet been received). To meet these requirements, law firms and other affected businesses would need to keep much more detailed work and billing records and hire additional accounting and support staff. This would substantially raise compliance costs for many law firms and other personal service businesses while greatly increasing the risk of noncompliance with the tax code.

In addition to creating unnecessary complexity and compliance costs, these mandatory accrual accounting proposals would lead to economic distortions that would adversely affect all law firms and other personal service businesses that currently use the cash method of accounting and their clients in several ways.

First, the proposals would impose substantial new financial burdens on many thousands of personal service businesses throughout the country—including many law firms—by forcing them to pay taxes on income they have not yet received and may never receive. Requiring these businesses to pay taxes on this “phantom” income—and to borrow money or use their scarce capital to do so—would impose a serious financial burden and hardship on many of these firms. The legal profession would suffer even greater financial hardship than other professions because many lawyers are not paid by the clients until long after the work is performed.

Second, mandatory accrual accounting would adversely affect clients, interfere with the lawyer-client relationship, and reduce the availability of legal services. If law firms are required to pay taxes on accrued income they have not yet received, the resulting financial pressures could force many firms charging on a traditional hourly fee basis to collect their fees immediately after the legal services are provided to the client or at least much sooner than they currently do. As a result, many clients could find it more difficult to afford legal counsel. In addition, many law firms would no longer be able to represent as many accident victims, start-up companies, or other clients on an alternative or flexible fee basis as they now do, and many firms would also have to reduce the amount of pro bono legal services they currently provide to their poorest clients.

Third, the proposals would constitute a major, unjustified tax increase on small businesses and discourage economic growth. The Joint Committee on Taxation estimated that the similar House proposal introduced in the last Congress, which closely parallels Section 51 of the Senate draft bill, would generate \$23.6 billion in new taxes over ten years by forcing many thousands of small businesses to pay taxes on income up to a year or more before it is actually received—if it is ever received. Because this acceleration of a firm’s tax liability would be permanent and continue year after year, it would constitute a major permanent tax increase for the firm, when compared to the taxes the firm currently pays under the cash method, until the firm eventually dissolves, merges with another firm, or otherwise ceases to exist.

The proposals would also discourage professional service providers from joining with other providers to create or expand a firm, even if it made economic sense and would benefit their clients, because it could trigger the costly accrual accounting requirement. For example, solo practitioner lawyers would be discouraged from entering into law firm partnerships—and existing law firms would be discouraged from growing or expanding—because once a firm exceeds \$10 million in annual gross receipts, it would be required to switch from cash to accrual accounting, thereby accelerating its tax payments. Sound tax policy should encourage, not discourage, the growth of small businesses, including those providing legal services, especially in today's difficult economic environment.

For all of these reasons, as discussions on tax reform continue, we urge you and the Committee to preserve the ability of law firms and other personal service businesses to use the simple cash method of accounting and not to support any proposals that would require these businesses to switch to the more burdensome accrual method.

Thank you for considering the ABA's views on this important issue. If you have any questions regarding our position, please contact ABA Governmental Affairs Director Thomas Susman at (202) 662-1765 or Associate Governmental Affairs Director Larson Frisby at (202) 662-1098.

Sincerely,

Paulette Brown
President, American Bar Association

cc: Members of the Senate Finance Committee
The Honorable Mark J. Mazur, Assistant Secretary of the Treasury for Tax Policy

AMERICAN COUNCIL OF LIFE INSURERS (ACLI)
Financial Security . . . for Life.
101 Constitution Avenue, NW, Washington, DC 20001-2133
www.acli.com

Hearing Statement of the Honorable Dirk Kempthorne
President and Chief Executive Officer

U.S. Senate Committee on Finance Hearing "Navigating Business Tax Reform"

April 26, 2016

The American Council of Life Insurers (ACLI) is pleased to submit this statement for the record for today's hearing titled "Navigating Business Tax Reform." We thank Chairman Orrin Hatch and Ranking Member Ron Wyden for holding this hearing. ACLI would like to take this opportunity to respectfully comment on a "corporate integration" proposal as publicly reported.

ACLI is a Washington, DC-based trade association with approximately 300 member companies operating in the United States and abroad. ACLI advocates in Federal, State, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums.

On behalf of the U.S. life insurance industry, we share the goal of encouraging economic growth through a competitive tax system. We understand that Chairman Hatch's corporate integration proposal would provide corporations with a dividends paid deduction which would be paid for, at least in part, by a nonrefundable 35 percent withholding tax on both interest and dividends paid.

The nature of the life insurance business is very different from that of a manufacturer or retailer in that it involves the satisfaction of long-duration promises. Life insurers receive premiums in exchange for a contractual promise to pay insurance or annuity benefits. Life insurers utilize those premiums as well as investment returns on the premiums to pay policyholder benefits as they arise, often many decades in the future. The protections and guarantees our products provide are not available from any other financial services companies.

The life insurance industry has priced its products and made guarantees to its policyholders based on receiving 100 percent of the investment income as it is earned by its investment portfolios in order to fulfill the future obligations and promises under its insurance and annuity contracts. A 35 percent, nonrefundable withholding tax on gross investment income would amount to a de facto gross income tax with a substantial retroactive effect on existing business. Specifically, earnings from current investments would fall far short of providing sufficient income each year to pay contractual obligations on in-force business. Therefore, a withholding tax on investment income would have a crippling effect on the life insurance industry.

The ACLI appreciates the opportunity to comment and point out the unique features of our products that make them so critical to the financial security of all Americans. ACLI and its member companies look forward to working with Senate Finance Committee Chairman Hatch and his staff to address the industry's concerns on these very important issues.

AMERICAN FARM BUREAU FEDERATION
SENATE COMMITTEE ON FINANCE
HEARING ON "NAVIGATING BUSINESS TAX REFORM"

April 26, 2016

Presented by Zippy Duvall, President

The Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral and fair to farmers and ranchers. We appreciate the opportunity to file this statement for the record for the full committee hearing on Navigating Business Tax Reform.

Agriculture operates in a world of uncertainty. From unpredictable commodity and product markets to fluctuating input prices, from uncertain weather to insect or disease outbreaks, running a farm or ranch business is challenging under the best of circumstances. Farmers and ranchers need a tax code that recognizes the financial challenges they face.

Tax reform should embrace the following overarching principals:

- **Comprehensive:** Tax reform should help all farm and ranch businesses: sole proprietors, partnerships, sub-S and C corporations.
- **Effective Tax Rate:** Tax reform should reduce rates low enough to account for any deductions/credits lost due to base broadening.
- **Estate Taxes:** Tax reform should repeal estate taxes. Stepped-up basis should continue.
- **Capital Gains Taxes:** Tax reform should lower taxes on capital investments. Capital gains taxes should not be levied on transfers at death.
- **Cost Recovery:** Tax reform should allow businesses to deduct expenses when incurred. Cash accounting should continue.
- **Simplification:** Tax reform should simplify the tax code to reduce the tax compliance burden.

Pass-through Businesses: Any tax reform proposal considered by Congress must be comprehensive and include individual as well as corporate tax reform. More than 96 percent of farms and 75 percent of farm sales are taxed under IRS provisions affecting individual taxpayers. Any tax reform proposal that fails to include the individual tax code will not help, and could even hurt, the bulk of agricultural producers who operate outside of the corporate tax code.

Effective Rates: Any tax reform plan that lowers rates by expanding the base should not increase the tax burden of farm and ranch businesses. Because profit margins in farming and ranching are tight, farm and ranch businesses are more likely to fall into lower tax brackets. Tax reform plans that fail to factor in the impact of lost deductions for all rate brackets could result in a tax increase for agriculture.

Cash Accounting: Cash accounting is the preferred method of accounting for farmers and ranchers because it provides the flexibility needed to optimize cash flow for business success, plan for business purchases and manage taxes. Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This gives them the flexibility they need to plan for major investments in their businesses and in many cases provides guaranteed availability of some agricultural inputs. Loss of cash accounting could create a situation where a farmer or rancher would have to pay taxes on income before receiving payment for sold commodities.

Accelerated Cost Recovery: Because production agriculture has high input costs, farmers and ranchers place a high value on immediate expensing of equipment and equipment repairs, production supplies and preproduction costs. This includes fertilizer and soil conditioners, soil and water conservation expenditures, the cost of raising dairy and breeding cattle, the cost of raising timber, endangered species recovery expenditures and reforestation expenses. Farm Bureau also places a priority on Section 179 small business expensing and supports bonus depreciation, shorted depreciation schedules, and the carry forward and back of unused deductions and credits. There should be annual expensing of preproduction expenditures and equipment repair costs should be treated as an expense rather than a capital improvement.

Estate Taxes: Farm Bureau supports permanent repeal of federal estate taxes. Until permanent repeal is achieved, the exemption should be increased, and indexed for inflation, and it should continue to provide for portability between spouses. Full unlimited stepped-up basis at death must be included in any estate tax reform. Farmland owners should have the option of unlimited current use valuation for estate tax purposes.

Capital Gains Taxes: Farm Bureau supports eliminating the capital gains tax. Until this is possible, the tax rate should be reduced and assets should be indexed for inflation. In addition, there should be an exclusion for agricultural land that remains in production, for transfers of farm business assets between family members, for farmland preservation easements and development rights, and for land taken by eminent domain. Taxes should be deferred when the proceeds are deposited into a retirement account. Farm Bureau supports the continuation of stepped-up basis.

Like-Kind Exchanges: Farm Bureau supports the continuation of Section 1031 like-kind exchanges, which help farmers and ranchers upgrade and improve their businesses by deferring taxes when they sell business capital and replace it with like-kind assets. Without the ability to defer taxes on exchanges, some farmers and ranchers would need to incur debt to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch.

Other Provisions Important to Farmers and Ranchers: Farm Bureau supports the continuation of the Domestic Production Activities Deduction (Section 199), farm and ranch income averaging, installment land sales, elimination of the UNICAP rules for plants, and the tax deduction for donated food and donated conservation easements.

AMERICAN PUBLIC POWER ASSOCIATION (APPA)

Senate Committee on Finance Hearing on

“Navigating Business Tax Reform”

Held on Tuesday, April 26, 2016

Introduction

The American Public Power Association (APPA) appreciates the opportunity to submit this statement for the record for the April 26, 2016, Senate Committee on Finance Hearing on “Navigating Business Tax Reform.”

APPA is the national service organization representing the interests of over 2,000 municipal and other state- and locally-owned, not-for-profit electric utilities (“public power utilities”) throughout the United States (all but Hawaii). Public power utilities serve some of the nation’s smallest towns—roughly four out of five public power utilities serve 10,000 or fewer customers—and largest cities, including Los Angeles

and San Antonio. Collectively, public power utilities deliver electricity to one of every seven U.S. electricity consumers (approximately 48 million people).

Public power utilities are operated by state and local governmental entities and, as a result, are exempt from federal income tax. However, several business tax reform proposals¹ have included municipal bond related provisions to raise revenue to offset the cost of lowering corporate income tax rates. Arguably, doing so makes these proposals “revenue-neutral.” In fact, while some of these municipal bond provisions relate to the taxation of business income, others impose new taxes on individuals or limit the purpose for which a municipal bond may be issued. More importantly, all would increase the cost of borrowing for state and local governments and, so, increase costs paid by state and local residents or lead to a reduction in services provided to these residents. As a result, including these provisions in a business tax reform proposal would shift costs from corporate taxpayers to individual taxpayers and state and local residents. APPA believes such proposals are particularly poorly timed when the nation faces crushing demand for critical infrastructure investments needed for economic growth and our citizens’ well-being.

Municipal Bonds

Municipal bonds are the largest source of financing for core infrastructure in the U.S.,² and are the single most important financing tool for public power, given the capital-intensive and long-lived nature of assets needed by the electric industry. Each year, on average, public power utilities make \$11 billion in new investments financed with municipal bonds. Power-related municipal bonds account for roughly 5 percent of municipal bond issuances every year.³ (See Appendix A for tabulation of power-related bond issuances, by state, over the last decade).

Municipal bonds long predate the modern income tax, having been used for more than 200 years by state and local governments to finance a wide range of public infrastructure. However, as the nation transitioned from dependence on excise taxes to an income tax as a primary source of revenue, a series of mid-19th Century Supreme Court decisions carved out the doctrine of reciprocal immunity, under which state and local bond issuances are exempt from federal taxation, while federal bonds are exempt from state and local tax. The federal tax exemption for municipal bonds was part of the original federal income tax enacted in 1913 and is codified today at 26 U.S.C. § 103. The state and local tax exemption for federal bonds was not codified until 1982 (at 31 U.S.C. § 3124).

Because interest on municipal bonds is exempt from federal income tax, investors accept a lower rate of return than they would otherwise demand from issuers of taxable debt. Investors are also attracted to municipal bonds because of the stability of the municipal bond market and the extremely low rate of default for municipal bonds compared to comparably rated corporate bonds. Historically, interest rates demanded by investors for tax-exempt municipal bonds have been an estimated average 200 basis points lower than comparable taxable corporate bonds. Savings to the issuer from this reduced cost in borrowing allow additional infrastructure investments or are passed through to taxpayers in the form of lower taxes or, in the case of public power customers, reduced utility rates.⁴

Proposals to Alter Tax Exempt Municipal Bonds

Several recent proposals to reform federal taxation of business rely on revenue raised from bond-related provisions to offset the cost of lowering marginal corporate income tax rates. While some of these provisions would directly affect corporations holding municipal bonds, others would also increase taxes on individual bondholders or save federal revenue by limiting the purposes for which municipal bonds can be issued. As a result, these proposals would use individual income tax revenue to finance corporate tax rate reductions.

Additionally, while the Joint Committee on Taxation will score these provisions as raising revenue from bondholders, we believe the after-tax effect on bondholders, whether businesses or an individuals, will be negligible. Instead, state and local gov-

¹ See, e.g., H.R. 1, the “Tax Reform Act of 2014” by Representative Dave Camp (R-MI).

² Cong. Budget Office, J. Comm. on Taxation, “Subsidizing Infrastructure Investment with Tax-Preferred Bonds” (Oct. 2009) (showing that for education, water, and sewer, nearly all capital investments are made by state and local governments and that for transportation most investments are made by state and local governments).

³ The Bond Buyer and Thomson Reuters “2014 Yearbook” (2014); The Bond Buyer and Thomson Reuters “2009 Yearbook” (2009).

⁴ American Public Power Association “2012–2013 Public Power Annual Directory and Statistical Report” 51 (2012).

ernmental issuers will pay the price of these tax increases, either because bondholders are demanding a higher rate of return to compensate for additional taxes paid, or because potential bondholders have exited the market for municipal bonds. The additional costs paid by state and local residents is important because revenue neutrality is being discussed as one way to ensure rough justice in business tax reform. The argument goes that every dollar of additional tax paid because of lost deductions, exclusions, or credits, will be returned in the form of lower marginal tax rates or other more simple deductions and exclusions. Using bond-related provisions to pay-for corporate tax rate reductions clearly violates this principle, pulling money out of the pockets of individual bondholders and state and local taxpayers (and utility customers) to the benefit of corporations, partnerships, and the like benefiting from business tax reform.

Finally, in so far as Congress feels that there is merit to some of these bond-related provisions beyond simply their ability to raise federal revenue, it would make more sense (and better bolster infrastructure investments) to marry them with provisions improving and updating the federal tax treatment of municipal bonds.⁵

Conclusion

Thank you for the opportunity to provide input as the Committee considers business tax reform. While bond-related provisions can be used as “pay-fors” to meet a federal budgetary or revenue neutrality goal on paper, new taxes and limitations on tax-exempt bonds will simply shift federal costs to state and local residents while permanently impairing the ability of public power utilities and state and local governments to meet their critical, public purpose infrastructure needs.

For more information please contact:

John Godfrey

Senior Government Relations Director
American Public Power Association
2451 Crystal Dr. Suite 1000
Arlington, VA 22202

jgodfrey@publicpower.org
(202) 467-2929

Appendix A

A Decade of Power-Related Municipal Bonds

Power-related municipal bonds issued in each state from 2004–2013
(By total dollar volume and number of bonds issued)

State	\$ Volume (millions)	Bonds Issued
Alabama	1,739	(33)
Alaska	436	(9)
Arizona	6,210	(20)
Arkansas	244	(15)
California	38,306	(237)
Colorado	726	(23)
Connecticut	266	(9)
Delaware	196	(5)
Florida	14,757	(134)
Georgia	10,071	(52)
Hawaii	481	(4)
Idaho	82	(1)
Illinois	2,928	(42)
Indiana	1,985	(41)
Iowa	340	(99)
Kansas	364	(45)
Kentucky	2,574	(42)
Louisiana	1,428	(18)

⁵ See, for example, American Public Power Association, Large Public Power Council, Transmission Access Policy Study Group, “Statement to the Senate Finance Committee Tax Reform Working Groups on Community Development and Infrastructure and Saving and Investment” 10–11 (April 15, 2015).

A Decade of Power-Related Municipal Bonds—Continued

Power-related municipal bonds issued in each state from 2004–2013
(By total dollar volume and number of bonds issued)

State	\$ Volume (millions)	Bonds Issued
Maine	7	(2)
Maryland	122	(1)
Massachusetts	382	(21)
Michigan	532	(26)
Minnesota	1,762	(112)
Mississippi	911	(15)
Missouri	2,541	(41)
Montana	22	(6)
Nebraska	8,510	(282)
Nevada	154	(5)
New Hampshire	0	(0)
New Jersey	174	(9)
New Mexico	56	(1)
New York	9,963	(46)
North Carolina	5,091	(37)
North Dakota	352	(4)
Ohio	6,969	(54)
Oklahoma	2,325	(19)
Oregon	922	(42)
Pennsylvania	777	(10)
Rhode Island	0	(0)
South Carolina	8,703	(47)
South Dakota	55	(13)
Tennessee	8,646	(73)
Texas	13,921	(91)
Utah	2,688	(31)
Vermont	91	(9)
Virginia	465	(8)
Washington	14,646	(188)
West Virginia	11	(1)
Wisconsin	1,384	(64)
Wyoming	403	(7)
Guam	207	(3)
Puerto Rico	8,511	(15)
Virgin Islands	227	(6)
U.S.TOTAL	\$177,401	2,149

Sources: The Bond Buyer/Thomson Reuters 2009, 2014 Yearbooks.

CASH TO ACCRUAL ACCOUNTING STAKEHOLDER COALITION

Dear Chairman Hatch and Ranking Member Wyden:

In connection with the Senate Finance Committee's recent hearing on "Navigating Business Tax Reform," we are submitting as a statement for the record the attached letter which was sent to the Committee's Business Income Tax Bipartisan Tax Working Group in April 2015. As discussed in the letter, we urge you preserve the current availability of the cash method of accounting as part of any business tax reform. Thank you for your consideration and your leadership on tax policy issues.

Sincerely,

The Cash to Accrual Accounting Stakeholder Coalition

April 15, 2015

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

We are writing in response to your invitation to stakeholders to submit ideas to the Committee's tax reform working groups on how best to reform the nation's tax code to make it simpler, fairer and more efficient. We applaud your efforts to improve the tax code and strengthen U.S. businesses, and we appreciate the opportunity to provide comments.

Specifically, we are writing to ask that you preserve the cash method of accounting for service pass-through entities, including partnerships and Subchapter S corporations, farmers and ranchers, and personal service corporations. The cash method of accounting is the foundation upon which these types of businesses have built their businesses for decades. Because these businesses are taxed at the owner level, forcing them to switch to the accrual method of accounting would result in an effective tax increase on their thousands upon thousands of individual owners that generate jobs and are integral to the vitality of local economies throughout our nation.

Under current law, there are two primary methods of accounting for tax purposes: cash and accrual. Under cash basis accounting, taxes are paid on cash actually collected and bills actually paid. Under accrual basis accounting, taxes are owed when the right to receive payment is fixed, even if that payment will not be received for several months or even several years. Internal Revenue Code section 448 allows the use of cash accounting for service pass-throughs; qualified personal service corporations; farmers and ranchers; and entities with average annual gross receipts of \$5 million or less.

Proposals in the last Congress would have required any business with average annual gross receipts greater than \$10 million to use the accrual method of accounting. By raising the threshold from \$5 to \$10 million, the proposals were intended to reduce recordkeeping burdens on small businesses. However, this expansion was paid for by forcing all other businesses currently using cash accounting to switch to accrual accounting. We do not oppose expanding the allowable use of cash accounting, but it is unfair and inconsistent with generally agreed upon tax reform principles to pay for good policy with bad policy that has no other justification than raising revenues. Further, there have been no allegations that the businesses affected by the proposals are abusing the cash method of accounting.

Pass-through entities account for more than 90 percent of all business entities in the United States and are represented across a diverse range of business professions and sectors. A substantial number of these businesses are service providers, farmers and ranchers that currently qualify to use cash accounting. These are businesses throughout America—farms, trucking, construction, engineers, architects, accountants, lawyers, dentists, doctors and other essential service providers—on which communities rely for services and jobs. These are not just a few big businesses and a few well-to-do owners. According to IRS data, there are over 60,000 Subchapter S corporations, 25,000 partnerships and at least 2,000 sole proprietors that would have to switch from cash to accrual accounting.

The negative impact of such a move would be significant:

Cash flow would be severely impaired. Businesses could be forced into debt to finance truces, including accelerated estimated tax payments, on money they may never receive. Many cash businesses operate on very small profit margins, so accelerating the recognition of income could be the difference between being liquid and illiquid. Many cash businesses have contracts with the government, which is known for long delays in making payments that already stretch their working capital. Structured settlements and alternative fee arrangements can result in substantial delays in collections, sometimes over several years; taxes owed in the year a matter is resolved could potentially exceed the cash actually collected.

A bad crop year could make a farm go under. For farmers and ranchers, cash accounting is crucial due to the number and enormity of up-front costs and the uncertainty of crop yields and market prices. A heavy rainfall, early freeze or sustained drought can devastate an agricultural community. Farmers and ranchers need the flexibility and simplicity of cash accounting to manage their tax burden by evening out annual revenues that can fluctuate greatly from one year to the next.

Recordkeeping burdens would escalate, in cost, staff time and complexity. Cash accounting is simple—cash in/cash out. Accrual accounting is much more complex, requiring sophisticated analyses of when the right to collect income or to

pay expenses is fixed and determinable. In order to comply with the more complex rules, businesses currently handling their own books and records may feel like they have no other choice than to hire outside help or buy expensive software.

These impacts are not about the size of a business or its gross receipts. Whether large or small, a business can have small profit margins, rely on government contracts, generate business through deferred fee structures or be wiped out through the vagaries of the weather. Cash diverted toward interest expense, taxes and higher recordkeeping costs is capital unavailable for use in the actual business, including paying wages, buying capital assets or investing in growth.

Proposals to limit the use of cash accounting are counterproductive to agreed-upon principles of tax reform. Tax reform should strengthen our economy, foster job growth, enhance U.S. competitiveness, and promote fairness and simplicity in the tax code. Accrual accounting does not make the system simpler, but more complex. Increasing the debt load of American businesses runs contrary to objectives to move toward equity financing instead of debt financing and will raise the cost of capital, creating a drag on economic growth and job creation. Putting U.S. businesses in a weaker position will put them at further disadvantage compared to foreign competitors. American businesses and their individual owners should not be asked to pay a significant price for reforms that will leave them in a worse position than when they started.

As discussions on tax reform continue, the undersigned respectfully request that the Committee and the working groups take our concerns into consideration and not propose to change the ability to use cash accounting. We would be happy to discuss any of these items further. Please feel free to contact Mary Burke Baker (mary.baker@klgates.com) or any of the signatories for additional information.

Thank you for your consideration of this important matter.

Sincerely,

American Council of Engineering Companies	Investment Adviser Association
American Farm Bureau Federation	Jackson Walker LLP
American Institute of Architects	K&L Gates LLP
Americans for Tax Reform	Little Mendelson PC
American Institute of CPAs	Miles and Stockbridge PC
Baker Botts LLP	Mitchell Silberberg and Knupp LLP
Baker Donelson Bearman Caldwell and Berkowitz PC	Morrison and Foerster LLP
Debevoise and Plimpton LLP	Nelson Mullins Riley and Scarborough LLP
Dorsey and Whitney LLP	Ogletree, Deakins, Nash, Smoak and Stewart PC
Dykema Gossett PLLC	Perkins Coie LLP
Farmers for Tax Fairness	Richards, Layton and Finger PA
Federal Communications Bar Association	Ropes and Gray LLP
Foley and Lardner LLP	State Bar of South Dakota
Hunton and Williams LLP	Steptoe and Johnson LLP

cc:

The Honorable John Thune, Co-Chair, Business Income Tax Working Group
 The Honorable Benjamin Cardin, Co-Chair, Business Income Tax Working Group
 The Honorable Pat Roberts, Member, Business Income Tax Working Group
 The Honorable Debbie Stabenow, Member, Business Income Tax Working Group
 The Honorable Richard Burr, Member, Business Income Tax Working Group
 The Honorable Tom Carper, Member, Business Income Tax Working Group
 The Honorable Johnny Isakson, Member, Business Income Tax Working Group
 The Honorable Bob Casey, Member, Business Income Tax Working Group
 The Honorable Rob Portman, Member, Business Income Tax Working Group
 The Honorable Mark Warner, Member, Business Income Tax Working Group
 The Honorable Pat Toomey, Member, Business Income Tax Working Group
 The Honorable Robert Menendez, Member, Business Income Tax Working Group
 The Honorable Dan Coats, Member, Business Income Tax Working Group
 The Honorable Bill Nelson, Member, Business Income Tax Working Group

CRANE COALITION
 c/o Ogilvy Government Relations
 1111 19th St. NW, Suite 1100
 Washington, DC 20036

Senate Committee on Finance
Hearing on “Navigating Business Tax Reform”

April 26, 2016

Last year, during the Finance Committee’s working group process on tax reform, the CRANE Coalition (“Cost Recovery Advances the Nation’s Economy”) submitted comments to the committee making the case for the preservation of accelerated depreciation in tax reform. We showed that cuts in accelerated depreciation are an unworkable budget offset for permanent tax reforms because the substantial early-year revenue gains from such cuts do not persist for the long term. Through a paper prepared by former revenue estimators from the staff of the Joint Committee on Taxation, we showed that reliance on such cuts to offset the cost of a tax reform measure in the first decade could lead to burgeoning revenue shortfalls for the government thereafter. Such revenue shortfalls would come just when baby-boom retirements are forecasted to create unsustainable budget deficits; the shortfalls could readily lead to the reversal of the very tax reforms for which the cuts in accelerated depreciation were enacted!

We also explained in our comments that cuts in accelerated depreciation would increase the cost of capital for domestic investment in plant and equipment. We pointed out that according to the Joint Tax Committee staff’s assessment of the tax reform proposal of former House Ways and Means Committee chair Dave Camp, on an overall basis the proposal would result in reduced capital stocks after 10 years because of cuts in accelerated depreciation and other cost-recovery mechanisms. It is axiomatic that investment is the key determinant of future growth; for Congress to consider a tax reform plan that would tend to dampen investment in plant and equipment would be to turn the idea of tax reform on its head.

After submitting our comments to the committee last year, we released another paper by the former Joint Committee economists, precisely on the economic effect of cuts in accelerated depreciation. The paper shows that the repeal of accelerated depreciation would increase the cost of capital by more than 10 percent for capital-intensive industries. The curtailment of other cost-recovery mechanisms, as in the Camp plan, would add to the increase, as would the elimination of bonus depreciation, also assumed in the Camp plan. The inevitable effect would be reduced investment and growth.

What CRANE members understand well is that accelerated depreciation is fundamentally about cash flow and that, for most companies, cash flow is a key determinant of investment. While some U.S. companies may be in a position to freely access the capital markets for all their capital needs, most are not—for financial, prudential, or other reasons. For most companies, if cash flow declines because of cuts in accelerated depreciation, investment inevitably will decline along with it.

In short, as we argued last year, accelerated depreciation promotes domestic investment and economic growth. Its repeal has no logical place in a tax reform measure meant to help get the tax code out of the way of the country’s economic growth.

If Congress is to consider tax reform, the key driver of the measure should be to spur faster economic growth for the benefit of all Americans. A tax reform measure that does not meet that test should not advance in Congress.

The Historical Perspective

For today’s hearing record, we believe it is important to consider accelerated depreciation from a broader historical perspective. From that point of view, we believe Congress would be making a serious mistake in turning its back on the tax code’s current system of accelerated depreciation when the system has taken so long to develop. The budgetary and political obstacles today to shifting the tax system in the direction of investment and growth are daunting by any measure, requiring nearly impossible political maneuvering over issues of progressivity, revenue levels, and the public perception of fairness. Especially given the budgetary constraints posed by the retirement of the baby boom generation, if Congress decides to turn back the

clock on accelerated depreciation now for sake of tax reform, the likelihood that Congress would be able to correct the mistake in coming years could be minimal.

The federal income tax was in place for four decades before the first permanent allowances for accelerated depreciation were added into the tax code, in 1954. The Internal Revenue Code of 1954 authorized the use of the double declining balance method and sum of the years' digits method of depreciation for assets with a useful life of more than three years. In adopting those provisions, this committee explained that the provision would boost investment and economic growth:

More liberal depreciation allowances are anticipated to have far-reaching economic effects. . . . The acceleration in the speed of the tax-free recovery of costs is of critical importance in the decision of management to incur risk. The faster tax write-off would increase available working capital and materially aid growing businesses in the financing of their expansion. For all segments of the American economy, liberalized depreciation policies should assist modernization and expansion of industrial capacity, with resulting economic growth, increased production, and a higher standard of living.¹

Over the decades from 1954 to the present, accelerated depreciation has gradually become more deeply embedded in federal tax policy. In 1958 and again in 1962, Congress liberalized the rules in a number of ways, such as by enacting section 179, which then, as today, was meant to provide rapid write-offs for smaller businesses. During the 1960s and 1970s, the administrative rules and regulations under which taxpayers determined the depreciable lives for assets moved steadily toward shorter lives.² The asset depreciation range (ADR) system prescribed by the Treasury Department in 1971 explicitly allowed taxpayers to select depreciable lives shorter than the Treasury's calculation of industry average.

In the 1980s, Congress further embedded accelerated depreciation in the tax law by enacting the accelerated cost recovery system (ACRS) and its scaled-back version, the modified accelerated cost recovery system (MACRS). As the rules settled out in 1986, most types of equipment were depreciable over either five years or seven years. Depreciation periods longer than five years applied to real property, public utility property, some transportation property, and certain other long-lived assets, but those periods were shorter than the periods applicable in the 1970s. Accelerated methods of depreciation (such as the double declining balance method) continued to apply to most types of assets other than real property. The accelerated depreciation rules adopted in the 1980s have persisted to the present day.

During the last 15 years, rapid recovery of capital costs has become even more central to the U.S. tax system as Congress has provided an add-on system of bonus depreciation during most of those years. Bonus depreciation has allowed taxpayers to deduct in the first year a prescribed portion of the cost of assets, ranging from 30 percent to 100 percent, depending on the particular year. The regular depreciation allowance (computed with respect to portion of the cost basis, if any, remaining after the bonus depreciation deduction) has remained applicable. Most depreciable assets other than public utility property and other such long-lived assets are eligible for bonus depreciation.

The determination by Congress in 1954 that liberal depreciation rules foster economic growth was reconfirmed more recently in a comprehensive 2007 Treasury Department study of the U.S. system for taxing business income. The study stated flatly that the repeal of incentives for domestic investment, including primarily accelerated depreciation "would discourage investment and have a detrimental effect on economic growth." Reduced incentives to invest, explained the report, "can hurt labor productivity, which is central to higher living standards for workers in the long run."³ The report went on to forecast that a budget-neutral tax reform measure preserving accelerated depreciation would boost economic growth better than a budget-neutral tax reform measure repealing it and, further, that a tax reform measure expanding accelerated depreciation would boost economic growth even more.⁴

¹ See U.S. Treasury Department, Office of Tax Analysis, "A History of U.S. Tax Depreciation Policy," OTA Paper 64 (May 1989), p. 13.

² *Id.*, at 12–19.

³ U.S. Department of the Treasury, *Approaches to Improve the Competitiveness of the U.S. Business Tax System for the 21st Century*, Dec. 20, 2007, p. 48.

⁴ *Id.*, at 49–50.

In sum, accelerated depreciation represents a slow, evolutionary process by the federal government over more than six decades to tilt the federal tax system in a direction that promotes investment and long-term economic growth. Any tax writers considering tilting the system in the other direction today by curtailing accelerated depreciation should consider realistically the length of the road to restore robust investment and growth incentives to the tax code in the future. For most of the 30 years since the tax reform act of 1986, tax reformers have continually laid out tax proposals for boosting investment and growth—proposals like corporate integration, full expensing of capital equipment, consumption taxes or business activity taxes as a replacement for income taxes, and others. But such tax initiatives have proven to be dead ends, over and over, as Congress has reliably chosen to devote available resources to other forms of tax cuts or to new programs like Medicare prescription drugs and the Affordable Care Act.

There is simply no apparent reason to think that tax writers will have an easier time in winning approval of pro-growth tax changes in coming years, given political and budget realities. The system of accelerated depreciation has evolved over more than six decades as a means of promoting investment and growth. The repeal or curtailment of the system by Congress at this time would likely end up effectively amounting to a permanent change in tax law. In other words, If Congress were to decide to repeal or curtail the system today, there would probably be little realistic chance of turning back.

Accelerated depreciation works. It is well understood by taxpayers. Tax writers would be abandoning six decades of evolution—much of it spawned by their own efforts—in abandoning accelerated depreciation now. The CRANE coalition urges Congress to preserve accelerated depreciation in any tax reform measure.

FINANCIAL EXECUTIVES INTERNATIONAL (FEI)

1250 Headquarters Plaza
West Tower, 7th Floor
Morristown, NJ 07960
973-765-1000 | Fax 973-765-1018

Financial Executives International's Committee on Private Company Policy
Senate Committee on Finance
Hearing on “Navigating Business Tax Reform”
April 26, 2016

Financial Executives International (FEI) represents over 10,000 Chief Financial Officers, Vice Presidents of Finance, Corporate Treasurers, Controllers and other senior financial executives from 74 chapters across the United States. Nearly 60% of our members work for private companies, and the Committee on Private Company Policy (CPC-P) focuses on these members' policy concerns. The following summarizes the CPC-P urges the Finance Committee to consider the following recommendations with respect to current efforts in Congress to reform the U.S. Tax Code.

Tax Reform

Private Companies in the U.S. Economy: Pass-through entities play a critical role in the U.S. economy, serving as a key source of jobs, wages and tax revenue in the United States. In 2011, pass-through entities accounted for 94% of all businesses, 64% of total net business income, 55% of all private sector employment, and paid more than \$1.6 trillion in wages and salaries.¹ In 2010, private companies generated 53% of fixed non-residential investment, and are, on average, 4 times more responsive to investment opportunities than public companies.² In 2012, pass-through entities contributed nearly \$840 billion in business AGI to individual returns.³ If tax

¹ Kyle Pomerleau, “An Overview of Pass-through Businesses in the United States,” Tax Foundation, January 2015.

² John Asker et al., “Corporate Investment and Stock Market Listing: A Puzzle?”, NBER, October 4, 2014.

³ Joseph Rosenberg, “Flow-Through Business Income as a Share of AGI,” *Tax Facts*, Urban Institute, Sept. 29, 2014.

reform is to have a meaningful impact on business investment, productivity growth and job creation, privately-held businesses cannot be left out of the equation.

Unfairness of Current System: While pass-throughs play a critical role in fueling U.S. economic activity, current tax rates place them at competitive disadvantage that could be deepened if recent “corporate-only” tax reform proposals are enacted. Since 2013, pass-throughs have been subjected to a higher marginal tax rate on business income than C-corporations. Currently, the top tax rate on individuals is 39.6% while the top corporate tax rate is 35%. Some recent business tax reform proposals would lower the corporate tax rate to 25%, while leaving the tax rate for pass-throughs unchanged. The disparity puts privately-held and family-owned businesses which operate as pass throughs at a huge competitive disadvantage, limiting their ability to create jobs and invest in their businesses. For example, a C-corporation that earns \$1 million would pay nearly \$350,000 in taxes at current rates. If that same business were organized as a partnership, it could pay as much as \$444,000 in taxes, a difference of 27%. If corporate tax rates were lowered to 28%, that difference would grow to 59%.

Tax Rate Equivalency: To level the playing field, restore fairness to the tax code, and better position pass throughs to create jobs and increase investment, any comprehensive tax reform bill should include provisions that permit the bifurcation of business and other income on an individual’s tax return, and the application of a business rate equivalent to the highest corporate rate.

- Congress should create an elective business equivalency rate (BER) on qualified active trade or business income that would ensure that all active business income, whether earned in a pass-through or in a corporation (C Corp), is taxed at a rate no higher than the maximum corporate rate. BER would be implemented in a two-step process:
 - The pass-through entity would report qualified trade or business income on Schedule K-1;
 - Taxpayers would report qualified business income on a new schedule similar to Schedule D (for capital gains) that automatically determines tax using the BER.
- In order to retain equivalency between pass-through and C-Corp rates, qualified business income would not be used when calculating AMT.

Territorial Tax System Access: Increasingly, large and medium-sized pass-throughs are net exporters, *i.e.*, they have real business activity offshore. Broadly, tax reform legislation should create a territorial system that puts U.S. companies on an even footing with their foreign competition, removes disincentives for capital mobility and earnings repatriation, and brings U.S. rates in line with other developed countries.

- Current territorial tax proposals are limited to C-Corps. Congress should grant pass-throughs access to any new territorial tax regime if they are willing to pay tolling charges on retained foreign earnings.
- Pass-throughs have very complex international structures because they don’t get 902 indirect credits even though they have exposure to Subpart F income. Some have CFCs for offshore deferral, but most use a combination of check the box and hybrid entities to manage tax exposure. A territorial system could reduce the need for this complexity.
- Under a territorial system, pass-throughs could establish specified accumulated adjustment accounts (AAA) for offshore earnings and the entity could make distributions comprised of proportionate shares of foreign and domestic earnings as disclosed in the K-1.

S-Corp Gains Recognition Period: Make permanent the reduced recognition period, 5 years, for built-in gains for S corporations.

Other Tax Issues

Estate Tax: While FEI supported most of the estate tax provisions in the American Taxpayer Relief Act of 2012, we continue to believe that repeal is the best solution to protect all family-owned businesses from the serious transition challenges posed by estate taxes, and thus support H.R. 1105 and S. 860.

- The estate tax is one of the largest drains on resources for privately held and family-owned businesses in the United States. The death of a shareholder in a closely held business creates a liquidity and tax event for the entity. To preserve the continuity of the business, companies often deploy techniques that pull capital out of the business while the principals are living to prepay the death tax liability. This inhibits companies from hiring workers and expanding their businesses. It adds significant costs for lawyers, accountants, life insur-

ance contracts and management's time, in addition to funding the tax itself. Banks, one of the principal funding sources for private companies, are reluctant to lend companies money for the purpose of satisfying the shareholder's death tax resulting in forced sales or liquidations.

- It is difficult to know the value of a privately held business for estate tax purposes (which is often audited and "negotiated"); this makes planning for the tax amount highly problematic. In many cases, the owners are faced with the difficult decision of selling their business while alive or risking them going out of business after their deaths.
- Consequently, if repeal is not forthcoming, in order to alleviate these pressures, FEI supports facilitating the election to allow the estate to pay the death taxes and provide a step up in basis to the heirs or defer the tax but keep a carry-over basis into the next generation.

For additional information please contact:

Brian Cove
Managing Director, Technical Activities
Financial Executives International
973-765-1092
bcove@financialexecutives.org

LIKE-KIND EXCHANGE STAKEHOLDER COALITION

May 10, 2016

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Hatch and Ranking Member Wyden:

As the Senate Finance Committee considers ways to create jobs, grow the economy, and raise wages, we strongly urge you to retain current law regarding like-kind exchanges under section 1031 of the Internal Revenue Code ("Code"). Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that firms and investors do not immediately recognize a gain or loss when they exchange assets for "like-kind" property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other "boot" is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the United States by allowing funds to be reinvested in the enterprise, which is the very reason section 1031 was enacted in the first place. These investments not only benefit the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like-kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating them or restricting their use would have a contraction effect on our economy by increasing the cost of capital. In fact, a recent macroeconomic analysis by Ernst and Young found that limitations on like-kind exchanges could lead to a decline in U.S. GDP of up to \$13.1 billion annually.¹

Companies in a wide range of industries, business structures, and sizes rely on the like kind exchange provision of the Code. These businesses—which include construction, industrial, and farm equipment; vehicle manufacturers and lessors; and real estate—provide essential products and services to U.S. consumers and are an

¹*Economic Impact of Repealing Like-Kind Exchange Rules*, Ernst and Young (March 2015, revised November 2015), at (iii), available at <http://www.1031taxreform.com/wp-content/uploads/EY-Report-for-LKE-Coalition-on-macroeconomic-impact-of-repealing-LKE-rules-revised-2015-11-18.pdf>.

integral part of our economy. A study by researchers at the University of Florida and Syracuse University supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and capital investments. The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset.² As a result, requiring the recognition of gain on like-kind exchanges would hamper the ability of businesses to be competitive in our global marketplace. The reduced investment in real estate and capital would also have significant upstream and downstream impacts on economic reactivity and employment in industries as diverse as real estate, agriculture, construction, tourism, hospitality, trucking, and equipment supply.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

Thank you for your consideration of this important matter.

Sincerely,

American Car Rental Association
American Truck Dealers
Asian American Hotel Owners Association
Avis Budget Group, Inc.
C.R. England, Inc.
Federation of Exchange Accommodators
Idaho Dairymen's Association
National Apartment Association
National Association of Realtors®
National Multifamily Housing Council
National Utility Contractors Association
Realtors® Land Institute
Truck Renting and Leasing Association

American Farm Bureau Federation
American Trucking Associations
Associated General Contractors of America
CCIM Institute
Equipment Leasing and Finance Association
Hertz Global Holdings, Inc.
Institute of Real Estate Management
National Association of Real Estate Investment Trusts
National Automobile Dealers Association
National Stone, Sand, and Gravel Association
The Real Estate Roundtable
South East Dairy Farmers Association
Western United Dairymen

NATIONAL CONFERENCE OF CPA PRACTITIONERS

22 Jericho Turnpike, Suite 110
Mineola, NY 11501
T: 516-333-8282
F: 516-333-4099

May 6, 2016

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Ron Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

RE: Importance of Maintaining Cash Method of Accounting

Dear Chairman Hatch and Ranking Member Wyden,

The National Conference of CPA Practitioners (NCCPAP) writes to you today regarding the April 26, 2016 hearing by the Senate Finance Committee on "Navigating Business Tax Reform." NCCPAP commends your ongoing efforts on tax reform and strongly encourages the importance of maintaining the cash method of accounting, as it is currently permitted, as part of the Internal Revenue Code.

²David Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, available at <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.

NCCPAP is a professional organization that advocates on issues that affect Certified Public Accountants in public practice and their small business and individual clients located throughout the United States. NCCPAP members serve more than one million business and individual clients and are in continual communication with regulatory bodies to keep them apprised of the needs of the local CPA practitioner. Below is a copy of testimony submitted to the House Small Business Committee in July 2014.

Discussions surrounding the proper basis of accounting most likely began the moment a second basis was developed. Today, we not only have the two primary bases—cash and accrual—but also others including tax, regulatory and “other.” Any basis other than the accrual method is referred to as an “Other Comprehensive Basis of Accounting (OCBOA).” For purposes of this testimony, I will be discussing the cash and accrual bases of accounting.

To further complicate the discussion, there are two distinct cash bases of accounting—cash and modified cash. Pure cash presentations in financial statements are very rare because cash receipts would not only include sales receipts but also proceeds from debt and fixed asset sales, and cash disbursements would include expenses, purchases of fixed assets, and loan repayments. This approach does not provide useful or realistic financial statements. Rather, a modified presentation has evolved to address these concerns. Therefore, when the term “cash basis of accounting” is used, the presenter is truly using the modified cash basis of accounting. As such, when discussing the cash basis of accounting, it is really a Modified Cash Basis, but hereinafter will be referred to as “cash basis.”

Under the cash basis of accounting, a taxpayer can defer income until cash is received but must also wait to deduct expenses until the amounts have actually been paid. Currently the cash basis of accounting is available for businesses operating as sole proprietors, S Corporations, partnerships that do not have a “C” Corporation as a partner, and personal service corporations (PSCs). A PSC performs activities in the fields of health, law, engineering, accounting, etc. whereby substantially all of the stock of the corporation is owned by employees performing services for the corporation in connection with those activities. In addition, some C Corporations and partnerships with C Corporation as partners can use the cash method if their average annual sales for the previous three years are less than \$5 million.

Accrual accounting is considered to be the standard accounting method for most other companies. The accrual method provides a more accurate picture of the company’s current financial condition, but its relative complexity makes it more expensive to implement. Generally, a small business that receives income from producing, purchasing or selling merchandise must compute its inventory and use the accrual method of accounting. However, a small business with average annual receipts of \$1 million or less can still use the cash method and account for inventory as materials and supplies. The costs for these materials and supplies would be deducted in the year the business sells the merchandise or pays for the items, whichever is later. Resellers with gross receipts of \$10 million or less are not required to use the accrual method of accounting.

Currently, if a small business has sales that require an accrual method of accounting or if the business simply wishes to convert from the cash method to the accrual method they must file IRS Form 3115, Application for Change in Accounting Method. The filing of this form is a request for a change in accounting method, not a guarantee. In preparing this form, the taxpayer must take into account any and all changes required to convert to an accrual basis as well as pay a filing fee.

The need for the accrual method arose out of the increasing complexity of business transactions and a desire for more accurate financial information. Selling on credit and projects that provide revenue streams over a long period of time affect the company’s financial condition at the point of the transaction. Therefore, it usually makes sense that such events should also be reflected on the financial statements during the same reporting period that these transactions occur.

The form to request a Federal Employer ID number (EIN) requires that an accounting method for the business must be selected. This form is completed prior to the business opening. Often, the primary understanding of accounting and record keeping of the business owner(s) falls under the cash basis of accounting. Throughout their adult lives, as individuals they have received W2s, 1099s, 1098s, and/or real estate bills. All of these documents were prepared under the cash basis of accounting. In fact, almost all personal tax returns are prepared on a cash basis of account-

ing. Therefore, when opening a business or even purchasing a rental property, the cash basis of accounting is the initial thought that comes to mind for the taxpayer.

In establishing a business, hopefully the business owners have consulted with professionals—attorneys to incorporate the entity, if applicable, and CPAs to ensure the proper business structure. Part of a CPA's job is to ensure that taxpayers comply with the tax codes so that they pay their fair share of taxes. Many business owners want to incorporate their business believing that there are special tax advantages, such as fewer tax audits. They don't realize that there are other considerations including keeping separate books and records, paying themselves a salary as an incorporated business is required to do, additional tax files, and the list goes on.

In recent years, Limited Liability Companies (LLCs) have become a common choice of business structure of the new small business. Often, however, the business owner is not aware of the various tax ramifications. If there is only one owner, the business is taxed as a sole proprietor and all of the business activity will be reported on Schedule C of the owner's individual tax return. With multiple owners, the entity would be taxed as a partnership. The entity can elect to be taxed as an S-Corporation regardless of the number of owners provided that none of the owners are corporations. Under the rules of S Corporations, owners with greater than a five percent ownership interest are required to draw reasonable compensation in the form of a salary where the tax withholdings can be sufficient to remove the burden of making quarterly estimated tax payments as individuals.

Regardless of whether the entity is taxed as an S corporation or partnership, the owners are subject to pass-through income based upon their ownership interest or partnership agreement. Often, this income relates to funds that are not always immediately available for distribution to the owner(s), which may be another challenge to taxpayers who have to follow accrual based accounting as this may trigger phantom income. Owner(s) may choose to keep the net income in the business to help fund expansion, debt service or unpaid bills. Countless times during tax season after the owner(s) receive Form K-1 from their partnership or S corporation, we have to explain to business owners why they are paying taxes on business income that they have not received. This is what is referred to as pass-through income of the business and is taxed at the individual level—frequently at lower tax rates than if taxed at corporate levels. Further complicating pass-through income is the fact that most partnership income is also subject to self-employment taxes.

Many small businesses still operate under the cash basis for tax purposes but opt to prepare accrual basis financial statements, as this *may* show them in a better financial position. This is often the case when there is a need for financing. In addition, many banks prefer an accrual basis as it provides them a more comprehensive view of the financial position of the entity because of the inclusion of accounts receivable and accounts payable in the financial statements.

Often business owners do not have the accounting background to properly and adequately track and report revenue and expenses in any manner other than cash basis without the assistance of CPAs, EAs, accountants and bookkeepers. Many owners simply think on the basis of cash in and cash out and give their accountants their bank statements, check stubs and invoices to prepare their financial books which are used solely to prepare their tax returns. Many small business owners do not have systems in place to fully track accounts receivable or accounts payable. Once the financial activity is recorded, small business owners would then need to adjust these statements into an accrual basis. These adjustments can include uncollected revenue, unpaid payroll and related liabilities, prepaid expenses, inventory, etc. Not only will the owners be responsible for knowing what adjustments need to be made, they also must be able to determine the valuation of these adjustments.

Despite the business owner's reliance on accounting professionals, the fiscal responsibility still falls on the owners. The business owners are and will remain responsible for all of the information that appears on their tax returns. The fact that their tax returns are professionally prepared does not alleviate the taxpayer responsibility for the accuracy of the data contained in the tax returns, but many business owners may not have the financial background to make this determination using the accrual basis of accounting.

If small businesses were required to convert their accounting method to the accrual basis, the overall impact might simply be a "one-time" hit. Meaning, once the conversion is complete, the annual effect might not be as significant as one might expect. The "one-time" hit, however, could be very significant depending on the business. Newer entities or entities with minimal accounts receivable or accounts pay-

able would likely have a small tax increase and possibly even a tax decrease. Entities with a larger receivable base, however, would not be so fortunate. To properly convert, they would need to report *all* open receivables as current income and all unpaid bills as current expenses. The impact of this added income could propel the owners into higher tax brackets, which in turn could lead to the phase-outs of itemized deductions and personal exemptions, phase-outs of other deductions and credits including tuition and student loans when the increased income is reported on their individual income tax returns. In addition, taxpayers may find themselves subject to the 3.9% Net Investment Income surtax that became effective last year.

These tax increases will not just affect the taxpayer's federal income tax. Rather, additional state and local taxes may also be due because state and local tax returns usually have to be filed on the same basis as the federal tax returns. Further, many municipalities also impose a tax on gross receipts of all businesses.

As discussed throughout the testimony, taxpayers often are unaware of the differences in accounting methods. If they were required to convert, this obviously creates a major business opportunity for CPAs, EA, bookkeepers, etc. Unfortunately, this will also open the door for unregulated preparers to take advantage of unknowing taxpayers and utilize creative accounting.

Over the last few years, I have attended many IRS meetings, including National Public Liaison (NPL) and Working Together Forums. If there is one common thread that has been resonating from the IRS, it has been to reduce taxpayer burden. While this can mean many things, ultimately I believe that the IRS realizes that business and taxes in today's economy have gotten even more complicated. The current tax code makes compliance even more complicated. In working to reduce the tax compliance burden, the IRS representatives have stressed the importance of e-Filing tax returns and have improved upon every tax season, added additional features to their website such as "where's my amended return" that allows taxpayers to track the processing of amended tax returns. Further, discussions have also centered on what can be done to ease the stress of taxpayers from regular tax filings and to respond to IRS notices that are sent. Requiring taxpayers to change their accounting methods without any specific reasons would truly be in conflict to what the IRS has been working to achieve.

In conclusion, after reviewing the facts surrounding the differences between cash and accrual basis accounting, I feel that the use of cash basis for small firms remains of great importance and should be continued. It is a method that is consistent with how the owners have been taxed throughout their lives on their personal tax returns and how they realistically live. Converting to an accrual basis would add an additional burden onto them—financial. They would need to retain accounting professionals to guide them in this process. The Federal Government would achieve what can best be described as a "one-time" boost of tax revenue from the conversion. Taxpayers would be paying taxes on net income that neither they nor the business has received and this tax increase will include federal, state and local taxes. If the taxpayer has uncollectable aged accounts receivable, the taxpayer will be able to then write off this revenue and potentially send cancellation of debt notices (a 1099C) to those who owe money to the business. If the business subsequently pays the old accounts receivable, the income would be reported at that time and a method would have to be developed to reverse the cancellation of debt notice. The end result would be that the taxpayer has reduced his or her tax burden and the effect of the conversion to accrual basis is further diminished.

All businesses have the opportunity to elect to track their accounting on an accrual basis. Not all have the opportunity to account on a cash basis. Some larger entities and many of those with inventory are required to account on an accrual basis. However, the majority of businesses are permitted to choose their accounting method. With the guidance of financial professionals, they are able to elect the most appropriate accounting method for their specific business. Forcing a business to use the accrual basis not only complicates their business but also requires the owners to take time away from operations to focus on changing an accounting method. Ultimately, one does not start a business to focus on accounting. Forcing this change will do just that.

Sincerely,

Stephen F. Mankowski, CPA, CGMA
Executive, VP, NCCPAP

NATIONAL MULTIFAMILY HOUSING COUNCIL (NMHC)
NATIONAL APARTMENT ASSOCIATION (NAA)

The National Multifamily Housing Council (NMHC) and National Apartment Association (NAA) respectfully submit this statement for the record for the Senate Finance Committee's April 26, 2016, business tax reform hearing titled "Navigating Business Tax Reform."

For more than 20 years, NMHC and NAA have partnered in a joint legislative program to provide a single voice for America's apartment industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. NMHC represents the principal officers of the apartment industry's largest and most prominent firms. As a federation of nearly 170 state and local affiliates, NAA encompasses over 69,000 members representing more than 8.1 million apartment homes throughout the United States and Canada.

Background on the Multifamily Housing Sector

Prior to addressing the multifamily housing industry's recommendations for tax reform, it is worthwhile to take a moment and note the fundamental role multifamily housing plays in providing safe and decent shelter to millions of Americans, as well as the sector's considerable impact on our nation's economy.

Today, 110 million Americans, over one-third of all Americans, rent their housing (whether in an apartment home or single-family home).¹ There are 18.3 million renter households, or over 15 percent of all households, who live in apartments (properties with five or more units).² On an aggregate basis, the value of the entire apartment stock is \$3.3 trillion.³ Our industry and its 37.8 million residents contributed \$1.3 trillion to the national economy in 2013 while supporting 12.3 million jobs.⁴

The U.S. is on the cusp of fundamental change in our housing dynamics as shifting demographics and housing preferences drive more people away from the typical suburban house. Rising demand is not just a consequence of the bursting of the housing price bubble. In the 5 years ending in 2015, the number of renters was up by 6.6 million; the number of homeowners was up by less than 400,000. Compared with 10 years ago, there were 10.8 million new renter households and just 605,000 new owner households. In other words, the growth in renter households precedes the 2008 housing crisis.⁵

Changing demographics are driving the demand for apartments. Married couples with children now represent only 21 percent of households. Single-person households (28 percent), single parent households (9 percent) and roommates (6 percent) collectively account for 43 percent of all households, and these households are more likely to rent.⁶ Moreover, the surge toward rental housing cuts across generations. In fact, fully 75 million Baby Boomers (those born between 1946 and 1964), as well as other empty nesters, have the option of downsizing as their children leave the house and many will choose the convenience of renting.⁷ Over half (57.5 percent) of the net increase in renter households from 2005 to 2015 came from householders 45 years or older.⁸

Unfortunately, the supply of new apartments is falling well short of demand. An estimated 300,000 to 400,000 units a year must be built to meet expected demand; yet, on average, just 208,000 apartments were delivered from 2011–2015.⁹ Furthermore, according to Harvard's America's Rental Housing, the number of renter

¹ 2014 American Community Survey, 1-Year Estimates. U.S. Census Bureau, "Total Population in Occupied Housing Units by Tenure."

² 2014 American Community Survey 1-Year Estimates, U.S. Census Bureau, "Tenure by Units in Structure."

³ NMHC estimate based on a report by Rosen Consulting. Updated June 2014.

⁴ National Apartment Association and National Multifamily Housing Council.

⁵ NMHC tabulations of 2015, 2010, and 2005 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau.

⁶ 2015 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau, "America's Families and Living Arrangements: 2015: Households" (H table series), table H3/Family groups (FG series), table FG6.

⁷ Annual Estimates of the Resident Population by Single Year of Age and Sex for the United States: April 1, 2010 to July 1, 2014, U.S. Census Bureau. Baby Boomers are defined as those born 1946 through 1964.

⁸ NMHC tabulations of 2015 Current Population Survey, Annual Social and Economic Supplement, U.S. Census Bureau.

⁹ U.S. Census Bureau, New Residential Construction, updated February 2016.

households could rise by more than 4.4 million in the next decade (depending upon the rate of immigration).¹⁰

Key Priorities for Tax Reform

Owners, operators, and developers of multifamily housing, who favor pro-growth tax reform that does not disadvantage multifamily housing relative to other asset classes, have a considerable stake in the outcome of the debate over how to reform and simplify the nation's tax code. Industry participants pay federal tax at each stage of an apartment's lifecycle. Put another way, federal taxes are paid when properties are built, operated, sold or transferred to heirs.

In providing our recommendations, which we respectfully make below, we are guided by the principle that real estate relies on the free-flow of capital and that investment decisions are driven by after-tax rates of return rather than solely on statutory tax rates. Thus, the number of layers of taxation, the marginal rate of tax imposed on income, cost recovery rules, investment incentives and taxes imposed when properties are sold, exchanged or transferred to heirs are all critical in assessing the viability of an investment. In developing reform proposals, we recommend that Congress certainly consider—but also look well beyond—lowering statutory tax rates and focus on the ability of a reformed system to efficiently allocate capital and drive job-creating business investment. As is outlined in the pages below, NMHC/NAA believe that any tax reform proposal must:

- Protect Pass-Through Entities from Higher Taxes or Compliance Burdens;
- Ensure Depreciation Rules Avoid Harming Multifamily Real Estate;
- Retain the Full Deductibility of Business Interest;
- Preserve the Ability to Conduct Like-Kind Exchanges;
- Maintain the Current Law Tax Treatment of Carried Interest;
- Preserve and Strengthen the Low-Income Housing Tax Credit;
- Maintain the Current Law Estate Tax;
- Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry; and
- Improve Incentives for Energy Efficiency in Commercial Buildings and Multifamily Properties

Priority 1: Tax Reform Must Not Harm Pass-Through Entities

The multifamily industry is dominated by “pass-through” entities (*e.g.*, LLCs, partnerships and S corporations) instead of publicly held corporations (*e.g.*, C corporations). Indeed, over three-quarters of apartment properties are owned by pass-through entities.¹¹ This means that a company's taxable income is passed through to the partners, who pay taxes on their share of the income on their individual tax returns. This treatment contrasts with the taxation of large publicly held corporations that generally face two levels of tax. Those entities remit tax at the corporate level under the corporate tax system. Shareholders are then taxed upon the receipt of dividend income.

The multifamily industry opposes any tax reform effort that would lead to higher taxes or compliance burdens for pass-through entities. For example, given that Congress raised marginal tax rates on ordinary income to as high as 39.6 percent as part of the American Taxpayer Relief Act of 2012 (Pub. L. 112–240), rates should certainly not be increased once again. Additionally, while many are calling for a reduction in the nation's 35 percent corporate tax rate, flow-through entities should not be called upon to make up the lost revenue from this change. Finally, a corporate rate cut should not be financed by denying flow-through taxpayers credits and deductions.

Priority 2: Ensure Depreciation Rules Avoid Harming Multifamily Real Estate

Enabling multifamily developers to recover their investment through depreciation rules that reflect underlying economic realities promotes apartment construction, economic growth and job creation. Tax reform should ensure that depreciation tax rules match the economic life of assets by taking into account natural wear and tear and technological obsolescence.

NMHC/NAA note that while we support depreciation periods that are set prospectively and reflect the economic lives of underlying assets, a retroactive cost-recovery

¹⁰ Harvard Joint Center for Housing Studies, “America's Rental Housing” (2015).

¹¹ U.S. Census Bureau and U.S. Department of Housing and Urban Development, *Rental Housing Finance Survey*, 2012.

proposal made in the 113th Congress by the staff of former Senate Finance Committee Chairman Baucus would have had a devastating effect on the apartment industry's ability to construct new apartment buildings, particularly when, as noted above, supply continues to fall short of demand. Former Chairman Baucus' staff discussion draft proposed to retroactively extend the tax recovery period for multifamily buildings from 27.5 years to 43 years¹² (a period well beyond economic life). The Baucus staff discussion draft also would have increased the 25 percent tax rate on recaptured depreciation to the ordinary income rate.¹³ As with the change to depreciation rules, this proposal would also have been applied retroactively. We are extremely pleased that the cost recovery legislation proposed by current Finance Committee Ranking Member Wyden on April 26, 2016, would leave the depreciation of multifamily property at 27.5 years.¹⁴

Extending the straight-line recovery period for residential rental property from 27.5 years to 43 years would reduce a multifamily operator's annual depreciation deduction by 36 percent. By creating an arbitrary and discriminatory cost recovery system that does not reflect the economic life of actual structures, the proposal would diminish investment and development in multifamily properties, drive down real estate values and stifle the multifamily industry's ability to continue creating new jobs. Put another way, the proposal would significantly impact cash flows and investment returns that are at the heart of a developer's analysis of whether a particular project is economically viable.

Furthermore, it is not just property owners who would suffer the consequences of depreciation periods that do not reflect the economic life of underlying assets. For example, pension plans and life insurance companies, which provide retirement and income security to millions of working Americans and retirees, could be harmed as their real estate investments lose value. Local governments would also see lower revenues as the value of multifamily properties decline, leaving a smaller amount of property taxes to finance core services, including law enforcement and schools. In this regard, the Tax Foundation in 2013 found that at 35 percent of total revenues collected:

Property taxes were the most prominent source of state and local tax revenues in Fiscal Year 2010. This category includes both commercial and residential real estate in addition to personal property tax revenues obtained from taxes on cars, boats, etc. Residential and commercial real estate are often a source of local tax revenue, while personal property taxes are often a source of state tax revenues.¹⁵

As noted above, the apartment industry supports depreciation periods that match the economic life of assets. We believe that Congress must use credible and contemporary research to set depreciation periods and should do so on a prospective basis. NMHC/NAA note that to arrive at a 43-year depreciation schedule for real property, former Chairman Baucus' staff relied on assistance from the Congressional Budget Office that used data that is 40 years to 50 years old.¹⁶ In particular, the estimates for the economic rate of depreciation for structures come from a Treasury study published in 1975 and a study by the National Bureau of Economic Research from 1963. These outdated studies do not reflect current economic realities, the degree of obso-

¹²United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 21, 2013. Section 11, Pooled asset cost recovery system and depreciation of real property.

¹³United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 2013, Section 12, Rules related to treatment of gains from depreciable property.

¹⁴Senator Wyden, *Cost Recovery Reform and Simplification Act of 2016*, Section 2, Pooled Asset Cost Recovery System and Depreciation of Straight Line Property.

¹⁵Liz Malm and Ellen Kant, Tax Foundation, *The Sources of State and Local Tax Revenues*, January 28, 2013.

¹⁶The Congressional Budget Office released a letter in November 2013 that states, "CBO was asked [by Finance Committee staff] to estimate the length of the period under the straight-line approach that would generate the same value of depreciation deductions for real property as would applying the average economic depreciation rate after adjusting for inflation. CBO estimates that period to be 43 years." Letter from CBO Director Douglas W. Elmendorf to Chairman Max Baucus, *Information on the Depreciation of Assets* (November 21, 2013), <http://www.cbo.gov/publication/44911>. A footnote in the CBO letter states: "The U.S. Bureau of Economic Analysis (BEA) computes economic depreciation rates for most asset types, which occasionally vary by industry (see BEA Depreciation Estimates, 2004, www.bea.gov/national/FA2004/Tableandtext.pdf). The data on which BEA relies is from National Bureau of Economic Research and Treasury Department studies conducted in the 1960s and 1970s."

lescence caused by increasingly sophisticated technology now commonly found in buildings or the manner in which contemporary buildings are designed.

NMHC/NAA recommend that the Finance Committee consider a recent study that suggests the depreciation of multifamily buildings should certainly be no longer than the current-law 27.5-year period and perhaps shorter. In particular, David Geitner and Sheharyar Bokhari of the MIT Center for Real Estate in November 2015 published a paper, *Commercial Buildings Capital Consumption in the United States*, which represents the first comprehensive study on this topic in nearly 40 years.¹⁷ By including capital improvement expenditures, the MIT study finds that residential properties net of land depreciate at 7.3 percent per year on average, which is a significantly faster rate than previously understood. Translated into tax policy terms, we believe this data shows that the current-law 27.5-year depreciation period overstates the economic life of an underlying multifamily asset.

Finally, a note is warranted regarding so-called depreciation recapture. Under current law, when a multifamily property is sold, there are two types of taxes that apply. First, gain from the sale of the property is taxed as a capital gain, typically at a rate of 20 percent for a general partner. Second, the portion of the gain attributable to prior depreciation deductions is generally subject to a 25 percent tax. This second tax is referred to as depreciation recapture.

Former Chairman Baucus's staff discussion draft proposed to retroactively repeal the 25 percent depreciation recapture rate and tax all depreciation recapture as ordinary income, potentially at rates of up to 39.6 percent.¹⁸ NMHC/NAA believe that depreciation recapture taxes as they stand today already can have a pernicious effect on property investment and should, at the very least, be left at current law rates.

After decades of operations, many multifamily owners have a very low tax basis in their properties. If they were to sell them, they, even under current law, would have to pay large depreciation recapture taxes. To avoid this huge tax bill, many current owners will not only avoid selling their properties, but they will also be reluctant to make additional capital investments in properties with little value. The result is deteriorating properties that are lost from the stock of safe, affordable housing. The other alternative is for the long-time owners to sell their properties to an entity that is able to pay a large enough sales price to cover the recapture taxes. To make their investment pay off, however, the new owner will likely convert the property to higher, market-rate rents, meaning a loss of our nation's affordable housing stock.

Therefore, either scenario can have the same result: the possible loss of hundreds of thousands of affordable housing units. Increasing depreciation recapture taxes will exacerbate this result and further discourage owners from selling these properties to entities that can retain them as affordable housing.

Priority 3: Retain the Full Deductibility of Business Interest

Under current law, business interest is fully deductible. However, deduction for business interest expenses should be curtailed. Unfortunately, curtailing this deductibility would greatly increase the cost of debt financing necessary for multifamily projects, curbing development activity.

As mentioned above, over three-quarters of multifamily properties are owned by pass-through entities. Although such entities can access equity from investors, they must generally borrow a significant portion of the funds necessary to finance a multifamily development. In fact, a typical multifamily deal might consist of 65 percent debt and 35 percent equity. Because such entities often look to debt markets, which lend money at a rate of interest, to garner capital, the full deductibility of interest expenses is critical to promoting investment. Indeed, according to the Federal Reserve, as of December 31, 2015, total multifamily debt outstanding was \$1,098.8 billion.¹⁹ Reducing the full deductibility of interest would undoubtedly increase investment costs for owners and developers of multifamily housing and negatively impact aggregate construction.

In addition to harming the multifamily industry, it is also instructive to note that modifying the full deductibility of business interest would be precedent setting. In

¹⁷David Geitner and Sheharyar Bokhari, MIT Center for Real Estate, *Commercial Buildings Capital Consumption in the United States*, November 2015.

¹⁸Chairman Baucus's staff discussion draft proposal did not set new and potentially lower rates for ordinary income, but the current-law top rate is 39.6 percent.

¹⁹Board of Governors of the Federal Reserve System, *Mortgage Debt Outstanding*, By type of property, multifamily residences, 2015Q4, March 2015.

fact, Drs. Robert Carroll and Thomas Neubig of Ernst and Young LLP concluded in their analysis, *Business Tax Reform and the Tax Treatment of Debt*:

The current income tax generally applies broad income tax principles to the taxation of interest. Interest expenses paid by borrowers are generally deductible as a business expense, while interest income received by lenders is generally includible in income and subject to tax at applicable recipient tax rates. With this treatment, interest income is generally subject to one level of tax under the graduated individual income tax rates. This is the same manner in which most other business expenses, such as wages payments to employees, are taxed, and also follows the practice in other developed nations.²⁰

Priority 4: Preserve the Ability to Conduct Like-Kind Exchanges

Since 1921, the Internal Revenue Code has codified the principle that the exchange of one property held for business use or investment for a property of a like-kind constitutes no change in the economic position of the taxpayer and, therefore, should not result in the imposition of tax. This concept is codified today in section 1031 of the Internal Revenue Code with respect to the exchange of real and personal property,²¹ and it is one of many non-recognition provisions in the Code that provide for deferral of gains.²² The Obama Administration's Fiscal Year 2017 budget targeted section 1031 by substantially restricting the provision with respect to real property by limiting the amount of gain that may be deferred to \$1 million annually.²³ Former Senate Finance Committee Chairman Baucus' November 2013 staff discussion draft proposal sought to repeal the ability to undertake like-kind exchanges.²⁴ Notably, however, Ranking Member Wyden's cost recovery proposal released on April 26, 2016, would appropriately retain current-law like-kind exchange rules for real property.²⁵

Like-kind exchanges play a significant role and are widely used in the multifamily industry. Current-law like-kind exchange rules enable the smooth functioning of the multifamily industry by allowing capital to flow more freely, which, thereby, supports economic growth and job creation. Multifamily property owners use section 1031 to efficiently allocate capital to optimize portfolios, realign property geographically to improve operating efficiencies and manage risk. By increasing the frequency of property transactions, the like-kind exchange rules facilitate a more dynamic multifamily sector that supports additional reinvestment and construction activity in the apartment industry.

²⁰ Drs. Robert Carroll and Thomas Neubig, *Business Tax Reform and the Tax Treatment of Debt: Revenue neutral rate reduction financed by an across-the-board interest deduction limit would deter investment*, Ernst and Young LLP, May 2012, p. 3.

²¹ Section 1031 permits taxpayers to exchange assets used for investment or business purposes, including multifamily properties, for other like-kind assets without the recognition of gain. The tax on such gain is deferred, and, in return the taxpayer carries over the basis of the original property to the new property, losing the ability to take depreciation at the higher exchange value. Gain is immediately recognized to the extent cash is received as part of the like-kind exchange, and the taxes paid on such gain serve to increase the newly acquired property's basis. Congress has largely left the like-kind rule unchanged since 1928, though it has narrowed its scope.

The like-kind exchange rules are based on the concept that when one property is exchanged for another property, there is no receipt of cash that gives the owner the ability to pay taxes on any unrealized gain. The deferral is limited to illiquid assets, such as real estate, and does not extend to investments that are liquid and readily convertible to cash, such as securities. Furthermore, the person who exchanges one property for another property of like-kind has not really changed his economic position; the taxpayer, having exchanged one property for another property of like-kind is in a nearly identical position to the holder of an asset that has appreciated or depreciated in value, but who has not yet exited the investment.

²² Under the tax code, the mere change in value of an asset, without realization of the gain or loss does not generally trigger a taxable event. In such situations, the proper tax treatment is to defer recognition of any gain and maintain in the new property the same basis as existed in the exchanged property. This is similar in concept to other non-recognition tax deferral provisions in the tax code, including property exchanges for stock under Section 351, property exchanges for an interest in a partnership under section 721, and stock exchanges for stock or property under section 361 pursuant to a corporate reorganization.

²³ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, Modify Like-Kind Exchange Rules, p. 107.

²⁴ United States Senate Committee on Finance, *Cost Recovery and Accounting Staff Discussion Legislative Language*, November 2013, Section 15, Repeal of like-kind exchanges.

²⁵ Senator Wyden, *Cost Recovery Reform and Simplification Act of 2016*, Section 2, Pooled Asset Cost Recovery System and Depreciation of Straight-Line Property.

According to recent research by Drs. David C. Ling and Milena Petrova regarding the economic impact of repealing like-kind exchanges for real estate and the multifamily industry in particular:²⁶

- Assuming a typical 9-year holding period, apartment rents would have to increase by 11.8 percent to offset the taxation of capital gains and depreciation recapture income at rates of 23.8 percent and 25 percent, respectively.
- Whether based on the number of transactions or dollar volume, multifamily properties, both large and small, are the property type most frequently acquired or disposed of with an exchange.
- Governments collect 19 percent more taxes on commercial properties sold following a like-kind exchange than by an ordinary sale.
- Nearly 9 in 10 (88 percent) of commercial properties acquired by a like-kind exchange result in a taxable sale in the very next transaction. Thus, like-kind exchange rules are not used to indefinitely defer taxes.

Additional recent research suggests that like-kind exchanges play such a critical role in driving investment that repealing the ability to conduct them would harm the economy even if the resulting revenue were used to reduce tax rates. Indeed, Ernst and Young LLP, in a March 2015 analysis, estimates that repealing like-kind exchange rules and using the resulting revenue to enact a revenue-neutral corporate income tax rate reduction or a revenue-neutral business sector income tax reduction (*i.e.*, encompassing both C corporations and flow-through entities) would reduce Gross Domestic Product (GDP) by \$8.1 billion each year and \$6.1 billion each year, respectively.²⁷ Put another way, a tax rate reduction financed by repealing like-kind exchange rules would, on a net basis, harm the economy.

One of the main reasons that GDP would decrease if the like-kind exchange rules were repealed is that such a policy would increase the cost of capital and, therefore, negatively impact investment, a key ingredient of economic growth. Indeed, Ernst and Young LLP data shows a repeal of like-kind exchange rules would cause overall investment in the economy to decline by \$7.0 billion per year if revenue from repeal were used to reduce corporate tax rates and by \$4.8 billion per year if revenue from repeal were used to reduce business sector income tax rates.²⁸

Ernst and Young LLP summed up its analysis of how repealing like-kind exchanges would impair investment by concluding:

While repealing like-kind exchange rules could help fund a reduced corporate income tax rate, its repeal increases the tax cost of investing by more than a corresponding revenue neutral reduction in the corporate tax rate. That is, rather than making the United States a more attractive place to invest, these results suggest this policy shift would leave the United States a less attractive place to invest.²⁹

This result, of course, moves in the opposite direction of one of the stated goals for tax reform put forward by many of its proponents.

Priority 5: Maintain the Current Law Tax Treatment of Carried Interest

NMHC/NAA would also like to use this opportunity to underscore our strong opposition to proposals to change the current law governing the tax treatment of carried interest. If enacted, this proposal would significantly reduce the ability to develop or rehab apartments across the nation.

A carried interest, also called a “promote,” has been a fundamental part of real estate partnerships for decades. Investing partners grant this interest to the general partners to recognize the value they bring to the venture as well as the risks they take. Such risks include responsibility for recourse debt, litigation risks and cost overruns, to name a few.

Current tax law, which treats carried interest as a capital gain, is the proper treatment of this income because carried interest represents a return on an underlying long-term capital asset, as well as risk and entrepreneurial activity. Extending ordinary income treatment to this revenue would be inappropriate and result in skewed and inconsistent tax treatment vis-à-vis other investments. Notably, any fees that

²⁶ David C. Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*, June 2015.

²⁷ Ernst and Young LLP, *Economic impact of repealing like-kind exchange rules*, March 2015.

²⁸ *Ibid.*

²⁹ *Ibid.*

a general partner receives that represent payment for operations and management activities are today properly taxed as ordinary income.

Taxing carried interest at ordinary income rates would adversely affect real estate partnerships. At a time when the nation already faces a 5.3 million unit shortage of affordable rental housing, increasing the tax rate on long-term capital gains would discourage real estate partnerships from investing in new construction. Furthermore, such a reduction would translate into fewer construction, maintenance, on-site employee and service provider jobs during a period in which the unemployment rate remains abnormally high.

Notably, former House Ways and Means Committee Chairman Camp recognized the devastating impact that a change in the manner in which carried interest is taxed would have on commercial real estate when he specifically exempted real estate from a change he sought to the taxation of carried interest in his Tax Reform Act of 2014.³⁰ Moreover, in 2010, both the U.S. Conference of Mayors and the National Association of Counties passed resolutions opposing the carried interest proposal as it relates to real estate partnerships and urged Congress to maintain the current law capital gains treatment of carried interest, noting that any change would bring extremely negative consequences to communities throughout the country.³¹

Finally, some in Congress see the tax revenue generated by the carried interest proposal as a way to offset the cost of other tax changes. Enacting a bad tax law, such as changing the taxation of carried interest, merely to gain revenue to make other tax changes, is a distorted view of good tax policy, which demands that each tax proposal be judged on its individual merits.

Priority 6: Preserve and Strengthen the Low-Income Housing Tax Credit

The Low-Income Housing Tax Credit (LIHTC) has a long history of successfully generating the capital needed to produce low-income housing while also enjoying broad bipartisan support in Congress. This public/private partnership program has led to the construction of nearly 2.8 million units since its inception in 1986.³² The LIHTC program also allocates units to low-income residents while helping to boost the economy. In fact, according to a December 2014 Department of Housing and Urban Development study, *Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012*, the median income of a household residing in a LIHTC unit was \$17,066³³ with just under two-thirds of residents earning 40 percent or less of area median income.³⁴ Finally, the National Association of Home Builders reports that, in a typical year, LIHTC development supports approximately: 95,700 jobs; \$3.5 billion in federal, state and local taxes; and \$9.1 billion in wages and business income.³⁵

Maintaining and bolstering the LIHTC's ability to both construct and rehab affordable housing is critical given acute supply shortages. Indeed, the Harvard Joint Center for Housing Studies estimated that there were only 58 affordable units for every 100 very low-income households (those earning up to 50 percent of area median income) in the United States in 2013.³⁶

The LIHTC has two components that enable the construction and redevelopment of affordable rental units. The so-called 9 percent tax credit supports new construction by subsidizing 70 percent of the costs. In contrast, the 4 percent tax credit can be used to subsidize 30 percent of the unit costs in an acquisition of a project or new

³⁰ H.R. 1, *Tax Reform Act of 2014*, Section 3621, Ordinary income treatment in the case of partnership interest held in connection with performance of services.

³¹ Resolutions Adopted by the Members of the U.S. Conference of Mayors, Carried Interest, 78th Winter Meeting, Washington, DC, 2010, http://www.usmayors.org/resolutions/78th_Winter_Conference/res_Carriedinterest.pdf.

³² National Association of Counties, *Resolution Urging Congress to Maintain the Current Capital Gains Tax Treatment of "Carried Interest" Used by Real Estate Partnerships*, Adopted March 8, 2010. https://www.novoco.com/hottopics/resource_files/naco_carried-interest_030910.pdf

³³ National Council of State Housing Agencies, *2015 Housing Credit Q&A*, February 25, 2015, <https://www.ncsha.org/resource/2015-housing-credit-qa>.

³⁴ Department of Housing and Urban Development, *Understanding Whom the LIHTC Program Serves: Tenants in LIHTC Units as of December 31, 2012*, December 2014, p. 23.

³⁵ *Ibid.*, p. 24.

³⁶ Robert Dietz, *The Economic Impact of the Affordable Housing Credit*, National Association of Home Builders, Eye on Housing, July 15, 2014, <http://eyeonhousing.org/2014/07/the-economic-impact-of-the-affordable-housing-credit/>.

³⁷ Harvard Joint Center for Housing Studies, "The State of the Nation's Housing 2015: Housing Challenges" (2015), available at <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/jchs-sonhr-2015-ch6.pdf>.

construction of a federally subsidized project and can be paired with additional federal subsidies.

Developers receive an allocation of LIHTCs from state agencies through a competitive application process. They generally sell these credits to investors, who receive a dollar-for-dollar reduction in their federal tax liability paid in annual allotments, generally over 10 years. The equity raised by selling the credits reduces the cost of apartment construction, which allows the property to operate at below-market rents for qualifying families; LIHTC-financed properties must be kept affordable for at least 15 years, but, in practice, a development receiving an allocation must commit to 30 years. Property compliance is monitored by state allocating agencies, the Internal Revenue Service, investors, equity syndicators and the developers.

First and foremost, Congress should retain the LIHTC as part of any effort to overhaul the nation's tax code. NMHC/NAA reminds Congress that tax-exempt private activity multifamily housing bonds are often paired with 4 percent tax credits to finance multifamily development, and that such tax-exempt bonds should be retained in any tax reform legislation as they play a critical role in making deals viable to investors.

Second, Congress should also look to strengthen the credit by both increasing program resources so that additional units can be developed or redeveloped and making targeted improvements to the program to improve its efficiency.

Congress could increase program authority by allocating additional tax credits or enabling states to exchange private activity bond volume cap into housing tax credits. A part of the LIHTC that could benefit from a targeted adjustment involves program rules that require owners to either rent 40 percent of their units to households earning no more than 60 percent of area median income (AMI) or 20 percent to those earning no more than 50 percent of AMI. If program rules were revised to allow owners to reserve 40 percent of the units for people whose *average* income is below 60 percent of AMI, it could serve a wider array of households. Notably, President Obama included a version of this proposal in his Fiscal Year 2017 Budget.³⁷

Priority 7: Preserve the Current Law Estate Tax

As part of the American Taxpayer Relief Act of 2012 (Pub. L. 112–240), Congress in January 2013 enacted permanent estate tax legislation. The Act sensibly made permanent the \$5 million exemption level (indexed for inflation) enacted as part of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 (Pub. L. 111–312) and set a top tax rate of 40 percent. Crucially, it also retained the stepped-up basis rules applicable to inherited assets. As many apartment executives prepare to leave a legacy to their heirs, it is vital to have clarity and consistency in the tax code with regard to estate tax rules. For this reason, the apartment industry remains supportive of the permanent estate tax legislation passed in early 2013.

There are three key elements to the estate tax: (1) the exemption level; (2) the estate tax rate; and (3) the basis rules. While all three elements can be important for all types of estates, estates with significant amounts of depreciable real property are especially concerned with how various types of basis rules may affect them.

- **Exemption Levels:** The estate tax exemption level is, in simplified terms, the amount that a donor may leave to an heir without incurring any federal estate tax liability. In 2016, there is a \$5–45 million exemption.
- **Tax Rates:** The estate tax rate applies to the value of an estate that exceeds the exemption level. The maximum rate is 40 percent.
- **Basis Rules:** The basis rules determine the tax basis to the recipient of inherited property. There are generally two different ways that basis is determined—stepped-up basis and carryover basis. The estate tax today features stepped-up basis rules, and under this regime, the tax basis of inherited property is generally reset to reflect the fair market value of the property at the date of the decedent's death. By contrast, under carryover basis, the tax basis of the inherited properties is the same for heirs as it was for the donor. This includes any decreases in tax basis to reflect depreciation allowances claimed by the donor in prior years. Retaining a stepped-up basis rule is critical for estates that con-

³⁷ Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, Reform and Expand the Low-Income Housing Tax Credit. Encourage mixed income occupancy by allowing LIHTC-supported projects to elect a criterion employing a restriction on average income, p. 67.

tain significant amounts of depreciated real property as it helps heirs reduce capital gains taxes and maximize depreciation deductions.

Priority 8: Reform the Foreign Investment in Real Property Tax Act to Promote Investment in the Domestic Apartment Industry

Enacted in 1980 to prevent foreign investors from harming family farmers by putting upward pressure on the price of U.S. farmland, the Foreign Investment in Real Property Tax Act (FIRPTA) (Pub. L. 96-499) serves as an impediment to investment in U.S. commercial real estate, including multifamily housing. The FIRPTA regime is particularly pernicious because it treats foreign investment in real estate differently than investment in other economic sectors and, thereby, prevents commercial real estate from securing a key source of private-sector capital that could be used to develop, upgrade, and refinance properties. Congress should enact tax reform that either repeals FIRPTA or, at the very least, further mitigates its corrosive effect on foreign investment in U.S. real estate.

Under current law, the U.S. does not generally impose capital gains taxes on foreign investors who sell interests in assets sourced to the U.S. unless those gains are effectively connected with a U.S. trade or business. This means that a foreign investor generally incurs no U.S. tax liability on capital gains attributable to the sale of stocks and bonds in non real estate U.S. companies.

FIRPTA, however, serves as an exception to the general tax rules and imposes a punitive barrier on foreign investment in U.S. real estate. Under FIRPTA, when a foreign person disposes of an interest in U.S. real property, the resulting capital gain is automatically treated as income effectively connected to a U.S. trade or business. Thus, the foreign investor is required to suffer a withholding tax on the proceeds of the sale only because it is associated with an investment in U.S. real estate.

In addition to levying tax, FIRPTA also mandates onerous administrative obligations that further deters foreign investment in U.S. real estate. First, the buyer of a property must withhold 15 percent of the sales price of a property sold by a foreign investor so as to ensure taxes are collected. Second, if they overpay tax through the withholding, foreigners investing in U.S. real estate must file tax returns with the IRS to receive a refund of the overpayment.

The taxes and administrative burdens FIRPTA imposes have negative consequences for U.S. commercial real estate and the multifamily industry. Because foreign investors can avoid U.S. tax and reduce their worldwide tax burden tax by investing in U.S. securities or in real estate outside of the U.S., they may simply choose not to invest in U.S. real estate. This is particularly harmful to an apartment industry that relies on capital to finance and refinance properties. Furthermore, because it is the sale of a U.S. property interest that triggers FIRPTA, foreign investors may hold on to U.S. real estate due solely to tax considerations.

Repealing FIRPTA would ensure that tax considerations will not prevent capital from flowing to the most productive investments. Such reform could unlock billions in foreign capital that could help to both drive new investment and refinance real estate loans. If outright repeal proves impossible, Congress should consider additional targeted reforms to the FIRPTA regime. NMHC/NAA were particularly pleased that Congress in late 2015 enacted legislation to both provide a partial exemption from FIRPTA for certain stock of real estate investment trusts and exempt from the application of FIRPTA gains of foreign pension funds from the disposition of U.S. real property interests.³⁸

Priority 9: Improve Incentives for Energy Efficiency in Commercial Buildings and Multifamily Properties

As the Finance Committee considers how the tax code could be used to facilitate national priorities in the energy sector, we wish to call your attention to the Energy Efficient Commercial Buildings Tax Deduction (Sec. 179D of the Internal Revenue Code of 1986) and the New Energy Efficient Home Credit (Section 45L of the Internal Revenue Code). The Energy Efficient Commercial Buildings Deduction lets owners of buildings with four or more stories deduct between \$0.60 and \$1.80 per square foot when they install certain energy efficient systems, including HVAC, lighting, and, or building envelope. The New Energy Efficient Home Credit enables developers of new low-rise multifamily properties (three stories or less) to claim a \$2,000 per-unit tax credit if those residences achieve a 50 percent energy savings

³⁸ Public Law 114-113, *Consolidated Appropriations Act, 2016, Division Q, Protecting Americans from Tax Hikes Act of 2015*.

for heating and cooling over the 2006 International Energy Conservation Code (IECC).

These incentives help to achieve improved environmental quality, reinforce our national security, create jobs in the construction and manufacturing sector and increase housing affordability by decreasing utility expenses for millions of Americans who live in apartment homes. We ask that both of these provisions be made permanent and not allowed to lapse at the end of 2016 as is scheduled under current law.

Additionally, we believe that Title I of the Energy Efficiency Tax Incentives Act (S. 2189), which was introduced in the 113th Congress by Finance Committee Senator Cardin, provides a responsible plan for enhancing the current Sec. 179D to assist property owners to make meaningful improvements in the energy performance of their properties.³⁹ Many older properties have been unable to fully utilize 179D because they have had difficulty in achieving the requisite 50 percent improvement in building energy performance over the level specified in the 2007 version of the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE) 90.1 code. While S. 2189 includes updated energy code references against which whole building performance will be measured for many properties, it also includes a pathway for older properties to qualify for incentives that will assist property owners in making building system upgrades that will yield significant energy savings.

Older building structures face technical limitations in achieving the energy performance metrics specified by the current code, let alone reaching the incremental “above-code” performance characteristics required to claim the 179D deduction. S. 2189 establishes a sliding scale of energy improvements, using the property’s current energy performance as the baseline. This pathway of significant improvement in energy performance relative to the property’s own baseline performance will provide a much-needed financial tool for property owners who want to make these types of investments but have not been able to do so.

Advances in residential construction methods have improved the energy use profile of new buildings; however, the majority of the nation’s building stock predates the use of highly energy efficient products and techniques. The U.S. Department of Energy (DOE) reports that housing built after 2000 used 14 percent less energy per square foot than housing built in the 1980s and 40 percent less than housing built before 1950.⁴⁰ As such, there is considerable room for improvement in energy performance even among well designed, constructed and maintained properties. A recent study conducted by CNT Energy and the American Council for an Energy-Efficient Economy finds that “[b]uilding owners often need financial incentives to adopt new technologies or equipment with higher upfront costs. Despite this, studies have documented that affordable housing, often multifamily, receives a disproportionately small share of available energy efficiency funding.”⁴¹

According to the American Housing Survey (2009), almost 81 percent of the nation’s stock of apartment properties (with 5 or more units) was constructed prior to 1990, which marks the decade in which the first building energy codes were implemented. This older stock of housing, which is an important source of affordable housing, represents a significant opportunity for achieving energy savings while at the same time adding to the available spending capacity of individuals who live in these apartment homes. This is a significant consideration given that in 2010 approximately 70 percent of renter households had incomes below the national median and more than 40 percent had incomes in the bottom quartile.⁴² Furthermore, “energy costs as a share of gross rents rose from 10.8 percent to 15.0 percent between 2001 and 2009. Lowest income renters saw the largest increase in their utility share, a jump from 12.7 percent to 17.4 percent.”⁴³

³⁹ S. 2189, *Energy Efficiency Tax Incentives Act*, Title I—Commercial Building Modernization

⁴⁰ U.S. Department of Energy, 2011 Buildings Energy Data Book, March 2012, Chapter 2.

⁴¹ CNT Energy and American Council for an Energy-Efficient Economy, *Engaging as Partners in Energy Efficiency: Multifamily Housing and Utilities*, January 2012, <http://www.cntenergy.org/media/Engaging-as-Partners-in-Energy-Efficiency-MF-Housing-and-Utilities-Final-012512.pdf>, p. 4.

⁴² Joint Center for Housing Studies of Harvard University, *America’s Rental Housing—Meeting Challenges, Building on Opportunities*, 2011, p. 17, <http://www.jchs.harvard.edu/sites/jchs.harvard.edu/files/americasrentalhousing-2011.pdf>; U.S. median household income fell from \$51,144 in 2010 to \$50,502 in 2011 according to the *United States Census, American Community Survey Briefs*, September 2012, Appendix Table 1, p. 5.

⁴³ *Ibid.*

There is often a relationship between the age of a residential building and energy expenditures. The per-square-foot energy costs of housing constructed from 1980 to 1989 is 16 percent higher than that of a building constructed after 2000. Those expenditures soar to a 28 percent increase in residential buildings built between 1970 and 1979 over post-2000 properties.⁴⁴ Energy efficiency in multifamily properties could be economically improved by 30 percent with a savings of \$9 billion in averted energy costs not to mention the substantial savings in greenhouse gas emissions.⁴⁵

NMHC/NAA believe that a sound national tax policy can be used to catalyze a market transformation marked by significant improvements in building energy performance. A meaningful and predictable tax incentive would leverage private investment in qualified building retrofits and would have a positive effect on the economy as it would result in increased demand for construction services, materials and equipment.

Conclusion

In closing, NMHC/NAA look forward to working with the Senate Finance Committee, as well as the entire Congress, to craft tax reform legislation that would promote economic growth and the nation's multifamily housing needs. In communities across the country, apartments enable people to live in a home that is right for them. Whether it is young professionals starting out, empty nesters looking to downsize and simplify, workers wanting to live near their jobs, married couples without children or families building a better life, apartment homes provide a sensible choice. We stand ready to work with Congress to ensure that the nation's tax code helps bring apartments, and the jobs and dollars they generate, to communities nationwide.

NRS INC.

2009 South Main Street
Moscow, Idaho 83843

Written Testimony Before the Committee on Finance, United States Senate
“Navigating Business Tax Reform”

April 26, 2016

Submitted by Bill Parks, President, NRS Inc.

Chairman Hatch, Ranking Member Wyden, and members of the committee: I am a retired professor of finance and the founding President of NRS, a 100% employee-owned company, which is the largest supplier of paddle sports accessories in the world. I have also published numerous articles in respected journals, including *Tax Notes*.

I would like to address a critical part of our current corporate tax system that is failing because it discourages small business capital formation. The code, perhaps inadvertently, dissuades small companies from being taxed as corporations. Speaker Ryan has pointed out the corporate rate for small business is 44.6% in the U.S. versus 15% in Canada.¹

An unintended consequence of our corporate tax system is that it discourages small businesses from growing. This happens because small businesses can easily avoid double taxation and paying any corporate income tax by simply organizing as “pass-through” entities like S corporations or limited liability companies. Only the C corporation can easily provide an incentive to reinvest in the business in the form of retained earnings. Therefore, while being a “pass-through” entity provides obvious tax advantages to small business owners, it discourages capital formation and growth. A small business organized as a C corporation, however, has an incentive to retain earnings not only directly for growth, but also because they are critical to obtaining loans to further finance growth. Those retained earnings will provide the safest, most accessible source of funds to grow the business. It is much more difficult for an S corporation or an LLC to reinvest its earnings because multiple owners will have disparate investment objectives and needs. Also, there is a psychological barrier to returning earnings to the company after they have been taxed.

⁴⁴ U.S. Department of Energy, *supra* note 1, at pp. 2–20 derived from Table 2.3.12.

⁴⁵ Joint Center for Housing Studies of Harvard University, *supra* note 2, at p. 33.

¹ Ryan, Paul, Interview by Greta Van Susteren, *On the Record*, Fox News Television Network, New York, November 4, 2015.

Pass-through entities are clearly the right vehicle for most situations; I am not advocating their demise. However, I am urging you to modify the corporate tax rate structure to make the C corporation a more attractive option to small businesses. Here are two ways to accomplish this:

1. Eliminate the “nasty notch”

The Tax Reform Act of 1986 made the C corporation even less attractive to small business by adding a surtax that brought the total federal marginal tax rate to 39% for income between \$100,000 and \$335,000. This nasty notch had the unintended consequences of not only discouraging C corporation formation, but also causing existing small C corporations to switch to S corporation or LLC status at the first opportunity.² In doing so, small businesses have avoided the corporate tax, but at the same time, they have less incentive to retain the earnings that are critical to growing a successful business.^{3, 4} The 39% marginal rate keeps all but the most stubborn entrepreneurs from electing C corporation status.⁵ The first step toward making C corporations more attractive to small business is to repeal the “nasty notch.”

2. Introduce a preferential corporate rate for small business

Over the last 30 years, the number of C corporations has plummeted. In 1980, the White House Conference on Small Business proposed that the number one need for small business was more graduation in corporate taxes. However, this has not happened. One reason is that many experts have seen corporate tax graduation as a give away to “high net worth individuals” that own most small businesses.⁶ But even if it were true, it is of little importance compared to the need to help small business grow. Many small businesses, induced into becoming LLCs or S corporations, may not be aware of how tilted the playing field is against them. They lack the retained earnings that make them good candidates for loans needed to fuel their growth.

With only 2% of business income tax coming from C corporations with less than \$50 million in sales,⁷ giving small business an incentive to be taxed as corporations by lowering their rate could provide great help to small and medium-sized businesses without seriously affecting revenue.

Therefore, I suggest that the corporate tax rate for the first \$2 million in income be 15% and that further graduation be considered, perhaps up to income of \$50 million.

Conclusion

Professors of tax accounting say, only partly in jest, that an accountant should lose his or her license for helping create a small business as a C corporation. Professors in law school state that an attorney should be disbarred for creating a small C corporation. And of course, many new businesses should start as S corporations or LLCs in order to flow through initial losses to offset other income. But after attaining profitability, the code should encourage growing companies to be taxed as corporations in order to encourage growth via retained earnings.

Eliminating the “nasty notch” and introducing preferential graduation for small business will stimulate growth and employment. Graduating corporate taxes to be far below the individual rates up to \$2 million or more would provide a powerful incentive for small businesses to be taxed as C corporations.

² Since 1986, while S corporations have grown at approximately 7% per year and LLCs multiplied many fold, C corporations have declined by approximately 1.5% per year.

³ Bill Parks, Can Corporate Tax Reform Build on Apple’s Proposal?, *Tax Notes*, April 4, 2016, p. 93.

⁴ Edward D. Kleinbard, Why Corporate Tax Reform Can Happen, *Tax Notes*, April 6, 2015, p. 94.

⁵ My personal stubbornness enabled NRS to grow over 40 years from an initial \$2,000 investment to almost \$40 million in sales as a C Corporation before recently becoming 100% employee owned.

⁶ This is ironic because The Tax Reform Act of 1986 prevented high income tax payers from turning themselves into corporations because it repealed the General Utilities Doctrine, “that permitted a firm to liquidate its assets at more than book value and to pass the proceeds of the liquidation through to stockholders without making the firm pay income taxes on the gains. As a result of the repeal, any gain from liquidation is taxed twice: once to the liquidating firm (C corporation) and again to the stockholders.”

⁷ Testimony of the staff of the Joint Committee on Taxation before the Senate Committee on Finance hearing on “Navigating Business Tax Reform,” April 26, 2016 by Thomas Barthold, p. 5.

Chairman Hatch, Ranking Member Wyden, and members of the committee: I am a retired professor of finance and the founding President of NRS, a 100% employee-owned company, which is the largest supplier of paddle sports accessories in the world. I have also published numerous articles in respected journals including *Tax Notes*.

Introduction

I want to address the problem of base erosion raised by the Finance Committee's Bipartisan Framework for International Tax Reform, released in July of 2015. The framework favors a dividend exemption, or hybrid territorial-type system, paired with base erosion measures.

The best way to limit base erosion under a territorial system would be for the U.S. to use Sales Factor Apportionment (SFA) to value a company's taxable profit. It is the only system that places all companies—U.S. domestics and U.S. and foreign multinational enterprises—on a level playing field.

Under SFA, a company's taxable profits would be allocated in the same proportion as its sales. If 40 percent of a company's sales were in the U.S., then the U.S. could tax 40 percent of its profit. Within a territorial system, SFA can reduce the offshoring of U.S. jobs and the incidence of corporate inversions. SFA will also encourage exports and raise revenue without raising tax rates.

Let me explain.

Present Corporate Tax Environment

Income shifting is a common multinational tax-avoidance strategy. Reducing accounting income correspondingly reduces the income tax obligation. If a U.S. multinational enterprise (MNE) with an effective tax rate of 30% shifts a million dollars of U.S. earnings to a subsidiary in Cayman Islands, which has no corporate income tax,¹ then it has reduced its U.S. tax obligation by \$300,000.

There are three common strategies for income shifting: (1) Transferring intellectual property such as a patent or copyright to a tax haven subsidiary, which then charges the U.S. parent high rates for its use. (2) Using internal "transfer prices" to reduce the parent company's profit, when the tax haven subsidiary is part of the firm's supply chain. (3) Having the tax-haven subsidiary issue loans to the U.S. parent because interest payments on those loans are tax-deductible for the parent. In addition to reducing taxable income, these strategies also give the parent access to overseas profits without the repatriation tax.²

These are just the simplest and most common methods. Today there is a proliferation of extremely complex methods that help MNEs lower their effective tax rates. In addition to the tax revenue lost, these practices undermine the competitiveness of U.S. domestic businesses, which can pay 40 percent or more in federal and state taxes when competing with MNEs that pay little or no U.S. taxes.

So what can be done to fix the problem?

Most people agree that it's wrong for large MNEs to pay far less tax than a domestic company. Still, there is broad disagreement between those who want to end deferral and tax foreign income on a worldwide basis, and those who argue that U.S. MNEs cannot compete due to our current worldwide tax system. Setting aside those who want to end corporate taxes altogether, what should tax reform look like? One of the most important criterion for a more equitable tax system must be that a MNE, whether U.S. or foreign, pays the same tax as a domestic company in the same situation.

So what should be done?

Permanent Establishment Rules

The permanent establishment rules may have been appropriate in the age of sailing ships, but they are wildly inappropriate in today's digital economy. Today a foreign MNE can establish a sales office in Ontario, drive across the bridge to Detroit, and sell \$1 billion in goods without ever creating a permanent establishment. With the use of Skype, the company could avoid a physical presence altogether. To correct this problem, New York State changed its rules so that every company that sells more than \$1 million in the state is deemed to have permanent establishment. This

¹Pomerleau, "Corporate Income Tax Rates Around the World, 2014" *Tax Foundation Fiscal Fact No. 436*, August 20, 2014.

²Udell and Vashist, "Sales-Factor Apportionment of Profits to Broaden the Tax Base," *Tax Notes*, July 15, 2014.

should be done nationwide with \$5 million in sales being sufficient to deem permanent establishment.

More Competitive Rates

The need for more competitive tax rates is real. If U.S. MNEs were to pay statutory rates on their foreign income they would be at a competitive disadvantage to foreign MNEs. Ending deferral will not fix the problem. While it would put domestic companies and U.S. MNEs on a more equal footing, it would do nothing to correct foreign MNEs' competitive advantage.

The Problem of Transfer Pricing

In this global economy, it's a fantasy that one can use a transfer price based on the Arms Length Price or Principle, ALP. While commodities can be priced this way (given the transaction between one buyer and one seller acting in their own self interest) that's not how most of today's business is done. Most products are not commodities and most transactions happen between related parties. Furthermore, companies build their transfer prices based on cost accounting. It is a mantra of cost accounting that there are different costs for different purposes. Given this, there will always be a range of acceptable prices, and a company will invariably choose the one that minimizes its total tax bill. Because of transfer pricing's inherent defect, no system that includes it can treat domestic companies fairly.

So what's the answer to these and other problems? I say it is Sales Factor Apportionment.

Sales Factor Apportionment

With SFA, a company's profits are allocated in the same proportion as its sales. As mentioned in the earlier example, if 40% of its sales were in the U.S., then the U.S. would consider 40% of its profits taxable. However, that would open up the system to various tax avoiding strategies. Therefore, to prevent abuse, all profits would be assumed taxable, and the company would have the responsibility to document that its sales remained outside the U.S. With this approach—subtraction method SFA—every company, including ones that have inverted, would pay the same taxes on its profit from sales (whether the company is domestic, a U.S. MNE, or a foreign MNE). The same would apply to firms that had inverted. And as an added bonus, states would be able to increase their tax revenue because MNEs would, for the first time, show their true domestic profits. This would end the so-called lockout effect.

SFA would make tax rates irrelevant to the worldwide competitiveness of U.S. firms. Though it's always desirable to lower rates, the main objective must be that all MNEs, foreign and domestic, pay equal taxes on their U.S. sales. Only SFA can accomplish that.

SFA has been calculated to raise \$46 billion annually (based on 2010 corporate earnings). Using 2014 earnings, that comes to roughly \$77 billion in additional revenue.³ In my other related submission, I suggest using some of that revenue to support small business.

Conclusion

Subtraction method SFA has real economic benefits and is virtually foolproof. U.S. and foreign MNEs would face an appropriate corporate tax, which would bring billions in locked-out funds back to the U.S. That would raise more tax revenue even at the current tax rates.

Domestic firms that export would also see their taxes reduced, because profits from their exports would not be taxed. Distortions would be minimized because sales are the last thing a company will give up. And finally, because SFA taxes all companies the same, the U.S. will no longer be at a competitive disadvantage in world markets.

Adopting SFA would make MNE avoidance of U.S. taxes essentially impossible.



³Udell and Vashist, *supra*.